

VONAGE HOLDINGS CORP
Form 10-Q
August 03, 2017

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 June 30, 2017

or

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 001-32887

VONAGE HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

Delaware 11-3547680
(State or other jurisdiction of (IRS Employer
incorporation or organization) Identification No.)

23 Main Street, 07733
Holmdel, NJ
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (732) 528-2600

(Former name, former address and former fiscal year, if changed since last report): Not Applicable

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a nonaccelerated filer, smaller reporting company, or an emerging growth company. See the definitions 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 (Do not check if a smaller reporting company)

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.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at	July 31, 2017
Common Stock, par value \$0.001		227,345,315 shares

VONAGE HOLDINGS CORP.
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Financial Information Presentation

For the financial information discussed in this Quarterly Report on Form 10-Q, other than per share and per line amounts, dollar amounts are presented in thousands, except where noted.

PART 1 - FINANCIAL INFORMATION

ITEM 1 - CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND NOTES

VONAGE HOLDINGS CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

	June 30, 2017 (unaudited)	December 31, 2016 (revised) ⁽¹⁾
Assets		
Current assets:		
Cash and cash equivalents	\$ 26,825	\$ 29,078
Marketable securities	—	601
Accounts receivable, net of allowance of \$3,112 and \$2,093, respectively	36,185	36,688
Inventory, net of allowance of \$137 and \$117, respectively	3,503	4,116
Deferred customer acquisition costs, current	1,486	2,610
Prepaid expenses	25,833	26,041
Other current assets	2,278	3,147
Total current assets	96,110	102,281
Property and equipment, net of accumulated depreciation of \$138,644 and \$129,166, respectively	44,688	48,415
Goodwill	366,806	360,363
Software, net of accumulated amortization of \$92,361 and \$87,626, respectively	23,867	21,971
Restricted cash	1,802	1,851
Intangible assets, net of accumulated amortization of \$107,914 and \$88,419, respectively	188,076	199,256
Deferred tax assets	204,286	184,210
Other assets	15,761	17,319
Total assets	\$ 941,396	\$ 935,666
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 23,045	\$ 30,751
Accrued expenses	84,170	109,195
Deferred revenue, current portion	31,157	32,442
Current maturities of capital lease obligations	1,021	3,288
Current portion of notes payable	18,750	18,750
Total current liabilities	158,143	194,426
Indebtedness under revolving credit facility	214,000	209,000
Notes payable, net of debt related costs and current portion	81,953	91,124
Capital lease obligations, net of current maturities	46	140
Other liabilities	5,084	4,435
Total liabilities	459,226	499,125
Commitments and Contingencies (Note 7)		
Stockholders' Equity		
Common stock, par value \$0.001 per share; 596,950 shares authorized at June 30, 2017 and December 31, 2016; 294,386 and 282,319 shares issued at June 30, 2017 and December 31, 2016, respectively; 227,287 and 219,001 shares outstanding at June 30, 2017 and December 31, 2016, respectively	294	282
Additional paid-in capital	1,349,356	1,310,847

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Accumulated deficit	(627,890)	(641,869)
Treasury stock, at cost, 67,099 shares at June 30, 2017 and 63,318 shares at December 31, 2016	(243,229)	(219,125)
Accumulated other comprehensive loss	3,639	(13,594)
Total stockholders' equity	482,170	436,541
Total liabilities and stockholders' equity	\$ 941,396	\$ 935,666

(1) see Note 3. Correction of Prior Period Financial Statements

See accompanying notes to condensed consolidated financial statements.

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VONAGE HOLDINGS CORP.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016 (revised) ⁽¹⁾	2017	2016 (revised) ⁽¹⁾
Total revenues	\$251,836	\$233,675	\$495,183	\$460,499
Operating Expenses:				
Cost of service (exclusive of depreciation and amortization)	97,674	76,078	185,270	145,228
Cost of goods sold	6,187	8,352	13,480	17,418
Sales and marketing	79,738	83,344	161,669	162,945
Engineering and development	6,670	7,243	15,040	14,077
General and administrative	36,514	35,053	71,600	61,723
Depreciation and amortization	18,394	18,218	36,341	35,197
Total operating expenses	245,177	228,288	483,400	436,588
Income from operations	6,659	5,387	11,783	23,911
Other Income (Expense):				
Interest income	4	25	9	46
Interest expense	(3,861)	(3,057)	(7,564)	(5,503)
Other income (expense), net	686	104	466	258
Total other income (expense), net	(3,171)	(2,928)	(7,089)	(5,199)
Income before income taxes	3,488	2,459	4,694	18,712
Income tax benefit (expense)	1,337	(2,241)	6,044	(10,563)
Net income	\$4,825	\$218	\$10,738	\$8,149
Earnings per common share:				
Basic	\$0.02	\$—	\$0.05	\$0.04
Diluted	\$0.02	\$—	\$0.04	\$0.04
Weighted-average common shares outstanding:				
Basic	223,492	213,558	221,930	213,800
Diluted	239,938	222,700	239,923	223,978

(1) see Note 3. Correction of Prior Period Financial Statements

See accompanying notes to condensed consolidated financial statements.

VONAGE HOLDINGS CORP.
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (In thousands)
 (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016 (revised) ⁽¹⁾	2017	2016 (revised) ⁽¹⁾
Net income	\$4,825	\$ 218	\$10,738	\$ 8,149
Other comprehensive income (loss):				
Foreign currency translation adjustment	14,185	(1,691)	17,232	(1,713)
Unrealized gain on available-for-sale securities	(20)	4	1	26
Total other comprehensive income (loss)	14,165	(1,687)	17,233	(1,687)
Comprehensive income (loss)	\$18,990	\$ (1,469)	\$27,971	\$ 6,462

(1) see Note 3. Correction of Prior Period Financial Statements

See accompanying notes to condensed consolidated financial statements.

VONAGE HOLDINGS CORP.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2017	2016 ⁽¹⁾
Cash flows from operating activities:		
Net income	\$10,738	\$8,149
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and impairment charges	17,381	18,579
Amortization of intangibles	18,826	16,618
Deferred income taxes	(8,111)	8,897
Allowance for doubtful accounts	452	597
Allowance for obsolete inventory	293	352
Amortization of debt issuance costs	204	517
Gain on sale of business	(928)	—
Loss on disposal of fixed assets	134	—
Share-based expense	20,891	16,670
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	1,280	(7,176)
Inventory	353	906
Prepaid expenses and other current assets	1,173	(2,587)
Deferred customer acquisition costs	1,129	913
Accounts payable	(8,124)	5,095
Accrued expenses	(23,787)	(23,311)
Deferred revenue	(1,506)	(1,534)
Other assets and liabilities	2,295	(158)
Net cash provided by operating activities	32,693	42,527
Cash flows from investing activities:		
Capital expenditures	(8,995)	(15,948)
Purchase of marketable securities	—	(5,664)
Maturities and sales of marketable securities	602	7,524
Acquisition and development of software assets	(6,884)	(5,655)
Acquisition of businesses, net of cash acquired	—	(163,042)
Proceeds from sale of business	1,000	—
Net cash used in investing activities	(14,277)	(182,785)
Cash flows from financing activities:		
Principal payments on capital lease obligations and other financing obligations	(4,861)	(6,329)
Principal payments on notes and revolving credit facility	(19,375)	(33,437)
Proceeds received from draw down of revolving credit facility and issuance of notes payable	15,000	181,250
Debt related costs	—	(1,316)
Common stock repurchases	(9,542)	(32,902)
Employee taxes paid on withholding shares	(14,562)	(3,966)
Proceeds from exercise of stock options	11,962	3,023
Net cash (used)/provided by financing activities	(21,378)	106,323
Effect of exchange rate changes on cash	660	(109)
Net decrease in cash, cash equivalents, and restricted cash	(2,302)	(34,044)
Cash, cash equivalents, and restricted cash, beginning of period	30,929	60,313

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Cash, cash equivalents, and restricted cash, end of period	\$28,627	\$26,269
Supplemental disclosures of cash flow information:		
Cash paid during the periods for:		
Interest	\$6,722	\$4,833
Income taxes	\$3,554	\$3,163
Non-cash investing and financing activities:		
Capital expenditures included in accounts payable and accrued liabilities	\$3,492	\$4,918
Issuance of common stock in connection with acquisition of business	\$—	\$31,591
Contingent consideration in connection with acquisition of business	\$—	\$16,472
Assumption of options in connection with acquisition of business	\$—	\$4,779

(1) See Note 2. Summary of Significant Accounting Policies for reclassification due to the adoptions of new Accounting Standard Updates and Note 3. Correction of Prior Period Financial Statements

See accompanying notes to condensed consolidated financial statements.

VONAGE HOLDINGS CORP.
 CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
 (In thousands)
 (Unaudited)

	Shares	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 2016 (Revised) ⁽¹⁾	219,001	\$ 282	\$1,310,847	\$(641,869)	\$(219,125)	\$(13,594)	\$436,541
Cumulative effect adjustment upon the adoption of ASU 2016-09			5,668	3,241			8,909
Stock option exercises	12,068	12	11,950				11,962
Share-based expense			20,891				20,891
Employee taxes paid on withholding shares	(2,183)				(14,562)		(14,562)
Common stock repurchases	(1,599)				(9,542)		(9,542)
Foreign currency translation adjustment						17,232	17,232
Unrealized loss on available-for-sale securities						1	1
Net income				10,738			10,738
Balance at June 30, 2017	227,287	\$ 294	\$1,349,356	\$(627,890)	\$(243,229)	\$ 3,639	\$482,170

(1) see Note 3. Correction of Prior Period Financial Statements

See accompanying notes to condensed consolidated financial statements.

VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 1. Basis of Presentation

Nature of Operations

Vonage Holdings Corp. ("Vonage", "Company", "we", "our", "us") is incorporated as a Delaware corporation. We are a leading provider of cloud communications services for business. We transform the way people work and businesses operate through a portfolio of cloud-based communications solutions that enable internal collaboration among employees, while also keeping companies closely connected with their customers, across any mode of communication, on any device.

Through our Nexmo subsidiary which was acquired on June 3, 2016, we are a global leader in the Communications-Platform-as-a-Service ("CPaaS") segment of the cloud communications market, providing innovative communication application program interfaces ("APIs") for text messaging and voice communications, allowing developers and enterprises to embed contextual communications into mobile apps, websites and business workflows via text, social media, chat apps and voice. With just few lines of code, developers can send and receive text messages and build programmable voice applications. Nexmo, the Vonage API Platform can scale from one API call to billions. The platform makes it easy for any of our developers to access communication services via software and APIs. Through Nexmo we have a global network of interconnected carriers delivering our API-based communications platform, enabling businesses to communicate with their customers reliably and with ease, no matter where in the world they are located. The addition of our Nexmo products to our business offering allows our customers to address their full communications needs, from employee to employee communications through business to customer communications.

We also provide a robust suite of feature-rich residential communication solutions.

Customers in the United States represented 85% and 93% of our consolidated revenues for the three months ended June 30, 2017 and 2016 and 86% and 94% for the six months ended June 30, 2017 and 2016, respectively, with the balance in Canada, the United Kingdom, and other countries. Nexmo Inc. ("Nexmo") has operations in the United States, United Kingdom, Hong Kong, and Singapore, and provides CPaaS solutions to our customers located in many countries around the world.

Unaudited Interim Financial Information

The accompanying unaudited interim condensed consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the SEC's regulations for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations, cash flows, and statement of stockholders' equity for the periods presented. The results for the three and six months ended June 30, 2017 are not necessarily indicative of the results to be expected for the full year.

These unaudited interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2016 filed with the Securities and Exchange Commission on February 28, 2017.

Use of Estimates

Our condensed consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported and disclosed in the condensed consolidated financial statements and the accompanying notes. Actual results could differ materially from these estimates.

Reclassifications

Reclassifications have been made to our condensed consolidated financial statements for the prior year period to conform to classification used in the current year period. The reclassifications did not affect results from operations or net assets.

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VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 2. Summary of Significant Accounting Policies

This footnote should be read in conjunction with the complete description of our significant accounting policies under Note 1, Basis of Presentation and Significant Accounting Policies to our Annual Report on Form 10-K for the year ended December 31, 2016.

Cost of Services

Cost of services excludes depreciation and amortization expense of \$6,863 and \$6,985 for the three months ended June 30, 2017 and 2016 and \$13,645 and \$13,818 for the six months ended June 30, 2017 and 2016, respectively.

Advertising Costs

We incurred advertising costs included in sales and marketing of \$14,994 and \$20,079 for the three months ended June 30, 2017 and 2016 and \$32,337 and \$36,958 for the six months ended June 30, 2017 and 2016, respectively.

Engineering and Development Expenses

Engineering and development expenses primarily include personnel and related costs for developers responsible for new products, and software engineers maintaining and enhancing existing products. Research and development costs related to new product development included in engineering and development were \$5,349 and \$5,402 for the three months ended June 30, 2017 and 2016 and \$11,695 and \$10,310 for the six months ended June 30, 2017 and 2016, respectively.

Restructuring Activities

During the three months ended June 30, 2017, we recognized \$4 million of costs associated with restructuring activities included in general and administrative expense and is primarily comprised of costs associated with severance and other employee related costs. As of June 30, 2017, the accrued severance of \$4 million is expected to be paid during the third quarter of 2017.

Fair Value of Financial Instruments

The Company records certain of its financial assets at fair value on a recurring basis. The Company's financial instruments, which includes cash and cash equivalents, accounts receivable and accounts payable, approximate fair value because of their short-term maturities. The carrying amounts of our capital leases approximate fair value of these obligations based upon management's best estimates of interest rates that would be available for similar debt obligations at June 30, 2017 and December 31, 2016. We believe the fair value of our debt at June 30, 2017 was approximately the same as its carrying amount as market conditions, including available interest rates, credit spread relative to our credit rating, and illiquidity, remain relatively unchanged from the issuance date of our debt on June 3, 2016 for a similar debt instrument.

As of June 30, 2017, we did not have any assets or liabilities that are measured and recognized at fair value on a recurring basis. The following table presents the assets and liabilities that are measured and recognized at fair value on a recurring basis classified under the appropriate level of the fair value hierarchy as of December 31, 2016:

	December 31, 2016
Level 1 Assets	
Money market fund ⁽¹⁾	\$ 300
Level 2 Assets	
Available-for-sale securities ⁽²⁾	\$ 601

(1) Included in cash and cash equivalents on our condensed consolidated balance sheet.

(2) Included in marketable securities on our condensed consolidated balance sheet.

VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Supplemental Balance Sheet Information

Cash, cash equivalents and restricted cash

	June 30, December 31,	
	2017	2016
Cash and cash equivalents	\$26,825	\$ 29,078
Cash collateralized letter of credit-lease deposits	\$1,580	\$ 1,578
Cash reserves	222	273
Restricted cash	\$1,802	\$ 1,851
Cash, cash equivalents, and restricted cash	\$28,627	\$ 30,929

Intangible assets, net

	June 30, December 31,	
	2017	2016
Customer relationships	129,635	133,774
Developed technology	51,882	57,245
Patents and patent licenses	4,789	5,547
Trade names	698	1,033
Non-compete agreements	1,072	1,657
Intangible assets, net	\$188,076	\$ 199,256

Accrued expenses

	June 30, December 31,	
	2017	2016
Compensation and related taxes and temporary labor	\$28,294	\$ 35,308
Marketing	11,911	11,979
Taxes and fees	14,380	18,976
Acquisition related consideration accounted for as compensation	1,733	6,608
Telecommunications	16,019	14,724
Settlement	—	5,000
Other accruals	8,333	12,846
Customer credits	1,200	2,074
Professional fees	2,300	1,680
Accrued expenses	\$84,170	\$ 109,195

Recent Accounting Pronouncements

In January 2017, FASB issued ASU 2017-04, "Intangibles - Goodwill and Other". The ASU simplifies the subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test. This ASU is effective for an annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019 on a prospective basis. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. We are currently evaluating the impact of adopting ASU 2017-04 on our condensed consolidated

financial statements and related disclosures.

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VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

In May 2014, FASB issued ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)" which was further amended through various updates issued by the FASB thereafter. The amendments of Topic 606 clarify the principles for recognizing revenue and provide a common revenue standard for U.S. GAAP and International Financial Reporting Standards, or IFRS, and to improve financial reporting. The core principle of these standards are that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Topic 606 also amends the current guidance for the recognition of costs to obtain and fulfill contracts with customers requiring that all incremental costs of obtaining and direct costs of fulfilling contracts with customers such as commissions be deferred and recognized over the expected customer life. In August 2015, an ASU was issued by the FASB which deferred the effective date to annual and interim periods beginning on or after December 15, 2017. We will adopt the requirements of the new standard in the first quarter of 2018 and anticipate using the modified retrospective transition method under which the standard will be applied only to the most current period presented and the cumulative effect of applying the standard will be recognized at the date of initial application.

We are in the process of evaluating the impact of the standard with respect to the terms of our revenue arrangements and expect our review to be substantially completed during the third quarter of 2017. We expect the timing of recognition of our sales commissions will also be impacted as a substantial portion of these costs which are currently expensed will be capitalized under the revised standard and amortized over the period of benefit.

In October 2016, FASB issued ASU 2016-16, "Income Taxes". This ASU improves the accounting for income tax consequences of intra-entity transfers of assets other than inventory. This ASU is effective for fiscal years beginning after December 15, 2017 on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Early adoption is permitted as of the beginning of an annual reporting period for which financial statements have not been issued or made available for issuance. We are currently evaluating the impact of adopting ASU 2016-16 on our condensed consolidated financial statements and related disclosures.

In August 2016, FASB issued ASU 2016-15, "Statement of Cash Flows". This ASU addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. This ASU is effective for fiscal years beginning after December 15, 2017 on a retrospective basis. Early adoption is permitted, including adoption in an interim period. The adoption of ASU 2016-15 will not have a material impact on our condensed consolidated financial statements and related disclosures.

In February 2016, FASB issued ASU 2016-02, "Leases". This ASU increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted for all entities. The adoption of this ASU will increase assets and liabilities for operating leases. We will adopt these ASUs when effective. We are currently evaluating the effect of adopting ASU 2016-02 on our condensed consolidated financial statements and related disclosures.

In January 2016, FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities". This ASU provide guidance concerning certain matters involving the recognition, measurement, and disclosure of financial assets and financial liabilities. The guidance does not alter the basic framework for classifying debt instruments held as financial assets. This ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is not permitted, with some exceptions. The adoption of ASU 2016-01 will not have a material impact on our condensed consolidated financial statements and related disclosures.

VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

The following standards were adopted by the Company during the current year:

In November 2016, FASB issued ASU 2016-18, "Statement of Cash Flows". This ASU requires that a statement of cash flows explains the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. As a result, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. We adopted this ASU in the first quarter of 2017 and applied the retrospective transition method for each period presented. For the six months ended June 30, 2016, \$690 and \$10 were reclassified from investing activity and effect of exchange rate changes on cash, respectively, and \$51, \$2,587 and \$1,938 were adjusted to acquisition of business, net of cash acquired, cash, cash equivalents, and restricted cash, beginning of the period and end of the period balances, respectively.

In March 2016, FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting". This ASU is issued as part of its Simplification Initiative. The areas for simplification in this ASU involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, recognition of share-based expense, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted for any entity in any interim or annual period. We adopted this ASU in the first quarter of 2017. We elected to account for forfeitures when they occur versus our prior practice of estimating the number of awards that are expected to vest. The election of this new ASU resulted in a one-time adjustment in 2017 to accumulated deficit and to additional paid-in-capital of \$5,668 and the corresponding benefit to our accumulated deficit and deferred tax asset of \$2,285 related to the reversal of forfeiture rate as of December 31, 2016. In addition, a benefit to our accumulated deficit and deferred tax asset of \$6,624 was recorded for excess tax benefits on equity compensation as of December 31, 2016. We also classified cash paid by us when directly withholding shares for tax-withholding purposes as a financing activity. As a result, \$3,966 was reclassified from operating activity to financing activity for the six months ended June 30, 2016.

In July 2015, FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory". This ASU applies to inventory that is measured using first-in, first-out ("FIFO") or average cost. Under the updated guidance, an entity should measure inventory that is within scope at the lower of cost and net realizable value, which is the estimated selling prices in the ordinary course of business, less reasonably predicible costs of completion, disposal and transportation. Subsequent measurement is unchanged for inventory that is measured using last-in, first-out ("LIFO") or the retail inventory. This ASU is effective for annual and interim periods beginning after December 15, 2016, and should be applied prospectively with early adoption on permitted at the beginning of an interim and annual reporting period. We adopted ASU 2015-11 in the first quarter of 2017 and the adoption of this ASU did not have a material impact on our condensed consolidated financial statements and related disclosures.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 3. Correction of Prior Period Financial Statements

In connection with the preparation of our condensed consolidated financial statements for the quarter ended March 31, 2017, and our remediation efforts related to the material weakness in our internal control over financial reporting related to our controls over the preparation of the annual tax provision, we identified an error as of December 31, 2016 in our recognition of a deferred tax asset related to contingent consideration with vesting requirements paid in connection with the acquisition of Nexmo. Based in part upon the vesting requirements of contingent consideration, we recorded the consideration as compensation expense in general and administrative expense in our consolidated statements of operations. However, for tax purposes the contingent consideration should have been recorded as merger consideration and not deductible compensation. The correction of this error requires the reversal of the deferred tax asset on the consolidated balance sheets and related tax benefits of \$4,756 as of December 31, 2016. In accordance with Staff Accounting Bulletin (“SAB”) No. 99, Materiality, and SAB No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements, we evaluated the error and determined that the related impact was not material to our results of operations or financial position for any prior annual or interim period, but that correcting the \$4,756 cumulative impact of the error would be material to our results of operations for the three months ended March 31, 2017. Accordingly, we have corrected the consolidated balance sheets as of December 31, 2016 and will correct this error in all prior periods presented by revising the appropriate condensed consolidated financial statements. This error had no impact on the three months ended March 31, 2016. The impact to the consolidated balance sheet as of December 31, 2016 and the consolidated statements of income for the three and six months ended June 30, 2016, the three and nine months ended September 30, 2016, and the three months and year ended December 31, 2016 is as follows:

Consolidated Balance Sheets

	As of December 31, 2016		
	As Reported	Adjustment	As Revised
Deferred tax assets, non-current	\$ 188,966	\$ 4,756	\$ 184,210
Total assets	940,422	4,756	935,666
Accumulated deficit	(637,113)	4,756	(641,869)
Total stockholders' equity	441,297	4,756	436,541
Total liabilities and stockholders' equity	940,422	4,756	935,666

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(Unaudited)

Condensed Consolidated Statements of Income

	Three Months Ended June 30, 2016			Six Months Ended June 30, 2016		
	As Reported	Adjustment	As Revised	As Reported	Adjustment	As Revised
	Income tax expense	\$(1,562)	\$ 679	\$(2,241)	\$(9,884)	\$ 679
Net income	897	679	218	8,828	679	8,149
Net income per common share:						
Basic	\$—	\$ —	\$—	\$0.04	\$ —	\$0.04
Diluted	\$—	\$ —	\$—	\$0.04	\$ —	\$0.04

	Three Months Ended September 30, 2016			Nine Months Ended September 30, 2016		
	As Reported	Adjustment	As Revised	As Reported	Adjustment	As Revised
	Income tax expense	\$(1,501)	\$ 2,038	\$(3,539)	\$(11,385)	\$ 2,717
Net income	9,078	2,038	7,040	17,906	2,717	15,189
Net income per common share:						
Basic	\$0.04	\$ 0.01	\$0.03	\$0.08	\$ 0.01	\$0.07
Diluted	\$0.04	\$ 0.01	\$0.03	\$0.08	\$ 0.01	\$0.07

	Three Months Ended December 31, 2016			Year Ended December 31, 2016		
	As Reported	Adjustment	As Revised	As Reported	Adjustment	As Revised
	Income tax expense	\$(1,553)	\$ 2,039	\$(3,592)	\$(12,938)	\$ 4,756
Net income	1	2,039	(2,038)	17,907	4,756	13,151
Net income per common share:						
Basic	\$—	\$ 0.01	\$(0.01)	\$0.08	\$ 0.02	\$0.06
Diluted	\$—	\$ 0.01	\$(0.01)	\$0.08	\$ 0.02	\$0.06

VONAGE HOLDINGS CORP.

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(Unaudited)

Note 4. Earnings Per Share

The following table sets forth the computation for basic and diluted earnings per share for the three and six months ended June 30, 2017 and 2016:

	Three Months Ended		Six Months Ended	
	June 30, 2017	June 30, 2016 (revised) ⁽¹⁾	June 30, 2017	June 30, 2016 (revised) ⁽¹⁾
Numerator				
Net income	\$4,825	\$ 218	\$10,738	\$ 8,149
Denominator				
Basic weighted average common shares outstanding	223,492	213,558	221,930	213,800
Dilutive effect of stock options and restricted stock units	16,446	9,142	17,993	10,178
Diluted weighted average common shares outstanding	239,938	222,700	239,923	223,978
Basic earnings per share				
Basic earnings per share	\$0.02	\$ —	\$0.05	\$ 0.04
Diluted earnings per share				
Diluted earnings per share	\$0.02	\$ —	\$0.04	\$ 0.04

(1) see Note 3. Correction of Prior Period Financial Statements

For the three and six months ended June 30, 2017 and 2016, the following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

	Three Months Ended		Six Months Ended	
	June 30, 2017	June 30, 2016	June 30, 2017	June 30, 2016
Restricted stock units	4,540	12,851	3,344	12,012
Stock options	4,605	14,597	4,254	14,400
	9,145	27,448	7,598	26,412

VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 5. Long-Term Note and Revolving Credit Facility

This footnote should be read in conjunction with the complete description of our financing arrangements under Note 6, Long-Term Debt and Revolving Credit Facility to our Annual Report on Form 10-K for the year ended December 31, 2016.

A schedule of long-term note and revolving credit facility at June 30, 2017 and December 31, 2016 is as follows:

	June 30, 2017	December 31, 2016
2.50-3.25% Term note - due 2020, net of debt related costs	\$81,953	\$ 91,124
2.50-3.25% Revolving credit facility - due 2020	214,000	209,000
Total Long-term note and revolving credit facility	\$295,953	\$ 300,124

2016 Financing

On June 3, 2016, we entered into Amendment No. 1 to the Amended and Restated Credit Agreement (the "2016 Credit Facility") consisting of a \$125.0 million term note and a \$325.0 million revolving credit facility. The co-borrowers under the 2016 Credit Facility are the Company and Vonage America Inc., the Company's wholly owned subsidiary. Obligations under the 2016 Credit Facility are guaranteed, fully and unconditionally, by the Company's other United States material subsidiaries and are secured by substantially all of the assets of each borrower and each guarantor. We used \$197.8 million of the net available proceeds of the 2016 Credit Facility to retire all of the debt under our 2015 Credit Facility. We used \$179.0 million from our 2016 Credit Facility in connection with the acquisition of Nexmo on June 3, 2016. Remaining proceeds from the term note and the undrawn revolving credit facility under the 2016 Credit Facility will be used for general corporate purposes. During the six months ended June 30, 2017, we made mandatory repayments of \$9.4 million under the term note and \$10.0 million under the revolving credit facility, respectively, and borrowed \$15.0 million under the revolving credit facility. In addition, the effective interest rate was 4.25% as of June 30, 2017.

Interest Rate Swap

On July 14, 2017, we executed on three interest rate swap agreements in order to hedge the variability of expected future cash interest payments related to the 2016 Credit Facility. The swaps have an aggregate notional amount of \$150 million and are effective on July 31, 2017 through June 3, 2020 concurrent with the term of the 2016 Credit Facility. Under the swaps our interest rate is fixed at 4.7%. The interest rate swaps will be accounted for as cash flow hedges in accordance with ASC 815, Derivatives and Hedging.

Note 6. Common Stock

As of June 30, 2017 and December 31, 2016, the Company had 596,950 shares of common stock authorized and had 11,369 shares available for grants under our share-based compensation programs as of June 30, 2017. For a detailed description of our share-based compensation programs refer to Note 9, Employee Benefit Plans in our Annual Report on Form 10-K for the year ended December 31, 2016.

Common Stock Repurchases

On December 9, 2014, Vonage's Board of Directors authorized a program for the Company to repurchase up to \$100.0 million of its outstanding common stock (the "2014 \$100.0 million repurchase program"). Repurchases under the 2014 \$100.0 million repurchase program are expected to be made over a four-year period ending on December 31, 2018.

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We repurchased the following shares of common stock with cash resources under the 2014 \$100.0 million repurchase program during the three and six months ended June 30, 2017 and 2016:

	Three Months Ended June 30, 2017	Six Months Ended June 30, 2017	2016
Shares of common stock repurchased	5,747	1,599	7,400
Value of common stock repurchased	\$24,754	\$9,510	\$32,762

As of June 30, 2017, \$42,533 remained of our 2014 \$100.0 million repurchase program. The repurchase program expires on December 31, 2018 but may be suspended or discontinued at any time without notice.

In any period under the 2014 \$100.0 million repurchase program, cash used in financing activities related to common stock repurchases may differ from the comparable change in stockholders' equity, reflecting timing differences between the recognition of share repurchase transactions and their settlement for cash.

Note 7. Commitments and Contingencies

From time to time, in addition to those identified below, we are subject to legal proceedings, claims, investigations, and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment, and other matters. From time to time we receive letters or other communications from third parties inviting us to obtain patent licenses that might be relevant to our business or alleging that our services infringe upon third party patents or other intellectual property. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss or range of loss can be reasonably estimated. These provisions, if any, are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. We believe that we have valid defenses with respect to the legal matters pending against us and are vigorously defending these matters. Given the uncertainty surrounding litigation and our inability to assess the likelihood of a favorable or unfavorable outcome in the matters noted below and our inability to reasonably estimate the amount of loss or range of loss, it is possible that the resolution of one or more of these matters could have a material adverse effect on our condensed consolidated financial position, cash flows or results of operations.

Litigation

IP Matters

Bear Creek Technologies, Inc. On June 26, 2017, the litigations brought by Bear Creek Technologies, Inc. against Vonage Holdings Corp. and certain of its subsidiaries were dismissed with prejudice pursuant to stipulation, with no settlement paid by the Company.

RPost Holdings, Inc. On August 24, 2012, RPost Holdings, Inc., RPost Communications Limited, and RMail Limited (collectively, "RPost") filed a lawsuit against StrongMail Systems, Inc. ("StrongMail") in the United States District Court for the Eastern District of Texas alleging that StrongMail's products and services, including its electronic mail marketing services, are covered by United States Patent Nos. 8,224,913, 8,209,389, 8,161,104, 7,966,372, and 6,182,219. On February 11, 2013, RPost filed an amended complaint, adding 27 new defendants, including Vonage America Inc. RPost's amended complaint alleges willful infringement of the RPost patents by Vonage and each of the other new defendants because they are customers of StrongMail. StrongMail has agreed to fully defend and indemnify Vonage in this lawsuit. Vonage answered the complaint on May 7, 2013. On September 17, 2015, the Court ordered the consolidation for pre-trial purposes of this case with other cases by RPost. The lead case has been administratively closed and stayed since January 30, 2014 due to multiple pending actions by third parties regarding ownership of the

patents at issue. On June 1, 2017, the parties in the consolidated actions filed a joint notice regarding status of the co-pending actions. Plaintiffs requested that the stay be lifted, while defendants maintain that the stay should remain in place.

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AIP Acquisition LLC. On January 3, 2014, AIP Acquisition LLC (“AIP”), filed a lawsuit against Vonage Holdings Corp., Vonage America, Inc., and Vonage Marketing LLC in the U.S. District Court for the District of Delaware alleging that Vonage’s products and services are covered by United States Patent No. 7,269,247. Vonage filed an answer and counterclaims on February 25, 2014. AIP filed an amended complaint on March 18, 2014, which Vonage answered on April 4, 2014. On April 8, 2014, the Court stayed the case pending final resolution of non-party Level 3’s inter partes review request of United States Patent No. 7,724,879, which is a continuation of the ‘247 patent. On October 8, 2014, the Patent Office issued a Final Written Decision, finding all challenged claims of the ‘879 patent to be invalid. On November 10, 2015, the Federal Circuit rejected AIP’s appeal and affirmed the Patent Office’s rejection of the ‘879 patent.

Cisco petitioned for inter partes review of the ‘247 patent on November 25, 2014, which was granted on May 20, 2015. On May 18, 2016, the Patent Office issued a Final Written Decision, finding all challenged claims of the ‘247 patent to be invalid. AIP appealed to the Federal Circuit, filing its opening brief on December 15, 2016. On December 20, 2016, the Patent Office filed a notice of intervention in the appellate proceedings. Briefing on the appeal is complete, with oral argument to be scheduled.

Commercial Litigation

Merkin & Smith, et al. On September 27, 2013, Arthur Merkin and James Smith filed a putative class action lawsuit against Vonage America, Inc. in the Superior Court of the State of California, County of Los Angeles, alleging that Vonage violated California’s Unfair Competition Law by charging its customers fictitious 911 taxes and fees. On October 30, 2013, Vonage filed a notice removing the case to the United States District Court for the Central District of California. On November 26, 2013, Vonage filed its Answer to the Complaint. On December 4, 2013, Vonage filed a Motion to Compel Arbitration, which the Court denied on February 4, 2014. On March 5, 2014, Vonage appealed that decision to the United States Court of Appeals for the Ninth Circuit. On March 26, 2014, the district court proceedings were stayed pending the appeal. On February 29, 2016, the Ninth Circuit reversed the district court’s ruling and remanded with instructions to grant the motion to compel arbitration. On March 22, 2016, Merkin and Smith filed a petition for rehearing. On May 4, 2016, the Ninth Circuit withdrew its February 29, 2016 decision and issued a new order reversing the district court’s order and remanded with instructions to compel arbitration. The Ninth Circuit also declared as moot the petition for rehearing. On June 27, 2016, the lower court stayed the case pending arbitration. A joint status report was filed with the District Court on December 23, 2016. A second joint status report was filed with the District Court on March 23, 2017. A third joint status report was filed with the District Court on June 27, 2017.

Regulation

Telephony services are subject to a broad spectrum of state and federal regulations. Because of the uncertainty over whether Voice over Internet Protocol (“VoIP”) should be treated as a telecommunications or information service, we have been involved in a substantial amount of state and federal regulatory activity. Implementation and interpretation of the existing laws and regulations is ongoing and is subject to litigation by various federal and state agencies and courts. Due to the uncertainty over the regulatory classification of VoIP service, there can be no assurance that we will not be subject to new regulations or existing regulations under new interpretations, and that such change would not introduce material additional costs to our business.

Federal - Net Neutrality

Clear and enforceable net neutrality rules make it more difficult for broadband Internet service providers to block or discriminate against Vonage service. In addition, explicitly applying net neutrality rules to wireless broadband Internet service providers could create greater opportunities for VoIP applications that run on wireless broadband Internet service. In December 2010, the FCC adopted net neutrality rules that applied strong net neutrality rules to wired broadband Internet service providers and limited rules to wireless broadband Internet service providers. On January

14, 2014, the D.C. Circuit Court of Appeals vacated a significant portion of the 2010 rules. On May 15, 2014, the FCC issued a Notice of Proposed Rulemaking (NPRM) proposing new net neutrality rules. After public response to the NPRM, the FCC adopted new neutrality rules on February 26, 2015. These rules prohibit broadband Internet service providers from: (1) blocking or throttling lawful content applications, or services; (2) imposing paid prioritization arrangements; and (3) unreasonably interfering or unreasonably disadvantaging consumers or edge providers. In addition, broadband Internet service providers are required to make certain disclosures regarding their network management practices, network performance, and commercial terms. These net neutrality rules apply the same requirements to wired and wireless broadband Internet service providers. Several parties filed appeals which are pending at the D.C. Circuit Court of Appeals. Oral arguments at the D.C. Circuit Court of Appeals were held on December 4, 2015. On June 14, 2016, the D.C. Circuit of Appeals denied the appeals. Several parties filed a petition for rehearing en banc on July 29, 2016, which was denied on May 1, 2017.

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Federal - Rural Call Completion Issues

On February 7, 2013, the FCC released a Notice of Proposed Rulemaking (NPRM) on rural call completion issues. The NPRM proposed new detailed reporting requirements to gauge rural call completion performance. Rural carriers have argued that VoIP provider call completion performance to rural areas is generally poor. On October 28, 2013, the FCC adopted an order on rural call completion imposing new reporting obligations and restricting certain call signaling practices. The call signaling rules went into effect on January 31, 2014. We filed for extensions of the rules, which the FCC granted, and as of April 17, 2014, we were compliant with the FCC call signaling rules. The effective date for the reporting requirements was April 1, 2015. We could be subject to an FCC enforcement action in the future in the event the FCC took the position that our rural call completion performance is inadequate or we were not compliant with the FCC's order. On June 22, 2017, the FCC issued a Second Further Notice of Proposed Rulemaking. The FCC has proposed changes to the FCC's rules that allegedly would more effectively address rural call completion problems while reducing burdens on covered providers. Vonage is reviewing and evaluating the FCC's proposed changes.

State Telecommunications Regulation

In general, the focus of interconnected VoIP telecommunications regulation is at the federal level. On November 12, 2004, the FCC issued a declaratory ruling providing that our service is subject to federal regulation and preempted the Minnesota Public Utilities Commission ("MPUC") from imposing certain of its regulations on us. The FCC's decision was based on its conclusion that our service is interstate in nature and cannot be separated into interstate and intrastate components. On March 21, 2007, the United States Court of Appeals for the 8th Circuit affirmed the FCC's declaratory ruling preempting state regulation of our service.

While this ruling does not exempt us from all state oversight of our service, it effectively prevents state telecommunications regulators from imposing certain burdensome and inconsistent market entry requirements and certain other state utility rules and regulations on our service. State regulators continue to probe the limits of federal preemption in their attempts to apply state telecommunications regulation to interconnected VoIP service. On July 16, 2009, the Nebraska Public Service Commission and the Kansas Corporation Commission filed a petition with the FCC seeking a declaratory ruling or, alternatively, adoption of a rule declaring that state authorities may apply universal service funding requirements to nomadic VoIP providers. We participated in the FCC proceedings on the petition. On November 5, 2010, the FCC issued a declaratory ruling that allowed states to assess state USF on nomadic VoIP providers on a going forward basis provided that the states comply with certain conditions to ensure that imposing state USF does not conflict with federal law or policy. More recently on July 28, 2015, the MPUC found that it has authority to regulate Charter's fixed, interconnected VoIP service. Charter challenged the MPUC's order at the U.S. District Court for Minnesota. This challenge is currently pending. We expect that state public utility commissions and state legislators will continue their attempts to apply state telecommunications regulations to nomadic VoIP service.

State and Municipal Taxes

In accordance with generally accepted accounting principles, we make a provision for a liability for taxes when it is both probable that a liability has been incurred and the amount of the liability or range of liability can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. For a period of time, we did not collect or remit state or municipal taxes (such as sales, excise, utility, use, and ad valorem taxes), fees or surcharges ("Taxes") on the charges to our customers for our services, except that we historically complied with the New Jersey sales tax. We have received inquiries or demands from a number of state and municipal taxing and 911 agencies seeking payment of Taxes that are applied to or collected from customers of providers of traditional public switched telephone network services. Although we have consistently maintained that these Taxes do not apply to our service for a variety of reasons depending on the statute or rule that establishes such obligations, we

are now collecting and remitting sales taxes in certain of those states including a number of states that have changed their statutes to expressly include VoIP. In addition, many states address how VoIP providers should contribute to support public safety agencies, and in those states we remit fees to the appropriate state agencies. We could also be contacted by state or municipal taxing and 911 agencies regarding Taxes that do explicitly apply to VoIP and these agencies could seek retroactive payment of Taxes. As such, we have reserves of \$653 and \$1,763 as of June 30, 2017 and December 31, 2016, respectively, as our best estimate of the potential tax exposure for any retroactive assessment. We believe the maximum estimated exposures for retroactive assessments are approximately \$2,000 and \$2,600 as of June 30, 2017 and December 31, 2016, respectively.

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(Unaudited)

Note 8. Acquisitions and Dispositions

Sale of Hosted Infrastructure Product Line

On May 31, 2017, we completed the sale of our Hosted Infrastructure product line for up to \$4.0 million consideration comprised of \$1.0 million received upon closing and the potential for an additional \$0.5 million to be paid six months from closing and up to \$2.5 million based on the achievement of financial objectives for net sales during the 18 months following closing. The results of our Hosted Infrastructure product line have been included within our business segment. As a result of the sale, we recorded a gain of \$928 within other income for the three months ended June 30, 2017. This disposal did not represent a strategic shift in operations and, therefore, did not qualify for presentation as discontinued operations.

Acquisition of Nexmo

Nexmo is a global leader in the Communications-Platform-as-a-Service ("CPaaS") segment of the cloud communications market. Nexmo provides innovative communication application program interfaces ("APIs") for text messaging and voice communications, allowing developers and enterprises to embed contextual communications into mobile apps, websites and business workflows via text, social media, chat apps and voice.

Pursuant to the Agreement and Plan of Merger dated May 5, 2016, by and among the Company, Neptune Acquisition Corp., a Delaware corporation and newly formed indirect, wholly owned subsidiary of Vonage ("Merger Sub"), Nexmo, a Delaware corporation, and Shareholder Representative Services LLC, a Colorado limited liability company, as representative of the security holders of Nexmo, on June 3, 2016, Merger Sub, on the terms and subject to the conditions thereof, merged with and into Nexmo, and Nexmo became a wholly owned indirect subsidiary of Vonage. On June 2, 2016, Vonage, Merger Sub, Nexmo and the Representative entered into Amendment No. 1 to the Merger Agreement (the "Amendment"). The Amendment amended the Merger Agreement to, among other things, (1) increase the purchase price payable to the Nexmo security holders by the amount of unrestricted cash and cash equivalents of Nexmo in lieu of the declaration of a dividend or other distribution of such unrestricted cash and cash equivalents to the Nexmo security holders, (2) clarify the treatment of enterprise management incentive options issued by Nexmo to certain of its employees located in the United Kingdom, and (3) add certain technical provisions with respect to deposits made to the escrow agent and the exchange agent in connection with the closing of the transactions contemplated by the Merger Agreement.

Under the agreement, Nexmo shareholders received consideration of \$231,122, with an additional earn-out opportunity (the "contingent consideration") of up to \$20,000 contingent upon Nexmo achieving certain performance targets. Of the consideration, \$194,684 (net of cash acquired of \$16,094) was paid at close, consisting of \$163,093 of cash (net of \$16,094 of cash acquired) and 6,823 in shares of Vonage common stock valued at \$31,591. The remaining \$36,438 of the \$231,122 purchase price is in the form of restricted cash, restricted stock and options held by Nexmo management and employees (the "Employee Payout Amount"), subject to vesting requirements over time and to be amortized to compensation expense quarterly until vested. We financed the transaction with \$179,000 from our 2016 Credit Facility. The purchase price was subject to adjustments pursuant to the merger agreement for closing cash and working capital of Nexmo, reductions for indebtedness and transaction expenses of Nexmo that remained unpaid as of closing, and escrow fund deposits. The aggregate consideration will be allocated among Nexmo equity holders.

The consideration was allocated to acquisition cost as follows:

Cash paid at closing (inclusive of cash acquired of \$16,094)	\$ 179,186
Stock paid at closing	31,591
Contingent consideration (described below)	16,472

Employee Payout Amount (described below)	4,779
Acquisition Cost	\$232,028

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In addition, Nexmo shareholders were eligible to earn a Variable Payout Amount of up to \$20,000, subject to the achievement of certain performance targets during the 12 month period following the closing of the transaction. The contingent consideration payable to the holders of Nexmo stock is determined based on (i) the achievement of certain revenue targets for the calendar year 2016, and (ii) Nexmo's revenues received from its top customers following the closing. The contingent consideration may be in the form of cash, a number of shares of Vonage common stock or a combination thereof, at our sole discretion. We estimated using probability weighting that the value of the contingent consideration is \$17,840 at the acquisition date and included that amount in acquisition cost at the net present value amount of \$16,472. As of December 31, 2016, Nexmo did not achieve the performance targets necessary to earn the Variable Payout Amount but the parties agreed to a \$5,000 settlement that the parties were paid in the first quarter of 2017. The \$5,000 settlement was reflected in accrued expenses within the condensed consolidated balance sheets and in general and administrative expenses in the condensed consolidated statements of income during the year ended December 31, 2016.

In addition, Nexmo management and employees were eligible to earn an Employee Payout Amount of \$36,438 attributable to restricted cash, restricted stock and assumed options, of which \$4,779 is included in acquisition cost as service had been provided pre-acquisition and \$31,659 will be recorded as post-acquisition expense assuming all amounts vest, of which \$31,087 will be recorded as compensation expense and \$572 will be recorded as interest expense as continued employment is a condition of receiving consideration.

Pursuant to the merger agreement, \$20,372 of the cash consideration and \$5,081 of the stock consideration were placed in escrow for unknown liabilities that may have existed as of the acquisition date.

For the three months ended June 30, 2017 and June 30, 2016, we incurred approximately \$10 and \$5,059, respectively, in acquisition related transaction costs, which were recorded in general and administrative expense in the accompanying condensed consolidated statements of income. For the full year 2016, we incurred approximately \$5.5 million in acquisition related transaction costs.

The acquisition was accounted for using the acquisition method of accounting under which assets and liabilities of Nexmo were recorded at their respective fair values including an amount for goodwill representing the difference between the acquisition consideration and the fair value of the identifiable net assets. We do not expect any portion of this goodwill to be deductible for tax purposes. The goodwill attributable to the acquisition has been recorded as a non-current asset and is not amortized, but is subject to an annual review for impairment. The factors that contributed to goodwill include synergies that are specific to our consolidated business, the acquisition of a talented workforce that provides us with expertise in the small and medium business markets, as well as other intangible assets that do not qualify for separate recognition.

The acquisition price was allocated to the tangible and identified intangible assets acquired and liabilities assumed as of the closing date. The fair values assigned to identifiable intangible assets assumed were based on management's current estimates and assumptions. The accounting for the Nexmo acquisition was completed during the three months ended June 30, 2017, at which point the fair values became final. The table below summarizes the provisional amounts recognized for assets acquired and liabilities assumed as of December 31, 2016 as well as adjustments made through the three months ended June 30, 2017, when the allocation became final. Measurement period adjustments primarily reflect the tax impact of the acquisition date fair values.

VONAGE HOLDINGS CORP.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

The purchase price was allocated as follows:

	Acquisition Date Fair Value as of December 31, 2016	Measurement period adjustments	Revised Acquisition Date Fair Value
Assets			
Current assets:			
Cash and cash equivalents	\$ 16,094	\$ —	\$ 16,094
Accounts receivable	8,764	—	8,764
Prepaid expenses and other current assets	3,507	—	3,507
Total current assets	28,365	—	28,365
Property and equipment	757	—	757
Software, net	242	—	242
Intangible assets	101,770	—	101,770
Restricted cash	51	—	51
Total assets acquired	131,185	—	131,185
Liabilities			
Current liabilities:			
Accounts payable	1,841	—	1,841
Accrued expenses	9,299	—	9,299
Deferred revenue, current portion	1,735	—	1,735
Total current liabilities	12,875	—	12,875
Deferred tax liabilities, net, non-current	29,355	(5,482)	23,873
Total liabilities assumed	42,230	(5,482)	36,748
Net identifiable assets acquired	88,955	5,482	94,437
Goodwill	143,073	(5,482)	137,591
Total purchase price	\$ 232,028	\$ —	\$ 232,028
Identifiable intangible assets recognized in connection with the acquisition included:			
	Amount		
Customer relationships	\$ 85,900		
Developed technologies	13,768		
Non-compete agreements	972		
Trade names	1,130		
	\$ 101,770		

VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Goodwill

The following table provides a summary of the changes in the carrying amounts of goodwill which is attributable to our business segment:

Balance at December 31, 2016	\$360,363
Decrease in goodwill related acquisition of Nexmo	(5,482)
Currency translation adjustments	11,925
Balance at June 30, 2017	\$366,806

Pro forma financial information

The following unaudited supplemental pro forma information presents the combined historical results of operations of Vonage and Nexmo for the six months ended June 30, 2016, as if the acquisition had been completed at the beginning of 2016.

	Six Months Ended June 30, 2016
Revenues	\$494,094
Net income	\$5,887
Earnings per common share - basic	\$0.03
Earnings per common share - diluted	\$0.03

The pro forma financial information includes certain adjustments to reflect expenses in the appropriate pro forma periods as though the companies were combined as of the beginning of 2016 and includes the pro-forma impact of amortization of identifiable intangibles assets and interest expense on borrowings under our revolving line of credit utilized to, in part, finance the acquisition. The pro forma data was also adjusted to eliminate non-recurring transaction costs incurred by us as well as the related tax impact. The pro forma results are not necessarily indicative of the results that we would have achieved had the transaction actually occurred on January 1, 2016 and does not purport to be indicative of future financial operating results nor does it reflect any operating efficiencies and cost savings that may be realized from the integration of the acquisition.

Note 9. Industry Segment and Geographic Information

ASC 280 "Segment Reporting" establishes reporting standards for an enterprise's business segments and related disclosures about its products, services, geographic areas and major customers. Under ASC 280, the method for determining what information to report is based upon the way management organizes the operating segments within the Company for making operating decisions and assessing financial performance. Our chief operating decision-maker reviews revenue and gross margin information for each of our reportable segments, but does not review operating expenses on a segment by segment basis. In addition, with the exception of goodwill and intangible assets, we do not identify or allocate our assets by the reportable segments.

VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Business

For our Business customers, we provide innovative, cloud-based Unified Communications as a Service, or UCaaS, solutions, comprised of integrated voice, text, video, data, collaboration, and mobile applications over our flexible, scalable Session Initiation Protocol (SIP) based Voice over Internet Protocol, or VoIP, network. Through Nexmo, the Vonage API Platform, we also offer Communications Platform as a Service, or CPaaS, solutions designed to enhance the way businesses communicate with their customers embedding communications into apps, websites and business processes. Together we have a robust set of product families tailored to serve the full range of the business value chain, from the small and medium business, or SMB, market, through mid-market and enterprise markets. We provide customers with multiple deployment options, designed to provide the reliability and quality of service they demand. We provide customers the ability to integrate our cloud communications platform with many cloud-based productivity and CRM solutions, including Google's G Suite, Zendesk, Salesforce's Sales Cloud, Oracle, Clio, and other CRM solutions. In combination, our products and services permit our business customers to communicate with their customers and employees through any cloud-connected device, in any place, at any time without the often costly investment required with on-site equipment.

Consumer

For our Consumer customers, we enable users to access and utilize our UCaaS services and features, via a single "identity," either a number or user name, regardless of how they are connected to the Internet, including over 3G, LTE, Cable, or DSL broadband networks. This technology enables us to offer our Consumer customers attractively priced voice and messaging services and other features around the world on a variety of devices.

For our segments we categorize revenues as follows:

Services revenues. Services revenues consists primarily of revenue attributable to our communication services for Consumer and Software Defined Wide Area Network, or SD-WAN, UCaaS and CPaaS services for Business,

Product revenues. Product revenues includes equipment sold to customers, shipping and handling, professional services, and broadband access.

USF revenues. USF revenues represent contributions to the Federal Universal Service Fund ("USF") and related fees.

For our segments we categorize cost of revenues as follows:

Services cost of revenues. Services cost of revenues consists of costs associated with network operations and technical support personnel, communication origination, and termination services provided by third party carriers and excludes depreciation and amortization.

Product cost of revenues. Product cost of revenues includes equipment sold to customers, shipping and handling, professional services, cost of certain products including equipment or services that we give customers as promotions, and broadband access.

USF cost of revenues. USF cost of revenues represents contributions to the Federal Universal Service Fund ("USF") and related fees.

VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Information about our segment results for the three and six months ended June 30, 2017 were as follows:

	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
	Business	Consumer	Total	Business	Consumer	Total
Revenues						
Service revenues	\$103,825	\$115,636	\$219,461	\$196,116	\$234,753	\$430,869
Product revenues ⁽¹⁾	13,392	201	13,593	26,752	404	27,156
Service and product revenues	117,217	115,837	233,054	222,868	235,157	458,025
USF revenues	6,497	12,285	18,782	12,648	24,510	37,158
Total revenues	123,714	128,122	251,836	235,516	259,667	495,183
Cost of revenues						
Service cost of revenues ⁽²⁾	49,246	21,435	70,681	88,441	43,535	131,976
Product cost of revenues ⁽¹⁾	12,456	1,942	14,398	25,658	3,958	29,616
Service and product cost of revenues	61,702	23,377	85,079	114,099	47,493	161,592
USF cost of revenues	6,497	12,285	18,782	12,648	24,510	37,158
Total cost of revenues	68,199	35,662	103,861	126,747	72,003	198,750
Gross margin						
Service margin	54,579	94,201	148,780	107,675	191,218	298,893
Product margin	936	(1,741)	(805)	1,094	(3,554)	(2,460)
Gross margin ex-USF (Service and product margin)	55,515	92,460	147,975	108,769	187,664	296,433
USF margin	—	—	—	—	—	—
Gross margin	\$55,515	\$92,460	\$147,975	\$108,769	\$187,664	\$296,433
Gross margin %						
Service margin %	52.6	% 81.5	% 67.8	% 54.9	% 81.5	% 69.4
Gross margin ex-USF (Service and product margin %)	47.4	% 79.8	% 63.5	% 48.8	% 79.8	% 64.7
Gross margin %	44.9	% 72.2	% 58.8	% 46.2	% 72.3	% 59.9

(1) Includes customer premise equipment, access, professional services, and shipping and handling.

(2) Excludes depreciation and amortization of \$5,003 and \$1,860 for the three months ended June 30, 2017 and \$9,878 and \$3,767 for the six months ended June 30, 2017, respectively.

VONAGE HOLDINGS CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Information about our segment results for the three and six months ended June 30, 2016 were as follows:

	Three Months Ended			Six Months Ended			
	June 30, 2016			June 30, 2016			
	Business	Consumer	Total	Business	Consumer	Total	
Revenues							
Service revenues	\$67,079	\$133,462	\$200,541	\$123,552	\$271,234	\$394,786	
Product revenues ⁽¹⁾	13,265	160	13,425	26,177	307	26,484	
Service and product revenues	80,344	133,622	213,966	149,729	271,541	421,270	
USF revenues	5,368	14,341	19,709	9,803	29,426	39,229	
Total revenues	85,712	147,963	233,675	159,532	300,967	460,499	
Cost of revenues							
Service cost of revenues ⁽²⁾	22,527	25,727	48,254	37,930	52,247	90,177	
Product cost of revenues ⁽¹⁾	12,902	3,564	16,466	25,364	7,865	33,229	
Service and product cost of revenues	35,429	29,291	64,720	63,294	60,112	123,406	
USF cost of revenues	5,369	14,341	19,710	9,814	29,426	39,240	
Total cost of revenues	40,798	43,632	84,430	73,108	89,538	162,646	
Gross margin							
Service margin	44,552	107,735	152,287	85,622	218,987	304,609	
Product margin	363	(3,404)	(3,041)	813	(7,558)	(6,745)	
Gross margin ex-USF (Service and product margin)	44,915	104,331	149,246	86,435	211,429	297,864	
USF margin	(1)	—	(1)	(11)	—	(11)	
Gross margin	\$44,914	\$104,331	\$149,245	\$86,424	\$211,429	\$297,853	
Gross margin %							
Service margin %	66.4	% 80.7	% 75.9	% 69.3	% 80.7	% 77.2	%
Gross margin ex-USF (Service and product margin %)	55.9	% 78.1	% 69.8	% 57.7	% 77.9	% 70.7	%
Gross margin %	52.4	% 70.5	% 63.9	% 54.2	% 70.2	% 64.7	%

(1) Includes customer premise equipment, access, professional services, and shipping and handling.

(2) Excludes depreciation and amortization of \$4,473 and \$2,512 for the three months ended June 30, 2016 and \$8,792 and \$5,026 for six months ended June 30, 2016, respectively

VONAGE HOLDINGS CORP.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

A reconciliation of the total of the reportable segments' gross margin to consolidated income before provision for income taxes is as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Total reportable gross margin	\$147,975	\$149,245	\$296,433	\$297,853
Sales and marketing	79,738	83,344	161,669	162,945
Engineering and development	6,670	7,243	15,040	14,077
General and administrative	36,514	35,053	71,600	61,723
Depreciation and amortization	18,394	18,218	36,341	35,197
Income from operations	6,659	5,387	11,783	23,911
Interest income	4	25	9	46
Interest expense	(3,861)	(3,057)	(7,564)	(5,503)
Other income (expense), net	686	104	466	258
Income before income taxes	\$3,488	\$2,459	\$4,694	\$18,712

Information about our operations by geographic location is as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Revenues:				
United States	\$214,182	\$217,871	\$427,506	\$435,088
Canada	9,002	6,540	16,447	12,613
United Kingdom	6,926	4,081	8,244	7,615
Other Countries ⁽¹⁾	21,726	5,183	42,986	5,183
	\$251,836	\$233,675	\$495,183	\$460,499

(1) No individual other international country represented greater than 10% of total revenue during the periods presented.

	June 30,	December 31,
	2017	2016
Long-lived assets:		
United States	\$622,754	\$ 629,269
United Kingdom	410	450
Israel	273	286
	\$623,437	\$ 630,005

VONAGE HOLDINGS CORP.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

Note 10. Income Taxes

Effective Tax Rate

The income tax provision consisted of the following:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Income before income taxes	\$3,488	\$2,459	\$4,694	\$18,712
Income tax benefit (expense)	1,337	(2,241)	6,044	(10,563)
Effective tax rate	(38.3)%	91.1 %	(128.8)%	56.5 %

We recognize income tax expense equal to pre-tax income multiplied by our effective income tax rate. In addition, adjustments are recorded for discrete period items and changes to our state effective tax rate which can cause the rate to fluctuate from quarter to quarter.

For the three months and six months ended June 30, 2017, our effective tax rate was different than the statutory rate due to discrete period tax benefits of \$8,325 and \$1,433 which were recognized related to excess tax benefits on equity compensation recognized primarily in the first quarter of 2017 as well as an adjustment to our deferred asset related to stock compensation.

For the three and six months ended June 30, 2016, our effective tax rate was different than the statutory rate due to a discrete period tax expense of \$1,220 was recorded related to expired stock options recognized in the first quarter of 2016 which was partially offset by \$389 which was recorded during the second quarter of 2016. The provision also includes the federal alternative minimum tax and state and local income taxes.

We do not have any uncertain tax positions as of June 30, 2017 and December 31, 2016.

Net Operating Loss Carry Forwards ("NOLs")

As of December 31, 2016, we had cumulative domestic Federal NOLs of \$575,476 and cumulative state NOLs of \$158,848, expiring at various times from years ending 2017 through 2036. In addition, we had NOLs for United Kingdom tax purposes of \$43,006 with no expiration date. In connection with the completion of our accounting of the acquisition of Nexmo, we adjusted our cumulative domestic Federal NOLs to \$585,622 as of June 30, 2017 and did not impact our cumulative state NOLs or the United Kingdom.

On June 8, 2017, at the Vonage 2017 annual meeting of stockholders, stockholders ratified the extension of the Tax Benefits Preservation Plan ("Preservation Plan") through June 30, 2019. Refer to Note 8, Common Stock to our Annual Report on Form 10-K for the year ended December 31, 2016 for a complete description of the Preservation Plan.

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

You should read the following discussion together with our condensed consolidated financial statements and the related notes included elsewhere in this Form 10-Q and our audited financial statements included in our Annual Report on Form 10-K. This discussion contains forward-looking statements. These forward-looking statements are based on information available at the time the statements are made and/or management's belief as of that time with respect to future events and involve risks and uncertainties that could cause actual results and outcomes to be materially different. Important factors that could cause such differences include but are not limited to: the competition we face; the expansion of competition in the cloud communications market; our ability to adapt to rapid changes in the cloud communications market; the nascent state of the cloud communications for business market; our ability to retain customers and attract new customers; the risk associated with developing and maintaining effective internal sales teams and effective distribution channels; risks related to the acquisition or integration of businesses we have acquired; security breaches and other compromises of information security; risks associated with sales of our services to medium-sized and enterprise customers; our reliance on third party hardware and software; our dependence on third party facilities, equipment, systems and services; system disruptions or flaws in our technology and systems; our ability to scale our business and grow efficiently; our dependence on third party vendors; the impact of fluctuations in economic conditions, particularly on our small and medium business customers; our ability to comply with data privacy and related regulatory matters; our ability to obtain or maintain relevant intellectual property licenses; failure to protect our trademarks and internally developed software; fraudulent use of our name or services; intellectual property and other litigation that have been and may be brought against us; reliance on third parties for our 911 services; uncertainties relating to regulation of VoIP services; risks associated with legislative, regulatory or judicial actions regarding our CPaaS products; the impact of governmental export controls or sanctions on our CPaaS products; our ability to establish and expand strategic alliances; risks associated with operating abroad; risks associated with the taxation of our business; risks associated with a material weakness in our internal controls; our dependence upon key personnel; governmental regulation and taxes in our international operations; liability under anti-corruption laws; our dependence on our customers' existing broadband connections; differences between our services and traditional telephone service; restrictions in our debt agreements that may limit our operating flexibility; foreign currency exchange risk; the market for our stock; our ability to obtain additional financing if required; any reinstatement of holdbacks by our credit card processors; our history of net losses and ability to achieve consistent profitability in the future; and other factors that are set forth in the "Risk Factors" in our Annual Report on Form 10-K, in our Quarterly Reports on Form 10-Q and in our Current Reports on Form 8-K. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, and therefore, you should not rely on these forward-looking statements as representing our views as of any date subsequent to the date this Form 10-Q is filed with the Securities and Exchange Commission.

Financial Information Presentation

For the financial information discussed in this Quarterly Report on Form 10-Q, other than per share, per line and per seat amounts, dollar amounts are presented in thousands, except where noted. All trademarks are the property of their owners.

Overview and Strategy

We are a leading provider of cloud communications services for businesses and consumers. Our business services transform the way people work and businesses operate through a portfolio of communications solutions that enable internal collaboration among employees, while also keeping companies closely connected with their customers, across any mode of communication, on any cloud-connected device. Vonage customers can choose among or combine two separate service delivery options to suit their specific cloud communication needs. They can buy Vonage Business as a subscription and they can buy our Vonage API Platform and consume our cloud communication as a service product as programmable modules, delivered via application program interfaces. We also provide a robust suite of feature-rich residential communication solutions.

Business

For our Business customers, we provide innovative, cloud-based Unified Communications as a Service, or UCaaS, solutions, comprised of integrated voice, text, video, data, collaboration, and mobile applications over our flexible, scalable Session Initiation Protocol (SIP) based Voice over Internet Protocol, or VoIP, network. Through our acquisition of Nexmo in 2016, we also offer CPaaS solutions designed to enhance the way businesses communicate with their customers by embedding communications into apps, websites and business processes. In combination, our products and services permit our business customers to communicate with their customers and employees through any cloud-connected device, in any place, at any time without the often costly investment required with on-site equipment. We have a robust set of product families tailored to serve the full range of the business value chain, from the small and medium business, or SMB, market, through mid-market and enterprise markets. We provide customers with multiple deployment options, designed to provide the reliability and quality of service they demand. We provide customers the ability to integrate our cloud communications platform with many cloud-based productivity and CRM solutions, including Google's G Suite, Zendesk, Salesforce's Sales Cloud, Oracle, and Clio.

Our Business strategy is to support the full range of business customers, using two product families: Vonage Essentials, based on our proprietary call processing platform that is purpose-built for SMB and mid-market customers; and Vonage Premier, based on Broadsoft's call processing platform in combination with other Vonage cloud based solutions, which serves larger customers, from mid-market businesses through large enterprises. We also organized our salesforce to address the full business market. We believe operating two platforms at scale enables us to deliver the right products and solutions to address the needs of diverse customers while maximizing our subscriber economics, regardless of segment served. Revenues are generated primarily through the sale of subscriptions for our UCaaS services. Our revenue generation efforts are focused on customer acquisition and retention as well as providing additional services to existing customers as they grow and scale.

Our diverse customer base spans a wide variety of industries, including manufacturing, automotive, legal, information technology, financial services, construction, real estate, engineering, healthcare, and non-profit.

Vonage Essentials. Vonage Essentials customers subscribe to our cloud-based communication services, delivered through our proprietary platform that is purpose-built for SMB and mid-market customers. Essentials provides a cost-effective, scalable, feature-rich solution, delivered over-the-top of a customer's broadband, typically month-to-month without a commitment. Vonage Essentials is sold primarily through our direct telesales and online channels, and is increasingly sold through our channel partners and field sales teams. We believe the strength of the Vonage brand directly contributes to a lower-cost customer acquisition model and provides attractive subscriber economics.

Vonage Premier. Our Vonage Premier offerings are tailor-made for the large mid-market and enterprise segments. Vonage Premier is a feature-rich/fully managed solution that utilizes Broadsoft Inc.'s ("Broadsoft") enterprise-grade call processing platform, in combination with other cloud services like advanced contact center, video conferencing and speak2dial, and can be provided with high-level quality of service ("QoS"), which is generally delivered over our national MPLS network, with 21 network Points of Presence (POPs) across the country. Vonage can also provide QoS-level quality over-the-top of the customer's broadband through our Smart-WAN router solution. Customers value our proprietary provisioning and feature-management tool, named Zeus, which enables the rapid deployment of solutions directly by Vonage while giving full visibility to our channel partners and our customers. Further differentiating Vonage is our robust service delivery team comprised of team members specializing in project management, voice and data provisioning, and line number porting. This team is intensely focused on providing an outstanding customer experience, and is rapidly becoming a competitive differentiator.

Our Vonage Premier offering is sold primarily through our channel partners, and our field and enterprise sales teams, and generally requires a three-year contract. We are a preferred provider for many of the largest master agents in the country, harnessing a network of over 20,000 sub agents selling both Vonage Premier and Vonage Essentials. We believe we have one of the largest multi-channel distribution sales platforms in our industry to serve the full range of business customers. We plan to capitalize on the growing adoption of cloud-based communications and collaboration solutions by continuing to expand our salesforce, expand into new markets, and enhance our relationships with existing customers to provide additional functionality and overall business value that can be achieved with our UCaaS platform.

Nexmo, the Vonage API Platform. We are a global leader in the CPaaS segment of the cloud communications market, providing innovative communication APIs for text messaging and voice communications, allowing developers and enterprises to embed contextual communications into mobile apps, websites and business workflows via text, social media, chat apps and voice. With just few lines of code, developers can send and receive text messages and build programmable voice applications. Nexmo, the Vonage API Platform can scale from one API call to billions. The platform makes it easy for any of our over 200,000 developers to access communication services via software and APIs. Through Nexmo we have a global network of interconnected carriers delivering our API-based communications platform, enabling businesses to communicate with their customers reliably and with ease, no matter where in the world they are located. The addition of our Nexmo products to our Business offering allows our customers to address their full communications needs, from employee to employee communications through business to customer communications.

Consumer

For our Consumer customers, we enable users to access and utilize our services and features, via a single “identity,” either a number or user name, regardless of how they are connected to the Internet, including over 3G, LTE, Cable, or DSL broadband networks. This technology enables us to offer our Consumer customers attractively priced voice and messaging services and other features around the world on a variety of devices.

Our Consumer strategy is focused on the continued penetration of our core North American markets, where we will continue to provide value in international long distance and target under-served ethnic segments. The markets for international long distance allow us to leverage our VoIP network by providing customers a low-cost and feature-rich alternative to services offered by telecom, cable, and international calling card providers.

We generate revenue through the acquisition and retention of Consumer customers. We are focused on optimizing the Consumer business for profitability to improve the strong cash flows of the business. During 2016, we continued our disciplined focus on marketing efficiency by shifting customer acquisition spend to our higher performing channels, improving the quality of customers we acquire and driving lower churn, all of which drive higher customer life-time value. This focus has led to a reallocation of marketing spend to our Business segment.

The result of these initiatives has been to create a strong cash flow business which provides financial stability, as well as cost synergies and structural advantages to our Business segment.

Services outside of the United States. We currently have UCaaS and consumer operations in the United States, United Kingdom, and Canada and believe that our low-cost Internet based communications platform enables us to cost effectively deliver voice and messaging services to other locations throughout the world. Through Nexmo, we have operations in the United States, United Kingdom, Hong Kong, and Singapore, and provide CPaaS solutions to our customers located in many countries around the world.

We had approximately 2.3 million combined consumer subscriber lines and business seats as of June 30, 2017. Customers in the United States represented 85% of our consolidated revenues at June 30, 2017, with the balance in Canada, the United Kingdom, and other countries. Nexmo has operations in the United States, United Kingdom, Hong Kong, and Singapore, and provides CPaaS solutions to our customers located in many countries around the world.

Trends in Our Industry

A number of trends in our industry have a significant effect on our results of operations and are important to an understanding of our financial statements.

Competitive landscape. We face intense competition from traditional telephone companies, wireless companies, cable companies, and alternative communication providers. Most traditional wireline and wireless telephone service providers and cable companies are substantially larger and better capitalized than we are and have the advantage of a large existing customer base. In addition, because our competitors provide other services, they often choose to offer VoIP services or other voice services as part of a bundle that includes other products, such as video, high speed Internet access, and wireless telephone service, which we do not offer. In addition, such competitors may in the future require new customers or existing customers making changes to their service to purchase voice services when purchasing high speed Internet access. Further, as wireless providers offer more minutes at lower prices, better coverage, and companion landline alternative services, their services have become more attractive to households as a replacement for wireline service. We also compete against alternative communication providers, such as Twilio, Ooma, magicJack, Skype, WhatsApp, and Google Voice. Some of these service providers have chosen to sacrifice telephony revenue in order to gain market share and have offered their services at low prices or for free. As we continue to introduce applications that integrate different forms of voice and messaging services over multiple devices, we are facing competition from emerging competitors focused on similar integration, as well as from alternative voice communication providers. In addition, our competitors have partnered and may in the future partner with other competitors to offer products and services, leveraging their collective competitive positions. We also are subject to the risk of future disruptive technologies. In connection with our emphasis on the international long distance market in the United States, we face competition from low-cost international calling cards and VoIP providers in addition to traditional telephone companies, cable companies, and wireless companies, each of which may implement promotional pricing targeting international long distance callers.

Regulation. Our business has developed in a relatively lightly regulated environment. The United States and other countries, however, are examining how VoIP services should be regulated. In particular, state telecommunications regulators continue to try to regulate VoIP service despite the FCC's 2004 Vonage Preemption Order that preempted state regulation. For example, on July 28, 2015, the Minnesota Public Utility Commission found that it has authority to regulate Charter's 'fixed' interconnected VoIP service. In addition to regulatory matters that directly address VoIP, a number of other regulatory initiatives could impact our business. One such regulatory initiative is net neutrality. On February 26, 2015, the FCC adopted strong net neutrality rules. Several parties filed appeals which are pending at the D.C. Circuit Court of Appeals. Oral arguments at the D.C. Circuit Court of Appeals were held on December 4, 2015. On June 14, 2016, the D.C. Circuit of Appeals denied the appeals. Several parties filed a petition for rehearing en banc on July 29, 2016, which was denied on May 1, 2017. See also the discussion under "Regulation" in Note 7 to our

financial statements for a discussion of regulatory issues that impact us.

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Key Operating Data

The table below includes key operating data that our management uses to measure the growth and operating performance of the Business segment:

Business	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Revenues ⁽¹⁾	\$123,714	\$85,712	\$235,516	\$159,532
Average monthly revenues per seat ⁽²⁾	\$43.99	\$44.76	\$43.93	\$44.65
Seats (at period end) ^{(2) (3)}	683,079	591,707	683,079	591,707
Revenue churn ⁽²⁾	1.4	% 1.4	% 1.4	% 1.4

(1) Includes revenue from CPaaS of \$35,171 and \$61,416 for the three and six months ended June 30, 2017, respectively, and \$7,698 for both the three and six months ended June 30, 2016.

(2) UCaaS only.

(3) Seats (at period end) included an adjustment of 13,352 for both the three and six months ended June 30, 2016. Revenues. Includes revenues from our business customers from acquired entities and excludes revenues from our legacy business customers.

Average monthly revenues per seat. Average monthly revenues per seat for a particular period is calculated by dividing revenues for that period by the simple average number of seats for the period, and dividing the result by the number of months in the period. The simple average number of seats for the period is the number of seats on the first day of the period, plus the number of seats on the last day of the period, divided by two. Our average monthly revenues per seat decreased from \$44.76 and \$44.65 for the three and six months ended June 30, 2016, respectively, to \$43.99 and \$43.93 for the three and six months ended June 30, 2017 due to our plan to sell access more selectively and the removal of one month of revenues associated with our Hosted Infrastructure product line.

Seats. Seats include, as of a particular date, all paid seats from which a customer can make an outbound telephone call on that date and virtual seats. Seats exclude electronic fax lines and toll free numbers, which do not allow outbound telephone calls by customers. Seats increased from 591,707 as of June 30, 2016 to 683,079 as of June 30, 2017. This increase is due to continued growth in our business customers as we have increased marketing investment to attract these more profitable customers.

Revenue Churn. Revenue churn is calculated by dividing the monthly recurring revenue from customers or customer locations that have terminated during a period by the simple average of the total monthly recurring revenue from all customers in a given period. The simple average of total monthly recurring revenue from all customers during the period is the total monthly recurring revenue on the first day of the period, plus the total monthly recurring revenue on the last day of the period, divided by two. Terminations, as used in the calculation of churn statistics, do not include customers terminated during the period if termination occurred within the first month after activation. Other companies may calculate revenue churn differently, and their revenue churn data may not be directly comparable to ours. Revenue churn was 1.4% for each of the three and six months ended June 30, 2017 and June 30, 2016. Our revenue churn will fluctuate over time due to economic conditions, loss of customers who are acquired, and competitive pressures including promotional pricing. We are continuing to invest in our overall quality of service which includes customer care headcount and systems, billing systems, on-boarding processes and self-service options to ensure we scale our processes to our growth and continue to improve the overall customer experience.

The table below includes key operating data that our management uses to measure the growth and operating performance of the Consumer segment:

Consumer	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Revenues	\$128,122	\$147,963	\$259,667	\$300,967
Average monthly revenues per subscriber line	\$26.33	\$26.61	\$26.18	\$26.64
Subscriber lines (at period end)	1,594,857	1,824,668	1,594,857	1,824,668
Customer churn	1.9	% 2.1	% 2.0	% 2.2

Revenues. Represents revenue from our Consumer customers including revenues from our legacy business customers using Vonage VoIP products.

Average monthly revenues per subscriber line. Average monthly revenues per subscriber line for a particular period is calculated by dividing our revenues for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. The simple average number of subscriber lines for the period is the number of subscriber lines on the first day of the period, plus the number of subscriber lines on the last day of the period, divided by two. Our average monthly revenues per subscriber line decreased from \$26.61 and \$26.64 for the three and six months ended June 30, 2016, respectively, to \$26.33 and \$26.18 for the three and six months ended June 30, 2017, respectively, due primarily to lower ILD pay-per-use revenue.

Subscriber lines. Our subscriber lines include, as of a particular date, all paid subscriber lines from which a customer can make an outbound telephone call on that date. Our subscriber lines include fax lines, including fax lines bundled with subscriber lines in our small office home office calling plans and soft phones, but do not include our virtual phone numbers and toll free numbers, which only allow inbound telephone calls to customers. Subscriber lines decreased from 1,824,668 as of June 30, 2016 to 1,594,857 as of June 30, 2017, reflecting planned actions to enhance the profitability of the assisted sales channel by eliminating lower performing locations and restructuring the pricing offers, and to shift investment to our business market.

Customer churn. Customer churn is calculated by dividing the number of customers that have terminated during a period by the simple average of number of customers in a given period. The simple average number of customers during the period is the number of customers on the first day of the period, plus the number of customers on the last day of the period, divided by two. Terminations, as used in the calculation of churn statistics, do not include customers terminated during the period if termination occurred within the first month after activation. Other companies may calculate customer churn differently, and their customer churn data may not be directly comparable to ours. Customer churn decreased to 1.9% for the three months ended June 30, 2017 from 2.1% for the three months ended June 30, 2016, and decreased to 2.0% from 2.2% the six months ended June 30, 2017 and 2016, respectively. We monitor customer churn on a daily basis and use it as an indicator of the level of customer satisfaction. Customers who have been with us for a year or more tend to have a lower churn rate than customers who have not. In addition, our customers who are international callers generally churn at a lower rate than customers who are domestic callers. Our customer churn will fluctuate over time due to economic conditions, competitive pressures including promotional pricing targeting international long distance callers, marketplace perception of our services, and our ability to provide high quality customer care and network quality and add future innovative products and services.

Results of Operations

The following table sets forth, as a percentage of total revenues, our consolidated statement of operations for the periods indicated:

	Three Months Ended June 30, 2017		Six Months Ended June 30, 2016	
	100 %	100 %	100 %	100 %
Total revenues	100 %	100 %	100 %	100 %
Operating Expenses:				
Cost of service (exclusive of depreciation and amortization)	39	33	37	32
Cost of goods sold	2	3	3	4
Sales and marketing	32	36	33	35
Engineering and development	3	3	3	3
General and administrative	14	15	14	13
Depreciation and amortization	7	8	7	8
Total operating expenses	97	98	97	95
Income from operations	3	2	3	5
Other Income (Expense):				
Interest income	—	—	—	—
Interest expense	(2)	(1)	(2)	(1)
Other income (expense), net	—	—	—	—
Total other income (expense), net	(2)	(1)	(2)	(1)
Income before income taxes	1	1	1	4
Income tax benefit (expense)	1	(1)	1	(2)
Net income	2 %	— %	2 %	2 %

Management's discussion of the results of operations for the Three and Six Months Ended June 30, 2017 and 2016
We calculate gross margin in order to evaluate operating revenues as total revenues less cost of service, which primarily consists of fees that we pay to third parties on an ongoing basis in order to provide our services, and cost of goods sold which primarily includes costs incurred when a customer first subscribes to our service. The following table presents the composition of gross margin for the three and six month periods ending June 30, 2017 and 2016: (in thousands, except percentages)

	Three Months Ended June 30,				Six Months Ended June 30,			
	2017	2016	Dollar Change	Percent Change	2017	2016	Dollar Change	Percent Change
Total revenues	\$251,836	\$233,675	\$18,161	8 %	\$495,183	\$460,499	\$34,684	8 %
Cost of service	97,674	76,078	21,596	28 %	185,270	145,228	40,042	28 %
Cost of goods sold	6,187	8,352	(2,165)	(26)%	13,480	17,418	(3,938)	(23)%
Gross margin	\$147,975	\$149,245	\$(1,270)	(1)%	\$296,433	\$297,853	\$(1,420)	— %

Excludes depreciation and amortization of \$6,863 and \$6,985 for the three months ended June 30, 2017 and 2016, respectively and \$13,645 and \$13,818 for the six months ended June 30, 2017 and 2016, respectively.

Business Gross Margin

(in thousands, except percentages)	Three Months Ended June 30,				Six Months Ended June 30,			
	2017	2016	Dollar Change	Percent Change	2017	2016	Dollar Change	Percent Change
Revenues								
Service revenues	\$103,825	\$67,079	\$36,746	55 %	\$196,116	\$123,552	\$72,564	59 %
Product revenues ⁽¹⁾	13,392	13,265	127	1 %	26,752	26,177	575	2 %
Service and product revenues	117,217	80,344	36,873	46 %	222,868	149,729	73,139	49 %
USF revenues	6,497	5,368	1,129	21 %	12,648	9,803	2,845	29 %
Total revenues	123,714	85,712	38,002	44 %	235,516	159,532	75,984	48 %
Cost of revenues								
Service cost of revenues ⁽²⁾	49,246	22,527	26,719	119 %	88,441	37,930	50,511	133 %
Product cost of revenues ⁽¹⁾	12,456	12,902	(446)	(3)%	25,658	25,364	294	1 %
Service and product cost of revenues	61,702	35,429	26,273	74 %	114,099	63,294	50,805	80 %
USF cost of revenues	6,497	5,369	1,128	21 %	12,648	9,814	2,834	29 %
Total cost of revenues	68,199	40,798	27,401	67 %	126,747	73,108	53,639	73 %
Gross margin								
Service margin	54,579	44,552	10,027	23 %	107,675	85,622	22,053	26 %
Gross margin ex-USF (Service and product margin)	55,515	44,915	10,600	24 %	108,769	86,435	22,334	26 %
Gross margin	\$55,515	\$44,914	\$10,601	24 %	\$108,769	\$86,424	\$22,345	26 %
Gross Margin %								
Service margin %		52.6%	66.4%		54.9%	69.3%		
Gross margin ex-USF (Service and product margin) %		47.4%	55.9%		48.8%	57.7%		
Gross margin %		44.9%	52.4%		46.2%	54.2%		

(1) Includes customer premise equipment, access, professional services, and shipping and handling.

(2) Excludes depreciation and amortization for the three and six months ended June 30, 2017 of \$5,003 and \$9,878, respectively and for the three and six months ended June 30, 2016 \$4,473, and \$8,792, respectively.

Three Months Ended June 30, 2017 compared to Three Months Ended June 30, 2016

Service revenues. Service revenues increased by \$36,746, or 55%, due primarily to Nexmo, which was acquired on June 3, 2016 and represents 34% of the total increase as compared to the prior year quarter which excludes a current period correction in reporting a portion of revenues on a gross basis rather than net. Service revenues were also favorably impacted by an increase in the number of Business seats as we have shifted marketing investments from Consumer to attract more profitable Business customers. During 2017, our CPaaS revenue growth has predominately come from lower margin business for which our strategy of increasing higher margin CPaaS integrated voice business is currently underway. This increase is slightly offset by decrease in service revenues attributed to the sale of our Hosted Infrastructure product line completed on May 31, 2017.

Service cost of revenues. Service cost of revenues increased by \$26,719, or 119%, due primarily to costs associated with Nexmo which was acquired on June 3, 2016. Costs were also slightly impacted by higher technical care costs and network operations cost in support of growth in segment.

USF revenues and USF cost of revenues. USF revenues increased by \$1,129, or 21% and USF cost of revenues increased by \$1,128, or 21%, due to synchronization of methodologies across Business segment and increase in the number of Business seats.

Six Months Ended June 30, 2017 compared to Six Months Ended June 30, 2016

Service revenues. Service revenues increased by \$72,564, or 59%, due primarily to the acquisition of Nexmo on June 3, 2016 which attributed to approximately 43% of the increase as compared to the six months ended June 30, 2016.

Also attributing to the increase in the current year was an increase in the number of Business seats as we have shifted marketing investments from Consumer to attract more profitable Business customers.

Service cost of revenues. Service cost of revenues increased by \$50,511, or 133%, due primarily to the acquisition of Nexmo along with the prospective presentation beginning the quarter ended June 30, 2017 of costs associated with Nexmo's trading activities on a gross basis as discussed above. Costs during the current year period are also slightly higher due to increased technical care costs and network operations cost in support of growth in the segment.

USF revenues and USF cost of revenues. USF revenues increased by \$2,845, or 29% and USF cost of revenues increased by \$2,834, or 29%, due to synchronization of methodologies across Business segment and increase in the number of Business seats.

Consumer Gross Margin

(in thousands, except percentages)	Three Months Ended June 30,				Six Months Ended June 30,			
	2017	2016	Dollar Change	Percent Change	2017	2016	Dollar Change	Percent Change
Revenues								
Service revenues	\$115,636	\$133,462	\$(17,826)	(13)%	\$234,753	\$271,234	\$(36,481)	(13)%
Product revenues ⁽¹⁾	201	160	41	26%	404	307	97	32%
Service and product revenues	115,837	133,622	(17,785)	(13)%	235,157	271,541	(36,384)	(13)%
USF revenues	12,285	14,341	(2,056)	(14)%	24,510	29,426	(4,916)	(17)%
Total revenues	128,122	147,963	(19,841)	(13)%	259,667	300,967	(41,300)	(14)%
Cost of revenues								
Service cost of revenues ⁽²⁾	21,435	25,727	(4,292)	(17)%				