BOISE INC.
Form SC 14D9
September 26, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14D-9

(Rule 14d-101)

Solicitation/Recommendation Statement

Under Section 14(d)(4) of the Securities Exchange Act of 1934

BOISE INC.

(Name of Subject Company)

BOISE INC.

(Name of Persons Filing Statement)

Common Stock, par value $0.0001 per share

(Title of Class of Securities)

09746Y105

(CUSIP Number of Class of Securities)

Karen E. Gowland

Senior Vice President, General Counsel and Secretary

Boise Inc.

1111 West Jefferson Street, Suite 200

Boise, Idaho 83702-5388

(208) 384-7000

(Name, address, and telephone numbers of person authorized to receive

notices and communications on behalf of the persons filing statement)

Copies to

Margaret A. Brown

Skadden, Arps, Slate, Meagher & Flom LLP

One Beacon Street

Boston, Massachusetts 02108

(617) 573-4800

¨ Check the box if the filing relates solely to preliminary communications made before the commencement of a tender offer.

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ITEM 1. SUBJECT COMPANY INFORMATION.

Name and Address.

The name of the subject company is Boise Inc., a Delaware corporation (the **Company**), and the address of the principal executive offices of the Company is 1111 West Jefferson Street, Suite 200, Boise, Idaho 83702-5388. The telephone number for the Company s principal executive offices is (208) 384-7000.

Securities.

The title of the class of equity securities to which this Solicitation/Recommendation Statement on Schedule 14D-9 (together with any Exhibits or Annexes hereto, this **Statement**) relates is the Company s common stock, par value $0.0001 per share (the **Company Common Stock**). As of the close of business on September 20, 2013, there were 100,882,451 shares of Company Common Stock issued and outstanding.

ITEM 2. IDENTITY AND BACKGROUND OF FILING PERSON.

Name and Address.

The name, business address and business telephone number of the Company, which is the person filing this Statement, are set forth above in *Item 1. Subject Company Information Name and Address.*

Tender Offer.

This Statement relates to the cash tender offer by Bee Acquisition Corporation, a Delaware corporation (**Purchaser**) and a wholly-owned subsidiary of Packaging Corporation of America (**Parent**), to purchase all of the outstanding shares (the **Shares**) of Company Common Stock at a purchase price of $12.55 per Share (such amount or any greater amount per Share that may be paid pursuant to the Offer, the **Offer Price**), net to the holder thereof in cash, without interest and subject to any withholding of taxes required by applicable law, upon the terms and subject to the conditions set forth in the Offer to Purchase, dated September 26, 2013 (as it may be amended or supplemented from time to time, the **Offer to Purchase**), and the related Letter of Transmittal (as it may be amended or supplemented from time to time, the **Letter of Transmittal**) (which offer, upon such terms and subject to such conditions, as it and they may be amended or supplemented from time to time, constitutes the **Offer**). Copies of the Offer to Purchase and the Letter of Transmittal are filed as Exhibits (a)(1)(A) and (a)(1)(B) hereto, respectively, and are incorporated herein by reference. The Offer is described in a Tender Offer Statement on Schedule TO, dated September 26, 2013 (together with the exhibits thereto, as it or they may be amended or supplemented from time to time, the **Schedule TO**), filed by Parent and Purchaser with the U.S. Securities and Exchange Commission (the **SEC**).

The Offer is being made pursuant to an Agreement and Plan of Merger, dated as of September 16, 2013 (as amended or supplemented from time to time, the **Merger Agreement**), by and among Parent, Purchaser and the Company. The Merger Agreement provides, among other things, that following the consummation of the Offer and subject to the satisfaction or waiver of the applicable conditions set forth in the Merger Agreement, and in accordance with the General Corporation Law of the State of Delaware (the **DGCL**), Purchaser will merge with and into the Company (the **Merger**), with the Company surviving as a wholly-owned subsidiary of Parent (the **Surviving Company**). The Merger will be governed by Section 251(h) of the DGCL, and consequently no stockholder vote will be required to consummate the Merger. At the effective time of the Merger (the **Effective Time**), each Share not acquired in the Offer (other than Shares owned by Parent, Purchaser, any other direct or indirect wholly-owned subsidiary of Parent or the Company, or by any stockholder of the Company who or which properly exercises appraisal rights pursuant to

Section 262 of the DGCL) will be cancelled and converted into the right to receive an amount in cash equal to the Offer Price (the **Merger Consideration**), without interest and subject to any withholding of taxes required by applicable law. A copy of the Merger Agreement is filed as Exhibit (e)(1) hereto and is incorporated herein by reference.

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The Offer is initially scheduled to expire at 12:00 midnight (Eastern Time) on October 24, 2013, subject to extension in certain circumstances as required or permitted by the Merger Agreement, the SEC or applicable law.

The foregoing summary of the Offer is qualified in its entirety by reference to the more detailed description and explanation contained in the Merger Agreement, the Offer to Purchase, the Letter of Transmittal and other related materials.

As set forth in the Schedule TO, the address of the principal executive offices of Parent and Purchaser is 1955 West Field Court, Lake Forest, Illinois 60045, and the telephone number at such offices is (847) 482-3000.

In addition, all of these materials (and all other tender offer documents filed with the SEC) will be available at no charge from the SEC through its website at www.sec.gov.

ITEM 3. PAST CONTACTS, TRANSACTIONS, NEGOTIATIONS AND AGREEMENTS.

Except as set forth in this Schedule 14D-9 or as otherwise incorporated herein by reference, to the knowledge of the Company, as of the date of this Schedule 14D-9, there are no material agreements, arrangements or understandings or any actual or potential conflicts of interest between the Company or any of its affiliates and (i) the Company s executive officers, directors or affiliates or (ii) Parent, Purchaser or any of their respective executive officers, directors or affiliates.

Arrangements with Parent and Purchaser.

The Merger Agreement.

The summary of the material terms of the Merger Agreement set forth in Section 10 *The Merger Agreement; Other Agreements Merger Agreement* of the Offer to Purchase and the description of the terms and conditions of the Offer contained in Section 1 *Terms of the Offer* and Section 15 *Conditions of the Offer* of the Offer to Purchase are incorporated herein by reference.

The Merger Agreement governs the contractual rights among the Company, Parent and Purchaser in relation to the Offer and the Merger. The Merger Agreement has been included as an exhibit to this Schedule 14D-9 to provide the Company s stockholders with information regarding the terms of the Merger Agreement and is not intended to modify or supplement any factual disclosures about the Company, Parent or Purchaser made in the Company s public reports filed with the SEC. In particular, the assertions embodied in the representations and warranties contained in the Merger Agreement are qualified by information in a confidential disclosure schedule provided by the Company to Parent and Purchaser in connection with the signing of the Merger Agreement. Such disclosure schedule contains information that modifies, qualifies and creates exceptions to the representations and warranties set forth in the Merger Agreement. Moreover, certain representations and warranties in the Merger Agreement were used for the purpose of allocating risk among the Company, Parent and Purchaser, rather than establishing matters of fact. Accordingly, the representations and warranties in the Merger Agreement may not represent the actual state of facts about the Company, Parent or Purchaser. Other than the indemnification provisions of the Merger Agreement (which are discussed in *Effect of the Offer on Directors and Officers Indemnification and Insurance* below), the rights of the Company s stockholders to receive the Offer Price and the Merger Consideration and the holders of certain equity awards to receive the consideration described in the Merger Agreement, the rights of the Company (on behalf of stockholders) to pursue certain equitable remedies on stockholders behalf and the rights of certain financing sources of Parent and Purchaser as set forth in the Merger Agreement, nothing in the Merger Agreement shall confer any rights or remedies upon any person other than the parties to the Merger Agreement. The Company s stockholders should not rely on the representations, warranties and covenants contained in the Merger Agreement or any descriptions thereof as characterizations of the actual state of facts or conditions of the Company, Parent, Purchaser or any of their respective subsidiaries or affiliates.

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The foregoing summary of the material terms of the Merger Agreement and the description of the terms and conditions to the Offer contained in the Offer to Purchase do not purport to be complete and are qualified in their entirety by reference to the Merger Agreement, a copy of which is filed as Exhibit (e)(1) hereto and is incorporated herein by reference.

Representation on Board.

The Merger Agreement provides that, promptly upon purchasing pursuant to the Offer that number of Shares validly tendered and not properly withdrawn prior to the expiration of the Offer which, together with the Shares, if any, then owned, directly or indirectly, by Parent or Purchaser or their respective subsidiaries, represents a majority of all the outstanding Shares on a fully diluted basis (after giving effect to the cancellation of outstanding stock options, restricted stock units and performance unit awards issued under the Boise Inc. Incentive and Performance Plan) (the **Minimum Condition**), and from time to time thereafter, Purchaser will be entitled, subject to applicable law and the rules and regulations, including listing standards, of the New York Stock Exchange (the **Securities Exchange Rules**), to designate such number of directors, rounded up to the next whole number, on the board of directors of the Company (the **Company Board**) as will give Purchaser representation on the Company Board equal to the product of the total number of directors on the Company Board (after giving effect to any increase in the number of directors as described below) and the percentage that such number of Shares so purchased (including Shares accepted for payment) bears to the total number of Shares outstanding, and the Company is required, upon request by Purchaser, to promptly increase the size of the Company Board or use its reasonable best efforts to secure the resignations of such number of directors as is necessary to provide Purchaser with such level of representation and to cause Purchaser s designees to be so elected or appointed. Subject to applicable law and the Securities Exchange Rules and certain limitations set forth in the Merger Agreement, the Company will, to the extent requested by Parent, also cause individuals so designated to constitute the same percentage as such individuals represent of the entire Company Board (but no less than a majority) on each committee of the Company Board.

So long as there is at least one director of the Company on the Company Board who is (i) an individual serving as a director of the Company from and after the date of the Merger Agreement or (ii) an individual becoming a director of the Company after the date of the Merger Agreement whose election, or nomination for election by the Company s stockholders, was approved by a vote of at least two-thirds of the directors described in clause (i) or this clause (ii) then comprising the Company Board other than a designee of Parent or Purchaser (each such director, a **Continuing Director**), any amendment or termination of the Merger Agreement requiring action by the Company Board, any extension of time for the performance of any of the obligations or other acts of Parent or Purchaser under the Merger Agreement and any waiver of compliance with any of the agreements or conditions under the Merger Agreement for the benefit of the Company, any exercise of the Company s rights or remedies under the Merger Agreement or any other action by the Company Board with respect to the transactions contemplated thereby, if such action could reasonably be expected to adversely affect any holders of Shares other than Parent, Purchaser or their subsidiaries, will require authorization by a majority of the Continuing Directors (or by the sole Continuing Director if there is only one).

For more information see Section 10 *The Merger Agreement; Other Agreements Merger Agreement Boise s Board of Directors* in the Offer to Purchase.

The summary of the provisions of the Merger Agreement concerning representation on the Company Board does not purport to be complete and is qualified in its entirety by reference to the Merger Agreement.

Confidentiality Agreement.

On September 6, 2013, Boise Paper Holdings, L.L.C., an indirect wholly-owned subsidiary of the Company (**BPH**), and Parent entered into a Confidentiality Agreement (the **Confidentiality Agreement**) that

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superseded all prior confidentiality agreements between the parties, and pursuant to which Parent agreed that, subject to certain limitations, any non-public information concerning the Company and its subsidiaries furnished to it or its representatives by or on behalf of the Company and BPH would, for a period of one year from the date of the Confidentiality Agreement, be used by Parent and its representatives solely for the purpose of evaluating a possible business combination transaction between Parent and the Company and would be kept confidential, except as otherwise provided in the Confidentiality Agreement. Parent also agreed that, subject to certain limited exceptions, it and its affiliates would not solicit for employment certain of the Company s employees prior to May 2, 2015.

The foregoing summary of the provisions of the Confidentiality Agreement does not purport to be complete and is qualified in its entirety by reference to the Confidentiality Agreement, a copy of which is filed as Exhibit (e)(2) hereto and is incorporated herein by reference.

Interests of Certain Persons; Agreements and Arrangements with Current Executive Officers and Directors of the Company.

The executive officers and directors of the Company may be deemed to have interests in the Offer and the Merger that are different from, or in addition to, their interests as Company stockholders generally. The Company Board was aware of these potentially differing interests (including as a result of equity awards and severance agreements discussed in this Schedule 14D-9) and considered them, among other matters, in evaluating and negotiating the Merger Agreement and in reaching its decision to approve the Merger Agreement and the transactions contemplated thereby, as more fully discussed below in *Item 4. The Solicitation or Recommendation Background and Reasons for the Company Board s Recommendation Reasons for the Recommendation*.

Treatment of Shares Held by Directors and Executive Officers Pursuant to the Offer and the Merger.

The Company s directors and executive officers who tender their Shares in the Offer will receive the same cash consideration per Share (on the same terms and conditions) as the other stockholders of the Company who tender their Shares in the Offer. If the directors and executive officers did not tender their Shares in the Offer and the Merger were to occur, they would receive the same cash consideration per Share (on the same terms and conditions) in the Merger as the other stockholders of the Company.

Effect of the Merger Agreement on Equity Awards.

Treatment of Company Options.

The Merger Agreement provides that immediately prior to the Acceptance Time, each outstanding compensatory option to purchase shares of Company Common Stock (**Company Option**) under the Boise Inc. Incentive and Performance Plan (the **Company Equity Plan**) will become fully vested and exercisable and will be cancelled, with the holder thereof becoming entitled to receive a cash payment from the Company equal to the product obtained by multiplying (i) the excess, if any, of the Offer Price over the exercise price per share of such Company Option by (ii) the number of shares of Company Common Stock issuable upon exercise of such Company Option, subject to any withholding of taxes required by applicable law.

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None of the Company s non-employee directors hold Company Options. Based upon the holdings of Company Options as of September 20, 2013, the respective exercise price of such options and the Offer Price of $12.55, the consideration that each of the Company s executive officers would receive with respect to their Company Options in connection with the Offer and Merger is as follows:

Name of Executive Officer	Number of Vested Company Options	Payments in Respect of Vested Company Options ($)	Number of Unvested Company Options	Payments in Respect of Unvested Company Options ($)(1)	Total Company Option Payments ($)
Alexander Toeldte	131,904	547,836	197,130	1,029,559	1,577,395
Samuel K. Cotterell	29,151	121,145	43,799	228,554	349,699
Judith M. Lassa	21,238	88,208	31,740	165,762	253,970
Karen E. Gowland	21,238	88,208	31,740	165,762	253,970
Robert Strenge	19,580	81,062	28,424	149,073	230,135
Bernadette Madarieta	9,871	40,769	14,016	73,757	114,526

(1) Includes payment in respect of dividend equivalent rights.

Treatment of Company Restricted Stock Units.

The Merger Agreement provides that, as of the time that Purchaser accepts for payment all Shares validly tendered and not properly withdrawn pursuant to the Offer (the **Acceptance Time**), each outstanding restricted stock unit as of immediately prior to the Acceptance Time (other than Company Performance Unit Awards) entitling the recipient to receive, upon vesting, shares of Company Common Stock granted under the Company Equity Plan (**Company RSU**), whether or not vested, will be cancelled in exchange for the right to receive a cash payment, without interest, equal to the product obtained by multiplying (i) the Offer Price by (ii) the number of shares of Company Common Stock underlying such Company RSU (assuming full vesting of such Company RSU), subject to any withholding of taxes required by applicable law.

The Merger Agreement provides that, as of the Acceptance Time, each restricted stock unit outstanding as of immediately prior to the Acceptance Time that entitles the recipient to receive, upon vesting based upon the attainment of designated performance goals, shares of Company Common Stock granted under the Company Equity Plan (**Company Performance Unit Awards**), whether or not vested, will be cancelled in exchange for the right to receive a cash payment, without interest. For Company Performance Unit Awards for which the applicable performance measure is total stockholder return, the cash payment will be equal to the product obtained by multiplying the Offer Price by the number of shares of Company Common Stock which may be earned pursuant to such Company Performance Unit Award based upon actual performance through the Acceptance Time. For other Company Performance Unit Awards, the cash payment will be equal to the product obtained by multiplying (i) the Offer Price by (ii) the greater of (a) the number of shares of Company Common Stock which may be earned pursuant to such Company Performance Unit Award based upon performance at the target level of performance and (b) the number of shares of Company Common Stock which may be earned pursuant to such Company Performance Unit Award based upon actual performance prior to the Acceptance Time (determined in accordance with the provisions of the award agreement governing such Company Performance Unit Award), subject to any withholding of taxes required by applicable law.

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None of the Company s non-employee directors hold Company RSUs or Company Performance Unit Awards. Based upon the holdings of Company RSUs and Company Performance Unit Awards as of September 20, 2013 and the Offer Price of $12.55, the consideration that each of the Company s executive officers would receive with respect to their Company RSUs and Company Performance Unit Awards in connection with the Offer and Merger is as follows:

Name of Executive Officer	Number of Company RSUs	Payments in Respect of Company RSUs ($)(1)	Number of Company Performance Unit Awards	Payments in Respect of Company Performance Unit Awards ($)(2)
Alexander Toeldte	90,462	1,135,298	306,146	4,927,397
Samuel K. Cotterell	43,021	562,177	70,034	1,128,756
Judith M. Lassa	68,374	874,321	73,534	1,213,691
Karen E. Gowland	33,916	441,873	56,110	911,575
Robert Strenge	26,515	347,798	42,343	682,639
Bernadette Madarieta	0	0	20,947	339,076

(1) Includes payments in respect of dividend equivalent rights.

(2) Includes payments in respect of dividend equivalent rights. For those Company Performance Unit Awards measured based on our comparative total stockholder return, the calculations assume performance corresponding to a maximum payout. The actual adjustment, which will depend on actual performance through the Acceptance Time, cannot be finally determined until the consummation of the Offer.

Treatment of Company Restricted Stock Awards.

The Merger Agreement provides that, as of the Acceptance Time, each restricted share of Company Common Stock (**Company Restricted Stock**) outstanding as of immediately prior to the Acceptance Time will, by virtue of the occurrence of the Acceptance Time and without any action on the part of any holder of any share of Company Restricted Stock, be fully vested immediately prior to the Acceptance Time and treated in the manner set forth in the Merger Agreement with respect to Shares generally.

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Based upon the holdings of Company Restricted Stock as of September 20, 2013 and the Merger Consideration of $12.55, the consideration that each of the Company s executive officers and directors would receive with respect to their Company Restricted Stock in connection with the Offer and Merger is as follows:

Name of Executive Officer or Director	Number of Shares of Company Restricted Stock	Payments in Respect of Restricted Stock ($)(1)
Carl A. Albert	69,183	868,247
Jonathan W. Berger	12,579	157,866
Jack Goldman	12,579	157,866
Heinrich R. Lenz	12,579	157,866
Jason G. Weiss	12,579	157,866
Alexander Toeldte	98,765	1,340,397
Samuel K. Cotterell	0	0
Judith M. Lassa	0	0
Karen E. Gowland	0	0
Robert Strenge	0	0
Bernadette Madarieta	13,164	172,829

(1) Includes payments in respect of dividend equivalent rights.

Severance Agreements with Executive Officers.

The Company s executive officers have entered into severance agreements with Boise Paper Holdings, L.L.C. which provide severance benefits upon termination of the executive s employment under certain circumstances.

The executive officer will receive the benefits provided under the agreement if the executive officer voluntarily terminates employment with good reason or the officer s employment is involuntarily terminated without cause (referred to as a qualifying termination). These benefits generally consist of (i) a lump sum severance payment and (ii) continued participation in the Company s benefit plans (or, for the chief executive officer, a payment in lieu of such continued participation). In addition, each of Ms. Lassa s and Ms. Gowland s agreements provides that if she has satisfied the service, but not the age, requirements of the Boise Paper Holdings, L.L.C. Supplemental Early Retirement Plan for Certain Elected Officers (the **SERP**), as in effect immediately prior to her separation, she will receive a monthly benefit, commencing on the earliest date she could have elected to begin receiving benefits under the SERP, equal to the benefit to which she would have been entitled under the SERP, had she satisfied the age and service requirements as of the date of her separation.

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Based on compensation and benefit levels as of September 20, 2013, and assuming (i) that the effective time of the Merger occurs on October 25, 2013, and (ii) that, for purposes of the amounts set forth in the table below, each of the listed executive officers experiences a qualifying termination of employment on such date, the executive officers would be entitled to receive the listed cash payments and benefits in addition to all of the payments described above with respect to Company equity awards. The dates used to quantify these interests have been selected for illustrative purposes only and do not necessarily reflect the dates on which certain events will occur.

Name of Executive Officer	Severance Payments ($)	Benefit Continuation ($)(1)	Unvested Pension Balance ($)(2)	Total ($)
Alexander Toeldte	3,400,000	37,202	0	3,437,202
Samuel K. Cotterell	1,402,500	9,377	0	1,411,877
Judith M. Lassa	1,442,000	8,575	931,033	2,381,608
Karen E. Gowland	635,250	18,392	942,542	1,596,184
Robert Strenge	547,800	15,085	0	562,885
Bernadette Madarieta	420,500	11,441	0	431,941

(1) The continuation of health and welfare benefit values are actuarial estimates of the Company s cost of continuing the benefit, based on our actual costs in 2012. Ms. Lassa s, Ms. Gowland s and Mr. Strenge s severance agreements also provide for continuation of his or her supplemental life insurance benefit, the value of which is estimated based on 2013 premium costs.

(2) In calculating the present values shown, SERP benefits are assumed to commence as of the first of the month following the Named Executive Officer reaching age 55. Present values are calculated as of October 1, 2013, using a 5.21% discount rate and the RP-2000 annuitant and non-annuitant mortality tables with static projections of mortality improvements as prescribed for 2014 funding valuations by Section 430(h)(3)(A) of the Internal Revenue Code of 1986, as amended.

Employee Benefit Matters.

The Merger Agreement provides that as of the Acceptance Time, and until the later of December 31, 2014 and one (1) year following the Effective Time, Parent agrees to (i) provide each employee of the Company or its subsidiaries as of the Acceptance Time with employee benefits, base salary or wages, incentive compensation opportunities, severance and other compensation that are not less favorable, in the aggregate, than those in effect for such employee immediately prior to the Acceptance Time and (ii) provide each such employee who incurs a termination of employment during such period with severance payments and severance benefits that are no less favorable than the severance payments and severance benefits to which such employee would have been entitled with respect to such termination under the severance plans or policies of the Company or the applicable subsidiary as in effect immediately prior to the Acceptance Time. Parent also agrees that, from and after the Acceptance Time, with respect to the 2013 calendar year, Parent shall continue to maintain each of the Company s annual bonus and incentive compensation plans and programs without adverse amendment, measure performance under such plans against the applicable performance goals in a manner that is consistent with the practice of the Company prior to the Acceptance Time and pay out the full amount of earned awards to participants in such plans according to the terms of such plans without application of any discretionary right to reduce the amount payable.

Effect of the Offer on Directors and Officers Indemnification and Insurance.

Parent and Purchaser have agreed that all rights to indemnification, advancement of expenses and exculpation from liabilities for acts or omissions occurring at or prior to the Acceptance Time in favor of each present and former director and officer of the Company or any of its subsidiaries, and each individual who is serving or has served at the request of the Company as a director, officer or trustee of another corporation, partnership, association, limited liability company, joint venture, trust or other entity or organization (each such individual, an **Indemnified Party**), as provided in the Company s and its subsidiaries respective certificates of incorporation or bylaws (or comparable organizational documents) or any indemnification or other agreements of the Company or any of its subsidiaries, in each case as in effect as of immediately prior to the Acceptance Time, shall be honored and fulfilled in all respects following the Acceptance Time. The Company had previously entered into indemnification agreements with its directors and certain of its executive officers. These agreements confirm the Company s obligations to indemnify the directors and officers to the fullest extent permitted by law. The agreements also provide that the Company will advance, if requested by an Indemnified Party, any and all expenses incurred in connection with a proceeding, subject to reimbursement by the indemnified person should a final judicial determination be made that indemnification is not available under applicable law. The Company s obligations under the agreements continue after the Indemnified Party is no longer serving the Company with respect to claims based on the Indemnified Party s service for the Company. In addition, the Merger Agreement provides that, for a period of six years after the Effective Time, Parent and its subsidiaries will cause the certificate of incorporation or bylaws (or comparable organizational documents) of each of the Surviving Company and its subsidiaries to contain provisions with respect to indemnification, advancement of expenses and exculpation that are at least as favorable as the indemnification, advancement of expenses and exculpation provisions contained in the certificates of incorporation and bylaws (or comparable organizational documents) of the Company and its subsidiaries as of the date of the Merger Agreement.

In addition, from and after the Acceptance Time to the date that is the sixth anniversary of the Effective Time, the Company and its subsidiaries are required to (and Parent has agreed to and will cause the Surviving Company and its subsidiaries to) indemnify and hold harmless each Indemnified Party from and against any costs, fees and expenses (including reasonable attorneys fees and investigation expenses), judgments, fines, losses, claims, damages, liabilities and amounts paid in settlement in connection with any claim, proceeding, investigation or inquiry, whether civil, criminal, administrative or investigative, to the extent arising directly or indirectly out of or pertaining directly or indirectly to (i) any action or omission or alleged action or omission in such Indemnified Party s capacity as a director, officer, employee or agent of the Company or any of its subsidiaries or (ii) any of the transactions contemplated by the Merger Agreement. Furthermore, during such period, the Company and its subsidiaries are required to (and Parent has agreed to and will cause the Surviving Company and its subsidiaries to) advance, prior to the final disposition for which indemnification may be sought under the Merger Agreement, all reasonable costs, fees and expenses (including reasonable attorneys fees and investigation expenses) incurred by such Indemnified Party in connection therewith upon receipt of an undertaking by such Indemnified Party to repay such advances if it is ultimately decided in a final, non-appealable judgment by a court of competent jurisdiction that such Indemnified Party is not entitled to indemnification. So long as any Indemnified Party, prior to the sixth anniversary of the Effective Time, delivers to Parent a written notice asserting a claim for indemnification under the provisions of the Merger Agreement, then such Indemnified Party s right to advancement of costs, fees and expenses pursuant to the Merger Agreement with respect to the claim asserted in such notice shall survive the sixth anniversary of the Effective Time until such time as such claim is fully and finally resolved.

Prior to the Acceptance Time, the Company will purchase a six-year tail prepaid directors and officers liability insurance policy on terms with respect to the coverage and amount that are equivalent to those of the Company s directors and officers liability insurance policy in effect as of the date of the Merger Agreement, for the benefit of the Indemnified Parties with respect to their acts or omissions occurring at or prior to the Effective Time (the **Tail Policy**). Parent must cause the Surviving Company to maintain the Tail Policy in full force and effect for the entire coverage period of the Tail Policy.

ITEM 4. THE SOLICITATION OR RECOMMENDATION.

Recommendation of the Company Board.

The Company Board, during a meeting held on September 15 and 16, 2013, by unanimous vote determined that the Merger Agreement and the transactions contemplated thereby, including the Offer and the Merger, are advisable, fair to and in the best interests of the Company and its stockholders and adopted and approved the Merger Agreement and the transactions contemplated thereby, including that the Merger will be governed by Section 251(h) of the DGCL and that the Merger will be consummated as soon as practicable following the Acceptance Time.

Accordingly, the Company Board unanimously recommends that Company stockholders accept the Offer and tender their Shares in the Offer.

Background and Reasons for the Company Board s Recommendation.

Background of the Offer.

In pursuing its objective of enhancing stockholder value, the Company Board from time to time has considered opportunities for a variety of transactions, including potential strategic acquisitions, dispositions and business combinations.

Over the past several years, representatives of the Company had discussed potential business combinations or joint ventures with a large paper and packaging producer (**Party A**). On December 22, 2011, the Company entered into an updated confidentiality agreement with Party A to aid the Company and Party A in evaluating potential transactions involving each other s paper and packaging assets. Throughout January 2012, representatives from the Company and Party A engaged in mutual due diligence and had several telephonic meetings to discuss possible transaction structures and preliminary valuations of their respective paper and packaging assets. By mid-to-late January 2012, the Company Board had determined that, given internal restructuring options available to the Company at that time, it was premature to pursue a transaction with Party A, but that the Company should keep the lines of communication open for a potential transaction in the future.

In the spring of 2012, the Company analyzed a possible division of the Company into separate paper and packaging companies, including the key legal, business and tax considerations that would inform such a decision. The Company Board also began to consider options for the Company s packaging business should a sale of the paper business take place.

Later during the spring of 2012, a member of the Company Board discussed with a private equity firm (**Party B**) a potential transaction with respect to the Company s paper business. Following up on these conversations, on June 13, 2012, Party B sent the Company a proposal with respect to a possible joint venture, whereby Party B would purchase a majority stake in the Company s paper business and the Company would retain a minority stake. On June 14, 2012, Alexander Toeldte, the President and CEO of the Company, and Carl Albert, the Chairman of the Company Board, met with a representative of Party B to discuss the June 13 proposal. On June 15, 2012, the Company Board was updated regarding Party B s June 13 proposal and Mr. Toeldte s and Mr. Albert s June 14 meeting with Party B s representative. On June 18, 2012, the Company Board formally met to discuss Party B s proposal. At that meeting, the Company Board determined not to pursue a transaction with Party B until a deeper review of strategic alternatives could be undertaken and then evaluated at the Company Board s regularly scheduled July 2012 meeting. On July 18, 2012, Party B delivered a written summary of terms related to its June 13, 2012 proposal.

At the Company Board s regularly scheduled meetings on July 24-26, 2012, the Company Board discussed a range of strategic alternatives, including Party B s proposal and a number of potential packaging acquisitions, as well as other organic and third-party strategic alternatives. Following these Company Board meetings, the Company informed Party B that it was not in a position to pursue Party B s transaction at this time, but might be interested in doing so at a later date.

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From late 2012 through February 2013, representatives of the Company and Party A from time to time discussed, both over the telephone and in person, whether Party A would be interested in exchanging certain of Party A s assets for certain of the Company s assets.

During the fall of 2012, the Company Board continued to discuss the possibility of selling the Company s paper assets to Party B, and on October 5, 2012, the Company entered into a confidentiality agreement with Party B to enable further exploration of this alternative. Thereafter, the parties engaged in an extensive due diligence process, including, on October 18, 2012, a presentation by the Company s management team to Party B.

On October 16, 2012, the Company publicly announced its decision to cease all production at its St. Helens, Oregon mill by the end of that year.

On November 9, 2012, Mr. Toeldte and the CEO of a paper company (**Party C**) discussed whether Party C would have an interest in purchasing all or some of the Company s paper business. Early the following week, the CEO of Party C called Mr. Toeldte and indicated that Party C might be interested in purchasing the Company s paper business; however, no formal proposal was forthcoming at that time.

On November 12, 2012, Party B presented a nonbinding proposal to acquire the Company s paper business for $700 million, less any long-term, non-operating liabilities, and net of any excess cash. On November 14, 2012, after discussing the proposal with Mr. Albert, Mr. Toeldte delivered a letter to Party B informing Party B that its proposed value was insufficient. At its November 15, 2012, meeting, the Company Board confirmed the decision not to proceed with discussions with Party B for a transaction at that price. At its November 19, 2012 meeting, the Company Board determined to further explore a potential transaction with Party B regarding a sale of the Company s paper business, contingent on Party B increasing the value of its previous offer.

On November 26, 2012, the Company entered into a confidentiality agreement with Party C and the companies began exchanging non-public information. Also on November 26, 2012, Party B presented a nonbinding proposal to acquire the Company s paper business for $765 million, less any long-term, non-operating liabilities, and net of any excess cash.

At its December 3, 2012 meeting the Company Board reviewed a number of strategic alternatives, including the November 26 proposal from Party B. The Company Board instructed management to inform Party B that the Company was not prepared to proceed with Party B at that time.

On December 14, 2012, the Company Board determined that in light of potential transactions, including with Party B, the Company should engage a financial advisor to assist the Company in its evaluation of strategic alternatives. Following the Company Board s determination, the Company s management began the process of engaging a financial advisor and in mid-January the Company s management met with potential financial advisors in New York City.

On December 22, 2012, Party A entered into a new confidentiality agreement with the Company.

During the first week of January 2013, Paul Stecko, Parent s Executive Chairman, telephoned Mr. Albert to express interest in potential strategic opportunities with Boise. Following their telephone conversation, Mr. Stecko and Mr. Albert agreed to meet in Los Angeles, California on January 17, 2013 in order to continue their discussions.

On January 17, 2013, Mr. Albert and Mr. Toeldte met with Mr. Stecko and Mark Kowlzan, Parent s Chief Executive Officer, to discuss potential strategic opportunities and, in particular, Parent s potential interest in the Company s packaging business. In late January and early February 2013, representatives of the Company held diligence meetings with representatives of Party B and Party C.

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On January 21, 2013, Mr. Albert, Mr. Toeldte and Michael Murphy, the Company s Corporate Vice President and Treasurer, met with Party B s representatives to discuss whether Party B could improve its proposal based on new information regarding planned cost reductions and restructuring initiatives.

In February 2013, the Company engaged J.P. Morgan Securities LLC (**J.P. Morgan**) to act as its financial advisor with respect to potential strategic transactions.

On February 11, 2013, Party B delivered a revised proposal in which Party B offered to purchase the Company s paper business for $765 million, less any long-term, non-operating liabilities, and net of any excess cash, plus a potential $50 million earn-out payment.

On February 13, 2013, Mr. Toeldte met with Party C s President and Chief Executive Officer to discuss Party C s interest in the Company s paper business, including whether Party C would have the financial capability to fund or finance an acquisition of the Company s paper business.

On March 3, 2013, Mr. Stecko and Mr. Albert discussed Parent s potential interest in acquiring the Company s packaging business or possibly the entire Company. Later in the week, Party B contacted the Company about Party B s proposal regarding a potential transaction for the Company s paper business, with a request that the Company negotiate exclusively with Party B.

On March 6, 2013, a representative of the Company called a representative of Party C to discuss whether Party C would be interested in making a proposal to purchase the Company s paper business. The next day, an affiliate of Party C contacted J.P. Morgan to indicate that Party C would be interested in purchasing the Company s paper business at a valuation of 3.0 - 3.5x the paper business s EBITDA.

At the March 19, 2013 meeting of the Company Board, J.P. Morgan presented its preliminary observations and recommendations with respect to the Company s strategic alternatives, including pursuing stand-alone operational improvements, exploring the sale of the business in whole or in part and acquisition opportunities. The Company Board discussed the continuing interest of Party B in the Company s paper business, and the Company Board directed management to pursue this opportunity while simultaneously exploring other alternatives, including the sale of the Company as a whole. The Company Board directed J.P. Morgan to contact potentially interested parties to determine interest in the Company s paper and packaging assets and the Company as a whole.

In late March 2013, J.P. Morgan began contacting 11 potential acquirors of the Company or its packaging business and four potential acquirors of the Company s paper business. J.P. Morgan contacted a representative of Parent s financial advisor, Merrill Lynch, Pierce, Fenner & Smith Incorporated (**BofA Merrill Lynch**). The BofA Merrill Lynch representative indicated, on behalf of Parent, that Parent s preference was to explore an acquisition of the Company s packaging business. In addition, a representative of J.P. Morgan met with a representative of Party B to discuss specific terms of a potential offer by Party B for the Company s paper business, including the Company s position that any agreement for the paper business should include a go-shop provision. Over the following days, the representatives of J.P. Morgan and Party B discussed possible terms of a potential agreement and confirmed Party B s continued interest in the Company. During this period, Mr. Toeldte and Mr. Murphy also met with representatives of a private equity firm (**Party D**) with regard to a potential acquisition of the Company by Party D. On March 27, 2013, as a result of J.P. Morgan s efforts to contact potential acquirors, the Company received a letter from another private equity firm (**Party E**), indicating an interest in acquiring the Company in a price range of $11.00 - $12.00 per share. J.P. Morgan also reached out to Party A to assess Party A s continuing interest in the Company s assets.

In early April 2013, the Company delivered a nonbinding indication of interest to a significant packaging company that was offering itself for sale (**Party F**). Thereafter, the Company conducted extensive diligence on Party F s operations, including presentations by Party F s management and tours of Party F s facilities.

Also in early April 2013, the Company executed an amended confidentiality agreement with Party A and the companies began exchanging non-public information. J.P. Morgan had discussions with a number of potentially

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interested parties, including another large paper manufacturer (**Party G**) to determine Party G s interest in the Company or certain of its assets, but Party G indicated it was not interested in proceeding in connection with a possible transaction, as well as a large packaging company (**Party H**), which indicated it would only be interested in acquiring the Company s packaging business. J.P. Morgan and the Company also had extensive conversations with Party B regarding Party B s strong interest in the Company s paper business.

On April 1, 2013, J.P. Morgan contacted BofA Merrill Lynch because Parent had expressed interest in an acquisition of the Company, but also had expressed a need to better understand whether a transaction for only certain assets, or the entire Company, would be possible before proceeding to sign a confidentiality agreement and conducting further diligence. On April 8, 2013, Parent sent an indication of interest to the Company to acquire all outstanding Shares at a price of $10.75 per share or, alternatively, to purchase the Company s packaging business on a debt-free basis for between $1.225 and $1.275 billion; Parent s indication of interest was confirmed in a follow-up call from BofA Merrill Lynch to J.P. Morgan.

On April 11, 2013, the Chairman and Chief Executive Officer of a paper and packaging company (**Party I**) called Mr. Albert to express an interest in a transaction for the entire Company. J.P. Morgan provided certain public information to Party I to aid Party I in refining its valuation of the Company. Throughout April 2013, representatives of J.P. Morgan and the Company continued to contact potential buyers of the Company or its paper or packaging businesses.

At the April 16, 2013 meeting of the Company Board, J.P. Morgan provided an update on all of the parties that had been contacted, noting that the interest in the Company s packaging business was significantly stronger than the interest in the Company s paper business, other than in the case of Party B, which continued to express strong interest in the Company s paper business.

On April 18, 2013, Party I sent a nonbinding indication of interest to J.P. Morgan for the acquisition of the Company s packaging business, on a debt-free basis, at a valuation of $1.0 - $1.1 billion.

On April 21, 2013, Party B delivered an updated written indication of interest in the Company s paper business for $775 million less deductions for certain long-term debt and other non-operating liabilities, and containing a request for a 30-day exclusivity period.

At the Company Board meeting held in conjunction with the Company s annual stockholder meeting on April 24, 2013, J.P. Morgan reviewed the status of various strategic alternatives. As Party B was the only party that had expressed an interest in acquiring the paper business in a valuation range that might be acceptable to the Company Board, the Company Board instructed management to proceed with negotiations and further diligence with Party B on a sale of the Company s paper business. At that meeting, the Company Board also instructed management and J.P. Morgan to pursue other options for a possible sale of the Company as a whole or for a sale of both the paper and packaging businesses to separate purchasers. The Company Board also instructed management to continue pursuing the potential acquisition of Party F. At that meeting, the Company Board also approved the Company undertaking major projects at its facilities in DeRidder, Louisiana and International Falls, Minnesota.

On April 25, 2013, Party A indicated to J.P. Morgan that it was not interested in acquiring the Company s paper business and, therefore, would not be submitting an indication of interest to purchase the Company as a whole.

On April 28, 2013, J.P. Morgan and Party B held discussions regarding the 30-day exclusivity period requested by Party B. On April 29, 2013, Party B delivered a draft letter of intent in respect of its earlier indication of interest.

At the end of April 2013, J.P. Morgan and the Company s outside counsel, Skadden, Arps, Slate, Meagher & Flom LLP (**Skadden**), held discussions with Party B and its financial advisors regarding the terms of a transaction involving the Company s paper business and the terms of the exclusivity agreement that Party B indicated it required before entering into negotiation of a definitive acquisition agreement.

On April 29, 2013, a representative of J.P. Morgan met with a principal of Party E to discuss Party E s potential interest in an acquisition of the Company. On that same day, J.P. Morgan received a call from the financial advisor to a potential strategic acquiror (**Party J**), expressing interest in the Company s packaging business.

On April 30, 2013, the Company sent its revised letter of intent and a draft of a purchase agreement to Party F.

Throughout May 2013, J.P. Morgan continued discussions with potential buyers of the Company s packaging business, and Company personnel began intensive diligence activities with a number of potential packaging acquirors, as well as Party B. The Company also entered into confidentiality agreements with five parties, including both strategic and financial potential buyers. During this time, Party I indicated it was no longer interested in a transaction with the Company. Party A also indicated that it did not believe it could present an attractive valuation for the Company s packaging business or paper business and that it did not intend to continue to pursue a transaction with the Company.

On May 2, 2013, the Company publicly announced that it was undertaking the projects at its facilities in DeRidder, Louisiana and International Falls, Minnesota.

Also on May 2, 2013, Parent and Boise Paper Holdings, L.L.C., a wholly-owned subsidiary of the Company, executed a confidentiality agreement. On May 6, 2013, the Company informed Parent that it would likely only be in a position to discuss a potential sale of the Company s packaging business following that time. Later that week, Parent proceeded with due diligence.

Following negotiations between J.P. Morgan and Skadden and Party B and its legal counsel, on May 7, 2013, the Company and Party B executed a modified letter of intent for a transaction involving the Company s paper business that included exclusivity provisions that, among other things, would not restrict the Company from soliciting proposals for the sale of its packaging business.

At a meeting held on May 9, 2013, the Company Board discussed the potential transaction with Party B and the status of discussions with potential acquirors of the Company s packaging business. The Company Board instructed management and J.P. Morgan to move forward on both processes and determined not to continue consideration of the acquisition of Party F.

On May 10, 2013, Party E delivered a signed confidentiality agreement to the Company.

On May 13, 2013, the Company received an indication of interest from Party H, expressing an interest in purchasing the Company s packaging business on a debt-free basis for between $950 million and $1,050 million structured as an asset acquisition. The next day, Party H sent the Company a revised indication of interest indicating that it would be interested in purchasing the Company s packaging business on a debt-free basis at the same $950 - $1,050 million price range, structured as an acquisition of equity interests.

During the week of May 13, 2013, Mr. Toeldte called a representative of a large packaging company (**Party K**) to discuss whether Party K would be interested in acquiring the Company s packaging business.

On May 14, 2013, Company management met with management of Parent in Chicago, Illinois. At the meeting, Company management gave a presentation regarding the Company s packaging business.

On May 20, 2013, Skadden sent Party B s legal counsel a draft purchase agreement for the Company s paper business. That same day, Mr. Toeldte and J.P. Morgan discussed the sale of the Company s packaging business with representatives of Party K. Following this conversation, J.P. Morgan contacted Party K asking it to provide a formal indication of interest for the Company s packaging business no later than July 2, 2013.

On May 29, 2013, at a meeting of the Company Board, management and J.P. Morgan presented a review of the status of the potential transaction with Party B and the status of the process to evaluate potential opportunities with respect to the Company s packaging business. That same day, the Company received an indication of interest from Parent at a valuation of $11.00 per share for an acquisition of the entire Company.

At a special meeting of the Company Board convened on May 30, 2013, management and J.P. Morgan updated the Company Board on the indication of interest from Parent and discussed the exclusivity obligation in the letter of intent signed with Party B that would prohibit the Company from discussing the indication of interest with Parent at that time.

On May 31, 2013, the Company received an indication of interest from Party J, expressing potential interest in purchasing the Company s packaging business on a debt-free basis for $1.3 billion.

On June 3, 2013, the Company received an indication of interest from Party H, expressing an interest in purchasing the Company s packaging business on a debt-free basis for between $1.2 and $1.3 billion.

Also on June 3, 2013, the Company received a markup of the draft purchase agreement from Party B s legal counsel. During the first week of June, the Company, J.P. Morgan and Skadden continued discussions, negotiations and diligence activities with Party B and its representatives. On June 7, 2013, the exclusivity period with Party B ended, with Party B making no request for an extension. Shortly thereafter, J.P. Morgan contacted other interested parties to solicit indications of interest for the entire Company. Mr. Albert called Mr. Stecko to encourage Parent to present a higher price for the Company, indicating that the Company was again in discussions with other interested parties. Thereafter, the Company and J.P. Morgan continued discussions and diligence activities with five parties interested in either the Company or its packaging business.

At a special meeting of the Company Board on June 10, 2013, J.P. Morgan and management updated the Company Board on strategic alternatives. Because there had been no further interest expressed in the Company s paper business, the Company Board renewed its consideration of a potential spin-off of that business. As part of this consideration, the Company Board discussed the possible complexities of splitting the Company or selling the Company in parts, including the risk of coordinating multiple transactions and the significant separation costs and negative tax implications that would result from selling the packaging business on a stand-alone basis.

On June 12, 2013, at a meeting in Salt Lake City, the Company s management made a presentation concerning the sale of the Company as a whole to Parent. That same day, a principal of Party B indicated to J.P. Morgan that Party B would only be interested in purchasing the paper business at a valuation at or near $500 million.

Throughout June 2013, management of the Company made presentations to potential acquirors and engaged in due diligence meetings, and J.P. Morgan reached out to additional private equity firms that it considered might have both an interest in some or all of the Company s assets and the financial ability to consummate a transaction. On June 19, 2013, Parent advised the Company that it was no longer interested in purchasing the Company as a whole, but remained interested in purchasing the Company s packaging business. During this period, two other potential acquirors indicated that they were no longer interested in continuing to pursue an acquisition of the Company or its businesses.

On June 27, 2013, Party E delivered a written indication of interest to the Company for the purchase of the entire Company at a price of $11.50 per share. At a special meeting of the Company Board the next day, J.P. Morgan reported on the indication of interest from Party E and the likelihood that Party E would consummate a transaction at that price. The Company Board also received updates on the parties that were still in the process and those that had determined not to proceed with consideration of a transaction. J.P. Morgan and management discussed with the Company Board the continued interest that the Company was receiving in connection with a sale of its packaging business and the significant tax and separation costs that would be associated with a sale of the packaging business on a stand-alone basis.

In early July 2013, J.P. Morgan continued to contact potential strategic and financial buyers, with one previously contacted financial buyer indicating it would no longer participate in the process.

On July 8, 2013, the Company Board met in person to determine whether to proceed with further diligence and with negotiations with Party E. J.P. Morgan updated the Company Board on the ongoing review of strategic alternatives and the status of the parties in the process, noting that while there continued to be strong interest in the Company s packaging business, there appeared to be no parties interested in an acquisition of the Company s paper business at a price that would meet the Company Board s expectations, and that Party E was the only party that had expressed a continuing interest in an acquisition of the entire Company. J.P. Morgan discussed other potential strategies with the Company Board, including the Company s continued investment in the Company s growth and a spin-off of the Company s paper business. The Company instructed management to continue to explore a transaction with Party E while also continuing to consider other internal and external options.

During July 2013, J.P. Morgan received a number of calls from Party K, which had earlier expressed interest in the Company s packaging business, and Party C, which had earlier expressed interest in the Company s paper business, requesting that the Company waive certain restrictions in the two parties respective confidentiality agreements, so that the two parties or their affiliates could present a joint bid for the Company. Due to the level of leverage that Party C maintained at the time, on July 9, 2013, the Company asked J.P. Morgan to diligence Party C s ability to utilize debt to finance an acquisition of the Company s paper business. Soon thereafter, J.P. Morgan advised the Company that there could be some limitations and risks associated with Party C s ability to utilize debt to finance an acquisition of the Company s paper business. The Company did not grant the requested confidentiality agreement waivers.

In the following days, J.P. Morgan continued to discuss a potential transaction with representatives of Party E and Party E began intensive diligence including meetings and mill tours.

During this time, Mr. Stecko called Mr. Albert to reaffirm Parent s interest in acquiring the Company s packaging business on a stand-alone basis. Representatives of Parent and the Company discussed possible transaction structures and valuations that could be attractive to both companies; however, Parent and the Company were not able to agree on a transaction structure and valuation acceptable to Parent that, taking into account taxes and separation costs, would be likely to provide a higher total return to the Company s stockholders than the transaction then proposed by Party E. Accordingly, on July 12, 2013, Parent and the Company ceased discussions regarding a potential strategic transaction.

In mid-July 2013, J.P. Morgan contacted an affiliate of Party C, which affiliate entered into a confidentiality agreement with the Company on July 22, 2013. The Company and the affiliate of Party C thereafter exchanged confidential information, and J.P. Morgan requested that Party C or its affiliate deliver an indication of interest with respect to the Company s paper business no later than July 30, 2013.

On July 18, 2013, the Company sent a draft merger agreement to Party E.

On July 24, 2013, the Company Board held an in-person meeting at which J.P. Morgan and management presented an update on the Company s strategic alternatives. The Company Board determined that it was not prepared to consider a transaction at less than $11.50 per share, noting that it did not currently have indications of interest that, when taking into account tax and separation costs, would be likely to result in more total value to stockholders than a whole Company transaction at $11.50 per share. The Company Board discussed whether a spin-off of the Company s paper business and a sale of the Company s packaging business could provide greater value to Company stockholders. The Company Board, with J.P. Morgan s input, discussed concerns regarding the probability of achieving higher levels of total value for the Company s stockholders in, as well as the risks

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and delays that could be involved in, a spin-off of the Company s paper business and a sale of the Company s packaging business. The Company Board determined that further analysis was warranted. The Company Board also determined that management should continue discussions with Party E and instructed J.P. Morgan to continue to reach out to potential acquirors.

On July 26, 2013, the Chief Executive Officer of Party K called Mr. Albert to discuss Party K s interest in teaming with a potential purchaser of the Company s paper business. Mr. Albert conveyed concern as to a three-party transaction or a transaction contingent upon a substantially concurrent sale of the paper business given the timing and consummation risk such transactions would represent. On July 31, 2013, J.P. Morgan contacted Party K s financial advisors to report that the Company would not be prepared to move forward with a three-party or contingent transaction at that time.

On August 1, 2013, a representative of Party E reaffirmed a price of $11.50 per share to Mr. Albert. On August 2, 2013, Party K sent a letter to the Company Board including a per share valuation of $11.25 - $12.00, and again requesting permission to partner with an affiliate of Party C. The following week, on August 9, 2013, a principal of Party E called J.P. Morgan to indicate that Party E was no longer willing to proceed at a price of $11.50 per share. Based on conversations with the Company s management and members of the Company Board, J.P. Morgan informed Party E that the Company was not prepared to proceed at a lower price and no further substantive negotiations or discussions followed between the Company and Party E.

On August 12, 2013, the Company received an indication of interest from Party C to acquire the Company s paper business at a valuation of $625 - $700 million. On August 20, 2013, Party K sent another letter to the Company Board reaffirming its interest in acquiring the Company and again seeking the Company s permission to partner with an affiliate of Party C. Mr. Toeldte responded to Party K by letter on August 22, 2013, reaffirming that Party K s proposal, which was viewed by the Company as containing a third-party contingency, was not actionable or compelling at that time.

On August 23, 2013, the Company Board received a strategic update from management and J.P. Morgan, includ/tr>

INCOME FROM OPERATIONS
15,619

14,197

29,580

27,113

OTHER INCOME
885

465

1,721

971

INCOME BEFORE INCOME TAXES
16,504

14,662

31,301

28,084

PROVISION FOR INCOME TAXES
1,123

760

1,720

83

NET INCOME
$
15,381

$
13,902

$
29,581

$
28,001

EARNINGS PER SHARE:

Basic
$
0.52

$
0.47

$
1.00

$
0.95

Diluted
$
0.51

$
0.46

$
0.97

$
0.92

SHARES USED IN PER SHARE CALCULATION:

Basic
29,505

29,720

29,651

29,589

Diluted
30,183

30,454

30,387

30,370

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

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POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(In thousands)	2018	2017	2018	2017
NET INCOME	$15,381	$13,902	$29,581	$28,001
Other comprehensive income, net of tax:				
Foreign currency translation adjustments, net of $0 tax in each of the three and six months ended June 30, 2018 and 2017	37	31	—	95
Unrealized gain (loss) on marketable securities, net of $0 tax in each of the three and six months ended June 30, 2018 and 2017	226	15	(12)	98
Amortization of defined benefit pension items, net of tax of $9 and $18 in the three and six months ended June 30, 2018, respectively, and $14 and $27 in the three and six months ended June 30, 2017, respectively	31	49	63	98
Total other comprehensive income	294	95	51	291
TOTAL COMPREHENSIVE INCOME	$15,675	$13,997	$29,632	$28,292

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

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POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(In thousands)	Six Months Ended June 30, 2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$29,581	$28,001
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	9,691	8,469
Amortization of intangibles	2,668	3,178
Loss on disposal of property and equipment	60	38
Stock-based compensation expense	11,740	11,296
Amortization of premium on marketable securities	376	508
Deferred income taxes	(900)	(648)
Increase in accounts receivable allowances	17	80
Change in operating assets and liabilities:		
Accounts receivable	9,938	(12,249)
Inventories	(11,737)	132
Prepaid expenses and other assets	(1,388)	(8,349)
Accounts payable	(7,276)	(3,629)
Taxes payable and accrued liabilities	(344)	3,208
Net cash provided by operating activities	42,426	30,035
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(10,513)	(22,876)
Acquisition of technology licenses	(500)	—
Purchases of marketable securities	—	(111,574)
Proceeds from sales and maturities of marketable securities	90,353	78,140
Net cash provided by (used in) investing activities	79,340	(56,310)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock under employee stock plans	5,635	5,089
Repurchase of common stock	(63,389)	—
Payments of dividends to stockholders	(9,480)	(8,299)
Proceeds from draw on line of credit	8,000	—
Payments on line of credit	(8,000)	—
Net cash used in financing activities	(67,234)	(3,210)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	54,532	(29,485)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	93,655	62,134
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$148,187	$32,649
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Unpaid property and equipment	$4,996	$5,851
Unpaid technology licenses	$500	$—
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid (refund) for income taxes, net	$4,178	$(1,775)

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

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION:

The condensed consolidated financial statements include the accounts of Power Integrations, Inc., a Delaware corporation (the “Company”), and its wholly owned subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and the financial condition of the Company at the date of the interim balance sheet in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Power Integrations, Inc. consolidated financial statements and the notes thereto for the year ended December 31, 2017, included in its Form 10-K filed on February 14, 2018, with the Securities and Exchange Commission.

2. SIGNIFICANT ACCOUNTING POLICIES AND RECENT ACCOUNTING PRONOUNCEMENTS:

Significant Accounting Policies and Estimates

No material changes have been made to the Company's significant accounting policies disclosed in Note 2, Significant Accounting Policies and Recent Accounting Pronouncements, in its Annual Report on Form 10-K, filed on February 14, 2018, for the year ended December 31, 2017.

Recent Accounting Pronouncements

In February 2016, the FASB amended the existing accounting standards for leases, ASU 2016-02, Leases. The amendments require lessees to recognize, on the balance sheet, assets and liabilities for the rights and obligations created by leases of greater than twelve months. The accounting by lessors will remain largely unchanged from that applied under previous U.S. GAAP. The Company is required to adopt the amendments in the first quarter of fiscal 2019, with early adoption permitted. The amendments require a modified retrospective transition approach to recognize and measure leases at the beginning of the earliest period presented. The Company is currently evaluating the impact of these amendments and the transition alternatives on its condensed consolidated financial statements.

3. COMPONENTS OF THE COMPANY’S CONDENSED CONSOLIDATED BALANCE SHEETS:

Accounts Receivable

(In thousands)	June 30, 2018	December 31, 2017
Accounts receivable trade	$55,128	$ 58,718
Allowances for ship and debit	(44,660)	(39,486)
Allowances for stock rotation and rebate	(2,874)	(1,700)
Allowances for doubtful accounts	(751)	(734)
Total	$6,843	$ 16,798

Inventories

(In thousands)	June 30, 2018	December 31, 2017
Raw materials	$25,421	$ 15,517
Work-in-process	15,403	16,765
Finished goods	28,000	24,805
Total	$68,824	$ 57,087

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Prepaid Expenses and Other Current Assets

(In thousands)	June 30, 2018	December 31, 2017
Prepaid legal fees	$151	$ 213
Prepaid income tax	864	460
Prepaid maintenance agreements	1,695	856
Interest receivable	690	1,195
Advance to suppliers	2,546	1,211
Other	4,673	3,823
Total	$10,619	$ 7,758

Intangible Assets

	June 30, 2018			December 31, 2017		
(In thousands)	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Domain name	$1,261	$ —	$1,261	$1,261	$ —	$1,261
In-process research and development	4,690	—	4,690	4,690	—	4,690
Developed technology	33,270	(20,838)	12,432	33,270	(19,211)	14,059
Customer relationships	20,030	(15,610)	4,420	20,030	(14,621)	5,409
Technology licenses	1,000	(52)	948	—	—	—
In-place leases	—	—	—	660	(660)	—
Total	$60,251	$ (36,500)	$23,751	$59,911	$ (34,492)	$25,419

The estimated future amortization expense related to finite-lived intangible assets at June 30, 2018, is as follows:

Fiscal Year	Estimated Amortization (In thousands)
2018 (remaining six months)	$ 2,599
2019	4,878
2020	3,653
2021	2,787
2022	1,709
Thereafter	2,174
Total [(1)]	$ 17,800

(1) The total above excludes $4.7 million of in-process research and development that will be amortized, upon completion of development, over the estimated useful life of the technology.

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss for the three and six months ended June 30, 2018 and 2017, were as follows:

	Unrealized Gains and Losses on Marketable Securities		Defined Benefit Pension Items		Foreign Currency Items		Total	
	Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,	
(In thousands)	2018	2017	2018	2017	2018	2017	2018	2017
Beginning balance	$(665)	$(137)	$(1,205)	$(1,887)	$(512)	$(490)	$(2,382)	$(2,514)
Other comprehensive income before reclassifications	226	15	—	—	37	31	263	46
Amounts reclassified from accumulated other comprehensive loss	—	—	31 (1)	49 (1)	—	—	31	49
Net-current period other comprehensive income	226	15	31	49	37	31	294	95
Ending balance	$(439)	$(122)	$(1,174)	$(1,838)	$(475)	$(459)	$(2,088)	$(2,419)

(1) This component of accumulated other comprehensive income (loss) is included in the computation of net periodic pension cost for the three months ended June 30, 2018 and 2017.

	Unrealized Gains and Losses on Marketable Securities		Defined Benefit Pension Items		Foreign Currency Items		Total	
	Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2018	2017	2018	2017	2018	2017	2018	2017
Beginning balance	$(427)	$(220)	$(1,237)	$(1,936)	$(475)	$(554)	$(2,139)	$(2,710)
Other comprehensive income (loss) before reclassifications	(12)	98	—	—	—	95	(12)	193
Amounts reclassified from accumulated other comprehensive loss	—	—	63 (1)	98 (1)	—	—	63	98
Net-current period other comprehensive income (loss)	(12)	98	63	98	—	95	51	291
Ending balance	$(439)	$(122)	$(1,174)	$(1,838)	$(475)	$(459)	$(2,088)	$(2,419)

(1) This component of accumulated other comprehensive income (loss) is included in the computation of net periodic pension cost for the six months ended June 30, 2018 and 2017.

4. FAIR VALUE MEASUREMENTS:

The FASB established a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices for identical assets in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

The Company's cash equivalents and short-term marketable securities are classified within Level 1 or Level 2 of the fair-value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency.

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair-value hierarchy of the Company's cash equivalents and marketable securities at June 30, 2018, and December 31, 2017, was as follows:

	Fair Value Measurement at June 30, 2018		
(In thousands)	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Corporate securities	$89,265	$ —	$ 89,265
Commercial paper	128,809	—	128,809
Government securities	9,229	—	9,229
Money market funds	467	467	—
Total	$227,770	$ 467	$ 227,303

	Fair Value Measurement at December 31, 2017		
(In thousands)	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Corporate securities	$179,951	$ —	$ 179,951
Commercial paper	51,122	—	51,122
Government securities	9,285	—	9,285
Money market funds	195	195	—
Total	$240,553	$ 195	$ 240,358

The Company did not transfer any investments between Level 1 and Level 2 of the fair-value hierarchy in the six months ended June 30, 2018, and the twelve months ended December 31, 2017.

5. MARKETABLE SECURITIES:
Amortized cost and estimated fair market value of marketable securities classified as available-for-sale (excluding cash equivalents) at June 30, 2018, were as follows:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Investments due in 3 months or less:				
Government securities	$ 9,234	$ —	$ (5)	$ 9,229
Corporate securities	47,926	—	(58)	47,868
Total	57,160	—	(63)	57,097
Investments due in 4-12 months:				

Corporate securities	21,981	—	(133)	21,848
Total	21,981	—	(133)	21,848
Investments due in 12 months or greater:				
Corporate securities	19,792	—	(243)	19,549
Total	19,792	—	(243)	19,549
Total marketable securities	$ 98,933	$ —	$ (439)	$ 98,494

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortized cost and estimated fair market value of marketable securities classified as available-for-sale (excluding cash equivalents) at December 31, 2017, were as follows:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Investments due in 3 months or less:				
Corporate securities	$ 38,485	$ —	$ (16)	$ 38,469
Total	38,485	—	(16)	38,469
Investments due in 4-12 months:				
Corporate securities	104,440	—	(199)	104,241
Government securities	9,302	—	(17)	9,285
Total	113,742	—	(216)	113,526
Investments due in 12 months or greater:				
Corporate securities	37,436	—	(195)	37,241
Total	37,436	—	(195)	37,241
Total marketable securities	$ 189,663	$ —	$ (427)	$ 189,236

As of June 30, 2018, and December 31, 2017, the Company evaluated the nature of the investments with a loss position, which were primarily high-quality corporate securities, and determined the unrealized losses were not other-than-temporary.

6. STOCK-BASED COMPENSATION:
The following table summarizes the stock-based compensation expense recognized in accordance with ASC 718-10 for the three and six months ended June 30, 2018, and June 30, 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2018	2017	2018	2017
Cost of revenues	$ 292	$ 351	$ 541	$ 494
Research and development	2,271	2,351	4,110	3,985
Sales and marketing	1,126	1,189	2,402	2,286
General and administrative	2,426	2,436	4,687	4,531
Total stock-based compensation expense	$ 6,115	$ 6,327	$ 11,740	$ 11,296

Stock-based compensation expense in the three months ended June 30, 2018, was approximately $6.1 million (comprising approximately $3.9 million related to restricted stock unit (RSU) awards, $1.8 million related to performance-based (PSU) awards and long-term performance-based (PRSU) awards and $0.4 million related to the Company's employee stock purchase plan). In the six months ended June 30, 2018, stock-based compensation expense was approximately $11.7 million (comprising approximately $8.2 million related to restricted stock unit (RSU) awards, $2.7 million related to performance-based (PSU) awards and long-term performance-based (PRSU) awards and $0.8 million related to the Company's employee stock purchase plan).
Stock-based compensation expense in the three months ended June 30, 2017, was approximately $6.3 million (comprising approximately $3.7 million related to RSUs, $2.3 million related to PSUs and PRSUs and $0.3 million related to the Company's employee stock purchase plan). In the six months ended June 30, 2017, stock-based compensation expense was approximately $11.3 million (comprising approximately $7.2 million related to RSUs, $3.5 million related to PSUs and PRSUs and $0.6 million related to the Company's employee stock purchase plan).

Stock Options

A summary of stock options outstanding as of June 30, 2018, and activity during the six months then ended, is presented below:

	Shares (In thousands)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at January 1, 2018	511	$ 29.03		
Granted	—	—		
Exercised	(126)	$ 23.29		
Forfeited or expired	—	—		
Outstanding at June 30, 2018	385	$ 30.92	1.87	$ 16,220
Vested and exercisable at June 30, 2018	385		1.87	$ 16,220

PSU Awards

Under the performance-based awards program, the Company grants awards in the performance year in an amount equal to twice the target number of shares to be issued if the maximum performance metrics are met. The number of shares that are released at the end of the performance year can range from zero to 200% of the target number depending on the Company's performance. The performance metrics of this program are annual targets consisting of a combination of net revenue, non-GAAP operating income and strategic goals.

As the net revenue, non-GAAP operating income and strategic goals are considered performance conditions, expense associated with these awards, net of estimated forfeitures, is recognized over the service period based on an assessment of the achievement of the performance targets. The fair value of these PSUs is determined using the fair value of the Company's common stock on the date of the grant, reduced by the discounted present value of dividends expected to be declared before the awards vest. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.

In January 2018, it was determined that approximately 79,000 shares of the PSUs granted in 2017, vested in aggregate and were released to the Company's employees and executives in the first quarter of 2018.

A summary of PSUs outstanding as of June 30, 2018, and activity during the six months then ended, is presented below:

	Shares (In thousands)	Weighted-Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at January 1, 2018	79	$ 63.99		
Granted	88	$ 62.82		
Vested	(79)	$ 63.99		
Forfeited	—	—		
Outstanding at June 30, 2018	88	$ 62.82	0.50	$ 6,458
Outstanding and expected to vest at June 30, 2018	47		0.50	$ 3,398

PRSU Awards

The Company's PRSU program provides for the issuance of PRSUs which will vest based on the Company's performance measured against the PRSU program's established revenue targets. PRSUs are granted in an amount equal to twice the target number of shares to be issued if the maximum performance metrics are met. The actual number of shares the recipient receives is determined at the end of a three-year performance period based on results achieved versus the Company's performance goals, and may range from zero to 200% of the target number. The performance goals for PRSUs granted in fiscal 2016, 2017 and 2018 were based on the Company’s annual revenue growth over the respective three-year performance period.

Expense associated with these awards, net of estimated forfeitures, is recorded throughout the year depending on the number of shares expected to vest based on progress toward the performance target. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.

In January 2018, it was determined that approximately 38,000 shares of the PRSUs granted in 2015, vested in aggregate and were released to the Company’s executives in the first quarter of 2018.

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POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of PRSUs outstanding as of June 30, 2018, and activity during the six months then ended, is presented below:

	Shares (In thousands)	Weighted-Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at January 1, 2018	184	$ 52.80		
Granted	72	$ 59.90		
Vested	(38)	$ 52.45		
Forfeited	—	—		
Outstanding at June 30, 2018	218	$ 55.20	1.49	$ 15,896
Outstanding and expected to vest at June 30, 2018	214		1.45	$ 15,637

RSU Awards

A summary of RSUs outstanding as of June 30, 2018, and activity during the six months then ended, is presented below:

	Shares (In thousands)	Weighted-Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at January 1, 2018	948	$ 55.51		
Granted	251	$ 62.31		
Vested	(282)	$ 53.80		
Forfeited	(16)	$ 58.66		
Outstanding at June 30, 2018	901	$ 57.88	2.23	$ 65,818
Outstanding and expected to vest at June 30, 2018	815		2.11	$ 59,552

7. SIGNIFICANT CUSTOMERS AND GEOGRAPHIC NET REVENUES:

Segment Reporting

The Company is organized and operates as one reportable segment, the design, development, manufacture and marketing of integrated circuits and related components for use primarily in the high-voltage power-conversion market. The Company’s chief operating decision maker, the Chief Executive Officer, reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance.

Customer Concentration

The Company's top ten customers accounted for approximately 59% and 58% of net revenues for the three and six months ended June 30, 2018, respectively, and approximately 57% of net revenues in the corresponding periods of 2017. A significant portion of these revenues are attributable to sales of the Company’s products to distributors of electronic components. These distributors sell the Company’s products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers. Sales to distributors were $83.0 million and $162.1 million for the three and six months ended June 30, 2018, respectively, and $85.5 million and $166.1 million, respectively, for the corresponding periods of 2017. Direct sales to OEMs and power-supply manufacturers accounted for the remainder.

In each of the three and six months ended June 30, 2018 and 2017, one customer, a distributor of the Company's products, accounted for more than 10% of the Company’s net revenues.

The following table discloses this customer’s percentage of revenues for the respective periods:

Customer	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Avnet	14 %	16 %	15 %	17 %

No other customer accounted for 10% or more of the Company’s net revenues in the periods presented.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments and trade receivables. The Company does not have any off-balance-sheet credit exposure related to its customers. As

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of June 30, 2018, and December 31, 2017, 65% and 64%, respectively, of accounts receivable were concentrated with the Company's top 10 customers. As of June 30, 2018, and December 31, 2017, one customer, a distributor of the Company's products, represented 10% or more of the Company's accounts receivable.

The following table discloses this customer's percentage of accounts receivable as of the respective dates:

Customer	June 30, 2018	December 31, 2017
Avnet	21 %	18 %

No other customer represented 10% or more of the Company's accounts receivable as of the dates presented.

Geographic Net Revenues

The Company markets its products globally through its sales personnel and a worldwide network of independent sales representatives and distributors. Geographic net revenues, based on "bill to" customer locations, for the three and six months ended June 30, 2018, and June 30, 2017, were as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
(In thousands)	2018	2017	2018	2017
United States of America	$3,729	$4,474	$7,596	$8,303
Hong Kong/China	58,614	56,547	109,971	111,392
Taiwan	12,914	10,762	24,800	23,796
Korea	8,229	9,678	17,878	19,184
Western Europe (excluding Germany)	11,476	12,751	25,068	24,722
Japan	5,647	5,837	10,198	10,485
Germany	3,705	2,915	7,009	5,711
Other	5,168	4,599	10,043	8,658
Total net revenues	$109,482	$107,563	$212,563	$212,251

8. COMMON STOCK REPURCHASES AND CASH DIVIDENDS:

Common Stock Repurchases

As of December 31, 2017, the Company had approximately $44.4 million available under its stock-repurchase program. In January 2018, the Company's board of directors authorized the use of an additional $30.0 million for the repurchase of the Company's common stock, with repurchases to be executed according to pre-defined price/volume guidelines. In the six months ended June 30, 2018, the Company repurchased approximately 0.9 million shares of its common stock for approximately $63.4 million. As of June 30, 2018, the Company had approximately $11.0 million remaining under its current repurchase program, which has no expiration date. Authorization of future repurchase programs is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors.

Cash Dividends

In January 2018, the Company's board of directors declared four quarterly cash dividends in the amount of $0.16 per share to be paid to stockholders of record at the end of each quarter in 2018. For the three and six months ended June 30, 2018, and June 30, 2017, cash dividends declared and paid were as follows:

	Three Months Ended		Six Months Ended	
(In thousands, except per share amounts)	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Dividends declared and paid	$4,705	$4,162	$9,480	$8,299
Dividends declared and paid per common share	$0.16	$0.14	$0.32	$0.28

9. EARNINGS PER SHARE:

Basic earnings per share are calculated by dividing net income by the weighted-average shares of common stock outstanding during the period. Diluted earnings per share are calculated by dividing net income by the weighted-average shares of common stock and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares included in this calculation consist of dilutive shares issuable upon the assumed exercise of outstanding common stock options, the assumed vesting of outstanding restricted stock units, the assumed issuance of awards under the stock purchase plan and contingently issuable performance-based awards, as computed using the treasury stock method.

A summary of the earnings per share calculation is as follows:

(In thousands, except per share amounts)	Three Months Ended June 30, 2018	2017	Six Months Ended June 30, 2018	2017
Basic earnings per share:				
Net income	$15,381	$13,902	$29,581	$28,001
Weighted-average common shares	29,505	29,720	29,651	29,589
Basic earnings per share	$0.52	$0.47	$1.00	$0.95
Diluted earnings per share: (1)				
Net income	$15,381	$13,902	$29,581	$28,001
Weighted-average common shares	29,505	29,720	29,651	29,589
Effect of dilutive awards:				
Employee stock plans	678	734	736	781
Diluted weighted-average common shares	30,183	30,454	30,387	30,370
Diluted earnings per share	$0.51	$0.46	$0.97	$0.92

(1) The Company includes the shares underlying performance-based awards in the calculation of diluted earnings per share if the performance conditions have been satisfied as of the end of the reporting period and excludes such shares when the necessary conditions have not been met. The Company has excluded the shares underlying the outstanding performance-based awards in the 2018 and 2017 calculations as the shares were not contingently issuable as of the end of the reporting periods.

In the three and six months ended June 30, 2018 and 2017, no outstanding stock awards were determined to be anti-dilutive and therefore excluded from the computation of diluted earnings per share.

10. PROVISION FOR INCOME TAXES:

U.S. Tax Reform

The Tax Cuts and Jobs Act (Tax Act) was enacted on December 22, 2017. The Act reduced the U.S. federal corporate tax rate from 35% to 21%, requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creates new taxes on certain foreign sourced earnings. The Company has not completed the accounting for the tax effects of enactment of the Tax Act; however, in certain cases, as described below, the Company has made a reasonable estimate of the effects on existing deferred tax balances and the one-time transition tax. In other cases, the Company has not been able to make a reasonable estimate. The Company has not recorded any additional measurement-period adjustments during the six months ended June 30, 2018. However, the Company continues to evaluate the provisions of the Tax Act, including the recently issued IRS notices, and expects to complete the accounting within the prescribed measurement period.

The SEC staff issued Staff Accounting Bulletin 118 (SAB 118), which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to

apply ASC 740 on the basis of the provisions of the tax laws that were in effect immediately before the enactment of the Tax Act.
The items for which the Company was able to determine a reasonable estimate includes a provisional one-time transition tax of $35.3 million, which was included as a component of the income tax provision for the year-ended December 31, 2017. This one-time transition tax was based on the Company’s estimated total post-1986 earnings and profits (E&P) previously deferred from U.S. income taxes. As of December 31, 2017, the Company had no additional undistributed foreign earnings that would be subject to the transition tax; although, this amount may change upon finalization of the total post-1986 foreign E&P balances and local foreign tax returns filed in the current year.

The Company also re-measured certain deferred tax assets and liabilities based on the rates at which they are expected to reverse in future periods, which is generally 21%. In the year ended December 31, 2017, the Company recorded a provisional amount of $4.9 million related to the re-measurement of the Company's deferred tax assets and liabilities. As the Company is still analyzing certain aspects of the Tax Act and refining calculations, the measurement of these balances may potentially change or give rise to new deferred tax amounts.

The Act also includes provisions for Global Intangible Low-Taxed Income ("GILTI") wherein taxes on foreign income are imposed in excess of a deemed return on tangible assets of foreign corporations. Due to the complexity of the GILTI tax rules and lack of IRS guidance, the Company continues to evaluate this provision of the Tax Act and the application of ASC 740. The Company is allowed to make an accounting policy choice of either (1) treating taxes due on future U.S. inclusions in taxable income related to GILTI as a current-period expense when incurred (the "period cost method") or (2) factoring such amounts into the Company's measurement of deferred taxes (the "deferred method"). The Company's selection of an accounting policy with respect to the new GILTI tax rules will depend, in part, on analyzing the Company's global income to determine whether the Company expects to have future U.S. inclusions in taxable income related to GILTI and, if so, what the impact is expected to be. Whether the Company expects to have future U.S. inclusions in taxable income related to GILTI depends on not only the Company's current structure and estimated future results of global operations but also the Company's intent and ability to modify the Company's structure and/or business. The Company has not made any provisional adjustments related to potential GILTI deferred taxes in the Company's financial statements and has not made a policy decision regarding whether to record deferred taxes on GILTI. However, the Company has included a current estimate of the 2018 GILTI impact in the computation of the annual effective tax rate.

Income Taxes

Income-tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries, adjusted for certain discrete items which are fully recognized in the period they occur.

The Company's effective tax rates for the three and six months ended June 30, 2018, were 6.8% and 5.5%, respectively, and 5.2% and 0.3% for the corresponding periods of 2017. In the three and six months ended June 30, 2018 and 2017, the effective tax rates for these periods were lower than the then statutory federal income-tax rates of 21% and 35%, respectively, due to the geographic distribution of the Company's world-wide earnings in lower tax jurisdictions, federal research tax credits, as well as the recognition of excess tax benefits related to share-based payments. These benefits were offset in part by the estimated 2018 GILTI tax for both the three and six months ended June 30, 2018.

As of June 30, 2018, the Company maintained a valuation allowance on its California deferred tax assets, New Jersey deferred tax assets, and capital losses for federal purposes, and a valuation allowance with respect to its deferred tax assets relating to tax credits in Canada.

Determining the consolidated provision for income tax expense, income tax liabilities and deferred tax assets and liabilities involves judgment. The Company calculates and provides for income taxes in each of the tax jurisdictions in which it operates, which involves estimating current tax exposures as well as making judgments regarding the recoverability of deferred tax assets in each jurisdiction. The estimates used could differ from actual results, which may have a significant impact on operating results in future periods.

11. COMMITMENTS:

Supplier Agreements

Under the terms of the Company's wafer-supply agreements with Seiko Epson Corporation ("Epson"), and ROHM Lapis Semiconductor Co., Ltd. ("Lapis") the wafers purchased from these suppliers are priced in U.S. dollars; however, these agreements also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar on future purchases. Each year, the Company's management and these two suppliers review and negotiate future pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between the Company and each of these suppliers on future purchases.

12. LEGAL PROCEEDINGS AND CONTINGENCIES:

From time to time in the ordinary course of business, the Company becomes involved in lawsuits, or customers and distributors may make claims against the Company. In accordance with ASC 450-10, Contingencies, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

On October 20, 2004, the Company filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as “Fairchild”) in the United States District Court for the District of Delaware.

In its complaint, the Company alleged that Fairchild has and is infringing four of Power Integrations' patents pertaining to pulse width modulation (PWM) integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integrations patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to the Company. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of the Company finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding $34.0 million in damages. Fairchild raised defenses contending that the asserted patents are invalid or unenforceable, and the Court held a second trial on these issues beginning on September 17, 2007. On September 21, 2007, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of all four patents-in-suit. Fairchild submitted further materials on the issue of enforceability along with various other post-trial motions, and the Company filed post-trial motions seeking a permanent injunction and increased damages and attorneys' fees, among other things. On September 24, 2008, the Court denied Fairchild's motion regarding enforceability and ruled that all four patents are enforceable. On December 12, 2008, the Court ruled on the remaining post-trial motions, including granting a permanent injunction, reducing the damages award to $6.1 million, granting Fairchild a new trial on the issue of willful infringement in view of an intervening change in the law, and denying the Company's motion for increased damages and attorneys' fees with leave to renew the motion after the resolution of the issue of willful infringement. On December 22, 2008, at Fairchild's request, the Court temporarily stayed the permanent injunction for 90 days. On January 12, 2009, Fairchild filed a notice of appeal challenging the Court's refusal to enter a more permanent stay of the injunction, and Fairchild filed additional motions requesting that both the Federal Circuit and the District Court extend the stay of injunction. The District Court temporarily extended the stay pending the Federal Circuit ruling on Fairchild's pending motion, but the Federal Circuit dismissed Fairchild's appeal and denied its motion on May 5, 2009, and the District Court issued an order on May 13, 2009 confirming the reinstatement of the permanent injunction as originally entered in December 2008. On June 22, 2009, the Court held a brief bench re-trial on the issue of willful infringement. On July 22, 2010, the Court found that Fairchild willfully infringed all four of the asserted patents, and the Court also invited briefing on enhanced damages and attorneys' fees. Fairchild also filed a motion requesting that the Court amend its findings regarding willfulness. On January 18, 2011, the Court denied Fairchild's request to amend the findings regarding Fairchild's willful infringement and doubled the damages award against Fairchild but declined to award attorneys' fees. On February 3, 2011, the Court entered final judgment in favor of the Company for a total damages award of $12.9 million. Fairchild filed a notice of appeal challenging the final judgment and a number of the underlying rulings, and the Company filed a cross-appeal seeking to increase the damages award. The appeal was argued on January 11, 2012, and the Federal Circuit issued a mixed ruling on March 26, 2013, affirming Fairchild's infringement of certain claims that support the basis for the permanent injunction while reversing, vacating, and remanding the findings with respect to other claims, including the Company's claim for damages. The Company filed a petition seeking Supreme Court review of the Federal Circuit's ruling on damages issues, and the Supreme Court called for a response from Fairchild but ultimately declined to review the case. On remand, the District Court reinstated the prior findings that Fairchild willfully infringed three of the Company's patents; the Company intends to pursue its claim for financial compensation based on Fairchild's infringement.

On May 23, 2008, the Company filed a complaint against Fairchild Semiconductor International, Inc., Fairchild Semiconductor Corporation, and Fairchild's wholly owned subsidiary System General Corporation (referred to collectively as "Fairchild"), in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has infringed and is infringing three patents pertaining to power supply controller integrated circuit devices. Fairchild answered the Company's complaint on November 7, 2008, denying infringement and asking for a declaration from the Court that it does not infringe any Power Integrations patent and that the patents are invalid and unenforceable. Fairchild's answer also included counterclaims accusing the Company of infringing three patents pertaining to primary side power conversion integrated circuit devices. Fairchild had earlier brought these same claims in a separate suit against the Company, also in Delaware, which Fairchild dismissed in favor of adding its claims to the Company's already pending suit against Fairchild. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. Fairchild also filed a motion to stay the case, but the Court denied that motion on December 19, 2008. On March 5, 2009, Fairchild filed a motion for summary judgment to preclude any recovery for post-verdict sales of parts found to infringe in the parties' other ongoing litigation, described above, and the Company filed its opposition and a cross-motion to preclude Fairchild from re-litigating the issues of infringement and damages for those same products. On June 26, 2009, the Court held a hearing on the parties' motions, and on July 9, 2009 the Court issued an order denying the parties' motions but staying proceedings with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case between the parties pending the entry of final judgment in that case; those products are expected to be addressed in the context of the parties' remand proceedings following the appeal in their earlier litigation in Delaware, and the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of the Company's and Fairchild's patents in suit. Following the Court's ruling on claim construction, Fairchild withdrew its claim related to one of its patents and significantly reduced the number of claims asserted for the remaining two patents. The parties thereafter filed and argued a number of motions for summary judgment, and the Court denied the majority of the parties' motions but granted the Company's motion to preclude Fairchild from re-arguing validity positions that were rejected in the prior case between the parties. Because the assigned Judge retired at the end of July 2010, the case was re-assigned to a different Judge, and the Court vacated the trial schedule and had the parties provide their input on the appropriate course of action. The Court thereafter set a trial schedule with the jury trial on infringement and validity to begin in July 2011. On April 18, 2011, the Court rescheduled the trial to begin in January 2012, and on June 2, 2011, the Court moved the trial date to April 2012 to permit the parties to address another patent the Company accused Fairchild of infringing. Following a trial in April 2012, the jury returned a verdict finding that Fairchild infringes two of the Company's patents, that Fairchild has induced others to infringe the Company's patents, and also upheld the validity of the infringed patents. Of the two remaining counterclaim patents Fairchild asserted in the case, one was found not to be infringed, but the jury found the second patent to be infringed by a limited number of the Company's products, although the jury further found the Company did not induce infringement by any customers, including customers outside the United States. On March 29, 2013, the District Court denied most of the parties' post-trial motions on liability but granted the Company's motion for judgment as a matter of law finding that Fairchild infringed another of the Company's patents. On April 25, 2013, the Court denied both parties' motions regarding the unenforceability of each other's patents. The Company challenged adverse findings on appeal; nevertheless, the Company estimated that even if the verdict on Fairchild's patent had ultimately been upheld, the sales potentially impacted would have amounted to less than 0.5% of the Company's revenues. The Company requested an injunction preventing further infringement of its own patents by Fairchild, and Fairchild requested an injunction as well. Following a hearing on the issue in June 2014, the Court denied Fairchild's request for an injunction against the Company and granted the Company's request for an injunction against Fairchild. On January 13, 2015, the District Court entered final judgment on the liability and validity issues discussed above, and both parties filed appeals with the Federal Circuit. After briefing was completed, oral argument on the appeal took place in early July 2016, and on December 12, 2016, the Federal Circuit issued its opinion in the appeal, overturning the lone infringement verdict against the Company, finding one of the Company's patents invalid, and overturning the District Court's jury instruction on inducement. In view of the Federal Circuit's rejection of the District Court's jury instruction on inducement, the Court also vacated the inducement findings and associated injunction against Fairchild and remanded the case for a retrial on inducement, but the underlying validity and infringement findings against Fairchild on those two patents remain intact. On remand, the Company will also be seeking financial damages as well as enhanced damages for Fairchild's willful infringement.

On June 28, 2004, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against System General Corporation (SG), a Taiwanese company, and its U.S. subsidiary. The Company's complaint alleged that certain integrated circuits produced by SG infringed and continue to infringe certain of its patents. On June 10, 2005, in response to the initiation of an International Trade Commission (ITC) investigation on the patents asserted in the District Court lawsuit, the District Court stayed all proceedings. Subsequent to the completion of the ITC proceedings, the District Court temporarily lifted the stay and scheduled a case management conference. On December 6, 2006, SG filed a notice of appeal of the ITC decision. In response, and by agreement of the parties, the District Court vacated the scheduled case management conference and renewed the stay of proceedings pending the outcome of the Federal Circuit appeal of the ITC determination. On November 19, 2007, the Federal Circuit affirmed the ITC's findings in all respects, and SG did not file a petition for review. The parties subsequently filed a motion to dismiss the District Court case without prejudice. On November 4, 2009, the Company re-filed its complaint for patent infringement against SG and its parent corporations, Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation, to address their continued infringement of patents at issue in the original suit that recently emerged from SG requested reexamination proceedings before the U.S. Patent and Trademark Office (USPTO). The Company seeks, among other things, an order enjoining SG and Fairchild from infringing the Company's patents and an award of damages resulting from the alleged infringement. Fairchild has denied infringement and asked for a declaration from the Court that it does not infringe any Power Integrations patent, that the patents are invalid, and that one of the two of the Company's patents now at issue in the case is unenforceable. On May 5, 2010, SG and Fairchild filed an amended answer including counterclaims accusing the Company of infringing two patents, and later Fairchild withdrew its claim for infringement of one of the patents it originally asserted against the Company but added another patent to the case over the Company's objections. Both parties filed summary judgment motions and challenges to each other's experts' testimony, and the Court granted the Company's motion for summary judgment of non-infringement with respect to one of Fairchild's two patents. Following a trial on the remaining claims in February 2014, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of the Company's patents-in-suit, finding that SG and Fairchild infringed the Company's asserted patents and induced infringement by others, and awarding $105.0 million in damages. The Jury also rejected Fairchild's remaining counterclaims for infringement against the Company. Fairchild challenged these rulings in post-trial motions, but the judge confirmed the jury's determinations on infringement and damages, although the Court declined to find Fairchild's infringement willful. Fairchild also pressed its unenforceability claim with respect to one of the two patents it was found to infringe in post-trial briefing, but the Court rejected Fairchild's unenforceability claim. Fairchild also requested reconsideration of the damages determinations, and the Court granted a new trial with respect to damages but none of the other issues addressed in the previous trial, with the retrial scheduled for December 2015. Thereafter, the parties completed pretrial proceedings challenging each other's experts, and the Court granted portions of each party's motions limiting the scope of expert testimony for purposes of the damages retrial, but neither party was successful in their efforts to prevent the other side's experts from testifying at trial. Following a retrial on the issue of damages in December 2015, the jury returned a verdict in the Company's favor, finding that the Company's patented technology created the basis for customer demand for the infringing Fairchild products and awarding $139.8 million in damages. Although the jury awarded damages, at this stage of the proceedings the Company cannot state the amount, if any, it might ultimately recover from Fairchild, and no benefits have been recorded in the Company's consolidated financial statements as a result of the damages verdict. Fairchild filed post-trial motions challenging the verdict, but the Court rejected Fairchild's motions challenging the damages verdict in August 2016. The Company also filed motions requesting enhanced damages and attorney fees and reinstatement of the willfulness finding against Fairchild in view of an intervening change of law; on January 13, 2017, the District Court reinstated the finding that Fairchild's infringement was willful but declined to enhance damages or award fees. In January 2017, Fairchild filed a further challenge to the verdict, but the Court rejected Fairchild's motion and entered a final judgment of $146.5 million after factoring in pre-judgment interest. Fairchild's appeal on the merits challenged the infringement findings and damages award. In July 2018, on appeal, the Federal Circuit affirmed the findings that Fairchild infringed both of the Company's asserted patents but vacated the damages award and remanded the case for further proceedings. The Company intends to pursue its claim for damages, although the claims at issue in litigation currently stand rejected in IPR proceedings, subject to appeal as discussed below.

On July 11, 2011, the Company filed a complaint in the U.S. District Court, District of Columbia, against David Kappos in his capacity as Director of the United States Patent and Trademark Office (PTO) as part of the ongoing reexamination proceedings related to one of the patents asserted against Fairchild and SG in the Delaware litigation described above. The Company filed a motion for summary judgment on a preliminary jurisdictional issue, and the PTO filed a cross-motion to dismiss on this same issue; briefing on those motions was completed in October, 2011. On November 18, 2013, the Court granted the PTO's motion and transferred the case to the Federal Circuit, where additional briefing took place. Following a hearing in May 2015, the Federal Circuit ruled in the Company's favor on August 12, 2015, overturning the PTO's claim construction and remanding the case for further proceedings. On remand, the PTO ignored the Federal Circuit's guidance, so the Company filed another appeal to the Federal Circuit; in that second appeal, the Federal Circuit overturned the PTO's rulings and confirmed the validity of the challenged claims of the Company's patent on March 19, 2018.

On May 1, 2012, Fairchild Semiconductor Corporation and Fairchild's wholly owned subsidiary, System General Corporation (referred to collectively as "Fairchild"), filed a complaint against the Company in the United States District Court for the District of Delaware. In its complaint, Fairchild alleged that the Company has infringed and is infringing four patents pertaining to power conversion integrated circuit devices. The Company answered Fairchild's complaint, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid, and the Company also asserted counterclaims against Fairchild for infringement of five of the Company's patents. Fairchild withdrew its claim for infringement of one of the patents it asserted against the Company after the Company's preliminary challenge. The parties streamlined their contentions in view of the Court's pretrial rulings, and following a trial in late May and early June 2015, a jury returned a verdict finding that Fairchild infringed one of the Company's patents, that Fairchild has induced and contributed to others' infringement of the Company's patent, and that the Company induced infringement of a Fairchild patent that was previously found infringed in the 2012 trial described above, with a damages award of $2.4 million in favor of Fairchild. Both parties filed post-trial motions and challenges to various portions of the jury verdicts, and the Court addressed the first wave of post-trial motions, denying each side's challenges to the verdict and denying Fairchild's request for an injunction. In parallel proceedings, the Federal Circuit overturned the underlying finding of infringement against the Company on the Fairchild patent-in-suit, and the Company moved to vacate the inducement and damages judgment against the Company, a motion that Fairchild did not oppose. Further proceedings and a retrial on indirect infringement and damages for Fairchild's infringement of one of the Company's asserted patents are expected in the coming months, with appeals to follow.

On October 21, 2015, the Company filed a complaint for patent infringement against in the United States District Court for the Northern District of California Fairchild Semiconductor Corporation, Fairchild Semiconductor International, Inc., and wholly-owned subsidiary Fairchild (Taiwan) Corporation (referred to collectively as "Fairchild") to address Fairchild's continued infringement of two patents Fairchild was previously found to infringe in the three

District Court cases the Company brought against Fairchild discussed above. In each of the three prior cases, Fairchild was found to infringe one of the patents at issue in the latest complaint, and Fairchild's challenges to the validity of the patents were rejected during the course of the prior lawsuits as well. Fairchild has answered the Company's complaint, denying infringement and asking for a declaration from the Court that it does not infringe any Power Integrations patent and that the patents are invalid. Fairchild's answer also included counterclaims accusing the Company of infringing four patents pertaining to power conversion integrated circuit devices, including one patent the Company was found not to infringe in prior litigation. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. On December 15, 2016, the Court stayed the case pending resolution of the parties' inter partes review (IPR) and reexamination proceedings regarding the patents-in-suit.

On March 10, 2016, Silver Star Capital, LLC filed a petition with the U.S. Patent & Trademark Office (PTO) requesting that the PTO conduct an IPR of the validity of the Company's U.S. Patent No. 6,212,079 (the '079 patent), which the Company has asserted against Fairchild Semiconductor in the California litigation initiated in 2004, as discussed above. The Company's '079 patent is also asserted in the Company's most recent lawsuits against Fairchild filed in October 2015 and against ON Semiconductor filed in November 2016, also discussed herein. On March 29, 2016, ON Semiconductor Corporation filed another petition requesting

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an IPR of the Company's '079 patent. Since that time, ON Semiconductor filed eleven more IPR petitions requesting review of various patents that the Company previously asserted against Fairchild as described above, and another three IPR petitions requesting review of various patents that the Company asserted against ON Semiconductor as described herein. The PTO denied Silver Star Capital's IPR petition on the '079 patent but instituted IPR proceedings with respect to ON Semiconductor's petition directed to the '079 patent. On September 22, 2017, the PTO rejected as obvious the claims of the Company's '079 patent that were asserted in litigation and which formed the basis for the $146.5 million judgment against Fairchild; an appeal has been filed to reverse the PTO's adverse findings, with further proceeding expected in the coming months. The PTO also instituted IPR proceedings in response to eight of ON Semiconductor's eleven other petitions challenging patents previously asserted against Fairchild, denying institution in three cases, and the PTO has rejected a number of the Company's patent claims in the context of these ongoing proceedings. In one case, the PTO rejected as anticipated the claims of the Company's U.S. Patent No. 6,538,908 that were asserted in litigation against Fairchild; an appeal is under way, with briefing expected in the coming months, and further proceedings and appeals regarding other IPRs are expected in the coming months as well. Although the validity of many of the Company's challenged patents has previously been confirmed in the Company's District Court litigation with Fairchild and in many cases in prior PTO reexamination proceedings as well, and though the Company intends to vigorously defend the validity of its patents, the outcome of the IPR proceedings is uncertain.

On April 1, 2016, Opticurrent, LLC filed a complaint against the Company in the United States District Court for the Eastern District of Texas. In its complaint, Opticurrent alleges that the Company has infringed and is infringing one patent pertaining to transistor switch devices. The Company filed a motion to transfer the case to California, which the Court granted, and the case was assigned to a new judge in San Francisco following the transfer. Further proceedings are expected over the course of the coming months, with trial scheduled for February 2019. The Company intends to vigorously defend itself against Opticurrent's claims.

On August 11, 2016, ON Semiconductor filed a complaint against the Company in the United States District Court for the District of Arizona. In its complaint, ON Semiconductor alleged that the Company has infringed and is infringing six patents and requested injunctive relief. The Company filed a motion to transfer the case to the Northern District of California, which the Court granted, and the case has been consolidated with the Company's affirmative case against ON Semiconductor in the Northern District of California, as discussed below. The Company believes it has valid defenses and intends to vigorously defend itself against ON Semiconductor's claims.

On November 1, 2016, the Company filed a lawsuit against ON Semiconductor in the United States District Court for the Northern District of California to address ON Semiconductor's infringement of six patents. The court denied ON Semiconductor's motion requesting that the case be transferred to Arizona and scheduled trial for December of 2019, with interim deadlines for hearing claim construction and dispositive motions. In consolidating the pleadings from the California and Arizona cases following the transfer of ON Semiconductor's case from Arizona, ON Semiconductor asserted two additional patents, bringing the total number of patents asserted against the Company to eight in this case, and ON Semiconductor's amended complaint also seeks a declaration of non-infringement with respect to another of the Company's patents that was previously asserted against Fairchild Semiconductor. Further proceedings and discovery will take place over the coming months, with a trial scheduled for December of 2019.

On December 27, 2016, ON Semiconductor filed a complaint against the Company in the United States District Court for the Eastern District of Texas. In its complaint, ON Semiconductor alleged that the Company has infringed and is infringing six patents and requests injunctive relief. On March 9, 2017, ON Semiconductor dismissed its Texas complaint and re-filed a substantially similar complaint in the District of Delaware. After the Company filed a motion to dismiss, ON Semiconductor filed an amended complaint; the Company has answered ON Semiconductor's complaint and asserted claims for infringement of several of the Company's patents. Trial has been scheduled for February of 2020, with interim deadlines for discovery and claim construction, and the Company believes it has valid defenses and intends to vigorously defend itself against ON Semiconductor's claims.

In November 2017, ON Semiconductor filed suit against the Company in Taiwan charging the Company with infringing three Taiwanese patents and seeking an injunction and damages of approximately $1.0 million. Briefing on various disputed issues is under way, and issues of jurisdiction, claim construction, validity, and infringement are expected to be addressed in the coming months, but the Company believes it has valid defenses and intends to vigorously defend itself against ON Semiconductor's claims.

The Company is unable to predict the outcome of legal proceedings with certainty, and there can be no assurance that Power Integrations will prevail in the above-mentioned unsettled litigations. These litigations, whether or not determined in Power Integrations' favor or settled, will be costly and will divert the efforts and attention of the Company's management and technical personnel from normal business operations, potentially causing a material adverse effect on the business, financial condition and operating results. Currently, the Company is not able to estimate a loss or a range of loss for the ongoing litigation disclosed above, however adverse determinations in litigation could result in monetary losses, the loss of proprietary rights, subject the Company to significant liabilities, require Power Integrations to seek licenses from third parties or prevent the Company from licensing the technology, any of which could have a material adverse effect on the Company's business, financial condition and operating results.

13. INDEMNIFICATIONS:

The Company sells products to its distributors under contracts, collectively referred to as Distributor Sales Agreements ("DSA"). Each DSA contains the relevant terms of the contractual arrangement with the distributor, and generally includes certain provisions for indemnifying the distributor against losses, expenses, and liabilities from damages that may be awarded against the distributor in the event the Company's products are found to infringe upon a patent, copyright, trademark, or other proprietary right of a third party ("Customer Indemnification"). The DSA generally limits the scope of and remedies for the Customer Indemnification obligations in a variety of industry-standard respects, including, but not limited to, limitations based on time and geography, and a right to replace an infringing product. The Company also, from time to time, has granted a specific indemnification right to individual customers.

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees' development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of June 30, 2018. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnifications.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and our results of operations should be read in conjunction with the condensed consolidated financial statements and the notes to those statements included elsewhere in this Quarterly Report on Form 10-Q, and with the consolidated financial statements and management's discussion and analysis of our financial condition and results of operations in our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on February 14, 2018. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those contained in these forward-looking statements due to a number of factors, including those discussed under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017, and in Part II, Item 1A -"Risk Factors" and elsewhere in this report. See also "Cautionary Note Regarding Forward-Looking Statements" at the beginning of this report.

Overview

We design, develop and market analog and mixed-signal integrated circuits (ICs) and other electronic components and circuitry used in high-voltage power conversion. Our products are used in power converters that convert electricity from a high-voltage source (typically 48 volts or higher) to the type of power required for a specified downstream use. In most cases, this conversion entails, among other functions, converting alternating current (AC) to direct current (DC) or vice versa, reducing or increasing the voltage, and regulating the output voltage and/or current according to the customer's specifications.

A large percentage of our products are ICs used in AC-DC power supplies, which convert the high-voltage AC from a wall outlet to the low-voltage DC required by most electronic devices. Power supplies incorporating our products are used with all manner of electronic products including mobile phones, computing and networking equipment, appliances, electronic utility meters, power tools, industrial controls, and lighting applications that utilize light-emitting diodes (LEDs), and "smart-home," or "internet of things" applications such as networked thermostats, power strips and other building-automation and security devices.

We also offer high-voltage gate drivers – either standalone ICs or circuit boards containing ICs, electrical isolation components and other circuitry – used to operate high-voltage switches such as insulated-gate bipolar transistors (IGBTs). These combinations of switches and drivers are used for power conversion in high-power applications (i.e., power levels ranging from a few kilowatts up to one gigawatt) such as industrial motors, solar- and wind-power systems, electric vehicles and high-voltage DC transmission systems.

Our products bring a number of important benefits to the power-conversion market compared with less advanced alternatives, including reduced component count and design complexity, smaller size, higher reliability and reduced time-to-market. Our products also improve the energy efficiency of power converters, helping our customers meet the increasingly stringent efficiency standards that have been adopted around the world for many electronic products, and improving the efficiency of renewable-energy systems, electric vehicles and other high-power applications.

While the size of our addressable market fluctuates with changes in macroeconomic and industry conditions, the market has generally exhibited a modest growth rate over time as growth in the unit volume of power converters has been offset to a large degree by reductions in the average selling price of components in this market. Therefore, the growth of our business depends largely on increasing our penetration of the markets that we serve and on further expanding our addressable market. Our growth strategy includes the following elements:

- Increase our penetration of the markets we serve. We currently address AC-DC power-supply applications with power outputs up to approximately 500 watts, and gate-driver applications of ten kilowatts and higher. Through our R&D efforts, we seek to introduce more advanced products for this market that offer higher levels of integration and performance compared to earlier products. We also continue to expand our sales and application-engineering staff and our network of distributors, as well as our offerings of technical documentation and design-support tools and services to help customers use our products. These tools and services include our PI Expert™ design software, which we offer free of charge, and our transformer-sample service.

Our market-penetration strategy also includes capitalizing on the importance of energy efficiency in the power conversion market. For example, our EcoSmart™ technology drastically reduces the amount of energy consumed by electronic products when they are not in use, helping our customers comply with regulations that seek to curb this so-called “standby” energy consumption. Also, our gate-driver products are critical components in energy-efficient DC motor drives, high-voltage DC transmission systems, renewable-energy installations and electric transportation applications.

- Increase the size of our addressable market. Prior to 2010 our addressable market consisted of AC-DC applications with up to about 50 watts of output, a served available market (“SAM”) opportunity of approximately $1.5 billion. Since that time we have expanded our SAM to approximately $3 billion through a variety of means. These include

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the introduction of products that enable us to address higher-power AC-DC applications (such as our Hiper™ product families, which address applications up to about 500 watts) and our entry into the gate-driver markets through the acquisition of CT-Concept Technologie AG in 2012. In 2016 we introduced the SCALE-iDriver™ family of gate-driver ICs, which enables us to address applications between approximately 10 kilowatts and 100 kilowatts, whereas previously our gate-driver products were primarily for applications above 100 kilowatts.

Also contributing to our SAM expansion has been the emergence of new applications within the power ranges that our products can address. For example, applications such as LED lighting, "smart" utility meters, battery-powered lawn equipment and bicycles, and USB power ports (installed alongside traditional AC wall outlets) can incorporate our products; the increased use of electronic intelligence and controls in consumer appliances has also enhanced our SAM.

Finally, we have enhanced our SAM by increasing the level of integration of our products, which in turn increases their value. For example, our InnoSwitch™ ICs integrate circuitry from the secondary, or low-voltage, side of AC-DC power supplies, whereas earlier product families integrated circuitry only on the primary, or high-voltage side.

We intend to continue expanding our SAM in the years ahead through all of the means described above.

Our quarterly operating results are difficult to predict and subject to significant fluctuations. We plan our production and inventory levels based on internal forecasts of projected customer demand, which are highly unpredictable and can fluctuate substantially. Customers typically may cancel or reschedule orders on short notice without significant penalty and, conversely, often place orders with very short lead times to delivery. Also, external factors such as global economic conditions and supply-chain dynamics can cause our operating results to be volatile. Furthermore, because our industry is intensely price-sensitive, our gross margin (gross profit divided by net revenues) is subject to change based on the relative pricing of solutions that compete with ours. Variations in product mix, end-market mix and customer mix can also cause our gross margin to fluctuate. Because we purchase a large percentage of our silicon wafers from foundries located in Japan, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. Changes in the prices of raw materials used in our products, such as copper and gold, can also affect our gross margin. Although our wafer-fabrication and assembly operations are outsourced, as are most of our test operations, a portion of our production costs are fixed in nature. As a result, our unit costs and gross margin are impacted by the volume of units we produce.

Recent Results

Our net revenues were $109.5 million and $107.6 million in the three months ended June 30, 2018 and 2017, respectively, and $212.6 million and $212.3 million in the six months ended June 30, 2018 and 2017, respectively. The increase in net revenues for the three month period was due primarily to higher unit sales into the industrial end-market, driven mainly by growth in high-power gate-driver applications. Net revenues for the six-month period were flat compared with the prior-year period as growth in the industrial, computer and consumer end-markets was offset by lower sales into the communications end-market for cellphone-charger and residential-networking applications.

Our top ten customers, including distributors that resell to OEMs and merchant power supply manufacturers, accounted for approximately 59% and 58% of our net revenues in the three and six months ended June 30, 2018, respectively, and approximately 57% of net revenues in each of the respective corresponding periods of 2017. Our top customer, a distributor of our products, accounted for approximately 14% and 15% of our net revenues in the three and six months ended June 30, 2018, respectively, and approximately 16% and 17% in the three and six months ended June 30, 2017, respectively. International sales accounted for approximately 97% and 96% of our net revenues in the three and six months ended June 30, 2018, respectively, and approximately 96% of net revenues in each of the respective corresponding periods of 2017.

Our gross margin was 51% and 50% in the three months ended June 30, 2018, and 2017, respectively, and 52% and 49% in the six months ended June 30, 2018, and 2017, respectively. The increases in gross margin as compared with the same periods in the prior year were due primarily to a favorable change in end-market mix, with a greater percentage of revenues coming from higher-margin end-markets; cost-reduction efforts also contributed to the increases.

Total operating expenses were $40.6 million and $39.3 million in the three months ended June 30, 2018 and 2017, respectively, and $80.2 million and $76.8 million in the six months ended June 30, 2018 and 2017, respectively. The increases were due primarily to the expansion of our workforce and annual merit increases, resulting in higher salary and related expenses, including stock-based compensation expense; also contributing to the increases were higher product-development expenses in support of our product-development efforts and increased legal expenses related to our litigation with ON Semiconductor.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those listed below. We base our estimates on historical facts and various other assumptions that we believe to be reasonable at the time the estimates are made. Actual results could differ from those estimates.

Our critical accounting policies are as follows:

- revenue recognition;
- stock-based compensation;
- estimating write-downs for excess and obsolete inventory;
- income taxes;
- business combinations; and
- goodwill and intangible assets.

Our critical accounting policies are important to the portrayal of our financial condition and results of operations, and require us to make judgments and estimates about matters that are inherently uncertain. There have been no material changes to our critical accounting policies and estimates disclosed in “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies and Estimates” and Note 2, Significant Accounting Policies and Recent Accounting Pronouncements, in each case in our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on February 14, 2018.

Results of Operations

The following table sets forth certain operating data as a percentage of net revenues for the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	48.6	50.3	48.4	51.0
Gross profit	51.4	49.7	51.6	49.0
Operating expenses:				
Research and development	16.4	16.1	16.6	16.0
Sales and marketing	12.3	12.2	12.5	11.9
General and administrative	8.4	8.2	8.6	8.2
Total operating expenses	37.1	36.5	37.7	36.1
Income from operations	14.3	13.2	13.9	12.9
Other income	0.8	0.4	0.8	0.5
Income before income taxes	15.1	13.6	14.7	13.4
Provision for income taxes	1.1	0.7	0.8	—
Net income	14.0 %	12.9 %	13.9 %	13.4 %

Comparison of the Three and Six Months Ended June 30, 2018 and 2017

Net revenues. Net revenues consist of revenues from product sales, which are calculated net of returns and allowances. Net revenues for the three and six months ended June 30, 2018 were $109.5 million and $212.6 million, respectively, and $107.6 million and $212.3 million, respectively, for the corresponding periods of 2017. The increase in net revenues for the three month period was due primarily to higher unit sales into the industrial end-market, driven mainly by growth in high-power gate-driver applications. Net revenues for the six-month period were flat compared with the prior-year period as growth in the industrial, computer and consumer end-markets was offset by lower sales into the communications end-market for cellphone-charger and residential-networking applications.

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Our revenue mix by end market for the three and six months ended June 30, 2018, compared to the corresponding periods in 2017 was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
End Market	2018	2017	2018	2017
Communications	20%	22%	20%	25%
Computer	5 %	4 %	5 %	4 %
Consumer	40%	41%	40%	39%
Industrial	35%	33%	35%	32%

International sales, consisting of sales outside of the United States of America based on "bill to" customer locations, were $105.8 million and $205.0 million in the three and six months ended June 30, 2018, respectively, and $103.1 million and $203.9 million in the corresponding periods of 2017, respectively. Although power converters using our products are distributed to end markets worldwide, most are manufactured in Asia. As a result, sales to this region represented 79% and 78%, of our net revenues in the three and six months ended June 30, 2018, respectively, and 78% and 79% of our net revenues in the corresponding periods of 2017, respectively. We expect international sales, and sales to the Asia region in particular, to continue to account for a large portion of our net revenues in the future.

Sales to distributors accounted for 76% of net revenues in each of the three and six months ended June 30, 2018, respectively, and 80% and 78% in the corresponding periods of 2017, respectively. Direct sales to OEMs and power-supply manufacturers accounted for the remainder.

In the three and six months ended June 30, 2018 and 2017, one customer, a distributor of our products, accounted for more than 10% of our net revenues.

The following table discloses this customer's percentage of revenues for the respective periods:

	Three Months Ended June 30,		Six Months Ended June 30,	
Customer	2018	2017	2018	2017
Avnet	14%	16%	15%	17%

No other customers accounted for 10% or more of our net revenues in these periods.

Gross profit. Gross profit is net revenues less cost of revenues. Our cost of revenues consists primarily of costs associated with the purchase of wafers from our contracted foundries, the assembly, packaging and testing of our products by sub-contractors, product testing performed in our own facilities, amortization of acquired intangible assets, and overhead associated with the management of our supply chain. Gross margin is gross profit divided by net revenues. The table below compares gross profit and gross margin for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in millions)	2018	2017	2018	2017
Net revenues	$109.5	$107.6	$212.6	$212.3
Gross profit	$56.2	$53.4	$109.8	$103.9
Gross margin	51.4 %	49.7 %	51.6 %	49.0 %

The increases in gross margin for the three and six months ended June 30, 2018, compared with the same periods in the prior year, was due primarily to a favorable change in end-market mix, with a greater percentage of revenues coming from higher-margin end-markets; cost-reduction efforts also contributed to the increases.

Research and development expenses. Research and development ("R&D") expenses consist primarily of employee-related expenses, including stock-based compensation, and expensed material and facility costs associated with the development of new technologies and new products. We also record R&D expenses for prototype wafers related to new products until such products are released to production. The table below compares R&D expenses for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in millions)	2018	2017	2018	2017
Net revenues	$109.5	$107.6	$212.6	$212.3
R&D expenses	$17.9	$17.3	$35.4	$34.0
R&D expenses as a % of net revenue	16.4 %	16.1 %	16.6 %	16.0 %

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R&D expenses increased in the three and six months ended June 30, 2018, as compared to the same periods in 2017, reflecting increased salary and related expenses from the expansion of headcount and annual merit increases, as well as higher product-development expenses, all in support of our product-development efforts.

Sales and marketing expenses. Sales and marketing ("S&M") expenses consist primarily of employee-related expenses, including stock-based compensation, commissions to sales representatives, amortization of intangible assets and facilities expenses, including expenses associated with our regional sales and support offices. The table below compares S&M expenses for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in millions)	2018	2017	2018	2017
Net revenues	$109.5	$107.6	$212.6	$212.3
S&M expenses	$13.5	$13.1	$26.6	$25.4
S&M expenses as a % of net revenue	12.3 %	12.2 %	12.5 %	11.9 %

S&M expenses increased in the three and six months ended June 30, 2018, as compared to the same periods in 2017, due primarily to increased salary and related expenses from the expansion of headcount and annual merit increases.

General and administrative expenses. General and administrative ("G&A") expenses consist primarily of employee-related expenses, including stock-based compensation expenses, for administration, finance, human resources and general management, as well as consulting, professional services, legal and audit expenses. The table below compares G&A expenses for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in millions)	2018	2017	2018	2017
Net revenues	$109.5	$107.6	$212.6	$212.3
G&A expenses	$9.2	$8.8	$18.2	$17.5
G&A expenses as a % of net revenue	8.4 %	8.2 %	8.6 %	8.2 %

G&A expenses increased in the three and six months ended June 30, 2018, as compared to the same periods in 2017, reflecting increased salary and related expenses due to annual merit increases as well as increased legal expenses related to our litigation with ON Semiconductor.

Other income. Other income consists primarily of interest income earned on cash and cash equivalents, marketable securities and other investments, and the impact of foreign exchange gains or losses. The table below compares other income for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in millions)	2018	2017	2018	2017
Net revenues	$109.5	$107.6	$212.6	$212.3
Other income	$0.9	$0.5	$1.7	$1.0
Other income as a % of net revenue	0.8 %	0.4 %	0.8 %	0.5 %

The increases in other income in the three and six months ended June 30, 2018, as compared to the same periods in 2017, were due primarily to increases in interest income reflecting higher yields earned on our cash and investments.

Provision for income taxes. Provision for income taxes represents federal, state and foreign taxes. The table below compares income-tax expense for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in millions)	2018	2017	2018	2017
Income before income taxes	$16.5	$14.7	$31.3	$28.1

Provision for (benefit from) income taxes	$1.1	$0.8	$1.7	$0.1
Effective tax rate	6.8 %	5.2 %	5.5 %	0.3 %

In the three and six months ended June 30, 2018 and 2017, the effective tax rate was lower than the then statutory federal income-tax rates of 21% and 35%, respectively, due to the geographic distribution of our world-wide earnings in lower tax jurisdictions, the impact of federal research tax credits, as well as the recognition of excess tax benefits related to share-based payments. Additionally, in the three and six months ended June 30, 2018, the effective tax rate was impacted by the estimated 2018 GILTI tax.

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Liquidity and Capital Resources

As of June 30, 2018, we had $246.7 million in cash, cash equivalents and short-term marketable securities, a decrease of approximately $36.2 million from $282.9 million as of December 31, 2017. As of June 30, 2018, we had working capital, defined as current assets less current liabilities, of $288.6 million, a decrease of approximately $24.9 million from $313.5 million as of December 31, 2017.

Operating activities generated cash of $42.4 million in the six months ended June 30, 2018. Net income for this period was $29.6 million; we also incurred non-cash stock-based compensation expense, depreciation and amortization of $11.7 million, $9.7 million and $2.7 million, respectively. Sources of cash also included a $9.9 million decrease in accounts receivable due to increased cash collections. These sources of cash were partially offset by an $11.7 million increase in inventory, reflecting anticipated demand, a $7.3 million decrease in accounts payable, excluding payables related to property and equipment, due primarily to the timing of payments, and a $1.4 million increase in prepaid expenses and other assets, primarily driven by prepaid taxes and maintenance agreements.

Operating activities generated cash of $30.0 million in the six months ended June 30, 2017. Net income for this period was $28.0 million; we also incurred non-cash stock-based compensation, depreciation and amortization expenses of $11.3 million, $8.5 million and $3.2 million, respectively. Sources of cash also included a $3.2 million increase in taxes payable and accrued liabilities. These sources of cash were partially offset by a $12.2 million increase in accounts receivable due to increased shipments, an $8.3 million increase in prepaid expenses and a $3.6 million decrease in accounts payable due primarily to the timing of payments.

Our investing activities provided $79.3 million of cash in the six months ended June 30, 2018, consisting of $90.4 million from sales and maturities of marketable securities, partially offset by $10.5 million for purchases of property and equipment, primarily for manufacturing. Our investing activities in the six months ended June 30, 2017, resulted in a $56.3 million net use of cash, consisting of $33.4 million for purchases of marketable securities, net of maturities, and $22.9 million for purchases of property and equipment, primarily production-related machinery and equipment.

Our financing activities in the six months ended June 30, 2018, resulted in a $67.2 million net use of cash, consisting of $63.4 million for the repurchase of our common stock and $9.5 million for the payment of dividends to stockholders. These uses of cash were offset in part by $5.6 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan. Our financing activities in the six months ended June 30, 2017, resulted in a $3.2 million net use of cash. Financing activities consisted of $8.3 million for the payment of dividends to stockholders, partially offset by proceeds of $5.1 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan.

On July 27, 2016, we entered into a Credit Agreement with a bank (the "Credit Agreement") that provides us with a $75.0 million revolving line of credit to use for general corporate purposes with a $20.0 million sub-limit for the issuance of standby and trade letters of credit. The Credit Agreement was amended on April 30, 2018, to extend the termination date from July 26, 2019, to April 30, 2022, with all other terms remaining the same. Our ability to borrow under the revolving line of credit is conditioned upon our compliance with specified covenants, including reporting and financial covenants, primarily a minimum liquidity measure and a debt to earnings ratio, with which we are currently in compliance. The Credit Agreement terminates on April 30, 2022; all advances under the revolving line of credit will become due on such date, or earlier in the event of a default. As of June 30, 2018, we had no amounts outstanding under our agreement.

In January 2017, our board of directors declared four cash dividends in the amount of $0.14 per share to be paid to stockholders of record at the end of each quarter in 2017. We paid a total of $16.6 million in cash dividends in 2017. In January 2018, our board of directors declared four quarterly cash dividends in the amount of $0.16 per share to be paid to stockholders of record at the end of each quarter in 2018. Dividend payouts of approximately $4.8 million and $4.7 million occurred on March 30, 2018 and June 29, 2018, respectively. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interests of our stockholders.

As of December 31, 2017, we had approximately $44.4 million available under our stock-repurchase program. In January 2018, our board of directors authorized the use of an additional $30.0 million for the repurchase of our common stock, with repurchases to be executed according to pre-defined price/volume guidelines. In the six months ended June 30, 2018 we repurchased approximately 0.9 million shares of our common stock for approximately $63.4 million. As of June 30, 2018, we had approximately $11.0 million remaining in our repurchase program, which has no expiration date. Authorization of future repurchase programs is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions and other factors.

As of June 30, 2018, we had a contractual obligation related to income tax, which consisted primarily of unrecognized tax benefits of approximately $18.4 million. A portion of the tax obligation is classified as long-term income taxes payable and a portion is recorded in deferred tax assets in our condensed consolidated balance sheet.

As of June 30, 2018, there were no material changes in our contractual commitments from those reported in our Annual Report on Form 10-K for the year ended December 31, 2017.

Our cash, cash equivalents and investment balances may change in future periods due to changes in our planned cash outlays, including changes in incremental costs such as direct and integration costs related to future acquisitions. We expect continued sales growth in our foreign business and plan to use the earnings generated by our foreign subsidiaries to continue to fund both the working capital and growth needs of our foreign entities, along with providing funding for any future foreign acquisitions. The recent Tax Act signed into law on December 22, 2017, subjects U.S. companies to a one-time transition tax on total post-1986 earnings and profits of their foreign subsidiaries and generally allows companies to repatriate accumulated foreign earnings without incurring additional U.S. federal taxes beginning after December 31, 2017. Accordingly, our worldwide cash and marketable securities are available to fund capital allocation needs, including capital and internal investments, acquisitions, stock repurchases and/or dividends without incurring additional U.S. federal income taxes.

If our operating results deteriorate during the remainder of 2018 as a result of a decrease in customer demand, pricing pressure, or other factors, our ability to generate positive cash flow from operations may be jeopardized. In that case, we may be forced to use our cash, cash equivalents and short-term investments, use our credit agreement or seek additional financing from third parties to fund our operations. We believe that cash generated from operations, together with existing sources of liquidity, will satisfy our projected working capital and other cash requirements for at least the next 12 months.

Off-Balance-Sheet Arrangements

As of June 30, 2018, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Recent Accounting Pronouncements

Information with respect to this item may be found in Note 2, Significant Accounting Policies and Recent Accounting Pronouncements, in our Notes to Unaudited Condensed Consolidated Financial Statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has not been a material change in our exposure to foreign currency exchange and interest rate risks from that described in our Annual Report on Form 10-K for the year ended December 31, 2017.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We consider cash invested in highly liquid financial instruments with a remaining maturity of three months or less at the date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months at the date of purchase are classified as short-term investments. We generally hold securities until maturity; however, they may be sold under certain circumstances, including, but not limited to, when necessary for the funding of acquisitions and other strategic investments, and therefore we classify our investment portfolio as available-for-sale. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we seek to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities and by constantly positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer, guarantor or depository. Our portfolio includes only marketable securities with active secondary or resale markets to facilitate portfolio liquidity. At June 30, 2018, and December 31, 2017, we held primarily cash equivalents and short-term investments with fixed interest rates.

Our investment securities are subject to market interest rate risk and will vary in value as market interest rates fluctuate. We monitor our investments per our above-mentioned investment policy; therefore, if market interest rates were to increase or decrease by 10% from interest rates as of June 30, 2018, or December 31, 2017, the increase or decrease in the fair market value of our portfolio on these dates would not have been material. We monitor our investments for impairment on a periodic basis. Refer to Note 5, Marketable Securities, in our Notes to Unaudited Condensed Consolidated Financial Statements, for a tabular presentation of our available-for-sale investments and the expected maturity dates.

Foreign Currency Exchange Risk. As of June 30, 2018, our primary transactional currency was U.S. dollars; in addition, we hold cash in Swiss francs and euro. We maintain cash denominated in Swiss francs and euro to fund the operations of our Swiss subsidiary. The foreign exchange rate fluctuation between the U.S. dollar versus the Swiss franc and euro is recorded in other income in our condensed consolidated statements of income.

We have sales offices in various other foreign countries in which our expenses are denominated in the local currency, primary Asia and Western Europe. Cash balances held in foreign countries are subject to local banking laws and may bear higher or lower risk than cash deposited in the United States. From time to time we may enter into foreign currency hedging contracts to hedge certain foreign currency transactions. As of June 30, 2018, and December 31, 2017, we did not have an open foreign currency hedge program utilizing foreign currency forward exchange contracts.

Two of our major suppliers, Epson and Lapis, have wafer supply agreements based in U.S. dollars; however, our agreements with Epson and Lapis also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar on future purchases. Each year, our management and these two suppliers review and negotiate future pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between us and each of these suppliers on future purchases.

Nevertheless, as a result of our above-mentioned supplier agreements, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. All else being equal, a 10% change in the value of the U.S. dollar compared to the Japanese yen would result in a corresponding change in our gross margin of approximately 1.0%; this sensitivity may increase or decrease depending on the percentage of our wafer supply that we purchase from some of our Japanese suppliers and could subject our gross profit and operating results to the potential for material fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

Limitation on Effectiveness of Controls

Any control system, no matter how well designed and operated, can provide only reasonable assurance as to the tested objectives. The design of any control system is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. The inherent limitations in any control system include the realities that judgments related to decision-making can be faulty, and that reduced effectiveness in controls can occur because of simple errors or mistakes. Due to the inherent limitations in a cost-effective control system, misstatements due to error may occur and may not be detected.

Evaluation of Disclosure Controls and Procedures

Management is required to evaluate our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”). Disclosure controls and procedures are controls and other procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms. Disclosure controls and procedures include controls and procedures designed to provide reasonable assurance that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure. Based on our management’s evaluation (with the participation of our principal executive officer and principal financial officer), our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2018, that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information with respect to this item may be found in Note 12, Legal Proceedings and Contingencies, in our Notes to Unaudited Condensed Consolidated Financial Statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

ITEM 1A. RISK FACTORS

As of the date of this filing, the risk factors have not changed substantively from those disclosed in Part 1 Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2017, which risk factors are incorporated by reference in this report.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In each of October 2015 and July 2017, our board of directors authorized the use of $30.0 million for the repurchase of our common stock, which were announced on October 28, 2015 and July 27, 2017, respectively. As of December 31, 2017, we had approximately $44.4 million available for future repurchases to be executed according to pre-defined price/volume guidelines.

In January 2018, our board of directors authorized the use of an additional $30.0 million for the repurchase of our common stock, which was announced on February 1, 2018. In the six months ended June 30, 2018, we purchased approximately 0.9 million shares for approximately $63.4 million. As of June 30, 2018, we had approximately $11.0 million remaining in our repurchase program, which has no expiration date.

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Issuer Purchases of Equity Securities

The following table summarizes repurchases of our common stock during the second quarter of fiscal 2018:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Repurchased Under the Plans or Programs (in millions)
April 1, 2018, to April 30, 2018	283,457	$ 68.12	283,457	$ 21.8
May 1, 2018, to May 31, 2018	133,553	$ 70.99	133,553	$ 12.3
June 1, 2018, to June 30, 2018	17,300	$ 74.28	17,300	$ 11.0
Total	434,310		434,310	

All of the shares repurchased were pursuant to our publicly announced repurchase program.

ITEM 6. EXHIBITS

EXHIBIT NUMBER	Exhibit Description	Incorporation by Reference Form	File Number	Exhibit/Appendix Reference	Filing Date	Filed Herewith
3.1	Restated Certificate of Incorporation.	10-K	000-23441	3.1	2/29/2012	
3.2	Amended and Restated Bylaws.	8-K	000-23441	3.1	4/26/2013	
4.1	Reference is made to Exhibits 3.1 to 3.2.					
10.1	First Amendment to Credit Agreement, dated April 30, 2018 by and between Power Integrations Inc. and Wells Fargo Bank, National Association					X
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.					X
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.					X
32.1**	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.					X
32.2**	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.					X
101.INS	XBRL Instance Document					X
101.SCH	XBRL Taxonomy Extension Schema Document					X

101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	X

All references in the table above to previously filed documents or descriptions are incorporating those documents and descriptions by reference thereto.

** The certifications attached as Exhibits 32.1 and 32.2 accompanying this Form 10-Q, are not deemed filed with the SEC, and are not to be incorporated by reference into any filing of Power Integrations, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-Q, irrespective of any general incorporation language contained in such filing.

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SIGNATURES

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

POWER INTEGRATIONS, INC.

Dated:	July 26, 2018	By:	/s/ SANDEEP NAYYAR
			Sandeep Nayyar
			Chief Financial Officer
			(Duly Authorized Officer, Principal Financial Officer and Principal Accounting Officer)

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