

POWER INTEGRATIONS INC
Form 10-Q
April 27, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2018

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission File Number 000-23441

POWER INTEGRATIONS, INC.
(Exact name of registrant as specified in its charter)

DELAWARE 94-3065014
(State or other jurisdiction of (I.R.S. Employer
Incorporation or organization) Identification No.)
5245 Hellyer Avenue, San Jose, California, 95138
(Address of principal executive offices) (Zip code)
(408) 414-9200
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company) Emerging growth company

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

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

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

| Class | Shares Outstanding at April 16, 2018 |
|---------------------------------|--------------------------------------|
| Common Stock, \$0.001 par value | 29,625,957 |

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Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q includes a number of forward-looking statements that involve many risks and uncertainties. Forward-looking statements are identified by the use of the words “would,” “could,” “will,” “may,” “expect,” “believe,” “should,” “anticipate,” “if,” “future,” “intend,” “plan,” “estimate,” “potential,” “target,” “seek,” or “continue” and similar phrases, including the negatives of these terms, or other variations of these terms, that denote future events. These statements reflect our current views with respect to future events and our potential financial performance and are subject to risks and uncertainties that could cause our actual results and financial position to differ materially and adversely from what is projected or implied in any forward-looking statements included in this Form 10-Q. These factors include, but are not limited to, the risks described under the caption “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, and in Item 2 of Part I — “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this Quarterly Report on Form 10-Q, including, but not limited to: our quarterly operating results are volatile and difficult to predict, and if we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly; if demand for our products declines in our major end markets, our net revenues will decrease; our products are sold through distributors, which limits our direct interaction with our end customers, therefore reducing our ability to forecast sales and increasing the complexity of our business; we depend on third-party suppliers to provide us with wafers for our products, and if they fail to provide us sufficient quantities of wafers, our business may suffer; intense competition may lead to a decrease in our average selling price and reduced sales volume of our products; if our products do not penetrate additional markets, our business will not grow as we expect; we do not have long-term contracts with any of our customers and if they fail to place, or if they cancel or reschedule orders for our products, our operating results and our business may suffer; if we are unable to adequately protect or enforce our intellectual property rights, we could lose market share, incur costly litigation expenses, suffer incremental price erosion or lose valuable assets, any of which could harm our operations and negatively impact our profitability. We make these forward-looking statements based upon information available on the date of this Form 10-Q, and we expressly disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information or otherwise, except as required by laws.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

POWER INTEGRATIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

| (In thousands) | March 31, 2018 | December 31, 2017 |
|--|-------------------|----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 121,327 | \$ 93,655 |
| Short-term marketable securities | 136,370 | 189,236 |
| Accounts receivable, net of allowances for doubtful accounts of \$739 and \$734 in 2018 and 2017, respectively | 17,727 | 16,798 |
| Inventories | 63,208 | 57,087 |
| Prepaid expenses and other current assets | 11,003 | 7,758 |
| Total current assets | 349,635 | 364,534 |
| PROPERTY AND EQUIPMENT, net | 109,871 | 111,705 |
| INTANGIBLE ASSETS, net | 25,071 | 25,419 |
| GOODWILL | 91,849 | 91,849 |
| DEFERRED TAX ASSETS | 2,506 | 2,364 |
| OTHER ASSETS | 25,502 | 25,203 |
| Total assets | \$ 604,434 | \$ 621,074 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 30,991 | \$ 33,211 |
| Accrued payroll and related expenses | 10,564 | 12,064 |
| Taxes payable | 2,183 | 1,767 |
| Other accrued liabilities | 4,427 | 4,009 |
| Total current liabilities | 48,165 | 51,051 |
| LONG-TERM INCOME TAXES PAYABLE | 18,138 | 18,259 |
| DEFERRED TAX LIABILITIES | 140 | 138 |
| OTHER LIABILITIES | 4,159 | 3,944 |
| Total liabilities | 70,602 | 73,392 |
| COMMITMENTS AND CONTINGENCIES (Notes 11, 12 and 13) | | |
| STOCKHOLDERS' EQUITY: | | |
| Common stock | 29 | 29 |
| Additional paid-in capital | 175,352 | 198,384 |
| Accumulated other comprehensive loss | (2,382) | (2,139) |
| Retained earnings | 360,833 | 351,408 |
| Total stockholders' equity | 533,832 | 547,682 |
| Total liabilities and stockholders' equity | \$ 604,434 | \$ 621,074 |

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 INCOME
 (Unaudited)

| (In thousands, except per share amounts) | Three Months Ended | |
|---|--------------------|------------|
| | March 31, | |
| | 2018 | 2017 |
| NET REVENUES | \$ 103,081 | \$ 104,688 |
| COST OF REVENUES | 49,537 | 54,212 |
| GROSS PROFIT | 53,544 | 50,476 |
| OPERATING EXPENSES: | | |
| Research and development | 17,481 | 16,640 |
| Sales and marketing | 13,088 | 12,216 |
| General and administrative | 9,014 | 8,704 |
| Total operating expenses | 39,583 | 37,560 |
| INCOME FROM OPERATIONS | 13,961 | 12,916 |
| OTHER INCOME | 836 | 506 |
| INCOME BEFORE INCOME TAXES | 14,797 | 13,422 |
| PROVISION FOR (BENEFIT FROM) INCOME TAXES | 597 | (677) |
| NET INCOME | \$ 14,200 | \$ 14,099 |
| EARNINGS PER SHARE: | | |
| Basic | \$ 0.48 | \$ 0.48 |
| Diluted | \$ 0.46 | \$ 0.47 |
| SHARES USED IN PER SHARE CALCULATION: | | |
| Basic | 29,799 | 29,456 |
| Diluted | 30,552 | 30,248 |

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 March 31, | |
|---|------------------------------------|-----------|
| (In thousands) | 2018 | 2017 |
| NET INCOME | \$ 14,200 | \$ 14,099 |
| Other comprehensive income, net of tax: | | |
| Foreign currency translation adjustments, net of \$0 tax in each of the three months ended March 31, 2018 and 2017 | (37 |) 64 |
| Unrealized gain (loss) on marketable securities, net of \$0 tax in each of the three months ended March 31, 2018 and 2017 | (238 |) 83 |
| Amortization of defined benefit pension items, net of tax of \$9 and \$13 in the three months ended March 31, 2018 and 2017, respectively | 32 | 49 |
| Total other comprehensive income (loss) | (243 |) 196 |
| TOTAL COMPREHENSIVE INCOME | \$ 13,957 | \$ 14,295 |

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)

| | Three Months Ended March 31, | |
|---|---------------------------------|------------------|
| (In thousands) | 2018 | 2017 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 14,200 | \$ 14,099 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 4,931 | 4,112 |
| Amortization of intangibles | 1,348 | 1,612 |
| Loss on disposal of property and equipment | 38 | 38 |
| Stock-based compensation expense | 5,625 | 4,969 |
| Amortization of premium on marketable securities | 262 | 251 |
| Deferred income taxes | (140) | (1,105) |
| Increase in accounts receivable allowances | 5 | — |
| Change in operating assets and liabilities: | | |
| Accounts receivable | (934) | (8,518) |
| Inventories | (6,121) | 1,415 |
| Prepaid expenses and other assets | (3,141) | (8,234) |
| Accounts payable | 233 | (2,377) |
| Taxes payable and accrued liabilities | (577) | (315) |
| Net cash provided by operating activities | 15,729 | 5,947 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (6,491) | (6,403) |
| Acquisition of technology licenses | (500) | — |
| Purchases of marketable securities | — | (61,938) |
| Proceeds from sales and maturities of marketable securities | 52,366 | 46,340 |
| Net cash provided by (used in) investing activities | 45,375 | (22,001) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Issuance of common stock under employee stock plans | 4,657 | 4,392 |
| Repurchase of common stock | (33,314) | — |
| Payments of dividends to stockholders | (4,775) | (4,137) |
| Proceeds from draw on line of credit | 8,000 | — |
| Payments on line of credit | (8,000) | — |
| Net cash provided by (used in) financing activities | (33,432) | 255 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 27,672 | (15,799) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 93,655 | 62,134 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 121,327 | \$ 46,335 |
| SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES: | | |
| Unpaid property and equipment | \$ 1,961 | \$ 11,953 |
| Unpaid technology licenses | \$ 500 | \$ — |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash paid (refund) for income taxes, net | \$ 273 | \$ (1,439) |

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) | March 31, December 31, | |
|--|------------------------|-----------|
| | 2018 | 2017 |
| Accounts receivable trade | \$ 68,474 | \$ 58,718 |
| Allowances for ship and debit | (47,262) | (39,486) |
| Allowances for stock rotation and rebate | (2,746) | (1,700) |
| Allowances for doubtful accounts | (739) | (734) |
| Total | \$ 17,727 | \$ 16,798 |

Inventories

| (In thousands) | March 31, December 31, | |
|-----------------|------------------------|-----------|
| | 2018 | 2017 |
| Raw materials | \$ 19,679 | \$ 15,517 |
| Work-in-process | 16,716 | 16,765 |
| Finished goods | 26,813 | 24,805 |
| Total | \$ 63,208 | \$ 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) | March 31, December 31, | |
|--------------------------------|------------------------|----------|
| | 2018 | 2017 |
| Prepaid legal fees | \$ 1,849 | \$ 213 |
| Prepaid income tax | 248 | 460 |
| Prepaid maintenance agreements | 1,978 | 856 |
| Interest receivable | 798 | 1,195 |
| Advance to suppliers | 1,601 | 1,211 |
| Other | 4,529 | 3,823 |
| Total | \$ 11,003 | \$ 7,758 |

Intangible Assets

| (In thousands) | March 31, 2018 | | | December 31, 2017 | | |
|-------------------------------------|----------------|-----------------------------|-----------|-------------------|-----------------------------|-----------|
| | 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 | (20,025) | 13,245 | 33,270 | (19,211) | 14,059 |
| Customer relationships | 20,030 | (15,135) | 4,895 | 20,030 | (14,621) | 5,409 |
| Technology licenses | 1,000 | (20) | 980 | — | — | — |
| In-place leases | — | — | — | 660 | (660) | — |
| Total | \$ 60,251 | \$ (35,180) | \$ 25,071 | \$ 59,911 | \$ (34,492) | \$ 25,419 |

The estimated future amortization expense related to finite-lived intangible assets at March 31, 2018, is as follows:

| Fiscal Year | Estimated Amortization (In thousands) |
|------------------------------|---|
| 2018 (remaining nine months) | \$ 3,919 |
| 2019 | 4,878 |
| 2020 | 3,653 |
| 2021 | 2,787 |
| 2022 | 1,709 |
| Thereafter | 2,174 |
| Total ⁽¹⁾ | \$ 19,120 |

(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.

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss for the three months ended March 31, 2018 and 2017, were as follows:

| (In thousands) | Unrealized Gains and Losses on Marketable Securities | | Defined Benefit Pension Items | | Foreign Currency Items | | Total | |
|----------------|--|--|---|---|--|--|--|--|
| | Three Months Ended March 31, 2018 | Three Months Ended March 31, 2017 | Three Months Ended March 31, 2018 | Three Months Ended March 31, 2017 | Three Months Ended March 31, 2018 | Three Months Ended March 31, 2017 | Three Months Ended March 31, 2018 | Three Months Ended March 31, 2017 |

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| | | | | | | | | |
|--|---------|---------|-----------|-----------|---------|---------|-----------|-----------|
| Beginning balance | \$(427) | \$(220) | \$(1,237) | \$(1,936) | \$(475) | \$(554) | \$(2,139) | \$(2,710) |
| Other comprehensive income (loss) before reclassifications | (238) | 83 | — | — | (37) | 64 | (275) | 147 |
| Amounts reclassified from accumulated other comprehensive loss | — | — | 32 | (1)49 | (1)— | — | 32 | 49 |
| Net-current period other comprehensive income (loss) | (238) | 83 | 32 | 49 | (37) | 64 | (243) | 196 |
| Ending balance | \$(665) | \$(137) | \$(1,205) | \$(1,887) | \$(512) | \$(490) | \$(2,382) | \$(2,514) |

(1) This component of accumulated other comprehensive income (loss) is included in the computation of net periodic pension cost for the three months ended March 31, 2018 and 2017.

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

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

| (In thousands) | Fair Value Measurement at March 31, 2018 | | |
|-----------------------|--|---|---|
| | Total Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
| Corporate securities | \$127,121 | \$ — | \$ 127,121 |
| Commercial paper | 87,387 | — | 87,387 |
| Government securities | 9,249 | — | 9,249 |
| Money market funds | 199 | 199 | — |
| Total | \$223,956 | \$ 199 | \$ 223,757 |
| (In thousands) | Fair Value Measurement at December 31, 2017 | | |
| | 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 three months ended March 31, 2018, and the twelve months ended December 31, 2017.

5. MARKETABLE SECURITIES:

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Amortized cost and estimated fair market value of marketable securities classified as available-for-sale (excluding cash equivalents) at March 31, 2018, were as follows:

| (In thousands) | Amortized Cost | Gross Unrealized Gains Losses | Estimated Fair Market Value |
|--|-------------------|--|--------------------------------------|
| Investments due in 3 months or less: | | | |
| Corporate securities | \$ 38,023 | \$—\$ (43) | \$37,980 |
| Total | 38,023 | — (43) | 37,980 |
| Investments due in 4-12 months: | | | |
| Corporate securities | 59,119 | — (223) | 58,896 |
| Government securities | 9,268 | — (19) | 9,249 |
| Total | 68,387 | — (242) | 68,145 |
| Investments due in 12 months or greater: | | | |
| Corporate securities | 30,625 | — (380) | 30,245 |
| Total | 30,625 | — (380) | 30,245 |
| Total marketable securities | \$ 137,035 | \$—\$ (665) | \$ 136,370 |

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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 | 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 March 31, 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 months ended March 31, 2018, and March 31, 2017:

| (In thousands) | Three Months Ended March 31, | |
|--|------------------------------------|---------|
| | 2018 | 2017 |
| Cost of revenues | \$249 | \$143 |
| Research and development | 1,839 | 1,634 |
| Sales and marketing | 1,276 | 1,097 |
| General and administrative | 2,261 | 2,095 |
| Total stock-based compensation expense | \$5,625 | \$4,969 |

Stock-based compensation expense in the three months ended March 31, 2018, was approximately \$5.6 million (comprising approximately \$4.3 million related to restricted stock unit (RSU) awards, \$0.9 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). Stock-based compensation expense in the three months ended March 31, 2017, was approximately \$5.0 million (comprising approximately \$3.5 million related to RSUs, \$1.2 million related to PSUs and PRSUs and \$0.3 million related to the Company's employee stock purchase plan).

Stock Options

A summary of stock options outstanding as of March 31, 2018, and activity during the three 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) |
|--------------------------|---|--|--|
|--------------------------|---|--|--|

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| | | | | | |
|--|-----|---|----------|------|-----------|
| Outstanding at January 1, 2018 | 511 | | \$ 29.03 | | |
| Granted | — | | — | | |
| Exercised | (84 |) | \$ 23.32 | | |
| Forfeited or expired | — | | — | | |
| Outstanding at March 31, 2018 | 427 | | \$ 30.16 | 1.98 | \$ 16,312 |
| Vested and exercisable at March 31, 2018 | 427 | | | 1.98 | \$ 16,312 |

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 March 31, 2018, and activity during the three 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 | 56 | \$ 61.12 | | |
| Vested | (79) | \$ 63.99 | | |
| Forfeited | — | — | | |
| Outstanding at March 31, 2018 | 56 | \$ 61.12 | 0.75 | \$ 3,841 |
| Outstanding and expected to vest at March 31, 2018 | 23 | | 0.75 | \$ 1,576 |

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.

A summary of PRSUs outstanding as of March 31, 2018, and activity during the three months then ended, is presented below:

| | Shares (In thousands) | Weighted- Average Grant Date Fair Value Per | Weighted-Average Remaining Contractual Term (In years) | Aggregate Intrinsic Value (In thousands) |
|--|-----------------------------|---|--|--|
|--|-----------------------------|---|--|--|

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| | | Share | | |
|--|-------|----------|------|-----------|
| Outstanding at January 1, 2018 | 184 | \$ 52.80 | | |
| Granted | 72 | \$ 59.90 | | |
| Vested | (38) | \$ 52.45 | | |
| Forfeited | — | — | | |
| Outstanding at March 31, 2018 | 218 | \$ 55.20 | 1.74 | \$ 14,873 |
| Outstanding and expected to vest at March 31, 2018 | 214 | | 1.70 | \$ 14,631 |

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

RSU Awards

A summary of RSUs outstanding as of March 31, 2018, and activity during the three 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 | 117 | \$ 60.03 | | |
| Vested | (99) | \$ 53.40 | | |
| Forfeited | (3) | \$ 56.42 | | |
| Outstanding at March 31, 2018 | 963 | \$ 56.27 | 2.40 | \$ 65,787 |
| Outstanding and expected to vest at March 31, 2018 | 880 | | 1.86 | \$ 60,173 |

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 58% of net revenues for the three months ended March 31, 2018, and approximately 59% of net revenues in the corresponding period of the previous year. 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 \$79.1 million and \$80.6 million in the three months ended March 31, 2018 and 2017, respectively. Direct sales to OEMs and power-supply manufacturers accounted for the remainder.

In each of the three months ended March 31, 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 March 31, 2018 | 2017 |
|----------|---|------|
| Avnet | 16% | 17% |

No other customers 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 of March 31, 2018, and December 31, 2017, 70% and 67%, respectively, of accounts receivable were concentrated with the Company's top 10 customers.

The following customers represented 10% or more of accounts receivable:

| Customer | March 31, | | December 31, | |
|-----------------|-----------|---|--------------|---|
| | 2018 | | 2017 | |
| Avnet | 20 | % | 18 | % |
| ATM Electronics | 10 | % | * | |

*Total customer percentage of accounts receivable was less than 10%.

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 months ended March 31, 2018, and March 31, 2017, were as follows:

| (In thousands) | Three Months Ended March 31, | |
|------------------------------------|------------------------------------|-----------|
| | 2018 | 2017 |
| United States of America | \$3,867 | \$3,829 |
| Hong Kong/China | 51,357 | 54,845 |
| Taiwan | 11,886 | 13,034 |
| Korea | 9,649 | 9,506 |
| Western Europe (excluding Germany) | 13,592 | 11,971 |
| Japan | 4,551 | 4,648 |
| Germany | 3,304 | 2,796 |
| Other | 4,875 | 4,059 |
| Total net revenues | \$103,081 | \$104,688 |

8. COMMON STOCK REPURCHASES AND CASH DIVIDENDS:

Common Stock Repurchases

As of December 31, 2017, the Company had approximately \$44.4 million remaining 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 three months ended March 31, 2018, the Company repurchased approximately 0.5 million shares of its common stock for approximately \$33.3 million. As of March 31, 2018, the Company had approximately \$41.1 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 months ended March 31, 2018, and March 31, 2017, cash dividends declared and paid were as follows:

| (In thousands, except per share amounts) | Three Months Ended March 31, | |
|--|------------------------------------|----------|
| | 2018 | 2017 |
| Dividends declared and paid | \$4,775 | \$ 4,137 |
| Dividends declared per common share | \$0.16 | \$ 0.14 |

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.

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

| | Three Months Ended March 31, | |
|--|------------------------------------|-----------|
| (In thousands, except per share amounts) | 2018 | 2017 |
| Basic earnings per share: | | |
| Net income | \$ 14,200 | \$ 14,099 |
| Weighted-average common shares | 29,799 | 29,456 |
| Basic earnings per share | \$0.48 | \$0.48 |
| Diluted earnings per share: ⁽¹⁾ | | |
| Net income | \$ 14,200 | \$ 14,099 |
| Weighted-average common shares | 29,799 | 29,456 |
| Effect of dilutive awards: | | |
| Employee stock plans | 753 | 792 |
| Diluted weighted-average common shares | 30,552 | 30,248 |
| Diluted earnings per share | \$0.46 | \$0.47 |

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 (1) 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 each of the three months ended March 31, 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 quarter ended March 31, 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 total post-1986 earnings and profits (E&P) previously deferred from U.S. income taxes. As of December 31, 2017, the Company had no 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 the amounts held in cash or other specified assets.

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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 is not yet able to reasonably estimate the effect of this provision of the Tax Act. Therefore, 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 months ended March 31, 2018 and 2017, were 4.0% and (5.0)%, respectively. In the three months ended March 31, 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 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. Additionally, in the three months ended March 31, 2018, the effective tax rate was impacted by the estimated 2018 GILTI tax.

As of March 31, 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

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

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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

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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 is under way, with briefing and oral argument now completed and a ruling expected in the coming months.

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 are expected in the coming months.

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 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 form the basis for the \$146.5 million judgment against Fairchild; an appeal has been filed to reverse the PTO's

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 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.

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 alleges 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 seven 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. No schedule has been set for trial at this preliminary stage, 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

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POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 March 31, 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 \$103.1 million and \$104.7 million in the three months ended March 31, 2018 and 2017, respectively. The decrease in net revenues was due primarily to lower unit sales into the communications end-market, reflecting reduced demand for power supplies for cell phone charging and networking applications. The decrease was partially offset by higher unit sales into the industrial and consumer end-markets, driven by growth from a broad range of industrial and consumer-appliance applications.

Our top ten customers, including distributors that resell to OEMs and merchant power supply manufacturers, accounted for 58% and 59% of our net revenues in the three months ended March 31, 2018 and 2017, respectively. Our top customer, a distributor of our products, accounted for approximately 16% and 17% of our net revenues in the three months ended March 31, 2018 and 2017, respectively. International sales accounted for 96% of our net revenues in each of the three-month periods ended March 31, 2018 and 2017.

Our gross margin was 52% and 48% in the three months ended March 31, 2018 and 2017, respectively. The increase in gross margin as compared with the same period 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.

Total operating expenses were \$39.6 million and \$37.6 million in the three months ended March 31, 2018 and 2017, respectively. The increase was due primarily to the expansion of our work force and annual merit increases, resulting in higher salary and related expenses, including stock-based compensation expense.

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.

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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 March 31, | |
|---|------------------------------------|---------|
| | 2018 | 2017 |
| Net revenues | 100.0% | 100.0 % |
| Cost of revenues | 48.1 | 51.8 |
| Gross profit | 51.9 | 48.2 |
| Operating expenses: | | |
| Research and development | 17.0 | 15.9 |
| Sales and marketing | 12.7 | 11.7 |
| General and administrative | 8.7 | 8.3 |
| Total operating expenses | 38.4 | 35.9 |
| Income from operations | 13.5 | 12.3 |
| Other income | 0.8 | 0.5 |
| Income before income taxes | 14.3 | 12.8 |
| Provision for (benefit from) income taxes | 0.6 | (0.7) |
| Net income | 13.7 % | 13.5 % |

Comparison of the Three Months Ended March 31, 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 months ended March 31, 2018 and 2017 were \$103.1 million and \$104.7 million, respectively. The decrease in net revenues, compared with the same period in the prior year, was due primarily to lower unit sales into the communications end-market, reflecting reduced demand for power supplies for cell phone charging and networking applications. The decrease was partially offset by higher unit sales into the industrial and consumer end-markets, driven by growth from a broad range of industrial and consumer-appliance applications.

Our revenue mix by end market for the three months ended March 31, 2018 and 2017 was as follows:

| | Three Months Ended March 31, | |
|----------------|---------------------------------------|------|
| End Market | 2018 | 2017 |
| Communications | 19% | 28% |
| Computer | 5 % | 4 % |

| | | |
|------------|-----|-----|
| Consumer | 40% | 37% |
| Industrial | 36% | 31% |

International sales, consisting of sales outside of the United States of America based on “bill to” customer locations, were \$99.2 million and \$100.9 million in the three months ended March 31, 2018 and 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 76% and 80%, of our net revenues in the three months ended March 31, 2018 and 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.

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Sales to distributors accounted for 77% of net revenues in each of the three months ended March 31, 2018 and 2017, respectively. Direct sales to OEMs and power-supply manufacturers accounted for the remainder.

In each of the three months ended March 31, 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 March 31, | |
|----------|------------------------------|------|
| Customer | 2018 | 2017 |
| Avnet | 16% | 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 months ended March 31, 2018 and 2017:

| | Three Months Ended March 31, | |
|-----------------------|------------------------------|----------|
| (dollars in millions) | 2018 | 2017 |
| Net revenues | \$ 103.1 | \$ 104.7 |
| Gross profit | \$ 53.5 | \$ 50.5 |
| Gross margin | 51.9 % | 48.2 % |

The increase in gross margin for the three months ended March 31, 2018, compared with the same period 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.

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 months ended March 31, 2018 and 2017:

| | Three Months Ended March 31, | |
|------------------------------------|------------------------------|----------|
| (dollars in millions) | 2018 | 2017 |
| Net revenues | \$ 103.1 | \$ 104.7 |
| R&D expenses | \$ 17.5 | \$ 16.6 |
| R&D expenses as a % of net revenue | 17.0 % | 15.9 % |

R&D expenses increased in the three months ended March 31, 2018 as compared to the same period 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 months ended March 31, 2018 and 2017:

Three Months Ended

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| (dollars in millions) | March 31, | |
|------------------------------------|-----------|---------|
| | 2018 | 2017 |
| Net revenues | \$103.1 | \$104.7 |
| S&M expenses | \$13.1 | \$12.2 |
| S&M expenses as a % of net revenue | 12.7 % | 11.7 % |

S&M expenses increased in the three months ended March 31, 2018 as compared to the same period in 2017, due primarily to increased salary and related expenses from the expansion of headcount and annual merit increases.

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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 months ended March 31, 2018 and 2017:

| (dollars in millions) | Three Months Ended March 31, | |
|------------------------------------|------------------------------------|---------|
| | 2018 | 2017 |
| Net revenues | \$103.1 | \$104.7 |
| G&A expenses | \$9.0 | \$8.7 |
| G&A expenses as a % of net revenue | 8.7 % | 8.3 % |

G&A expenses increased in the three months ended March 31, 2018 as compared to the same period in 2017, reflecting increased salary and related expenses due to annual merit increases.

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 months ended March 31, 2018 and 2017:

| (dollars in millions) | Three Months Ended March 31, | |
|------------------------------------|------------------------------------|---------|
| | 2018 | 2017 |
| Net revenues | \$103.1 | \$104.7 |
| Other income | \$0.8 | \$0.5 |
| Other income as a % of net revenue | 0.8 % | 0.5 % |

The increase in other income in the three months ended March 31, 2018 as compared to the same period in 2017, was primarily due to an increase 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 months ended March 31, 2018 and 2017:

| (dollars in millions) | Three Months Ended March 31, | |
|---|------------------------------------|---------|
| | 2018 | 2017 |
| Income before income taxes | \$14.8 | \$13.4 |
| Provision for (benefit from) income taxes | \$0.6 | \$(0.7) |
| Effective tax rate | 4.0 % | (5.0) % |

Our effective tax rates for the three months ended March 31, 2018 and 2017 were 4.0% and (5.0)%, respectively. In the three months ended March 31, 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 months ended March 31, 2018, the effective tax rate was impacted by the estimated 2018 GILTI tax.

Liquidity and Capital Resources

As of March 31, 2018, we had \$257.7 million in cash, cash equivalents and short-term marketable securities, a decrease of approximately \$25.2 million from \$282.9 million as of December 31, 2017. As of March 31, 2018, we had working capital, defined as current assets less current liabilities, of \$301.5 million, a decrease of approximately \$12.0 million from \$313.5 million as of December 31, 2017.

Operating activities generated cash of \$15.7 million in the three months ended March 31, 2018. Net income for this period was \$14.2 million; we also incurred non-cash stock-based compensation expense, depreciation and amortization of \$5.6 million, \$4.9 million and \$1.3 million, respectively. Sources of cash also included a \$0.2 million

increase in accounts payable, excluding payables related to property and equipment, due primarily to the timing of payments. These sources of cash were partially offset by a \$6.1 million increase in inventory, reflecting anticipated demand, a \$3.1 million increase in prepaid expenses and other assets, primarily driven by prepaid legal fees and prepaid maintenance agreements, as well as a \$0.9 million increase in accounts receivable due to the timing of cash collections.

Operating activities generated cash of \$5.9 million in the three months ended March 31, 2017. Net income for this period was \$14.1 million; we also incurred non-cash stock-based compensation expense, depreciation and amortization of \$5.0 million, \$4.1 million and \$1.6 million, respectively. Sources of cash also included a \$1.4 million decrease in inventory due to increased sales during the quarter. These sources of cash were partially offset by an \$8.5 million increase in accounts receivable due to increased

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sales in March 2017 compared to December 2016, an \$8.2 million increase in prepaid expenses and supplier advances and a \$2.4 million decrease in accounts payable, excluding payables related to property and equipment, due primarily to the timing of payments and a \$1.1 million increase in deferred income taxes.

Our investing activities provided \$45.4 million of cash in the three months ended March 31, 2018, consisting of \$52.4 million from sales and maturities of marketable securities, partially offset by \$6.5 million for purchases of property and equipment, primarily production-related machinery and equipment. Our investing activities in the three months ended March 31, 2017, resulted in a \$22.0 million net use of cash, consisting of \$15.6 million for purchases of marketable securities, net of maturities, and \$6.4 million for purchases of property and equipment, primarily production-related machinery and equipment.

Our financing activities in the three months ended March 31, 2018, resulted in a \$33.4 million net use of cash, consisting of \$33.3 million for the repurchase of our common stock and \$4.8 million for the payment of dividends to stockholders. These uses of cash were offset in part by \$4.7 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 three months ended March 31, 2017 provided \$0.3 million of cash. Financing activities consisted of proceeds of \$4.4 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, offset by \$4.1 million for the payment of dividends to stockholders.

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. 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 July 26, 2019; all advances under the revolving line of credit will become due on such date, or earlier in the event of a default. As of March 31, 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. A dividend payout of \$4.8 million occurred on March 30, 2018. 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 remaining 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 three months ended March 31, 2018 we repurchased approximately 0.5 million shares of our common stock for approximately \$33.3 million. As of March 31, 2018, we had approximately \$41.1 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 March 31, 2018, we had a contractual obligation related to income tax, which consisted primarily of unrecognized tax benefits of approximately \$18.7 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 March 31, 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, as of March 31, 2018, 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.

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Off-Balance-Sheet Arrangements

As of March 31, 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 March 31, 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 March 31, 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 March 31, 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 March 31, 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

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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 March 31, 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 three months ended March 31, 2018, we purchased approximately 0.5 million shares for approximately \$33.3 million. As of March 31, 2018, we had approximately \$41.1 million remaining in our repurchase program, which has no expiration date.

Issuer Purchases of Equity Securities

The following table summarizes repurchases of our common stock during the first 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 | Approximate Dollar Value of Shares that May Yet be Repurchased Under the Plans or |
|--------|---|---------------------------------------|--|---|
|--------|---|---------------------------------------|--|---|

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| | | | Plans or Programs | Programs (in millions) |
|--|---------|----------|----------------------|---------------------------|
| January 1, 2018, to January 31, 2018 | 2,000 | \$ 74.78 | 2,000 | \$ 74.2 |
| February 1, 2018, to February 28, 2018 | 301,832 | \$ 65.11 | 301,832 | \$ 54.6 |
| March 1, 2018, to March 31, 2018 | 194,443 | \$ 69.49 | 194,443 | \$ 41.1 |
| Total | 498,275 | | 498,275 | |

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

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ITEM 6. EXHIBITS

| EXHIBIT NUMBER | Exhibit Description | Incorporation by Reference | | | Filing Date | Filed Herewith |
|-------------------|--|----------------------------|----------------|-------------------------------|----------------|-------------------|
| | | Form | File Number | Exhibit/Appendix Reference | | |
| 3.1 | <u>Restated Certificate of Incorporation.</u> | 10-K | 000-23441 | 3.1 | 2/29/2012 | |
| 3.2 | <u>Amended and Restated Bylaws.</u> | 8-K | 000-23441 | 3.1 | 4/26/2013 | |
| 4.1 | Reference is made to Exhibits 3.1 to 3.2. | | | | | |
| 10.1 | <u>2018 compensation arrangements with named executive officers.</u> | 10-K | 000-23441 | Item 9B | 2/14/2018 | |
| 10.2 | <u>Director Equity Compensation Program, as revised in March 2018</u> | | | | | X |
| 31.1 | <u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> | | | | | X |
| 31.2 | <u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> | | | | | X |
| 32.1** | <u>Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> | | | | | X |
| 32.2** | <u>Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> | | | | | X |
| 101.INS | XBRL Instance Document | | | | | X |
| 101.SCH | XBRL Taxonomy Extension Schema Document | | | | | X |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document | | | | | X |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document | | | | | X |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document | | | | | X |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document | | | | | X |

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

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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: April 26, 2018 By: /s/ SANDEEP NAYYAR

Sandeep Nayyar

Chief Financial Officer

(Duly Authorized Officer, Principal Financial Officer and Principal Accounting Officer)