

VONAGE HOLDINGS CORP
Form 10-Q
August 04, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2006

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 0-51947

VONAGE HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

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Delaware

(State or other jurisdiction of incorporation or organization)

11-3547680

(IRS Employer Identification No.)

23 Main Street, Holmdel, NJ

(Address of principal executive offices)

07733

(Zip Code)

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

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

Class	Outstanding at July 31, 2006
Common Stock, par value \$0.001	154,724,830 shares

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Part I Financial Information

Item 1. Financial Statements

VONAGE HOLDINGS CORP.
CONSOLIDATED BALANCE SHEETS
(In thousands, except par value)

Assets	June 30, 2006 (unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 312,235	\$ 132,549
Marketable securities	285,486	133,830
Accounts receivable, net of allowance of \$424 and \$210, respectively	10,550	7,435
Inventory, net of allowance of \$626 and \$732, respectively	11,333	15,687
Deferred customer acquisition costs, current	9,481	6,125
Prepaid expenses and other current assets	20,079	8,228
Total current assets	649,164	303,854
Property and equipment, net of accumulated depreciation	124,734	103,638
Deferred customer acquisition costs, non-current	29,351	19,899
Deferred financing costs, net	8,854	9,577
Restricted cash	8,922	7,453
Due from related parties	73	75
Intangible assets, net	5,241	
Other assets	799	2,386
Total assets	\$ 827,138	\$ 446,882
Liabilities and Stockholders' Equity (Deficit)		
Liabilities		
Current liabilities:		
Accounts payable	\$ 44,994	\$ 16,467
Accrued expenses	93,983	98,035
Deferred revenue, current portion	30,274	20,449
Current maturities of capital lease obligations	934	773
Total current liabilities	170,185	135,724
Convertible notes, net	253,407	247,958
Deferred revenue, net of current portion	32,205	21,600
Capital lease obligations, net of current maturities	23,791	21,658
Total liabilities	479,588	426,940
Commitments and Contingencies		
Redeemable Preferred Stock		
Series A Redeemable Convertible Preferred stock, par value \$0.001 per share; authorized 8,000 shares, 8,000 shares issued and outstanding (liquidation preference \$16,000)		15,968
Series A-2 Redeemable Convertible Preferred Stock, par value \$0.001 per share; authorized 6,067 shares, 5,167 shares issued and outstanding (liquidation preference \$20,667)		20,292
Series A-2 Redeemable Convertible Preferred Stock Warrant to purchase 900 shares		1,557
Series B Redeemable Convertible Preferred Stock, par value \$0.001 per share; authorized 3,750 shares, 3,750 shares issued and outstanding (liquidation preference \$16,200)		14,489
Series C Redeemable Convertible Preferred Stock, par value \$0.001 per share; authorized 8,000 shares, 8,000 shares issued and outstanding (liquidation preference \$43,200)		38,090
Series D Redeemable Convertible Preferred Stock, par value \$0.001 per share; authorized 8,729 shares, 8,729 shares issued and outstanding (liquidation preference \$113,389)		102,722
Series E Redeemable Convertible Preferred Stock, par value \$0.001 per share; authorized 9,435 shares, 9,429 shares issued and outstanding (liquidation preference \$215,924)		195,736
Stock subscription receivable		(427)
Total redeemable preferred stock		388,427
Stockholders' Equity (Deficit)		

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Common stock, par value \$0.001 per share; authorized 596,950 shares at June 30, 2006 and December 31, 2005 issued 156,019 and 1,642 shares at June 30, 2006 and December 31, 2005 respectively; 154,727 and 1,404 outstanding at June 30, 2006 and December 31, 2005, respectively

	156	2
Additional paid-in capital	908,203	14,794
Stock subscription receivable	(6,617	) (37
Accumulated deficit	(541,580	) (382,284
Treasury stock, at cost, 1,292 shares and 238 shares, respectively	(12,331	) (619
Deferred compensation		(167
Accumulated other comprehensive loss	(281	) (174
Total stockholders' equity (deficit)	347,550	(368,485
Total liabilities, redeemable preferred stock and stockholders' equity (deficit)	\$ 827,138	\$ 446,882

The accompanying notes are an integral part of the consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2006	2005	June 30, 2006	2005
Operating Revenues:				
Telephony services	\$ 136,636	\$ 57,539	\$ 248,294	\$ 96,122
Customer equipment and shipping	6,742	1,896	13,967	4,023
	143,378	59,435	262,261	100,145
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization of \$3,133, \$1,426, \$5,685 and \$2,380, respectively)	38,946	17,719	76,530	29,827
Direct cost of goods sold	16,047	9,241	33,627	20,829
Selling, general and administrative	66,109	33,225	118,984	53,778
Marketing	90,164	61,937	178,452	117,373
Depreciation and amortization	5,740	2,266	10,699	3,876
	217,006	124,388	418,292	225,683
Loss from operations	(73,628)	(64,953)	(156,031)	(125,538)
Other Income (Expense):				
Interest income	3,980	1,336	6,721	1,914
Interest expense	(4,484)	(1)	(9,978)	(1)
Other, net	(4)	(5)	(8))
	(508)	1,330	(3,265)	1,913
Loss before income taxes	(74,136)	(63,623)	(159,296)	(123,625)
Income taxes				
Net loss	\$ (74,136)	\$ (63,623)	\$ (159,296)	\$ (123,625)
Net loss per common share:				
Basic and diluted	\$ (1.16)	\$ (46.32)	\$ (4.85)	\$ (90.17)
Weighted-average common shares outstanding:				
Basic and diluted	63,995	1,373	32,875	1,371

The accompanying notes are an integral part of the consolidated financial statements.

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net loss	\$ (159,296)	\$ (123,625)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	10,699	3,876
Beneficial conversion on interest in kind on convertible notes	9	
Accrued interest	4,226	(657)
Allowance for doubtful accounts	214	100
Allowance for obsolete inventory	177	355
Amortization of deferred financing costs	1,001	
Loss on disposal of fixed assets	9	
Stock option compensation	12,642	
Other		(54)
Changes in operating assets and liabilities:		
Accounts receivable	(3,316)	(1,788)
Inventory	4,212	(4,617)
Prepaid expenses and other current assets	(11,661)	(4,906)
Deferred customer acquisition costs	(12,753)	(6,296)
Due from related parties	11	16
Other assets	(307)	(70)
Accounts payable	27,947	30,323
Accrued expenses	(12,480)	25,490
Deferred revenue	20,334	11,935
Net cash used in operating activities	(118,332)	(69,918)
Cash flows from investing activities:		
Capital expenditures	(29,076)	(24,295)
Purchase of intangible assets	(5,241)	
Purchase of marketable securities	(325,855)	(152,633)
Maturities and sales of marketable securities	174,141	88,320
Increase in restricted cash	(1,447)	(7,213)
Net cash used in investing activities	(187,478)	(95,821)
Cash flows from financing activities:		
Principal payments on capital lease obligations	(367)	(5)
Proceeds from notes issuance	2,047	
Debt issuance costs	(278)	
Proceeds from preferred stock issuance, net		193,242
Proceeds from subscription receivable, net	53	150
Proceeds from common stock issuance, net	495,636	
Purchase of treasury stock	(11,712)	
Proceeds from exercise of stock options	53	6
Net cash provided by financing activities	485,432	193,393

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Effect of exchange rate changes on cash	64	(4)
Net change in cash and cash equivalents	179,686	27,650	
Cash and cash equivalents, beginning of period	132,549	43,029	
Cash and cash equivalents, end of period	\$ 312,235	\$ 70,679	
Supplemental disclosures of cash flow information:			
Cash paid during the periods for:			
Interest	\$ 4,609	\$ 1	

The accompanying notes are an integral part of the consolidated financial statements.

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VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIT)

(In thousands)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Stock Subscription Receivable	Deferred Compensation	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Loss	Total
Balance at December 31, 2005	\$ 2	\$ 14,794	\$ (37)	\$ (167)	\$(382,284)	\$(619)	\$(174)	\$(368,485)
Stock option exercises		53						53
Stock option compensation		12,642						12,642
Reverse unamortized deferred compensation		(167)	)	167				
Beneficial conversion of interest in kind on convertible notes		214						214
Issuance of common stock, net	31	491,935						491,966
Issuance of common stock upon conversion of preferred stock	123	387,175						387,298
Conversion of preferred stock warrant to common stock warrant		1,557						1,557
Conversion of preferred stock subscription receivable to common stock subscription receivable			(374)	)				(374)
Directed share program transactions			(6,206)	)		(11,712)	)	(17,918)
Comprehensive loss:								
Change in unrealized loss on available-for-sale investments							(58)	(58)
Foreign currency translation adjustment							(49)	(49)
Net loss					(159,296)	)		(159,296)
Total comprehensive loss					(159,296)	)	(107)	(159,403)
Balance at June 30, 2006	\$ 156	\$ 908,203	\$ (6,617)	)\$	\$(541,580)	\$(12,331)	\$(281)	\$ 347,550

The accompanying notes are an integral part of the consolidated financial statements.

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

Note 1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Vonage Holdings Corp. (Vonage , We, Our , Us) is incorporated as a Delaware corporation. The original Certificate of Incorporation was filed in May 2000 as MIN-X.COM, INC., our original name, which was changed in February 2001 to Vonage Holdings Corp. We are a provider of broadband Voice over Internet Protocol (VoIP) services to residential and small and home office customers. We launched service in the United States in October 2002, in Canada in November 2004 and in the United Kingdom in May 2005.

We have incurred significant operating losses since inception. As a result, we have generated negative cash flows from operations, and have an accumulated deficit at June 30, 2006. Our primary source of funds to date has been through the issuance of equity and debt securities, including net proceeds from our initial public offering (IPO) in May 2006.

Unaudited Interim Financial Information

The accompanying unaudited interim consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations, cash flows and statement of stockholders' equity (deficit) for the periods presented. The results for the three and six month periods ended June 30, 2006 are not necessarily indicative of the results to be expected for the full year.

These unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in our Registration Statement on Form S-1 (Registration No. 333-131659).

Significant Accounting Policies

Basis of Consolidation

The consolidated financial statements include the accounts of Vonage and our wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

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

On an ongoing basis, we evaluate our estimates including, the following:

- those related to the average period of service to a customer (the customer relationship period) used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation;
- the useful lives of property and equipment; and
- assumptions used for the purpose of determining stock-based compensation using the Black-Scholes option model (Model), and on various other assumptions that we believed to be reasonable. The key inputs for this Model are stock price at valuation date, strike price for the option, the dividend yield, risk-free interest rate, life of option in years and

volatility.

We base our estimates on historical experience, available market information, appropriate valuation methodologies, and on various other assumptions that we believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Restricted Cash and Letters of Credit

We report the collateralization of certain letters of credit as restricted cash. The amount of collateralized letters of credit primarily related to lease deposits for our offices and certain purchased customer equipment were \$8,519 and \$7,210 at June 30, 2006 and December 31, 2005, respectively, with corresponding restricted cash of \$8,922 and \$7,453, respectively at June 30, 2006 and December 31, 2005, respectively.

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

Patents

The three patents we acquired on June 27, 2006 are directed to the compression of packetized digital signals commonly used in VoIP technology. Beginning in July 2006, we will begin amortizing the acquisition cost of these patents over the estimated useful lives of the patents.

Fair Value of Financial Instruments

The carrying amounts of our financial instruments, including cash and cash equivalents, marketable securities, accounts receivable and accounts payable, approximate fair value because of their short maturities. The carrying amounts of our capital leases approximate fair value of these obligations based upon management's best estimates of interest rates that would be available for similar debt obligations at June 30, 2006 and December 31, 2005. Our convertible notes are carried at estimated fair value less any unamortized discount.

Loss per Share

Basic and diluted loss per common share is calculated by dividing loss to common stockholders by the weighted average number of common shares outstanding during the period. The effects of potentially dilutive common shares, including shares issued under our 2001 Stock Incentive Plan and 2006 Incentive Plan using the treasury stock method and our convertible notes and common stock warrants using the if-converted method, have been excluded from the calculation of diluted loss per common share because of their anti-dilutive effects.

The following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

	Three and Six Months Ended June 30 ,	
	2006	2005
Common stock warrants	3,085	3,085
Convertible notes	17,826	
Employee stock options	16,599	8,271
	37,510	11,356

Stock-Based Compensation

Prior to the adoption of Statement of Financial Accounting Standards No. 123(R) (SFAS 123(R)), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25 (APB 25) as allowed under Statement of Financial Accounting Standards No. 123. Under the intrinsic value method, no stock-based compensation expense for employee stock options had been recognized in our results of operations in prior periods. In accordance with the modified prospective transition method that we used in adopting SFAS 123(R) as of January 1, 2006, the consolidated financial statements prior to 2006 have not been restated to reflect, and do not include, the possible impact of SFAS 123(R). The table below reflects the pro forma net loss and net loss per share for the three and six months ended June 30, 2005:

	Three Months Ended June 30 , 2005	Six Months Ended June 30 , 2005
Net loss attributable to common shareholders, as reported	\$ (63,623)	\$ (123,625)
Deduct total stock-based employee compensation expense determined under fair value based method for all awards	(1,072)	(1,385)
Net loss, proforma	\$ (64,695)	\$ (125,010)
Net loss per common share:		
As reported basic and diluted	\$ (46.32)	\$ (90.17)
Pro forma basic and diluted	\$ (47.12)	\$ (91.18)

Weighted-average common shares outstanding:

Basic and diluted

1,373

1,371

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

The fair value for these options was estimated at the date of grant using a Black-Scholes option-pricing model. Expected volatilities are based on a combination of historical volatilities experienced by companies considered representative of us in terms of industry. Prior to the adoption of FAS 123(R), we used 0% expected volatility while we were a private company. We also use historical data to estimate the term that options are expected to be outstanding and the forfeiture rate of options granted. The risk-free interest rate is based on the U.S. Treasury zero-coupon securities with a term approximating the expected term. The assumptions used to value options are as follows:

	Three Months Ended		Six Months Ended					
	June 30, 2006	2005	June 30, 2006	2005				
Risk-free interest rate	5.10	%	4.36	%	4.72-5.10	%	4.36	%
Expected stock price volatility	50.18	%	0.00	%	50.18-50.80	%	0.00	%
Dividend yield	0.00	%	0.00	%	0.00	%	0.00	%
Expected life (in years)	8.63		8.83		8.63-8.90		8.83	

Recent Accounting Pronouncements

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. In addition, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. Earlier application is permitted as long as the enterprise has not yet issued financial statements, including interim financial statements, in the period of adoption. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption of this standard. Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 should be reported as an adjustment to the opening balance of retained earnings (or other appropriate components of equity) for that fiscal year. We believe the adoption of FIN 48 will not have a material effect on our consolidated financial statements.

Note 2. Income Taxes

As of June 30, 2006, we had net operating loss carryforwards for U.S. federal and state tax purposes of \$448,345 and \$434,151, respectively, expiring at various times from years ending 2020 through 2026. In addition, we have net operating loss carryforwards for Canadian tax purposes of \$32,204 expiring through 2013. We also have net operating loss carryforwards for United Kingdom tax purposes of \$10,714 with no expiration date.

Under Section 382 of the Internal Revenue Code, if a corporation undergoes an ownership change (generally defined as a greater than 50% change (by value) in its equity ownership over a three-year period), the corporation's ability to use its pre-change of control net operating loss carry forward and other pre-change tax attributes against its post-change income may be limited. The Section 382 limitation is applied annually so as to limit the use of pre-change net operating loss carry forwards to an amount that generally equals the value of a corporation's stock immediately before the ownership change multiplied by a designated federal long-term tax-exempt rate. In addition, we may be able to increase the base Section 382 limitation amount during the first five years following the ownership change to the extent we realize built-in gains during that time period. A built-in gain generally is gain or income attributable to an asset that was held at the date of the ownership change and that had a fair market value in excess of the tax basis at the date of the ownership change. Section 382 provides that any unused Section 382 limitation amount can be carried forward and aggregated with the following year's available net operating losses. Due to the cumulative impact of our equity issuances over the past three years, a change of ownership occurred upon the issuance of our Series E Preferred Stock at the end of April 2005. As a result, \$171,147 of the total U.S net operating losses will be subject to an annual base limitation of \$39,374. As noted above, we believe we may be able to increase the base Section 382 limitation for built-in gains during the first five years following the ownership change.

We are currently conducting research to evaluate the impact of Section 382 in relation to our May 2006 IPO. The results of which may indicate a further limitation on the utilization of the \$277,198 in U.S. net operating losses accumulated since our Series E preferred stock issuance in April

2005.

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

Note 3. Convertible Notes

In December 2005 and January 2006, we issued \$249,900 aggregate principal amount of convertible notes due December 1, 2010 (the Notes). We plan to use the proceeds from the offering of the Notes for working capital and other general corporate purposes (including the funding of our operating losses).

The holders may require us to repurchase all or any portion of the Notes on December 16, 2008 at a price in cash equal to 100% of the principal amount of the Notes plus any accrued and unpaid interest and late charges.

We may, at our option, pay interest on the Notes in cash or in kind. If paid in cash, interest will accrue at a rate of 5% per annum and be payable quarterly in arrears. If paid in kind, the interest will accrue at a rate of 7% per annum and be payable quarterly in arrears. Interest paid in kind will increase the principal amount outstanding and will thereafter accrue interest during each period. The first interest payment was made on March 1, 2006. We elected to pay this interest in kind in the amount of \$3,645. The interest payment due on June 1, 2006 for \$3,170 was paid in cash.

Upon an event of default, the interest rate will be the greater of the interest rate then in effect or 15% per annum. If interest on the Notes is not paid in full on any interest payment date, the principal amount of the Notes will be increased for subsequent interest accrual periods by an amount that reflects the accretion of the unpaid interest at an annual rate equal to the interest rate then in effect plus 2%, calculated on a quarterly basis, from, and including, the first day of the relevant interest accrual period.

We may redeem any or all of the Notes at any time beginning June 16, 2007, provided that, among other things, the Common Stock has traded at a price greater than 150% of the then applicable conversion price of the Notes for 20 consecutive trading days. The Notes are redeemable at a price equal to 100% of the principal amount plus accrued and unpaid interest and any late charges, plus the aggregate net present value of the remaining scheduled interest payments through December 16, 2008, if any, calculated as provided in the Notes.

We also may redeem any or all of the Notes at any time after December 16, 2008 at a price equal to 100% of the principal amount plus accrued and unpaid interest and any late charges, subject to certain conditions.

Following a change of control (as defined in the Notes) the holders of the Notes may require us to redeem the Notes at a price equal to 100% of the principal amount plus accrued and unpaid interest and late charges. In addition, upon conversions in connection with certain transactions, including certain changes of control, holders of the Notes will be entitled to receive a make-whole premium as calculated in the Notes.

The Notes may, at the option of the holder, be converted into shares of Common Stock at any time. Immediately following the completion of our IPO in May 2006, the conversion price was \$14.22. The conversion price is subject to certain anti-dilution adjustments.

Following an event of default, the Notes will become due and payable, either automatically or upon declaration by holders of more than 25% of the aggregate principal amount of the Notes.

We have agreed to file resale shelf registration statements covering the shares of Common Stock issuable upon conversion of the Notes within 90 calendar days after the IPO and use reasonable best efforts to have such registration statement be declared effective within 180 calendar days after the IPO. We will pay the holders of the Notes a fee of 1% of the principal amount of the Notes on the day that this timetable has not been met and a fee of 2% of the principal amount of the Notes every 30th day thereafter until the failure is cured. We believe we will meet these required deadlines and will not incur these fees.

We evaluate the provisions of the Notes periodically to determine whether any of the provisions would be considered embedded derivatives that would require bifurcation under Statement of Financial Accounting Standards No. 133, (Accounting for Derivative Instruments and Hedging Activities) (SFAS 133). Because the shares of Common Stock underlying the Notes have not been registered for resale, they are not readily convertible to cash. Thus, the conversion option does not meet the net settlement requirement of SFAS No. 133 and would not be considered a derivative if freestanding. Accordingly, the Notes do not contain an embedded conversion feature that must be bifurcated. Once the underlying shares of Common Stock are registered we may determine that our Notes contain an embedded conversion feature that would require bifurcation from the Notes. At that time, the fair value of the embedded derivatives would be bifurcated from the Notes and recorded as a non-current liability with an offset recorded as a discount to the Notes that would be amortized to interest expense over the remaining life of the Notes using the effective interest method. The fair value of the embedded derivatives would be revalued each reporting period with the change in the fair

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value recorded as other income or expense in the statement of operations. We identified certain other embedded derivatives and concluded their value was de minimus.

Since the Notes issued in December 2005 and January 2006 did not contain an embedded conversion feature that required bifurcation, we evaluated the conversion feature to determine if it was a beneficial conversion feature under EITF 98-5 and 00-27. The conversion price equaled the fair value of the underlying Common Stock. As such, there was no beneficial conversion feature for those issuances. For the Notes issued on March 1, 2006 for the payment of interest in kind, the fair market value of the underlying Common Stock exceeded the conversion price. Accordingly, we recorded the intrinsic value of the beneficial conversion feature on 256 shares in the amount of \$214 as a discount to the Notes with an offsetting amount increasing additional paid-in-capital in March 2006. This beneficial conversion feature will be amortized over the remaining life of the Notes to interest expense on our consolidated statement of operations using the effective interest method. The amortization for the three months and six months ended June 30, 2006 was \$7 and \$9, respectively.

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

Note 4. Common Stock

Stock Split

In May 2006, our board of directors approved a 1-for-2.8 reverse stock split of our common stock, which was effected on May 18, 2006. All share and per share amounts contained in our financial statements have been retroactively adjusted to reflect the reverse stock split.

Initial Public Offering

On February 8, 2006, we filed a Registration Statement on Form S-1 (File No. 333-131659) (*Registration Statement*) with the Securities and Exchange Commission (*SEC*) relating to our IPO. The Registration Statement was declared effective by the SEC on May 23, 2006. The managing underwriters for our IPO were Citigroup Global Markets Inc., Deutsche Bank Securities Inc., UBS Investment Bank LLC, Bear Stearns & Co. Inc., Piper Jaffray & Co. and Thomas Weisel Partners LLC (*Underwriters*). In May 2006, we sold 31,250 shares of common stock in our IPO at a price to the public of \$17.00 per share for an aggregate offering price of \$531,250. In connection with the offering, we paid \$31,875 in underwriting discounts and commissions and incurred an estimated \$7,409 of other offering expenses. After deducting the underwriting discounts and commissions and the other offering expenses, our net proceeds from the offering equaled approximately \$492,000.

Directed Share Program

In connection with our IPO, we requested that our underwriters reserve 4,219 shares for our customers to purchase at the initial public offering price of \$17.00 per share through the Vonage Customer Directed Share Program (*DSP*). In connection with our IPO, we entered into an Underwriting Agreement, dated May 23, 2006, pursuant to which we agreed to indemnify the Underwriters for any losses caused by the failure of any participant in the DSP to pay for and accept delivery of the shares that had been allocated to such participant in connection with our IPO. In the weeks following the IPO, certain participants in the DSP that had been allocated shares failed to pay for and accept delivery of such shares. As a result of this failure and as part of the indemnification obligations, we acquired from the Underwriters or their affiliates 1,054 shares of our common stock which had an aggregate fair market value of \$11,712. We recorded these shares as treasury stock on the consolidated balance sheet at June 30, 2006. In addition, we expect to reimburse the Underwriters an additional amount of approximately \$6,206 in accordance with the Underwriting Agreement once certain conditions are satisfied, and which amount has been recorded in accrued expenses. Because we expect to pursue the collection of monies owed from the DSP participants who failed to pay for their shares, we recorded a stock subscription receivable of \$6,206 representing the difference between the aggregate IPO price value of the unpaid DSP shares and the \$11,712 we paid for these shares. In July 2006, we purchased an additional 1 share for \$11 and we do not anticipate making any further purchase of securities pursuant to our indemnification obligations under the Underwriting Agreement.

Note 5. Preferred Stock

Preferred Stock

Prior to our IPO, our Certificate of Incorporation, as amended, authorized 43,981 shares of Preferred Stock at \$0.001 par value. The authorized shares were designated as follows: 8,000 as Series A Redeemable Convertible Preferred Stock (*Series A Preferred Stock*), 6,067 as Series A-2 Redeemable Convertible Preferred Stock (*Series A-2 Preferred Stock*), 3,750 as Series B Redeemable Convertible Preferred Stock (*Series B Preferred Stock*), 8,000 as Series C Redeemable Convertible Preferred Stock (*Series C Preferred Stock*), 8,729 as Series D Redeemable Convertible Preferred Stock (*Series D Preferred Stock*) and 9,435 as Series E Redeemable Convertible Preferred Stock (*Series E Preferred Stock*).

In May 2006, upon completion of our IPO, all of our outstanding preferred stock automatically converted into 123,069 shares of our common stock.

Subsequent to our IPO, our Certificate of Incorporation, as amended, authorizes 5,000 shares of preferred stock at \$0.001 par value. We have no outstanding shares of preferred stock as of June 30, 2006.

Preferred Stock Warrant

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In connection with \$20,000 of notes payable from our principal stockholder and Chairman, we included aggregate warrants to purchase \$3,600 of value of Series A-2 Preferred Stock at the strike price equal to the stock price paid by Series B Preferred Stock investors. At the time these notes payable were converted into Series A-2 Preferred Stock, we issued a warrant to purchase 900 shares of Series A-2 Preferred Stock at an exercise price of \$4.00 per share, which equaled the fair market value at that date. In addition, we determined the relative fair value of the warrants was \$1,557 using the Black-Scholes valuation method. This amount

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was recorded in 2003 as debt conversion expense and as an increase to Series A-2 Redeemable Convertible Preferred Stock Warrant. Upon completion of our IPO, the warrants to purchase Series A-2 Preferred Stock automatically converted into warrants to purchase common stock and are included on our balance sheet under additional paid-in capital.

Note 6. Employee Benefit Plans

2001 Stock Incentive Plan

In February 2001, we adopted the 2001 Stock Incentive Plan, which is an amendment and restatement of the 2000 Stock Incentive Plan of MIN-X.COM, INC. The plan provides for the granting of options or restricted stock awards to our officers, directors and employees. The objectives of the plan include attracting and retaining personnel, providing for additional performance incentives, and promoting our success by providing employees the opportunity to acquire stock. During 2004, we increased the number of shares authorized for issuance pursuant to options or restricted stock awards from 4,286 to 7,503 shares under the plan, as amended. During 2005, the number of shares authorized for issuance pursuant to options or restricted stock awards was increased from 7,503 to 28,286. At June 30, 2006, 4,865 shares were subject to exercisable options or restricted stock awards under the 2001 Stock Incentive Plan. In management's opinion, all stock options were granted with an exercise price at or above the fair market value of our common stock at the date of grant with the exception of a grant in 2005 for 125 shares. Initially, we recorded deferred compensation in 2005 related to this option grant. On January 1, 2006, we reversed the remaining deferred compensation balance in accordance with SFAS 123(R). Stock options generally vest over a four-year period and expire ten years after the grant date.

On January 1, 2006, we adopted SFAS 123(R), which requires recognition of compensation expense for all stock-based awards made to employees in our consolidated financial statements. Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Under the intrinsic value method, no stock-based compensation expense for employee stock options had been recognized in our results of operations in prior periods, unless the exercise price of the stock options granted to employees and directors was less than the fair market value of the underlying stock at the date of grant. In accordance with the modified prospective transition method that we used in adopting SFAS 123(R), our consolidated financial statements prior to fiscal year 2006 have not been restated to reflect, and do not include, the possible impact of SFAS 123(R).

Beginning January 1, 2006, we estimated the volatility of our stock using historical volatility of comparable public companies in accordance with guidance in SFAS 123(R) and Staff Accounting Bulletin No. 107 (SAB 107). We will continue to use the volatility of comparable companies until historical volatility is relevant to measure expected volatility for future option grants. The expected volatilities of comparable public companies used for the second quarter were between 31.69% - 69.95%. Prior to the adoption of FAS 123(R), we used 0% expected volatility while we were a private company.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of our employee stock options. The expected term of employee stock options represents the weighted-average period that the stock options are expected to remain outstanding, which we derive based on our historical settlement experience.

As stock-based compensation expense recognized in our results is based on awards ultimately expected to vest, the amount has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on our historical experience. Prior to January 1, 2006, we also used historical experience to estimate forfeitures for the purposes of our pro forma information under SFAS 123.

Stock option activity was as follows:

	Number of Options	Range of Exercise Prices	Weighted Average Exercise Price
Balance at December 31, 2005	13,372	\$ 0.70 - \$35.00	\$ 5.88
Granted	4,302	\$ 8.75 - \$18.00	\$ 14.91
Exercised	(57)		
Canceled	(1,018)		
Balance at June 30, 2006	16,599	\$ 0.70 - \$35.00	\$ 8.10

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At June 30, 2006, 11,580 options were available for future grant under the plan.

Total stock option compensation expense recognized for the three and six months ended June 30, 2006 was \$8,190 and \$12,642, respectively. The weighted average grant date fair value of options granted during the three and six months ended June 30, 2006 was

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\$8.90 and \$9.53, respectively. The total intrinsic value of options exercised during the three and six months ended June 30, 2006 was \$707 and \$857, respectively. The total fair value of options that vested during the three and six months ended June 30, 2006 was \$3,504 and \$5,079, respectively.

As of June 30, 2006, total unamortized stock-based compensation was \$34,242, which is expected to be amortized over the remaining vesting period of each grant, up to the next 48 months. Compensation costs for all stock-based awards are recognized using the ratable single-option approach on an accrual basis.

The following is a summary of the status of stock options outstanding at June 30, 2006:

Exercise Price Range	Outstanding Options			Exercisable Options	
	Number	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
\$0.00 - \$3.50	4,828	7.3	\$ 1.50	2,890	\$ 1.35
\$3.50 - \$7.80	2,201	8.3	\$ 6.92	697	\$ 6.90
\$7.81 - \$11.00	5,229	9.1	\$ 8.98	1,032	\$ 8.94
\$11.01 - \$19.00	4,326	9.7	\$ 14.90	231	\$ 14.70
\$19.01 - \$35.00	15	5.3	\$ 33.36	15	\$ 33.36
	16,599	8.6	\$ 8.10	4,865	\$ 4.49

Additional information with respect to stock option activity is as follows:

(Shares and Intrinsic Value in Thousands)	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value	Weighted Average Grant Date Fair Value
Shares outstanding at December 31, 2005	13,372	\$ 5.88	8.8	\$ 112,051	\$ 1.82
Granted	4,302	\$ 14.91		\$	\$ 9.53
Exercised	(57)	\$ 0.92		\$ 857	\$ 0.24
Canceled	(1,018)	\$ 8.05		\$ 2,353	\$ 3.62
Shares outstanding at June 30, 2006	16,599	\$ 8.10	8.6	\$ 39,875	\$ 3.76
Shares exercisable at June 30, 2006	4,865	\$ 4.49	7.6	\$ 23,049	\$ 1.60
Unvested shares at December 31, 2005	10,207	\$ 6.75		\$ 76,443	\$ 2.10
Unvested shares at June 30, 2006	11,734	\$ 9.59		\$ 16,826	\$ 4.65

2006 Incentive Plan

In May 2006 we adopted the 2006 Incentive Plan. There have been no grants made under this plan through June 30, 2006. The 2006 Incentive Plan permits the grant of stock options, restricted stock, restricted stock units, stock appreciation rights, performance stock, performance units, annual awards and other awards based on, or related to, shares of our common stock. Options awarded under our 2006 Incentive Plan may be nonstatutory stock options or may qualify as incentive stock options under Section 422 of the Internal Revenue Code of 1986, as amended. Our 2006 Incentive Plan contains various limits with respect to the types of awards, as follows:

- a maximum of 20,000,000 shares may be issued under the plan pursuant to incentive stock options;
- a maximum of 10,000,000 shares may be issued pursuant to options and stock appreciation rights granted to any participant in a calendar year;

- a maximum of \$5,000 may be paid pursuant to annual awards granted to any participant in a calendar year; and
- a maximum of \$10,000 may be paid (in the case of awards denominated in cash) and a maximum of 10,000,000 shares may be issued (in the case of awards denominated in shares) pursuant to awards, other than options, stock appreciation rights or annual awards, granted to any participant in a calendar year.

The maximum number of shares of our common stock that are authorized for issuance under our 2006 Incentive Plan will be determined under a formula set forth in the plan, and will equal approximately 17.65% of the number of shares that are issued and outstanding from time to time, less the number of shares that are available for issuance under our 2001 Stock

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Incentive Plan. Following termination of our 2001 Stock Incentive Plan, the number of remaining shares available for issuance under our 2001 Stock Incentive Plan, or that becomes available for issuance upon expiration or cancellation, without payment or settlement, of awards under our 2001 Stock Incentive Plan, also will become available for issuance under our 2006 Incentive Plan. Shares issued under the plan may be authorized and unissued shares or may be issued shares that we have reacquired. Shares covered by awards that are forfeited, cancelled or otherwise expire without having been exercised or settled, or that are settled by cash or other non-share consideration, will become available for issuance pursuant to a new award. Shares that are tendered or withheld to pay the exercise price of an award or to satisfy tax withholding obligations will not be available for issuance pursuant to new awards.

Note 7. Commitments and Contingencies

Litigation

During June and July 2006, the Company, several of our officers and directors, and the firms who served as the underwriters in our IPO were named as defendants in multiple class action lawsuits.

The complaints assert claims under the federal securities laws on behalf of a professed class consisting of all those who were allegedly damaged as a result of acquiring our common stock in connection with our IPO. The complaints allege, among other things, that we omitted and/or misstated certain facts concerning the IPO's Customer Directed Share Program. Some complaints also allege the IPO prospectus contained misrepresentations or omissions concerning certain of our products and/or the prior experience of some of our management. We expect the complaints to be consolidated at some time in the future.

On July 14, 2006, the Company and the firms who served as the underwriters in our IPO were named as defendants in a separate lawsuit filed in the United States District Court for the District of New Jersey. This purported class action lawsuit asserts state law breach of contract and negligence claims relating to the alleged inability of participants in our Customer Directed Share Program to trade their shares after the IPO.

Although we believe that we and the individual defendants have meritorious defenses to the claims made in each of the aforementioned complaints and intend to contest each lawsuit vigorously, an adverse resolution of any of the lawsuits may have a material adverse effect on our financial position and results of operations in the period in which the lawsuits are resolved. We are not presently able to reasonably estimate potential losses, if any, related to the lawsuits, and as such, the accompanying financial statements do not contain adjustments for this litigation.

On June 12, 2006, a lawsuit was filed against us and our subsidiary Vonage America Inc. (Vonage America) in the United States District Court for the Eastern District of Virginia alleging that we have infringed seven patents in connection with providing VoIP services. The complaint seeks injunctive relief, compensatory and treble damages and attorney fees. We have not yet filed our answer to this litigation. We believe that we have meritorious defenses against the asserted claims, and intend to vigorously defend the lawsuit. We are not presently able to reasonably estimate potential losses, if any, related to the lawsuit, and as such, the accompanying financial statements do not contain adjustments for this litigation.

On July 10, 2006, a lawsuit was filed against us and Vonage America in the United States District Court for the Eastern District of Texas alleging that we have infringed one patent in connection with voice mail technology. The complaint seeks injunctive relief, compensatory and treble damages and attorney's fees. We have not yet filed an answer to this litigation. We believe that we have meritorious defenses against the asserted claims, and intend to vigorously defend the lawsuit. We are not presently able to reasonably estimate potential losses, if any, related to the lawsuit, and as such, the accompanying financial statements do not contain adjustments for this litigation.

The state attorney general of the State of New Jersey had initiated an investigation concerning our marketing disclosures and advertising. In June 2006, we entered into an Assurance of Voluntary Compliance to resolve the issues in controversy without admitting any violation of law.

State and Municipal Taxes

In the past, we did not collect or remit state or municipal taxes (such as sales, excise, and ad valorem taxes), fees or surcharges (Taxes) on the charges to our customers for its services, except that we have historically complied with the New Jersey sales tax. We have received inquiries or demands from a number of state and municipal taxing and 911 agencies seeking payment of Taxes that are applied to or collected from customers of providers of traditional public switched telephone network services. Although we have consistently maintained that these Taxes do not apply to our service for a variety of reasons depending on the statute or rule that establishes such obligations, a number of states have

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changed their statutes as part of the streamlined sales tax initiatives and numerous other states have entered into sales tax agreements with us. As of June 30, 2006, we began collecting and remitting sales taxes in thirty-eight states and began collecting and remitting sales taxes in another two states on August 1, 2006. We also believe it is likely that we eventually will be required to collect and remit sales taxes in virtually all U.S. states that charge sales taxes. In addition, a few states address how VoIP providers should contribute to support public safety agencies, and in those states we began to remit fees to the appropriate state agencies. We have also contacted authorities in each of the other states to discuss how we can financially contribute to the 911 system. We do not know

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how all these discussions will be resolved, but there is a possibility that we will be required to pay or collect and remit some or all of these taxes in the future. Additionally, some of these Taxes could apply to us retroactively. As such, we have recorded a reserve of \$12,530 at June 30, 2006 as our best estimate of the potential tax exposure for any retroactive assessment. We believe the maximum estimated exposure for retroactive assessments is \$27,396 as of June 30, 2006.

Universal Service Fund

In late June 2006, the FCC released an Order in which it will require VoIP service providers to contribute to the Universal Service Fund (USF). This Order will be effective upon publication in the Federal Register, and require the first filing by August 1, 2006, with USF contributions effective for the fourth quarter of 2006. Vonage is to register with the FCC and report revenue for contribution using one of three methods, (1) using the interim safe harbor of 64.9%; (2) report based on our actual interstate telecommunications revenues; or (3) rely on traffic studies based on certain conditions. While our reporting methodology is still under review, we would anticipate a nominal price increase to appear on customer invoices on or about October 1, 2006. The Company has also filed an appeal with respect to this Order.

Note 8. Subsequent Events

State Attorney General Proceedings

As we disclosed in our Registration Statement on Form S-1, several state attorneys general had initiated investigations and, in two states, had commenced litigation concerning our marketing disclosures and advertising. We were cooperating with those investigations and pursuing joint settlement negotiations with the attorneys general of Florida, Illinois, Massachusetts, Texas and Michigan and separate negotiations with the attorney general of Connecticut. In July 2006 we reached an agreement in principle to settle the litigation with the state attorney general of Texas and the investigations being conducted by the state attorneys general of Florida, Illinois, Massachusetts and Michigan. This agreement in principle is subject to finalizing the documentation memorializing the settlement and executing such settlement documentation. With respect to our joint settlement negotiations, we have recorded a reserve to cover the potential exposure relating to these investigations, which was not material to our June 30, 2006 financial statements.

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

You should read the following discussion together with our consolidated financial statements and the related notes included elsewhere in this Form 10-Q and our audited financial statements included in our Registration Statement on Form S-1 (File No. 333-31659). This discussion contains forward-looking statements, which involve risks and uncertainties. Our actual results may differ materially from those we currently anticipate as a result of many factors, including the factors we describe under Risk Factors, and elsewhere in this Form 10-Q.

Overview

We are a leading provider of broadband telephone services with over 1.8 million subscriber lines as of June 30, 2006. Our services use Voice over Internet Protocol, or VoIP, technology, which enables voice communications over the Internet through the conversion and compression of voice signals into data packets. In order to use our service offerings, customers must have access to a broadband Internet connection with sufficient bandwidth (generally 60 kilobits per second or more) for transmitting those data packets.

We earn revenue and generate cash primarily through our broadband telephone service plans, each of which offers a different pricing structure based on a fixed monthly fee. We generate most of our revenue from those fees, substantially all of which we bill to our customers' credit cards one month in advance.

We have invested heavily in an integrated marketing strategy to build a strong brand awareness that supports our sales and distribution efforts. We acquire customers through a number of sales channels, including our websites, toll free numbers and a presence in major retailers located in the United States, Canada and the United Kingdom. We also acquire a significant number of new customers through Refer-a-Friend, our online customer referral program.

We launched our service in the United States in October 2002, in Canada in November 2004 and in the United Kingdom in May 2005. Since our U.S. launch, we have experienced rapid revenue and subscriber line growth. While our revenue has grown rapidly, we have incurred an accumulated deficit of \$541.6 million from our inception through June 30, 2006. Although our net losses initially were driven primarily by start-up costs and the cost of developing our technology, more recently our net losses have been driven by our growth strategy. In order to grow our customer base and revenue, we have chosen to increase our marketing expenses significantly, rather than seeking to generate net income. In addition, we plan to continue to invest in research and development and customer care. We are pursuing growth, rather than profitability, in the near term to capitalize on the current expansion of the broadband and VoIP markets, and to establish and maintain a leading position in the market for broadband telephone services. We incurred marketing expense of \$90.2 million and \$178.5 million and a net loss of \$74.1 million and \$159.3 million for the three and six months ended June 30, 2006, respectively. We intend to continue to pursue growth because we believe it will position us as a strong competitor in the long term. Although we believe we will achieve profitability in the future utilizing this strategy, we ultimately may not be successful and we may never achieve profitability.

Trends in Our Industry and Business

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

Broadband adoption. The number of U.S. households with broadband Internet access has grown significantly. We expect this trend to continue. We benefit from this trend because our service requires a broadband Internet connection and our potential addressable market increases as broadband adoption increases.

Changing competitive landscape. We are facing increasing competition from other companies that offer multiple services such as cable television, voice and broadband Internet service. Several of these competitors are offering VoIP or other voice services as part of a bundle, in which they offer voice services at a lower price than we do to new subscribers. In addition, several of these competitors are working to develop new integrated offerings that we cannot provide and that could make their services more attractive to customers. We also compete against established alternative voice communication providers and independent VoIP service providers. Some of these service providers may choose to sacrifice revenue in order to gain market share and have offered their services at lower prices or for free. These offerings could negatively affect our ability to acquire new customers or retain our existing customers.

Subscriber line growth. Since our launch, we have experienced rapid subscriber line growth. For example, we grew from 85,717 subscriber lines as of December 31, 2003 to 390,566 as of December 31, 2004 to 1,269,038 as of December 31, 2005. In addition, we grew from 847,849 subscriber lines as of June 30 2005 to 1,853,253 as of June 30, 2006 or over 1 million incremental subscriber lines. We believe we will continue to add a significant number of subscriber lines in future periods; however, we do not expect to sustain our historical subscriber line growth rate on a percentage basis due to a combination of increased competition, a significantly larger and growing customer base and increasing saturation among our initial target customer base, which included many early adopters.

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Average monthly customer churn. For the three months ended June 30, 2006, we experienced average monthly customer churn of 2.3% compared to 2.1% for the three months ended June 30, 2005. We believe this increase was driven by our continued rapid growth and inability to hire enough qualified customer care employees which led to less than satisfactory customer care during the first half of 2006. We are working to improve our customer care. We believe that our churn will fluctuate over time and may continue to increase as we shift our marketing focus from early adopters to mainstream customers and acquire customers from new sources, such as outbound telemarketing, that historically have had a higher churn rate.

Average monthly revenue per line. Our average monthly revenue per line increased to \$27.70 for the three months ended June 30, 2006 compared to \$26.63 for the three months ended June 30, 2005. For 2006, we believe that our average monthly revenue per line will remain steady or slightly increase. We recently began charging customers an Emergency 911 Cost Recovery fee, which has increased average monthly revenue per line. In addition, an increasing number of customers are choosing the residential unlimited plan as a result of the first month free promotion which has a positive effect on longer term average monthly revenue per line. These increases could be negatively impacted by the timing and duration of promotions such as the second line promotion introduced in late May 2006. In addition, in May 2006 we started offering free calls to certain countries in Europe for customers on our unlimited plans, which will decrease average monthly revenue per line.

Average monthly direct cost of telephony services per line. Our average monthly direct cost of telephony services per line decreased to \$7.52 for the three months ended June 30, 2006 compared to \$7.94 for the three months ended June 30, 2005. This decrease has been driven by changes in customers' calling patterns as international calling is a lower portion of our overall call volume and our fixed network costs are being spread over a larger subscriber line base. These decreases were partially offset by the costs of E-911 compliance.

Regulation. Our business has developed in an environment largely free from regulation. However, the United States and other countries have begun to examine how VoIP services should be regulated, and a number of initiatives could have an impact on our business. For example, the FCC has concluded that wireline broadband Internet access, such as DSL and Internet access provided by cable companies, is an information service and is subject to lighter regulation than telecommunications services. This order may give providers of wireline broadband Internet access the right to discriminate against our services, charge their customers an extra fee to use our service or block our service. We believe it is unlikely that this will occur on a widespread basis, but if it does it would have a material adverse effect on us. Other regulatory initiatives include the assertion of state regulatory authority over us, FCC rulemaking regarding emergency calling services and proposed reforms for the intercarrier compensation system. In addition, the FCC recently concluded that VoIP providers must begin contributing to the Universal Service Fund on October 1, 2006, an order that we are appealing. On a positive note, the Internal Revenue Service has discontinued the requirement to collect the Federal Excise Tax which we stopped collecting on June 24, 2006. Complying with regulatory developments will impact our business by increasing our operating expenses, including legal and consulting fees, requiring us to make significant capital expenditures or increasing the taxes and regulatory fees we pay.

E-911 roll-out. As of July 31, 2006, we were providing E-911 services to approximately 83% of our U.S. subscriber lines. We expect to complete the E-911 roll-out to nearly all of our remaining subscriber lines within the year. If the FCC orders us to disconnect customers or stop accepting new customers in areas where we have not yet implemented E-911 capability, it would reduce our subscriber growth while we work to complete the roll-out. This may result in an increase in our marketing cost per gross subscriber line addition, since most of our marketing programs are national in nature and we cannot significantly reduce our marketing costs in areas in which we could not accept new customers.

Operating Revenues

Operating revenues consists of telephony services revenue and customer equipment and shipping revenue.

Telephony services revenue. Substantially all of our operating revenues are telephony services revenue. In the United States, we offer two residential plans, Residential Premium Unlimited and Residential Basic 500, and two small office and home office plans, Small Business Unlimited and Small Business Basic. Each of our unlimited plans offers unlimited domestic calling including Puerto Rico and Canada, subject to certain restrictions, and each of our basic plans offers a limited number of domestic calling minutes per month. Under our basic plans, we charge on a per minute basis when the number of domestic calling minutes included in the plan is exceeded for a particular month. International calls (except for calls to certain European countries) under our unlimited plans are charged on a per minute basis. These per minute fees are not included in our monthly subscription fees. We offer similar plans in Canada and the United Kingdom.

We derive most of our telephony services revenue from monthly subscription fees that we charge our customers under our service plans. We also offer residential fax service, virtual phone numbers, toll free numbers and other services, for each of which we charge an additional monthly fee. One business fax line is included with each of our two small office and home office plans, but we charge monthly fees for additional business fax lines. We automatically charge these fees to our customers' credit cards monthly in advance. We automatically charge the per minute fees not included in our monthly subscription fees to our customers' credit cards monthly in arrears unless they exceed a certain dollar threshold, in which case they are charged immediately.

By collecting monthly subscription fees in advance and certain other charges immediately after they are incurred, we are able to reduce the amount of accounts receivable that we have outstanding, thus allowing us to have lower working capital requirements. Collecting in this manner also helps us mitigate bad debt exposure, which is recorded as a reduction to revenue. If a customer's credit card is declined, we generally suspend international calling capabilities as well as the customer's ability to incur domestic usage charges in excess of their plan minutes. Historically, in most cases, we are able to correct the problem with the customer within the current monthly billing cycle. If the customer's credit card cannot be successfully processed during two billing cycles (i.e. the current and subsequent month's billing cycle), we terminate the account.

We also generate revenue by charging a fee for activating service. Through June 2005, we charged an activation fee to our direct channel customers, or those customers who purchase equipment directly from us. Beginning in July 2005, we also began charging an activation fee to our retail channel customers, or customers who purchase equipment from retail stores. For our direct channel customers, activation fees, together with the related customer acquisition amounts for equipment are deferred and amortized over the estimated average customer relationship period. For our retail channel customers, rebates and retailer commissions up to but not exceeding the activation fee, are also deferred and amortized over the estimated average customer relationship period. The amortization of deferred customer equipment expense is recorded to direct cost of goods sold. The amortization of deferred rebates is recorded as a reduction to telephony services revenue. The amortization of deferred retailer commissions is recorded as marketing expense. Through December 31, 2004, we estimated that the average customer relationship period would be 30 months based upon comparisons to other telecommunications companies. For 2005, this period was reevaluated based on our experience to date and we now estimate it will be 60 months. We have applied the 60-month customer relationship period on a prospective basis beginning January 1, 2005. For 2006, we have confirmed that the customer relationship period should be 60 months.

In the United States, we charge regulatory recovery fees on a monthly basis to defray the costs associated with regulatory consulting and compliance as well as related litigation, E-911 compliance and to cover taxes that we are charged by the suppliers of telecommunications services. We record these fees as revenue.

Prior to June 30, 2005, we generally charged a disconnect fee to customers who did not return their customer equipment to us upon termination of service, regardless of the length of time between activation and termination. On July 1, 2005, we changed our termination policy. We no longer accept returns of any customer equipment after 30 days, and we charge a disconnect fee to customers who terminate their service within one year of activation. Disconnect fees are recorded as revenue and are recognized at the time the customer terminates service.

Telephony services revenue is offset by the cost of certain customer acquisition activities, such as rebates and promotions.

Customer equipment and shipping revenue. Customer equipment and shipping revenue consists of revenue from sales of customer equipment to our wholesalers or directly to customers. In addition, customer equipment and shipping revenue includes the fees that we charge our customers for shipping any equipment to them.

Operating Expenses

Operating expenses consists of direct cost of telephony services, direct cost of goods sold, selling, general and administrative expense, marketing expense and depreciation and amortization.

Direct cost of telephony services. Direct cost of telephony services primarily consists of fees that we pay to third parties on an ongoing basis in order to provide our services. These fees include:

- Access charges that we pay to other telephone companies to terminate domestic and international calls on the public switched telephone network. These costs represented approximately 57% and 64% of our direct cost of telephony services for the three months ended June 30, 2006 and 2005, respectively, with a portion of these payments ultimately being made to incumbent telephone companies. When a Vonage subscriber calls another Vonage subscriber, we do not pay an access charge.
- The cost of leasing interconnections to route calls over the Internet and transfer calls between the Internet and the public switched telephone networks of various long distance carriers.
- The cost of leasing from other telephone companies the telephone numbers that we provide to our customers. We lease these telephone numbers on a monthly basis.

- The cost of co-locating our regional data connection point equipment in third-party facilities owned by other telephone companies, internet service providers, or collocation facility providers.
- The cost of providing local number portability, which allows customers to move their existing telephone numbers from another provider to our service. Only regulated telecommunications providers have access to the centralized number databases that facilitate this process. Because we are not a regulated telecommunications provider, we must pay other telecommunications providers to process our local number portability requests.
- The cost of complying with the new FCC regulations regarding VoIP emergency services, which require us to provide enhanced emergency dialing capabilities to transmit 911 calls for all of our customers.

- Taxes that we pay on our purchase of telecommunications services from our suppliers.

Direct cost of goods sold. Direct cost of goods sold primarily consists of costs that we incur when a customer first subscribes to our service. These costs include:

- The cost of the equipment that we provide to customers who subscribe to our service through our direct sales channel in excess of activation fees. The remaining cost of customer equipment is deferred and amortized over the estimated average customer relationship period.
- The cost of shipping and handling for customer equipment, together with the installation manual, that we ship to customers.
- The cost of products or services that we give customers as promotions.

Selling, general and administrative expense. Selling, general and administrative expense includes:

- Compensation and benefit costs for all employees, which is the largest component of selling, general and administrative expense and includes customer care, research and development, network engineering and operations, sales and marketing, executive, legal, finance, human resources and business development personnel.
- Compensation expense related to stock-based awards to employees and directors.
- Outsourced labor related to customer care and retail in-store support activities.
- Transaction fees paid to credit card companies, which include a per transaction charge in addition to a percent of billings charge.
- Rent and related expenses.
- Professional fees for legal, accounting, tax, public relations, lobbying and development activities.

We anticipate an increase in our selling, general and administrative expense as we hire additional personnel to address our growing subscriber base and to handle the obligations of a public company but expect selling, general and administrative expense to decrease as a percentage of revenue in 2006.

Marketing expense. Marketing expense consists of:

- Advertising costs, which comprise a majority of our marketing expense and include online, television, print and radio advertising, direct mail, alternative media, promotions, sponsorships and inbound and outbound telemarketing.
- Creative and production costs.
- The costs to serve and track our online advertising.
- Certain amounts we pay to retailers for newspaper insert advertising, product placement and activation commissions.
- The cost associated with our customer referral program.

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For 2006, we expect to spend between \$360 million and \$380 million for marketing expense, compared to \$243.4 million in 2005. Because our marketing commitments are generally six weeks or less in duration, we are able to significantly reduce marketing expense relatively quickly if it becomes prudent to do so.

Depreciation and amortization expenses. Depreciation and amortization expenses include:

- Depreciation of our network equipment, furniture and fixtures, and employee computer equipment.
- Amortization of leasehold improvements and purchased software.
- Amortization of intangible assets (patents).

Other Income (Expense)

Other Income (Expense) consists of:

- Interest income on cash, cash equivalents and marketable securities.
- Interest expense on notes payable and capital leases.
- Amortization of deferred financing costs.
- Accretion of convertible notes.
- Gain or loss on disposal of property and equipment.
- Debt conversion expense relating to the conversion of notes payable to equity.

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For 2006 and subsequent years through 2010, we will have annual interest expense on our convertible notes of at least \$12.7 million unless the convertible notes are converted or repaid prior to maturity date. This amount will increase if we pay interest in kind on these notes.

Key Operating Data

The following table contains certain key operating data that our management uses to measure the growth of our business and our operating performance:

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Gross subscriber line additions	377,005	262,310	798,895	542,433
Net subscriber line additions	255,936	207,950	584,215	457,283
Subscriber lines	1,853,253	847,849	1,853,253	847,849
Average monthly customer churn	2.3	% 2.1	% 2.3	% 2.0
Average monthly revenue per line	\$ 27.70	\$ 26.63	\$ 28.00	\$ 26.96
Average monthly telephony services revenue per line	\$ 26.40	\$ 25.78	\$ 26.51	\$ 25.87
Average monthly direct cost of telephony services per line	\$ 7.52	\$ 7.94	\$ 8.17	\$ 8.03
Marketing costs per gross subscriber line addition	\$ 239.16	\$ 236.12	\$ 223.37	\$ 216.38
Employees (excluding temp help)	1,602	1,397	1,602	1,397

Gross subscriber line additions. Gross subscriber line additions for a particular period are calculated by taking the net subscriber line additions during that particular period and adding to that the number of subscriber lines that terminated during that period. This number does not include subscriber lines both added and terminated during the period, where termination occurred within the first 30 days after activation. The number does include, however, subscriber lines added during the period that are terminated within 30 days of activation but after the end of the period.

Net subscriber line additions. Net subscriber line additions for a particular period reflect the number of subscriber lines at the end of the period, less the number of subscriber lines at the beginning of the period.

Subscriber lines. Our subscriber lines include, as of a particular date, all subscriber lines from which a customer can make an outbound telephone call on that date. Our subscriber lines include fax lines and SoftPhones but do not include our virtual phone numbers or toll free numbers, which only allow inbound telephone calls to customers. We added over 1 million subscribers from 847,849 subscriber lines as of June 30, 2005 to 1,853,253 as of June 30, 2006. The increase in our subscriber lines was directly related to an increase in our advertising spending and our expansion to other media, such as television, direct mail, alternative media and outbound telemarketing, which have a broader customer reach.

Average monthly customer churn. Average monthly customer churn for a particular period is calculated by dividing the number of customers that terminated during that period by the simple average number of customers during the period, and dividing the result by the number of months in the period. The simple average number of customers during the period is the number of customers on the first day of the period, plus the number of customers on the last day of the period, divided by two. Terminations, as used in the calculation of churn statistics, do not include customers terminated during the period if termination occurred within the first 30 days after activation. Our average monthly customer churn was 2.3% for the three months ended June 30, 2006 compared to 2.1% for the three months ended June 30, 2005. We believe this increase was driven by our continued rapid growth and inability to hire enough qualified customer care employees which led to less than satisfactory customer care during the first half of 2006. We are working to improve our customer care. We monitor churn on a daily basis and use it as an indicator of the level of customer satisfaction. Other companies may calculate churn differently, and their churn data may not be directly comparable to ours. Customers who have been with us for a year or more tend to have a significantly lower churn rate than customers who have not. This means that during periods of rapid customer growth or if we fail to address issues

with our customer care our churn rate is likely to increase. In addition, our churn will fluctuate over time and may increase as we shift our marketing focus from early adopters to mainstream customers and acquire customers from new sources, such as outbound telemarketing, that historically have had a higher churn rate. Also, our churn rate could be negatively affected by increased competition.

Average monthly revenue per line. Average monthly revenue per line for a particular period is calculated by dividing our total revenue for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. The simple average number of subscriber lines for the period is the number of subscriber lines on the first day of the period, plus the number of subscriber lines on the last day of the period, divided by two. Our average monthly revenue per line was \$27.70 for the three months ended June 30, 2006 compared to \$26.63 for the three months ended June 30, 2005.

Average monthly telephony services revenue per line. Average monthly telephony services revenue per line for a particular period is calculated by dividing our total telephony services revenue for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. Our average monthly telephony services revenue per line was \$26.40 for the three months ended June 30, 2006 compared with \$25.78 for the three months ended June 30, 2005.

Average monthly direct cost of telephony services per line. Average monthly direct cost of telephony services per line for a particular period is calculated by dividing our direct cost of telephony services for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. We use the average monthly direct cost of telephony services per line to evaluate how effective we are at managing our costs of providing service. Our average monthly direct cost of telephony services per line decreased from \$7.94 for the three months ended June 30, 2005 to \$7.52 for the three months ended June 30, 2006.

Marketing cost per gross subscriber line addition. Marketing cost per gross subscriber line addition is calculated by dividing our marketing expense for a particular period by the number of gross subscriber line additions during the period. Marketing expense does not include the cost of certain customer acquisition activities, such as rebates and promotions, which are accounted for as an offset to revenues, or customer equipment subsidies, which are accounted for as direct cost of goods sold. As a result, it does not represent the full cost to us of obtaining a new customer. Our marketing cost per gross subscriber line addition has fluctuated over time and may increase in 2006 for several reasons. We will increase our advertising spending and have added advertising in more expensive media with a broader reach, such as television, to enhance our brand awareness. In addition, we believe it is generally more expensive to acquire mainstream consumers than early adopters of new technologies and we have increased our focus on more mainstream consumers.

When we increase our total marketing expense, we generally experience, over the short term, a significant increase in marketing cost per gross subscriber line addition. However, we track the efficiency of our marketing programs and make adjustments on how we allocate our funds. These adjustments can result in a subsequent slight decrease in marketing cost per gross subscriber line addition after the initial increase in marketing expense.

Employees. Employees represent the number of personnel that are on our payroll and exclude temporary or outsourced labor. One challenge we face in enhancing the efficiency of our selling, general and administrative expense is our high turnover among our customer care employees.

Non-GAAP Financial Measures

We use adjusted loss from operations and pre-marketing operating income as principal indicators of the operating performance of our business. These are non-GAAP financial measures. Generally, a non-GAAP financial measure is a numerical measure of a company's financial performance, financial position or cash flows that exclude, or include, amounts that are included in, or excluded from, the most directly comparable measure calculated and presented in accordance with GAAP. We believe adjusted loss from operations permits a comparative assessment of our operating performance, relative to our performance based on our GAAP results, while isolating the effects of depreciation and amortization, which may vary from period to period without any correlation to underlying operating performance, and of non-cash stock option compensation, which is a non-cash expense that also varies from period to period. Non-cash stock option compensation is included in our results of operations for periods beginning January 1, 2006. In addition, as we are currently growing both our revenue and customer base and enhancing the awareness of our brand, we have chosen to invest significant amounts on our marketing activities, and we intend to continue to do so. Given that this strategy currently results in operating losses, we believe that pre-marketing operating income is an important metric to evaluate the profitability of the existing customer base to justify the level of continued investment in growing that customer base. We provide information relating to our adjusted loss from operations and pre-marketing operating income so that investors have the same data that we employ in assessing our overall operations. We believe that trends in our adjusted loss from operations and pre-marketing operating income are valuable indicators of the operating performance of our company on a consolidated basis and of our ability to produce operating cash flow to fund working capital needs, to service debt obligations and to fund capital expenditures.

Adjusted loss from operations and pre-marketing operating income as used by us may not be directly comparable to similarly titled measures reported by other companies due to differences in accounting policies and items excluded or included in the adjustments, which limits its usefulness as a comparative measure. These non-GAAP financial measures should be considered in addition to results prepared in accordance with GAAP, but should not be considered a substitute for, or superior to, GAAP results.

Adjusted loss from operations and Pre-Marketing operating income. We define adjusted loss from operations as loss from operations before depreciation and amortization and non-cash stock compensation expense. We define pre-marketing operating income as loss from operations before depreciation and amortization, non-cash stock compensation expense,

marketing expense, customer equipment and shipping revenue and direct cost of goods sold.

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The following table sets forth a reconciliation of our loss from operations to adjusted loss from operations and pre-marketing operating income (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2006	2005	June 30, 2006	2005
Reconciliation of Loss from operations to Adjusted loss from Operations and Pre-Marketing Operating Income:				
Loss from operations	\$ (73,628)	\$ (64,953)	\$ (156,031)	\$ (125,538)
Depreciation and amortization	5,740	2,266	10,699	3,876
Non-cash stock compensation	8,190		12,642	
Adjusted loss from operations	(59,698)	(62,687)	(132,690)	(121,662)
Marketing	90,164	61,937	178,452	117,373
Customer equipment and shipping	(6,742)	(1,896)	(13,967)	(4,023)
Direct cost of goods sold	16,047	9,241	33,627	20,829
Pre-marketing operating income	\$ 39,771	\$ 6,595	\$ 65,422	\$ 12,517

Results of Operations

	Three Months Ended		Six Months Ended	
	June 30, 2006	2005	June 30, 2006	2005
Operating Revenues:				
Telephony services	95	% 97	% 95	% 96
Customer equipment and shipping	5	3	5	4
	100	100	100	