

NATUS MEDICAL INC
Form 10-Q
August 08, 2018
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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, 2018

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: 000-33001

NATUS MEDICAL INCORPORATED
(Exact name of registrant as specified in its charter)

Delaware 77-0154833
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)
6701 Koll Center Parkway, Suite 120, Pleasanton, CA 94566
(Address of principal executive offices) (Zip Code)
(925) 223-6700
(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 shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

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

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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

The number of issued and outstanding shares of the registrant's Common Stock, \$0.001 par value, as of August 1, 2018 was 33,440,032.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

NATUS MEDICAL INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)
(in thousands, except share and per share amounts)

| | June 30, 2018 | December 31, 2017 |
|---|------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$54,908 | \$88,950 |
| Accounts receivable, net of allowance for doubtful accounts of \$6,575 in 2018 and \$8,978 in 2017 | 122,971 | 126,809 |
| Inventories | 76,630 | 71,529 |
| Prepaid expenses and other current assets | 32,224 | 18,340 |
| Total current assets | 286,733 | 305,628 |
| Property and equipment, net | 21,645 | 22,071 |
| Intangible assets, net | 162,559 | 172,582 |
| Goodwill | 163,550 | 172,998 |
| Deferred income tax | 10,296 | 10,709 |
| Other assets | 18,855 | 25,931 |
| Total assets | \$663,638 | \$709,919 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$24,053 | \$25,242 |
| Accrued liabilities | 54,874 | 51,738 |
| Deferred revenue | 16,892 | 15,157 |
| Total current liabilities | 95,819 | 92,137 |
| Long-term liabilities: | | |
| Other liabilities | 21,970 | 21,995 |
| Long-term debt, net | 119,379 | 154,283 |
| Deferred income tax | 18,936 | 19,407 |
| Total liabilities | 256,104 | 287,822 |
| Stockholders' equity: | | |
| Common stock, \$0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 33,590,337 in 2018 and 33,134,101 in 2017 | 321,295 | 316,577 |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued and outstanding in 2018 and 2017 | — | — |
| Retained earnings | 119,470 | 129,115 |
| Accumulated other comprehensive loss | (33,231) | (23,595) |
| Total stockholders' equity | 407,534 | 422,097 |
| Total liabilities and stockholders' equity | \$663,638 | \$709,919 |

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

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in thousands, except per share amounts)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------|------------------|------------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Revenue | \$ 130,653 | \$ 122,227 | \$ 259,261 | \$ 246,887 |
| Cost of revenue | 52,897 | 54,589 | 108,266 | 111,502 |
| Intangibles amortization | 2,717 | 1,500 | 4,305 | 2,500 |
| Gross profit | 75,039 | 66,138 | 146,690 | 132,885 |
| Operating expenses: | | | | |
| Marketing and selling | 33,401 | 30,354 | 69,273 | 62,569 |
| Research and development | 15,616 | 13,713 | 31,059 | 26,466 |
| General and administrative | 23,721 | 24,156 | 41,169 | 40,172 |
| Intangibles amortization | 4,151 | 3,885 | 8,957 | 7,959 |
| Restructuring | 1,938 | 307 | 2,750 | 593 |
| Total operating expenses | 78,827 | 72,415 | 153,208 | 137,759 |
| Loss from operations | (3,788) | (6,277) | (6,518) | (4,874) |
| Other expense, net | (2,398) | (378) | (4,218) | (1,418) |
| Loss before provision for income tax | (6,186) | (6,655) | (10,736) | (6,292) |
| Provision for income tax | (3,609) | (1,621) | (5,009) | (1,606) |
| Net loss | \$(2,577) | \$(5,034) | \$(5,727) | \$(4,686) |
| Loss per share: | | | | |
| Basic | \$(0.08) | \$(0.15) | \$(0.17) | \$(0.14) |
| Diluted | \$(0.08) | \$(0.15) | \$(0.17) | \$(0.14) |
| Weighted average shares used in the calculation of loss per share: | | | | |
| Basic | 32,859 | 32,529 | 32,809 | 32,507 |
| Diluted | 32,859 | 32,529 | 32,809 | 32,507 |
| Other comprehensive income (loss): | | | | |
| Unrealized loss on available-for-sale investments | — | 12 | — | (45) |
| Foreign currency translation adjustment | (13,253) | 8,558 | (9,636) | 12,205 |
| Total other comprehensive income (loss) | (13,253) | 8,570 | (9,636) | 12,160 |
| Comprehensive income (loss) | (15,830) | 3,536 | (15,363) | 7,474 |

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

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)
 (in thousands)

| | Six Months Ended June 30, | |
|--|------------------------------|------------|
| | 2018 | 2017 |
| Operating activities: | | |
| Net loss | \$(5,727) | \$(4,686) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Provision for losses on accounts receivable | 4,089 | 7,072 |
| Depreciation and amortization | 16,694 | 13,819 |
| Loss (gain) on disposal of property and equipment | 160 | (6) |
| Warranty reserve | 975 | 5,708 |
| Share-based compensation | 5,632 | 4,975 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 2,064 | (8,898) |
| Inventories | (2,483) | 6,092 |
| Prepaid expenses and other assets | (15,141) | 677 |
| Accounts payable | (364) | (796) |
| Accrued liabilities | 3,414 | (10,504) |
| Deferred revenue | 1,687 | (8,888) |
| Deferred income tax | 326 | 5,749 |
| Net cash provided by operating activities | 11,326 | 10,314 |
| Investing activities: | | |
| Acquisition of businesses, net of cash acquired | 151 | (147,436) |
| Purchase of property and equipment | (3,387) | (1,464) |
| Purchase of intangible assets | (298) | — |
| Sale of short-term investments | — | 34,019 |
| Net cash used in investing activities | (3,534) | (114,881) |
| Financing activities: | | |
| Proceeds from stock option exercises and Employee Stock Purchase Program purchases | 5,092 | 2,073 |
| Repurchase of common stock | (5,630) | (2,268) |
| Taxes paid related to net share settlement of equity awards | (326) | (3,136) |
| Contingent consideration | (147) | (2,500) |
| Proceeds from borrowings | — | 10,000 |
| Deferred debt issuance costs | — | (38) |
| Payments on borrowings | (35,000) | (40,000) |
| Net cash used in financing activities | (36,011) | (35,869) |
| Exchange rate changes effect on cash and cash equivalents | (5,823) | 7,188 |
| Net decrease in cash and cash equivalents | (34,042) | (133,248) |
| Cash and cash equivalents, beginning of period | 88,950 | 213,551 |
| Cash and cash equivalents, end of period | \$54,908 | \$80,303 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | \$2,966 | \$2,102 |
| Cash paid for income taxes | \$7,234 | \$3,056 |
| Non-cash investing activities: | | |
| Property and equipment included in accounts payable | \$93 | \$297 |
| Inventory transferred to property and equipment | \$293 | \$773 |

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

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1 - Basis of Presentation and Significant Accounting Policies

The accompanying interim condensed consolidated financial statements of Natus Medical Incorporated (“Natus,” or the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). Except where noted below within Note 1, the accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Interim financial reports are prepared in accordance with the rules and regulations of the Securities and Exchange Commission; accordingly, the reports do not include all of the information and notes required by GAAP for annual financial statements. The interim financial information is unaudited, and reflects all normal adjustments that are, in the opinion of management, necessary for the fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. The consolidated balance sheet as of December 31, 2017 was derived from audited financial statements, but does not include all disclosures required by GAAP. The accompanying financial statements should be read in conjunction with the financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Operating results for the three and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Recent Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (“ASU 2014-09”), which supersedes nearly all existing revenue recognition guidance. The standard's core principle is that an entity should recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard creates a five-step model to achieve its core principle: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction's price to the separate performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. In addition, entities must disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Qualitative and quantitative disclosures are required about: (i) the entity's contracts with customers; (ii) the significant judgments, and changes in judgments, made in applying the guidance to those contracts; and (iii) any assets recognized from the costs to obtain or fulfill a contract with a customer.

The Company adopted the new revenue standard on January 1, 2018, without any material impact to its accounting policies or its reported results. The Company utilized the modified retrospective method of transition and applied a practical expedient permitting the Company to not disclose the consideration allocated to the remaining performance obligations or an explanation of when the Company expects to recognize revenue for all reporting periods presented before January 1, 2018, the date of initial application.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740). This update is to remove the prohibition in ASC 740 against the immediate recognition of the current and deferred income tax effects of intra-entity transfers of assets other than inventory. Under the ASU, the selling entity is required to recognize any current tax expense or benefit upon transfer of the asset. Similarly, the purchasing entity is required to recognize a deferred tax asset or deferred tax liability, as well as the related deferred tax benefit or expense, upon receipt of the asset. The Company adopted this guidance on a modified retrospective basis on January 1, 2018, recognizing a charge to retained earnings of approximately \$3.9 million which reflects the unamortized portion of the deferred tax asset for both the consideration as well as the reserve.

In January 2017, the FASB issued ASU 2017-01, Business Combinations (Topic 805). This update is to

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clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisition (or disposals) of assets or businesses. The definition of a business affected many areas of accounting including acquisitions, disposals, goodwill, and consolidation. The adoption of this guidance prospectively on January 1, 2018 had no impact to the Company.

In May 2017, the FASB issued ASU 2017-09, Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting. This update provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. The adoption of this guidance prospectively on January 1, 2018 had no impact to the Company.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. This update amends and simplifies existing hedge accounting guidance and allows for more hedging strategies to be eligible for hedge accounting. In addition, the ASU amends disclosure requirements and how hedge effectiveness is assessed. Effective January 1, 2018, the Company elected to early adopt ASU 2017-12. The adoption of this standard did not have an impact on the Company's consolidated financial statements.

Recent Issued Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This standard requires a lessee to recognize the lease assets and lease liabilities arising from operating leases in the statement of financial position. Qualitative along with specific quantitative disclosures are required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018 including interim periods within those fiscal years. In July 2018, the FASB issued ASU 2018-10, Codification Improvements to Topic 842, Leases. The amendments in ASU 2018-10 provide additional clarification and implementation guidance on certain aspects of the previously issued ASU 2016-02, Leases (Topic 842), and have the same effective and transition requirements as ASU 2016-02. The Company is in the process of evaluating the impact of this standard on its consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350). This update modifies the concept of impairment from the condition that exists when the carrying amount of goodwill exceeds its implied fair value to the condition that exists when the carrying amount of a reporting unit exceeds its fair value. An entity no longer will determine goodwill impairment by calculating the implied fair value of goodwill by assigning the fair value of a reporting unit to all of its assets and liabilities as if that reporting unit had been acquired in a business combination. Because these amendments eliminate Step 2 from the goodwill impairment test, they should reduce the cost and complexity of evaluating goodwill for impairment. ASU 2017-04 is effective for the Company's annual and any interim goodwill impairment tests performed on or after January 1, 2020. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220). This update permits a company to reclassify its disproportionate income tax effects of the Tax Cuts and Jobs Act of 2017 (the "2017 Act") on items within accumulated other comprehensive income ("AOCI") to retained earnings (termed "stranded tax effects"). Only the stranded tax effects resulting from the 2017 Act are eligible for reclassification. The ASU also requires certain new disclosures, some of which are applicable for all companies. The ASU is effective for the Company on January 1, 2019. The Company is in the process of evaluating the impact of this standard on its consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. This update simplifies the accounting for share-based payments made to nonemployees so the accounting for such payments is substantially the same as those made to employees. Under this ASU, share based awards to nonemployees will be measured at fair value on the grant date of the awards. Entities will need to assess the probability of satisfying performance conditions if any are present, and awards will continue to be classified according to ASC 718 upon vesting. This eliminates the need to reassess classification upon vesting, consistent with awards granted to employees. This ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, and early adoption is permitted. The Company is in the process of evaluating the impact of this standard on its consolidated financial

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statements.

In July 2018, the FASB issued ASU 2018-09, Codification Improvements. This update makes changes to a variety of topics to clarify, correct errors in, or make minor improvements to the Accounting Standard Codification. The majority of the amendments in ASU 2018-09 will be effective for us in annual periods beginning after December 15, 2018. The Company is in the process of evaluating the impact of this standard on its consolidated financial statements.

Significant Accounting Policies**Revenue Recognition**

Revenue is recognized when obligations under the terms of a contract with a customer are satisfied; generally this occurs with the transfer of control of devices, supplies, or services. Revenue is measured as the amount of consideration the Company expects to receive in exchange for transferring goods or providing services.

For the majority of devices and supplies, the Company transfers control and recognizes revenue when products ship from the warehouse to the customer. The Company generally does not provide rights of return on devices and supplies. Freight charges billed to customers are included in revenue and freight-related expenses are charged to cost of revenue.

Depending on the terms of the arrangement, the Company may also defer the recognition of a portion of the consideration received because it has to satisfy a future obligation (e.g. installation). Judgment is required to determine the standalone selling price ("SSP") for each distinct performance obligation. The Company uses a single amount to estimate SSP for items that are not sold separately. In instances where SSP is not directly observable, such as when the Company does not sell the product or service separately, the SSP is determined using information that may include market conditions and other observable inputs.

The Company sells separately-priced service contracts that extend maintenance coverages for both medical devices and data management systems beyond the base agreements to customers. The separately priced service contracts range from 12 months to 36 months. The Company receives payment at the inception of the contract and recognizes revenue ratably over the service period.

For products containing embedded software, the Company determined the hardware and software components function together to deliver the products' essential functionality and are considered a combined performance obligation. Revenue recognition policies for sales of these products are substantially the same as for other tangible products.

The following information summarizes the Company's contract assets and liabilities (in thousands):

| | June 30, December | |
|------------------|-------------------|-----------|
| | 2018 | 31, 2017 |
| Contract Assets | \$2,942 | \$ 2,884 |
| Deferred Revenue | \$20,847 | \$ 18,901 |

Contract assets for the periods presented primarily represent the difference between revenue recognized based on the relative selling price of the related performance obligations and the contractual billing terms in the arrangements.

Deferred revenue for the periods presented was primarily related to extended service contracts, installation, and training, for which the service fees are billed up-front. The associated deferred revenue is generally recognized ratably over the extended service period or when installation and training are complete.

The following table summarized the changes in the contract assets and contract liability balances for the six months ended June 30, 2018:

| | |
|---------------------------------|---------|
| Unbilled AR, December 31, 2017 | \$2,884 |
| Additions | 387 |
| Transferred to Trade Receivable | (329) |
| Unbilled AR, June 30, 2018 | \$2,942 |

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| | |
|-------------------------------------|----------|
| Deferred Revenue, December 31, 2017 | \$18,901 |
| Additions | 11,724 |
| Revenue Recognized | (9,778) |
| Deferred Revenue, June 30, 2018 | \$20,847 |

At June 30, 2018, the short-term portion of the contract liability of \$16.9 million and the long-term portion of \$3.9 million were included in deferred revenue and other long term liabilities respectively, in the consolidated balance sheet. As of June 30, 2018, the Company is expected to recognize revenue associated with deferred revenue of approximately \$10.9 million for the remainder of 2018, \$7.2 million in 2019, \$1.5 million in 2020, \$0.7 million in 2021, and \$0.5 million thereafter.

Financial Instruments and Derivatives

As part of a risk management strategy, the Company may enter into derivative contracts with various counterparts. All derivatives are recognized on the balance sheet at their estimated fair value. On the date a derivative contract is entered into, it is designated as a fair value hedge, a cash flow hedge, a foreign currency fair value or cash flow hedge, a hedge of net investment in a foreign operation, or a trading or non-hedging instrument.

Changes in the estimated fair value of a derivative which is highly effective and that is designated and qualifies as a cash flow hedge, to the extent that the hedge is effective, are initially recorded in other comprehensive income. Subsequently when the variability of cash flows of the hedged transaction affects earnings, it is reclassified into earnings as a component of interest expense. Any hedge ineffectiveness, which represents the amount by which the changes in the estimated fair value of the derivative differ from the variability in the cash flows of the forecasted transaction, is recognized in current-period earnings as a component of interest expense. When an interest rate swap designated as a cash flow hedge no longer qualifies for hedge accounting, changes in estimated fair value of the hedge previously deferred to accumulated other comprehensive income, along with any changes in estimated fair value occurring thereafter, are recognized in earnings. Cash flows from interest rate swap agreements are classified as net cash provided from operating activities on the consolidated statements of cash flows. The Company's accounting policy is to present the cash flows from the hedging instruments in the same category in the consolidated statements of cash flows as the category for the cash flows the hedged items.

2 - Business Combinations**Integra**

On October 6, 2017, the Company acquired certain neurosurgery business assets from Integra LifeSciences (“Integra” or “Neurosurgery”) for \$46.2 million in cash. As part of the acquisition, the Company acquired a global product line, including the manufacturing facility, it leases from a third party and the U.S. rights related to four other product lines. The total purchase price has been preliminarily allocated to \$14.0 million of tangible assets, \$25.6 million of intangible assets with an associated weighted average life of 9 years being amortized on the straight line method, and \$7.9 million of goodwill, offset by \$1.3 million of net liabilities. The purchase price allocation is considered preliminary at this time although no material adjustments are anticipated. Besides pro forma revenue, pro forma financial information for the Integra acquisition is not presented as certain Integra expense data necessary to present pro forma net income and pro forma earnings per share is not available. Pro forma revenue assuming the acquisition had occurred on January 1, 2017 is \$135.0 million and \$271.5 million for the three and six months ended June 30, 2017.

3 - Earnings Per Share

The components of basic and diluted EPS are as follows (in thousands, except per share amounts):

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| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-----------|------------------|-----------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Net loss | \$(2,577) | \$(5,034) | \$(5,727) | \$(4,686) |
| Weighted average common shares | 32,859 | 32,529 | 32,809 | 32,507 |
| Dilutive effect of stock based awards | — | — | — | — |
| Diluted Shares | 32,859 | 32,529 | 32,809 | 32,507 |
| Basic loss per share | \$(0.08) | \$(0.15) | \$(0.17) | \$(0.14) |
| Diluted loss per share | \$(0.08) | \$(0.15) | \$(0.17) | \$(0.14) |
| Shares excluded from calculation of diluted EPS | 382 | 505 | 387 | 553 |

4 - Inventories

Inventories consist of the following (in thousands):

| | June 30, 2018 | December 31, 2017 |
|---------------------------------|---------------|-------------------|
| Raw materials and subassemblies | \$30,759 | \$44,699 |
| Work in process | 3,328 | 3,788 |
| Finished goods | 60,055 | 43,488 |
| Total inventories | 94,142 | 91,975 |
| Less: Non-current inventories | (17,512) | (20,446) |
| Inventories, current | \$76,630 | \$71,529 |

As of June 30, 2018 and December 31, 2017, the Company has classified \$17.5 million and \$20.4 million, respectively, of inventories as other assets. This inventory consists primarily of service components used to repair products held by customers pursuant to warranty obligations and extended service contracts, including service components for products the Company no longer sells, inventory purchased for lifetime buys, and inventory impacted by ship holds. The Company believes these inventories will be utilized for their intended purpose.

5 – Intangible Assets

The following table summarizes the components of gross and net intangible asset balances (in thousands):

| | June 30, 2018 | | | | December 31, 2017 | | | |
|--|-----------------------|------------------------|--------------------------|----------------|-----------------------|------------------------|--------------------------|----------------|
| | Gross Carrying Amount | Accumulated Impairment | Accumulated Amortization | Net Book Value | Gross Carrying Amount | Accumulated Impairment | Accumulated Amortization | Net Book Value |
| Intangible assets with definite lives: | | | | | | | | |
| Technology | \$112,126 | \$(1,046) | \$(46,064) | \$65,016 | \$101,045 | \$(1,058) | \$(42,048) | \$57,939 |
| Customer related | 100,534 | (50) | (33,708) | 66,776 | 108,074 | (50) | (28,972) | 79,052 |
| Trade names | 47,506 | (3,873) | (16,230) | 27,403 | 49,313 | (3,916) | (13,273) | 32,124 |
| Internally developed software | 15,902 | — | (13,346) | 2,556 | 15,610 | — | (12,293) | 3,317 |
| Patents | 2,743 | (132) | (2,507) | 104 | 2,778 | (133) | (2,495) | 150 |
| Service Agreements | 1,190 | — | (486) | 704 | — | — | — | — |
| Definite-lived intangible assets | \$280,001 | \$(5,101) | \$(112,341) | \$162,559 | \$276,820 | \$(5,157) | \$(99,081) | \$172,582 |

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Finite-lived intangible assets are amortized over their weighted average lives, which are 14 years for technology, 10 years for customer related intangibles, 10 years for trade names, 6 years for internally developed software, 13 years for patents, 2 years for service agreements and 11 years in total.

Internally developed software consists of \$13.7 million relating to costs incurred for development of internal use computer software and \$2.2 million for development of software to be sold.

Amortization expense related to intangible assets with definite lives was as follows (in thousands):

| | Three Months | | Six Months | |
|-------------------------------|--------------|---------|------------|----------|
| | Ended | | Ended | |
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Technology | \$2,558 | \$1,791 | \$4,378 | \$3,117 |
| Customer related | 2,302 | 2,155 | 5,183 | 4,363 |
| Trade names | 1,456 | 1,318 | 3,082 | 2,905 |
| Internally developed software | 528 | 503 | 1,058 | 1,007 |
| Patents | 22 | 28 | 43 | 55 |
| Service Agreements | \$486 | \$— | \$486 | \$— |
| Total amortization | \$7,352 | \$5,795 | \$14,230 | \$11,447 |

Expected amortization expense related to amortizable intangible assets is as follows (in thousands):

| | |
|-------------------------------------|-----------|
| Six months ending December 31, 2018 | \$13,629 |
| 2019 | 26,060 |
| 2020 | 23,581 |
| 2021 | 22,171 |
| 2022 | 18,532 |
| 2023 | 17,509 |
| Thereafter | 41,077 |
| Total expected amortization expense | \$162,559 |

6 – Goodwill

The carrying amount of goodwill and the changes in the balance are as follows (in thousands):

| | |
|--|-----------|
| December 31, 2017 | \$172,998 |
| Purchase accounting adjustments (7,565) | |
| Foreign currency translation (1,883) | |
| June 30, 2018 | \$163,550 |

7 - Property and Equipment, net

Property and equipment, net consist of the following (in thousands):

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| | June 30, 2018 | December 31, 2017 |
|------------------------------------|------------------|----------------------|
| Land | \$1,828 | \$2,815 |
| Buildings | 4,913 | 5,096 |
| Leasehold improvements | 3,920 | 3,295 |
| Equipment and furniture | 25,549 | 25,612 |
| Computer software and hardware | 11,015 | 9,760 |
| Demonstration and loaned equipment | 12,142 | 11,932 |
| | 59,367 | 58,510 |
| Accumulated depreciation | (37,722) | (36,439) |
| Total | \$21,645 | \$22,071 |

Depreciation expense of property and equipment was approximately \$1.4 million and \$2.4 million for the three and six months ended June 30, 2018 and approximately \$1.2 million and \$2.3 million for the three and six months ended June 30, 2017.

8 - Reserve for Product Warranties

The Company provides a warranty for products that is generally one year in length, but in some cases regulations may require them to provide repair or remediation beyond the typical warranty period. If any of the products contain defects, the Company may incur additional repair and remediation costs. Service for domestic customers is provided by Company-owned service centers that perform all service, repair, and calibration services. Service for international customers is provided by a combination of Company-owned facilities, vendors on a contract basis, and distributors.

A warranty reserve is included in accrued liabilities for the expected future costs of servicing products. Additions to the reserve are based on management's best estimate of probable liability. The Company considers a combination of factors including material and labor costs, regulatory requirements, and other judgments in determining the amount of the reserve. The reserve is reduced as costs are incurred to honor existing warranty and regulatory obligations.

As of June 30, 2018, the Company had accrued \$5.6 million of estimated costs to bring certain products into U.S. regulatory compliance. The Company's estimate of these costs associated with bringing the products into compliance is primarily based upon the number of units outstanding that may require repair, costs associated with shipping, and the assumption the FDA will approve the Company's plan for compliance.

The details of activity in the warranty reserve are as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------------|----------|------------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| Balance, beginning of period | \$9,068 | \$12,721 | \$10,995 | \$10,670 |
| Assumed through acquisitions | — | — | — | 1,166 |
| Additions (decreases) charged to expense | 2,100 | 2,902 | 975 | 5,708 |
| Reductions | (255) | (1,484) | (1,057) | (3,405) |
| Balance, end of period | \$10,913 | \$14,139 | \$10,913 | \$14,139 |

The estimates the Company uses in projecting future product warranty costs may prove to be incorrect. Any future determination that product warranty reserves are understated could result in increases to cost of sales and reductions in operating profits and results of operations.

9 - Share-Based Compensation

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As of June 30, 2018, the Company has two active share-based compensation plans, the 2011 Stock Awards Plan and the 2011 Employee Stock Purchase Plan. The terms of awards granted during the six months ended June 30, 2018 and the methods for determining grant-date fair value of the awards are consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2017.

Details of share-based compensation expense are as follows (in thousands):

| | Three Months Ended | | Six Months Ended | |
|----------------------------|--------------------|---------|------------------|---------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Cost of revenue | \$71 | \$40 | \$139 | \$121 |
| Marketing and selling | 199 | 117 | 396 | 186 |
| Research and development | 272 | 311 | 549 | 778 |
| General and administrative | 2,728 | 1,751 | 4,548 | 3,890 |
| Total | \$3,270 | \$2,219 | \$5,632 | \$4,975 |

As of June 30, 2018, unrecognized compensation expense related to the unvested portion of stock options and other stock awards was approximately \$17.6 million, which is expected to be recognized over a weighted average period of 2.3 years.

10 - Other Income (Expense), net

Other income (expense), net consists of (in thousands):

| | Three Months Ended | | Six Months Ended | |
|-----------------------------------|--------------------|---------|------------------|-----------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Interest income | \$(5) | \$96 | \$5 | \$428 |
| Interest expense | (1,641) | (1,284) | (3,601) | (2,264) |
| Foreign currency gain (loss) | (838) | 897 | (234) | 469 |
| Other income | 86 | (87) | (388) | (51) |
| Total other income (expense), net | \$(2,398) | \$(378) | \$(4,218) | \$(1,418) |

11 - Income Taxes

The Company recorded a benefit from income tax of \$3.6 million and \$5.0 million for the three and six months ended June 30, 2018, respectively. The effective tax rate was 58.3% and 46.7% for the three and six months ended June 30, 2018, respectively.

The Company recorded a benefit from income tax of \$1.6 million and \$1.6 million for the three and six months ended June 30, 2017, respectively. The effective tax rate was 24.4% and 25.5% for the three and six months ended June 30, 2017, respectively.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 ("2017 Act") was signed into law making significant changes to the Internal Revenue Code. These changes include a federal statutory rate reduction from 35% to 21%, the transition of U.S. international taxation from a worldwide tax system to a territorial system, and a one-time transition tax on the mandatory deemed repatriation of cumulative foreign earnings as of December 31, 2017.

The increase in the effective tax rate for the three and six months ended June 30, 2018 compared with the three and six months ended June 30, 2017 is primarily attributable to the changes enacted by the 2017 Act and certain discrete items. The Company's effective tax rate for the three and six months ended June 30, 2018 differed from the federal statutory tax rate of 21% primarily due to the recognition of excess tax benefits of stock-based compensation and Federal and California research and development credits, non-deductible expenses, and the

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international provisions from the 2017 Act. The changes attributable to the 2017 Act which impacted the effective tax rate directly increased the amount of non-deductible executive compensation and introduced a new type of deemed inclusion related to global intangible low taxed income (“GILTI”). The tax rate for the three and six months ended June 30, 2018 was significantly greater than the tax rate for the three and six months ended June 30, 2017, largely due to the changes from the 2017 Act. The tax rate was also impacted to a lesser degree by shifts in geographical mix and discrete items.

On December 22, 2017, Staff Accounting Bulletin No. 118 (“SAB 118”) was issued to address the application of U.S. GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the 2017 Act. In the fourth quarter of 2017, the Company recorded a provisional amount of \$16.6 million related to the one-time transition tax on the mandatory deemed repatriation of foreign earnings, net of foreign tax credits. The transition tax will be paid in installments over an eight-year period, which started in 2018, and will not accrue interest. For the three and six months ended June 30, 2018, there were no significant adjustments to this amount although it remains provisional. Additional work is still necessary for a more detailed analysis of the Company's deferred tax assets and liabilities and its historical foreign earnings as well as potential correlative adjustments. The future issuance of U.S. Treasury Regulations, administrative interpretations or court decisions interpreting the 2017 Act may require further adjustments and changes in the Company's estimate. The final determination of the transition tax and remeasurement of the Company's deferred assets and liabilities will be completed as additional information becomes available, but no later than one year from the enactment of the 2017 Act. Any subsequent adjustment to these amounts will be recorded to current tax expense in the quarter of 2018 when the analysis is complete.

On August 1, 2018, The Department of Treasury and the IRS released proposed regulations under Section 965 (“the proposed 965 regulations”). The proposed 965 regulations provide guidance relating to the one-time transition tax on the mandatory deemed repatriation of foreign earnings from the enactment of the 2017 Act on December 22, 2017. The Company is reviewing the proposed 965 regulations to determine the impact, if any, on the one-time transition tax liability. Due to the timing of the release of the proposed regulations, as well as the complexity, detail and length of the regulations, the Company is not able to provide guidance on impact at this time but expects to do so in the next quarterly filing.

For the three and six months ended June 30, 2018, the Company has calculated its best estimate of the impact of the GILTI in its income tax provision in accordance with its understanding of the Act and guidance available as of the date of this filing. The Company has made a policy election to treat the GILTI as a period cost and does not recognize deferred taxes when basis differences exist that are expected to affect the amount of the GILTI inclusion upon reversal.

On July 24, 2018, the Ninth Circuit Court of Appeals issued an opinion in *Altera Corp. v. Commissioner* requiring related parties in an intercompany cost-sharing arrangement to share expenses related to share-based compensation. This opinion reversed the prior decision of the United States Tax Court. On August 7, 2018, the *Altera* opinion was withdrawn to permit time for a reconstituted panel to consider the appeal. The Company will continue to monitor ongoing developments and potential impacts to the consolidated financial statements.

The Company recorded \$12.0 thousand of net tax benefit related to unrecognized tax benefits for the six months ended June 30, 2018, primarily due to the lapse of the applicable statute of limitations. Within the next twelve months, it is possible that uncertain tax benefit may change with a range of approximately zero to \$0.9 million. The Company's tax returns remain open to examination as follows: U.S Federal, 2014 through 2017, U.S. States, 2013 through 2017, and significant foreign jurisdictions, 2013 through 2017.

12 - Debt and Credit Arrangements

The Company has a Credit Agreement with JP Morgan Chase Bank (“JP Morgan”) and Citibank, NA (“Citibank”). The Credit Agreement provides for an aggregate \$225.0 million of secured revolving credit facility. The Credit Agreement contains covenants, including covenants relating to maintenance of books and records, financial reporting and notification, compliance with laws, maintenance of properties and insurance, and limitations on guaranties, investments, issuance of debt, lease obligations and capital expenditures, and is secured by virtually

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all of the Company's assets. The Credit Agreement provides for events of default, including failure to pay any principal or interest when due, failure to perform or observe covenants, bankruptcy or insolvency events and the occurrence of a material adverse effect. The Company has no other significant credit facilities.

In addition to the customary restrictive covenants listed above, the Credit Agreement also contains financial covenants that require the Company to maintain a certain leverage ratio and fixed charge coverage ratio, each as defined in the Credit Agreement:

• Leverage Ratio, as defined, to be no higher than 2.75 to 1.00.

• Interest Coverage Ratio, as defined, to be at least 1.75 to 1.00 at all times.

At June 30, 2018, the Company was in compliance with the Leverage Ratio at 2.01 to 1.00 and the Interest Coverage Ratio at 5.98 to 1.00.

At June 30, 2018, the Company had \$120.0 million outstanding under the Credit Agreement.

Pursuant to the terms of the Credit Agreement, the outstanding principal balance will bear interest at either (a) a fluctuating rate per annum equal to the Applicable Rate, as defined in the Credit Agreement, depending on our leverage ratio plus the higher of (i) the federal funds rate plus one-half of one percent per annum; (ii) the prime rate in effect on such a day; and (iii) the LIBOR rate plus one percent, or (b) a fluctuating rate per annum of LIBOR Rate plus the Applicable Rate, which ranges between 1.75% to 2.75%. The effective interest rate during the six months ended June 30, 2018 was 4.27%. The Credit Agreement matures on September 23, 2021, at which time all principal amounts outstanding under the Credit Agreement will be due and payable.

Long-term debt consists of (in thousands):

| | June 30, 2018 | December 31, 2017 |
|---|------------------|----------------------|
| Revolving credit facility | \$120,000 | \$155,000 |
| Debt issuance costs | (621) | (717) |
| Less: current portion of long-term debt | — | — |
| Total long-term debt | \$119,379 | \$154,283 |

As of June 30, 2018, the carrying value of total debt approximated fair market value.

13 - Financial Instruments and Derivatives

The Company uses interest rate swap derivative instruments to manage earnings and cash flow exposure resulting from changes in interest rates. These interest rate swaps apply a fixed interest rate on a portion of the Company's expected LIBOR-indexed floating-rate borrowings. The Company held the following interest rate swaps as of June 30, 2018 (in thousands):

| Hedged Item | Current Notional Amount | Designation Date | Effective Date | Termination Date | Fixed Interest Rate | Floating Rate | Estimated Fair Value |
|--|-------------------------------|---------------------|-------------------|-----------------------|------------------------|----------------------|----------------------------|
| 1-month USD LIBOR Loan | \$40,000 | May 31, 2018 | June 1, 2018 | September 23, 2021 | 2.611% | 1-month USD LIBOR | \$ (1) |
| Total interest rate derivatives designated as cash flow hedge | \$40,000 | | | | | | \$ (1) |

The Company designated these derivative instruments as cash flow hedges. The Company assesses the effectiveness of these derivative instruments and records the change in the fair value of a derivative instrument designated as a cash flow hedge as unrealized gains or losses in accumulated other comprehensive income (“AOCI”), net of tax. Once the hedged item affects earnings, the effective portion of any gain or loss will be

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reclassified to earnings. If the hedged cash flow does not occur, or if it becomes probable that it will not occur, the Company will reclassify the amount of any gain or loss on the related cash flow hedge to interest expense at that time. As of June 30, 2018, the Company expects that approximately \$72,000 of losses associated with the cash flow hedge, net of tax, could be reclassified from AOCI into earnings within the next twelve months.

14 - Segment, Customer and Geographic Information

The Company operates in one reportable segment in which the Company provides healthcare products and services used for the screening, detection, treatment, monitoring and tracking of common medical ailments.

End-user customer base includes hospitals, clinics, laboratories, physicians, audiologists, and governmental agencies.

Most of the Company's international sales are to distributors who resell products to end users or sub-distributors.

Revenue and long-lived asset information are as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|-------------------------------|-----------------------------------|-----------|------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Consolidated Revenue: | | | | |
| United States | \$75,467 | \$67,100 | \$144,154 | \$131,808 |
| International | 55,186 | 55,127 | 115,107 | 115,079 |
| Totals | \$130,653 | \$122,227 | \$259,261 | \$246,887 |
| | Three Months Ended June 30, | | Six Months Ended June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Revenue by End Market: | | | | |
| Neurology Products | | | | |
| Devices and Systems | \$50,308 | \$41,584 | \$96,361 | \$79,773 |
| Supplies | 16,535 | 15,182 | 33,707 | 30,069 |
| Services | 3,565 | 2,551 | 6,303 | 5,743 |
| Total Neurology Revenue | 70,408 | 59,317 | 136,371 | 115,585 |
| Newborn Care Products | | | | |
| Devices and Systems | 13,985 | 17,464 | 29,951 | 41,602 |
| Supplies | 9,625 | 11,299 | 19,147 | 22,745 |
| Services | 5,477 | 5,345 | 10,880 | 10,395 |
| Total Newborn Care Revenue | 29,087 | 34,108 | 59,978 | 74,742 |
| Otometrics Products | | | | |
| Devices and Systems | 30,572 | 22,522 | 57,340 | 43,900 |
| Supplies | 586 | 6,280 | 5,572 | 12,660 |
| Total Otometrics Revenue | 31,158 | 28,802 | 62,912 | 56,560 |
| Total Revenue | \$130,653 | \$122,227 | \$259,261 | \$246,887 |

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| | June 30, 2018 | December 31, 2017 |
|------------------------------|---------------|-------------------|
| Property and equipment, net: | | |
| United States | \$11,149 | \$10,128 |
| Canada | 4,137 | 5,068 |
| Argentina | 1,035 | 1,591 |
| Ireland | 3,413 | 3,178 |
| Denmark | 1,072 | 1,158 |
| Other countries | 839 | 948 |
| Totals | \$21,645 | \$22,071 |

During the three and six months ended June 30, 2018 and 2017, no single customer or country outside the United States contributed to more than 10% of consolidated revenue.

15 - Fair Value Measurements

ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Fair value is defined under ASC 820 as the exit price associated with the sale of an asset or transfer of a liability in an orderly transaction between market participants at the measurement date. ASC 820 establishes the following three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value:

Level 1 - Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are used when little or no market data is available. The fair value hierarchy gives the lowest priority to Level 3 inputs.

The derivative financial instruments described in Note 13 are measured at fair value on a recurring basis and are presented on the consolidated balance sheets at fair value. The table below presents the fair value of the derivative financial instruments as well as the classification on the consolidated balance sheet (in thousands):

| | December 31, 2017 | Additions | Payments | Adjustments | June 30, 2018 |
|-----------------------|-------------------|-----------|----------|-------------|---------------|
| Liabilities: | | | | | |
| Interest Rate Swap \$ | —\$ | 1 | \$ | —\$ | —\$ 1 |
| Total | \$ | —\$ 1 | \$ | —\$ | —\$ 1 |

The Company estimates the fair value of the interest rate swaps by calculating the present value of the expected future cash flows of each swap. The calculation incorporated the contractual terms of the derivatives, observable market interest rates which are considered to be Level 2 inputs, and credit risk adjustments, if any, to reflect the counterpart's as well as the Company's nonperformance risk. As of June 30, 2018, there have been no events of default under the interest rate swap agreement.

The following financial instruments are not measured at fair value on the Company's consolidated balance sheet as of June 30, 2018 and December 31, 2017, but require disclosure of their fair values: cash and cash equivalents, accounts receivable, and accounts payable. The carrying value of these financial instruments approximates fair values because of their relatively short maturity.

In the third quarter of 2014, the Company listed its facility in Mundelein, Illinois for sale. This asset was measured at fair value less cost to sell as of September 30, 2014 based on market price and is classified as a Level 2 asset. The book value of this asset on June 30, 2014 was \$3.6 million. The Company expensed \$2.2 million during the third quarter of 2014 for this impairment and an additional \$0.2 million in the second quarter of 2018. As of

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June 30, 2018, the Company is carrying the asset as held for sale in other current assets on the accompanying condensed consolidated balance sheet at a value of \$1.2 million.

In the second quarter of 2018, the Company listed a portion of vacant land located in Canada for sale. The Company plans to sell 1.5 acres of the vacant land. This asset was measured at fair value less cost to sell as of June 30, 2018 based on market price and is classified as a Level 2 asset. The book value of this asset on June 30, 2018 was \$0.9 million, which is the amount in other current assets on the accompanying condensed consolidated balance sheet.

The Company also has contingent consideration associated with earn-outs from acquisitions. Contingent consideration liabilities are classified as Level 3 liabilities, as the Company uses unobservable inputs to value them, which is a probability-based income approach. Contingent consideration is classified as accrued liabilities on the condensed consolidated balance sheet. Subsequent changes in the fair value of contingent consideration liabilities are recorded within the Company's income statement as an operating expense.

Contingent considerations are as follows (in thousands):

| | December 31, 2017 | Additions | Payments | Adjustments | June 30, 2018 |
|--------------------------|----------------------|-----------|----------|-------------|------------------|
| Liabilities: | | | | | |
| Contingent consideration | \$ 147 | \$ — | \$(147) | \$ — | \$ — |
| Total | \$ 147 | \$ — | \$(147) | \$ — | \$ — |

The significant unobservable inputs used in the fair value measurement of contingent consideration related to the acquisitions are annualized revenue forecasts developed by the Company's management and the probability of achievement of those revenue forecasts. Significant changes in these unobservable inputs may result in a significant impact to the fair value measurement.

16 - Subsequent Events

Impact of Foreign Currency Translation - Argentina

Effective July 1, 2018, Argentina's economy is considered to be highly inflationary under U.S. GAAP since it has experienced a rate of general inflation in excess of 100% over the latest three-year period, based upon the cumulative inflation rates published by Center for Audit Quality (CAQ) SEC Regulations Committee and its International Practices Task Force (IPTF). As a result, beginning July 1, 2018, the U.S. dollar will be the functional currency for the Company's subsidiary in Argentina, Medix I.C.S.A. ("Medix"). Accordingly, all gains and losses resulting from the translation of the Company's Argentinian operations are required to be recorded directly in the statement of operations. Through June 30, 2018, prior to being designated as highly inflationary, currency translation adjustments of Medix's balance sheet are reflected in shareholders' equity as part of Other Comprehensive Income; however subsequent to July 1, 2018, such adjustments will be reflected in earnings.

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

Overview

The following Management Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") supplements the MD&A in the Annual Report on Form 10-K for the year ended December 31, 2017 of Natus Medical Incorporated. MD&A should be read in conjunction with our condensed consolidated financial statements and accompanying footnotes, the risk factors referred to in Part II, Item 1A of this report, our Annual Report filed on Form 10-K for the year ended December 31, 2017 and the cautionary information regarding forward-looking statements at the end of this section.

Our Business

Natus is a leading provider of newborn care, neurology, and hearing and balance assessment healthcare products and services used for the screening, diagnosis, detection, treatment, monitoring and tracking of common

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medical ailments in newborn care, hearing impairment, neurological dysfunction, epilepsy, sleep disorders, neuromuscular diseases and balance and mobility disorders.

We have completed a number of acquisitions since 2003, consisting of either the purchase of a company, substantially all of the assets of a company, or individual products or product lines. In January 2017 we acquired Otometrics and in October 2017 we acquired the neurocritical care and neurosurgical product lines from Integra.

End Markets

Our products address the below end markets:

Neurology - Includes products and services for diagnostic electroencephalography and long term monitoring, Intensive Care Unit monitoring, electromyography, sleep analysis or polysomnography, intra-operative monitoring, diagnostic and monitoring transcranial doppler ultrasound technology, and neurocritical and neurosurgical solutions.

Newborn Care - Includes products and services for newborn care including video streaming, hearing screening, brain injury, thermoregulation, jaundice management, retinopathy of prematurity, and various disposable products, as well as products for diagnostic hearing assessment for children through adult populations, and products to diagnose and assist in treating balance and mobility disorders.

Otometrics - Includes products such as computer-based audiological, otoneurologic and vestibular instrumentation and sound rooms for hearing and balance care professionals worldwide. Otometrics has a complete product and brand portfolio known for its sophisticated design technology in the hearing and balance assessment markets. Global brands include Aurical®, ICS®, and Madsen®.

Segment and Geographic Information

We operate in one reportable segment, which we have presented as the aggregation of our Neuro, Newborn Care, and Otometrics product families. Within this reportable segment we are organized on the basis of the healthcare products and services we provide which are used for the screening, detection, treatment, monitoring, and tracking of common medical ailments in newborn care, hearing impairment, neurological dysfunction, epilepsy, and sleep disorders.

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors, who in turn resell our products to end users or sub-distributors.

Information regarding our sales and long-lived assets in the U.S. and in countries outside the U.S. is contained in Note 14 – Segment, Customer and Geographic Information of our condensed consolidated financial statements included in this report and is incorporated in this section by reference.

Revenue by Product Category

We generate our revenue from sales of Devices and Systems, which are generally non-recurring, and from related Supplies and Services, which are generally recurring. The products that are attributable to these categories are described in our Annual Report on Form 10-K for the year ended December 31, 2017. Revenue from Devices and Systems, Supplies, and Services, as a percent of total revenue for the three and six months ended June 30, 2018 and 2017, is as follows:

| | Three Months Ended June 30, 2018 | | Six Months Ended June 30, 2017 | |
|---------------------|--|-------|---|-------|
| Devices and Systems | 73 % | 67 % | 70 % | 66 % |
| Supplies | 20 % | 27 % | 23 % | 27 % |
| Services | 7 % | 6 % | 7 % | 7 % |
| Total | 100 % | 100 % | 100 % | 100 % |

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2018 Second Quarter Overview

Our business and operating results are driven in part by worldwide economic conditions. Our sales are significantly dependent on both capital spending by hospitals in the United States and healthcare spending by ministries of health outside the United States.

Our consolidated revenue increased \$8.4 million in the second quarter ended June 30, 2018 to \$130.7 million compared to \$122.2 million in the second quarter of the previous year. Revenue growth was driven primarily from the addition of our Neurosurgery business and supplemented by organic growth in our Neurology and Otometrics business units, offset by a decline in Newborn Care driven by non-recurring orders from the prior period.

Net loss was \$2.6 million or \$0.08 per share in the three months ended June 30, 2018, compared with net loss of \$5.0 million or \$0.15 per diluted share in the same period in 2017. The reduction in net loss was primarily due to a higher operating margin in Neurology due to higher revenue driven by the acquisition of Neurosurgery and increased Supplies and Global Neuro-Diagnostics (“GND”) revenue. Also contributing to reduction in net loss was a decrease in expenses related to remediation of the warning letter received for our Seattle facility.

Application of Critical Accounting Policies

We prepare our financial statements in accordance with accounting principles generally accepted in the United States of America (“GAAP”). In so doing, we must often make estimates and use assumptions that can be subjective, and, consequently, our actual results could differ from those estimates. For any given individual estimate or assumption we make, there may also be other estimates or assumptions that are reasonable.

We believe that the following critical accounting policies require the use of significant estimates, assumptions, and judgments:

• Revenue recognition

• Acquisition accounting

• Income taxes

The use of different estimates, assumptions, or judgments could have a material effect on the reported amounts of assets, liabilities, revenue, expenses, and related disclosures as of the date of the financial statements and during the reporting period. These critical accounting policies are described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2017, under Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations.

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Results of Operations

The following table sets forth selected consolidated statement of operations data as a percentage of total revenue for the periods indicated:

| | Three Months Ended | | Six Months Ended | |
|--------------------------------------|--------------------|---------|------------------|---------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Revenue | 100.0 % | 100.0 % | 100.0 % | 100.0 % |
| Cost of revenue | 40.5 % | 44.7 % | 41.8 % | 45.2 % |
| Intangibles amortization | 2.1 % | 1.2 % | 1.7 % | 1.0 % |
| Gross profit | 57.4 % | 54.1 % | 56.5 % | 53.8 % |
| Operating expenses: | | | | |
| Marketing and selling | 25.6 % | 24.8 % | 26.7 % | 25.3 % |
| Research and development | 12.0 % | 11.2 % | 12.0 % | 10.7 % |
| General and administrative | 18.2 % | 19.8 % | 15.9 % | 16.3 % |
| Intangibles amortization | 3.2 % | 3.2 % | 3.5 % | 3.2 % |
| Restructuring | 1.5 % | 0.3 % | 1.1 % | 0.2 % |
| Total operating expenses | 60.5 % | 59.3 % | 59.2 % | 55.7 % |
| Loss from operations | (3.1)% | (5.2)% | (2.7)% | (1.9)% |
| Other expense, net | (1.8)% | (0.3)% | (1.6)% | (0.6)% |
| Loss before provision for income tax | (4.9)% | (5.5)% | (4.3)% | (2.5)% |
| Provision for income tax | (2.8)% | (1.3)% | (1.9)% | (0.7)% |
| Net loss | (2.1)% | (4.2)% | (2.4)% | (1.8)% |

Revenues

The following table shows revenue by products during the three and six months ended June 30, 2018 and June 30, 2017 (in thousands):

| | Three Months Ended | | | Six Months Ended | | |
|----------------------------|--------------------|-----------|--------|------------------|-----------|--------|
| | June 30, | | | June 30, | | |
| | 2018 | 2017 | Change | 2018 | 2017 | Change |
| Neurology Products | | | | | | |
| Devices and Systems | \$50,308 | \$41,584 | 21 % | \$96,361 | \$79,773 | 21 % |
| Supplies | 16,535 | 15,182 | 9 % | 33,707 | 30,069 | 12 % |
| Services | 3,565 | 2,551 | 40 % | 6,303 | 5,743 | 10 % |
| Total Neurology Revenue | 70,408 | 59,317 | 19 % | 136,371 | 115,585 | 18 % |
| Newborn Care Products | | | | | | |
| Devices and Systems | 13,985 | 17,464 | (20)% | 29,951 | 41,602 | (28)% |
| Supplies | 9,625 | 11,299 | (15)% | 19,147 | 22,745 | (16)% |
| Services | 5,477 | 5,345 | 2 % | 10,880 | 10,395 | 5 % |
| Total Newborn Care Revenue | 29,087 | 34,108 | (15)% | 59,978 | 74,742 | (20)% |
| Otometrics Products | | | | | | |
| Devices and Systems | 30,572 | 22,522 | 36 % | 57,340 | 43,900 | 31 % |
| Supplies | 586 | 6,280 | (91)% | 5,572 | 12,660 | (56)% |
| Total Otometrics Revenue | 31,158 | 28,802 | 8 % | 62,912 | 56,560 | 11 % |
| Total Revenue | \$130,653 | \$122,227 | 7 % | \$259,261 | \$246,887 | 5 % |

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For the three months ended June 30, 2018, Neurology revenue increased by 19% compared to the same quarter last year. Revenue from sales of Neurology Devices and Systems increased by 21% driven mainly by the addition of revenue from Neurosurgery product lines and growth in polysomnography (“PSG”) sales in our domestic market. Revenue from Supplies increased by 9% mainly in our domestic market and was due in part to the addition of revenue from Neurosurgery products. Revenue from Services increased by 40% primarily due to an increase in the amount of revenue recognized per test day in the current quarter for our GND Services.

For the three months ended June 30, 2018, Newborn Care revenue decreased by 15% compared to the same quarter last year. The decrease is attributable to a one-time shipment of hearing devices and supplies to China, Japan, and Australia in the second quarter of 2017, a decline due to unfavorable foreign exchange rates in Argentina, temporary placement of balance and mobility on regulatory ship hold in the first quarter of 2018, and end-of-life decisions for certain products that did not have the required scale to remain viable.

For the three months ended June 30, 2018, Otometrics revenue increased by 8% compared to the same period last year. This increase was driven by higher sales by distributors and in Germany and China. This increase was partly offset by a decline in domestic sales which was largely attributable to the restructuring of the US sales team and also to the impact of Otometrics going live on our global ERP platform, in June.

For the six months ended June 30, 2018, Neurology revenue increased by 18% compared to the same quarter last year. Revenue from sales of Neurology Devices and Systems increased by 21% driven mainly by the addition of revenue from Neurosurgery product lines. Revenue from Supplies increased by 12% mainly in our domestic market and was due in part to the addition of revenue from Neurosurgery products. Revenue from Services increased by 10% due to an increase in the amount of revenue recognized per test day for our GND Services in the current quarter partially offset by a decline in the number of test days completed.

For the six months ended June 30, 2018, Newborn Care revenue decreased by 20% compared to the same quarter last year. The decrease is primarily due to the recognition of approximately \$10.0 million of revenue in the first half of 2017 from our contract with the government of Venezuela which did not reoccur in 2018. We also experienced a one-time shipment of NeoBlue blanket backlog in the first quarter of 2017 and a one-time shipment of hearing devices and supplies to China, Japan, and Australia in the second quarter of 2017. In addition to non-recurring orders from the prior year, the temporary placement of balance and mobility on regulatory ship hold in the first quarter of 2018, and end-of-life decisions for certain products that did not have the required scale to remain viable also contributed to the decline in revenue during the first half of 2018.

For the six months ended June 30, 2018, Otometrics revenue increased by 11% compared to the same period last year. This increase was driven by higher sales in International sales, in addition to favorable foreign exchange rates. This increase was partly offset by a decline in domestic sales which was largely attributable to the restructuring of the US sales team.

Revenue from domestic sales increased to \$75.5 million for the three months ended June 30, 2018 compared to \$67.1 million in the three months ended June 30, 2017. The increase in domestic revenue was driven by the addition of Neurosurgery which was partly offset by declines in Otometrics and Newborn Care domestic revenue.

Revenue from international sales remained approximately flat at \$55.2 million for the three months ended June 30, 2018 compared to \$55.1 million in the second quarter of 2017. A decrease in the Newborn Care international revenue was offset by the addition of Neurosurgery revenue, and higher Otometrics international revenue.

Cost of Revenue and Gross Profit

Cost of revenue and gross profit consists of (in thousands):

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| | Three Months Ended | | Six Months Ended | |
|--------------------------|--------------------|-----------|------------------|-----------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Revenue | \$130,653 | \$122,227 | \$259,261 | \$246,887 |
| Cost of revenue | 52,897 | 54,589 | 108,266 | 111,502 |
| Intangibles amortization | 2,717 | 1,500 | 4,305 | 2,500 |
| Gross profit | 75,039 | 66,138 | 146,690 | 132,885 |
| Gross profit percentage | 57.4 | % 54.1 | % 56.6 | % 53.8 |

For the three and six months ended June 30, 2018, gross profit as a percentage of revenue increased 3.3% and 2.7%, respectively, compared to the same period in the prior year. This increase was primarily driven by increased device and systems sales which have a higher gross margin than supplies and services.

Operating Costs

Operating costs consist of (in thousands):

| | Three Months Ended | | Six Months Ended | |
|----------------------------|--------------------|----------|------------------|----------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Marketing and selling | \$33,401 | \$30,354 | \$69,273 | \$62,569 |
| Percentage of revenue | 25.6 | % 24.8 | % 26.7 | % 25.3 |
| Research and development | \$15,616 | \$13,713 | \$31,059 | \$26,466 |
| Percentage of revenue | 12.0 | % 11.2 | % 12.0 | % 10.7 |
| General and administrative | \$23,721 | \$24,156 | \$41,169 | \$40,172 |
| Percentage of revenue | 18.2 | % 19.8 | % 15.9 | % 16.3 |
| Intangibles amortization | \$4,151 | \$3,885 | \$8,957 | \$7,959 |
| Percentage of revenue | 3.2 | % 3.2 | % 3.5 | % 3.2 |
| Restructuring | \$1,938 | \$307 | \$2,750 | \$593 |
| Percentage of revenue | 1.5 | % 0.3 | % 1.1 | % 0.2 |

Marketing and Selling

Marketing and selling expenses increased in both an absolute sense and as a percentage of revenue for the three and six months ended June 30, 2018 compared to the same period in 2017. This was primarily due to the addition of Neurosurgery and an increase in spend for Otometrics.

Research and Development

Research and development expenses increased in both an absolute sense and as a percentage of revenue during the three and six months ended June 30, 2018 compared to the same periods in 2017. The increase relates to the addition of Neurosurgery products and increased spend on new product development, including Otoscan® and Retcam products.

General and Administrative

General and administrative expense during the three and six months ended June 30, 2018 included extraordinary expenses incurred related to our annual meeting. These additional expenses were offset primarily by a reduction in bad debt expense recognized during the period related to our Peloton business.

Intangibles Amortization

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Intangibles amortization increased during the three and six months ended June 30, 2018 as compared to the same periods in 2017. This increase was attributable to intangibles acquired in the Integra assets acquisition during the fourth quarter of 2017.

Restructuring

Restructuring expenses increased during the three and six months ended June 30, 2018 compared to the same periods in 2017. The increase was due to an increase in severance expense in our Otometrics business.

Other Income (Expense), net

Other income (expense), net consists of investment income, interest expense, net currency exchange gains and losses, and other miscellaneous income and expense. For the three months ended June 30, 2018 we reported \$2.4 million of other expense compared to \$0.4 million of other expense for the same period in 2017. For the six months ended June 30, 2018 we reported \$4.2 million of other expense compared to other expense of \$1.4 million for the same period in 2017. This increase in expense in both the three and six months ended June 30, 2018 was attributable to a higher interest expense than previous quarters due to borrowing to complete the Otometrics acquisition and acquisition of Neurosurgery assets as well as exchange rate fluctuations.

Provision for Income Tax

We recorded a benefit from income tax of \$3.6 million and \$5.0 million for the three and six months ended June 30, 2018, respectively. The effective tax rate was 58.3% and 46.7% for the three and six months ended June 30, 2018, respectively.

We recorded a benefit from income tax of \$1.6 million and \$1.6 million for the three and six months ended June 30, 2017, respectively. The effective tax rate was 24.4% and 25.5% for the three and six months ended June 30, 2017, respectively.

The increase in the effective tax rate for the three and six months ended June 30, 2018 compared with the three and six months ended June 30, 2017 is primarily attributable to the changes enacted by the Tax Cuts and Jobs Act of 2017 (the "2017 Act") and certain discrete items. Our effective tax rate for the three and six months ended June 30, 2018 differed from the federal statutory tax rate of 21% primarily due to the recognition of excess tax benefits of stock-based compensation and Federal and California research and development credits, non-deductible expenses, and the international provisions from the U.S. tax reform enacted in December 2017. The changes attributable to the 2017 Act which impacted the effective tax rate directly increased the amount of non-deductible executive compensation and introduced a new type of deemed inclusion related to global intangible low taxed income. The tax rate for the three and six months ended June 30, 2018 was significantly greater than the tax rate for the three and six months ended June 30, 2017, largely due to the changes from the 2017 Act. The tax rate was also impacted to a lesser degree by shifts in geographical mix and discrete events.

We recorded \$12.0 thousand of net tax benefit related to unrecognized tax benefits for the six months ended June 30, 2018, primarily due to the lapse of the applicable statute of limitations. Within the next twelve months, it is possible our uncertain tax benefit may change with a range of approximately zero to \$0.9 million. Our tax returns remain open to examination as follows: U.S Federal, 2014 through 2017, U.S. States, 2013 through 2017, and significant foreign jurisdictions, 2013 through 2017.

Liquidity and Capital Resources

Liquidity and capital resources consist of (in thousands):

| | June 30, 2018 | December 31, 2017 |
|---------------------------|---------------|-------------------|
| Cash and cash equivalents | \$54,908 | \$ 88,950 |
| Working capital | 190,914 | 213,491 |

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| | Six Months Ended | |
|---|------------------|-----------|
| | June 30, | |
| | 2018 | 2017 |
| Net cash provided by operating activities | \$11,326 | \$10,314 |
| Net cash used in investing activities | (3,534) | (114,881) |
| Net cash used in financing activities | (36,011) | (35,869) |

We believe that our current cash and cash equivalents and any cash generated from operations will be sufficient to meet our ongoing operating requirements for the foreseeable future.

As of June 30, 2018, we had cash and cash equivalents outside the U.S. in certain of our international subsidiaries of \$47.4 million. We intend to permanently reinvest the cash held by our international subsidiaries except for Excel-Tech and Natus Ireland, which we intend to repatriate. If, however, a portion of these funds were needed for and distributed to our operations in the United States, we would be subject to additional U.S. income taxes and foreign withholding taxes depending on facts and circumstances at the time of distribution. The amount of taxes due would depend on the amount and manner of repatriation, as well as the country from which the funds were repatriated.

On September 23, 2016, we entered into a Credit Agreement with JP Morgan Chase Bank and Citibank, NA that provides for an aggregate \$150.0 million secured revolving credit facility. On September 15, 2017, we exercised our right to increase the amount available under the facility by \$75.0 million, bringing the aggregate revolving credit facility to \$225.0 million. The Credit Agreement contains covenants, including covenants relating to maintenance of books and records, financial reporting and notification, compliance with laws, maintenance of properties and insurance, and limitations on guaranties, investments, issuances of debt, lease obligations and capital expenditures. The Credit Agreement provides for events of default, including failure to pay any principal or interest when due, failure to perform or observe covenants, bankruptcy or insolvency events and the occurrence of a material adverse effect. We have no other significant credit facilities. As of June 30, 2018 we had \$120.0 million outstanding under the Credit Facility.

During the six months ended June 30, 2018 cash provided by operating activities of \$11.3 million was the result of \$5.7 million of net loss, non-cash adjustments to net loss of \$27.6 million, and net cash outflows of \$10.5 million from changes in operating assets and liabilities. The change in non-cash adjustment to net loss was driven by increased depreciation and amortization due to the Neurosurgery assets acquisition, share based compensation, and accounts receivable reserves. Cash used in investing activities during the period was \$3.5 million, driven by cash used to acquire other property and equipment. Cash used in financing activities during the six months ended June 30, 2018 was \$36.0 million and consisted of repayment of borrowing of \$35.0 million, \$5.6 million for repurchases of common stock under our share repurchase program, \$0.3 million for taxes paid related to net share settlement of equity awards, and \$0.1 million for contingent consideration payments, partially offset by stock option exercises of \$5.1 million. During the six months ended June 30, 2017 cash provided by operating activities of \$10.3 million was the result of \$4.7 million of net income, non-cash adjustments to net income of \$31.6 million, and net cash inflows of \$16.6 million from changes in operating assets and liabilities. The change in non-cash adjustment to net income was driven by increased depreciation and amortization and additional warranty and accounts receivable reserves. Cash used in investing activities during the 2017 period was \$114.9 million, driven by the acquisition of Otometrics for \$149.2 million, offset by the sale of short-term investments of \$34.0 million. Cash used to acquire other property and equipment was \$1.5 million. Cash used in financing activities during the six months ended June 30, 2017 was \$35.9 million and consisted of \$40.0 million for payment on borrowings, \$3.1 million for taxes paid related to net share settlement of equity awards, \$2.5 million for a contingent consideration payment for the Retcam acquisition, and \$2.3 million for repurchase of common stock under our share repurchase program, partially offset by proceeds from borrowing of \$10.0 million and stock option exercises of \$2.1 million.

Our future liquidity and capital requirements will depend on numerous factors, including the:

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Extent to which we make acquisitions;

Amount and timing of revenue;

Extent to which our existing and new products gain market acceptance;

Cost and timing of product development efforts and the success of these development efforts;

- Cost and timing of marketing and selling activities;
and

Availability of borrowings under line of credit arrangements and the availability of other means of financing.

Commitments and Contingencies

In the normal course of business, we enter into obligations and commitments that require future contractual payments. The commitments result primarily from firm, non-cancellable purchase orders placed with contract vendors that manufacture some of the components used in our medical devices and related disposable supply products, as well as commitments for leased office space, and bank debt. The following table summarized our contractual obligations and commercial commitments as of June 30, 2018 (in thousands):

| | Total | Payments Due by Period | | | |
|------------------------------------|-----------|------------------------|-----------|-----------|----------------------|
| | | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
| Unconditional purchase obligations | \$64,597 | \$62,024 | \$ 2,573 | \$— | \$— |
| Operating lease obligations | 28,766 | 3,220 | 11,075 | 7,427 | 7,044 |
| Bank debt | 120,000 | — | — | 120,000 | — |
| Interest payments | 11,234 | 2,884 | 7,317 | 1,033 | — |
| Repatriation tax | \$11,754 | \$1,078 | \$ 2,034 | \$2,923 | \$ 5,719 |
| Total | \$236,351 | \$69,206 | \$ 22,999 | \$131,383 | \$ 12,763 |

Purchase obligations are defined as agreements to purchase goods or services that are enforceable and legally binding. Included in the purchase obligations category above are obligations related to purchase orders for inventory purchases under our standard terms and conditions and under negotiated agreements with vendors. We expect to receive consideration (products or services) for these purchase obligations. The purchase obligation amounts do not represent all anticipated purchases in the future, but represent only those items for which we are contractually obligated. The table above does not include obligations under employment agreements for services rendered in the ordinary course of business.

The interest payments note above are an estimate of expected interest payments, but could vary materially based on the timing of future loan draws and payments. See Note 12 to these Condensed Consolidated Financial Statements for additional discussion on our debt and credit arrangements.

We are not able to reasonably estimate the timing of any potential payments for uncertain tax positions under ASC 740, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement 109. As a result, the preceding table excludes any potential future payments related to our ASC 740 liability for uncertain tax positions. See Note 11 of our Condensed Consolidated Financial Statements for further discussion on income taxes.

Off Balance Sheet Arrangements

Under our bylaws, we have agreed to indemnify our officers and directors for certain events or occurrences arising as a result of the officer or director serving in such capacity. We have a directors and officers' liability insurance policy that limits our exposure and enables us to recover a portion of any future amounts paid resulting from the indemnification of our officers and directors. In addition, we enter into indemnification agreements with other parties in the ordinary course of business. In some cases we have obtained liability insurance providing

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coverage that limits our exposure for these other indemnified matters. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. We believe the estimated fair value of these indemnification agreements is minimal and have not recorded a liability for these agreements. During the six months ended June 30, 2018, we had no other off-balance sheet arrangements that had, or are reasonably likely to have, a material effect on our condensed consolidated financial condition, results of operations, or liquidity.

Recent Accounting Pronouncements

See Note 1 to our Condensed Consolidated Financial Statements for a discussion of new accounting pronouncements that affect us.

Cautionary Information Regarding Forward Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 about Natus Medical Incorporated. These statements include, among other things, statements concerning our expectations, beliefs, plans, intentions, future operations, financial condition and prospects, and business strategies. The words “may,” “will,” “continue,” “estimate,” “project,” “intend,” “believe,” “expect,” “anticipate,” and other similar expressions generally identify forward-looking statements. Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: our expectations regarding our new products, including the timing of the release of our Otoscan® product, our expected repatriation of offshore cash, the sufficiency of our current cash and cash equivalents, and any cash generated from operations to meet our ongoing operating and capital requirements for the foreseeable future, and our intent to acquire additional technologies, products, or businesses.

Forward-looking statements are not guarantees of future performance and are subject to substantial risks and uncertainties that could cause the actual results predicted in the forward-looking statements as well as our future financial condition and results of operations to differ materially from our historical results or currently anticipated results. Investors should carefully review the information contained under the caption “Risk Factors” referred to in Part II, Item 1A of this report for a description of risks and uncertainties. All forward-looking statements are based on information available to us on the date hereof, and we assume no obligation to update forward-looking statements.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to risks associated with changes in interest rates, as the interest rates on a revolving credit facility may vary with the federal funds rate, LIBOR, and our ability to repay the debt. Please refer to Part II, Item 7A.

Quantitative and Qualitative Disclosures About Market Risk included in our Annual Report on Form 10-K for the year ended December 31, 2017 for a more complete discussion on the market risks we encounter.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the rules of the Securities and Exchange Commission, “disclosure controls and procedures” are controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in our reports that we file or submit under the Securities Exchange Act of 1934 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.

At December 31, 2017, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, had evaluated the effectiveness of our disclosure controls and procedures as of the end of that period. Based

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on that evaluation, our management, including our chief executive officer and chief financial officer, concluded that our disclosure controls and procedures were not effective as of December 31, 2017. That conclusion was based on the material weakness in our internal control over financial reporting further described below.

A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of our annual or interim consolidated financial statements will not be prevented or detected on a timely basis.

The material weakness identified by our management was due to not performing an effective risk assessment relating to significant acquisitions, and as a result we did not adequately design control activities over the accounting for the acquisition of Otometrics. This material weakness did not result in material misstatements in the consolidated financial statements as of and for the fiscal year ended December 31, 2017. However, the control deficiencies create a reasonable possibility that a future material misstatement will not be prevented or detected on a timely basis.

At June 30, 2018, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were not effective as of June 30, 2018 due to the material weakness described above that has not yet been remediated.

Changes in Internal Control over Financial Reporting

Other than the actions taken as described below under “Remediation Efforts to Address Material Weakness”, there were no changes in the Company's internal control over financial reporting during the second quarter of 2018, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonable likely to materially affect, our internal control over financial reporting.

Remediation Effort to Address Material Weakness

To remediate the material weakness in our internal control over financial reporting described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017, we will operate our redesigned purchase price allocation controls to account for the Integra Asset Acquisition of our Neurosurgery business which we acquired during the fourth quarter of 2017. Our remediation actions will include:

- improving the design of internal controls related to our review of key assumptions and data used to allocate acquisition purchase price by evaluating the specific financial reporting risks associated with each acquisition as they occur;

- improving the design of internal controls related to the evidence and documentation of internal control procedures with respect to the process of determining purchase price allocation; and

- sufficiently distinguishing our internal controls from the process we undertake to allocate purchase price.

With the oversight of senior management and our audit committee, we have begun taking the above steps. While our remediation efforts are in process, they have not been completed.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

In January 2017, a putative class action lawsuit (Badger v. Natus Medical Incorporation, et al., No. 17-cv-00458-JSW) alleging violations of federal securities laws was filed in the United States District Court for the Northern District of California, naming as defendants the Company and certain officers and a director. In July 2017, plaintiffs filed an amended complaint with a new lead plaintiff (Costabile v. Natus Medical Incorporation, et al., No. 17-cv-00458-JSW) alleging violations of federal securities laws based on allegedly false and misleading statements. The defendants moved to dismiss the Amended Complaint, and in February 2018 the motion to dismiss was granted with leave to amend. The plaintiffs re-filed an amended complaint in April 2018 and Natus responded

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in May 2018. A decision is expected later this year. The Company continues to believe that the plaintiffs' allegations are without merit, and intends to vigorously defend against the claims.

We currently are, and may from time to time become, a party to various other legal proceedings or claims that arise in the ordinary course of business. Our management reviews these matters if and when they arise and believes that the resolution of any such matters currently known will not have a material effect on our results of operations or financial position.

ITEM 1A. Risk Factors

A description of the risks associated with our business, financial condition and results of operations is set forth in Part 1, Item 1A "Risk Factors" of our Annual Report on Form 10-K for the fiscal year ended December 31, 2017. There have been no material changes in our risks from such description.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information regarding repurchases by the Company of its common stock for the three and six months ended June 30, 2018.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------------------|----------------------------------|------------------------------|--|--|
| April 1, 2018 - April 30, 2018 | — | \$ — | — | \$ 25,276,129 |
| May 1, 2018 - May 31, 2018 | — | \$ — | — | \$ 25,276,129 |
| June 1, 2018 - June 30, 2018 | 25,652 | \$ 34.79 | 25,652 | \$ 24,383,696 |
| Total | 25,652 | \$ 34.79 | 25,652 | \$ 24,383,696 |

On February 22, 2018, the Board of Directors authorized the repurchase of up to \$30 million in common stock with an expiration date of February 26, 2019.

ITEM 5. Other Information

None

ITEM 6. Exhibits

(a) Exhibits

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| Exhibit No. | Exhibit | Incorporated By Reference | | | |
|--------------|---|---------------------------|-------------|-----------|----------------|
| | | Filing | Exhibit No. | File Date | Filed Herewith |
| <u>31.1</u> | <u>Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> | | | | X |
| <u>31.2</u> | <u>Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> | | | | X |
| <u>32.1</u> | <u>Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> | | | | X |
| <u>10.16</u> | <u>Terms of Resignation between Natus Medical Incorporated and James B. Hawkins dated July 11, 2018</u> | | | | X |
| 101 | The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Operations and Comprehensive Income, (iii) Condensed Consolidated Statements of Cash Flows, and (iv) Notes to Condensed Consolidated Financial Statements. | | | | X |

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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.

NATUS MEDICAL INCORPORATED

Dated: August 8, 2018 By: /s/ Jonathan A. Kennedy
Jonathan A. Kennedy
President and Chief Executive Officer
(Principal Executive Officer)

Dated: August 8, 2018 By: /s/ Sharon R. Villaverde
Sharon R. Villaverde
Interim Chief Financial Officer
(Principal Financial and Accounting Officer)