

UNITED STATES  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

  
**FORM 20-F**

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

Or

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

For the fiscal year ended December 31, 2017

Or

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

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

Date of event requiring this shell company report.....

For the transition period from            to

Commission File number: 000-23288

**SILICOM LTD.**

(Exact name of Registrant as specified in its charter and as translated into English)

ISRAEL  
(Jurisdiction of incorporation  
or organization)

14 Atir Yeda Street,  
Kfar Sava 4464323, Israel  
(Address of principal executive offices)

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E-mail: erang@silicom.co.il  
14 Atir Yeda Street,  
Kfar Sava 4464323, Israel

(Name, Telephone, E-mail and/or Facsimile number and Address of Company Contact Person)

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**Securities registered or to be registered pursuant to Section 12(b) of the Act:**

<b>None</b> <b>Title of each class</b>	<b>None</b> <b>Name of each exchange on which registered</b>
Ordinary Shares, NIS 0.01 nominal value per share	NASDAQ GLOBAL SELECT MARKET

**Securities registered or to be registered pursuant to Section 12(g) of the Act:**

**None**  
**(Title of Class)**

**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:**

**None**  
**(Title of Class)**

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

7,549,531

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes  No

Note—Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Emerging growth company

If an emerging growth company that prepares its financial statements in accordance with U.S. GAAP, 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 which basis of accounting the registrant has used to prepare the financial statements included in this filing:

US GAAP  International Financial Reporting Standards as issued by the International Accounting Standards Board  Other

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes  No

This annual report on Form 20-F includes certain "forward-looking" statements within the meaning of Section 21E of the Securities Exchange Act of 1934. The use of the words "projects," "expects," "may," "plans" or "intends", or words of similar import, identifies a statement as "forward-looking." There can be no assurance, however, that actual results will not differ materially from our expectations or projections. Factors that could cause actual results to differ from our expectations or projections include the risks and uncertainties relating to our business described in this report at Item 3 titled "Risk Factors."

As used herein or any in any document incorporated by reference hereto, the "Company", "Silicom Ltd.", "Silicom", "Registrant", "we", "us", or "our" refers to Silicom Ltd. and its subsidiaries.

We have prepared our consolidated financial statements in United States dollars and in accordance with accounting principles generally accepted in the United States. All references herein to "dollars" or "\$" are to United States dollars, and all references to "Shekels" or "NIS" are to New Israeli Shekels.

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**Part I.**

**Item 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not Applicable.

**Item 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not Applicable.

**Item 3. KEY INFORMATION**

**A. Selected Financial Data**

The selected data presented below under the captions "Consolidated Statements of Operations Data" and "Consolidated Balance Sheets Data" for and as of the end of each of the years in the five-year period ended December 31, 2017, are derived from our audited consolidated financial statements. The consolidated financial statements as of December 31, 2017, and for each of the years in the three-year period ended December 31, 2017, and the report thereon, are included elsewhere in this annual report. The selected data set forth below should be read in conjunction with our consolidated financial statements and the notes thereto, which are set forth in "Item 18 – Financial Statements" and the other financial information appearing elsewhere in this annual report.

**CONSOLIDATED STATEMENTS OF OPERATIONS DATA:**

	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
Sales	\$ 73,298	\$ 75,622	\$ 82,738	\$ 100,347	125,690
Cost of sales	43,865	44,835	48,659	61,796	79,762
Gross profit	29,433	30,787	34,079	38,551	45,928
Research and development expenses	5,465	6,480	9,702	12,663	13,915
Sales and marketing expenses	3,818	4,418	5,651	6,423	6,722
General and administrative expenses	2,572	2,798	3,611	3,969	4,507
Contingent consideration expense (benefit)	0	45	(3,090)	(334)	(4,642)
Total operating expenses	11,855	13,741	15,874	22,721	20,502
Operating income	17,578	17,046	18,205	15,830	25,426
Financial income, net	404	263	220	35	156
Income before income taxes	17,982	17,309	18,425	15,865	25,582
Income tax expenses	905	2,704	1,905	2,728	3,868
Net income <sup>(1)</sup>	17,077	14,605	16,520	13,137	21,714
Net income per share					
Basic income per ordinary share	\$ 2.404	\$ 2.033	\$ 2.273	\$ 1.789	\$ 2.912
Diluted income per ordinary share	\$ 2.357	\$ 1.996	\$ 2.242	\$ 1.767	\$ 2.856
Weighted average number of ordinary shares used to compute basic income per share (in thousands)	7,103	7,184	7,269	7,344	7,456
Weighted average number of ordinary shares used to compute diluted income per share (in thousands)	7,246	7,319	7,368	7,435	7,602

(1) Net income is after deduction of taxes on income, which have been reduced by virtue of tax benefits to which the Company is entitled in its capacity as an "Approved Enterprise", "Benefited Enterprise" or "Preferred Enterprise", as applicable with respect to each of the years indicated above, under Israeli law. As such, the Company was required to pay taxes at a reduced effective rate. The Company selected the 2004 tax year (for which the tax benefits ended at the end of 2013), the 2006 tax year, the 2009 tax year and the 2012 tax year as its Year of Election under its capacity as "Approved Enterprise" or "Benefited Enterprise" for each of the Years of Election. In 2014 the Company elected to be taxed under its capacity as a "Preferred Enterprise", following which its benefits under the Investment Law under its capacities as "Approved Enterprise" or "Benefited Enterprise", as applicable, were ceased. As of 2014, the benefits under the Investment Law under the Company's capacity as a "Preferred Enterprise" commenced. See Note 14C to the Financial Statements and "Item 10 – Additional Information – Taxation".



**CONSOLIDATED BALANCE SHEET DATA**

	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
Total assets	\$ 105,257	\$ 122,436	\$ 139,998	\$ 146,437	\$ 162,614
Total current liabilities	\$ 11,948	\$ 19,006	\$ 19,814	\$ 17,964	\$ 19,049
Long-term liability	\$ 2,618	\$ 2,698	\$ 7,350	\$ 7,081	\$ 2,765
Shareholders' equity	\$ 90,691	\$ 100,732	\$ 112,834	\$ 121,392	\$ 140,800
Capital stock	\$ 21	\$ 21	\$ 21	\$ 22	\$ 22
Number of ordinary shares issued(1)	7,154,984	7,233,604	7,299,315	7,396,584	7,564,502

(1) Including 14,971 held by one of our subsidiaries - Silicom Connectivity Solutions, Inc. Under the Israeli Companies Law 5759-1999 (the "**Companies Law**") these shares held by such subsidiary are non-voting shares.

The following table sets forth information regarding the exchange rates of U.S. Dollars per NIS for the periods indicated. Average rates are calculated by using the daily representative rates as reported by the Bank of Israel on the last day of each month during the periods presented.

<b>Year Ended December 31,</b>	<b>NIS per U.S. \$</b>			
	<b>High</b>	<b>Low</b>	<b>Average</b>	<b>Period End</b>
2017	3.860	3.467	3.600	3.467
2016	3.983	3.746	3.841	3.845
2015	4.053	3.761	3.887	3.902
2014	3.994	3.402	3.577	3.889
2013	3.728	3.471	3.601	3.471

The following table sets forth the high and low daily representative rates for the NIS as reported by the Bank of Israel for each of the prior six months.

Month	NIS per U.S. \$			Period End
	High	Low	Average	
March 2018	3.514	3.431	3.469	3.514
February 2018	3.535	3.427	3.494	3.485
January 2018	3.460	3.388	3.423	3.405
December 2017	3.550	3.467	3.504	3.467
November 2017	3.544	3.499	3.517	3.499
October 2017	3.542	3.491	3.512	3.521

The NIS to U.S. Dollar exchange rate on March 31, 2018, as published by the Bank of Israel, was NIS 3.514.

#### Dividends

Prior to 2013, we had not paid dividends to our shareholders. On January 14, 2013, we announced that our Board of Directors adopted a policy for distributing dividends, subject to all applicable laws. According to this policy, each year we will distribute a dividend of up to 50% of our annual distributable profits. As part of the stated policy, the Company's Board of Directors reserves the right to declare additional dividend distributions, to change the rate of dividend distributions (either as a policy or on a one-time basis), to cancel a specific distribution or to cancel the policy as a whole at any time, at its sole discretion. According to the policy, the actual distribution of a dividend will be subject to meeting the conditions required by applicable law, including the distribution tests set forth in Section 302 of the Companies Law, and to the specific decision of the Company's Board of Directors for each distribution. On March 15, 2018, our Board of Directors adopted a resolution to suspend until further notice the said dividend policy in order to increase our available funds in support of our long-term growth. Future dividend policies will be reviewed by the Board of Directors based upon conditions then existing, including our earnings, financial condition, capital requirements and other factors. Our ability to pay cash dividends may be restricted by instruments governing any of our obligations.

Dividends paid by an Israeli resident company to non-Israeli shareholders are generally subject to withholding tax in Israel at a rate of up to 25% (or 30% if such non-Israeli shareholder is a "substantial shareholder" at the time receiving the dividend or on any date in the 12 months preceding such date), but the actual withholding rate may be lower or higher than 25% depending upon the type of shareholder. In our case, the applicable withholding tax rate will also depend on the particular Israeli production facilities that have generated the earnings that are the source of the specific dividend and, accordingly, the applicable withholding rate may change from time to time.

On March 18, 2013 our Board of Directors declared a continuing dividend for 2012 of US \$0.55 (NIS 2.03 according to the NIS-USD exchange rate as of March 18, 2013, as reported by the Bank of Israel) per share payable on April 17, 2013 to shareholders of record as of April 4, 2013, and in the aggregate amount of approximately US \$3.9 million (approximately NIS 14.4 million according to the NIS-USD exchange rate as of March 18, 2013, as reported by the Bank of Israel) for 2012. Taxes were withheld at source by the Company as required pursuant to Israeli law.

On March 18, 2014 our Board of Directors declared a continuing dividend for 2013 of US \$1.00 (NIS 3.462 according to the NIS-USD exchange rate as of March 18, 2014, as reported by the Bank of Israel) per share payable on April 17, 2014 to shareholders of record at the close of the NASDAQ Global Select Market on April 3, 2014, and in the aggregate amount of approximately US \$7.2 million (approximately NIS 24.9 million according to the NIS-USD exchange rate as of March 18, 2014, as reported by the Bank of Israel) for 2013. Taxes were withheld at source by the Company as required pursuant to Israeli law.

On March 23, 2015 our Board of Directors declared a continuing dividend for 2014 of US \$1.00 (NIS 4.018 according to the NIS-USD exchange rate as of March 23, 2015, as reported by the Bank of Israel) per share payable on April 21, 2015 to shareholders of record at the close of the NASDAQ Global Select Market on April 6, 2015, and in the aggregate amount of approximately US \$7.3 million (approximately NIS 29.3 million according to the NIS-USD exchange rate as of March 23, 2015, as reported by the Bank of Israel) for 2014. Taxes were withheld at source by the Company as required pursuant to Israeli law.

On March 21, 2016 our Board of Directors declared a continuing dividend for 2015 of US \$1.00 (NIS 3.855 according to the NIS-USD exchange rate as of March 21, 2016, as reported by the Bank of Israel) per share payable on April 14, 2016 to shareholders of record at the close of the NASDAQ Global Select Market on April 4, 2016, and in the aggregate amount of approximately US \$7.3 million (approximately NIS 28.1 million according to the NIS-USD exchange rate as of March 21, 2016, as reported by the Bank of Israel) for 2015. Taxes were withheld at source by the Company as required pursuant to Israeli law.

On March 15, 2017 our Board of Directors declared a continuing dividend for 2016 of US \$1.00 (NIS 3.66 according to the NIS-USD exchange rate as of March 15, 2017, as reported by the Bank of Israel) per share payable on April 5, 2017 to shareholders of record at the close of the NASDAQ Global Select Market on March 27, 2017, and in the aggregate amount of approximately US \$7.4 million (approximately NIS 27.1 million according to the NIS-USD exchange rate as of March 15, 2017, as reported by the Bank of Israel) for 2016. Taxes were withheld at source by the Company as required pursuant to Israeli law.

For more information on the taxation of dividends generally, and for our calculation of the tax withheld on the dividends paid as detailed above, see the section entitled "Taxation of Dividends" in Section 10.E "Taxation".

**Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the receipt of any dividend distributions made to our shareholders, including, in particular, the effect of any foreign, state or local taxes, and of any taxes withheld at source by the Company.**

**B. Capitalization and indebtedness**

Not Applicable

**C. Reason for the offer and use of proceeds**

Not Applicable

#### **D. Risk Factors**

This annual report and statements that we may make from time to time may contain forward-looking information. There can be no assurance that actual results will not differ materially from our expectations, statements or projections. Factors that could cause actual results to differ from our expectations, statements or projections include the risks and uncertainties relating to our business described below.

##### **Risks Relating to Our Business**

###### ***The markets for our products change rapidly and demand for new products is difficult to predict.***

The markets for our products are characterized by rapidly changing technology and evolving industry standards. For example, the migration to higher line rate Ethernet solutions, the adaptation of new bus interfaces and increased use of emerging technologies such as Cloud, Virtualization, NFV, SD-WAN and SDN, cause some of our customers to demand such new products and technologies. In the event that such customers decide to begin using new technologies, we may not be able to develop products for the new technologies in a timely manner. Such customers may also select competing products despite our ability to develop products incorporating new technologies. For example, with the shift towards running applications in the Cloud we anticipate that the demand will grow for add-on adapters and products which address the challenges presented by the Cloud, such as switch in every server, hardware acceleration, power, heat and space limitations in such environments which increase the need for essential building blocks in generic servers, which can potentially be served by our products. Another example is related to the NFV and SD-WAN market sectors, in which our virtualized CPE (vCPE) and CPE solutions may have significant demand. However, there is no assurance that our customers will buy such CPE products from us or that we will be able to generate significant sales in these areas or other areas in which we operate. Consequently, we may suffer from reduced sales to such customers and accumulate unusable inventory which can be used only with older technologies. We intend to continue investing in product and technology development. Although we have recorded growing sales of our line of products, there can be no assurance that we will continue to be successful in the marketing of our current products and in developing, manufacturing and marketing enhanced and new products in a timely manner. Any decrease in the price of, or demand for, any of our products or solutions could have a material adverse effect on our business, results of operations and financial condition.

###### ***The market for Cloud-based and Cloud-focused solutions is rapidly developing, and if it develops in ways that are different from what we anticipate or expect, our business could be harmed.***

In recent years, the Cloud-based market has rapidly developed, and the demand for Cloud-based data centers utilizing virtualization and SDN has increased. We expect the Cloud-based data centers to be increasingly based on generic server platforms. These platforms will all need offload capabilities in order to address the performance challenges realized due to the huge amount of traffic, the high volume of data, the need to encrypt such data, the need to run in virtualized environment, which by itself is a challenge for the server CPU, and the need to include switching within the server for high efficiency SDN. We anticipate that consequently the demand for add-on adapters which address these challenges will grow. Power, heat and space limitations in such environments increase the need for hardware accelerators. Such systems will require essential building blocks in their own generic servers, which can be served by our products.

While we believe that we address the above needs with a comprehensive suite of products, and while during 2017, we experienced significant growth in the value of Cloud related orders we received for our products, many factors may affect the market acceptance of cloud-based and cloud-focused solutions, the achievement of Design Wins relating to such solutions, the consummation of Design Wins achieved by us and/or the acceptance of add-on products incorporated into such solutions. Some of these factors include the possibility of seeing a reduction in the number of physical servers and appliances required by the providers of cloud based or virtualized solutions, or the evolving of different architecture designs which provide for functionality which our products offer without the need for add on adapters. These factors may also affect our ability to accurately predict the anticipated revenues which may be generated under any such Design Win, our growth potential in the Cloud, our operations, including our inventory levels, and our financial results.

In addition, we believe that market's demand for our products and solutions in the Cloud demonstrates that the ongoing industry transition to the Cloud continues to represent a fast growing opportunity for us. Nonetheless, if significant organizations providing Cloud based solutions or other virtualized networks do not perceive the benefits of our cloud-focused and/or virtualized network based solutions, or if our competitors or new market entrants are able to develop solutions for this market that do not require add on products such as ours, or offer features that are, or are perceived to be, more effective than our solutions, this would have a material adverse effect on our ability to achieve and/or consummate Design Wins, on our business, and on our results of operations and financial condition.

***The market for Edge Networking Devices to Telcos and service providers for NFV and/or SD-WAN deployments is rapidly developing, and if it develops in ways that are different from what we anticipate or expect, our business could be harmed.***

Recently, with the evolution of the NFV and SD-WAN, most Telcos and Telco-related service providers are seeking for solutions which utilize virtual CPEs and/or universal CPEs (uCPE) for the deployment of SD-WAN or other applications within an NFV architecture. We believe that our uCPE and vCPE products address the requirements of such Telcos and service providers' needs and requirements, and we have been engaged in several bids and RFPs during 2017, some of which we hope would turn into awards and/or deliveries during 2018.

While we believe that we address the above needs with a comprehensive suite of products, many factors may affect the market acceptance of such solutions and our ability to secure Design Wins and/or awards in this market. Some of these factors include our lack of experience in transacting with such Telcos and service providers, our competition with competitors which may offer a wider selection of products, or products which include a wider, better suited or more advanced features than the ones included in our products, development of technologies of LTE and WiFi with which our current products may not be compatible, and the price expectations of such Telcos and service providers which may require us to lower our prices, which may lead to lower gross profit and may have an adverse effect on our financial results.

We believe that market's demand for our products and solutions in the NFV and SD-WAN era demonstrate that the Telcos and service providers related industry is transitioning into uCPEs and vCPEs which represent a fast growing opportunity for us. Nonetheless, if such Telcos and service providers do not perceive the benefits of our Edge Networking vCPEs/uCPEs, or if our competitors or new market entrants are able to develop solutions for this market that are better suited to the market demand, offer their solutions at lower prices than us, or offer features that are, or are perceived to be, more effective than ours, this would have a material adverse effect on our business, results of operations and financial condition.

***The rapid development of our business in the Cloud-based and Telco-related markets may require us to offer our potential customers with longer payment terms in order to better position ourselves in these markets, to hold higher inventory levels and to increase our need for working capital significantly.***

The rapid development of our business in the Cloud-based and Telco-related markets, which we anticipate would constitute our main growth engines in the future, may require us to offer longer payment terms to our targeted Cloud-related and Telco-related customers as customary in these markets and in order to establish and maintain relationships with such targeted customers and strengthen our competitive position in such markets. In addition, we may be required to hold higher inventory levels by such customers in order to meet such customers' expectations of an on-demand delivery, making the higher available inventory pivotal to our ability to position ourselves and compete in such markets. These factors may increase our need for working capital significantly in order to support our activities in these markets as mentioned above. There is no assurance that we will be able to reach such additional working capital levels, which may impair our business and growth strategy, and/or have an adverse effect on our financial results.

***Our networking and data infrastructure solution products which are targeted by us mainly to OEMs, Cloud and Telco customers, are characterized by long sales cycles***

We target and sell our networking and data infrastructure solution products mainly to original equipment manufacturers ("OEMs"), Cloud and Telco customers. The decision making process of our customers includes several time consuming processes, resulting from the critical importance of our products in their systems. They need to define the required configuration of their server system/appliance, derive the need and type of adapters or other add-on products, evaluate our products, intensively test and qualify our products and then (or in parallel) negotiate the terms for a purchase. It may therefore take 12 months or more from the time we first contact a prospective customer before such customer implements our cards in its system constituting what is known as a Design Win. Additionally, once a Design Win for one of our products is secured, our sales of these products typically involve significant capital investment decisions by the customer or its prospective end customers, as well as a significant amount of time to educate such end customers as to the benefits of systems and appliances that include our products. As a result, before purchasing systems and appliances which include our products (and consequently facilitating sales of our products), companies spend a substantial amount of time performing internal reviews and obtaining capital expenditure approvals, consequently lengthening the period of time required for a Design Win to mature into consistent sales. These long sales cycles make it difficult to predict when and to what extent discussions with potential customers will materialize into sales and could cause our revenue and operating results to fluctuate widely from period to period. In addition, our allocation of significant resources to potential sales opportunities that do not materialize into sales could have a material adverse effect on our business, results of operations and financial condition.

In addition, once a Design Win has been secured, the ramp-up of sales under the Design Win is dependent on various factors which are not under our control. This introduces uncertainty into our ability to accurately predict the ramp-up of sales and deployment run rate of our products with our customers, may result in significant quarterly or even annual fluctuations in the sale rates of our products and may have an adverse effect on our backlog, actual sales and results of operation.

***The loss of Design Wins from Cloud and Telco customers may result in significant quarterly and even annual fluctuations in our revenues.***

We anticipate that the Cloud-based and Telco-related markets would constitute our main growth engines in the future. We further anticipate that Design Wins secured from Cloud and Telco customers would be significantly larger in size than our Design Wins from our OEM customers. In light of the risk factors related to our operations in the Cloud-based and Telco-related markets as detailed elsewhere in this Annual Report, we may experience losses of Design Wins in such markets, for which we may not be able to compensate in a timely manner. The losses of such Design Wins may result in significant quarterly or even annual fluctuations in our revenues and results of operations.

***The rapid development of our business in the Cloud-based and Telco-related markets may lead to a decrease in our gross margins which may result in a decrease in our profitability.***

The rapid development of our business in the Cloud-based and Telco-related markets, and our increasing operations and efforts in these markets, require us to adopt a lower gross margin strategy relatively to our gross margins in past years in order to take advantage of increased revenue potential and opportunities in these markets. While in the past we were able to increase our profitability while operating under such lower gross margins, there can be no assurance that we will be able to maintain or increase our profitability and/or earnings per share in the future and we may not be successful in maintaining or increasing our profitability and/or earnings per share while operating under such lower gross margins in the future.

***The loss of our largest ever Design Win which we announced in 2017 may lead to excess inventory levels, may lead to significant write-offs, may cause legal disputes, may significantly increase our operational efforts related to such loss and may divert the management's attention, which will be harmful for our business and impair our financial results.***

During 2017 we announced our largest-ever Design Win with a giant top-tier Cloud player. For additional information regarding our announcements relating to said Design Win which we published in 2017, see "Item 4.B. – Business Overview."

In March, 2018, we announced the Cloud player that awarded us the Design Win referred to above, has decided to abort the new Cloud infrastructure architecture for which it had ordered our product.

The cancellation of our largest-ever Design Win described above, that took place after the balance sheet date, under which we have open purchase orders, may lead to excess inventory levels and write-offs and increase our operational costs, especially in the event the purchase orders placed under the Design Win are not consummated. In addition, such cancellation may lead to legal disputes, either as plaintiffs or as defendants, with our suppliers, customers and other third parties in connection with the Design Win or as a result of the cancellation thereof, all of which may increase our operational efforts and expenses and divert the management's attention from our core business. We may also be required to find alternative use for any unused inventory relating to the Design Win, and if we are unable to find such alternative use or sell such inventory to other customers, we will experience additional write-offs. The cancellation of the Design Win may also have a material adverse effect on our efforts to position ourselves in the Cloud market, may impact the market's acceptance of our products and may impact our growth potential in this market. All of these factors may have a material adverse effect on our financial condition and results of operation. While we focus our efforts on securing additional Design Wins in the Cloud and Telco-related markets, our share price has declined since we announced the cancellation of this Design Win, and may continue to decline in the future as a result thereof.

***A loss of a material Design Win may lead to a decrease in the volume of orders placed in relation to such Design Win by a few of our customers, which would be harmful for our business and impair our financial results.***

In some cases, one of our Design Wins may lead to the placement of purchase orders for our products by several of our customers for the purpose of integrating our products into their own systems, as part of the assembly process relating to the said Design Win. The loss of such material Design Win may lead to a decrease in the purchase orders placed by such customers, impair our revenues generated from such customers and have a material adverse effect on our business and financial results.

***Difficulties in the fulfilment of financial obligations of one or more of our customers may have an adverse effect on our ability to consummate the collection of consideration payable under purchase orders placed by, or invoiced to, such customers under one or more Design Wins in relation to which such customers operate.***

In some cases, one of our customers places orders under several Design Wins for our products for the purpose of integrating our products into systems, as part of the assembly process relating to the said Design Wins. In some cases, one or more of such customers is a major customer. For example, as of December 31, 2017, three of our customers accounted for approximately 62% of our accounts receivables. Difficulties in the fulfilment of such customer's financial obligations towards us may expose us to credit risks, may have a material adverse effect on our business, including on our ability to consummate the collection of consideration payable by, or invoiced to, such customer in connection with the Design Wins under which such customer placed orders, may lead to financial losses, may increase our collection expenses, may lead to excess inventory levels, may lead to significant write-offs, may cause legal disputes, may delay the consummation of the relevant Design Win and may ultimately lead to the reduction in order placed under, or even cancellation of, such Design Win. This may have a material adverse effect on our business and our financial condition and results.



***The market for our products is highly competitive and some of our competitors may be better positioned than we are.***

The market for our products is highly competitive. We face competition from numerous companies, some of which are more established, benefit from greater market recognition and have greater financial, production and marketing resources than we do. For example, our main competitors in the non-bypass server adapters space are Mellanox and Broadcom, which may offer solutions competing with our developed products. In addition, Cavium, Caswell, Lanner and Napatech are the main competitors of some of our Smart Cards products. There may be other solutions which might also compete with our other products. We cannot guarantee that our present or contemplated products will continue to be distinguishable from those of our competitors or that the marketplace will find our products preferable to those of our competitors. Furthermore, there can be no assurance that competitive pressures will not result in price reductions that could materially adversely affect our business and financial condition and the results of our operations. For more information regarding our competitors see "Item 4B – Information on the Company – Business Overview – Competition".

***We may not be successful in achieving and consummating Design Wins for our Cloud and Telco related products, which we anticipate would constitute our main growth engines in the future.***

Our ability to achieve Design Wins for our Cloud and Telco related products, and to consummate the sales of our products under Design Wins achieved, is dependent on a large number of factors, many of which are not under our control. These factors include the highly competitive nature of the markets in which we operate, including the Cloud and Telco markets, the long sale cycles of our products to our OEMs, Cloud and Telco customers, as well as other factors detailed in this Item 3.D. In addition, the loss, ineffectiveness or inability to maintain our customer relationships or our inability to develop new customer relationships, may have an adverse effect on our ability to achieve or consummate Design Wins for our Cloud and Telco related products.

***We may need to invest significantly in research and development and business development in order to diversify our product offering and enter new markets.***

Most of our revenues are generated from the sale of our networking and data infrastructure solution products. The technology industry in which we operate is characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. While these changes could lead to a reduction in the demand for our existing products, they could also create an opportunity for us to expand our product offering to our existing customers and to new customers. Accordingly, our future success may depend on our ability to diversify our product offering and enter new markets, which could involve numerous risks, including:

- Substantial research and development and business development expenditures, which could divert funds from other corporate uses and/or have a significant negative effect on our short-term results;
- Diversion of management's attention from our core business; and
- Entering markets in which we have little or no experience.

There can be no assurance that we will be able to successfully complete the development and market introduction of new products and no assurance that we will be able to successfully enter new markets. This could have a material adverse effect on our business, results of operations and financial condition.

***We may experience difficulty in developing new, commercially successful products at acceptable release times.***

We conduct extensive research, development and engineering activities. Our efforts emphasize the development of new products, cost reduction of current products, and the enhancement of existing products, generally in response to rapidly changing customer preferences, technologies and industry standards. We cannot guarantee the continued success of our products, nor that they will continue to be widely accepted by the marketplace or that any of our ongoing development efforts will result in other commercially successful products, that such products will be released in a timely manner or at a competitive price, or that we will be able to respond effectively to technological changes or new product announcements by others.

***Significant growth in markets demanding functionality similar to the functionality offered by certain of our products may cause manufacturers to integrate such characteristics into server motherboards or increase the market share of servers and appliances that already have such functionality in-built, eliminating the need for our add-on products.***

A significant portion of our products sold are add-on adapters that are added to existing servers in order to improve their functionality. If demand for improved functionality similar to the functionality of our add-on adapters increases significantly, server manufacturers may begin incorporating such functionality as a part of the basic design of their servers, thereby eliminating the need to achieve such functionality through add-on adapters. Furthermore, the market-share of special purpose servers and appliances that already have such functionality built-in may increase, consequently reducing the market share of solutions based on servers with add-on adapters. We cannot assure you that such a trend will not occur in connection with our add-on adapters or any of our other products. Such a trend would have a material adverse effect on our business, results of operations and financial condition.

***Our customers may replace the servers and appliances they currently use, use or sell servers and appliances that do not require our cards, and/or incorporate cards other than ours.***

Many of our customers that use and/or sell servers and appliances which include our cards do so for a few years, and then consider migration to a newer generation. We cannot guarantee that our cards will be needed or selected for such new generation or compatible with it. A decision by a current customer to select a new server and/or appliance without including our cards in such new server and/or appliance may have a significant adverse effect on our results of operations.

***We may experience difficulty in developing solutions for servers and appliances with proprietary interfaces which may be used by some of our potential customers.***

The market for networking and data infrastructure includes servers and appliances that make use of proprietary interfaces. These servers and appliances are offered to our potential customers in addition to the customary servers and appliances which use standard interfaces. Our potential customers may decide to use servers and appliances with such proprietary interfaces instead of the customary standard interfaces for which several manufacturers may provide add-on cards. There could be no assurance that we would be able to develop non-standard add-on cards for servers and appliances with proprietary interfaces or, if we are successful in developing such cards, that manufacturers of the proprietary interfaces or the customers electing to use these interfaces will make use of our cards in such non-standard environments.

***Our short lead time of customer orders introduces uncertainty into our revenues and severely limits our ability to accurately forecast future sales.***

Our sales are made on the basis of purchase orders rather than long-term purchase commitments. In addition, our customers may defer purchase orders. The short lead time for firm purchase orders introduce uncertainty into our revenue and production forecasts and business planning, and lead to our inability to accurately forecast future revenues from product sales. As a result, even dramatic fluctuation in revenue (whether increase or decrease) might not be detected until the very end of a financial quarter, which may not enable us to monitor costs in a timely manner to compensate for such fluctuation.

***The short lead time of customer orders combined with the long lead time of our suppliers when ordering certain components for our products could result in either a surplus or lack of sufficient supplies, and impact negatively on our finances.***

While we are generally required to fill orders for our products within one or two weeks following the receipt of a firm purchase order, we are usually required to place orders of certain components for our products within sixteen to twenty weeks prior to delivery. As a result, we must have a significant amount of components in our inventory to be able to meet our best forecasts of projected purchase orders as opposed to on the basis of firm purchase orders. In the event that firm purchase orders are significantly lower than such forecasts, a significant part of our inventory will not be used and we may be unable to adjust costs in a timely manner to compensate for revenue shortfalls and in the event that firm purchase orders exceed such forecasts, we will not be able to fill such purchase orders which may lead to the loss of business from a customer.

***The loss of a significant customer may have a material adverse effect on us.***

We depend on a small amount of customers for our products. Our top four customers in 2017 accounted for approximately 48% of our revenues in 2017 (out of which our top customer accounted for approximately 21% of our revenues in 2017). We expect that a small number of customers will continue to account for a significant portion of our revenues for the foreseeable future. Loss or cancellation of business from, significant changes in deliveries to, or decreases in the prices of products sold to, one or more of our key customers has, in the past, significantly reduced our revenues for a reporting period and could, in the future, harm our margins, results of operations, financial condition and business.

***The loss or ineffectiveness of any of our customer relationships or a reduction of purchase orders by such customers may have a material adverse effect on our operations and financial results.***

Our sales and marketing strategy includes development and maintenance of strategic relationships with leading OEMs in the servers industry and server-based systems industry, as well as leading Cloud and Telco customers, which integrate our products into their systems. These customers are not within our control, are not obligated to purchase our products, and may select other products that may compete with our lines of products. A reduction in their sales efforts or discontinuance of sales of our products by our OEMs, and/or the reduction in or discontinuance of deployments by our Cloud or Telco customers, could lead to reduced sales and could materially adversely affect our operating results. In addition, there is the risk that our customers would build up inventories in anticipation of a growth in sales or deployments. If such growth does not occur as anticipated, such customers may substantially decrease the amount of products ordered in subsequent quarters or discontinue product orders. The termination or loss of either one or more of our key customer relationships at approximately the same time, without being able to compensate this loss with sales to other customers might have a material adverse effect on our operations and financial results.

***We are dependent on key personnel.***

Our success has been, and will be, dependent to a large degree on our ability to retain the services of key personnel and to attract additional qualified personnel in the future. Competition for such personnel is intense. There can be no assurance that we will be able to attract, assimilate or retain key personnel in the future and our failure to do so would have a material adverse effect on our business, financial condition and results of operations.

***We may not be able to prevent others from claiming that we have infringed their proprietary rights.***

We cannot guarantee that one or more parties will not assert infringement claims against us. The cost of responding to claims could be significant, regardless of whether the claims have merit. Significant and protracted litigation may be necessary to determine the scope of the proprietary rights of others or to defend against claims of infringement, regardless of whether the claims have merit. Although we believe that all our products use only our intellectual property, or intellectual property which is properly licensed to us, and are working to ensure that all our employees are properly assigning or licensing to us all rights to the intellectual property which we use in our products on a regular basis, in the event that any infringement claim is brought against us and infringement is proven, we could be required to discontinue the use of the relevant technology, to cease the manufacture, use and sale of infringing products, to incur significant litigation damages, costs and expenses, to develop non-infringing technology or to obtain licenses to the alleged infringing technology and to pay royalties to use such licenses. There can be no assurance that we would be able to develop any such alternative technologies or obtain any such licenses on terms commercially acceptable to us.

Although in the past we have resolved a claim of infringement through a license agreement, the terms of which did not have a material effect on our business, any infringement claim or other litigation against us, could seriously harm our business, operating results and financial condition. While there are no other lawsuits or other claims currently pending against us or our subsidiaries regarding the infringement of patents or intellectual property rights of others, except for any such claims or legal proceedings that, if adversely determined, would not adversely affect the use or exploitation of such intellectual property right by the Company or by (i) any of our subsidiaries; (ii) our assets acquired from ADI Engineering, Inc. in 2015 under the ADI APA, as defined below; or (iii) the creation, development, manufacturing, marketing, provision, distribution, licensing, or sale of any product or service created, developed, manufactured or otherwise provided by any of the Company, any of our subsidiaries or in relation to the assets acquired by us from ADI under the ADI APA, we have been a party to such claims in the past and may be party to such claims in the future.

***We may not be able to protect our intellectual proprietary rights.***

Our success, ability to compete, and future revenue growth are dependent and will depend, in part, on our ability to protect our intellectual property. It is possible that competitors or other unauthorized third parties may obtain, copy, use or disclose our technologies and processes. Any of our existing, acquired, or future patents or other rights to our intellectual property may be challenged, invalidated or circumvented. If our intellectual property rights do not adequately protect our technology, our competitors may be able to offer products similar to ours.

In order to establish and protect the technology we use in our products, we primarily rely on a combination of non-disclosure agreements and technical measures, and to a lesser degree on patents. We enter into confidentiality arrangements with our employees, key consultants and other third parties with whom we conduct business. In addition, our employees and key consultants involved in the development of our technologies are required to sign non-compete and invention assignment agreements. We also control access to and distribution of our technologies, documentation and other proprietary information. Despite these efforts, internal or external parties may attempt to copy, disclose, obtain or use our products, services or technology without our authorization.

Despite perceived exclusive access to any intellectual property rights obtained via acquisition, and our best efforts during any such acquisition process to secure such rights, internal or external parties may attempt to copy, disclose, obtain or use our products, services or technology without our authorization, or others may assert infringement claims against us with respect to a product of ours which utilizes such acquired intellectual property rights.

We believe that the measures we take afford only limited protection, and accordingly, there can be no assurance that the steps we take will be adequate to prevent the challenging of our rights in our technology, or misappropriation of our technology or the independent development of similar technologies by others.

In addition, the process of seeking patent protection to our technology may take a long time and be expensive. We cannot assure you that patents will be issued from pending or future applications or that, if patents are issued, they will not be challenged, invalidated or circumvented or that the rights granted under the patents will provide us with meaningful protection or any commercial advantage.

In addition, we cannot assure you that other countries in which we market our services and products will protect our intellectual property rights to the same extent as the United States. Effective intellectual property enforcement may be unavailable or limited in some countries. It may be difficult for us to protect our intellectual property from misuse or infringement by other companies in these countries. Our inability to enforce our intellectual property rights in some countries may harm our business and results of operations. Litigation, which could result in substantial costs to us and diversion of our resources, may also be necessary to enforce our patents or other intellectual property rights.

Further, we cannot assure you that we will at all times enforce our patents or other intellectual property rights or that courts will uphold our intellectual property rights, or enforce the contractual arrangements that we have entered into to protect our proprietary technology, which could reduce our opportunities to generate revenues. Our intellectual property assignment, confidentiality and non-competition agreements may not be enforceable and our proprietary technology may not remain a secret. Others may develop similar technology and use this technology to compete with us. Despite our efforts to protect our proprietary rights, former employees and other unauthorized parties may attempt to copy aspects of our products or obtain and use information that we regard as proprietary.

***Loss of our sources for certain key components could harm our operations.***

Although we generally use standard parts and components for our products, certain key components used in our products are currently available from only one source, and others are available from a limited number of sources, on which we depend. Nevertheless, we believe that we maintain a sufficient inventory of these components to protect against delays in deliveries. However, we cannot guarantee that we will not experience delays in the supply of critical components in the future or that we will have a sufficient inventory of critical components at such time to produce products at full capacity. For example, a key component in many of our cards is manufactured by Intel®. While we have not encountered difficulties in purchasing such components from Intel's distributors, we cannot guarantee that we will continue to be able to purchase such components without delays or at reasonable prices. In the event that we are not able to purchase key components of our products from our limited sources, or are able to purchase these key components only under unreasonable terms, we may need to redesign certain products. We cannot guarantee that we will have adequate resources for such a redesign or that such a redesign will be successful. Such inability to obtain alternative resources or to successfully redesign our products could have a material adverse effect on our business, results of operations and financial condition.

***Inability to cooperate with and receive information from our key component manufacturers could affect our ability to develop new products required by our customers and by the industry in which we operate.***

Our products are based on silicon which is mostly manufactured by Intel® and Xilinx. In order to design our products, we need to receive information that enables us to design products with the use of such silicon. There can be no assurance that we will continue to receive all the information required for designing products with the use of new silicon continuously released by the above mentioned companies. The reduction in the level of cooperation with our manufacturers, including as a result of such manufacturers' decision to compete with our products, or our inability to obtain information from our manufacturers relating to their products used by us, may adversely affect our ability to develop new products required by customers and by the industry in which we operate.

***We may make acquisitions or pursue mergers that could disrupt our business and harm our financial condition.***

As part of our business strategy, we have sought and may continue to seek to invest in or acquire other businesses, technologies or assets, and we may enter into joint ventures or other strategic relationships with third parties.

We may assume liabilities, incur amortization expenses related to intangible assets or realize large and immediate write-offs in connection with future acquisitions. In addition, the future valuation of these acquisitions may decrease from the market price paid by us, which may result in the writing-off, or impairment, of the relevant assets. In addition, our operation of any acquired or merged businesses, technologies or assets could involve numerous risks, including:

- Post-merger integration problems resulting from the combination of any acquired operations with our own operations or from the combination of two or more operations into a new merged entity;

- Diversion of management's attention from our core business;
- Substantial expenditures, which could divert funds from other corporate uses;
- Entering markets in which we have little or no experience; and
- Loss of key employees of the acquired operations.

We cannot be certain that any acquisition or merger will be successful. If the operation of the business of any acquisition or merger disrupts our operations, our business may suffer. In addition, even if we successfully integrate the acquired business with our own, we may not receive the intended benefits of the acquisition.

***We may be subject to risks associated with laws, regulations and customer initiatives relating to the environment, conflict minerals or other social responsibility issues, which may force us to incur additional expenses, may make our supply chain more complex and may result in damage to our reputation with customers.***

The Dodd-Frank Wall Street Reform and Consumer Protection Act included disclosure requirements regarding the use of "conflict" minerals mined from the Democratic Republic of Congo and adjoining countries ("**DRC**") and procedures regarding a manufacturer's efforts to prevent the sourcing of such "conflict" minerals. These requirements will require companies to diligence, disclose and report whether or not such "conflict" minerals originate from the DRC. The implementation of these requirements could adversely affect the sourcing, availability and pricing of minerals such as cassiterite, wolframite, columbite-tantalite (coltan), and gold or their derivatives, which are limited to tantalum, tin and tungsten, which are used in the manufacture of certain components used in our products. As a result, this could limit the pool of suppliers who can provide us DRC "conflict free" components and parts, and we may not be able to obtain DRC "conflict free" products or supplies in sufficient quantities for our operations. Also, because our supply chain is complex, we may face reputational challenges with our customers, shareholders and other stakeholders if we are unable to sufficiently verify the origins for the minerals used in our products. In such event, we may also face difficulties in satisfying customers who require that all of the components of our products are certified as conflict mineral free. In addition, we will incur additional costs to comply with the disclosure requirements, including costs related to determining the source of any of the relevant minerals and metals used in our products. For additional information see "Item 4 – Information on the Company – Business Overview".

***We depend on governmental licenses for our exports.***

Our international sales depend largely on export licenses from the government of Israel in relation to products which contain encryption capabilities, which we are currently required to hold. As of the date of this annual report, we have obtained all such licenses necessary to carry out our international sales. If we fail to obtain a material license in the future, or if a material license previously obtained is revoked or expires and is not renewed, our ability to sell our products to overseas customers could be interrupted, resulting in a material adverse effect on our business, results of operations and financial condition.

## Risks Relating to Operations in Israel and Internationally

*The tax benefits available to us under Israeli law require us to meet several conditions and may be terminated or reduced in the future, which would increase our taxes.*

Our production facilities have been granted "Approved Enterprise" or "Benefited Enterprise" status in past years and currently hold a "Preferred Enterprise" status under the Encouragement of Capital Investments Law, and since and as such, we are entitled to certain tax benefits. In order to be eligible for these tax benefits, we must meet certain conditions. If we fail to meet these conditions in the future, the tax benefits could be reduced or canceled. These tax benefits may not be continued in the future at their current levels, or at any level. The termination or reduction of these benefits may increase our income tax expense in the future. To the best of our knowledge, to date we have met the conditions for benefits under each of our "Approved Enterprise" and "Benefited Enterprise" plans and under our "Preferred Enterprise" status in all material respects. There can be no assurance, however, that we will continue to meet such conditions in the future. If these tax benefits are reduced, cancelled or discontinued, our Israeli taxable income would be subject to "regular" Israeli corporate tax rate. The regular corporate tax rate for Israeli companies in 2013 was 25%, 26.5% in 2014 and 2015 and 25% in 2016. In December 2016, the regular tax rate in Israel was reduced to 24% in 2017 and to 23% as from 2018 and thereafter. See "Item 10 – Additional Information – Taxation – the Encouragement of Capital Investments Law, 1959" for more information about our "Benefited Enterprise" status.

*The government programs and benefits which we previously received require us to meet several conditions in order to transfer intellectual property developed using government funding abroad, or in order to consult a change in control.*

We received grants from the Government of Israel through programs with the Office of the Chief Scientist of the Israeli Ministry of Economy and Industry, or OCS, as it was known prior to Amendment No. 7 (the "**R&D Amendment**") to the Israeli Law for the Encouragement of Industrial Research and Development, 1984, and related regulations (the "**R&D Law**"), now known as the Israel Innovation Authority (the "**IIA**").

On July 29, 2015, the Israeli Parliament, the Knesset, enacted the R&D Amendment, which, effective as of January 1, 2016, amends material provisions of the R&D Law, including royalty rates, changes to royalty rates upon transfer of manufacturing rights abroad, etc., leaves substantial discretion with the newly established IIA, and, until recently, included only guidelines to some of the core issues of the R&D Law, thus causing much ambiguity as to the implementation of the R&D Amendment and its effect on companies which developed know-how using funds received from the OCS.

The IIA has recently published a directive incorporating most of the former provisions, including those with respect to transfer of manufacturing rights, transfer of know-how and others. These provisions include limitations and requirements for payment with respect to outsourcing or transferring development or manufacturing activities with respect to any product or technology outside of Israel, and change in control in companies which received government funding from the OCS or IIA, which may impair our ability to sell our technology assets outside of Israel or to outsource, transfer development or manufacturing activities with respect to any product or technology outside of Israel, or consummate a change in control in the Company.



*The political environment and hostilities in Israel could harm our business.*

Since the establishment of the State of Israel in 1948, a state of hostility has existed between Israel and the Arab countries in the region. This state of hostility has varied in degree and intensity over time. There has also been conflict and unrest between Israel, the Palestinian Authority and certain terrorist groups operating within the Palestinian Authority and Lebanon. In addition, internal conflicts within neighboring countries such as Egypt and Syria also affect Israel, both directly and indirectly. A significant increase in violence began in September 2000 and has continued with varying levels of severity through 2013, such as Israel's war with the Hezbollah militant group in July and August of 2006. In December 2008 and January 2009 there was an escalation in violence among Israel, Hamas, the Palestinian Authority and other groups, as well as extensive hostilities along Israel's border with the Gaza Strip, which resulted in missiles being fired from the Gaza Strip into Southern Israel. Similar hostilities accompanied by missiles being fired from the Gaza Strip into Southern Israel, as well as areas more centrally located near Tel Aviv and at areas surrounding Jerusalem, occurred during November 2012. During the summer of 2014, another escalation in violence among Israel, Hamas, the Palestinian Authority and other groups took place. This escalation became known as "Operation Protective Edge", which resulted in missiles being fired from the Gaza Strip into Southern and Central Israel, as well as civil insurrection of Palestinians in the West Bank. In October 2015, Israel encountered another escalation in violence with the Palestinian population, which resulted in clashes between Israel and armed Palestinians on the border with Gaza, in the West Bank and in Israeli cities. Since February 2011, Egypt has experienced political turbulence and an increase in terrorist activity in the Sinai Peninsula, following the resignation of Hosni Mubarak as president. This included protests throughout Egypt, and the appointment of a military regime in his stead, followed by the elections to parliament which brought groups affiliated with the Muslim Brotherhood (which had been previously outlawed by Egypt), and the subsequent overthrow of this elected government by a military regime instead. Such political turbulence and violence may damage peaceful and diplomatic relations between Israel and Egypt, and could affect the region as a whole. Similar civil unrest and political turbulence has occurred in other countries in the region, including Syria which shares a common border with Israel, and is affecting the political stability of those countries. Since April 2011, internal conflict in Syria has escalated, and evidence indicates that chemical weapons have been used in the region. Intervention may be contemplated by outside parties in order to prevent further chemical weapon use. This instability and any intervention may lead to deterioration of the political and economic relationships that exist between the State of Israel and some of these countries, and may have the potential for additional conflicts in the region. In addition, Iran has threatened to attack Israel and is widely believed to be developing nuclear weapons. Iran is also believed to have a strong influence among extremist groups in the region, such as Hamas in Gaza, Hezbollah in Lebanon. Iran is known to support the government of Syria in its battles against various rebel militia groups in Syria. Furthermore, 2014 saw the rise of an Islamic fundamentalist group, known as ISIS. Following swift conquering operations, ISIS gained control of vast areas in the Middle East, including in Iraq and Syria, which contributed to the turmoil experienced in these areas. As a result, the United States armed forces have engaged in limited operations to eradicate ISIS, following which Russia's armed forces have also engaged in limited operations to defeat ISIS and other rebel groups operating in Syria. 2017 saw several defeats by ISIS, and the establishment of Hezbollah and other Shiite groups in Syria. These situations may potentially escalate in the future to more violent events which may affect Israel and us. Furthermore, several countries still restrict trade with Israeli companies and additional countries may impose such restrictions as a result of changes in the military and/or political conditions in Israel and/or the surrounding countries, which may limit our ability to make sales in, or purchase components from, those countries. Any future armed conflict, political instability, continued violence in the region or restrictions could have a material adverse effect on our business, operating results and financial condition. While such hostilities did not in the past have a material adverse impact on our business, we cannot guarantee that hostilities will not be renewed and have such an effect in the future. The political and security situation in Israel may result in parties with whom we have contracts claiming that they are not obligated to perform their commitments under those agreements pursuant to force majeure provisions. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could adversely affect our operations and could make it more difficult for us to raise capital or obtain components used in our products. Since many of our facilities are located in Israel, we could experience serious disruptions if acts associated with this conflict result in any serious damage to our facilities. Any insurance coverage we may have may not adequately compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business. Any future armed conflict or political instability in the region would likely negatively affect business conditions and hamper results of operations.

***Many of our employees in Israel are required to perform military reserve duty.***

All non-exempt male adult citizens and permanent residents of Israel under the age of 40, or older for reserves officers or citizens with certain occupations, as well as certain female adult citizens and permanent residents of Israel, are obligated to perform military reserve duty and may be called to active duty under emergency circumstances. In recent years, there have been significant call-ups of military reservists, and it is possible that there will be additional call-ups in the future. While we have operated effectively despite these conditions in the past, we cannot assess what impact these conditions may have in the future, particularly if emergency circumstances arise. Our operations could be disrupted by the absence for a significant period of one or more of our executive officers or key employees or a significant number of our other employees due to military service. Any disruption in our operations would harm our business.

***Exchange rate fluctuations and international risks could increase the cost of our operations.***

Approximately 95% of our international sales are denominated in U.S. Dollars and may be subject to government controls and other risks, including, in some cases, export licenses, federal restrictions on export, currency fluctuations, political instability, trade restrictions, and changes in tariffs and freight rates. Our U.S. dollar costs in Israel and Denmark will increase further to the extent that inflation in Israel and Denmark exceeds the devaluation of the NIS and Danish Krone ("DKK"), respectively, against the dollar, if the timing of such devaluation lags behind inflation in Israel or Denmark, or if the dollar devalues against the NIS or DKK.

***We are affected by worldwide downturns in industries based on technology.***

The volatility in the securities markets and its effect on high-technology companies may have a ripple effect on our performance. In the downturn which the markets experienced beginning in 2001, technology companies dealing in communications and computers were severely affected and some were forced to cease operations. We felt the effects of this downturn in 2001 through 2003. We were also affected by the downturn in the economic markets which began in 2008, posing a risk to industries based on technology as well as the overall economy. We can give no assurance that our results will not be affected on a going forward basis by any economic downturns.

***General economic conditions may adversely affect the Company's results.***

Uncertainty in global economic conditions, including any disruption in financial and credit markets, pose a risk to the overall economy that could impact demand for our and our customers' products, as well as our ability to manage commercial relationships with our customers, suppliers and creditors. If the global economic situation worsens, our business could be negatively impacted, including such areas as reduced demand for our products and services, or supplier or customer disruptions, which could reduce our revenues or our ability to collect our accounts receivable and have a material adverse effect on our financial condition and results of operations.

***Israeli courts might not enforce judgments rendered outside of Israel.***

We are incorporated in Israel. All of our executive officers and directors are non-residents of the United States, and a substantial portion of our assets and the assets of these persons are located outside the United States. Therefore, it may be difficult to enforce a judgment obtained in the United States against us or any such persons. It may also be difficult to enforce civil liabilities under U.S. federal securities laws in original actions instituted in Israel. However, subject to certain time limitations, Israeli courts may enforce U.S. final executory judgments for liquidated amounts in civil matters obtained after due trial before a court of competent jurisdiction (according to the rules of private international law currently prevailing in Israel) which enforces similar Israeli judgments, provided that the requisite procedural and legal requirements are adhered to.

If a foreign judgment is enforced by an Israeli court, it generally will be payable in NIS, which can then be converted into foreign currency at the rate of exchange of such foreign currency on the date of payment. Pending collection, the amount of the judgment of an Israeli court stated in NIS (without any linkage to a foreign currency) ordinarily will be linked to the Israeli consumer price index plus interest at the annual statutory rate prevailing at such time. Judgment creditors bear the risk of unfavorable exchange rates.

**Risks Related to our Ordinary Shares**

***We are affected by volatility in the securities markets.***

The securities markets in general have experienced volatility which has particularly affected the securities of many high-technology companies and particularly those in the fields of communications, software and internet, including companies that have a significant presence in Israel. This volatility has often been unrelated to the operating performance of these companies and may cause difficulties in raising additional financing required to effectively operate and develop their businesses. Such difficulties and the volatility of the securities markets in general may affect our financial condition and results.

***We may experience a decline in our share price and there is no guarantee that our share price will rise at all.***

In the past, our share price has fallen during periods of uncertainty in global economic conditions and we expect it to be affected by such uncertainty again to the extent that it resumes. We cannot assure you that our share price will stabilize, or not decline, in the coming fiscal year.

***We may not be able to distribute dividends in the future.***

On January 14, 2013, we announced a dividend policy for distributing up to 50% of our annual distributable profits as a dividend. Our Board of Directors declared a dividend for 2012 which was distributed in April 2013, for 2013 which was distributed in April 2014, for 2014 which was distributed in April 2015, for 2015 which was distributed in April 2016 and for 2016 which was distributed in April 2017. As part of the stated dividend policy the Company's Board of Directors reserved the right to declare additional dividend distributions, to change the rate of dividend distributions (either as a policy or on a one-time basis), to cancel a specific distribution or to cancel the policy as a whole at any time, at its sole discretion. On March 15, 2018, our Board of Directors adopted a resolution to suspend until further notice the said dividend policy in order to increase our available funds in support of our long-term growth.

Our ability to distribute dividends in the future may be adversely affected by the risk factors described in this report. Any dividend will depend on our earnings, capital requirements, financial condition and other business and economic factors affecting us at the time as our board of directors may consider relevant. Our ability to pay cash dividends may be restricted by instruments governing any of our obligations. We are restricted by Israeli law to pay dividends in any fiscal year only out of "profits", as defined by the Israeli Companies Law, unless otherwise authorized by an Israeli court, and provided that the distribution is not reasonably expected to impair our ability to fulfill our outstanding and expected obligations. There is no assurance that we will be able to pay dividends or increase our payment of dividends in the future, nor is there any assurance that our Board of Directors will not further change our dividend policy in the future. If we are unable to pay dividends at levels anticipated by investors in our shares, the market price of our shares may be negatively affected and the value of our shareholders' investment may be reduced. See "Item 8.A – Consolidated Statements and Other Financial Information", under the caption "8A – Dividend Policy" for additional information regarding the payment of dividends.

***If we fail to meet continued listing standards of NASDAQ, our shares may be delisted, which could have a material adverse effect on the liquidity of our shares***

Our ordinary shares are currently traded on the NASDAQ Global Select Market. The NASDAQ has requirements that a company must meet in order to remain listed on NASDAQ. In particular, NASDAQ rules require us to maintain a minimum bid price of \$1.00 per share of our ordinary shares. If the closing bid price of our common stock were to fall below \$1.00 per share for 30 consecutive trading days or we do not meet other listing requirements, we would fail to be in compliance with NASDAQ's listing standards. There can be no assurance that we will continue to meet the minimum bid price requirement, or any other requirement in the future. If we fail to meet the minimum bid price requirement, The NASDAQ Stock Market may initiate the delisting process with a notification letter. If we were to receive such a notification, we would be afforded a grace period of 180 calendar days to regain compliance with the minimum bid price requirement. In order to regain compliance, our ordinary shares would need to maintain a minimum closing bid price of at least \$1.00 per share for a minimum of 10 consecutive trading days. If our ordinary shares were to be delisted, our liquidity would be adversely affected and our market price could decrease.

***The trading volume of our shares has been low in the past and may be low in the future, resulting in lower than expected market prices for our shares.***

Our shares have been traded at low volumes in the past and may be traded at low volumes in the future for reasons related or unrelated to our performance. This low trading volume may result in lower than expected market prices for our ordinary shares and our shareholders may not be able to resell their shares for more than they paid for them.

***If we are characterized as a passive foreign investment company for U.S. federal income tax purposes, our U.S. shareholders may suffer adverse tax consequences.***

We will be a passive foreign investment company, or PFIC, if 75% or more of our gross income in a taxable year, including our pro-rata share of the gross income of any company, U.S. or foreign, in which we are considered to own, directly or indirectly, 25% or more of the shares by value, is passive income. Alternatively, we will be considered to be a PFIC if at least 50% of our assets in a taxable year, averaged over the year and ordinarily determined based on fair market value and including our pro-rata share of the assets of any company in which we are considered to own, directly or indirectly, 25% or more of the shares by value, are held for the production of, or produce, passive income. If we were to be a PFIC, and a U.S. Holder does not make an election to treat us as a "qualified electing fund," or QEF, or a "mark-to-market" election, "excess distributions" to a U.S. Holder, and any gain recognized by a U.S. Holder on a disposition of our ordinary shares, would be taxed in an unfavorable way. Among other consequences, our dividends, to the extent that they constituted excess distributions, would be taxed at the regular rates applicable to ordinary income, rather than the 20% maximum rate applicable to certain dividends received by an individual from a qualified foreign corporation, and certain "interest" charges may apply. In addition, gains on the sale of our shares would be treated in the same way as excess distributions. The tests for determining PFIC status are applied annually and it is difficult to make accurate predictions of future income and assets, which are relevant to the determination of PFIC status. In addition, under the applicable statutory and regulatory provisions, it is unclear whether we would be permitted to use a gross loss from sales (sales less cost of goods sold) to offset our passive income in the calculation of gross income. As a result of our substantial cash position, if the value of our shares declines, there is a substantial risk that we will be classified as a PFIC under the asset test described above. There can be no assurance that we will not be classified as a PFIC by the U.S. Internal Revenue Service. In light of the uncertainties described above, no assurance can be given that we will not be a PFIC in any year. A U.S. Holder who makes a QEF election is taxed currently on such holder's proportionate share of our earnings. If the IRS determines that we are a PFIC for a year with respect to which we have determined that we were not a PFIC, however, it might be too late for a U.S. Holder to make a timely QEF election, unless the U.S. Holder qualifies under the applicable Treasury regulations to make a retroactive (late) election. U.S. Holders who hold ordinary shares during a period when we are a PFIC will be subject to the foregoing rules, even if we cease to be a PFIC, subject to exceptions for U.S. Holders who made a timely QEF or mark-to-market election, or certain other elections. We do not currently intend to prepare or provide the information that would enable you to make a Qualified Election Fund election. Accordingly, our shareholders are urged to consult their tax advisors regarding the application of PFIC rules.

***Our investment portfolio may be impaired by disruptions in the financial and credit markets.***

Our investment portfolio currently consists of corporate debt securities which the Company classified at December 31, 2017 as "held-to-maturity". As of December 31, 2017, we hold approximately US\$ 13.7 million in corporate debt securities.

Due to possible significant disruptions in the financial and credit markets, the corporate debt securities in our portfolio are subject to a possible increased risk of default due to bankruptcy, lack of liquidity, operational failure or other factors affecting the issuers of those securities. In addition, securities in our portfolio are subject to other risks, such as credit, liquidity, market and interest rate risks, which may be exacerbated by market disruptions, and which may impair the assets. We may be required to adjust the carrying value of our investment securities due to a default, lack of liquidity or other event, if the event constitutes an impairment which is considered to be other-than-temporary. As of December 31, 2017, we were not required to adjust the carrying value of our investment securities since there were no other-than-temporary impairments.

If we will experience such a loss, it will be recorded in our consolidated statement of operations which could materially adversely impact our consolidated results of operations and financial condition.

#### **Item 4. INFORMATION ON THE COMPANY.**

##### **A. History and Development of the Company**

Our legal and commercial name is Silicom Ltd. We were incorporated under the laws of the State of Israel in 1987, and we operate under Israeli law and legislation. Our registered and principal executive offices are located in Israel at 14 Atir Yeda Street, Kfar Sava, Israel 4464323, and our telephone number is +972-(0)9-764-4555.

Our shares have been listed on the NASDAQ Global Select Market since January 2, 2014 under the ticker symbol "SILC". Prior thereto our shares were listed on the NASDAQ Global Market (previously known as the NASDAQ National Market) under the ticker symbol "SILC" (and previously "SILCF") from February 11, 2008. Prior thereto, our shares were listed on the NASDAQ Capital Market (previously known as the NASDAQ Small-Cap). On December 20, 2005, we obtained the approval of the Tel Aviv Stock Exchange, or TASE, for the listing of our shares on TASE. Trading of our shares on TASE commenced on December 27, 2005. On October 26, 2015, our Board of Directors resolved to act to delist the Company's shares from trading on the TASE. Consequently, we applied to the TASE and requested that TASE initiate the delisting process. On October 29, 2015, the TASE announced to the TASE members on the TASE electronic filing site, the MAYA, and on the ISA electronic filing site, the MAGNA, that the last trading day in the Company's shares on the TASE shall be January 26, 2016 and that on January 28, 2016, the Company's shares shall be delisted from trading on the TASE. Accordingly, the last trading day in our shares on the TASE was January 26, 2016, and on January 28, 2016, our shares were delisted from trading on the TASE. Our shares are currently listed only on the NASDAQ Global Select Market. See "Item 9 – The Offer and Listing – Markets and Share Price History".

In March 2014, we filed a "shelf" registration statement with the Securities and Exchange Commission (the "SEC") effective until April 4, 2017, under which we were authorized to sell up to \$80,000,000 of our ordinary shares in one or more offerings. On April 3, 2017, we filed a replacement "shelf" registration statement with the SEC (the "**April 2017 Shelf Registration Statement**"), designated to replace our March 2014 "shelf" registration statement, which was declared effective on June 1, 2017, under which we have not offered any securities for sale to date. Under the April 2017 Shelf Registration Statement we may sell up to \$80,000,000 of our ordinary shares in one or more offerings once it is declared effective by the SEC. We may offer securities under the April 2017 Shelf Registration Statement until May 31, 2020.

In December 2014, we entered into a share purchase agreement with Fiberblaze A/S (now Silicom Denmark (Fiberblaze A/S)), a provider of high performance application acceleration solutions for the mobile, telecommunication, network monitoring, cyber security, financial and related industries ("**Fiberblaze**"), Nikolaj Herman, Fiberblaze Holding APS ("**Fiberblaze Holding**"), a Danish company, Hilmer APS, a Danish company ("**Hilmer**"), and Jakob Hilmer, for the purchase of the entire share capital of Fiberblaze and Fiberblaze US (the "**Fiberblaze SPA**") in consideration for an amount of approximately \$10 million, plus such additional amounts as earn out payments in the event Fiberblaze meets pre-determined criteria during the Evaluation Period (as such term is defined in the Fiberblaze SPA). In 2016 we paid an earn out payment in the amount of US\$ 1,463 thousand, of which 90% was paid in cash and 10% in options to purchase ordinary shares of the Company. For additional information regarding the Fiberblaze SPA, see "Item 10 – Additional Information – Material Contracts", "Item 19 – Exhibits – Exhibit 4.7. – Fiberblaze SPA" and Note 3B to our financial statements included elsewhere in this annual report.

In September 2015, we, together with our wholly owned subsidiary, Silicom Connectivity Solutions, Inc., entered into an asset purchase agreement with ADI Engineering, Inc. ("**ADI**"), a US company which provides Intel®-based products targeted at SDN, NFV, IoT ('Internet of Things'), Cloud computing and Virtualization, Steve Yates and Patricia Yates (the "**ADI APA**") for the purchase of ADI's assets in consideration for an amount equal to \$10 million in cash at closing, and an additional consideration subject to the attainment of certain future performance milestones (the "**Excess Consideration**"). In 2016 we paid an Excess Consideration in the amount of US\$ 3,000 thousand for the attainment of the 2015 performance milestone detailed in the ADI APA. In 2017 and 2018 we did not pay any Excess Consideration since the respective performance milestones for each of 2016 and 2017, respectively, were not attained. For additional information regarding the ADI APA, see "Item 10 – Additional Information – Material Contracts", "Item 19 – Exhibits – Exhibit 4.8. – ADI APA" and Note 3A to our financial statements included elsewhere in this annual report.

### **Principal capital expenditures and divestitures**

From January 1, 2017 to December 31, 2017, our capital expenditures totaled to approximately \$2,118 thousand (compared to \$1,705 thousand during 2016 and \$20,771 thousand during 2015), of which approximately \$2,006 thousand (compared to \$1,589 thousand during 2016 and \$1,608 thousand during 2015) can be attributed to machinery and equipment, and approximately \$112 thousand (compared to \$116 thousand during 2016 and \$1,374 thousand during 2015) can be attributed to office furniture and equipment and leasehold improvements. We have financed our capital expenditures from our available internal resources, and expect to continue to finance our capital expenditures in a similar manner in 2018.

### **B. Business Overview**

We are an industry-leading provider of high-performance networking and data infrastructure solutions. Designed primarily to improve performance and efficiency in Cloud and Data Center environments, our solutions increase throughput, decrease latency and boost the performance of servers and networking appliances, the infrastructure backbone that enables advanced Cloud architectures and leading technologies like NFV, SD-WAN and Cyber Security. Our innovative solutions for high-density networking, high-speed fabric switching, offloading and acceleration, which utilize a range of cutting-edge silicon technologies as well as FPGA-based solutions, are ideal for scaling-up and scaling-out cloud infrastructures.

Our products are used by major Cloud players, service providers, telcos and OEMs as components of their infrastructure offerings, including both add-on adapters in the Data Center and stand-alone virtualized/universal CPE devices at the edge.

## **Products**

Our products are comprised of:

- (i) Server network interface cards with and without bypass (Server Adapters);
- (ii) Intelligent and programmable cards, with features such as encryption, acceleration, data compression, redirection and switching, packet processing, time stamping, packet capture solutions, FPGA based ultra-low latency solutions, other offload features and/or compute blades (Smart Cards); and
- (iii) Stand-alone Products: CPE and vCPE edge devices for SD-WAN and NFV deployments, Networking Targeted Appliances, Bypass Switches and Intelligent Bypass Switches.

### ***Server Adapters***

We have developed a line of products for the server networking industry which facilitates interaction between servers and switches, allowing them to communicate with each other through a larger number of ports and with higher performance than their original manufacturer designed capabilities. Our designs have resulted in powerful products that allow server-based systems to fully exploit the high speed potential of 1/10/25/40/100 Gigabit Ethernet. The products have either one, two, four, six or eight ports, which plug into the servers which need to have such capabilities.

Some of these server adapter products incorporate a bypass feature. Intended for mission-critical environments, our Bypass Networking Cards feature innovative bypass circuitry to maintain continuity of network connectivity in the event of an appliance or server failure. Upon the occurrence of an appliance or server failure, the card's bypass mechanism automatically reroutes traffic to bypass faulty components, enabling customers to have reliable and always available network accessibility. As with all of our Multiport Ethernet Networking Cards, the Bypass Cards also improve server throughput and performance during normal operations by introducing more ports and better throughput while reducing network congestion, simplifying network management, and minimizing CPU utilization.

On April 3, 2017, we issued a Press Release on Form 6-K announcing that we have secured an important first Design Win for several versions of our Bypass cards from a well-established Cyber Security customer which has now standardized on us as its networking add-on solution provider.

On September 5, 2017, we issued a Press Release on Form 6-K announcing the achievement of a significant new Cloud Design Win for the supply of off-the-shelf 10G Multi-Port Server Adapters to be used to upgrade one of our customer's existing Cloud platforms.

### ***Smart Cards***

Our Smart Card products include smart server adapters such as: (a) redirector and switching cards, (b) encryption and data compression hardware acceleration cards, (c) FPGA based packet processing cards, and (d) compute blades which offer general compute capability in networking intensive environment.



Our redirector and switching card cards improve performance by: (a) enabling switching fabric on a network interface card ("NIC") while (in some cases) providing separate data path and management path for the switching fabric and sometimes eliminating the need for a Top Of Rack switch within the Cloud, (b) enabling traffic filtering in order to reduce the amount of traffic received by the server, limiting it to only essential traffic for the server CPU, and consequently improving server performance, (c) load-balancing between external servers and/or CPUs and/or CPU cores increasing the efficiency of the server, and (d) offloading some of the CPU tasks to the switch on the NIC.

Our product line of high-performance encryption cards is designed to improve the throughput of servers the traffic into which requires encryption or decryption. The products improve the performance of such servers by independently executing encryption tasks, thereby accelerating the encryption process and freeing the CPUs of such servers for other activities. This product line can off-load not only encryption functionality, but compression functionality as well. The market need for compression off-load was previously limited to some content delivery and WAN optimization networking applications; however, such compression off-load is now becoming more and more important in the storage market especially within the Big-Data area, which is the market sector that is the primary target of this functionality.

Our 1G/10G/25G/40G/100G FPGA (field programmable gate array) based packet processing cards are based either on a combined standard Intel® networking silicon and an FPGA, or on a pure FPGA based solution, working at wire speed to achieve a variety of functionalities. Our products include three levels of solutions: The first level include minimal solution related IP, where we provide our customers with "Naked" FPGA cards, which they can use to program in any way they want. In these cards, other than the hardware we only provide FPGA and software which are required to test and verify the cards functionality. In the second level we provide a framework for a Smart Card. Such a framework allows the customer to add to the FPGA its own application, while the various interfaces are already a part of the framework, providing optimized solutions for low latency, throughput and speed. In the third level we provide solutions implemented in the FPGA. Such solutions are related to Packet Capturing, HFT, encryption/decryption, Deep Packet Inspection (DPI) and other Cloud and NFV related applications. The implementation of these solutions by the customers is proposed both in an "as is" model and as a sample code which the customer can then use as the basis to what it wants to do.

Our compute blades offer general compute capability in networking intensive environment. These compute blades could be integrated in an appliance, micro server, CPE equipment and alike. In addition, we use our low end compute blades for IoT.

On January 9, 2017, we issued a Press Release on Form 6-K announcing that we achieved our first Object Storage Design Win with one of the world's largest technology companies, a visionary leader in the Object Storage market. The Design Win is for high-performance connectivity adapters that will be used to enhance the throughput of the customer's object storage cloud platforms.

On February 23, 2017, we issued a Press Release on Form 6-K announcing that one of our biggest customers has selected our encryption cards for its next-generation appliances.

On May 16, 2017, we issued a Press Release on Form 6-K announcing that we have been awarded a Design Win from a new customer, a leading Flash-Only Storage company for a proprietary new front-loading compression module. Based on latest compression technology, the new product uses NVMe, a standard developed primarily for high-speed flash-based storage, to create a state-of-the-art PCI-E compression module that can be replaced or added to storage appliances in the field.

On June 15, 2017, we issued a Press Release on Form 6-K announcing that we have been awarded a new Design Win from an existing customer, a leading provider of Cloud and Enterprise networking applications and appliances. The current Design Win is for our latest generation of high-end and low-end encryption hardware acceleration cards that the client will deploy in its next-generation solutions.

On August 7, 2017, we issued a Press Release on Form 6-K announcing the achievement of a Design Win awarded by one of our significant long-term customers for an advanced FPGA-based card to be used in a new Network Visibility application. On November 1, 2017, we issued a Press Release on Form 6-K announcing that we have been awarded a Design Win from a leading Fintech player for our most advanced FPGA-based networking card. We believe that this win positions our FPGA technology as a platform for a variety of emerging new "FPGA in the Cloud" applications.

On November 1, 2017, we issued a Press Release on Form 6-K announcing announced that one of our existing customers, a world-leading Cyber Security player, has selected our encryption solution, and plans to deploy it in a number of its new platforms.

On February 7, 2018, we issued a Press Release on Form 6-K announcing that one of our long-term customers, a rapidly-growing Cyber Security company which is now moving heavily into the processing of higher volumes of data at much higher data rates, has standardized on our high-density server adapters with the intention of eventually using them to replace all of its lower speed/lower density adapters. With this new Design Win, this customer's run rate has risen to \$1 million per year, and is expected to ramp up to approximately \$1.5 million per year.

On March 21, 2017, we issued a Press Release on Form 6-K announcing the achievement of our largest-ever Design Win granted to us by a Cloud player for a highly customized version of our 100-Gigabit high bandwidth switch fabric on a NIC cloud solution.

On March 13, 2018, we announced that such Cloud player has decided to abort the new cloud infrastructure architecture for which it had ordered our product. In communicating its decision, the customer indicated that the cancellation of such Design Win was unrelated to our product, development or support, which was flawless, and that rather, its decision to abort the configuration was based on modification to its technical and business strategy.

### ***Stand-alone Products***

Our main Stand-Alone product line includes a family of CPE (Customer Premise Equipment), vCPE or Edge Networking Devices products. These products are full computing platforms in a networking intensive environment, mostly existing in the Cloud edge, and offered by both Cloud Vendors, Telco's and application vendors. Such platforms are based on compute blades, integrating such blades into a full CPE/EDGE/Appliance Units. Our products in this family includes very low end IoT devices, going through typical branch/CPE units and up to rack mounted devices targeting large scale branches.

On November 20, 2017, we issued a Press Release on Form 6-K announcing that a leading provider of Cloud-based networking solutions has selected our vCPE edge devices as its hardware platform for a customized Cloud-based SD-WAN networking solution.

Another stand-alone product line includes our Bypass Switches and Intelligent Bypass Switches which allow the use of our solutions even where the networking component of the solution is already present.

We market such stand-alone bypass units for: (a) entry level bypass switch 1/10Gbps, directed at power failure bypass; and (b) high end 1G/10G/25G/40G/100Gbps Intelligent Bypass Solution which includes switch with self-generating heartbeat and versatile monitoring and control options.

### **Principal Markets**

The principal markets in which we compete are set forth more particularly in, and are incorporated by reference to Note 12A to the consolidated financial statements set forth in Item 18 of this annual report. In 2015, 2016 and 2017 approximately 66%, 65% and 80% of our sales, respectively, were in North America, 20%, 24% and 16% of our sales, respectively, were in Europe, and 14%, 11% and 4% of our sales, respectively, were in Asia-Pacific. Our main business is not seasonal, and we believe that there are sufficient sources and raw materials available to sustain it.

### **Manufacturing and Suppliers**

Our manufacturing operations consist primarily of producing finished goods on our own from (i) components purchased from third parties, (ii) sub-assemblies manufactured by sub-contractors. In addition, we perform testing and quality assurance procedures with respect to the components and sub-assemblies which are incorporated into our final products and to the final products themselves. In addition, we use turnkey manufacturers to manufacture our products.

We seek to monitor quality with respect to each stage of the production process including, but not limited to, the selection of component suppliers, warehouse procedures and final testing, packaging and shipping. We have been certified as complying with "ISO-28001:2007", "ISO 9001:2015" and "ISO 14001:2015", which are the quality control standard used in our industry. We believe that our quality assurance procedures have been instrumental in achieving a high degree of reliability for our products. We intend to continue to maintain and improve the efficiency of such procedures.

Although we generally use standard parts and components for our products, certain key components used in our products are currently available from only one source, and others are available from a limited number of sources, on which we are dependent. For example, a key component in many of our products is manufactured by Intel®. We believe that we maintain a sufficient inventory of these components to protect against delays in deliveries. For additional information see the risk factor entitled "Loss of our sources for certain key components could harm our operations" under Item 3.D – "Risk Factors".

Firm purchase orders for our products generally include an agreed supply date for the supply of our products. In addition, we may agree to fill orders for our products within short periods of time after receipt of a firm purchase order based on the immediate availability of our products and/or components in our inventory. Consequently, we need to maintain inventory at levels that are in accordance with our forecasts and those of our customers. There can be no assurance that such forecasts will indeed materialize into firm purchase orders and consequently we cannot guarantee that the full volume of such inventory will be delivered against firm purchase orders and not remain unused.

The Dodd-Frank Wall Street Reform and Consumer Protection Act included disclosure requirements regarding the use of "conflict" minerals mined from the DRC and procedures regarding a manufacturer's efforts to prevent the sourcing of such "conflict" minerals. These requirements will require companies to undertake due diligence, disclose and report whether or not such "conflict" minerals originate from the DRC. This implementation of these requirements could adversely affect the sourcing, availability and pricing of minerals such as cassiterite, wolframite, columbite-tantalite (coltan), gold and/or their derivatives (tantalum, tin, and tungsten) which are used in the manufacture of certain components used in our products, as well as affect the companies we use to manufacture components of our products. As a result, this could limit the pool of suppliers who can provide us DRC "conflict free" components and parts, and we may not be able to obtain DRC "conflict free" products or supplies in sufficient quantities for our operations. In circumstances where conflict minerals in our products are found to be sourced from the DRC, we may take actions to change materials or designs to reduce the possibility that our purchase of conflict minerals may fund armed groups in the region. These actions could add engineering and other costs to the manufacture of our products, and we may not be able to obtain "conflict free" products or supplies in sufficient quantities for our operations. In addition, we incur additional costs to comply with the disclosure requirements, including costs related to determining the source of any of the relevant minerals and metals used in our products, as further elaborated below. Also, because our supply chain is complex, we may face reputational challenges with our customers, shareholders and other stakeholders if we are unable to sufficiently verify the origins for the minerals used in our products. In such event, we may also face difficulties in satisfying customers who require that all of the components of our products are certified as conflict mineral free. There can be no assurance that we will not experience delays in the supply of critical components in the future or that we will have a sufficient inventory of critical components at such time to produce products at full capacity. If we do experience such delays and there is an insufficient inventory of critical components at that time, our operations and financial results would be adversely affected.

In June 2014, May 2015, May 2016 and May 2017, we issued our Specialized Disclosure Report for the years ended December 31, 2013, December 31, 2014, December 31, 2015 and December 31, 2016, respectively, in compliance with Rule 13p-1 under the Exchange Act, according to which, some conflict minerals (gold, tantalum, tin, and tungsten) are necessary to the functionality or production of certain of our products. Conflict minerals are obtained, via our direct suppliers, from sources worldwide, and our desire is not to eliminate those originating in the DRC and adjoining countries but rather to obtain conflict minerals from sources that do not directly or indirectly finance or benefit armed groups in the DRC and adjoining countries.

We have also adopted a policy with respect to the sourcing of conflict minerals, according to which as part of our commitment to corporate responsibility and respecting human rights in our own operations and in our global supply chain, it is our goal to seek to use tantalum, tin, tungsten and gold in our products that are "DRC conflict free", while continuing to support responsible in-region mineral sourcing from the DRC and adjoining countries.

Furthermore, since the origin of conflict minerals cannot be determined with any certainty once the ores are smelted, refined and converted to ingots, bullion or other conflict minerals containing derivatives, we rely on our direct suppliers to assist with our reasonable country of origin inquiry and due diligence efforts, including the identification of smelters and refiners, for the conflict minerals contained in the materials which they supply to us.

Based on our reasonable country of origin inquiry and due diligence process, we concluded that during 2013, 2014 and 2015 (i) we manufactured, and contracted to manufacture, products as to which conflict minerals are necessary to the functionality or production of our products and (ii) as a result of the reasonable country of origin inquiry and due diligence measures, we determined that our products to which conflict minerals are necessary to the functionality or production of our products, in 2013, 2014, 2015 and 2016 were "DRC Conflict Undeterminable" (as defined in Rule 13p-1 under the Exchange Act). We made this determination due to insufficient information provided by some of our active suppliers and manufacturers who supplied some of the necessary conflict minerals, which originated in the DRC and adjoining countries, but who were unable to indicate whether such necessary conflict minerals were from recycle or scrap sources, were DRC conflict free or were not found to be DRC conflict free. In 2015 and 2016, however, we identified Suppliers of Conflict Materials of such products. In 2015, 183 suppliers out of a total of 209 suppliers delivered satisfactory responses via the Conflict Free Sourcing Initiative Reporting Template (the "CMRT"). In 2016, 234 suppliers out of a total of 256 suppliers delivered satisfactory responses via the CMRT. During the reporting period for the calendar year ending December 31, 2017, we have continued to improve our efforts to mitigate risks, engaging in the required diligence process, following-up on high risk responsive or non-compliant suppliers, working with suppliers to educate them on conflict minerals sourcing, contacting selected smelters and refiners that have not received a "conflict free" designation etc. We intend to request that all of our direct suppliers become conflict free as related to goods supplied to us.

## Marketing Channels

The principal market sectors for our products are:

- (i) Network appliances, including WAN Optimization and SD-WAN, Internet Security, Cyber Security, Application Delivery, Traffic Management, Network Monitoring and Analytics, High Frequency Trading (HFT) for the financial service market and other mission-critical sectors;
- (ii) The "Cloud";
- (iii) SD-WAN and NFV deployments requiring CPEs and vCPEs;
- (iv) Servers;
- (v) Data Storage including Big Data; and
- (vi) IoT.

Our main business model for our line of products is called the Design Win Model. The following are the main aspects of this model:

- We approach a potential customer or are approached by such customer;
- If the potential customer shows interest in the products and we believe that achievement of a business relationship with the potential customer is possible, we ship products for such potential customer's evaluation;
- During the evaluation process the potential customer receives a few units of the relevant product for initial basic testing. If the evaluation process is successful, we ship products for qualification;
- During the qualification process the potential customer usually purchases a larger amount of our products for more specific testing, which may include certain adaptations of our products to its needs;
- If the qualification process is successful, we enter into negotiations regarding the terms of a business relationship; and
- In some cases, typically with the larger customers, the evaluation and qualification process may take 12 months or more.

Once all phases mentioned above are concluded, the customer will purchase products from us in order to incorporate such products within its server based systems, and then sell or deploy such systems with our cards embedded in them. The sale or deployment of our products within such systems is the objective of our Design Win Model. In most cases once we secure a Design Win our customer will continue to buy our cards for as long as it continues to sell or deploy its server based system.

Over the last few years, our sales and marketing has been mostly carried out through a network of strategic relationships with leading OEMs which sell our products, generally as a part of their systems and sometimes under their own private labels. Our current original equipment manufacturer customers are mostly active in the Cyber Security market, Application Delivery market, Traffic management market, Network Monitoring market, data storage market, general servers market, WAN optimization market, SD-WAN market and other server based applications markets. Our OEM customers sell their products to Governments, Enterprises (headquarter and branch) and to Data Centers (regular and virtualized, including to the Cloud). Our strategy of carrying out strategic relationships with OEM customers continues to be the major strategy under which we operate. We believe that these relationships enable us to take advantage of the superior financial resources and market presence of these companies to increase our sales and establish, maintain and strengthen our position and reputation in the market. In addition, we believe that relationships with OEMs improve access to new technologies developed by such OEMs, thereby ensuring smooth integration of our products and technology with those of the OEMs. In furtherance of this strategy, during the last few years we entered into strategic arrangements with OEMs and continued securing successful Design Wins with OEMs who purchase our products. The majority of our revenues in 2017 were attributed to the sale of our products to OEM customers. In 2017 we have increased the proportion of our sales to Cloud/Virtualized data Center/SDN customers within our group of OEM customers, and we believe that we will continue to gradually increase the proportion of our sales to such customers. This is due to the fact that: (a) the market is moving towards running applications in the Cloud; and (b) Cloud and web 2.0 companies are typically either using standard servers or design their own "white boxes" into both of which we offer our solutions. While there are no assurances that such solutions will be accepted by such Cloud and Web 2.0 players, we believe that this trend has significant potential for us.

On top of OEM customers and due to the market shift into the Cloud, we are now implementing an additional marketing strategy which involves our direct sales to major Cloud players and Telcos which are operating Cloud based solutions and services. We sell to these players both server adapters (smart and regular) and stand-alone CPEs. During 2017 we announced several Design Wins with such Cloud players, including the largest Design Win we have ever announced, which was later cancelled by the Cloud player, as we announced in March, 2018. The main aspects of the OEM business model, by which in most cases our customer will continue to buy our cards for as long as it continues to sell or deploy its system, are maintained in our business model when we sell directly to Cloud players.

The loss of some of our OEM and/or Cloud customers, or any single key OEM or Cloud customer, may have a material adverse effect on our operations and financial results and we cannot assure you that we will be able to enter into strategic relationships with OEMs or Cloud players in the future. Payment terms of our OEM and Cloud customers are primarily up to 90 days net. Approximately 95% of our international sales are denominated in U.S. Dollars and may be subject to government controls and other risks, including, in some cases, export licenses, federal restrictions on export, currency fluctuations, political instability, trade restrictions and changes in tariffs and freight rates. We have experienced no material difficulties to date as a result of these factors.

Our arrangements with our OEM and Cloud customers (and distributors and resellers when applicable) are generally non-exclusive. We have generally experienced good relations with our customers and are not aware of any pending terminations other than with respect to products that newer technologies have eliminated the need for.

Our customers, including our OEM customers, Cloud customers, distributors and resellers are not within our control. They are not obligated to purchase products from us and may use or represent other lines of products. A reduction in sales effort or discontinuance of sales of our products by our OEM customers, or reduction in sales to our Cloud customers, could lead to reduced sales and could materially adversely affect our operating results. In addition, our business model also entails the risk that our customers, will build up inventories in anticipation of a growth in deployments or sales. If such growth does not occur as anticipated, these customers may substantially decrease the amount of products ordered from us in subsequent quarters, discontinue product orders or even attempt to return unused or unsold products. The loss of a major customer or group of customers or a loss or ineffectiveness of several of our OEM and/or Cloud relationships at approximately the same time, or the loss of any key Cloud or OEM customer, might have a material adverse effect on us.

### **Patents and Licenses**

Our success and ability to compete are dependent to a significant degree on our technology. In order to establish and protect the technology we develop and/or acquire to use in our products, we primarily rely on a combination of non-disclosure agreements and technical measures, and to a lesser degree on patent. These measures afford only limited protection, and accordingly, there can be no assurance that the steps we take will be adequate to prevent misappropriation of our technology or the independent development of similar technologies by others. Despite our efforts to protect our technology, unauthorized parties may attempt to copy aspects of our products and develop similar hardware or software or to obtain and use information that we regard as proprietary. In addition, there can be no assurance that one or more parties will not assert infringement claims against us. The cost of responding to claims could be significant, regardless of whether the claims are valid. We cannot assure that the scope of any issued patent will adequately protect our intellectual property rights, or that patents will not be challenged, invalidated or circumvented or that the rights granted under the patents will provide us with meaningful protection or any commercial advantage.

On April 8, 2010, we filed a patent application in the United States in the United States Patents and Trademarks Office, or the USPTO, for the 'Server-Based Network Appliance'. On June 12, 2012 we were issued patent No. 8,199,523 entitled 'Server-Based Network Appliance' from the United States Patent and Trademark Office, which relates to a server-based network appliance in which a computer motherboard is mounted in a case with the bus slots of the motherboard adjacent to the rear side of the case.

On September 16, 2013, we acquired all of the intellectual property related to the unique Virtualization Off-Load Engine developed during the last two years by Net Perform Technology, Ltd., a privately held company registered in Hong Kong, China. Despite perceived exclusive access to this product, and our best efforts during the acquisition process to secure same, internal or external parties may assert a claim of infringement regarding such intellectual property. We do not consider this intellectual property to be material for our operations.

On February 8, 2015 we filed a patent application (14/616,718) in the USPTO with respect to Hybrid Networking Application Switch. On January 2, 2018 we were issued patent No. 9,858,227 entitled 'Hybrid Networking Application Switch' from the United States Patent and Trademark Office. The patent relates to a unique solution for combining functionalities of a rack mounted networking switch and a rack mounted server into a single rack mounted enclosure comprising a hybrid networking application switch or an accelerated hybrid networking application switch.

For additional information regarding the risks to the Company with respect to patents and other intellectual property rights see the risk factor entitled "We may not be able to protect our intellectual proprietary rights" under Item 3.D – "Risk Factors".

## **Competition**

The networking and data infrastructure solutions industry is highly competitive. We face competition from numerous companies, some of which are more established, benefit from greater market recognition and have greater financial, production and marketing resources than we do. We cannot guarantee that our present or any contemplated products will continue to be distinguishable from those of our competitors or that the marketplace will find our products preferable to those of our competitors. Furthermore, there can be no assurance that competitive pressures will not result in price reductions that could materially adversely affect our business and financial condition and the results of our operations.

We believe that our expanded feature set coupled with the general wide spectrum of solutions we offer gives us a competitive edge.

With respect to Server Adapters, until recently our main competitor in the non-bypass server adapters was Intel®. However, we believe that Intel seems to be targeting mostly major Cloud accounts and we target smaller accounts in this market and pursue major Cloud accounts only with solutions which are not competing with Intel's standard cards, our main competitors in the Non Bypass Server Adapters space are Mellanox and Broadcom. In the Bypass Server Adapter product line, our competition is not as significant. To the best of our knowledge, our only significant competitors in this industry are Interface Masters, Portwell, Caswell, Lanner and Adlink. In addition, there may be other local solutions which might also compete with our products. Although the situation may change in the future, we believe that our competition in the bypass card market is less significant than our competition in the non-bypass card market.



In the Smart Cards products sector, our competition is fragmented, and differs with respect to the specific solution being offered by us. In this sector, Cavium, Tlera (now a part of Mellanox), Netronome, Napatech, Solarflare Myricom (a subsidiary of CSP), Lanner and Caswell compete with certain of our Smart Cards. With respect to the encryption products of our Smart Cards sector, our main competitor is Cavium. With respect to the compression products of our Smart Cards sector, our main competitors are Cavium and Exar. In addition, Lanner, Portwell and Nexcom compete with our compute blades and network processor based cards.

In the Stand-alone Products sector, our competition is fragmented, and differs with respect to the specific solution offered by us. With respect to the Bypass Switches and Intelligent Bypass Switches solutions (in which solutions are offered in the form of an external box instead of an embedded card), to the best of our knowledge our main competitors are Net Optics (subsidiary of IXIA), Gigamon, and Interface Masters. With respect to our CPE/Edge/Low End Appliance products, to the best of our knowledge our main competitors are Portwell, Caswell, Lanner and Nexcom.

#### **Governmental Regulation Affecting the Company**

We are affected by the terms of research and development grants we have received from the IIA. Under the terms of Israeli Government participation, a royalty of 3% or up to 5% of the net sales of products developed from a project funded by the OCS must be paid under the terms of the pre-R&D Amendment regime, beginning with the commencement of sales of products developed with grant funds and ending when a dollar-linked amount equal to 100% of such grants plus interest at LIBOR is repaid. The terms of Israeli Government participation also impose significant restrictions on manufacturing outside Israel of products developed with government grants, in accordance with the terms and conditions of the pre-R&D Amendment regime. In addition, according to the pre-R&D Amendment regime the transfer to third parties of technologies developed through such projects is subject to approval of the OCS. Following the R&D Amendment there is currently much ambiguity regarding its implementation and its effect on research and development grants received prior thereto.

On July 29, 2015, the Israeli Parliament, the Knesset, enacted the R&D Amendment, designated to provide the ability to respond quickly to the challenges of a changing world, after reaching the conclusion that the pre-R&D Amendment regime was found to not have the required flexibility in today's rapidly changing world. Pursuant to the R&D Amendment, the OCS was replaced with the newly established IIA, which will be comprised of a Council body, the Chief Scientist, the Director General and a member of the Research Committee. According to the R&D Amendment, the Council has broad discretion regarding material matters, including with respect to the new funding programs ("**Tracks**"), is required to determine certain characteristics (which are mainly technical but also include the type of Benefit ("**Benefit**", as defined under the R&D Amendment, includes grants, loans, exemptions, discounts, guarantees and additional means of assistance, but with the exclusion of purchase of shares), to be granted as well as its scope, conditions for receipt of approval for the Benefit and the identity of the party which is permitted to perform the approved activities, and may determine additional matters, including delay in payment of the Benefit and requests for provision of guarantees for its receipt, payment of an advance by the IIA, what know-how will be developed and requirements regarding its full or partial ownership, provisions regarding transfer, disclosure or exposure of know-how to third parties in Israel and abroad (including payment or non-payment for the same, as well as ceilings for such payments), requirements with respect to manufacture in Israel and transfer of manufacture abroad (including payment for such transfer), performance of innovative activities for the benefit of third parties, etc. In addition, while the pre-R&D Amendment regime provided base-line default terms and conditions with respect to the core issues relevant for OCS grant recipients, as provided above, these default provisions were largely rescinded by the R&D Amendment. Many of these matters are now decided separately for each Track by the Council, based on certain guidelines stipulated in the R&D Amendment. Such guidelines provide, for example, that considerable preference should be given to having ownership of IIA-funded know-how and rights vest with the Benefit recipient and/or with an Israeli company, with transfer of know-how and related rights abroad to be permitted only in exceptional circumstances. In addition, the R&D Amendment determines that the transfer of manufacturing rights abroad, whether under a license or otherwise, shall only be allowed in special circumstances.

On May 7, 2017, the IIA published the Rules for Granting Authorization for Use of Know-How Outside of Israel (the "**Licensing Rules**"). The Licensing Rules enable the approval of out-licensing arrangements and other arrangements for granting of an authorization to an entity outside of Israel to use know-how developed under research and development programs funded by the IIA. Subject to payment of a "License Fee" to the IIA, at a rate that will be determined by the IIA in accordance with the Licensing Rules, the IIA may now approve arrangements for the license of know-how outside of Israel. This allows companies that have received IIA support to commercialize know-how in a manner which was not previously available. In addition, the IIA has recently published a directive incorporating most of the former provisions, including those with respect to transfer of manufacturing rights, transfer of know-how and others.

In addition, we receive certain tax benefits and reduced tax rates from the Israeli government due to our status as a "Preferred Enterprise" under the Law for the Encouragement of Capital Investments-1959, as amended. See "Item 10 – Additional Information – Taxation". The entitlement to these benefits is conditional upon our fulfillment of the conditions stipulated by the law and the regulations promulgated thereunder. In the event of failure to comply with these conditions, the benefits could be canceled and we would be required to refund the amount of the benefits, in whole or in part, with the addition of linkage differences and interest.

### C. **Organizational Structure**

We have the following two wholly owned subsidiaries:

- Silicom Connectivity Solutions, Inc. – a private company incorporated in the United States; and
- Silicom Denmark (Fiberblaze A/S) – a private company incorporated in Denmark. On December 10, 2014, we entered into the Fiberblaze SPA for the purchase of the entire holdings in Fiberblaze, pursuant to which we became its sole shareholder. As part of the Fiberblaze SPA, we have also purchased Fiberblaze US LLC, a private company incorporated in the United States, being a 100% owned subsidiary of Fiberblaze. In October 2016 we commenced a voluntary liquidation process for the liquidation of Fiberblaze US LLC, which was completed in August 2017. In 2017 we changed the name of the company from Fiberblaze A/S to the company's current name – Silicom Denmark (Fiberblaze A/S) and all the rights related to the company's previous name remained ours. See "Item 10 – Additional Information – C. "Material Contracts" for additional information on the Fiberblaze SPA.

In addition, two of our founders, Messrs. Yehuda and Zohar Zisapel, are also founders of, and in certain instances still directors and/or material shareholders of some of the corporations within the "Rad Group". See "Item 7 – Major Shareholders and Related Party Transactions" for additional information on our relationships with members of this group of companies.

**D. Property, Plant and Equipment**

We do not own any real property, but we lease property at six locations. Our manufacturing plant and additional storage space are located in Yokne'am, Israel, our executive offices are located in Kfar Sava, Israel, our marketing and sales offices are located in our Kfar Sava, Israel offices and in Paramus, New Jersey, the United States, and our research and development facilities are located in Kfar Sava, Israel, in Søborg, Denmark, and in Charlottesville, Virginia, the United States.

Until April, 2015 we leased office space in Kfar Sava of approximately 1,050 square meters in size, for which we paid a monthly rent of approximately \$16,000. Following the termination of such lease agreement in accordance with its terms, we decided to move to our new offices in Kfar Sava, which we are leasing for a period of five years, ending February 28, 2020, with an option to renew the term for an additional five-year period. This facility is approximately 1,500 square meters in size and the monthly payments (which include various management services) are approximately \$35,000.

We have conducted our manufacturing in Yokne'am, Israel since 2000. In January 2014, following the termination our lease (in effect since January 2009) due to our decision not to exercise our option to renew it, we moved to a new facility in Yokne'am, which we are leasing pursuant to a sub-lease for a period of three years, ending December 31, 2016, with an option to renew the term for an additional period of three years under the same terms, which we exercised on October 11, 2016 for a period of 36 additional months commencing January 1, 2017 under the same terms of the lease previously in effect. This facility is approximately 2,400 square meters in size plus additional warehouse areas of approximately 250 meters in size and the monthly payments (which include rental payments, as well as fees for various management and upkeep services) are approximately \$45,000.

In August 2016 we entered into a Lease Agreement with Naji Ezekiel & Sons - Management and Maintenance Ltd., for the lease of 450 square meters of storage space in Yokne'am Illit and the monthly payments are approximately \$6,000. This agreement is in effect for a period of 24 months, with an option put in place to extend the term by 12 months, twice at an increase of 5% in rental fees per renewal period.

We also lease office space in Charlottesville, Virginia, in the United States. The lease is for a period of 26 months ending December 31, 2017. On June 7, 2017 we extended the lease for an additional one-year period starting January 1, 2018 under the same terms. This facility is approximately 929 square meters in size and the monthly payments are approximately \$11,000.

Between February 2004 and December 2016, we sub-leased office space in Paramus, New Jersey, from our affiliate, Radcom Equipment, Inc. This sub-lease was extended for a short period until April 2017 for a total of \$11,000. As of April 2017, we lease office space of approximately 2,500 square feet in the same building in which we previously sub-leased our office space, for the same purpose, from our affiliates, Zohar Zisapel Properties, Inc. and Yehuda Zisapel Properties, Inc. Our current lease is until March 2022, and we have an option to renew it for an additional five-year term. Currently, the monthly rent payments for this space are approximately \$3,800. See "Item 7 – Major Shareholders and Related Party Transactions."

In addition, we lease office space, which we increased in 2017 from approximately 388 square meters to approximately 1,000 square meters, in Søborg, Denmark. The term of the lease agreement expires on September 30, 2020. The lease can be terminated by a six-month advanced notice to the landlord. The monthly rent payment for this space increased in 2017 as a result of our bigger leased space from approximately \$9,000 to approximately \$13,000.

We believe that our facilities in Israel, the United States and Denmark are suitable and adequate for our operations as currently conducted. In the event that additional facilities are required or we need to seek alternative rental properties, we believe that we could obtain such additional or alternative facilities at commercially reasonable prices.

#### **Item 4A. UNRESOLVED STAFF COMMENTS**

There are no unresolved staff comments.

#### **Item 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

##### **General**

Silicom was incorporated in Israel and commenced operations in 1987. We have traditionally been engaged in the design, manufacture, marketing and support of connectivity solutions for computers. We are currently engaged in the design, manufacture, marketing and support of high-performance networking and data infrastructure solutions. Designed primarily to improve performance and efficiency in Cloud and Data Center environments, our solutions increase throughput, decrease latency and boost the performance of servers and networking appliances, the infrastructure backbone that enables advanced Cloud architectures and leading technologies like NFV, SD-WAN and Cyber Security. Our products are used by major Cloud players, service providers, telcos and OEMs as components of their infrastructure offerings, including both add-on adapters in the Data Center and stand-alone virtualized/universal CPE devices at the edge. In 2015, 2016 and 2017 we recorded sales from all of our networking and data infrastructure solutions of approximately \$82.7 million, \$100.3 million, and \$125.7 million respectively. We primarily sell our products to major Cloud players, service providers, telcos and OEMs and, to a lesser extent, through independent distributors (on a non-exclusive basis).

##### **Critical Accounting Policies**

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of the financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies are limited to those described below.

- Goodwill and other intangible assets - Goodwill reflects the excess of the purchase price of business acquired over the fair value of net assets acquired. Goodwill is not amortized but instead is tested for impairment at least annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

The Company operates in one operating segment and this segment comprises one reporting unit.

Goodwill is reviewed for impairment at least annually in accordance with ASU 2011-08, Testing Goodwill for Impairment. ASU 2011-08 provides an entity the option to perform a qualitative assessment to determine whether it is more likely than-not that the fair value of a reporting unit is less than its carrying amount prior to performing the two-step goodwill impairment test. If this is the case, the two-step goodwill impairment test is required. If it is more likely than-not that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required.

If the two-step goodwill impairment test is required, first, the fair value of the reporting unit is compared with its carrying amount (including goodwill). If the fair value of the reporting unit is less than its carrying amount, an indication of goodwill impairment exists for the reporting unit and the entity must perform step two of the impairment test (measurement). Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation and the residual fair value after this allocation is the implied fair value of the reporting unit goodwill. If the fair value of the reporting unit exceeds its carrying amount, step two does not need to be performed. During the year ended December 31, 2017, no impairments were found and therefore no impairment losses were recorded.

Intangible assets that are not considered to have an indefinite useful life are amortized over their estimated useful lives of 3 years. The acquired customer relationships and current technology are amortized over their estimated useful lives in proportion to the economic benefits realized. This accounting policy results in amortization of such intangible assets in the straight-line method.

- Inventories – Inventories are stated at the lower of cost and net realizable value. Cost is determined using the "weighted average-cost" method.
- Marketable securities – We account for investments which we intend and are able to hold to maturity, that are classified as held-to-maturity investments as defined in ASC 320-10, "Accounting for Certain Investments in Debt and Equity Securities".

When other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether we intend to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If we intend to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the amortized cost basis of the investment and its fair value at the balance sheet date. If we do not intend to sell the security and it is not more likely than not that we will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings.

- **Income Taxes** – We account for income taxes under ASC 740-10, "Accounting for Income taxes". Under ASC 740-10, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets and liabilities are classified as non-current. Income tax expenses represent the tax payable for the period and the changes during the period in deferred tax assets and liabilities. As of December 31, 2017, the deferred tax assets were \$899 thousand and the deferred tax liabilities were \$0 thousand, whereas in 2016, the deferred tax assets were \$1,537 thousand and the deferred tax liabilities were \$0 thousand.

We recognize the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

ASC 740, "Accounting for Uncertainty in Income Taxes" clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. This interpretation prescribes a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. ASC 740 also provides guidance on de-recognition of tax positions, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition. ASC 740 requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position.

As of January 1, 2017 and for the twelve months ended December 31, 2017, we did not have any significant unrecognized tax benefits. In addition, we do not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months.

- Accounting for Stock-Based Compensation – The Company recognizes compensation expense in accordance with ASC topic 718, "Compensation – stock compensation" based on estimated grant date fair value using an option-pricing model. For our option grants granted after January 1, 2008 which include features that are not supported by the Black and Scholes valuation model, such as expiration of said awards if the closing price of our shares falls below 50% of the respective awards' exercise price, we recognize compensation expense based on estimated grant date fair value using the Monte Carlo option-pricing model or the Binomial option-pricing model. Where our option awards granted after January 1, 2008 do not include features that are not supported by the Black and Scholes valuation model, we recognize compensation expense based on estimated grant date fair value using the Black and Scholes model. For our RSU grants, we recognize compensation expenses based on the market value of our shares on the date of grant, less an estimate of dividends that will not accrue to RSU holders prior to vesting.

#### **Recent Accounting Pronouncements.**

- In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. ASU 2014-09 outlines a new, single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The new model will require revenue recognition to depict the transfer of promised goods or services to customers in an amount that reflects the consideration a company expects to receive in exchange for those goods or services. The amendments in ASU 2014-09 are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The standard can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. The Company has adopted this ASU on January 1, 2018 with no cumulative effect. In 2017 we examined the new standard's impact on our financial statements. Based on our examination as of the date of this annual report, the standard will not have a material effect.
- In February 2016, the FASB issued ASU 2016-02, which requires lessees to recognize most of their leases on balance sheet as a right-of-use asset and a lease liability. This ASU is effective for interim and annual periods in fiscal years beginning after December 15, 2018. Early adoption is permitted.

Based on our current assessment, we do not expect this ASU to have a material impact on the results of our operations.

- In June 2016, the FASB issued ASU 2016-13, Measurement of Credit Losses on Financial Instruments, which significantly changes the way entities recognize impairment of many financial assets by requiring immediate recognition of estimated credit losses expected to occur over their remaining life. This ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted for annual and interim periods in fiscal years beginning after December 15, 2018.

The impact of adopting the new standard on the net income is not expected to be material.

- In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment," which eliminates the requirement to calculate the implied fair value of goodwill in Step 2 of the goodwill impairment test. Under ASU 2017-04, goodwill impairment charges will be based on the excess of a reporting unit's carrying amount over its fair value as determined in Step 1 of the testing. ASU 2017-04 is effective for interim and annual testing dates after December 15, 2019, with early adoption permitted for interim and annual goodwill impairment testing dates after January 1, 2017.

We do not expect the adoption of ASU 2017-04 to have material impact on our financial position, results of operations, cash flows or presentation thereof.

**A. Operating Results**

You should read the following management's discussion and analysis of our financial condition and operating results in conjunction with the consolidated financial statements and the related notes thereto included in this annual report. The following table sets forth, for the periods indicated, the relationship (in percentages) of items from our Consolidated Statement of Operations Data to our total sales:

**Year Ended December 31,**

	<u>2015</u>	<u>2016</u>	<u>2017</u>
<b>Sales</b>	100%	100%	100%
<b>Cost of sales</b>	58.8	61.6	63.5
<b>Gross profit</b>	41.2	38.4	36.5
<b>Research and development expenses</b>	11.7	12.6	11.1
<b>Sales and marketing expenses</b>	6.8	6.4	5.3
<b>General and administrative expenses</b>	4.4	3.9	3.6
<b>Contingent consideration expense (benefit)</b>	(3.7)	(0.3)	(3.7)
<b>Operating Income</b>	22.0	15.8	20.2
<b>Financial income, net</b>	0.3	-	0.2
<b>Income before income taxes</b>	22.3	15.8	20.4
<b>Income tax expenses</b>	2.3	2.7	3.1
<b>Net Income</b>	20.0	13.1	17.3

Sales in 2017 increased by 25.3% to \$125,690 thousand compared to \$100,347 thousand in 2016. The increase in sales was mainly attributed to our success in our target markets, especially those driven by Cloud Computing. This achievement was part of our continued success in expanding our customer base and product offering supporting important market trends like Cloud Computing, Cyber security, SDN, NFV, Virtualization and SD-WAN.



Sales in 2016 increased by 21.3% to 100,347 thousand compared to \$82,738 thousand in 2015. The increase in sales was mainly attributed to our continued success in our target markets including those driven by trends like Cyber security, Cloud Computing, SDN, NFV, Virtualization and other trends, and to our continued success in expanding our product offering and customer base.

Gross profit in 2017 was \$45,928 thousand compared to \$38,551 thousand in 2016. Gross profit as a percentage of sales in 2017 was 36.5%, compared to 38.4% in 2016. Our gross profit is largely dependent on the mix of products we sell during a specific year. The lower gross profit percentage in 2017 compared to 2016 was primarily a result of changes to the mix of products we sold in 2017, which was influenced by our strategic decision to take advantage of increased revenue potential and opportunities, especially in the Cloud related business. Gross profit was also affected by, among other factors, write-downs of inventory made with respect to any slow moving or obsolete inventory we can no longer use. The inventory write-downs as a percentage of sales in 2017 decreased to 2.3%, compared to 3.2% in 2016.

Gross profit in 2016 was \$38,551 thousand compared to \$34,079 thousand in 2015. Gross profit as a percentage of sales in 2016 was 38.4%, compared to 41.2% in 2015. Our gross profit is largely dependent on the mix of products we sell during a specific year. The lower gross profit percentage in 2016 compared to 2015 was primarily a result of changes to the mix of products we sold in 2016. Gross profit was also affected by, among other factors, write-downs of inventory made with respect to any slow moving or obsolete inventory we can no longer use. The inventory write-downs as a percentage of sales in 2016 increased to 3.2%, compared to 0.3% in 2015.

Research and development expenses in 2017 increased by 9.9% to \$13,915 thousand compared to \$12,663 thousand in 2016. This increase was mainly attributed to the increase in the number of our research and development employees required for our continued investment in new product development, enhancements to existing products and the development of new networking and connectivity technologies expanding our product offering to our target markets, which contributed approximately \$827 thousand to such increase, combined with a weakening of the US Dollar against the New Israeli Shekel and the Danish Krone (since a significant portion of our research and development expenses are incurred in New Israeli Shekels and Danish Krone) which contributed approximately \$498 thousand to the increase, offset by a slight decrease in amortization of acquired intangible assets which amounted to approximately \$1,251 thousand in 2017, compared to \$1,324 thousand in 2016.

Research and development expenses in 2016 increased by 30.5% to \$12,663 thousand compared to \$9,702 thousand in 2015. This increase was mainly attributed to the increase in the number of our research and development employees required for our continued investment in new product development, enhancements to existing products and the development of new networking and connectivity technologies expanding our product offering to our target markets, which contributed approximately \$2,248 thousand to such increase and to an increase in amortization of acquired intangible assets which amounted to approximately \$1,324 thousand in 2016, compared to \$693 thousand in 2015, combined with a slight weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our research and development expenses are incurred in New Israeli Shekels) which contributed approximately \$82 thousand to the increase.

Sales and marketing expenses in 2017 increased by 4.7% to \$6,722 thousand compared to \$6,423 thousand in 2016. This increase was mainly attributed to our continued investment in the promotion of our networking and data infrastructure solutions to our target markets including those driven by trends like Cloud Computing, Cyber security, SDN, NFV, Virtualization, SD-WAN and other trends, by, among others, our continued effort to expand exposure of our product offering and expanding our customer base, which contributed approximately \$164 thousand to such increase, combined with a weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our sales and marketing expenses are incurred in New Israeli Shekels) which contributed approximately \$144 thousand to the increase, offset by a slight decrease in amortization of acquired intangible assets which amounted to approximately \$637 thousand in 2017, compared to \$646 thousand in 2016.

Sales and marketing expenses in 2016 increased by 13.7% to \$6,423 thousand compared to \$5,651 thousand in 2015. This increase was mainly attributed to our continued investment in the promotion of our server networking products to our target markets including those driven by trends like Cyber security, Cloud Computing, SDN, NFV, Virtualization, SD-WAN and other trends, by, among others, our continued effort to expand exposure of our product offering and expanding our customer base, which contributed approximately \$364 thousand to such increase and to an increase in amortization of acquired intangible assets which amounted to approximately \$646 thousand in 2016, compared to \$262 thousand in 2015, combined with a slight weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our sales and marketing expenses are incurred in New Israeli Shekels) of approximately \$24 thousand.

General and administrative expenses in 2017 increased by 13.6% to \$4,507 thousand compared to \$3,969 thousand in 2016. This increase was mainly attributed to the growth in our activity, which contributed approximately \$340 thousand to such increase, combined with a weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our general and administrative expenses are incurred in New Israeli Shekels) which contributed approximately \$198 thousand to the increase.

In 2017 we had a contingent consideration benefit in the amount of \$4,642 thousand compared to a contingent consideration benefit in the amount of \$334 thousand in 2016. For additional information see Note 3 to our financial statements included elsewhere in this annual report.

General and administrative expenses in 2016 increased by 9.9% to \$3,969 thousand compared to \$3,611 thousand in 2015. This increase was mainly attributed to the growth in our activity, which contributed approximately \$327 thousand to such increase, combined with a slight weakening of the US Dollar against the New Israeli Shekel (since a significant portion of our general and administrative expenses are incurred in New Israeli Shekels) of approximately \$31 thousand.

In 2016 we had a contingent consideration benefit in the amount of \$334 thousand compared to a contingent consideration benefit in the amount of \$3,090 thousand in 2015. For additional information see Note 3 to our financial statements included elsewhere in this annual report.

Financial income, net in 2017 increased by 345.7% to \$156 thousand compared to \$35 thousand in 2016. The increase resulted from the net effect of the following factors: (i) a decrease in income from investment in marketable securities, attributed to lower funds available for investment, which amounted to \$310 thousand in 2017 compared to \$393 thousand in 2016, (ii) a decrease in bank fees, which contributed approximately \$13 thousand to the increase, and (iii) to a lower offsetting effect of the weakening of the US Dollar against the New Israeli Shekel and the Danish Krone, which created a net financial expense in US Dollars from exchange rate differences (a portion of our balance sheet assets and obligations are denominated in New Israeli Shekels as well as Danish Krone) of \$45 thousand in 2017 compared to \$236 thousand in 2016.

Financial income, net in 2016 decreased by 84.1% to \$35 thousand compared to \$220 thousand in 2015. The decrease was attributed to a decrease in income from investments in marketable securities due to less funds being available for investment, and to an increase in expenses attributed to a slight weakening of the US Dollar against the New Israeli Shekel which created a net financial expense in US Dollars from exchange rate differences (a portion of our balance sheet assets and obligations are denominated in New Israeli Shekels).

In 2017 we recorded current income tax expenses of \$3,474 thousand and deferred income tax expense of \$453 thousand compared to current income tax expenses of \$2,962 thousand and deferred income tax benefit of \$260 thousand in 2016. The increase in our current income tax expenses was mainly attributed to the increase in our activity and the resulting taxable income. The increase in the deferred income tax expenses was mainly attributed to an increase in deferred income tax expenses in relation to acquired goodwill, which amounted to \$465 thousand in 2017 compared to \$154 thousand in 2016, as well as to an increase in deferred income tax expenses in relation to R&D expenses, which amounted to \$103 thousand in 2017 compared to deferred income tax benefit of \$209 thousand in 2016. In addition, in 2017 we recorded an income tax benefit relating to prior years in the amount of \$59 thousand, compared to an income tax expense relating to prior years in the amount of \$26 thousand in 2016.

In 2016 we recorded current income tax expenses of \$2,962 thousand and deferred income tax benefit of \$260 thousand compared to similar current income tax expenses of \$2,848 thousand and deferred income tax benefit of \$907 thousand in 2015. The decrease in the deferred income tax benefit was mainly attributed to a decrease in tax benefits relating to share based compensation provided by us to our employees and directors, which amounted to \$1 thousand in 2016 compared to \$242 thousand in 2015, as well as to tax loss carryforwards, which amounted to \$161 thousand in 2016 compared to \$179 thousand in 2015, and to an increase in deferred income tax expenses in relation to amortization of acquired goodwill, which amounted to \$154 thousand in 2016 compared to \$61 thousand in 2015. In addition, in 2016 we recorded an income tax expense relating to prior years of \$26 thousand, while in 2015 we recorded income tax benefits relating to prior years of \$36 thousand.

In 2017 we recorded net income of \$21,714 thousand compared to net income of \$13,137 thousand in 2016, an increase of 65.3%. The increase was mainly attributed to the following factors: (i) an increase in our activity, and (ii) the increase in contingent consideration benefit we recorded in 2017, which amounted to \$4,642 thousand, compared to a contingent consideration benefit of \$334 thousand in 2016.

In 2016 we recorded net income of \$13,137 thousand compared to net income of \$16,520 thousand in 2015, a 20.5% decrease. This decrease was mainly attributed to higher operating expenses we incurred in 2016 relative to operating expenses we incurred in 2015. In addition, in 2016 we recorded a contingent consideration benefit of \$334 thousand compared to a contingent consideration benefit of \$3,090 thousand in 2015.

## **Impact of Inflation and Currency Fluctuations on Results of Operations, Liabilities and Assets**

Since the majority of our revenues are denominated and paid in U.S. Dollars, we believe that inflation in Israel and in Denmark and fluctuations in the U.S. dollar exchange rates do not have any material effect on our revenue. Inflation in Israel or Denmark and the Israeli and Danish currency as well as U.S. dollar exchange rate fluctuations, may however, have an effect on our expenses and, as a result, on our net income/loss. The cost of our Israeli and Danish operations, as expressed in U.S. Dollars, is influenced by the extent to which any change in the rates of inflation in Israel or Denmark are not offset (or are offset on a lagging basis) by a change in valuation of the NIS or DKK in relation to the U.S. dollar.

We do not presently engage in any hedging or other transactions intended to manage the risks relating to foreign currency exchange rate or interest rate fluctuations. However, we may in the future undertake such transactions, if management determines that it is necessary to offset such risks.

### **B. Liquidity and Capital Resources**

As of December 31, 2017, we had working capital of \$104,401 thousand and our current ratio (current assets to current liabilities) was 6.48.

Cash and cash equivalents as of December 31, 2017 increased by \$5,104 thousand to \$17,021 thousand, compared to \$11,917 thousand as of December 31, 2016. Short-term marketable securities decreased by \$8,511 thousand to \$7,752 thousand, compared to \$16,263 thousand as of December 31, 2016, and long-term marketable securities decreased by \$1,824 thousand to \$5,945 thousand, compared to \$7,769 thousand as of December 31, 2016. The net decrease of \$5,231 thousand in these three balance sheet items in 2017 was mainly due to payment of dividend which contributed approximately \$7,382 thousand to such changes, to property, plant and equipment expenditures which contributed approximately \$1,690 thousand to such changes, offset by positive cash provided by operating activities in the amount of \$1,408 thousand, and to consideration received in connection with exercise of options to purchase our ordinary shares in the amount of approximately \$2,651 thousand.

Trade receivables (including trade receivable from related parties) increased to \$41,367 thousand as of December 31, 2017, compared to \$27,722 thousand as of December 31, 2016. This increase was mainly attributed to the increase in our revenue. Other receivables increased to \$5,823 thousand as of December 31, 2017, compared to \$3,113 thousand as of December 31, 2016. This increase was mainly attributed to the increase of our activity.

Trade payables (including trade payables to related parties) increased to \$12,629 thousand as of December 31, 2017, compared to \$10,480 thousand as of December 31, 2016. This increase was mainly attributed to the increase in our activity. Other payables and accrued liabilities decreased to \$6,420 thousand as of December 31, 2017, compared to \$7,484 thousand as of December 31, 2016.

Cash provided by operating activities in 2017 amounted to \$1,408 thousand compared to cash used by operating activities in the amount of \$2,707 thousand in 2016. The cash provided by operating activities in 2017 was primarily the result of the increase in our net income in 2017.

Inventories increased to \$51,487 thousand as of December 31, 2017, compared to \$44,280 thousand as of December 31, 2016. The increase was attributed, mainly, to our growing sales accompanied by our customers' expectations of a swift delivery, making the readily available inventory pivotal to our business goals.

Capital expenditures on property and equipment for the year ended December 31, 2017 were \$2,118 thousand, compared to \$1,705 thousand as of December 31, 2016. This increase was mainly attributed to an increase in the investment in the equipment used for our production and research and development efforts.

We have cash and cash equivalents that we believe are sufficient for our present requirements. Furthermore, our cash resources are sufficient to fund our operating needs for at least the next twelve months.

**C. Research and development, patents and licenses, etc.**

Since we commenced operations, we have conducted extensive research, development and engineering activities. Our efforts emphasize the development of new products, cost reduction of current products, and the enhancement of existing products, generally in response to rapidly changing customer preferences, technologies and industry standards.

Because the market for our products is characterized by rapidly changing technology and evolving industry standards, our success depends upon our ability to select, develop, manufacture and market new and enhanced products in a timely manner to meet changing market needs. As such, we invest significant resources in research and new product development, enhancements to existing products, and the development of new networking and connectivity technologies, and we expect to continue to do so.

As of June 2012 we have a patent No. 8,199,523 entitled 'Server-Based Network Appliance' from the United States Patent and Trademark Office, which relates to a server-based network appliance in which a computer motherboard is mounted in a case with the bus slots of the motherboard adjacent to the rear side of the case.

On September 16, 2013, we acquired all of the intellectual property related to the unique Virtualization Off-Load Engine developed during the last two years by Net Perform Technology, Ltd., a privately held company registered in Hong Kong, China.

As of December 2014, we own or have licenses or similar rights with respect to Silicom Denmark (Fiberblaze A/S), including Silicom Denmark (Fiberblaze A/S)'s high performance OEM hardware platform for Ethernet and network interface product family, registered names and domain name.

As of September 2015, we own all intellectual property and intellectual property rights in which ADI has an ownership interest or have licenses or similar right where ADI has such licenses or rights, including with respect to custom embedded, communications and networking products based on the latest Intel® silicon, registered names and domain name.

As of January, 2018 we have a patent No. 9,858,227 entitled 'Hybrid Networking Application Switch' from the United States Patent and Trademark Office, which relates to a unique solution for combining functionalities of a rack mounted networking switch and a rack mounted server into a single rack mounted enclosure comprising a hybrid networking application switch or an accelerated hybrid networking application switch.

We cannot assure you that the scope of any issued patent will adequately protect our intellectual property rights, or that patents will not be challenged, invalidated or circumvented or that the rights granted under the patents will provide us with meaningful protection or any commercial advantage.

For additional information regarding the risks to the Company with respect to patents and other intellectual property rights see the risk factor entitled "We may not be able to protect our intellectual proprietary rights" under Item 3.D – "Risk Factors".

The Government of Israel encourages research and development projects oriented towards products for export or projects which will otherwise benefit the Israeli economy. In each of the three fiscal years from 1999 to 2001, we received grants from the OCS, recently replaced by the IIA, for the development of systems and products. We have received from the OCS up to 30% of certain research and development expenditures for particular projects. Under the terms of Israeli Government participation, as in effect prior to the R&D Amendment, a royalty of 2% or up to 5% of the net sales of products developed from a project funded by the OCS must be paid, beginning with the commencement of sales of products developed with grant funds and ending when a dollar-linked amount equal to 100% of such grants without interest, for projects approved prior to December 2000, and plus interest at LIBOR, for amounts received after that date, is repaid. The terms of Israeli Government participation, as in effect prior to the R&D Amendment, also place restrictions on the location of the manufacturing of products developed with government grants, which, in general, must be performed in Israel, and on the transfer to third parties of technologies developed through projects in which the government participates. The R&D Amendment amended the core terms of the Israeli Government participation and placed substantial discretion in a new authority established to replace the OCS and provided only guidelines regarding material terms such as royalty rates and transfer of know-how developed with government grants. The OCS has previously provided funding in relation to our research and development efforts. As of the date hereof, we have received funding from the OCS in the aggregate amount of approximately \$4,388,000 (which together with accrued interest is approximately \$6,788,000), and have paid the OCS an aggregate amount of approximately \$1,428,000 in royalties in relation thereto. See "Item 4.B. – Information on the Company – Business Overview – Governmental Regulation Affecting the Company."

In August 2005, we received approval for a \$54 thousand dollar grant from the Korea-Israel Industrial Research and Development Foundation, or Koril-RDF, in connection with the joint development of a certain product with a Korean company. Under the terms of this grant we are required to repay the amounts received at a rate of 2.5% per year of our gross sales of the product developed with the grant in each such year, until 100% of the grant (and any other sums received from Koril-RDF) are repaid. The annual payment for every year following the first sale of the product will not exceed certain percentages of the amounts received from Koril-RDF. We received approximately 20% of certain research and development expenditures for a particular project in 2003 and approximately 30% of such expenditures for a particular project in 2004. As of January 2006 and to date, our research and development activities have been sponsored and funded by us, and we did not participate in any new encouragement programs or received any additional grants from the OCS, IIA or Koril-RDF. As of December 31, 2017, we have closed all of our OCS funded programs, and do not anticipate having any sales of products funded by OCS grants or be required to pay any royalties to the OCS with respect thereto.

We expect that we will continue to commit resources to research and development in the future. As of March 31, 2018, we had 101 employees engaged primarily in research and development and design activities of which 60 employees in Israel, 25 in Denmark and 16 in the U.S.A. In 2015, 2016 and 2017, our research and development expenses were \$9,702, \$12,663 and \$13,915 respectively, constituting approximately 11.7%, 12.7% and 11.07% respectively, of our sales. The increase in our research and development expenses in 2017 compared to 2016 was mainly attributed to the increase in the number of our research and development employees required for our continued investment in new product development, enhancements to existing products and the development of new networking and connectivity technologies expanding our product offering to our target markets combined with a weakening of the US Dollar against the New Israeli Shekel and the Danish Krone (since a significant portion of our research and development expenses are incurred in New Israeli Shekels and Danish Krone), offset by a slight decrease in amortization of acquired intangible assets.

#### **D. Trend Information**

In today's network-based environment, there is a growing demand for server-based systems. We believe that the markets for such systems are continuously growing. Exploding data and internet traffic increase the need for connectivity and bandwidth, which results in the increased need of networking throughput, connectivity, compute power and storage. Such growing demand was the basis for the emerging technologies of virtualization, Cloud, SDN, NFV and SD-WAN, all of which are targeting the implementation of a more effective model for all the above mentioned tasks.

In view of such an anticipated increase in Cloud-based data centers and edge devices utilizing virtualization, SDN and NFV, the systems are increasingly based on generic server platforms. These platforms all need enhanced connectivity as well as offload capabilities in order to address the performance challenges realized due to the huge amount of traffic, the high volume of data, the need to encrypt such data, the need to run in virtualized environment, which by itself is a challenge for the server CPU, and the need to include switching within the server for high efficiency SDN. We anticipate that consequently the demand for add-on adapters and vCPEs which address these challenges will grow. Power, heat and space limitations in such environments increase the need for hardware accelerators and other innovative solutions. Such systems require essential building blocks in their own generic servers, which can be served by our products.

We address the above needs with a comprehensive suite of cards and vCPEs which are able to either off-load CPU tasks onto a separate intelligent add-on card thereby freeing up server cycles and improving the server's Networking and Storage I/O or by providing modular vCPEs which allow various levels of performance and the integration of additional off-loading and non-offloading functionalities. Our solutions are based on either Intel® silicon which includes such functionality for encryption/decryption and compression or with cards which include intelligent engines, such as FPGAs, Network Processors and with our switch fabric redirector cards which deal with load balancing between servers/CPUs/CPU cores and perform traffic filtering to increase the efficiency of the server. We believe that our Server network interface cards (with and without bypass), Intelligent and programmable cards, and Stand-alone products such as vCPEs will all continue to be key driver of our growth in the coming years. A distinct advantage of these products is that the demand in the server based industry has been continuously growing, especially as our products are suited to the growth in the Cloud related technologies.

The sales cycles in the markets for our products are long. Continuing to achieve Design Wins according to the process described above and obtaining new customers is time consuming. However, each Design Win we have achieved and continue to achieve may represent an opportunity for sustained, long-term revenues once we establish a relationship with a customer.

Although we expect our business and products to further develop in the coming years, there is no assurance that we will continue to generate significant sales in the areas in which we operate.

#### **E. Off-Balance Sheet Arrangements**

On July 22, 2002, our Audit Committee and the Board of Directors approved an Indemnification Agreement with our directors and officers. Our shareholders approved the terms of this agreement in a General and Extraordinary Meeting held on January 7, 2004. In Amendment 3 to the Companies Law, the instances in which a company may indemnify its officers and directors were broadened. In December 2007 each of our Audit Committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers so as to reflect this amendment. Our shareholders approved the terms of this new Indemnification Agreement in January 2008. The Indemnification Agreement provides that the directors and officers will be exempt from liability in certain circumstances. The Indemnification Agreement also provides for the indemnification by us for certain obligations and expenses imposed on the officer in connection with an act performed in his or her capacity as an officer of the Company. This right to indemnification is limited, and does not cover, among other things, a breach of an officer's duty of loyalty, a willful breach of an officer's duty of care, or a reckless disregard for the circumstances or consequences of a breach of duty of care. The right to indemnification also does not cover acts that are taken intentionally to unlawfully realize personal gain. The maximum amount of our liability under these Indemnification Agreements for any monetary obligation imposed on an officer or a director in favor of another person by a judgment is currently \$3,000,000 for each instance of a covered scenario. In addition, we would be liable to indemnify the officer or director for all reasonable litigation expenses with respect to certain proceedings. We are not aware of any material pending action that may result in anyone claiming such indemnification.

An amendment in 2011 to the Israeli Securities Law, 5728-1968 (the "**Israeli Securities Law**"), and a corresponding amendment to the Companies Law, authorized the Israel Securities Authority (the "**ISA**") to impose administrative sanctions against Israeli public companies and their office holders for certain violations of the Israeli Securities Law or the Companies Law. These sanctions include monetary sanctions and certain restrictions on serving as a director or senior officer of a public company for certain periods of time. The Israeli Securities Law and the Companies Law provide that only certain types of such liabilities may be reimbursed by indemnification and insurance. Specifically, legal expenses (including attorneys' fees) incurred by an individual in the applicable administrative enforcement proceeding and certain compensation payable to injured parties for damages suffered by them are permitted to be reimbursed via indemnification or insurance, provided that such indemnification and insurance are authorized by the company's articles of association, and receive the requisite corporate approvals. In January 2012 each of our Audit Committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers serving in such capacities from time to time so as to reflect this amendment, and at the Annual General Meeting of the Shareholders held on April 11, 2012 our shareholders approved these amendments to the Company's Articles of Association (the "**Articles**") and a revised form of Indemnification Agreement for directors serving in such capacity from time to time.



As per Amendment 20 to the Companies Law ("Amendment 20"), it was decided on July 31, 2013, at the Extraordinary General Meeting of the Shareholders to adopt the Executive Compensation Policy of the Company, which was recommended by our Compensation Committee and approved by our Board of Directors. The Executive Compensation Policy included the above referenced form of Indemnification Agreement to be entered into by the Company with our directors and officers serving in such capacities from time to time. The Executive Compensation Policy also noted that going forward, any change to the Indemnification Agreement, including any changes which materially depart from the key terms of the current agreement (provided that such changes apply equally to all executives of the Company, including directors) will be submitted to the Company's Compensation Committee and the Board of Directors for their approval but shall not, unless required by law or the Company's Articles, be presented at a General Meeting of the shareholders. As set forth in the Companies Law, an Executive Compensation Policy for a period exceeding three years has to be re-approved once every three years. Accordingly, our amended Executive Compensation Policy was brought for shareholders' re-approval at the annual general meeting of our shareholders in 2016.

We are not a party to any other material off-balance sheet arrangements or contingent obligations.

**F. Tabular disclosure of contractual obligations**

The following table shows our outstanding contractual obligations by category and by payments due as of December 31, 2017:

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating Leases	\$3,102	\$1,665	\$1,387	\$50	
Purchase Obligations	\$23,055	\$23,055			
Total	\$26,157	\$24,720	\$1,387	\$50	

Our total outstanding contingencies in respect of OCS or IIA royalty-bearing participations received or accrued, net of royalties paid or accrued before interest, amounted to approximately \$2,960 thousand as of December 31, 2017 which are attributable to sales of certain discontinued products. As of the date of this annual report, all of our OCS programs have been closed per our request. We are not anticipating any sales of our products developed with OCS funding and accordingly don't expect to be required to pay any royalties to the OCS. In the unlikely event we do sell products developed using OCS funding, we will be required to pay royalties to the IIA as set forth in the R&D Law.

**Other Long-Term Liabilities Reflected on the Company's Balance Sheet:**

The liability for employees' severance benefits amounted to approximately \$2,765 thousand as of December 31, 2017.

The liability for employees' severance benefits is calculated on the basis of the latest monthly salary paid to each employee multiplied by the number of years of employment. The liability is covered by the amounts deposited by us into employees' managers' insurance and/or pension fund accounts in respect of severance obligations to such employees, including accumulated income thereon as well as by the unfunded provision reflected on the balance sheet. Such liability will be removed, either by termination of employment or retirement.

While the timing of such obligations cannot be pre-determined (and as such were not included in the above table), such liability will be removed, either by termination of employment or retirement.

**Item 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

**A. Directors and Senior Management**

The following table and notes thereto set forth information regarding our directors and senior management as of March 31, 2018:

<b>Name</b>	<b>Age</b>	<b>Position with Company</b>
Avi Eizenman <sup>(1)</sup>	60	Active Chairman of the Board
Shaike Orbach <sup>(2)</sup>	66	President, Chief Executive Officer, Director
Ayelet Aya Hayak <sup>(3)</sup>	48	External Director
Ilan Erez <sup>(3)</sup>	50	External Director
Eli Doron <sup>(4)</sup>	65	Director
Eran Gilad	50	Chief Financial Officer and Company Secretary

(1) Was re-elected for an additional three-year term, commencing as of June 8, 2016.

(2) Was re-elected for an additional three-year term, commencing as of June 5, 2017.

(3) Was re-elected for an additional three-year term, commencing as of June 5, 2017.

(4) Was re-elected for an additional two-year term, commencing as of June 8, 2016.

*Avi Eizenman* co-founded the Company in 1987 and has served as a Director since its inception. Mr. Eizenman also served as our President and Chief Executive Officer from the Company's inception until April 1, 2001, and on such date, he resigned from his positions as President and Chief Executive Officer and was appointed Active Chairman of the Board of Directors. Mr. Eizenman served as head of the ASIC department at Scitex Ltd. in 1986. From 1979 until 1985, Mr. Eizenman held various positions, including project manager, ASIC specialist and engineer, with the Electronic Research & Development Department of the Israeli Ministry of Defense. Mr. Eizenman holds a B.Sc. degree, with honors, in Electrical Engineering from the Technion, and an M.B.A. from Tel Aviv University.

**Shaike Orbach** has been our President and Chief Executive Officer since April 2001. In December 2001, Mr. Orbach was named a Director, replacing Zohar Zisapel, who resigned from the Board of Directors. Prior to that, for a period of four and a half years, Mr. Orbach was President and CEO of Opgal Ltd., a high-tech subsidiary of Israel's Rafael and El-Op corporations. Previously, he was General Manager of Edusoft, an Israeli company the shares of which were traded on the NASDAQ National Market (now, the NASDAQ Global Market), and Managing Director of Tecsys Ltd. He holds a B.Sc degree in Mechanical Engineering from the Technion.

**Ayelet Aya Hayak** was elected by the shareholders as an external director for an initial three-year term commencing July 1, 2013 and re-elected for a second three-year term at the 2016 annual general meeting of our shareholders. Ms. Hayak is the CEO of Imdecol Ltd. and also serves as a director in several companies, among which are Ashra the Israel Foreign Trade Risks Insurance Corporation Ltd. and M.I. Holdings Ltd. Between 2009 and 2011 Ms. Hayak served as the CEO of Paula Ltd. Ms. Hayek holds a BA degree in accounting and business administration from the Tel Aviv College of Management and is also a Certified Public Accountant.

**Ilan Erez** serves as an external director since July 2010, when he was elected by our shareholders for an initial three-year term commencing July 2010 and was elected by the shareholders for a third three-year term commencing June 2016. Mr. Erez has been General Manager of 3D Systems Corporation's (NYSE: DDD) Software Business Unit since September 2016 and co-managed that business unit from May 2015 to September 2016. 3D Systems provides comprehensive 3D products and services, including 3D printers, print materials, on-demand manufacturing services and digital design and manufacturing tools. From 2005 to 2015, Mr. Erez served as Chief Financial Officer of Cimatron Ltd. (NASDAQ: CIMT) engaged in the design and sale of CAD/CAM software for the tool-making and discrete manufacturing industries. From 1998 to 2005 Mr. Erez served as the Chief Financial Officer of the Company. He also served as VP Operations of the Company from May 2001 to 2005. From 1996 to 1998 Mr. Erez served as Controller and Assistant to the Chief Executive Officer of Bio-Dar Ltd. From 1994 to 1996 Mr. Erez served as an auditor at Kesselman & Kesselman, a PWC member firm. Mr. Erez is a Certified Public Accountant in Israel and holds a B.A in Accounting and Economics from the Hebrew University and an LL.M. in Business Law from Bar-Ilan University.

**Eran Gilad** is our Chief Financial Officer from May 2005 and the Secretary of the Company from 2012. From 1995 to 2005 Mr. Gilad held senior financial and operational positions in various public and private companies operating in the high-tech field. He is a Certified Public Accountant in Israel and holds an M.A in Economics from Tel-Aviv University and a B.A in Accounting and Economics from Tel-Aviv University.

**Eli Doron** is the founder of Connesta Ltd. ("**Connesta**"), an Israeli high-tech company engaged in developing and providing SaaS virtual control room solutions, founded in 2011. From inception, Mr. Doron serves as the Chief Executive Officer of Connesta. Prior thereto and during 2010, Mr. Doron was the Chief Executive Officer of Computerized Electricity Systems ("**CES**"). Prior to joining CES, Mr. Doron was the co-founder of Radvision Ltd. (formerly NASDAQ: RVSN. Acquired by Avaya Ltd. in 2011; "**Radvision**"). From 1992 and until 2009 Mr. Doron served as the Chief Technology Officer of Radvision, and from 2006 and until 2009 he served as President of Radvision. Prior to founding Radvision and from 1983, Mr. Doron served at SIMTECH Advanced Training and Simulation Systems Ltd., initially as hardware manager and from 1988 as Chief Technology Officer. Prior thereto and from 1977, Mr. Doron served as an electronic engineer at MBT Israel Aircraft Industries Ltd. Mr. Doron holds a B.Sc degree in electronics and computer science from Ben-Gurion University and an M.B.A. degree from the University of Bradford in the United Kingdom.

## B. Compensation

In accordance with the Companies Law, the following table presents information regarding compensation actually received by our five most highly paid executive officers during the year ended December 31, 2017. All amounts are in USD.

Name and Position	Salary and Benefits(1)	Cash Bonus(2)	Equity-based Compensation(3)	Total
Avi Eizenman – Active Chairman	499,447	350,000	573,910	1,423,357
Yeshayahu ('Shaik') Orbach – CEO and President	365,459	350,000	573,910	1,289,369
Elad Blatt – Chief Strategy and Business Development Officer	231,895	77,608	107,800	417,303
David Castiel – VP Engineering	218,386	55,536	107,800	381,722
David Hendel – VP Research and Development	215,969	40,109	107,800	363,878

- (1) **"Salary and Benefits"** include annual salary or service fees paid, payments to the National Insurance Institute, manager's insurance and pension funds, severance, advanced education funds, basic health insurance, vacation pay, recuperation pay, tax gross-up payments, automobile-related expenses, telephone expenses and benefits and perquisites as mandated by Israeli or applicable law.
- (2) **"Cash Bonus"** includes bonus payments as recorded in our financial statements for the year ended December 31, 2017.
- (3) **"Equity-based Compensation"** includes the expense recorded in our financial statements for the year ended December 31, 2017 with respect to equity-based compensation granted to the executive offices detailed above.

The aggregate direct remuneration paid to all persons as a group who served in the capacity of director or executive officer during the year ended December 31, 2017 was \$3,131 thousand. The aggregate amount accrued to provide for severance payments to all persons as a group who served in the capacity of director or executive officer as of the year ended December 31, 2017 was \$ 1,197 thousand. The severance terms of our Chief Executive Officer and Chairman of the Board, as previously approved by the audit committee, board of directors and shareholders of the Company, and in accordance with the Executive Compensation Policy of the Company which was approved and re-approved by the shareholders, may entitle them, in certain circumstances, to additional payments. We pay cash compensation to Avi Eizenman who is an active Chairman of the Board, and to Shaiké Orbach, who is the President and Chief Executive Officer.

Avi Eizenman and Shaiké Orbach may also be entitled to cash bonuses by meeting some pre-determined thresholds, and as calculated based on a pre-determined formulas set by our board of directors, as approved by the annual general meeting of our shareholders for the years commencing 2017 on June 8, 2016. Mr. Eizenman and Mr. Orbach's annual cash bonuses may not exceed the value of 18 of their monthly salaries, respectively. Mr. Eizenman and Mr. Orbach's annual cash bonus formulas were based on achieving one or more of the following thresholds: (i) the Company's actual annual revenue for each applicable year is 80% or more of the pre-determined budget target for the relevant year; and (ii) the Company's actual annual operating profit for each applicable year is 65% or more of the pre-determined budget target for the relevant year. The Compensation Committee may, in its sole discretion, raise or lower such annual cash bonuses by up to 30%. Furthermore, in accordance with the Company's recoupment policy, Mr. Eizenman and Mr. Orbach may be required to reimburse the Company for the cash bonuses (or any part thereof) paid in the previous 3 years, in the event such cash bonuses were based on financial data included in the Company's financial statements that were found to be inaccurate and were subsequently restated.

Non-employee directors, including External Directors within the meaning of the Companies Law, are entitled to be paid cash compensation for board and any committee member services, as applicable, in accordance with the amounts which are permitted under the Companies Regulations (Rules Regarding Compensation and Expenses of External Directors) - 2000 enacted pursuant to the Companies Law. Office holders, including External Directors or Independent Directors, may waive their entitlement to their compensation, subject to applicable law.

All our officers other than Mr. Eli Doron and the external directors work full time for us. We do not currently grant any variable bonus or equity-based compensation, nor any separation payments to our non-employee directors. Certain of the compensation previously paid to our directors was paid in the form of options which were granted under share option plans which have expired, including under the Share Option Plan (2004), or options and RSU's which were and could be granted under the Silicom Ltd. - Global Share Incentive Plan (2013), as described below.

On December 30, 2004, our shareholders adopted our Share Option Plan (2004). Under the original terms of the Share Option Plan (2004) up to a maximum of 282,750 of our ordinary shares are reserved for issuance, subject to certain adjustments, upon the exercise of options granted to employees, directors, officers, consultants and service providers. In December 2007, the Board of Directors increased the number of our ordinary shares available for issuance under the Share Option Plan (2004) by 300,000. In August 2012, the Board of Directors increased the number of our ordinary shares available for issuance under the Share Option Plan (2004) by an additional 500,000. The Share Option Plan (2004) was administered by the board of directors, which designated the optionees, dates of grant, vesting periods and the exercise price of options. The options issued under the Share Option Plan (2004) were non-assignable except by the laws of descent. Certain tax advantages applied to certain of our directors, officers and employees with respect to options granted to them under the Share Option Plan (2004). As of March 31, 2018, we have granted a total of 1,036,000 options under the Share Option Plan (2004), of which the following were granted to directors and officers: (a) in 2004 a total of 150,000 options were granted with an exercise price of \$2.53, and with an expiration date upon the tenth anniversary of the grant date, (b) in 2005 a total of 15,000 options were granted with an exercise price of \$3.19, and with an expiration date upon the tenth anniversary of the grant date, (c) in 2008 a total of 91,250 options were granted with an exercise price of \$3.82, and with an expiration date upon the earlier to occur of: (i) the eighth anniversary of the grant date; and (ii) the closing price of the shares falling below US\$ 1.91, (d) in 2010 a total of 110,000 options were granted with an exercise price of \$18.82 and with an expiration date upon the earlier to occur of: (i) the eighth anniversary of the grant date; and (ii) the closing price of the shares falling below US\$ 9.41, and (e) in 2012 a total of 90,000 options were granted with an exercise price of \$15.28 and with an expiration date upon the earlier to occur of: (i) the eighth anniversary of the grant date; and (ii) the closing price of the shares falling below US\$ 7.64. As of March 31, 2018, a total of 36,625 of the options granted under the Share Option Plan (2004) were returned to the company after not being exercised following the cessation of employment of certain employees, as set forth in the terms of grant of such options, and 200,000 of the options granted under the Share Option Plan (2004) expired without exercise due to the expiration of their term. The Share Option Plan (2004) expired at the end of 2014, upon which expiration any unallocated shares under this plan have been returned to the general pool of registered but unissued share capital of the Company. As of March 31, 2018, there were no outstanding options under the Share Option Plan (2004) which were granted to directors and officers.

On October 21, 2013, our board of directors adopted our Global Share Incentive Plan (2013). On April 30, 2014, the annual general meeting of our shareholders approved the Global Share Incentive Plan (2013) to qualify for incentive stock options for U.S. tax purposes. The Global Share Incentive Plan (2013) is administered by the board of directors, which determines the number of our ordinary shares available for issuance under the plan, designates the award recipients and types of awards, dates of grant, vesting periods and the exercise price of awards. Under the Global Share Incentive Plan (2013) the Company may grant awards of options, restricted shares, restricted share units ("RSUs") or other equity-based awards. The board of directors has determined that initially up to a maximum of 500,000 of our ordinary shares are reserved for issuance, subject to certain adjustments, upon the exercise of equity-based awards granted to employees, directors, officers, consultants and service providers. On January 29, 2018, our board of directors increased the number of our ordinary shares available for issuance under the Global Share Incentive Plan (2013) by 600,000 ordinary shares. The awards are non-assignable except by the laws of descent. Certain tax advantages apply to certain of our directors, officers and employees with respect to equity-based awards granted to them under Global Share Incentive Plan (2013).

As of December 31, 2016, our compensation committee and board of directors, respectively, have approved the grant of a total of 82,000 RSUs and 209,963 options under the Global Share Incentive Plan (2013), of which the following were granted to directors and officers: (a) in 2014 a total of 54,000 RSUs (all of which have been vested) were granted, (b) in 2015 a total of 29,999 options were granted with an exercise price of \$26.91, and with an expiration date upon the earlier to occur of: (i) July 28, 2023; and (ii) the closing price of the shares falling below US\$ 13.46 at any time after the date of grant, (c) in 2016 a total of 29,999 options were granted with an exercise price of \$ 28.38, and with an expiration date upon the earlier to occur of: (i) June 8, 2024; and (ii) the closing price of the shares falling below US\$ 14.19 at any time after the date of grant.

In January 2017, our compensation committee and board of directors, respectively, approved a grant under the Global Share Incentive Plan (2013) of a total of (a) 119,925 options of which a total of 29,999 options were granted to directors and officers with an exercise price of US\$ 39.62, and an expiration date upon the earlier to occur of: (i) January 30, 2025; and (ii) the closing price of the shares falling below US\$ 19.81 at any time after the date of grant, and (b) 78,000 RSUs were granted, of which 54,000 RSUs were granted to directors and officers. 50% of the RSUs will vest on the second anniversary of the date of the grant and the additional 50% of the RSUs will vest on the third anniversary of the date of the grant. The annual general meeting of our shareholders gave effect to such grants of options and of RSUs granted to directors in their meeting on June 5, 2017.

In addition, in April, 2018, our compensation committee and board of directors, respectively, approved the grant under the Global Share Incentive Plan (2013) of a total of 137,010 options under the Global Share Incentive Plan (2013), of which 29,999 options were granted to directors and officers, with an exercise price equal to the average closing price of the Company's ordinary shares on the thirty trading days preceding the date of the approval of such grant by the board of directors (which is also the grant date). Options granted to our directors under this grant are subject to the approval of our 2018 Annual General Meeting.

As of March 31, 2018, a total of 22,503 of the options granted under the Global Share Incentive Plan (2013) were returned to the company after not being exercised following the cessation of employment of certain employees, as set forth in the terms of grant of such options.

### **C. Board Practices**

Avi Eizenman was re-elected to the board of directors most recently on June 8, 2016 to serve until the Annual General Meeting to be held in the year 2019, and until his successor has been duly elected, subject to the Companies Law and our Articles. Avi Eizenman is a founder of the Company and has served as a Director since our inception in 1987. Shaiké Orbach was re-elected to hold office as a director most recently on June 5, 2017 to serve until the Annual General Meeting which will take place in 2020. Eli Doron was re-elected to the board of directors most recently on June 8, 2016, to serve until the Annual General Meeting to be held in 2018. On July 1, 2010 Mr. Ilan Erez was elected as an external director for an initial term of three years in accordance with Section 245(a) of the Israeli Companies Law, with such terms ending as of July 1, 2013. At the Annual General Meeting of our shareholders held on April 14, 2013, the shareholders re-elected Mr. Ilan Erez as an external director for an additional second three-year term, and elected Ms. Ayelet Aya Hayak as an external director for an initial three-year term, with such terms of office for the external directors commencing as of July 1, 2013. Mr. Ilan Erez and Ms. Ayelet Aya Hayak were re-elected as External Directors for a third three-year term and second three-year term, respectively, at the Annual General Meeting of our shareholders, which took place on June 8, 2016.

None of the members of the board of directors is entitled to receive any severance or similar benefits upon termination of his or her service with the board of directors, except for Avi Eizenman, who also functions as the active Chairman of the Board and Shaiké Orbach, who also functions as President and Chief Executive Officer (See "Item 6.B – Directors and Senior Management – Compensation" above).

In December 2007 our Audit Committee and Board of Directors approved severance arrangements for each of Mr. Avi Eizenman and Mr. Shaiké Orbach, which provide for extended notice provisions and severance payments in the event of termination. The arrangements were approved by our shareholders in January 2008, and include the following main terms and conditions (identical with respect to each of Mr. Avi Eizenman and Mr. Shaiké Orbach):

#### **Notice of Termination**

The termination of employment of Mr. Avi Eizenman or Mr. Shaiké Orbach, by him or by us, for any reason other than cause (which is generally defined as willful conduct or omission materially injurious to the company), death or disability, shall require 12 months advance written notice. If, however, following a change in control transaction, either: (i) he shall give notice of termination of his employment for good reason (which is generally defined as an adverse change to the status, responsibilities, salary or other material terms of his employment); or (ii) we shall give notice of termination of his employment for any reason other than cause or disability, 18 months advance written notice shall be required. A change in control transaction includes transactions such as sale of all or substantially all of the company's shares or assets, or a merger, acquisition, or other reorganization in which control of our company changes following such transaction.

#### **Severance Payments**

If the employment of Mr. Avi Eizenman or Mr. Shaiké Orbach shall be terminated for any reason other than cause, he shall be entitled to receive his last full monthly salary multiplied by the number of years (or portions thereof) that he was employed by us (i.e. the severance amount he would be entitled to receive under the Israeli law, had we terminated his employment for any reason other than cause) (the "**Severance Law Amount**"). If, however, his employment shall be terminated: (i) by the company for any reason other than cause or disability; or (ii) by him for a good reason following a change in control, he shall be entitled to receive one and half times the Severance Law Amount. If the executive's employment under the arrangement is terminated by reason of death or disability, then, in addition to the above, he shall be entitled to receive a lump sum severance payment equal to his last full monthly salary multiplied by twelve 12 months.

As per Amendment 20, it was decided at the Extraordinary General Meeting of the Shareholders on July 31, 2013, to adopt the Executive Compensation Policy of the Company, which included the above referenced extended notice provisions, and severance payments in the event of termination, with respect to each of Mr. Avi Eizenman and Mr. Shaiké Orbach. The Executive Compensation Policy was re-approved by our Annual General Meeting convened in June 2016.



## Board of Directors

Our Articles provide for a board of directors of not less than two and not more than eight members. At the Annual General Meeting of the Shareholders on June 8, 2016, it was decided to adopt a new Directors Voting Mechanism, and to amend the Articles accordingly. Under the new Directors Voting Mechanism, directors are divided into three groups, Group A, Group B and Group C. Each group is brought for re-election once every three years, on a rotating basis, such that at each annual general meeting of the shareholders a given group of directors is brought for election, to serve on a continuous basis for a three-year term, until the annual general meeting in three years' time and until their respective successors are duly elected, at which point their term in office shall expire. At each annual general meeting, the annual general meeting shall be entitled to elect directors to replace the directors whose three-year term in office has expired, and so on ad infinitum, so that each year, the term in office of one group of directors shall expire. Other officers serve at the discretion of the board of directors. The Amended and Restated Articles of the Company provide that any director may, subject to the provisions of the Companies Law and the approval by the Board of Directors, appoint another person to serve as a substitute director and may cancel such appointment. Under the Companies Law, a person who is already serving as a director will not be permitted to act as a substitute director. Additionally, the Companies Law prohibits a person from serving as a substitute director for more than one director. Appointment of a substitute director for a member of a board committee is only permitted if the substitute is a member of the board of directors and does not already serve as a member of such committee. If the committee member being substituted is an external director, the substitute may only be another external director who possesses the same expertise as the external director being substituted. The term of appointment of a substitute director may be for one meeting of the board of directors or for a specified period or until notice is given of the cancellation of the appointment. To our knowledge, no director currently intends to appoint any other person as a substitute director, except if the director is unable to attend a meeting of the board of directors.

## External Directors

Under the Companies Law, companies registered under the laws of Israel the shares of which have been offered to the public in or outside of Israel are required to appoint no less than two external directors. No person may be appointed as an external director if such person is a relative (as defined in the Companies Law) of a "controlling shareholder" or if such person, or the person's relative, partner, employer or any entity under the person's control, has or had, on or within the two years preceding the date of the person's appointment to serve as external director, any affiliation with any of either the company, any entity or person controlling, controlled by or under common control with the company, or relatives of such person. The term "**affiliation**" includes:

- An employment relationship;
- A business or professional relationship maintained on a regular basis;
- Control; and
- Service as an office holder.

The Israeli Minister of Justice, in consultation with the ISA, may determine that certain matters will not constitute an affiliation, and has issued certain regulations with respect thereof.

If the company does not have a "controlling shareholder" or a shareholder who holds company shares entitling him to vote at least 25% of the votes in a shareholders meeting, then the company may not appoint as an external director any person or such person's relative, partner, employer or any entity under the person's control, who has or had, on or within the two years preceding the date of the person's appointment to serve as external director, any affiliation with the Chairman of the Board, Chief Executive Officer, a substantial shareholder who holds at least 5% of the issued and outstanding shares of the company or voting rights which entitle him to vote at least 5% of the votes in a shareholders meeting, or the Chief Financial Officer.

A person shall be qualified to serve as an external director only if he or she possesses "expertise in finance and accounting" or "professional qualifications". At least one external director must possess "expertise in finance and accounting".

A director can satisfy the requirements of having "expertise in finance and accounting" if due to his or her education, experience and qualifications he or she has acquired expertise and understanding in business and accounting matters and financial statements, in a manner that allows him or her to understand, in depth, the company's financial statements and to spur a discussion regarding the manner in which the financial data is presented.

A public company's board of directors must evaluate the proposed external director's "expertise in finance and accounting", by considering, among other things, such candidate's education, experience and knowledge in the following: (i) accounting and auditing issues typical to the field in which the company operates and to companies of a size and complexity similar to such company; (ii) the company's independent public accountant's duties and obligations; (iii) preparation of the company's consolidated financial statements and their approval in accordance with the Companies Law and the Israeli Securities Law.

A director is deemed to be "professionally qualified" if he or she meets any of the following criteria: (i) has an academic degree in any of the following professions: economics, business administration, accounting, law or public administration; (ii) has a different academic degree or has completed higher education in a field that is the company's main field of operations, or a field relevant to his or her position; or (iii) has at least five years' experience in any of the following, or has at least a cumulative total of at least five years' experience in any two of the following: (A) a senior position in the business management of a corporation with a significant extent of business, (B) a senior public position or a senior position in public service, or (C) a senior position in the company's main field of operations. As with a candidate's "expertise in finance and accounting", the board of directors here too must evaluate the proposed external director's "professional qualification" in accordance with the criteria set forth above.

The declaration required by law to be signed by a candidate to serve as an external director must include a statement by such candidate concerning his or her education and experience, if relevant, in order that the board of directors may properly evaluate whether such candidate meets the requirements of having "expertise in finance and accounting" or being "professionally qualified" as set forth in the regulations. Additionally, the candidate should submit documents and certificates that support the statements set forth in the declaration.

No person may serve as an external director if the person's position or other business activities create, or may create, a conflict of interest with the person's responsibilities as an external director or may otherwise interfere with the person's ability to serve as an external director. Additionally, no person may serve as an external director if the person, the person's relative, spouse, employer or any entity controlling or controlled by the person, has a business or professional relationship with someone with whom affiliation is prohibited, even if such relationship is not maintained on a regular basis, excepting negligible relationships, or if such person received from the company any compensation as an external director in excess of what is permitted by the Companies Law. Pursuant to the recently enacted amendment to the Companies Regulations (Matters Which do not Constitute Affiliation), 2006, effective as of April 3, 2016 (the "**Amendment to the Affiliation Regulations**"), business or professional relationship maintained on a regular basis between the company and the external director will not constitute affiliation if the relationship commenced after the appointment of the external director for office, the company and the external director consider the relationship to be negligible and the audit committee approved, based on information presented to it, that the relationship is negligible, and the external director declared that he did not know and could not have reasonably know about the formation of the relationship and has no control over its existence or termination. If, at the time external directors are to be appointed, all current members of the board of directors who are not controlling shareholders or relatives of such shareholders are of the same gender, then at least one external director must be of the other gender.

External directors are to be elected for a term of three years by a majority vote at a shareholders' meeting, provided that either:

- the majority includes at least a majority of the shares held by non-controlling and disinterested shareholders who are present and voting at the meeting; or
- the total number of shares held by non-controlling and disinterested shareholders that voted against the election of the director does not exceed two percent of the aggregate voting rights in the company.

External directors may be re-elected for two additional terms of three years each, provided that with respect to the appointment for each such additional three-year term, one of the following has occurred: (i) the reappointment of the external director has been proposed by one or more shareholders holding together 1% or more of the aggregate voting rights in the company and the appointment was approved at the general meeting of the shareholders by a simple majority, provided that: (1)(a) in calculating the majority, votes of controlling shareholders or shareholders having a personal interest in the appointment as a result of an affiliation with a "controlling shareholder" and abstentions are disregarded and (b) the total number of shares of shareholders who do not have a personal interest in the appointment as a result of an affiliation with a "controlling shareholder" and/or who are not controlling shareholders, present and voting in favor of the appointment exceed 2% of the aggregate voting rights in the company, and (2) pursuant to a recently enacted amendment to the Companies Law ("**Amendment 22**"), effective as of January 10, 2014, the external director who has been nominated in such fashion is not a "linked or competing shareholder", and does not have or has not had, on or within the two years preceding the date of such person's appointment to serve as another term as external director, any affiliation with a linked or competing shareholder. The term "linked or competing shareholder" means the shareholder(s) who nominated the external director for reappointment or a material shareholder of the company holding more than 5% of the shares in the company, provided that at the time of the reappointment, such shareholder(s) of the company, the "controlling shareholder" of such shareholder(s) of the company, or a company under such shareholder(s) of the company's control, has a business relationship with the company or are competitors of the company; the Israeli Minister of Justice, in consultation with the ISA, may determine that certain matters will not constitute a business relationship or competition with the company; (ii) the reappointment of the external director has been proposed by the board of directors and the appointment was approved by the majority of shareholders required for the initial appointment of an external director; or (iii) pursuant to a recently enacted amendment to the Companies Law ("**Amendment 26**"), effective as of November 25, 2014, the external director has proposed himself for reappointment and the reappointment was approved in accordance with Sub-section (i) above.

However, under regulations promulgated pursuant to the Companies Law, companies whose shares are listed for trading on specified exchanges outside of Israel, including the NASDAQ Global Select, Global and Capital Markets, may elect external directors for additional terms that do not exceed three years each, beyond the three three-year terms generally applicable, provided that, if an external director is being re-elected for an additional term or terms beyond three three-year terms: (i) the audit committee and board of directors must determine that, in light of the external director's expertise and special contribution to the board of directors and its committees, the re-election for an additional term is to the company's benefit; (ii) the external director must be re-elected by the required majority of shareholders and subject to the terms specified in the Companies Law; and (iii) the term during which the nominee has served as an external director and the reasons given by the audit committee and board of directors for extending his or her term of office must be presented to the shareholders prior to their approval.

Further to these regulations, a recent amendment to the Companies Regulations (Relief for Companies Whose Shares are Registered for Trading Outside of Israel) – 2000, (the "**Amendment to the Relief Regulations**"), provides additional exemptions for such companies whose shares are listed for trading on specified exchanges outside of Israel, including the NASDAQ Global Select, Global and Capital Markets, provided that: (i) such company does not have a "controlling shareholder"; and (ii) the company complies with the requirements of the foreign securities laws and stock exchange regulations applicable to companies which are incorporated under the laws of such foreign countries with regard to appointing independent directors and composition of the compensation and audit committees. Any company that satisfies the above criteria and elects to comply with the applicable foreign securities laws and stock exchange regulations, shall be exempt from the following rules under the Companies Law: (i) to have at least 2 external directors appointed to serve in a public company; (ii) at least one of the external directors is required to have financial and accounting expertise and the rest are required to have professional expertise; (iii) the external directors shall be appointed by the general meeting and subject to certain voting thresholds; (iv) if all of the board members who are not controlling shareholders are of one sex, the appointed external director shall be of the other sex; (v) all of the board committees which are empowered and authorized to exercise any of the board's authorities must consist of at least one external director. The exemption from these rules under Amendment 1 requires that the board be composed of both male and female directors.

External directors may be removed only by the same percentage of shareholders as is required for their election, or by a court, and then only if the external directors cease to meet the statutory qualifications for their appointment, violate their duty of loyalty to the company or are found by a court to be unable to perform their duties on a full time basis. External directors may also be removed by an Israeli court if they are found guilty of bribery, fraud, administrative offenses in a company or use of inside information. Each committee of a company's board of directors which has been granted any authority normally reserved for the board of directors must include at least one external director; provided, however, that the audit committee and compensation committee must each include all external directors then serving on the board of directors.

Following termination of service as an external director, a public company, a "controlling shareholder" thereof and any entity controlled by a "controlling shareholder", may not grant any benefit, directly or indirectly, to any person who served as an external director of such public company, or to his or her spouse or child, including, not appointing such person, or his or her spouse or child, as an office holder of such public company or of any entity controlled by a "controlling shareholder" of such public company, not employing such person or his or her spouse or child and not receiving professional services for pay from such person, either directly or indirectly, including through a corporation controlled by such person, all until the lapse of two years from termination of office with respect to the external director, his or her spouse or child; and with respect to other relatives of the former external director - until the lapse of one year from termination of office.

An external director is entitled to compensation as provided in regulations adopted under the Companies Law and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an external director. At the Annual Shareholders Meeting of the Company held on June 8, 2016, the shareholders of the Company re-elected Mr. Ilan Erez as an external director for a third three-year term and re-elected Ms. Ayelet Aya Hayak as an external director for a second three-year term.

#### **Audit Committee**

The Companies Law requires public companies to appoint an audit committee. The responsibilities of the audit committee pursuant to the Companies Law include identifying irregularities in the management of our business and approving related party transactions as required by law, classifying company transactions as extraordinary transactions or non-extraordinary transactions and as material or non-material transactions in which an officer has an interest (which will have the effect of determining the kind of corporate approvals required for such transaction), assessing the proper function of the company's internal audit regime and determining whether its internal auditor has the requisite tools and resources required to perform his role and to regulate the company's rules on employee complaints, reviewing the scope of work of the company's independent accountants and their fees, and implementing a whistleblower protection plan with respect to employee complaints of business irregularities. Pursuant to Amendment 22, effective as of January 10, 2014, the responsibilities of the audit committee under the Companies Law also include the following matters: (i) to establish procedures to be followed in respect of related party transactions with a "controlling shareholder" (where such are not extraordinary transactions), which may include, where applicable, the establishment of a competitive process for such transaction, under the supervision of the audit committee, or individual, or other committee or body selected by the audit committee, in accordance with criteria determined by the audit committee; and (ii) to determine procedures for approving certain related party transactions with a "controlling shareholder", which were determined by the audit committee not to be extraordinary transactions, but which were also determined by the audit committee not to be negligible transactions.

Under the Companies Law, an audit committee must consist of at least three directors, including all the external directors of the company, and a majority of the members of the audit committee must be independent or external directors. The Companies Law defines independent directors as either external directors or directors who: (1) meet the requirements of an external director, other than the requirement to possess accounting and financial expertise or "professional qualifications", with Audit Committee confirmation of such; (2) have been directors in the company for an uninterrupted duration of less than 9 years (and any interim period during which such person was not a director which is less than 2 years shall not be deemed to interrupt the duration); and, (3) were classified as such by the company.

The following persons may not be a member of the audit committee:

- The chairman of the board of directors;
- Any director employed by or otherwise providing services to the company or to the "controlling shareholder" or entity under such controlling shareholder's control;
- Any director who derives his salary primarily from a controlling shareholder;
- A "controlling shareholder"; or
- Any relative of a "controlling shareholder".

According to the Companies Law, (1) the chairman of the audit committee must be an external director, (2) the required quorum for audit committee meetings and decisions is a majority of the committee members, of which the majority of members present must be independent and external directors, and (3) any person who is not eligible to serve on the audit committee is further restricted from participating in its meetings and votes, unless the chairman of the audit committee determines that such person's presence is necessary in order to present a certain matter, provided however, that company employees who are not controlling shareholders or relatives of such shareholders may be present in the meetings but not for the actual votes, and likewise, company counsel and company secretary who are not controlling shareholders or relatives of such shareholders may be present in the meetings and for the decisions if such presence is requested by the audit committee.

Pursuant to the Amendment to the Relief Regulations, companies whose shares are listed for trading on specified exchanges outside of Israel, including the NASDAQ Global Select, Global and Capital Markets, and which satisfy the criteria detailed above, are exempt from the following rules regarding the audit committee under the Companies Law: (i) the committee shall be comprised of at least 3 members, who shall include all of the external directors, and the majority of the members shall be independent; (ii) the audit committee may not include the chairman of the board, or any director employed by the Company, by a controlling shareholder or by any entity controlled by a controlling shareholder, or any director providing services to us, to a controlling shareholder or to any entity controlled by a controlling shareholder on a regular basis, or any director whose income is primarily dependent on a controlling shareholder, and may not include a controlling shareholder or any relatives of a controlling shareholder; (iii) the controlling shareholder or his relatives shall not be members of the audit committee; (iv) the chairman of the audit committee shall be an external director; (v) a person who is prohibited from being a member of the audit committee shall not be present at the committee's meetings; (vi) if the committee also serves as a financials committee, the rules applicable to the financials committee shall apply; (vii) the legal quorum shall be the majority of the committee members, provided that the majority of directors present are independent, at least one of whom is an external director.

Currently, Ms. Ayelet Aya Hayak, Mr. Ilan Erez and Mr. Eli Doron serve as members of our audit committee, and Mr. Ilan Erez serves as the chairperson.

## Compensation Committee

In December 2012, Amendment 20 went into effect, pursuant to which, the Board of Directors of Israeli publicly traded companies are required to appoint a compensation committee comprised of at least three members, including all external directors, who must also comprise a majority of the members of the compensation committee. In addition, the chairman of the compensation committee must be an external director. Following the compensation committee's recommendations, the Board of Directors is required to establish a compensation policy, which includes a framework for establishing the terms of office and employment of the office holders and guidelines with respect to the structure of the variable pay of office holders. Such guidelines are the basis for adequate balance between the components of compensation, which exists when a linkage is maintained between compensation and performance and the creation of value for shareholders in the Company, while maintaining the Company's ability to recruit and maintain talented officeholders and incentivizing them to pursue the Company's objectives. In particular, an appropriate balance between the fixed component (base salary and additional benefits) and the variable component and capital compensation avoids placing an exaggerated emphasis on one component.

The following persons may not be a member of the compensation committee:

- The chairman of the board of directors;
- Any director employed by or otherwise providing services to the company or to the controlling shareholder or entity under such controlling shareholder's control;
- Any director who derives his salary primarily from a "controlling shareholder";
- A "controlling shareholder"; or
- Any relative of a "controlling shareholder".

The responsibilities of the compensation committee include the following:

1. To recommend to the Board of Directors as to a compensation policy for officers of the company, as well as to recommend, once every three years to extend the compensation policy subject to receipt of the required corporate approvals;
2. To recommend to the Board of Directors as to any updates to the compensation policy which may be required;
3. To review the implementation of the compensation policy by the company;
4. To approve transactions relating to terms of office and employment of certain company office holders, which require the approval of the compensation committee pursuant to the Companies Law; and
5. To exempt, under certain circumstances, a transaction relating to terms of office and employment from the requirement of approval of the shareholders meeting.

In December 2012, our Board of Directors changed the composition of the members of our compensation committee by removing Mr. Avi Eizenman from the compensation committee, and appointing the Company's two external directors, Mr. Ilan Erez and Ms. Einat Domb-Har to our compensation committee, and appointing Mr. Ilan Erez as chairman of our compensation committee. On July 1, 2013, following the election of Ms. Ayelet Aya Hayak as an external director instead of Ms. Einat Domb-Har, Ms. Aya Hayak replaced Ms. Domb-Har on our compensation committee. Following the election of Mr. Eli Doron as a member of our board of directors, Mr. Eli Doron replaced Mr. Zohar Zisapel on our compensation committee. Our compensation committee has been charged by the Board of Directors to act in accordance with the powers and prerogatives delegated to it by the Companies Law and take any decisions and make any recommendations to the Board all as set forth in the Companies Law.

Pursuant to Amendment 27 to the Companies Law, effective as of April 3, 2016 ("**Amendment 27**"), the audit committee may serve as the company's compensation committee, provided that it meets the composition requirements of the compensation committee.

Pursuant to the Amendment to the Relief Regulations, companies whose shares are listed for trading on specified exchanges outside of Israel, including the NASDAQ Global Select, Global and Capital Markets, and satisfying the criteria detailed above, are exempt from the following rules regarding the Compensation Committee under the Companies Law: (i) the board of a public company is required to appoint a compensation committee; (ii) the compensation committee shall be comprised of at least 3 members, all of the external directors shall be members and shall constitute the majority of its members and the rest of the members shall be members whose terms of service are as required under the Companies Law.

Under Section 267B(a) and Parts A and B of Annex IA of the Companies Law, which were legislated as part of Amendment 20, a company's compensation policy shall be determined based on, and take into account, the following parameters:

- a. Advancement of the goals of the company, its working plan and its long term policy;
- b. The creation of proper incentives for the office holders while taking into consideration, inter alia, the company's risk management policies;
- c. The company's size and nature of its operations;
- d. The contributions of the relevant office holders in achieving the goals of the company and profit in the long term in light of their positions;
- e. The education, skills, expertise and achievements of the relevant office holders;
- f. The role of the office holders, areas of their responsibilities and previous agreements with them;
- g. The correlation of the proposed compensation with the compensation of other employees of the company, and the effect of such differences in compensation on the employment relations in the company; and
- h. The long term performance of the office holder.

In addition, the compensation policy should take into account that in the event the compensation paid to office holders shall include variable components – it should address the ability of the board of directors to reduce the value of the variable component from time to time or to set a cap on the exercise value of convertible securities components that are not paid out in cash. Additionally, in the event that the terms of office and employment include grants or payments made upon termination – such grants should take into consideration the length of the term of office or period of employment, the terms of employment of the office holder during such period, the company's success during said period and the office holder's contribution to obtaining the company's goals and maximizing its profits as well as the circumstances and context of the termination.



In addition, the compensation policy must set forth standards and rules on the following issues: (a) with respect to variable components of compensation - basing the compensation on long term performance and measurable criteria (though a non-material portion of the variable components can be discretionary awards taking into account the contribution of the officer holder to the company. Pursuant to Amendment 27, variable components in the amount of up to a three month salary of the relevant office holder, on an annual basis, shall be considered a non-material portion of the variable components); (b) establishing the appropriate ratio between variable components and fixed components and placing a cap on such variable components (including a cap on the grant date value of convertible securities components that are not paid out in cash); (c) setting forth a rule requiring an office holder to return amounts paid, in the event that it is later revealed that such amounts were paid on the basis of data which prove to be erroneous and resulted in an amendment and restatement of the company's financial statements; (d) determining minimum holding or vesting periods for equity based variable components of compensation, while taking into consideration appropriate long term incentives; and (e) setting a cap on grants or benefits paid upon termination.

The board of directors of a company is obligated to adopt a compensation policy after considering the recommendations of the compensation committee. The final adoption of the compensation committee is subject to the approval of the shareholders of the company, which such approval is subject to certain special majority requirements, as set forth in the Israeli Companies Law, pursuant to which one of the following must be met:

- (i) the majority of the votes includes at least a majority of all the votes of shareholders who are not controlling shareholders of the company or who do not have a personal interest in the compensation policy and participating in the vote; abstentions shall not be included in the total of the votes of the aforesaid shareholders; or
- (ii) the total of opposing votes from among the shareholders described in subsection (i) above does not exceed 2% of all the voting rights in the company.

Nonetheless, even if the shareholders of the company do not approve the compensation policy, the board of directors of a company may approve the compensation policy, provided that the compensation committee and, thereafter, the board of directors determined, based on detailed, documented, reasons and after a second review of the compensation policy, that the approval of the compensation policy is for the benefit of the company.

#### **Executive Compensation Policy**

On July 31, 2013, an Extraordinary General Meeting of the Shareholders of the Company took place, approving the Executive Compensation Policy (the "**Policy**"), which had been recommended by the Compensation Committee and approved by the Board of Directors, for the Company's directors and office holders, in accordance with the requirements of the Companies Law. The Policy was re-approved by our shareholders at the Annual General Meeting of our shareholders, which took place on June 8, 2016.

The Policy includes, among other issues prescribed by the Companies Law, a framework for establishing the terms of office and employment of the office holders, a recoupment policy, and guidelines with respect to the structure of the variable pay of office holders.

Each of our compensation committee and board of directors may engage compensation advisors and other professionals to assist in formulating compensation packages in line with the Policy, including, without limitation, to assist in collecting relevant data, framing the appropriate factors to be considered and evaluating the different factors being considered.

All compensation arrangements of office holders are to be approved in the manner prescribed by applicable law. Our office holders, including External Directors or Independent Directors, may waive their entitlement to their compensation, subject to applicable law.

Our recoupment policy relating to office holder compensation allows for the recovery of all or a portion of any compensation paid to our office holders paid during the previous three years on the basis of financial data included in our financial statements in any fiscal year that were found to be inaccurate and were subsequently restated. In such event, we will seek reimbursement from the office holders to the extent such office holders would not have been entitled to all or a portion of such compensation, based on the financial data included in the restated financial statements. Our compensation committee will be responsible for approving the amounts to be recouped and for setting terms for such recoupment from time to time. Notwithstanding the aforesaid, the recoupment policy will not be triggered in the event of a financial restatement due to changes in the applicable reporting or accounting standards. The above noted recoupment policy does not derogate from any relevant recoupment or clawback provisions under any applicable law or regulatory rules which apply to us.

All of our office holders (other than non-employee directors) may be incentivized through cash bonuses and long-term equity-based incentives to provide the office holder with a stake in our success – thus linking the office holder's long-term financial interests with the interests of our shareholders. In accordance with the Policy, the incentives are developed through a program that sets performance targets based on each office holder's role and scope. Actual payments are driven by the business and individual performance vis-à-vis the performance targets set at the beginning of the year. The formula for the performance targets and the maximum variable components payable to each office holder (other than directors) shall be presented and recommended by our Chief Executive Officer and reviewed and approved by our compensation committee and our board of directors. The formula for the performance targets and the maximum variable components payable to any employee office holders who are also directors shall be presented and recommended by our compensation committee and reviewed and approved by our board of directors and our shareholders. The maximum value of the variable compensation components for an office holder at the Company shall not exceed eighty percent of such office holder's total compensation package on an annual basis. The maximum annual value of the equity-based long-term compensation components and cash bonuses of all of our office holders shall not exceed two percent of our market cap.

Unless otherwise specified in the terms of the variable compensation of an office holder, our Policy dictates that the board of directors shall not have discretion to unilaterally reduce such office holder's variable compensation. Equity based compensation may be granted in any form permitted under our equity incentive plans, as in effect from time to time (collectively, the "**Equity Incentive Plans**"), including stock options, restricted share units and restricted stock. Equity grants to office holders shall be made in accordance with the terms of the Equity Incentive Plans. All equity-based incentives granted to our office holders shall be subject to vesting periods in order to promote long-term retention of the awarded office holders. Unless determined otherwise in a specific award agreement approved by the compensation committee and the board of directors, grants to our office holders other than directors shall vest gradually over a period of between two to four years. We do not have any equity ownership guidelines that require any of our office holders to hold a stated number or fixed percentage of our ordinary shares, nor do they have to continue to hold for any period of time shares in the Company which they acquired as a result of the exercise of fully vested equity grants. The value of the equity-based compensation shall be calculated on the grant date, according to acceptable valuation practices at the time of grant. The board of directors shall not have discretion to limit the value of the equity-based compensation at the time of exercise. The board of directors may, following approval by our compensation committee, extend the period of time for which an award to an office holder is to remain exercisable, or make provisions with respect to the acceleration of the vesting period of any office holder's awards, including, without limitation, in connection with a corporate transaction involving a change of control.

Our compensation committee will periodically review the Policy and monitor its implementation, and recommend to our board of directors and shareholders to amend the Policy as it deems necessary from time to time. The term of the Policy shall be three years as of the date of its re-adoption on June 8, 2016, during which, the Board of Directors is required to examine the Policy and revise it from time to time, if the circumstances under which it had been adopted have materially changed. Following such three year term, the Policy, including any revisions recommended by our compensation committee and approved by our board of directors, as applicable, will be brought once again to the shareholders for approval.

#### **Internal Auditor**

Under the Companies Law, the board of directors of a public company must appoint an internal auditor, who is nominated by the audit committee. The role of the internal auditor is to examine, among other matters, whether our actions comply with the law and orderly business procedure. Under the Companies Law, the internal auditor may be an employee of the company but not an office holder (as defined in Item 10 below), nor an affiliate, nor a relative of an office holder or affiliate, and he or she may not be our independent accountant or its representative. Doron Cohen of Fahn Kaneh Control Management Ltd. (a subsidiary of Fahn Kanne & Co. - Grant Thornton Israel) serves as our internal auditor.

#### D. Employees

The number of employees over the last three financial years is set forth in the table below.

As of December 31	2015	2016	2017
Total Employees	238	240	255
Marketing, Sales, Customer Services	26	24	23
Research & Development	81	79	93
Manufacturing	114	121	123
Corporate Operations and Administration	17	16	16

As of March 31, 2018, we had 264 employees, including 24 in marketing, sales and customer services, 101 in research and development, 123 in manufacturing, and 16 in corporate operations and administration. All such employees, except for 24 employees of our subsidiaries in the United States and 33 of our subsidiary in Denmark, are based in Israel. We consider our relations with our employees excellent and have never experienced a labor dispute, strike or work stoppage. None of our employees is represented by a labor union. We do not employ a significant number of temporary employees, but we do use temporary employees from time to time, as necessary.

In Israel we are subject to certain labor statutes and national labor court precedent rulings, as well as to certain provisions of the collective bargaining agreements between the Histadrut (General Federation of Labor in Israel) and the Coordination Bureau of Economic Organizations including the Industrialists' Associations. These provisions of collective bargaining agreements are applicable to our Israeli employees by virtue of expansion orders issued in accordance with relevant labor laws by the Israeli Ministry of Labor and Welfare, and which apply such agreement provisions to our employees even though they are not directly part of a union that has signed a collective bargaining agreement. The laws and labor court rulings that apply to our employees principally concern the minimum wage laws, procedures for dismissing employees, determination of severance pay, leaves of absence (such as annual vacation or maternity leave), sick pay and other conditions for employment. The expansion orders which apply to our employees principally concern the requirement for length of the work day and workweek, mandatory contributions to a pension fund, annual recreation allowance, travel expenses payment and other conditions of employment. We generally provide our employees with benefits and working conditions beyond the required minimums.

Israeli Severance Pay Law, 1963 generally requires severance pay, which may be funded by managers' insurance and/or a pension fund described below, upon the retirement or death of an employee or termination of employment without cause (as defined in the law). The payments to the managers' insurance and/or pension fund in respect of severance pay amount to approximately 8.33% of an employee's wages, in the aggregate. Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute, which is similar to the United States Social Security Administration. Such amounts also include payments for national health insurance. The payments to the National Insurance Institute (including payments for healthcare insurance) are paid on a differential basis, such that with respect to the part of the employer's wage which is equal to up to 60% of the average wage in Israel, the employer is required to pay an amount equal to 3.45% of such part of the employee's wage and the employee is required to pay an amount equal to 3.50% of such part of the employee's wage, and for the remainder of the employee's wage, the employer is required to pay an amount equal to 7.50% of such part of the employee's wage and the employee is required to pay an amount equal to 12% of such part of the employee's wage.

As required by applicable law, we contribute to either a fund known as managers' insurance or to a pension fund, or to a combination of both. Such practice was further reinforced in July 1, 2008, when we entered into agreements with a majority of its employees in order to implement Section 14 to the Severance Pay Law, according to which the payment of monthly deposits by us into managers' insurance and/or pension fund are in respect of severance obligation to such employees. See Note 9 of our consolidated financial statements. These funds provide a combination of savings plan, insurance and severance pay benefits to the employee, giving the employee a lump sum payment upon retirement and securing the severance pay or part of it, if legally entitled, upon termination of employment. Each employee contributes an aggregate amount equal to 6% of his or her base salary to such funds, and we contribute, in the aggregate, an additional 12.5% to 14.83% of the employee's base salary, with such amount including the 8.33% which is contributed as severance pay as noted above.

#### E. Share Ownership

The following table sets forth, as of March 31, 2018 the number of shares owned by our officers, directors and senior management. The percentages shown are based on 7,549,531 ordinary shares outstanding as of March 31, 2018:

Name and Address	Number of Shares and Options Owned <sup>1</sup>	Percent of Outstanding Shares
Avi Eizenmann	240,751	3.17%
Shaika Orbach	*	*
Eli Doron	*	*
Ayelet Aya Hayak	*	*
Ilan Erez	*	*
Eran Gilad	*	*
All directors and officers as a group	240,751	3.17%

\* Denotes ownership of less than 1% of the outstanding shares.

(1) The table above includes the number of shares and options that are exercisable within 60 days of March 31, 2018. Ordinary shares subject to these options are deemed beneficially owned for the purpose of computing the ownership percentage of the person or group holding these options, but are not deemed outstanding for purposes of computing the ownership percentage of any other person. Except where otherwise indicated, and subject to applicable community property laws, based on information furnished to us by such owners or otherwise disclosed in any public filings, to our knowledge, the persons and entities named in the table have sole voting and dispositive power with respect to all shares shown as beneficially owned by them.

See also "Item 6 – Directors and Senior Management – Compensation."

**Item 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

**A. Major Shareholders**

The shareholders of the Company who beneficially own over 5% or more of each class of shares, as well as the number of shares owned and the percentage of outstanding shares owned by each, and additional information, is set forth below. The voting rights of our major shareholders do not differ from the voting rights of other holders of our ordinary shares. All of the information with respect to beneficial ownership of the Ordinary Shares is given to the best of our knowledge.

<b>Name of Shareholder</b>	<b>Number of Shares and Options Owned<sup>1</sup></b>	<b>Percentage of Outstanding Shares</b>
Zohar Zisapel <sup>2</sup>	1,511,722	20.02%
Dov Yelin/Yair Lapidot/Yelin Lapidot Holdings Management Ltd. <sup>3</sup>	615,748	8.16%
Wellington Management Group LLP <sup>4</sup>	424,489	5.62%

(1) The table above includes the number of shares and options that are exercisable within 60 days of March 31, 2018. Ordinary shares subject to these options are deemed beneficially owned for the purpose of computing the ownership percentage of the person or group holding these options, but are not deemed outstanding for purposes of computing the ownership percentage of any other person. Except where otherwise indicated, and subject to applicable community property laws, based on information furnished to us by such owners or otherwise disclosed in any public filings, to our knowledge, the persons and entities named in the table have sole voting and dispositive power with respect to all shares shown as beneficially owned by them.

(2) Based on Schedule 13D/A filed on March 5, 2009.

- (3) As reported on the Schedules 13G/A filed by each of Dov Yelin ("**Yelin**"), Yair Lapidot ("**Lapidot**") and Yelin Lapidot Holdings Management Ltd. (collectively, "**Yelin Lapidot**") with the SEC on January 31, 2018, all ordinary shares of the Company are beneficially owned by provident funds managed by Yelin Lapidot Provident Funds Management Ltd. and/or mutual funds managed by Yelin Lapidot Mutual Funds Management Ltd. (the "**Subsidiaries**"), each a wholly-owned subsidiary of Yelin Lapidot Holdings Management Ltd. ("**Yelin Lapidot Holdings**"). Yelin Lapidot has reported on the Schedules 13G/A that Messrs. Yelin and Lapidot each own 24.38% of the share capital and 25% of the voting rights of Yelin Lapidot Holdings, and are responsible for the day-to-day management of Yelin Lapidot Holdings. The Subsidiaries operate under independent management and make their own independent voting and investment decisions, and that any economic interest or beneficial ownership in any of the securities covered by the report is held for the benefit of the members of the provident funds or mutual funds, as the case may be. Yelin Lapidot also stated that the report on Schedule 13G/A shall not be construed as an admission by Messrs. Yelin and Lapidot, Yelin Lapidot Holdings Management Ltd. or the Subsidiaries that he or it is the beneficial owner of any of the securities covered by the report on Schedule 13G/A, and that each of Messrs. Yelin and Lapidot, Yelin Lapidot Holdings, and the Subsidiaries disclaims beneficial ownership of any such securities. On April 2, 2018, Yelin Lapidot updated the Company in correspondence between the two that as of March 30, 2018, a total of 615,748 ordinary shares of the Company are beneficially owned by the Subsidiaries.
- (4) As reported on the Schedule 13G filed by Wellington Management Group LLP with the SEC on February 8, 2018, the securities as to which the Schedule was filed are owned of record by clients of one or more of the following investment advisers, which are directly or indirectly owned by Wellington Management Group LLP: Wellington Management Company LLP, Wellington Management Canada LLC, Wellington Management Singapore Pte Ltd., Wellington Management Hong Kong Ltd., Wellington Management International Ltd., Wellington Management Japan Pte Ltd., Wellington Management Australia Pty Ltd. (jointly, the "**Wellington Investment Advisers**"). According to the report of Schedule 13G, those clients have the right to receive, or the power to direct the receipt of, dividends from, or the proceeds from the sale of, such securities, and no such client is known to have such right or power with respect to more than five percent of that class of securities. In addition, according to the report on Schedule 13G, the securities as to which the report was filed by Wellington Management Group LLP, as parent holding company of certain holding companies and the Wellington Investment Advisers, are owned of record by clients of the Wellington Investment Advisers. According to the report of Schedule 13G, Wellington Investment Advisers Holdings LLP controls directly, or indirectly through Wellington Management Global Holdings, Ltd., the Wellington Investment Advisers, Wellington Investment Advisers Holdings LLP is owned by Wellington Group Holdings LLP, and Wellington Group Holdings LLP is owned by Wellington Management Group LLP. On March 2, 2018, Wellington Management Group LLP updated the Company in correspondence between the two that as of the date thereof, a total of 424,489 ordinary shares of the Company are owned of record by clients of one or more of the Wellington Investment Advisers.

The Company's major shareholders do not have different voting rights.

As of March 31, 2018, there were 5 record holders of ordinary shares, including 2 record holders in the United States. Collectively, these 2 record holders in the United States held less than 1% of the outstanding ordinary shares.

## B. Related Party Transactions

Messrs. Yehuda and Zohar Zisapel are brothers and are our founders. On July 15, 2010 Mr. Yehuda Zisapel resigned from serving as director on our board of directors. On September 2, 2010, Mr. Zohar Zisapel was appointed as a director on our board until July 28, 2015, when he ceased serving as a director. Messrs. Yehuda and Zohar Zisapel are also founders, directors and principal shareholders of several other corporations within the "Rad Group", as described in "Item 6 – Directors, Senior Management and Employees".

There are other members of the "Rad Group" that are actively engaged in designing, manufacturing, marketing and supporting data communications products, none of which are currently the same as our products. Certain products of members of the "Rad Group" are complementary to, and may be used in connection with, our products.

The "Rad Group" provides us with certain services, and is reimbursed by us for the costs of providing such services. During 2017, we purchased from the "Rad Group" internet services for an amount of up to \$40,000, services and equipment for our research and development activities for an amount of up to \$78,000, and car leasing services for an amount of up to \$6,000. From January 2004 and until January 2017 we also sub-leased office space in Paramus, New Jersey, for an annual amount of up to \$24,000 (monthly rent payments of approximately \$2,000) from Radcom Equipment, Inc.. The sub-lease was extended for a short period until April 2017 for a total of \$11,000, and as of April 2017 we lease office space (in the same building in which we leased office space under the previous sub-lease agreement) from Zohar Zisapel Properties, Inc. and Yehuda Zisapel Properties, Inc. (all of which are affiliated companies of the "Rad Group"), for monthly rent payments (including utilities) of approximately \$3,800.

During 2017, we sold Stand-alone Products and Smart Cards to members of the "Rad Group" for an amount of approximately \$1,275,000.

The material terms of the arrangements with the "Rad Group", described in the preceding paragraphs, occur within the Company's ordinary course of business, and on market terms. We believe that such arrangements are neither material to us nor unusual in their nature or conditions. We further believe that the terms of the transactions in which we have engaged and are currently engaged with other members of the "Rad Group" are generally no less favorable to us than terms which might be available to us from unaffiliated third parties.

Our board of directors approved a resolution on January 23, 2011 under which sales to or purchases from any members of the "Rad Group" must meet certain criteria or otherwise be specifically approved by the relevant corporate bodies, as applicable in accordance with Israeli law. These criteria included a stipulation that transactions between us and members of the "Rad Group" relate to standard equipment, services and products purchased or sold by us and the "Rad Group", as applicable. Our board of directors approved sales to or purchases from the "Rad Group", from time to time, of standard equipment, services and products, which are (i) within our ordinary course of business and (ii) at least at market terms and at a value lower than 0.5% of our annual turnover per transaction and 2.5% of our annual turnover for all such transactions in a financial year, aggregated together. Our management is required to examine on a quarterly basis whether transactions with the "Rad Group" comply with such criteria. Transactions which do not meet the criteria will require specific corporate approvals in the applicable manner prescribed by Israeli law. Further, all future related party transactions and arrangements (or modifications of existing ones) with members of the "Rad Group", transactions in which office holders of the Company have a personal interest, or transactions which raise issues of such office holders' fiduciary duties, could require additional corporate approvals as applicable under the Companies Law.



Except as indicated above, we do not currently directly compete with other members of the "Rad Group" and do not currently contemplate engaging in competition with any other member of the "Rad Group" in the future. However, opportunities to develop, manufacture or sell new products (or otherwise enter new fields) may arise in the future, which opportunities might be pursued by us or by one or more other members of the "Rad Group" to the exclusion of (or in competition with) other members of the "Rad Group" (including us). In the event that any such opportunity arises, the directors then in office will determine whether or not we should seek to pursue it. Any such determination will be based upon such factors as the directors then deem relevant. However, in making any such determination, the directors will be bound by their fiduciary duties to the Company (and to any other corporation or other person to whom they then owe a fiduciary duty).

On July 22, 2002, our audit committee and the Board of Directors approved an Indemnification Agreement with our directors and officers. Our shareholders approved the terms of this agreement in a General and Extraordinary Meeting held on January 7, 2004. In Amendment 3 to the Companies Law, effective as of 2005, the instances in which a company may indemnify its officers and directors were broadened. In December 2007 each of our audit committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers so as to reflect this amendment. Our shareholders approved the terms of this new Indemnification Agreement in January 2008. According to Amendment 16 to the Israeli Securities Law, and to a corresponding amendment to the Companies Law, both effective as of 2011, the ISA is authorized to impose administrative sanctions against companies like ours and their office holders for certain violations of the Israeli Securities Law or the Companies Law. These sanctions include monetary sanctions and certain restrictions on serving as a director or senior officer of a public company for certain periods of time. The Israeli Securities Law and the Companies Law provide that only certain types of such liabilities may be reimbursed by indemnification and insurance. Specifically, legal expenses (including attorneys' fees) incurred by an individual in the applicable administrative enforcement proceeding and certain compensation payable to injured parties for damages suffered by them are permitted to be reimbursed via indemnification or insurance, provided that such indemnification and insurance are authorized by the company's articles of association, and receive the requisite corporate approvals. In January 2012 each of our audit committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers so as to reflect this amendment, and our shareholders approved these amendments to the Articles of Association and a revised form of Indemnification Agreement for directors at the Annual General Meeting of the Shareholders held on April 11, 2012.

The Indemnification Agreement provides that our directors and officers will be exempt from liability in certain circumstances. The Indemnification Agreement also provides for the indemnification by the Company for certain obligations and expenses imposed on the officer in connection with act performed in his or her capacity as an officer of the Company. This right to indemnification is limited, and does not cover, among other things, a breach of an officer's duty of loyalty, a willful breach of an officer's duty of care, or a reckless disregard for the circumstances or consequences of a breach of a duty of care. The right to indemnification also does not cover acts that are taken intentionally to unlawfully realize personal gain. The maximum amount of our liability under these Indemnification Agreements for any monetary obligation imposed on an officer or a director in favor of another person by a judgment is currently \$3,000,000 for each instance of a covered scenario. In addition, we would be liable to indemnify the officer or director for all reasonable litigation expenses with respect to certain proceedings. We have maintained liability insurance for our directors and officers. On September 23, 2007 our shareholders approved the procurement of a policy, which provides for total coverage of up to \$4,000,000. All of our directors are parties to our Indemnification Agreements and are covered by our directors and officers insurance policy.

As per Amendment 20, it was decided on July 31, 2013, at the Extraordinary General Meeting of the Shareholders to adopt the Executive Compensation Policy of the Company, which was recommended by our compensation committee and approved by our board of directors. Our approved Executive Compensation Policy includes the above referenced form of Indemnification Agreement to be entered into by the Company with our directors and officers serving in such capacities from time to time, as well as the above referenced directors and officers liability insurance policy. Under the Executive Compensation Policy, any change to the Indemnification Agreement or the insurance policy, including the cost and/or any changes which materially depart from the key terms of the current agreement and/or insurance policy (provided that such changes apply equally to all executives of the Company, including directors) will be submitted to the Company's compensation committee and the board of directors for their approval but shall not, unless required by law or the Company's Articles, be presented at a General Meeting of the shareholders.

See also "Item 6 – Directors and Senior Management – Compensation."

**Item 8. FINANCIAL INFORMATION**

**A. Consolidated Statements and Other Financial Information**

Our consolidated financial statements and other financial information are included herein on pages F-1 through F-46.

- A1. See Item 18 for our consolidated financial statements.
- A2. See Item 18 for our consolidated financial statements, which cover the last three financial years.
- A3. See page F-3 for the audit report of our accountants, entitled "Report of Independent Registered Public Accounting Firm."
- A4. Not applicable.
- A5. Not applicable.
- A6. See Note 12A to our audited consolidated financial statements included in Item 18 of this annual report for the geographic distribution of our sales based on the location of the customer.

#### A7. Litigation

On March 2, 2012 Internet Machines LLC, a Texas limited liability company filed a patent infringement lawsuit in the Court against numerous defendants (including many switch manufacturers) with respect to certain patents for switches, and included our US subsidiary amongst the list of defendants named in such lawsuit. The lawsuit claimed that the defendants infringed certain patents purported to be owned by Internet Machines LLC and sought unspecified compensation for damages as well as injunctive relief. The defendants filed answers and counterclaims to the complaint asserting that they did not infringe any claims of the asserted patents and the claims of the patents were invalid and/or unenforceable. While one of our switch suppliers (which was also named as a defendant in the aforesaid lawsuit) agreed to indemnify us with respect to certain liabilities, there was no certainty that we would have been ultimately able to collect all or any amounts under such indemnity should we would have been found liable under the lawsuit. On September 4, 2012, the Court granted the defendants' motion to stay the pending litigation and on April 28, 2015, the lawsuit was dismissed with prejudice by the Court.

Other than the above, we are not a party to any material litigation and we are not aware of any pending or threatened litigation that would have a material adverse effect on us or our business.

#### A8. Dividend Policy

Prior to 2013, we had not paid dividends in the past. On January 14, 2013, we announced that our Board of Directors has adopted a policy for distributing dividends, subject to all applicable laws. According to this policy, each year we will distribute a dividend of up to 50% of our annual distributable profits. As part of the stated policy, the Company's Board of Directors reserves the right to declare additional dividend distributions, to change the rate of dividend distributions (either as a policy or on a one-time basis), to cancel a specific distribution or to cancel the policy as a whole at any time, at its sole discretion. According to the said policy, the actual distribution of a dividend will be subject to meeting the conditions required by applicable law, including the distribution tests set forth in Section 302 of the Companies Law, and to the specific decision of the Company's Board of Directors for each distribution. Future dividend policy will be reviewed by the Board of Directors based upon conditions then existing, including our earnings, financial condition, capital requirements and other factors. Our ability to pay cash dividends may be restricted by instruments governing any of our obligations. On March 15, 2018, our Board of Directors adopted a resolution to suspend until further notice the said dividend policy in order to increase our available funds in support of our long-term growth.

Dividends paid by an Israeli company to shareholders residing outside Israel are generally subject to withholding of Israeli income tax at a rate of 25-30%. Such tax rates apply unless a lower rate is provided in a treaty between Israel and the shareholder's country of residence. In our case, the applicable withholding tax rate will also depend on the particular Israeli production facilities that have generated the earnings that are the source of the specific dividend and, accordingly, the applicable rate may change from time to time.

On March 18, 2013 our Board of Directors declared a dividend of US \$0.55 per share which was paid on April 17, 2013 to shareholders of record as of April 4, 2013, and in the aggregate amount of approximately US \$3.9 million for 2012.

On March 18, 2014 our Board of Directors declared a dividend of US \$1.00 per share payable on April 17, 2014 to shareholders of record at the close of the NASDAQ Global Select Market on April 3, 2014, and in the aggregate amount of approximately US \$7.2 million for 2013.

On March 23, 2015 our Board of Directors declared a dividend of US \$1.00 per share payable on April 21, 2015 to shareholders of record at the close of the NASDAQ Global Select Market on April 6, 2015, and in the aggregate amount of approximately US \$7.3 million for 2014.

On March 21, 2016 our Board of Directors declared a dividend of US \$1.00 per share payable on April 14, 2016 to shareholders of record at the close of the NASDAQ Global Select Market on April 4, 2016, and in the aggregate amount of approximately US \$7.3 million for 2015.

On March 15, 2017 our Board of Directors declared a dividend of US \$1.00 per share payable on April 5, 2017 to shareholders of record at the close of the NASDAQ Global Select Market on March 27, 2017, and in the aggregate amount of approximately US \$7.4 million for 2016.

## B. Significant Changes

Since the date of the annual financial statements included in this Annual Report, no significant changes have occurred.

## Item 9. THE OFFER AND LISTING

### A. Offer and listing details

#### Markets and Share Price History

Following our delisting from trading on the TASE, the only trading market for our ordinary shares is the NASDAQ Global Select Market, where our shares have been listed and traded under the symbol SILC since January 2, 2014. Prior thereto our shares were listed and traded on the NASDAQ Global Market (previously NASDAQ National Market) under the symbol SILC (previously SILCF) from February 11, 2008. Prior thereto, our shares were listed and traded on the NASDAQ Capital Market (previously known as the NASDAQ Small-Cap).

The table below sets forth the high and low reported sales prices in Dollars of our ordinary shares, as reported by NASDAQ during the indicated periods:

PERIOD	LOW	HIGH
<b>LAST 6 CALENDAR MONTHS</b>		
March 2018	32.00	64.18
February 2018	60.73	67.15
January 2018	62.75	77.95
December 2017	67.83	73.15
November 2017	67.77	77.05
October 2017	56.99	73.68
<b>FINANCIAL QUARTERS DURING THE PAST TWO YEARS</b>		
First Quarter 2018	32.00	77.95
Fourth Quarter 2017	56.99	77.05
Third Quarter 2017	43.75	59.43
Second Quarter 2017	43.56	55.66
First Quarter 2017	34.86	50.00
Fourth Quarter 2016	34.46	42.69
Third Quarter 2016	27.06	44.00
Second Quarter 2016	25.48	34.35
<b>FIVE MOST RECENT FULL FINANCIAL YEARS</b>		
2017	34.86	77.05
2016	25.48	44.00
2015	24.86	48.43
2014	26.00	73.44
2013	17.97	46.15

On December 27, 2005, our shares commenced trading on the TASE in Israel under the symbol "SILC". On October 26, 2015, our Board of Directors resolved to act to delist the Company's shares from trading on the TASE. The last trading day in our shares on the TASE was January 26, 2016, and on January 28, 2016, our shares were delisted from trading on the TASE. The following table sets forth, for the periods indicated, the high and low reported sales prices, in NIS, of the ordinary shares on the TASE, until delisted from trading as set forth above:

<b>PERIOD</b>	<b>LOW</b>	<b>HIGH</b>
<b>FINANCIAL QUARTERS DURING THE PAST TWO YEARS</b>		
First Quarter 2016 <sup>1</sup>	125.00	169.00
<b>FIVE MOST RECENT FULL FINANCIAL YEARS</b>		
2015	96.01	189.60
2014	89.74	257.20
2013	66.50	166.60
2012	51.60	73.00
2011	44.16	80.64

(1) Until January 28, 2016, when the Company's shares were delisted from trading on the TASE in accordance with the Company's initiated delisting procedure.

**Item 10. ADDITIONAL INFORMATION**

**A. Share Capital**

Not applicable

**B. Memorandum and Articles of Association**

**Articles of Association**

Our shareholders approved our Amended and Restated Articles on January 24, 2008, as well as certain additional amendments to the Articles on April 11, 2012 and June 8, 2016. Our objective as stated in the Articles is to carry on any business and perform any act which is not prohibited by law.

We have currently outstanding only one class of shares, our Ordinary Shares, having a nominal value of NIS 0.01 per share. Holders of Ordinary Shares have one vote per share, and are entitled to participate equally in the payment of dividends and share distributions and, in the event of a liquidation of the Company, in the distribution of assets after satisfaction of liabilities to creditors. No preferred shares are currently authorized.

Our Articles require that we hold our annual general meeting of shareholders each year no later than 15 months from the last annual meeting, at a time and place, either within or without the State of Israel, determined by the board of directors, upon 21 days' prior notice to our shareholders or 35 days' prior notice to the extent required with respect to certain matters as required under the regulations to the Companies Law. In general, no business may be commenced at a general meeting until a quorum of two or more shareholders holding at least 33 1/3% of the voting rights is present in person or by proxy. Shareholders may vote in person or by proxy.

In general, a simple majority is required to amend our Articles.

Pursuant to the Israeli Companies Law, resolutions regarding the following matters must be passed at a general meeting of shareholders:

- Appointment or termination of our auditors;
- Appointment and dismissal of external directors, unless the company elects to opt-in to the exemptions promulgated under the Amendment to the Relief Regulations as detailed above, under which there is no requirement to appoint external directors;
- Approval of interested party acts and transactions requiring general meeting approval as provided in sections 255 and 268 to 275 of the Israeli Companies Law;
- A merger as provided in section 320(a) of the Israeli Companies Law;
- The exercise of the powers of the board of directors, if the board of directors is unable to exercise its powers and the exercise of any of its powers is vital for our proper management, as provided in section 52(a) of the Israeli Companies Law;

- Amendments to our Articles; and
- Approval of an increase or decrease of the registered share capital.

An extraordinary general meeting may be convened by demand of two directors or by written request of one or more shareholders holding at least 5% of our issued share capital and 1% of the voting rights or one or more shareholders holding at least 5% of the voting rights. Shareholders requesting a special meeting must include in their request all relevant information, including the reason that such subject is proposed to be brought before the special meeting.

Our ordinary shares may generally be freely transferred under our amended and restated Articles, unless the transfer is restricted or prohibited by applicable law or the rules of the stock exchange on which the shares are traded. The ownership or voting of our ordinary shares by non-residents of Israel is not restricted in any way by our amended and restated Articles or the laws of the State of Israel, except under certain circumstances for ownership by nationals of certain countries that are, or have been, in a state of war with Israel.

#### **The Companies Law**

We are subject to the provisions of the Companies Law. The Companies Law codifies the fiduciary duties that "office holders", including directors and executive officers, owe to a company. An office holder, as defined in the Companies Law, is a general manager (also referred to as the "chief executive officer"), chief business manager, deputy general manager, vice general manager, executive Vice-President, Vice-President, any other person assuming the responsibilities of any of the foregoing positions without regard to such person's title, as well as a director, or another manager directly subordinate to the general manager. Each person listed in the table in "Item 6 – Directors, Senior Management and Employees" above is an office holder of Silicom.

The Companies Law requires that an office holder of a company promptly disclose, no later than the first board meeting in which such transaction is discussed, any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. In addition, if the transaction is an extraordinary transaction, the office holder must also disclose any personal interest held by the office holder's relative (which includes for these purposes any members of his/her (or his/her spouse's) immediate family or the spouses of any such members of his or her (or his/her spouse's) immediate family), or by any corporation in which the office holder or the office holder's relative is a 5% or greater shareholder, holder of 5% or more of the voting power, director or general manager or in which he or she has the right to appoint at least one director or the general manager. An extraordinary transaction is defined as a transaction not in the ordinary course of business, not on market terms, or that is likely to have a material impact on the company's profitability, assets or liabilities.

In the case of a transaction in which an office holder of the company has a personal interest and which is not an extraordinary transaction, after the office holder complies with the above disclosure requirement, board approval is required unless the articles of association of the company provide otherwise. The transaction must be for the benefit of the company. If the transaction is an extraordinary transaction, then, in addition to any approval required by the articles of association, it must also be approved by the audit committee and by the board of directors, and, under specified circumstances, by a meeting of the shareholders, as well.

Subject to certain exceptions provided for in the regulations to the Companies Law, agreements regarding directors' terms of compensation require the approval of the compensation committee, board of directors and the shareholders of the company. The transaction must be for the benefit of the company.

In matters concerning an extraordinary transaction in which a person has a personal interest, as well as matters concerning his or her terms of compensation, he or she shall not be permitted to vote on the matter or be present in the audit committee or board of directors meeting in which the matter is considered, however, with respect to an office holder, he/she may be present at the meeting discussions if the chairman determines that the presence of the office holder is necessary in order to present the matter. However, if a majority of the audit committee or of the board of directors has a personal interest in the matter then:

- All of the directors are permitted to vote on the matter and attend the meeting in which the matter is considered; and
- The matter requires approval of the shareholders at a general meeting.

According to the Companies Law, the personal interest disclosure requirements discussed above also apply to a "controlling shareholder" of a public company. Such requirements also apply to certain shareholders of a public company who have a personal interest in the adoption by the shareholders of certain proposals with respect to (i) certain private placements that will increase their relative holdings in the company, (ii) certain special tender offers or forced bring along share purchase transactions, (iii) election of external directors, (iv) approval of a compensation policy governing the terms of employment and compensation of office holders, (v) approval of the terms of employment and compensation of the general manager, (vi) approval of the terms of employment and compensation of office holders of the company when such terms deviate from the compensation policy previously approved by the company's shareholders, and (vii) approving the appointment of either (1) the chairman of the board or his/her relative as the chief executive officer of the company, or (2) the chief executive officer or his/her relative as the chairman of the board of directors of the company. If any shareholder casting a vote at a shareholders meeting in connection with such proposals as aforesaid does not notify the company if he, she or it has a personal interest with respect to such proposal, his, her or its vote with respect to the proposal will be disqualified.

The term "controlling shareholder" is defined as a shareholder who has the ability to direct the activities of a company, other than if this power derives solely from the shareholder's position on the board of directors or any other position with the company, and the definition of "controlling shareholder" in connection with matters governing: (i) extraordinary transactions with a "controlling shareholder" or in which a "controlling shareholder" has a personal interest, (ii) certain private placements in which the "controlling shareholder" has a personal interest, (iii) certain transactions with a "controlling shareholder" or relative with respect to services provided to or employment by the company, (iv) the terms of employment and compensation of the general manager, and (v) the terms of employment and compensation of office holders of the company when such terms deviate from the compensation policy previously approved by the company's shareholders, also includes shareholders that hold 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company (and the holdings of two or more shareholders which each have a personal interest in such matter will be aggregated for the purposes of determining such threshold).



In general, extraordinary transactions with a "controlling shareholder" or in which a "controlling shareholder" has a personal interest, and agreements relating to non-office holder employment and compensation terms of a "controlling shareholder" (or a relative of such) or to the provision of services to the company by such "controlling shareholder" (or relative of such), require the approval of the audit committee, the board of directors and the shareholders of the company. Agreements relating to the terms of office and employment of a "controlling shareholder" (or relative of such) as an office holder in the company require the approval of the compensation committee, the board of directors and the shareholders of the company.

The shareholder approval for such matters requiring shareholder disclosure of a personal interest as noted above, generally must either include at least a majority of the shares held by non-controlling and disinterested shareholders who actively participate in the voting process (without taking abstaining votes into account), or, alternatively, the total shareholdings of the non-controlling and disinterested shareholders who vote against the transaction must not represent more than two percent of the voting rights in the company. The shareholder approval for approving the appointment of either (1) the chairman of the board or his/her relative as the chief executive officer of the company, or (2) the chief executive officer or his/her relative as the chairman of the board of directors of the company, must either include at least two-thirds of the shares held by non-controlling and disinterested shareholders who actively participate in the voting process (without taking abstaining votes into account), or, alternatively, the total shareholdings of the non-controlling and disinterested shareholders who vote against the transaction must not represent more than two percent of the voting rights in the company. Agreements and extraordinary transactions with a "controlling shareholder" or in which a "controlling shareholder" has a personal interest, or agreements relating to any employment terms of a "controlling shareholder" (or relative if such) or to the provision of services to the company by such "controlling shareholder" (or relative if such), as aforesaid, with duration exceeding three years, are subject to re-approval once every three years by the audit committee (or compensation committee, as applicable), the board of directors and the shareholders of the company. Extraordinary transactions with a "controlling shareholder" or in which a "controlling shareholder" has a personal interest may be approved in advance for a period exceeding three years if the audit committee determines such approval reasonable under the circumstances. In addition, agreements and extraordinary transactions with duration exceeding three years which were approved prior to Amendment 16 to the Companies Law, which was passed by the Israeli legislature, the Knesset, in March 2011 and which came into effect gradually during the year 2011 (the "**Amendment 16**") will need to be re-approved by the proper corporate actions at the later of (i) the first general meeting held after May 14, 2011, (ii) November 14, 2011 or (iii) the expiration of three years from the date on which they were originally approved, even though they were properly approved prior to the passing of the Amendment 16.

The board of directors of an Israeli company whose shares or debentures are publicly traded is obligated to adopt a compensation policy governing the terms of office and employment of office holders, after considering the recommendations of the compensation committee. The final adoption of the compensation policy is subject to the approval of the shareholders of the company. Such shareholder approval is subject to certain special majority requirements, as set forth in the Companies Law, pursuant to which the shareholder majority approval must also either include at least a majority of the shares held by non-controlling and disinterested shareholders who actively participate in the voting process (without taking abstaining votes into account), or, alternatively, the total shareholdings of the non-controlling and disinterested shareholders who voted against the transaction must not represent more than two percent of the voting rights in the company.

Nonetheless, even if the shareholders of the company do not approve the proposed compensation policy, the board of directors of a company may approve the proposed compensation policy, provided that the compensation committee and, thereafter, the board of directors resolved, based on detailed, documented, reasons and after a second review of the compensation policy, that the approval of such compensation policy is for the benefit of the company.

Pursuant to the Companies Law, the terms of office and employment of an office holder in a public company should be in accordance with the company's compensation policy. Nonetheless, provisions were established in the Companies Law that allow a company, under special circumstances, to approve terms of office and employment that are not in line with the approved compensation policy.

Terms of office and employment of office holders who are neither directors nor the general manager and which comply with the company's compensation policy require approval by the (i) compensation committee; and (ii) the board of directors. Approval of terms of office and employment for such office holders which do not comply with the compensation policy may nonetheless be approved subject to two cumulative conditions: (i) the compensation committee and thereafter the board of directors, approved the terms after having taken into account the various policy considerations and mandatory requirements set forth in the Companies Law with respect to office holder compensation, and (ii) the shareholders of the company approved the terms of office and employment for such office holders by means of the special majority required for approving the compensation policy (as detailed above). Following the Amendment to the Affiliation Regulations, non-material changes to the terms of compensation of office holders who are subordinated to the company general manager will require only general manager approval, provided that the company's compensation policy includes a reasonable range for such non-material changes.

Terms of office and employment of the general manager which comply with the company's compensation policy require approval by the (i) compensation committee; (ii) the board of directors and (iii) the shareholders of the company by means of the special majority required for approving the compensation policy (as detailed above). Approval of terms of office and employment for the general manager which do not comply with the compensation policy may nonetheless be approved subject to two cumulative conditions: (i) the compensation committee and thereafter the board of directors, approved the terms after having taken into account the various policy considerations and mandatory requirements set forth in the Companies Law with respect to office holder compensation, and (ii) the shareholders of the company approved the terms of office and employment for the general manager which deviate from the compensation policy by means of the special majority required for approving the compensation policy (as detailed above). Notwithstanding the foregoing, a company may be exempted from receiving shareholder approval with respect to the terms of office and employment of a proposed candidate for general manager if such candidate meets certain independence criteria, the terms of office and employment are in line with the compensation policy, and the compensation committee has determined for specified reasons that presenting the matter for shareholder approval would thwart the proposed engagement. In addition, following the Amendment to the Affiliation Regulations, the terms of compensation of the general manager will not require shareholders' approval when extending or re-approving the company's engagement with its general manager, provided that such terms are not more beneficial compared to his previous compensation terms approved by the shareholders pursuant to the Companies Law and provided that such terms comply with the company's compensation policy.

Terms of office and employment of office holders (including the general manager) that are not directors may nonetheless be approved by the company despite shareholder rejection, provided that a company's compensation committee and thereafter the board of directors have determined to approve such terms of office and employment based on detailed reasoning, after having re-examined the proposed terms of office and employment, and having taken the shareholder rejection into consideration.

Terms of office and employment of directors which comply with the company's compensation policy require approval by the (i) compensation committee; (ii) the board of directors and (iii) the shareholders of the company. Approval of terms of office and employment for directors of a company which do not comply with the compensation policy may nonetheless be approved subject to two cumulative conditions: (i) the compensation committee and thereafter the board of directors, approved the terms after having taken into account the various policy considerations and mandatory requirements set forth in the Companies Law with respect to office holder compensation, and (ii) the shareholders of the company have approved the terms by means of the special majority required for approving the compensation policy (as detailed above).

Private placements in a public company require approval by a company's board of directors and shareholders in the following cases:

1. A private placement that meets all of the following conditions:
  - The private placement will increase the relative holdings of a shareholder that holds five percent or more of the company's outstanding share capital, assuming the exercise of all of the securities convertible into shares held by that person, or that will cause any person to become, as a result of the issuance, a holder of more than five percent of the company's outstanding share capital.
  - 20 percent or more of the voting rights in the company prior to such issuance are being offered.
  - All or part of the consideration for the offering is not cash or registered securities, or the private placement is not being offered at market terms.
2. A private placement which results in anyone becoming a "controlling shareholder" of the public company.

In addition, under the Companies Law, certain transactions or a series of transactions are considered to be one private placement. A private placement that meets all of the above conditions, and which must be approved by the shareholders, must also be for the benefit of the company.

Any placement of securities that does not fit the above description may be issued at the discretion of the board of directors.

Under the Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders when exercising his or her rights and refrain from abusing his power in the company, including, among other things, voting in the general meeting of shareholders on the following matters:

- Any amendment to the articles of association;
- An increase of the company's authorized share capital;
- A merger; or
- Approval of interested party acts and transactions that require general meeting approval as provided in sections 255 and 268 to 275 of the Israeli Companies Law.

Furthermore, the Companies Law requires that a shareholder refrain from acting in a discriminatory manner towards other shareholders.

The Companies Law does not describe the substance of the aforementioned duties of shareholders, but provides that laws applicable to a breach of contract, adjusted according to the circumstances shall apply to a breach of such duties. With respect to the obligation to refrain from acting discriminatorily, a shareholder that is discriminated against can petition the court to instruct the company to remove or prevent the discrimination, as well as provide instructions with respect to future actions.

In addition, any "controlling shareholder", any shareholder who knows that it possesses power to determine the outcome of a shareholder vote and any shareholder who, pursuant to the provisions of a company's articles of association, has the power to appoint or prevent the appointment of an office holder in the company is under a duty to act with fairness towards the company. The breach of such duty is governed by Israeli contract laws. The Companies Law does not describe the substance of this duty to act with fairness, but provides that laws applicable to a breach of contract, adjusted according to the circumstances, and taking into account the status within the company of such shareholder, shall apply to a breach of such duty.

The Companies Law requires that specified types of transactions, actions and arrangements be approved as provided for in a company's articles of association and in some circumstances by the audit committee or compensation committee, by the board of directors and by the general meeting of the shareholders.

As stated above, the Israeli legislature, the Knesset, approved Amendment 16 to the Companies Law which came into effect during 2011, Amendment 20 which came into effect at the end of 2012, and Amendment 22 which came into effect at the beginning of 2014 and Amendment 26 which came into effect at the end of 2014. The purposes of these amendments to the Companies Law were to revise and enhance existing provisions governing corporate governance practices of Israeli companies, to regulate executive pay in Israeli publicly traded companies and to revise and enhance existing provisions governing approval of executive compensation. The principal provisions set forth in these amendments to the Companies Law are incorporated into the above discussions of the Company. Additional changes to the Companies Law pursuant to these recently passed amendments include:

- Code of Corporate Governance. Under the Sixteenth Amendment, a code of recommended corporate governance practices has been attached as an annex to the Companies Law. In the explanatory notes to the legislation, the Knesset noted that an "adopt or disclose non-adoption" regulation would be issued by the ISA with respect to such code. As of the date of this Annual Report, the ISA has issued reporting instructions with respect to this code which are applicable only to publicly traded companies whose securities are traded solely on the Tel Aviv Stock Exchange and which report solely to the ISA.

- Fines. The ISA shall be authorized to impose fines on any person or company performing a violation, in connection with a publicly traded company which reports to the ISA, and specifically designated as a violation under the Sixteenth Amendment.

Although we expect to be in compliance with the Companies Law, there is no assurance that we will not be required to adjust our current corporate governance practices, as discussed in this annual report, pursuant to the provisions of the Companies Law, and recently passed amendments to the Companies Law.

#### **The Israeli Securities Law and the Securities Law Amendment**

On February 27, 2011, an amendment to the Israeli Securities Law came into effect (the "**Securities Law Amendment**"), which applies to Israeli public companies, including companies the securities of which are also listed on NASDAQ Global Market. The main purpose of the Securities Law Amendment is creating an administrative enforcement procedure to be used by the ISA to enhance the efficacy of enforcement in the securities market in Israel. The new administrative enforcement procedure may be applied to any company or person (including director, officer or shareholder of a company) performing any of the actions specifically designated as breaches of law under the Securities Law Amendment.

Furthermore, the Securities Law Amendment requires that the chief executive officer of a company supervise and take all reasonable measures to prevent the company or any of its employees from breaching the Israeli Securities Law.

Under the Securities Law Amendment, a company cannot obtain insurance against or indemnify a third party (including its officers and/or employees) for any administrative procedure and/or monetary fine (other than for certain legal expenses and payments of damages to an injured party). The Securities Law Amendment permits insurance and/or indemnification for expenses related to an administrative procedure, such as reasonable legal fees, provided that it is permitted under the company's articles of association. In January 2012 each of our Audit Committee and Board of Directors approved a new form of Indemnification Agreement with our directors and officers serving in such positions from time to time so as to reflect this amendment, subject to approval of our shareholders to the relevant changes required to our Articles. Our shareholders approved these amendments to the Articles and a revised form of Indemnification Agreement for directors serving in such capacity from time to time, at the Annual General Meeting of the Shareholders held on April 11, 2012. As per Amendment 20, it was decided on July 31, 2013, at the Extraordinary General Meeting of the Shareholders to adopt the Executive Compensation Policy of the Company, which had been recommended by our Compensation Committee and approved by our Board of Directors. The Policy was re-approved by our shareholders at the Annual General Meeting which took place on June 8, 2016. Our approved Executive Compensation Policy includes the above referenced form of Indemnification Agreement to be entered into by the Company with our directors and officers serving in such capacities from time to time.

We continue to examine the implications of the Securities Law Amendment and to review all of our internal policies and procedures in order to ensure compliance with all the securities laws to which we are subject; however, its effect and consequences, as well as our scope of exposure, are yet to be entirely determined in practice. There is no assurance that we will not be required to take certain actions in order to enhance our compliance with the provisions of the Securities Law Amendment, such as adopting and implementing an internal enforcement plan as well as additional internal policies and procedures in order to reduce our exposure to potential breaches of the Israeli Securities Law.

#### **NASDAQ Listing Rules and Home Country Practices**

Below is a concise summary of the significant ways in which our corporate practices, which are in accordance with Israeli law and practice, including the provisions of the Companies Law, differ from the requirements which may be applicable to domestic U.S. listed companies:

- Distribution of annual and quarterly reports to shareholders – Under Israeli law we are not required to distribute annual and quarterly reports directly to shareholders and the generally accepted business practice in Israel is not to distribute such reports to shareholders. We do however make our audited financial statements available to our shareholders prior to our annual general meeting and furnish our quarterly and annual financial results with the SEC on Form 6-K.
- Independence, Nomination and Compensation of Directors – A majority of our board of directors may not necessarily be comprised of independent directors as defined in NASDAQ Listing Rule 5605(a)(2). Our board of directors contains two external directors in accordance with the provisions of the Companies Law. Israeli law does not require, nor do our external directors conduct, regularly scheduled meetings at which only they are present. In addition, with the exception of our external directors, our directors are elected to our board of directors in accordance with the new directors voting mechanism approved by our shareholders on the Annual General Meeting which took place on June 8, 2016. According to said directors voting mechanism, directors are divided into three groups, Group A, Group B and Group C. Each group is brought for re-election once every three years, on a rotating basis, such that at each annual general meeting of the shareholders a given group of directors is brought for election, to serve on a continuous basis for a three-year term, until the third annual general meeting following the meeting on which such group was elected for service and until their respective successors are duly elected, at which point their term in office shall expire. At each annual general meeting, the annual general meeting shall be entitled to elect directors to replace the directors whose three-year term in office has expired, and so on ad infinitum, so that each year, the term in office of one group of directors shall expire. The nominations for director which are presented to our shareholders are generally made by our board of directors. One or more shareholders of a company holding at least one percent of the voting power of the company may nominate a currently serving external director for an additional three year term. Israeli law does not require the adoption of, and our board has not adopted, a formal written charter or board resolution addressing the nomination process and related matters. Compensation of our directors and other officers of the Company is determined in accordance with Israeli law.

- *Audit Committee* – Our audit committee does not meet with all the requirements of NASDAQ Listing Rule 5605. We are of the opinion that the members of our audit committee comply with the requirements of NASDAQ Listing Rule 5605(c)(3) and Rule 10A-3(b) of the general rules and regulations promulgated under the Securities Act of 1933 and all requirements under Israeli law. Our audit committee has not adopted a formal written audit committee charter specifying the items enumerated in NASDAQ Listing Rule 5605(c)(1).
- *Compensation Committee* - We follow the provisions of the Companies Law with respect to matters in connection with the composition and responsibilities of our compensation committee, office holder compensation, and any required approval by the shareholders of such compensation. Israeli law, and our amended and restated Articles, do not require that a compensation committee composed solely of independent members of our board of directors determine (or recommend to the board of directors for determination) an executive officer's compensation, as required under NASDAQ's listing standards related to compensation committee independence and responsibilities; nor do they require that the Company adopt and file a compensation committee charter. Instead, our compensation committee has been established and conducts itself in accordance with provisions governing the composition of and the responsibilities of a compensation committee as set forth in the Companies Law. Furthermore, the compensation of office holders is determined and approved by our compensation committee and our board of directors, and in certain circumstances by our shareholders, either in consistency with our previously approved Executive Compensation Policy or, in special circumstances in deviation therefrom, taking into account certain considerations set forth in the Companies Law. The requirements for shareholder approval of any office holder compensation, and the relevant majority or special majority for such approval, are all as set forth in the Companies Law. Thus, we will seek shareholder approval for all corporate actions with respect to office holder compensation requiring such approval under the requirements of the Companies Law, including seeking prior approval of the shareholders for the Executive Compensation Policy and for certain office holder compensation, rather than seeking approval for such corporate actions in accordance with NASDAQ Listing Rules.
- *Quorum* – Under Israeli law a company is entitled to determine in its articles of association the number of shareholders and percentage of holdings required for a quorum at a shareholders meeting. Our Articles provide that a quorum of two or more shareholders, present in person or by proxy, holding shares conferring in the aggregate more than thirty three and a third (33 1/3 %) percent of the voting power of the Company is required for commencement of business at a general meeting.
- *Approval of Related Party Transactions* – All related party transactions are approved in accordance with the requirements and procedures for approval of interested party acts and transactions, set forth in sections 268 to 275 of the Companies Law.
- *Shareholder Approval* – We seek shareholder approval for all corporate action requiring such approval, in accordance with the requirements of the Companies Law.

- Equity Compensation Plans – We do not necessarily seek shareholder approval for the establishment of, and amendments to, stock option or equity compensation plans (as set forth in NASDAQ Listing Rule 5635(c)), as such matters are not subject to shareholder approval under Israeli law. We will attempt to seek shareholder approval for our stock option or equity compensation plans (and the relevant annexes thereto) to the extent required in order to ensure they are tax qualified for our employees in the United States. However, even if such approval is not received, then the stock option or equity compensation plans will continue to be in effect, but the Company will be unable to grant options to its U.S. employees that qualify as Incentive Stock Options for U.S. federal tax purpose. Our stock option or other equity compensation plans are also available to our non-U.S. employees, and provide features necessary to comply with applicable non-U.S. tax laws.

### C. **Material Contracts**

All of our contracts over the past two years have been entered into in the ordinary course of business, except for some of our real property leases.

#### **Fiberblaze Share Purchase Agreement**

On December 10, 2014, we entered into the Fiberblaze SPA with Fiberblaze, Fiberblaze Holding, Hilmer, Jakob Hilmer and Nikolaj Herman (Fiberblaze Holding and Hilmer together, the "**Selling Shareholders**"). Under the Fiberblaze SPA, we purchased all of the share capital of Fiberblaze and Fiberblaze US LLC, a New York company and wholly owned subsidiary of Fiberblaze, for consideration of approximately \$10,000,000 in cash (of which \$3,000,000 was deposited in an escrow account to be distributed in accordance with specific terms or to be released to the Selling Shareholders upon the lapse of 18 months from the date of the Fiberblaze SPA), subject to certain adjustments, as well as additional consideration to be paid upon the attainment of future performance milestones relating to Fiberblaze revenues and achievement of design wins until August 31, 2015 (the "**Additional Consideration**"). Under the terms of the Fiberblaze SPA, ninety percent of the Additional Consideration, which amounted to \$1,460,000, was paid in cash during 2016, and the remaining ten percent was paid by way of a grant of 6,704 options to purchase the Company's ordinary shares with an exercise price equal to the closing trading price of the Company's ordinary shares on the NASDAQ Stock Market on the date of grant.

#### **ADI Engineering Asset Purchase Agreement**

On September 30, 2015, we, together with one of our wholly owned subsidiaries, Silicom Connectivity Solutions, Inc., entered into the ADI APA with ADI, Steve Yates and Patricia Yates. Under the ADI APA, we purchased ADI's assets in consideration for an amount equal to \$10,000,000 in cash at closing, as well as the Excess Consideration to be paid upon the attainment of future performance milestones for each of the years 2015, 2016 and 2017. In April 2016 we paid the Excess Consideration for the attainment of the 2015 performance milestone detailed in the ADI APA, in the amount of \$3,000,000. In 2017 and 2018 we did not pay any Excess Consideration since the respective performance milestones for 2016 and for 2017, respectively, were not attained. For additional information see Note 3A to our consolidated financial statements included elsewhere in this annual report.

Information regarding our real property leases is provided in "Item 4 – Information on the Company – Property, Plant and Equipment" and "Item 19 – Exhibits".



#### **D. Exchange Controls**

Under current Israeli laws and regulations, any dividends or other distributions paid in respect of our ordinary shares purchased by nonresidents of Israel with certain non-Israeli currencies (including U.S. Dollars) and any amounts payable upon the dissolution, liquidation or winding up of our affairs, as well as the proceeds of any sale in Israel of our securities to an Israeli resident, will be freely repatriable in such non-Israeli currencies, provided that Israeli income tax has been paid on (or withheld from) such payments. Because exchange rates between the NIS and the U.S. dollar fluctuate continuously, U.S. shareholders will be subject to any such currency fluctuation during the period from when such dividend is declared through the date payment is made in U.S. Dollars.

There are currently no Israeli currency control restrictions on remittances of dividends on our ordinary shares, proceeds from the sale of the shares or interest or other payments to non-residents of Israel, except under certain circumstances, for shareholders who are subjects of countries that are, or have been, in a state of war with Israel.

#### **E. Taxation**

The following is a summary of some of the current tax law applicable to companies in Israel, with special reference to its effect on us. The following also contains a discussion of specified Israeli tax consequences to our shareholders and government programs from which we benefit. To the extent that the discussion is based on tax legislation (including the legislation passed as part of the recent tax reform in Israel) that has not been subject to judicial or administrative interpretation, there can be no assurance that the views expressed in the discussion will be accepted by the tax authorities or courts.

The discussion is not intended, and should not be construed, as legal or professional tax advice and is not exhaustive of all possible tax considerations.

**Holders of our ordinary shares should consult their own tax advisors as to the United States, Israeli or other tax consequences of the purchase, ownership and disposition of our ordinary shares, or receipt of any dividend distributions made to our shareholders, including, in particular, the effect of any foreign, state or local taxes, including pursuant to the Tax Act (as defined below), and of any taxes withheld at source by the Company.**

#### **General Corporate Tax**

Israeli companies are subject to corporate tax at the rate of 24% as of 2017, and 23% as from 2018. However, the effective tax rate payable by a company which derives income from a "Benefited Enterprise" or from a "Preferred Enterprise" (as further discussed below) may be considerably less.

In 2006, transfer pricing regulations came into force, following the introduction of Section 85A of the Israeli Income Tax Ordinance (New Version), 5721-1961, referred to herein as the Israeli Tax Ordinance, under Amendment 132. In principal, the transfer pricing rules require that cross-border transactions between related parties be carried out implementing an arms' length principle and reported and taxed accordingly.

In 2008, an amendment to the Income Tax Law (Inflationary Adjustments), 1985 was enacted which limits the scope of the law starting in 2008 and thereafter. Starting in 2008, the revenues for tax purposes are measured in nominal values, excluding certain adjustments for changes in the Israeli Consumer Price Index carried out in the period up to December 31, 2007. The amended law includes, among other provisions, the elimination of the inflationary additions and deductions and the additional deduction for depreciation for the period starting in 2008.

## The Encouragement of Capital Investments Law, 1959

Certain of our facilities have been granted "Benefited Enterprise" status under the Encouragement of Capital Investments Law, 1959, (the "**Investment Law**"). In the past, the Investment Law provided that a capital investment in eligible facilities might, under certain circumstances and upon approval of the appointed authority, designated as a "Benefited Enterprise". Each certificate of approval for a "Benefited Enterprise" related to a specific investment program delineated both by its financial scope, including its capital sources and its physical characteristics, for example, the equipment to be purchased and utilized pursuant to the program. The tax benefits derived from any such certificate of approval relate only to taxable income attributable to the specific "Benefited Enterprise".

An amendment to the Investment Law which came into effect as of April 1, 2005 (the "**First Amendment**") has significantly changed the provisions of the Investment Law. The First Amendment determined criteria for the approval of a facility as a "Benefited Enterprise", such as provisions generally requiring that at least 25% of the income of a "Benefited Enterprise" will be derived from exports. Additionally, as explained below, the First Amendment sets forth major changes in the manner in which tax benefits were awarded under the Investment Law whereby companies would no longer require appointed authority's approval (and "Benefited Enterprise" status) in order to qualify for tax benefits. However, the Investment Law provides that terms and benefits included in any certificate of approval already granted will remain subject to the provisions of the Investment Law as in effect on the date of such approval. Therefore, the tax benefits granted to our Benefited Enterprises under the Investment Law prior to the First Amendment, generally were not subject to the provisions of the First Amendment. Many of the requirements under the Investment Law following the First Amendment were amended again in a second amendment to the Investment Law (the "**Second Amendment**"), as will be described below.

### *Tax Benefits Prior to the First Amendment*

In general, taxable income of a company derived from a "Benefited Enterprise" was subject to tax exemption and/or reduced corporate tax (this also applies to Benefited Enterprises approved after the First Amendment, as explained below). The reduced corporate tax rate applies for a period of time termed the "benefit period". The benefit period was a period of seven years commencing with the year in which the "Benefited Enterprise" first generates taxable income. In any event, the benefit period was limited to 12 years from the commencement of production or operation, or 14 years from the year in which the approval was received, whichever is earlier. Under certain circumstances (as further detailed below), the benefit period may have been extended to a maximum of ten years from the commencement of the benefit period. In the event that a company was operating under more than one approval or that only part of its capital investments were approved (a "**Mixed Enterprise**"), its effective corporate tax rate was the result of a weighted combination of the various applicable rates.

Prior to the First Amendment, a company owning a "Benefited Enterprise" approved after April 1, 1986 (or prior thereto provided no government grants or loans had previously been granted regarding such enterprise) was entitled to elect (as we have) to forego certain Government grants extended to Benefited Enterprises in return for an "alternative route" of tax benefits (the "**Alternative Route**"). Under the Alternative Route, a company's undistributed income derived from a "Benefited Enterprise" was exempt from corporate tax for a period of between two and ten years from the first year of taxable income, depending on the geographic location of the "Benefited Enterprise" within Israel, and such company was eligible for the reduced tax rates under the Investment Law for the remainder of the benefit period as mentioned above.

Our production facilities have been granted "Benefited Enterprise" status under the Alternative Route according to the Investment Law. The initial Benefited Enterprise status was granted in 1988 ("**Initial Benefited Enterprise**"). An extension program was granted "Benefited Enterprise" status in 1995 (the "**Extended Benefited Enterprise**"). Income derived from our Benefited Enterprises is tax exempt during six years of the seven year tax benefit period and is subject to a reduced tax rate of 25% in the seventh year. The seven year period of benefits commences in the year the "Benefited Enterprise" first earns taxable income but is limited to twelve years from commencement of production or fourteen years from date of approval, whichever is earlier. The period of tax benefits, relating to our Initial Benefited Enterprise, commenced in 1991 and expired in 1997. The period of tax benefits relating to our Extended Benefited Enterprise commenced in 1997 and expired in 2006, as explained below.

In June 1995, we reached an agreement with the tax authorities regarding our entitlement to benefits under the Investment Law. The agreement, effective from tax year 1994 and thereafter, relates to the method of determination of taxable income from our research and development activities. Pursuant to the agreement, for the purpose of determining our tax liability, our income will be allocated to our manufacturing plant and to our research and development center, according to a formula based on the net costs plus royalties of the research and development center and our profitability. Income allocated to the expansion of the manufacturing plant will benefit from a ten-year tax exemption, while income allocated to the research and development center will benefit from a two-year exemption, and for a five-year period immediately following will be taxed at a 25% rate.

Our income to be attributed to our Extended Benefited Enterprise in any year will be computed as a ratio of the increase in our sales turnover, if any, in that year to our turnover in the year before the Extended Benefited Enterprise commenced its tax benefits entitlement. The tax authorities have reserved their right to reconsider our claim to such tax benefits in future years.

The entitlement to the above benefits is conditional upon our fulfillment of the conditions stipulated by the law, regulations published thereunder and the instruments of approval for the specific investments in the "Benefited Enterprise". In the event of failure to comply with these conditions, the benefits may be canceled and we may be required to refund the amount of the benefits, in whole or in part, with the addition of linkage differences, interest and penalties. Should we derive income from sources other than the "Benefited Enterprise" during the relevant periods of benefits, such income will be taxable at regular corporate tax rates stated above.

A company that elected the Alternative Route prior to the First Amendment and that subsequently paid a dividend out of tax exempted income derived from the Benefited Enterprise(s) will be subject to Company Tax in the year the dividend is distributed in respect of the amount distributed (including the corporate tax thereon), at the rate that would have been applicable had the company not elected the Alternative Route. In addition, the dividend recipient is taxed at the rate applicable to dividends from Benefited Enterprises, if the dividend is distributed during the tax exemption period or within a specified period thereafter (in the event, however, that the company qualified as a Foreign Investors' Company, there was no such time limitation).

Subject to certain provisions concerning income subject to the Alternative Route, all dividends are considered to be attributable to the entire enterprise and the effective tax rate is the result of a weighted combination of the various applicable tax rates. Under the Investment Law, a company that has elected the alternative package of benefits was not required to distribute exempt retained profits, and may generally decide from which year's profits to declare dividends.

The Investment Law also provided that a "Benefited Enterprise" was entitled to accelerated depreciation on its property and equipment that were included in an approved investment program. We have not utilized this benefit.

Grants and certain other incentives received by a company in accordance with the Investment Law remained subject to final ratification by the appointed authority and final determination by the Israeli Tax Authority. Such ratification and determination were conditional upon fulfillment of all of the terms of the approved program.

#### *Tax Benefits under the First Amendment*

As a result of the First Amendment, a company was no longer required to acquire "Benefited Enterprise" status in order to receive the tax benefits previously available under the Alternative Route and therefore such companies did not need to apply to the appointed authority for this purpose.

Tax benefits were available under the First Amendment to production facilities and other eligible facilities, which were generally required to derive more than 25% of their business income from exports. In order to receive the tax benefits, the First Amendment stated that the company must make an investment in the "Benefited Enterprise" exceeding a minimum amount specified in the Investment Law. Such investment could have been made over a period of no more than three years, such period concluding at the end of the year in which the company requested to have the tax benefits apply to its "Benefited Enterprise" (the "Year of Election"). Where the company requested to have the tax benefits apply to an expansion of existing facilities, only the expansion was considered a "Benefited Enterprise" and the company's effective tax rate was the result of a weighted combination of the applicable rates. In the case of an expansion of existing facilities, the minimum investment required in order to qualify as a "Benefited Enterprise" was determined as a certain percentage of the company's production assets before the expansion and in any case was not less than a minimum amount specified in the Investment Law.

The tax benefits which were available under the First Amendment to qualifying income of a "Benefited Enterprise" were determined by the geographic location of the "Benefited Enterprise" in Israel. The Investment Law divides the country into three zones – A, B and C, so that a "Benefited Enterprise" operating in Zone A (which generally includes areas remote from the center of Israel) received the greatest benefits and Benefited Enterprises in Zone C received the least benefits.

The First Amendment provided that a company producing income from a "Benefited Enterprise" in Zone A could have elected either that (i) the undistributed income derived from the "Benefited Enterprise" will be fully tax exempt for the entire benefit period described below (the "Tax Exemption"), in which case the ordinary provisions described below concerning the taxation of the company and shareholder for distribution of dividends will apply; or (ii) that the income from its "Benefited Enterprise" will be subject to corporate tax at a rate of 11.5%, in which case dividends paid out of such income to a foreign resident will be taxed at a rate of 4% and to an Israeli resident will be taxed at a rate of 20%, and the company will not be subject to additional tax upon dividend distribution. Further benefits were available in the event of certain large investments by multinational companies. Benefited Enterprises located in Zones B and C was exempt from tax for six and two years, respectively, and subject to tax at a rate of 10%-25% for the remainder of the benefit period, depending on the extent of foreign investment in the Company, as described above.

Dividends paid out of income derived by a "Benefited Enterprise", or out of dividends received from a company whose income was derived from a "Benefited Enterprise", were generally subject to withholding tax at the rate of 15% (or 20% if the Year of Election is 2014 onwards) or less under certain anti double-taxation treaties, such tax being deductible at source. The reduced withholding tax rate of 20% was limited to dividends and distributions out of income derived during the benefit period and actually paid at any time up to 12 years thereafter. A company qualified for tax benefits under the First Amendment which paid a dividend out of income derived by its "Benefited Enterprise" during the Tax Exemption period will be subject to corporate tax in respect of the gross amount of the dividend. The rate of the tax was the rate which would have been applicable had the company not been tax exempt. Such tax rate was lower in the case of a qualified "Foreign Investors' Company".

The period for which tax benefits were available under the First Amendment was also determined by the geographical location of the "Benefited Enterprise" in Israel. The benefit period for Benefited Enterprises in Zone A ended on the earlier of (i) a period of ten years from the tax year in which the company first derived taxable income from the "Benefited Enterprise" (the "**Commencement Year**"); or (ii) twelve years (or in certain cases fourteen years) from the first day of the Year of Election. The benefit period for Benefited Enterprises in Zones B and C was extended until the earlier of (i) seven years from the Commencement Year or (ii) 12 years from the first day of the Year of Election. This period could have been extended for Benefited Enterprises owned by a "Foreign Investors' Company" during all or part of the benefit period.

Additionally, the First Amendment sets forth a minimal amount of foreign investment required for a company to be regarded a "Foreign Investors' Company".

We have selected the 2004 tax year, the 2006 tax year, the 2009 tax year and the 2012 tax year to be our Year of Election, from which the period of benefits under the Investment Law commenced.

There can be no assurance that we will attain additional tax benefits as a Benefited Enterprises in the future.

#### *The Second Amendment to the Investment Law*

The Israeli legislature approved significant changes to the Investment Law, which revamped the tax incentive regime in Israel and which became effective as of January 6, 2011. The main changes enacted under the Second Amendment are, inter alia, as follows:

- Replacement of all future tax incentives under the existing law as amended by the First Amendment; as a result, commencing 2011, industrial companies that meet the conditions set out by the Second Amendment will no longer be entitled to the existing tax incentives provided under the First Amendment, such as the exemption from tax on undistributed profits and a reduced tax rate thereafter, but rather to the tax incentives under the Second Amendment;

- Under the transition provisions, any tax benefits obtained prior to 2011 shall continue to apply until expired, unless the company elects to apply the provisions of the Second Amendment to its income; and
- Pursuant to the second Amendment, a "Preferred Enterprise" is entitled to a reduced corporate flat tax rate of 15% with respect to its preferred income derived by its "Preferred Enterprise" in 2011-2012, unless the "Preferred Enterprise" is located in a certain development zone, in which case the rate will be 10%. Such corporate tax rates are 12.5% and 7% with respect to 2013, 16% and 9% with respect to 2014, 16% and 9% with respect to 2015-2016 and 16% and 7.5% with respect to 2017 and thereafter. Income derived by a Preferred Company from a 'Special Preferred Enterprise' (as such term is defined in the Investment Law) would be entitled, during a benefits period of 10 years, to further reduced tax rates of 8%, or to 5% if the "Special Preferred Enterprise" is located in a certain development zone. Under the Second Amendment, the tax incentives offered by the Investment Law are no longer dependent neither on minimum qualified investments nor on foreign ownership. Companies will be able to enjoy both government grants and tax benefits concurrently. Governmental grants will not necessarily be dependent on the extent of enterprise's investment in assets and/or equipment. Commencing 2011, the approval of "Preferred Enterprise" status by either the Israeli Tax Authorities or the appointed authority will be accepted by the other. Therefore a "Preferred Enterprise" will be eligible to receive both tax incentives and government grants, under certain conditions.

**"Preferred Income"** is defined as income from the sale of products of the "Preferred Enterprise" (including components that were produced by other enterprises); income from the sale of semiconductors by other non-related enterprises which use the Preferred Enterprise's self-developed know-how; income for providing a right to use the Preferred Enterprise's know-how or software; royalties from the use of the know-how or software which was confirmed by the Head of The appointed authority to be related to the production activity of the "Preferred Enterprise" and services with respect to the aforementioned sales. In addition, the definition of "Preferred Income" also includes income from the provision of industrial R&D services to foreign residents to the extent that the services were approved by the Head of Research for the Industrial Development and Administration.

**"Preferred Enterprise"** is defined as an Industrial Enterprise (including, inter alia, an enterprise which develops software, an enterprise which provides approved R&D services to foreign residents and an enterprise which the Chief Scientist confirmed is carrying out R&D in the field of alternative energy), which generally more than 25% of its business income is from export to market consisting more than 14 million residents. As mentioned above, the new tax incentives no longer depend on minimum qualified investments nor on foreign ownership.

Chapter B2 of the Investment Law determines the conditions and limitations applying to the tax benefits offered to a "Special Preferred Enterprise". Chapter B2 determines that a "Special Preferred Enterprise" is entitled to benefited corporate income tax rate: of 5% if located in a preferred zone and 8% if not.

"**Special Preferred Enterprise**" is defined following the Second Amendment as a "Preferred Enterprise" which meets one of the following conditions: (a) its Preferred Income is equal to or exceeds NIS 1 billion; (b) the total income of the company which owns the "Preferred Enterprise" or which operates in the same field of the "Preferred Enterprise" and which consolidates in its financial reports the company that owns the "Preferred Enterprise" equals or exceeds NIS 10 billion; and (c) its business plan was approved by the authorities as significantly benefitting the Israeli economy, either by an investment of at least NIS 400 - 800 million in assets; Annual growth of 100 - 150 million NIS in R&D (or half of this amount if the average annual R&D is above NIS 500 million) compared to the average R&D in the three tax years prior to the year of approval; or the employment of at least 250 to 500 new employees, for preferred zones and regular zones, respectively.

Dividends paid out of income attributed to a "Preferred Enterprise" are generally subject to withholding tax at source at a rate of 20% (15% until 2014) or such lower rate as may be provided in an applicable tax treaty, subject to the submission and approval of a request submitted on behalf of the recipient of such dividends to the Israel Tax Authority. However, if such dividends are paid to an Israeli company no tax will be withheld. Such an exemption may apply under the transition rules also to dividends distributed to an Israeli company by an Israeli company which owns a "Benefited Enterprise" or a "Benefited Enterprise" and which elected to convert to the new law until June 30, 2015 (in respect to their existing programs).

The Company elected in 2014 to apply the provisions of the Second Amendment to the Investment Law to its income commencing with the 2014 fiscal year. Thus, as from the 2014 fiscal year, we are no longer entitled to the existing tax incentives provided under the First Amendment, such as the exemption from tax on undistributed profits and a reduced tax rate thereafter, but rather to the tax incentives under the Second Amendment.

There can be no assurance that we will comply with the conditions of the Investment Law in the future or that we will be entitled to any additional benefits under the amended Investment Law and whether the influence of the changes to the Investment Law will be beneficial to the Company or not.

#### **Law for the Encouragement of Industrial Research and Development, 1984**

Under the terms of the pre-R&D Amendment regime, research and development programs approved by the Research Committee (the "**Research Committee**") of the OCS were eligible for grants or loans if they met certain criteria, in return for the payment of royalties from the sale of the product developed in accordance with the program and subject to other restrictions. Once a project was approved, the OCS would award grants of up to 50% of the project's expenditures in return for royalties, usually at the rate of 3% to 5% of sales of products developed with such grants. For projects approved after January 1, 1999, the amount of royalties payable is up to a dollar-linked amount equal to 100% of such grants plus interest at LIBOR.

The terms of these grants prohibited the manufacture outside of Israel of the product developed in accordance with the program without the prior consent of the Research Committee of the OCS. Such approval, if granted, was generally subject to an increase in the total amount to be repaid to the OCS to between 120% and 300% of the amount granted, depending on the extent of the manufacturing to be conducted outside of Israel.

The R&D Law, as in effect prior to the R&D Amendment, also provided that know-how from the research and development, which is used to produce the product, may not be transferred to Israeli third parties without the approval of the Research Committee. Until 2005, the Research Law stated that such know-how may not be transferred to non-Israeli third parties at all. An amendment to the Research Law set forth certain exceptions to this rule; however, the practical implications of such exceptions were quite limited. The R&D Law, as in effect prior to the R&D Amendment, stressed that it is not just transfer of know-how that is prohibited, but also transfer of any rights in such know-how. Such restriction did not apply to exports from Israel of final products developed with such technologies. It was possible to receive approval of the transfer only if the transferee undertook to abide by all of the provisions of the R&D Law and regulations promulgated thereunder, including the restrictions on the transfer of know-how and the obligation to pay royalties. There could be no assurance that such consent, if requested, would be granted or, if granted, that such consent would be on reasonable commercial terms. For additional information regarding the R&D Law and R&D Amendment, see "Item 4.B. – Information on the Company – Business Overview – Governmental Regulation Affecting the Company".

#### *Tax Benefits for Research and Development*

Israeli tax law allows, under certain conditions, a tax deduction in the year incurred for expenditures (including capital expenditures) in scientific research and development projects, if the expenditures are approved by the relevant Israeli Government Ministry (determined by the field of research) and the research and development is for the promotion of the enterprise and is carried out by or on behalf of the company seeking such deduction. Such expenditures not so approved are required to be deducted over a three-year period. Though we received such approvals for the years 2006, 2007 and 2008 and could deduct the expenditures in the year the expenditures were incurred, we chose to deduct the expenditures over a three-year period. We also received such approvals for the years 2009, 2010, 2011 and 2012 and deducted such expenditures in the year the expenditures were incurred.

#### **Law for the Encouragement of Industry (Taxes), 1969**

Under the Law for the Encouragement of Industry (Taxes), 1969 (the "**Industry Encouragement Law**"), Industrial Companies (as defined below) are entitled to the following tax benefits:

- (a) Amortization of expenses incurred in connection with certain public securities issuances over a three-year period; and
- (b) Accelerated depreciation rates on know-how, patents and/or right to use a patent or certain other intangible property rights.

Eligibility for benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. Under the Industry Encouragement Law, an "Industrial Company" is defined as a company resident in Israel, at least 90% of the income of which, in any tax year, determined in Israeli currency, exclusive of income from government loans, is derived from an "Industrial Enterprise" owned by it. An "Industrial Enterprise" is defined as an enterprise whose major activity in a given tax year is industrial production activity.



We believe that we currently qualify as an "Industrial Company" within the definition of the Industry Encouragement Law. No assurance can be given that we will continue to qualify as an "Industrial Company" or that the benefits described above will be available in the future.

#### **Calculation of Results for Tax Purposes**

The Israeli Income Tax Regulations (Rules for Maintaining Accounting Records of Foreign Investors' Companies and Certain Partnerships and Determining Their Taxable Income), 1986 provide that as a "Foreign Investors' Company" (as defined in the Investment Law described above) is eligible to calculate its taxable income in accordance with these regulations, and therefore, if we elect to follow such regulations, our taxable income or loss is to be calculated in Dollars. We have elected to apply these regulations and accordingly our taxable income or loss is calculated in Dollars in the manner set forth in such regulations.

#### **Taxation of our Shareholders**

##### *Capital Gains Taxes Applicable to Israeli Resident Shareholders.*

In general, an individual is subject to a 25% tax rate on real capital gains derived from the sale of shares, as long as the individual is not a "substantial shareholder" in the company issuing the shares. A "substantial shareholder" is generally a person who alone, or together with his relative or another person who collaborates with him on a permanent basis, holds, directly or indirectly, at least 10% of any of the "Means of control" of the corporation. "Means of control" generally include the right to vote, receive profits, nominate a director or an officer, receive assets upon liquidation, or order someone who holds any of the aforesaid rights how to act, and all regardless of the source of such right.

A "substantial shareholder" will be subject to tax at a rate of 30% in respect of real capital gains derived from the sale of shares issued by a company in which he or she is a "substantial shareholder". The determination of whether the individual is a "substantial shareholder" will be made on the date on which the securities are sold. In addition, the individual will be deemed to be a "substantial shareholder" if at any time during the 12 months preceding the date of sale, he or she was a "substantial shareholder".

##### *Capital Gains Taxes Applicable to Non-Israeli Resident Shareholders.*

Shareholders that are not Israeli residents are generally exempt from Israeli capital gains tax on any gains derived from the sale, exchange or disposition of our shares, provided that such shareholders did not acquire their shares prior to our initial public offering on the TASE and such gains were not derived from a permanent establishment or business activity of such shareholders in Israel. However, non-Israeli corporations will not be entitled to the foregoing exemptions if an Israeli resident(s) (i) have a controlling interest of 25% or more in such non-Israeli corporation; or (ii) are the beneficiaries of or are entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

In addition, under the U.S.-Israel Income Tax Treaty, 1995, or the U.S.-Israel Tax Treaty, the sale, exchange or disposition of our shares by a shareholder who is a U.S. resident (for purposes of the U.S.-Israel Tax Treaty) holding the shares as a capital asset is exempt from Israeli capital gains tax unless either (i) the shareholder holds, directly or indirectly, shares representing 10% or more of our voting capital during any part of the 12-month period preceding such sale, exchange or disposition; or (ii) the capital gains arising from such sale are attributable to a permanent establishment of the shareholder located in Israel; or (iii) the shareholder, being an individual, was present in Israel for a period of time or several periods of time, which aggregate to a total of 183 days or more, during a single taxable year. In either case, the sale, exchange or disposition of the shares would be subject to Israeli tax, to the extent applicable; however, under the U.S.-Israel Tax Treaty, the U.S. resident would be permitted to claim a credit for the tax against the U.S. federal income tax imposed with respect to the sale, exchange or disposition, subject to the limitations in U.S. laws applicable to foreign tax credits. The U.S.-Israel Tax Treaty does not relate to U.S. state or local taxes.

Shareholders may be required to demonstrate that they are exempt from tax on their capital gains in order to avoid withholding of tax at source at the time of sale.

*Taxation of Israeli Shareholders on Receipt of Dividends.*

Residents of Israel who are individuals are generally subject to Israeli income tax on the receipt of dividends paid on our shares at the rate of 25%, which tax will be withheld at the source. With respect to a person who is a "substantial shareholder" at the time of receiving the dividend or on any date within the 12 months preceding such date, the applicable tax rate is 30%.

Israeli resident corporations are generally exempt from Israeli tax for dividends paid on our shares.

In case of dividends paid out of the profits of a "Preferred Enterprise", the applicable tax rate is 20% for an individual and 0% for a corporation.

*Taxation of Non-Israeli Shareholders on Receipt of Dividends.*

Non-residents of Israel are generally subject to Israeli income tax on the receipt of dividends paid on our shares at the rate of 25% or 30%, if such person (including a non-Israeli corporation) is a "substantial shareholder" at the time of receipt of the dividend or on any date in the 12 months preceding such date, which tax will be withheld at the source, unless a different rate is provided in a tax treaty between Israel and the shareholder's country of residence. Under the U.S.-Israel Tax Treaty, the maximum rate of tax withheld in Israel on dividends paid to a holder of our ordinary shares who is a U.S. resident (for purposes of the U.S.-Israel Tax Treaty) is 25% or 15% in the case of dividends paid out of the profits of a "Benefited Enterprise" (as such term is defined in the Investment Law), subject to certain conditions. However, generally, the maximum rate of withholding tax on dividends that are paid to a U.S. corporation holding 10% or more of our outstanding voting capital throughout the tax year in which the dividend is distributed as well as the previous tax year and the dividend is not paid from the profits of a "Benefited Enterprise", the Israeli tax withheld may not exceed 12.5%, subject to certain conditions. A non-resident of Israel who receives dividends from which tax was withheld is generally exempt from the duty to file returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer, and the taxpayer has no other taxable sources of income in Israel.

In case of dividends paid out of the profits of a "Preferred Enterprise", the applicable tax rate is 20%.

Residents of the United States will generally have taxes in Israel withheld at source.

The following data regarding the calculation of the tax rate withheld at source with regards to the distribution of dividends on April 17, 2013, April 17, 2014, April 21, 2015, April 14, 2016, and April 5, 2017, is hereby provided

Source	% of Dividend	Individual Tax %	Corporations Tax %	Foreign Resident Tax%
<b>Dividend Distributed on April 17, 2013</b>				
Regular Income	34.6031	25	0	25
Benefited Enterprise	65.3969	15	15	15
<b>Dividend Distributed on April 17, 2014</b>				
Regular Income	52.9928	25	0	25
Benefited Enterprise	47.0071	15	15	15
<b>Dividend Distributed on April 21, 2015</b>				
Regular Income	5.5888	25	0	25
Benefited Enterprise	12.7771	15	0	15
Preferred Enterprise	81.6341	20	0	20
<b>Dividend Distributed on April 14, 2016</b>				
Regular Income	0	25	0	25
Preferred Enterprise	100.0000	20	0	20
<b>Dividend Distributed on April 5, 2017</b>				
Regular Income	0	25	0	25
Preferred Enterprise	100.0000	20	0	20

With regards to the distribution of dividend dated April 17, 2013, the weighted tax for individuals was 18.46031%, for corporations 9.80954%, and for foreign residents 18.46031%. With regards to the distribution of dividend dated April 17, 2014, the weighted tax for individuals was 20.29928%, for corporations 7.05108%, and for foreign residents 20.29928%. With regards to the distribution of dividend dated April 21, 2015, the weighted tax for individuals was 19.64059%, for corporations 0.00000%, and for foreign residents 19.64059%. With regards to the distribution of dividend dated April 14, 2016, the weighted tax for individuals was 20.00000%, for corporations 0.00000%, and for foreign residents 20.00000%. With regards to the distribution of dividend dated April 5, 2017, the weighted tax for individuals was 20.00000%, for corporations 0.00000%, and for foreign residents 20.00000%.

The above noted dividend distributions with respect to the fiscal years 2013, 2014, 2015, 2016 and 2017 are each from income sources which would not generate additional tax liability to the Company as a result of such distributions. We anticipate that any future dividends distributed pursuant to our previously announced dividend policy, will likewise be distributed from income sources which will not impose additional tax liabilities on us.

#### *Excess Tax.*

Individuals who are subject to tax in Israel are also subject to an additional tax at a rate of 3% in 2017 and thereafter (2% in 2016) on annual income exceeding a certain threshold (NIS 641,880 as of 2018, NIS 640,000 as of 2017 and NIS 803,520 as of 2016), including, but not limited to, dividends, interest and capital gains.

#### **Passive Foreign Investment Company Status under U.S. Federal Income Tax Law**

In general, a non-U.S. corporation will be classified for U.S. tax purposes as a passive foreign investment company (hereafter also referred to as a "PFIC") in any taxable year in which either (i) 75% or more of its gross income (including the pro-rata gross income of any company (U.S. or foreign) in which it is considered to own 25% or more of the ordinary shares by value) for the taxable year is passive income, or (ii) at least 50% of the average value of all of its gross assets (including the pro-rata fair market value of the assets of any company in which it is considered to own 25% or more of the ordinary shares by value) during the taxable year, calculated quarterly by value, produce, or are held for the production of, passive income. Passive income for these purposes includes items such as dividends, interest, royalties, rents and gains from commodities and securities transactions.

**If we are classified as a passive foreign investment company, highly complex rules will apply to our U.S. shareholders. Accordingly, U.S. shareholders are urged to consult their tax advisors regarding the application of such rules.**

If a corporation is a passive foreign investment company, a U.S. shareholder will be subject to one of three alternative taxing regimes:

The simplest is the "QEF" regime. If the shareholder elects to treat the PFIC as a QEF, then each year the shareholder includes in its gross income a proportionate share of the PFIC's ordinary income and net capital gain. We do not currently intend to prepare or provide the information that would enable you to make a Qualified Election Fund election. A second regime may be elected if the PFIC stock is "marketable". The U.S. shareholder may elect to "mark the stock to market" each year. At the end of each taxable year, the shareholder recognizes gain equal to the excess of the fair market value of the PFIC stock over the shareholder's tax basis in the stock. Losses may also be recognized to the extent of previously recognized gains.

A U.S. shareholder making neither of these elections is subject to the "excess distribution" regime. The tax is triggered when the shareholder receives an "excess distribution" from the PFIC. An "excess distribution" is either (1) a distribution with respect to stock that is greater than 125% of the average of such distributions over the preceding three years, or (2) 100% of the gain from the disposition of shares in the PFIC.

An "excess distribution" is subject to special tax rules. In most cases, only a portion of it is included in the gross income of the U.S. shareholder and taxed at normal rates. The remainder is never so included, but is used as the basis for calculating a "deferred tax amount", which is simply added to the shareholder's tax liability.

The deferred tax amount is computed as follows. The "excess distribution" is first ratably allocated, share by share, to each day of the shareholder's holding period. Portions allocated to the current year, and to any pre-PFIC years (that is, years before 1987, when there were no PFICs, or years before the first year in which the company was a PFIC with respect to that shareholder), are included in ordinary income for the current year. Portions allocated to prior PFIC years are hypothetically taxed at the highest marginal rate in effect for those years (without regard to the shareholder's actual rate or to any deductions or credits for those years). To this hypothetical tax is added the interest that the shareholder would have paid if it were simply paying that tax late for that year. The sum of the tax and the interest charge is the deferred tax amount, which cannot be offset or otherwise affected by current net operating losses or other deductions.

A U.S. person who inherits shares in a foreign corporation that was a PFIC in the hands of the decedent (who did not make either of the elections described above), is denied the otherwise available step-up in the tax basis of such shares to fair market value at the date of death. The U.S. person steps into the shoes of the decedent and will be subject to the rules described above.

Although a determination as to a corporation's PFIC status is made annually, an initial determination that a corporation is a PFIC for any taxable year generally will cause the above-described consequences to apply for all future years as to U.S. shareholders who held shares in the corporation at any time during the PFIC taxable year and who made neither a valid QEF election with respect to such shares nor a valid election to mark such shares to market. This will be true even if the corporation loses its PFIC status in later years. However, with respect to a PFIC that does not make any distributions or deemed distributions, the above tax treatment would apply only to gains realized on the disposition of such shares by a U.S. shareholder.

If we are classified as a PFIC, complicated rules will apply to our U.S. shareholders. Our status in future years will depend on our assets and activities in those years, although shareholders will be treated as continuing to own an interest in a passive foreign investment company if we are a passive foreign investment company in any year in which a shareholder owns our shares, unless certain elections are made.

This discussion does not address all aspects of U.S. federal income taxation that may be relevant to a U.S. shareholder in light of his or her particular circumstances or to a U.S. shareholder subject to special treatment under U.S. federal income tax law. We do not currently intend to prepare or provide the information that would enable you to make a Qualified Election Fund election. U.S. shareholders are urged to consult their tax advisors about the U.S. federal income taxation rules to which they will be subject, as well as the PFIC rules, including the advisability, procedure and timing of making a mark-to-market election, in connection with their holding of our shares, including warrants or rights to acquire our shares.

## **Certain Reporting Requirements**

Certain U.S. investors are required to file IRS Form 926, Return by U.S. Transferor of Property to a Foreign Corporation, and certain U.S. Investors may be required to file IRS Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, reporting transfers of cash or other property to us and information relating to the U.S. investor and us. Substantial penalties may be imposed upon a U.S. investor that fails to comply. Each U.S. investor should consult its own tax advisor regarding these requirements.

In addition, recently enacted legislation imposes new reporting requirements for the holder of certain foreign financial assets, including equity of foreign entities, if the aggregate value of all of these assets exceeds certain thresholds. Our shares are expected to be subject to these new reporting requirements unless the shares are held in an account at a domestic financial institution. Penalties may apply to any failure to comply with such reporting requirements. U.S. investors should consult their own tax advisors regarding the application of this legislation.

## **Backup Withholding Tax and Information Reporting Requirements**

Generally, information reporting requirements will apply to distributions with respect to our shares or proceeds on the disposition of our shares paid within the United States (and, in certain cases, outside the United States) to U.S. investors other than certain exempt recipients, such as corporations. Furthermore, backup withholding (currently at 28%) may apply to such amounts if the U.S. investor fails to (i) provide a correct taxpayer identification number, (ii) report interest and dividends required to be shown on its U.S. federal income tax return, or (iii) make other appropriate certifications in the required manner. U.S. investors who are required to establish their exempt status generally must provide such certification on IRS Form W-9.

Backup withholding is not an additional tax. Amounts withheld as backup withholding from a payment may be credited against a U.S. investor's U.S. federal income tax liability and such U.S. investor may obtain a refund of any excess amounts withheld by filing the appropriate claim for refund with the IRS and furnishing any required information in a timely manner.

## **Tax Assessment**

The company and its subsidiaries file income tax returns in Israel, U.S.A and Denmark.

The Israeli tax returns of the Company are open for examination by the Israeli Tax Authority for tax years beginning in 2013.

The Federal tax returns of our U.S. subsidiary are open for examination by the Federal Tax Authorities for tax years beginning in 2014. The New Jersey state tax returns of the U.S. subsidiary are open to examination by the New Jersey State Tax Authority for the tax years beginning in 2013. The California State Tax returns of the U.S. subsidiary are open to examination by the California State Tax Authority for tax years beginning in 2013. The Virginia State Tax returns of the U.S. subsidiary are open to examination by the Virginia State Tax Authority for tax periods beginning in 2015. The Tennessee State Tax returns of the U.S. subsidiary are open for examination by the Tennessee State Tax Authority for tax years beginning in 2016. The New Mexico, New York and Texas State Tax returns of the U.S. subsidiary are open for examination by the respective jurisdiction tax authorities for tax years beginning in 2017.

The Danish tax returns of our Danish subsidiary are open for examination by the Danish Tax Authority for tax years beginning on September 1, 2013.

The Federal tax returns, New York State tax returns and New York City tax returns of Fiberblaze US LLC, our U.S. granddaughter company which was voluntarily liquidated in August 2017, are open for examination by the Federal, New York State and New York City Tax Authorities, respectively, for tax years beginning on September 1, 2014.

#### **Tax Cuts and Jobs Act**

On December 22, 2017, President Trump signed into law H.R. 1, originally known as the "Tax Cuts and Jobs Act" (the "**Tax Act**") which reformed the Internal Revenue Code of 1986, as amended. The Tax Act instituted fundamental changes to the US tax system. The Tax Act also permanently reduces the corporate income tax rate to 21% effective as of January 1, 2018, which will impact us by reduction of the corporate income tax rate of our US subsidiary to 21% effective January 1, 2018.

#### **F. Dividends and Paying Agents**

Not applicable

#### **G. Statement by experts**

Not applicable

#### **H. Documents on Display**

We are required to file reports and other information with the SEC under the Securities Exchange Act of 1934 (the "**Exchange Act**") and the regulations thereunder applicable to foreign private issuers. Although as a foreign private issuer we are not required to file periodic information as frequently or as promptly as United States companies, we generally do publicly announce our quarterly and year-end results promptly and file periodic information with the SEC under cover of Form 6-K. We are also exempt from the rules under the Exchange Act prescribing the furnishing and content of proxy statements and our officers, directors and principal shareholders are exempt from the reporting and other provisions in Section 16 of the Exchange Act.

You may review a copy of our filings with the SEC, including any exhibits and schedules, at the SEC's public reference room at 100 F Street N.E., Washington, D.C. 20549. You may call the SEC at 1-800-SEC-0330 for further information on the public reference room. As a foreign private issuer, all documents which were filed after November 4, 2002 on the SEC's EDGAR system will be available for retrieval on the SEC's website at [www.sec.gov](http://www.sec.gov). These SEC filings are also available to the public on (i) the ISA's Magna website at [www.magna.isa.gov.il](http://www.magna.isa.gov.il), (ii) the Tel Aviv Stock Exchange website at <http://www.maya.tase.co.il>, and (iii) from commercial document retrieval services. The documents referred to in this document may be inspected at the Company's offices, located at 14 Atir Yeda Street, Kfar Sava, Israel 4464323.

Any statement in this annual report about any of our contracts or other documents is not necessarily complete. If the contract or document is filed as an exhibit to the annual report the contract or document is deemed to modify the description contained in this annual report. We urge you to review the exhibits themselves for a complete description of the contract or document.

Our website is <http://www.silicom.co.il>. We do not intend for any information contained on our internet website to be considered part of this annual report, and we have included our website address in this annual report solely as an inactive textual reference. We will post on our website any materials required to be posted on such website under applicable corporate or securities laws and regulations, including posting any XBRL interactive financial data required to be filed with the SEC, and any notices of general meetings of our shareholders.

#### **I. Subsidiary information**

Not applicable

#### **Item 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the risk of loss related to changes in market prices, including interest rates and foreign exchange rates, of financial instruments that may adversely impact our consolidated financial position, results of operations or cash flows. Our primary market risk exposures relate to our investment portfolio and fluctuation of the exchange rate of the US Dollar, which is the primary currency in which we conduct our operations, against the NIS with respect to the Company's Israeli operations, and against the DKK and Euro with respect to Danish operations.

##### **Interest Rate Risk**

As of December 31, 2017, our investment portfolio consisted of approximately \$13.7 million invested in corporate debt securities. These securities are classified as "held to maturity". All of the Company's investments are in fixed-rate instruments. In addition, since the securities are "held to maturity", any changes in fair value of the Company's instruments due to fluctuations in the interest rates, that are not classified as other-than-temporary impairment (OTTI), do not affect the Company's profit or loss.

For quantitative information on the Company's marketable securities, please see Note 5 to our consolidated financial statements included elsewhere in this annual report.

As of December 31, 2017, we did not have any short or long term interest bearing loans or debts, hence with respect to the Company's business operations, we do not have any exposure to interest rate risk.

##### **Foreign Currency Exchange Risk**

Most of our revenues are generated in U.S. Dollars. In addition, most of our costs are denominated and determined in U.S. Dollars and NIS. According to the salient economic factors indicated in ASC 830 "Foreign Currency Matters" (formerly SFAS No. 52), "Foreign Currency Translation", our cash flow, sale price, sales market, expense, financing and inter-company transactions, and arrangement indicators, are predominantly denominated in U.S. Dollars, and so, the U.S. dollar is the primary currency of the economic environment in which we operate. Thus, the U.S. dollar is our functional and reporting currency. In our balance sheet, we re-measure into U.S. Dollars all monetary accounts (principally cash and cash equivalents and liabilities) that are maintained in other currencies. For this re-measurement, we use the relevant foreign exchange rate at the balance sheet date. Any gain or loss that results from this re-measurement is reflected in the statement of operations as appropriate. We measure and record non-monetary accounts in our balance sheet in U.S. Dollars. For this measurement, we use the U.S. dollar value in effect at the date that the asset or liability was initially recorded in our balance sheet (the date of the transaction).



As of December 31, 2017 we had accounts receivable in NIS or in funds linked thereto in the amount of \$6,429 thousand. Market risk was estimated as the potential decrease in balance resulting from a hypothetical 10% increase in the year-end Dollar exchange rate. Assuming such increase in the Dollar exchange rate, the balance of our accounts receivable would decrease by \$584 thousand. As of December 31, 2017 we had accounts payable in NIS or linked thereto in the amount of \$9,175 thousand. Market risk was estimated as the potential increase in balance resulting from a hypothetical 10% decrease in the year-end Dollar exchange rate. Assuming such decrease in the Dollar exchange rate, the balance of our accounts payable would increase by \$1,019 thousand.

As of December 31, 2017 we had accounts receivable in EURO and DKK, or in funds linked thereto, in the amount of \$558 thousand. Market risk was estimated as the potential decrease in balance resulting from a hypothetical 10% increase in the year-end Dollar exchange rate. Assuming such increase in the Dollar exchange rate, the balance of our accounts receivable would decrease by \$51 thousand. As of December 31, 2017 we had accounts payable in EURO and DKK, or linked thereto, in the amount of \$679 thousand. Market risk was estimated as the potential increase in balance resulting from a hypothetical 10% decrease in the year-end Dollar exchange rate. Assuming such decrease in the Dollar exchange rate, the balance of our accounts payable would increase by \$75 thousand.

In 2017 there was a decrease of 9.83% in the Dollar exchange rate to the NIS which resulted in an aggregate increase in the fair value of our assets of \$892 thousand and an aggregate increase in the fair value of our liabilities of \$1,120 thousand.

Since the majority of our revenues is denominated and paid in U.S. Dollars, we believe that fluctuations in the U.S. Dollar exchange rate do not have a significant effect on our accounts receivable. Inflation in Israel and the Israeli currency as well as U.S. Dollar exchange rate fluctuations may have only a limited effect on our accounts payable, as described above. Inflation in Denmark and the Danish currency as well as U.S. Dollar exchange rate fluctuations are expected to have only a limited effect on our accounts payable.

Our operating expenses may be affected by fluctuations in the value of the U.S. dollar as it relates to the NIS. By way of example, a hypothetical 10% weakening in the value of the U.S. Dollar relative to the NIS in 2017 would have resulted in an increase in operating expenses of approximately \$793 thousand for the year ended December 31, 2017. In addition, our operating expenses may be affected by fluctuations in the value of the U.S. Dollar as it relates to the DKK. By way of example, a hypothetical 10% weakening in the value of the U.S. dollar relative to the DKK in 2017 would have resulted in an increase in operating expenses of approximately \$509 thousand for the year ended December 31, 2017.

As of December 31, 2017, all of our investments, other than a portion of our cash and cash equivalents comprising a small portion of our overall investment portfolio, consisted of investments denominated in U.S. Dollars, and our portfolio is therefore not subject to significant exposure to foreign currency exchange risk.

As of December 31, 2017, we were not engaged in any hedging or other transactions intended to manage the risks relating to foreign currency exchange rate or interest rate fluctuations.

## **Credit Risk**

Our investment portfolio includes "held to maturity" marketable securities. These securities include investments issued by highly rated corporations. As of December 31, 2017, the rating of the securities in our portfolio was at least A. Nonetheless, these investments are subject to general credit and counterparty risks (such as that the counterparty to a financial instrument fails to meet its contractual obligations), which were exacerbated by the recent turmoil that has affected the financial markets and the global economy and caused credit issues for a number of reputable financial institutions. Any changes in fair value of our investment securities due to credit risk do not affect our profit or loss unless there is OTTI (referred to in ASC 320-10).

As of December 31, 2017, we were not required to adjust the carrying value of our investment securities since there were no other-than-temporary impairments.

In addition, as of December 31, 2017, three of our customers accounted for approximately 62% of our accounts receivables. We expect that a small number of customers will account for a significant portion of our accounts receivable for the foreseeable future. Difficulties in the fulfillment of the financial obligations of one or more of such customers may expose us to credit risk and may have a material adverse effect on our business and our financial condition and results. For additional information see "Item 3.D. Key Information – Risk Factors - Difficulties in the fulfillment of financial obligations of one or more of our customers may have an adverse effect on our ability to consummate the collection of consideration payable under purchase orders placed by, or invoiced to, such customers under one or more Design Wins in relation to which such customers operate" and Note 12C to our financial statements for the year ended December 31, 2017.

### **Item 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not Applicable.

## **PART II**

### **Item 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

None.

### **Item 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

None.

### **Item 15. CONTROLS AND PROCEDURES**

#### **Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in its Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our Chief Executive Officer and Chief Financial Officer to allow timely decisions regarding required disclosure. Our management, including our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of our disclosure controls and procedures, as defined under Exchange Act Rule 13a-15(e) and Rule 15d-15(e), as of the end of the period covered by this Annual Report on Form 20-F. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective.

## **Management's Annual Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Management assessed our internal control over financial reporting as of December 31, 2017, the end of our fiscal year. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "Internal Control — Integrated Framework (2013)".

Based on our assessment, management has concluded that our internal control over financial reporting was effective as of December 31, 2017 to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles. We reviewed the results of management's assessment with the Audit Committee of our Board of Directors.

This annual report includes, on page F-3 of this form 20-F, an attestation report of the Company's registered public accounting firm on management's assessment of the Company's internal control over financial reporting.

### **Inherent Limitations on Effectiveness of Controls**

Internal control over financial reporting has inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitation, there is a risk that material misstatements will not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

### **Changes in Internal Control over Financial Reporting**

There was no change in our internal controls over financial reporting that occurred during the period covered by this annual report that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

### **Item 15T. CONTROLS AND PROCEDURES**

Not Applicable.

### **Item 16. Reserved**

### **Item 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our board of directors had determined that both Ms. Ayelet Aya Hayak and Mr. Ilan Erez were our audit committee financial experts.

**Item 16B. CODE OF ETHICS**

Our company has adopted a code of ethics, which applies to all our employees, officers and directors, including our Chief Executive Officer, our Chief Financial Officer, our Director of Finance and our Corporate Controller.

**Item 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The following table presents fees for professional services for the audit of the Company's consolidated annual financial statements for the years ended December 31, 2017 and 2016, audit-related services and tax services rendered by Somekh Chaikin, a member firm of KPMG International.

	<u>2017</u>	<u>2016</u>
Audit Fees(1)	\$ 127,000	\$ 120,000
Audit-Related Fees(2)	\$ 6,500	--
Tax Fees(3)	\$ 19,000	\$ 55,000

- (1) Audit fees consist of fees for professional services rendered for the audit of the Company's annual consolidated financial statements and services normally provided by the independent auditor in connection with statutory and regulatory filings or engagements.
- (2) Audit-Related Fees consist of accounting consultation and consultation on financial accounting standards, not arising as part of the audit.
- (3) Tax Fees are the aggregate fees billed for professional services rendered for tax compliance, transfer pricing studies, and tax advice other than in connection with the Audit. Tax compliance involves audit of original and amended tax returns, tax planning and tax advice.

**Audit committee's pre-approval policies and procedures**

We are required to obtain the approval of our audit committee (and subsequently the consent of the board of directors and shareholders) before engaging our independent auditors, Somekh Chaikin, a member firm of KPMG International, to audit our consolidated financial statements, as well as to provide other audit or permitted non-audit services to us. This policy, which is designed to assure that such engagements do not impair the independence of our auditors, requires pre-approval from the audit committee on an annual basis for the various audit and non-audit services that may be performed by our auditors. Our audit committee is not permitted to approve the engagement of our auditors for any services that would be inconsistent with maintaining the auditor's independence or that are not permitted by applicable law.

**Item 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not Applicable.

**Item 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

Not Applicable.

**Item 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT**

Not Applicable.

**Item 16G. CORPORATE GOVERNANCE**

Our corporate governance practices differ from those followed by domestic companies as required under the listing standards of the NASDAQ Global Market, due to an exemption that we obtained from NASDAQ as foreign private issuer which enables us to comply with our home country laws of the State of Israel, including the provisions of the Companies Law, in lieu of NASDAQ Listing Rules. Below is a concise summary of the significant ways in which our corporate governance practices differ from the corporate governance requirements of NASDAQ applicable to domestic U.S. listed companies:

- We are not required to distribute annual and quarterly reports directly to shareholders, but we do make our audited financial statements available to our shareholders prior to our annual general meeting and furnish our quarterly and annual financial results with the SEC on Form 6-K;
- A majority of our board of directors may not necessarily be comprised of independent directors as defined in the NASDAQ Listing Rules, but our board of directors contains two external directors in accordance with the Companies Law. Israeli law does not require, nor do our external directors conduct, regularly scheduled meetings at which only they are present. In addition, with the exception of our external directors, our directors are elected for terms of one year or until the following annual meeting, by a general meeting of our shareholders. The nominations for director which are presented to our shareholders are also generally made by our board of directors. Pursuant to the Companies Law, one or more shareholders of a company holding at least one percent of the voting power of the company may nominate a currently serving external director for an additional three year term. Israeli law does not require the adoption of and our board has not adopted a formal written charter or board resolution addressing the nomination process and related matters. Compensation of our directors and other officers of the Company is determined in accordance with Israeli law;
- Our audit committee has not adopted a formal written audit committee charter specifying the items enumerated in NASDAQ Listing Rule 5605(c)(1). We believe that the members of our audit committee comply with the requirements of the Israeli law, as well as NASDAQ Listing Rule 5605(c)(3) and Rule 10A-3(b) of the general rules and regulations promulgated under the Securities Act of 1933. For a detailed discussion please refer to "Item 6 – Directors, Senior Management and Employees – Audit Committee";
- As opposed to NASDAQ Listing Rule 5620(c)(3), which sets forth a minimum quorum for a shareholders meeting, under Israeli law a company is entitled to determine in its articles of association the number of shareholders and percentage of holdings required for a quorum at a shareholders meeting. Our current Articles provide that a quorum of two or more shareholders, present in person or by proxy, holding shares conferring in the aggregate more than thirty three and a third (33 1/3 %) percent of the voting power of the Company is required;

- All related party transactions are approved in accordance with the requirements and procedures for approval of interested party acts and transactions set forth in the Companies Law, and are not subject to the review process set forth in NASDAQ Listing Rule 5630. For a detailed discussion please refer to "Item 10 – Additional Information – the Companies Law";
- We seek shareholder approval for all corporate action requiring such approval in accordance with the requirements of the Companies Law rather than under the requirements of the NASDAQ Marketplace Rules, including (but not limited to) the appointment or termination of auditors, appointment and dismissal of directors, approval of interested party acts and transactions requiring general meeting approval as discussed above and a merger;
- We follow the provisions of the Companies Law with respect to matters in connection with the composition and responsibilities of our compensation committee, office holder compensation, and any required approval by the shareholders of such compensation. Israeli law, and our amended and restated Articles, do not require that a compensation committee composed solely of independent members of our board of directors determine (or recommend to the board of directors for determination) an executive officer's compensation, as required under NASDAQ listing standards related to compensation committee independence and responsibilities; nor do they require that the Company adopt and file a compensation committee charter. Instead, our compensation committee has been established and conducts itself in accordance with provisions governing the composition of and the responsibilities of a compensation committee as set forth in the Companies Law. Furthermore, the compensation of office holders is determined and approved by our compensation committee and our board of directors, and in certain circumstances by our shareholders, either in consistency with our previously approved Executive Compensation Policy or, in special circumstances in deviation therefrom, taking into account certain considerations set forth in the Companies Law. The requirements for approval by the shareholders for any office holder compensation, and the relevant majority or special majority for such approval, are all as set forth in the Companies Law. Thus, we will seek shareholder approval for all corporate actions with respect to office holder compensation requiring such approval under the requirements of the Companies Law, including seeking prior approval of the shareholders for the Executive Compensation Policy and for certain office holder compensation, rather than seeking approval for such corporate actions in accordance with NASDAQ Listing Rules; and

- We do not necessarily seek shareholder approval for the establishment of, and amendments to, stock option or equity compensation plans (as set forth in NASDAQ Listing Rule 5635(c)), as such matters are not subject to shareholder approval under Israeli law. We will attempt to seek shareholder approval for our stock option or equity compensation plans (and the relevant annexes thereto) to the extent required in order to ensure they are tax qualified for our employees in the United States. However, if such approval is not received, then the stock option or equity compensation plans will continue to be in effect, but the Company will be unable to grant options to its U.S. employees that qualify as Incentive Stock Options for U.S. federal tax purpose. Our stock option or other equity compensation plans are also available to our non-U.S. employees, and provide features necessary to comply with applicable non-U.S. tax laws.

**Item 16H. MINE SAFETY DISCLOSURE**

Not Applicable.

**PART III**

**Item 17. FINANCIAL STATEMENTS**

Not Applicable.

**Item 18. FINANCIAL STATEMENTS**

See pages F-1 to F-46.

**Item 19. EXHIBITS**

- 1.1 Amended and Restated Articles of Association, adopted on January 24, 2008, filed by us as an Exhibit to our registration statement on Form S-8, as filed with the Securities and Exchange Commission on February 11, 2008, and incorporated herein by reference.
- 1.2 Amendment to Articles of Association of the Registrant incorporated by reference to Proposal 5 found in Exhibit 2 to the Form 6-K as filed with the Securities and Exchange Commission on March 1, 2012, and incorporated herein by reference.
- 1.3 Amendment to Articles of Association of the Registrant incorporated by reference to Annex B found in Exhibit 2 to the Form 6-K as filed with the Securities and Exchange Commission on April 26, 2016, and incorporated herein by reference.
- 4.1 Lease between the Company, C.P.M Medical Equipment Ltd. and Klimotech Ltd., for premises in Kfar Sava, Israel, dated December 3, 2014, filed by us as Exhibit 4.2 to our annual report on Form 20-F for the fiscal year ended December 31, 2014, as filed with the Securities and Exchange Commission on March 24, 2015, and incorporated herein by reference. As this lease is written in Hebrew, a summary is included in the Exhibit.
- 4.2 Sublease Agreement between the Company and Lumenis Ltd. for the site of our manufacturing facility in Yokne'am, Israel, dated August 1, 2013, and an amendment dated November 21, 2013, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2013, as filed with the Securities and Exchange Commission on March 20, 2014, and incorporated herein by reference. As this sublease agreement and the amendment are written in Hebrew, a summary was included in the Exhibit.

- [4.3 Lease between the Company and Naji Ezekiel & Sons - Management and Maintenance Ltd., for office space in Yokne'am Illit, dated as of August 15, 2016, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2016, as filed with the Securities and Exchange Commission on April 28, 2017, and incorporated herein by reference. As this sublease agreement and the amendment are written in Hebrew, a summary was included in the Exhibit.](#)
- 4.4 Lease between Silicom Connectivity Solutions, Inc. and RAD Data Communications Inc., for space in Mahwah, New Jersey, dated as of September 1, 1997, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2000, as filed with the Securities and Exchange Commission on June 30, 2001, and incorporated herein by reference.
- [4.5 Sublease Agreement between Silicom Connectivity Solutions, Inc. and Radcom Equipmet, Inc., for space in Paramus, New Jersey, dated as of February 1, 2004, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2003, as filed with the Securities and Exchange Commission on June 30, 2004, and incorporated herein by reference.](#)
- [4.6 Lease agreement between Silicom Connectivity Solutions, Inc. and Zohar Zisapel Properties, Inc. and Yehuda Zisapel Properties, Inc., for space in Paramus, New Jersey, dated January 25, 2017, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2016, as filed with the Securities and Exchange Commission on April 28, 2017, and incorporated herein by reference.](#)
- [4.7 The Executive Compensation Policy of the Company approved by the Shareholders on July 31, 2013, filed by us as Annex A to Proposal 1 found in Exhibit 2 to the Form 6-K as filed with the Securities and Exchange Commission on June 26, 2013, and incorporated herein by reference.](#)
- [4.8 Share Purchase Agreement by and among the Company, Fiberblaze A/S, Fiberblaze Holding APS, and Hilmer APS, dated December 10, 2014, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2014, as filed with the Securities and Exchange Commission on March 24, 2015, and incorporated herein by reference.](#)
- [4.9 Asset Purchase Agreement by and among the Company, the Company's wholly owned subsidiary Silicom Connectivity Solutions, Inc., ADI Engineering, Inc., Steve Yates and Patricia Yates, dated September 30, 2015 filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2015, as filed with the Securities and Exchange Commission on April 26, 2016, and incorporated herein by reference.](#)
8. [List of subsidiaries. \(\\*\)](#)
- [11.1 Code of Ethics, filed by us as an Exhibit to our annual report on Form 20-F for the fiscal year ended December 31, 2007, as filed with the Securities and Exchange Commission on March 26, 2008, and incorporated herein by reference.](#)



- [12.1 Certification by Chief Executive Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002. \(\\*\)](#)
- [12.2 Certification by Chief Financial Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002. \(\\*\)](#)
- [13.1 Certification by Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. \(\\*\)](#)
- [13.2 Certification by Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. \(\\*\)](#)
- [15.1 Consent of Somekh Chaikin, Independent Registered Public Accounting Firm, a member firm of KPMG International. \(\\*\)](#)

101.INS\* XBRL Instance Document  
101.SCH\* XBRL Taxonomy Extension Schema Document  
101.CAL\* XBRL Taxonomy Extension Calculation Linkbase Document  
101.DEF\* XBRL Taxonomy Extension Definition Linkbase Document  
101.LAB\* XBRL Taxonomy Extension Label Linkbase Document  
101.PRE\* XBRL Taxonomy Extension Presentation Linkbase Document

(\*) Filed herewith.

**SIGNATURES**

The Registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

**SILICOMLIMITED**

By: /S/ Shaiké Orbach  
Shaiké Orbach  
Chief Executive Officer

April 30, 2018

**Silicom Ltd.**

**and its Subsidiaries**

**Consolidated  
Financial Statements**

**As of and for the year ended  
December 31, 2017**

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## Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of  
Silicom Ltd.:

### *Opinions on the Consolidated Financial Statements and Internal Control Over Financial Reporting*

We have audited the accompanying consolidated balance sheets of Silicom Ltd. and subsidiaries (the Company) as of December 31, 2016 and 2017, the related consolidated statements of operations, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2017, and the related notes (collectively, the consolidated financial statements). We also have audited the Company's internal control over financial reporting as of December 31, 2017, based on "criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission".

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2016 and 2017, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2017, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on "criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission".

### *Basis for Opinions*

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Form 6-K. Our responsibility is to express an opinion on the Company's consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

*Definition and Limitations of Internal Control Over Financial Reporting*

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Somekh Chaikin

Certified Public Accountants (Isr.)  
Member Firm of KPMG International

We have served as the Company's auditor since 1997.

Tel Aviv, Israel  
March 15, 2018

## Consolidated Balance Sheets as of December 31

	Note	2016 US\$ thousands	2017 US\$ thousands
<b>Assets</b>			
<b>Current assets</b>			
Cash and cash equivalents	4	11,917	17,021
Marketable securities	2F, 5	16,263	7,752
Accounts receivable:			
Trade, net	2G	27,305	40,742
Other		3,113	5,823
Related parties		417	625
Inventories	6	44,280	51,487
<b>Total current assets</b>		<b>103,295</b>	<b>123,450</b>
<b>Marketable securities</b>	2F, 5	7,769	5,945
<b>Assets held for employees' severance benefits</b>	9	1,436	1,591
<b>Deferred tax assets</b>	14G	1,537	899
<b>Property, plant and equipment ("PPE"), net</b>	7	3,915	4,121
<b>Intangible assets, net</b>	8	2,924	1,047
<b>Goodwill</b>		<b>25,561</b>	<b>25,561</b>
<b>Total assets</b>		<b>146,437</b>	<b>162,614</b>

Avi Eizenman  
Chairman of the Board of Directors

Shaiké Orbach  
Chief Executive Officer

Eran Gilad  
Chief Financial Officer

Kfar-Saba, Israel  
March 15, 2018

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

## Consolidated Balance Sheets as of December 31 (Continued)

	Note	2016 US\$ thousands	2017 US\$ thousands
<b>Liabilities and shareholders' equity</b>			
<b>Current liabilities</b>			
Trade accounts payable		10,476	12,619
Other accounts payable and accrued expenses		7,484	6,420
Related parties		4	10
<b>Total current liabilities</b>		<b>17,964</b>	<b>19,049</b>
<b>Long-term liabilities</b>			
Contingent consideration	3	4,642	-
Liability for employees' severance benefits	9	2,439	2,765
<b>Total liabilities</b>		<b>25,045</b>	<b>21,814</b>
<b>Commitments and contingencies</b>	10		
<b>Shareholders' equity</b>	11		
Ordinary shares, ILS 0.01 par value; 10,000,000 shares authorized; 7,396,584 and 7,564,502 issued as at December 31, 2016 and 2017, respectively; 7,381,613 and 7,549,531 outstanding as at December 31, 2016 and 2017, respectively		22	22
Additional paid-in capital		46,833	51,909
Treasury shares (at cost) - 14,971 ordinary shares as at December 31, 2016 and 2017		(38)	(38)
Retained earnings		74,575	88,907
<b>Total shareholders' equity</b>		<b>121,392</b>	<b>140,800</b>
<b>Total liabilities and shareholders' equity</b>		<b>146,437</b>	<b>162,614</b>

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



## Consolidated Statements of Operations for the Year Ended December 31

		2015	2016	2017
	Note	US\$ thousands		
		Except for share and per share data		
Sales*	12	82,738	100,347	125,690
Cost of sales		48,659	61,796	79,762
<b>Gross profit</b>		34,079	38,551	45,928
<b>Operating expenses</b>				
Research and development**		9,702	12,663	13,915
Sales and marketing		5,651	6,423	6,722
General and administrative		3,611	3,969	4,507
Contingent consideration benefit	3	(3,090)	(334)	(4,642)
Total operating expenses		15,874	22,721	20,502
<b>Operating income</b>		18,205	15,830	25,426
Financial income, net	13	220	35	156
<b>Income before income taxes</b>		18,425	15,865	25,582
Income taxes	14	1,905	2,728	3,868
<b>Net income</b>		16,520	13,137	21,714
<b>Income per share:</b>				
Basic income per ordinary share (US\$)	2S	2.273	1.789	2.912
Diluted income per ordinary share (US\$)		2.242	1.767	2.856
Weighted average number of ordinary shares used to compute basic income per share (in thousands)		7,269	7,344	7,456
Weighted average number of ordinary shares used to compute diluted income per share (in thousands)		7,368	7,435	7,602

\* Including sales to related parties in the amount of US\$ 1,154 thousand, US\$ 762 thousand and US\$ 1,275 thousand in 2015, 2016 and 2017, respectively.

\*\* Including services from related parties in the amount of US\$ 285 thousand, US\$ 351 thousand and US\$ 170 thousand in 2015, 2016 and 2017, respectively.

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

**Consolidated Statements of Changes in Shareholders' Equity**

	Ordinary shares		Additional paid-in capital	Treasury shares	Retained earnings	Total shareholders' equity
	Number of shares(1)		US\$ thousands			
<b>Balance at January 1, 2015</b>	7,218,633	21	41,245	(38)	59,504	100,732
Exercise of options and RSUs(2)	65,711	*-	943	-	-	943
Share-based compensation	-	-	1,913	-	-	1,913
Dividend (US \$1.00 per share)	-	-	-	-	(7,274)	(7,274)
Net income	-	-	-	-	16,520	16,520
<b>Balance at December 31, 2015</b>	7,284,344	21	44,101	(38)	68,750	112,834
Exercise of options and RSUs(2)	97,269	1	951	-	-	952
Share-based compensation	-	-	1,781	-	-	1,781
Dividend (US \$1.00 per share)	-	-	-	-	(7,312)	(7,312)
Net income	-	-	-	-	13,137	13,137
<b>Balance at December 31, 2016</b>	7,381,613	22	46,833	(38)	74,575	121,392
Exercise of options and RSUs(2)	167,918	*-	2,651	-	-	2,651
Share-based compensation	-	-	2,425	-	-	2,425
Dividend (US \$1.00 per share)	-	-	-	-	(7,382)	(7,382)
Net income	-	-	-	-	21,714	21,714
<b>Balance at December 31, 2017</b>	7,549,531	22	51,909	(38)	88,907	140,800

(1) Net of 14,971 shares held by Silicom Inc.

(2) Restricted share units (hereinafter - "RSUs")

\* Less than 1 thousand.

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

## Consolidated Statements of Cash Flows for the Year Ended December 31

	2015	2016	2017
	US\$ thousands		
<b>Cash flows from operating activities</b>			
Net income	16,520	13,137	21,714
<b>Adjustments required to reconcile net income to net cash provided by (used in) operating activities:</b>			
Depreciation and amortization	2,767	3,856	3,799
Write-down of obsolete inventory	219	3,170	2,918
Change in liability for employees' severance benefits, net	(112)	126	171
Discount on marketable securities, net	561	358	217
Share-based compensation expense	1,998	1,550	2,425
Deferred taxes income	(907)	(260)	453
Capital gain	(3)	-	-
Changes in assets and liabilities:			
Accounts receivable - trade	(4,850)	(4,007)	(13,237)
Accounts receivable - other	127	(1,832)	(2,475)
Accounts receivable - related parties	(83)	56	(208)
Inventories	(939)	(21,426)	(10,287)
Trade accounts payable	234	1,809	1,698
Other accounts payable and accrued expenses	853	1,098	(1,144)
Contingent consideration benefit	(3,090)	(334)	(4,642)
Accounts payable - related parties	(8)	(8)	6
Net cash provided by (used in) operating activities	<u>13,287</u>	<u>(2,707)</u>	<u>1,408</u>
<b>Cash flows from investing activities</b>			
Proceeds from short term bank deposits, net	4,000	-	-
Sale of property, plant and equipment	19	-	-
Purchase of property, plant and equipment	(2,984)	(1,441)	(1,690)
Investment in intangible assets	-	-	(11)
Proceeds from maturity of marketable securities	15,100	8,575	16,175
Purchases of marketable securities	(12,935)	-	(5,961)
Business acquisition, net of acquired cash (see Note 3)	(10,000)	-	-
Net cash provided by (used in) investing activities	<u>(6,800)</u>	<u>7,134</u>	<u>8,513</u>
<b>Cash flows from financing activities</b>			
Exercise of options	943	952	2,651
Dividend	(7,274)	(7,312)	(7,382)
Payment made in connection with contingent consideration	-	(4,463)	-
Net cash used in financing activities	<u>(6,331)</u>	<u>(10,823)</u>	<u>(4,731)</u>
Effect of exchange rate changes on cash balances held	132	135	(86)
Increase (decrease) in cash and cash equivalents	288	(6,261)	5,104
Cash and cash equivalents at beginning of year	17,890	18,178	11,917
<b>Cash and cash equivalents at end of year</b>	<u>18,178</u>	<u>11,917</u>	<u>17,021</u>
<b>Supplementary cash flow information</b>			
A. Non-cash transactions:			
Investments in PPE and intangible assets	<u>72</u>	<u>39</u>	<u>119</u>
B. Cash paid during the year for:			
Income taxes	<u>4,487</u>	<u>4,648</u>	<u>4,584</u>

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

**Notes to the Consolidated Financial Statements**

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**Note 1 - General**

Silicom Ltd. is an Israeli corporation engaged in designing, manufacturing, marketing and supporting high performance networking and data infrastructure solutions for a broad range of servers, server based systems and communications devices.

The Company's shares have been traded in the United States on the National Association of Securities Dealers Automated Quotation System ("NASDAQ") since February 1994. Since January 2, 2014 the Company's shares have been traded on the NASDAQ Global Select Market (prior thereto they were traded on the NASDAQ Global Market). The Company's shares were traded in Israel on the Tel Aviv Stock Exchange ("TASE") from December 2005 through January 26, 2016, after which, on January 28, 2016, the Company delisted from trading on the TASE.

In these financial statements the terms "Company" or "Silicom" refer to Silicom Ltd. and its wholly owned subsidiaries, Silicom Connectivity Solutions, Inc. (hereinafter - "Silicom Inc.") and Silicom Denmark A/S (Fiberblaze A/S) (hereinafter - "Silicom Denmark"), whereas the term "subsidiaries" refers to Silicom Inc. and Silicom Denmark.

**Note 2 - Summary of Significant Accounting Policies**

The significant accounting policies, which are applied consistently throughout the periods presented, are as follows:

**A. Financial statements in US dollars**

Substantially all sales of the Company are made outside of Israel (see Note 12A regarding geographical distribution), in US dollars ("dollars"). Most purchases of materials and components, and a significant part of the marketing costs are made or incurred, primarily in dollars. Therefore, the functional currency of the Company is the dollar.

Transactions and monetary balances in other currencies are translated into the functional currency using the current exchange rate.

All exchange gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in earnings when they arise.

**Note 2 - Summary of significant Accounting Policies (cont'd)****B. Basis of presentation**

The accompanying consolidated financial statements have been prepared with accounting principles generally accepted in the United States of America and include the accounts of the Company and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

**C. Estimates and assumptions**

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant items subject to such estimates and assumptions include income taxes, inventories, marketable securities, goodwill, intangible assets and share-based compensation.

**D. Business combinations**

The Company accounts for business combination in accordance with ASC No. 805, "Business Combinations". ASC No. 805 requires recognition of assets acquired and liabilities assumed at the acquisition date, measured at their fair values as of that date. Any excess of the fair value of net assets acquired over purchase price and any subsequent changes in estimated contingencies are to be recorded in the consolidated statements of operations.

**E. Cash and cash equivalents**

The Company considers highly liquid investments with original maturities of three months or less from the date of deposit to be cash equivalents.

**F. Marketable securities**

The Company classifies its marketable securities as held-to-maturity as they are debt securities in which the Company has the intent and ability to hold to maturity. Held-to-maturity (HTM) debt securities are recorded at amortized cost adjusted for the amortization or accretion of premiums or discounts.

Premiums and discounts on debt securities are amortized or accreted over the life of the related held-to-maturity security as an adjustment to yield using the effective interest method.

**Note 2 - Summary of significant Accounting Policies (cont'd)****F. Marketable securities (cont'd)**

Such amortization and accretion is included in the "Financial income, net" line item in the consolidated statements of operations.

When other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether the Company intends to sell the security or it is more likely than not that it will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss.

A decline in the market value of HTM security below cost that is deemed to be other than temporary results in an impairment to reduce the carrying amount to fair value. To determine whether an impairment is other than temporary, the Company considers all available information relevant to the collectibility of the security, including past events, current conditions, and reasonable and supportable forecasts when developing estimate of cash flows expected to be collected. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year end, forecasted performance of the investee, and the general market condition in the geographic area or industry the investee operates in.

If the Company intends to sell the security or it is more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment is separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings.

**G. Trade accounts receivable, net**

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Amounts collected on trade accounts receivable are included in net cash provided by operating activities in the consolidated statements of cash flows. The Company maintains an allowance for doubtful accounts for estimated losses inherent in its accounts receivable portfolio. In establishing the required allowance, management considers historical losses adjusted to take into account current market conditions and its customers' financial condition, the amount of receivables in dispute, and the current receivables aging and current payment patterns.

As of December 31, 2016 and 2017, the provision for doubtful accounts receivable amounted to US\$ 20 thousand.

**H. Inventories**

Inventories are stated at the lower of cost and net realizable value. Cost is determined using the "weighted average-cost" method. The Company writes down obsolete or slow moving inventory to its market value, on a quarterly basis.

## Notes to the Consolidated Financial Statements

## Note 2 - Summary of significant Accounting Policies (cont'd)

**I. Assets held for employees' severance benefits**

Assets held for employees' severance benefits represent contributions to severance pay funds and cash surrender value of insurance policies. The assets are recorded at their current cash redemption value.

**J. Property, plant and equipment**

Property, plant and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated on the straight-line basis over the estimated useful life of the assets at the following annual rates:

	%
Machinery and equipment	15 - 33
Office furniture and equipment	6 - 33
Leasehold improvements	*

\* Over the shorter term of the lease or the life of the asset

**K. Goodwill and other intangible assets**

Goodwill reflects the excess of the purchase price of business acquired over the fair value of net assets acquired. Goodwill is not amortized but instead is tested for impairment at least annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

The Company operates in one operating segment and this segment comprises one reporting unit.

Goodwill is reviewed for impairment at least annually in accordance with ASU 2011-08, Testing Goodwill for Impairment. ASU 2011-08 provides an entity the option to perform a qualitative assessment to determine whether it is more likely than-not that the fair value of a reporting unit is less than its carrying amount prior to performing the two-step goodwill impairment test. If this is the case, the two-step goodwill impairment test is required. If it is more likely than-not that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required.

**Note 2 - Summary of significant Accounting Policies (cont'd)****K. Goodwill and other intangible assets (cont'd)**

If the two-step goodwill impairment test is required, first, the fair value of the reporting unit is compared with its carrying amount (including goodwill). If the fair value of the reporting unit is less than its carrying amount, an indication of goodwill impairment exists for the reporting unit and the entity must perform step two of the impairment test (measurement). Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation and the residual fair value after this allocation is the implied fair value of the reporting unit goodwill. If the fair value of the reporting unit exceeds its carrying amount, step two does not need to be performed. During the year ended December 31, 2017, no impairments were found and therefore no impairment losses were recorded.

Intangible assets that are not considered to have an indefinite useful life are amortized over their estimated useful lives of 3 years. The acquired customer relationships and current technology are amortized over their estimated useful lives in proportion to the economic benefits realized. This accounting policy results in amortization of such intangible assets in the straight-line method.

**L. Impairment of Long-Lived Assets**

In accordance with Impairment or Disposal of Long-Lived Assets Subsections of FASBASC Subtopic 360-10, Property, Plant, and Equipment - Overall long-lived assets, such as property, plant, equipment and purchase intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If circumstances require a long-lived asset or an asset group to be tested for possible impairment, the Company first compares undiscounted cash flows expected to be generated by that asset or asset group to its carrying value. If the carrying value of the long-lived asset or asset group is not recoverable on an undiscounted cash flow basis, an impairment is recognized to the extent that the carrying value exceeds its fair value. Fair value is determined through various valuation techniques including discounted cash flow models, quoted market values and third party independent appraisals, as considered necessary.

**M. Revenue recognition**

Revenues from sales of products are recognized upon delivery provided that the collection of the resulting receivable is reasonably assured, there is persuasive evidence of an arrangement, no significant obligations in respect of installation remain and the price is fixed or determinable.

Sales taxes collected from customers and remitted to governmental authorities are accounted for on a net basis and, therefore, are excluded from revenues in the consolidated statements of operations.

**N. Research and development costs**

Research and development costs are expensed as incurred.



**Note 2 - Summary of significant Accounting Policies (cont'd)****O. Allowance for product warranty**

The Company grants service warranties related to certain products to end-users. The Company estimates its obligation for such warranties to be immaterial on the basis of historical experience. Accordingly, these financial statements do not include an accrual for warranty obligations.

**P. Treasury shares**

Treasury shares are recorded at cost and presented as a reduction of shareholders' equity.

**Q. Income taxes**

Deferred taxes are accounted for under the asset and liability method based on the estimated future tax effects of temporary differences between the financial statements carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are presented as non-current assets and liabilities and measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the consolidated statements of operations in the period that includes the enactment date. The Company recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs.

**R. Share-based compensation**

The Company recognizes compensation expense based on estimated grant date fair value in accordance with ASC Topic 718, Compensation -Stock Compensation as follows:

When portions of an award vest in increments during the requisite service period (graded-vesting award), the Company's accounting policy is to recognize compensation cost for the award over the requisite service period for each separately vesting portion of the award.

**S. Basic and diluted earnings per share**

Basic income per ordinary share is calculated by dividing the net income attributable to ordinary shares, by the weighted average number of ordinary shares outstanding. Diluted income per ordinary share calculation is similar to basic income per ordinary share except that the weighted average of common shares outstanding is increased to include outstanding potential common shares during the period if dilutive. Potential common shares arise from stock options and RSUs, and the dilutive effect is reflected by the application of the treasury stock method.

## Notes to the Consolidated Financial Statements

## Note 2 - Summary of significant Accounting Policies (cont'd)

## S. Basic and diluted earnings per share (cont'd)

The following table summarizes information related to the computation of basic and diluted income per ordinary share for the years indicated.

	Year ended December 31		
	2015	2016	2017
Net income attributable to ordinary shares (US\$ thousands)	16,520	13,137	21,714
Weighted average number of ordinary shares outstanding used in basic income per ordinary share calculation	7,268,536	7,343,696	7,455,528
Add assumed exercise of outstanding dilutive potential ordinary shares	99,448	91,485	146,443
Weighted average number of ordinary shares outstanding used in diluted income per ordinary share calculation	7,367,984	7,435,181	7,601,971
Basic income per ordinary shares (US\$)	2.273	1.789	2.912
Diluted income per ordinary shares (US\$)	2.242	1.767	2.856
The weighted average number of shares related to options and RSUs excluded from the diluted earnings per share calculation because of anti-dilutive effect	43,181	9,633	-

## T. Comprehensive Income

For the years ended December 31, 2015, 2016 and 2017, comprehensive income equals net income.

## U. Fair Value Measurements

The Company's financial instruments consist mainly of cash and cash equivalents, marketable securities, trade and other receivables and trade accounts payable. The carrying amounts of these financial instruments, except for marketable securities, approximate their fair value because of the short maturity of these investments. The fair value of marketable securities is presented in Note 5 to these consolidated financial statements. Assets held for severance benefits are recorded at their current cash redemption value.

**Note 2 - Summary of Significant Accounting Policies (cont'd)****U. Fair Value Measurements (cont'd)**

The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible. The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

Level 1 Inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.

Level 2 Inputs: Other than quoted prices included in Level 1 inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the asset or liability.

Level 3 Inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at measurement date.

**V. Concentrations of risks****(1) Credit risk**

Financial instruments, which potentially subject the Company to significant concentrations of credit risk, consist principally of cash and cash equivalents, marketable securities, trade receivables and assets held for employees' severance benefits. Cash and cash equivalents balances of the Company, which are subject to credit risk, consist of cash accounts held with major financial institutions. Marketable securities consist of held to maturity marketable securities issued by highly rated corporations. As of December 31, 2016 and 2017, the ratings of the securities in the Company's portfolio was at least A. Nonetheless, these investments are subject to general credit and counterparty risks (such as that the counterparty to a financial instrument fails to meet its contractual obligations). The Company closely monitors extensions of credit and has never experienced significant credit losses. See note 12.

Subsequent to the balance sheet date, on March 13, 2018, the Company announced that the top-10 Cloud player that awarded its largest-ever design win has decided to abort the new cloud infrastructure architecture for which it had ordered the Company's products. As of December 31, 2017, the Company had open receivables from few of the Company's customers that are related to this design win, out of which, an amount of approximately \$10 million is still outstanding as of the date of announcement (March 13, 2018). The Company expects that these customers will fully meet their contractual obligations and that these outstanding amounts are not impaired.

**(2) Significant customers**

The Company's top two customers accounted for approximately 34% of its revenues in 2017. The Company expects that a small number of customers will continue to account for a significant portion of its revenues for the foreseeable future. See note 12.

**W. Liabilities for loss contingencies**

Liabilities for loss contingencies arising from claims, assessments, litigation, fines, and penalties and other sources are recorded when it is probable that a liability has been incurred and the amount can be reasonably estimated. Legal costs incurred in connection with loss contingencies are expensed as incurred.

**Note 2 - Summary of Significant Accounting Policies (cont'd)****X. Recent Accounting Pronouncements**

- (1) In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. ASU 2014-09 outlines a new, single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The new model will require revenue recognition to depict the transfer of promised goods or services to customers in an amount that reflects the consideration a company expects to receive in exchange for those goods or services. The amendments in ASU 2014-09 are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The standard can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. The Company will adopt this ASU on January 1, 2018 with no cumulative effect. In 2017 the company examined the new standard's impact on its financial statements. Based on the Company's examination as of the date of these financial statements, the standard will not have a material effect.
- (2) In February 2016, the FASB issued ASU 2016-02, which requires lessees to recognize most of their leases on balance sheet as a right-of-use asset and a lease liability. This ASU is effective for interim and annual periods in fiscal years beginning after December 15, 2018. Early adoption is permitted. Based on the Company's current assessment, it doesn't expect this ASU to have a material impact on the results of its operations.

**Note 2 - Summary of Significant Accounting Policies (cont'd)****X. Recent Accounting Pronouncements (cont'd)**

- (3) In June 2016, the FASB issued ASU 2016-13, Measurement of Credit Losses on Financial Instruments, which significantly changes the way entities recognize impairment of many financial assets by requiring immediate recognition of estimated credit losses expected to occur over their remaining life. This ASU is effective for annual and interim periods in fiscal years beginning after December 15, 2019. Early adoption is permitted for annual and interim periods in fiscal years beginning after December 15, 2018. The impact of adopting the new standard on the net income is not expected to be material.
- (4) In January 2017, the FASB issued ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment," which eliminates the requirement to calculate the implied fair value of goodwill in Step 2 of the goodwill impairment test. Under ASU 2017-04, goodwill impairment charges will be based on the excess of a reporting unit's carrying amount over its fair value as determined in Step 1 of the testing. ASU 2017-04 is effective for interim and annual testing dates after December 15, 2019, with early adoption permitted for interim and annual goodwill impairment testing dates after January 1, 2017. The Company do not expect the adoption of ASU 2017-04 to have material impact on its financial position, results of operations, cash flows or presentation thereof.

**Note 3 - Acquisitions****A. ADI Engineering, Inc.**

On October 28, 2015 (hereinafter – "closing date") the Company acquired certain assets from ADI Engineering, Inc. (hereinafter – "ADI"), a privately-held, US-based provider of custom embedded communications and networking products, for an aggregate purchase price of US\$ 10,000 thousand in cash and estimated contingent consideration of US\$ 7,802 thousand in cash and in options to ordinary shares, payable in three yearly payments, after the closing, subject to the attainment of certain performance milestones until December 31, 2017. The fair value measurement of the contingent consideration is classified at level 2 and level 3 of the fair value hierarchy (see Note 2U). Of the total purchase price of US\$ 17,802 thousand, US\$ 222 thousand was attributed to tangible assets, US\$ 4,261 thousand was attributed to intangible assets and US\$ 13,319 thousand was attributed to goodwill. The goodwill is primarily attributable to the synergies expected to arise after the acquisition. The recognized goodwill is deductible for income tax purposes for 10 years.

In connection with the contingent consideration, during 2016 the Company paid ADI an amount of US\$ 3,000 thousand.

Any amount not paid was charged to the statement of operations as an income.

**B. Silicom Denmark**

On December 10, 2014 (hereinafter – "closing date"), the Company completed the acquisition of all of the outstanding shares and voting interests of Silicom Denmark, a provider of high performance application acceleration solutions, for an aggregate purchase price of US\$ 10,161 thousand in cash and estimated contingent consideration of US\$ 4,683 thousand in cash and in options to ordinary shares, subject to the attainment of certain performance milestones until August 31, 2015. The fair value measurement of the contingent consideration is classified at level 3 of the fair value hierarchy (see Note 2U). Of the total estimated purchase price of US\$ 14,844 thousand, US\$ 2,022 thousand was attributed to tangible assets, US\$ 1,996 thousand was attributed to intangible assets, US\$ 12,242 thousand was attributed to goodwill and US\$ 1,416 was attributed to liabilities assumed. The goodwill is primarily attributable to the synergies expected to arise after the acquisition. None of the recognized goodwill is expected to be deductible for income tax purposes.

In connection with the contingent consideration, during 2016 the Company paid to the Silicom Denmark sellers an amount of US\$ 1,463 thousand, of which 90% was paid in cash and 10% in options to ordinary shares of the Company.

In relation to this acquisition, on April 18, 2016, the Company granted, in the aggregate, 22,795 options to the Silicom Denmark sellers and to the Silicom Denmark employees (see Note 11I).

Any amount not paid was charged to the statement of operations as an income.

## Notes to the Consolidated Financial Statements

## Note 4 - Cash and Cash Equivalents

	December 31	
	2016	2017
	US\$ thousands	
Cash	5,858	12,834
Cash equivalents *	6,059	4,187
	<u>11,917</u>	<u>17,021</u>

\* Comprised mainly of deposits in banks as at December 31, 2016 and 2017 carrying a weighted average interest rate of 0.30% and 0.07%, respectively.

## Notes to the Consolidated Financial Statements

## Note 5 - Marketable Securities

The Company's investment in marketable securities as of December 31, 2016 and 2017 are classified as "held-to-maturity" and consist of the following:

	<u>Amortized cost basis**</u>	<u>Gross unrealized holding gains</u>	<u>Gross unrealized holding (losses)</u>	<u>Aggregate fair value*</u>
	<u>US\$ thousands</u>			
At December 31, 2017				
Held to maturity:				
Corporate debt securities				
Current	7,798	-	(49)	7,749
Non-Current	5,976	-	(95)	5,881
	<u>13,774</u>	<u>-</u>	<u>(144)</u>	<u>13,630</u>
At December 31, 2016				
Held to maturity:				
Corporate debt securities				
Current	16,390	-	(97)	16,293
Non-Current	7,815	-	(62)	7,753
	<u>24,205</u>	<u>-</u>	<u>(159)</u>	<u>24,046</u>

\* Fair value is being determined using quoted market prices in active markets (Level 1).

\*\* Including accrued interest in the amount of US\$ 173 thousand and US\$ 77 thousand as of December 31, 2016 and 2017 respectively. The accrued interest is presented as part of other account receivable on the balance sheet.

Activity in marketable securities in 2017	<u>US\$ thousands</u>
<b>Balance at January 1, 2017</b>	24,205
Purchases of marketable securities	5,961
Discount on marketable securities, net	(217)
Proceeds from maturity of marketable securities	<u>(16,175)</u>
<b>Balance at December 31, 2017</b>	<u>13,774</u>



## Notes to the Consolidated Financial Statements

## Note 5 - Marketable Securities (Cont'd)

The following table summarizes the gross unrealized losses on investment securities for which other-than-temporary impairments have not been recognized and the fair value of those securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2017:

Held to maturity:	Less than 12 months		12 months or more		Total	
	Unrealized Losses	Fair value	Unrealized Losses	Fair value	Unrealized Losses	Fair value
Corporate debt securities	(95)	5,881	(49)	7,749	(144)	13,630

The unrealized losses on the investments were caused by changes in interest rate. The Company has the ability and intent to hold these investments until maturity and it is more likely than not that the Company will not be required to sell any of the securities before recovery; therefore these investments are not considered other than temporarily impaired.

## Note 6 - Inventories

	December 31	
	2016	2017
	US\$ thousands	
Raw materials and components	16,435	24,407
Products in process	19,098	15,079
Finished products	8,747	12,001
	44,280	51,487

## Notes to the Consolidated Financial Statements

## Note 7 - Property, Plant and Equipment, Net

	December 31	
	2016	2017
	US\$ thousands	
Machinery and equipment	8,507	10,531
Office furniture and equipment	634	665
Leasehold improvements	2,277	2,309
Property, plant and equipment	11,418	13,505
Accumulated depreciation	(7,503)	(9,384)
Property, Plant and equipment, net	3,915	4,121

Depreciation expense for the years ended December 31, 2015, 2016 and 2017 were US\$ 1,599 thousand, US\$ 1,616 thousand and US\$ 1,911 thousand, respectively.

## Notes to the Consolidated Financial Statements

## Note 8 - Intangible Assets

## Intangible assets

Net intangible assets as of December 31, 2017 are as follows:

	Useful life	December 31	
		2016	2017
		US\$ thousands	
Original cost:			
Current technology	3	3,833	3,844
Customer relationships	3	1,937	1,937
		<u>5,770</u>	<u>5,781</u>
Accumulated amortization:			
Current technology		1,930	3,181
Customer relationships		916	1,553
		<u>2,846</u>	<u>4,734</u>
Intangible assets, Net:			
Current technology		1,903	663
Customer relationships		1,021	384
		<u>2,924</u>	<u>1,047</u>

Amortization expense for the years ended December 31, 2015, 2016 and 2017 were US\$ 1,168 thousand, US\$ 2,240 thousand and US\$ 1,888 thousand, respectively.

**Note 9 - Assets Held and Liability for Employees' Severance Benefits**

- A. Under Israeli law and labor agreements, Silicom is required to make severance payments to retired or dismissed employees and to employees leaving employment in certain other circumstances.

In respect of the liability to the employees, individual insurance policies are purchased and deposits are made with recognized severance pay funds.

The liability for severance pay is calculated on the basis of the latest salary paid to each employee multiplied by the number of years of employment. The liability is covered by the amounts deposited including accumulated income thereon as well as by the unfunded provision.

- B. According to Section 14 to the Severance Pay Law ("Section 14") the payment of monthly deposits by a company into recognized severance and pension funds or insurance policies releases it from any additional severance obligation to the employees that have entered into agreements with the company pursuant to such Section 14. Commencing July 1, 2008, the Company has entered into agreements with a majority of its employees in order to implement Section 14. Therefore, as of that date, the payment of monthly deposits by the Company into recognized severance and pension funds or insurance policies releases it from any additional severance obligation to those employees that have entered into such agreements and therefore the Company incurs no additional liability since that date with respect to such employees. Amounts accumulated in the pension funds or insurance policies pursuant to Section 14 are not supervised or administrated by the Company and therefore neither such amounts nor the corresponding accrual are reflected in the balance sheet.

- C. Consequently, the assets held for employees' severance benefits reported on the balance sheet, in respect of deposits for those employees who have signed agreements pursuant to Section 14, represent the redemption value of deposits made through June 30, 2008. The liability for employee severance benefits, with respect to those employees, represents the liability of the Company for employees' severance benefits as of June 30, 2008.

As a result of the implementation of Section 14, as described above, the liability with respect to those employees is calculated on the basis of number of years of employment as of June 30, 2008, multiplied by the latest salary paid. The liability is covered by the amounts deposited, including accumulated income thereon, as well as by the unfunded provision. Such liability will be removed, either upon termination of employment or retirement.

- D. Expenses recorded with respect to employees' severance payments for the years ended December 31, 2015, 2016 and 2017 were US\$ 543 thousand, US\$ 761 thousand and US\$ 830 thousand, respectively.

**Notes to the Consolidated Financial Statements**

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**Note 10 - Commitments and Contingencies****Lease commitments**

The premises and facilities occupied by the Company are leased under various operating lease agreements. Furthermore, the Company has entered into several operating lease agreements for motor vehicles in Israel.

The agreements related to leases in Israel are in Israeli Shekel ("ILS") or in ILS, linked to the Israeli Consumer Price Index or to the US Dollars. The agreements related to leases in the USA are in US Dollars and the agreements related to leases in Denmark are in Danish Krone ("DKK").

The minimum future rental payments under the above leases at exchange rates in effect on December 31, 2017, are as follows:

<b>Year ended December 31</b>	<b>US\$ thousands</b>
2018	1,665
2019	1,211
2020 and on	226

Of the amounts above, US\$ 50 thousand in 2018, relate to related parties.

Rental expenses under the lease agreements for the years ended December 31, 2015, 2016 and 2017 were US\$ 1,403 thousand, US\$ 1,563 thousand and US\$ 1,760 thousand, respectively.

**Note 11 - Shareholders' Equity****Share based compensation**

- A. On July 21, 2004, the Board resolved, subject to shareholders' approval that was given on December 30, 2004, to adopt the Share Option Plan (2004) (the "2004 Plan"). Option grants to employees under the 2004 Plan, including terms of vesting and the exercise price, are subject to the Board of Directors' approval. Option grants to directors and certain other officers are generally subject to the approvals of the Compensation Committee as well as Board of Directors, and grants to directors or a CEO will also generally have to be approved by the Shareholders. The term of the options shall not exceed 10 years from the date that the option was granted.

The 2004 Plan initially covered up to 282,750 options and subsequent to an amendment by the board in 2007 it covered up to 582,750 options. In August 2012, the Board of Directors increased the number of the ordinary shares available for issuance under the 2004 Plan by an additional 500,000. All options are at a conversion rate of 1:1.

On October 21, 2013 the Board resolved to adopt the Global Share Incentive Plan (2013) (the "2013 Plan") and to reserve up to 500,000 ordinary shares for issuance under the 2013 Plan to employees, directors, officers and consultants of the Company or of any subsidiary or affiliate of the Company. Grants under the 2013 Plan, whether as options, restricted stock units, restricted stock or other equity based awards, including their terms, are subject to the Board of Directors' approval. Grants to directors and certain other officers are generally subject to the approvals of the Compensation Committee as well as Board of Directors, and grants to directors or a CEO (and under certain circumstances certain other officers) will also have to be approved by the Shareholders.

- B. Options or RSUs granted to Israeli residents may be granted under Section 102 of the Israeli Income Tax Ordinance pursuant to which the awards of options, or the ordinary shares issued upon their exercise, must be deposited with a trustee for at least two years following the date of grant. Under Section 102, any tax payable by an employee from the grant or exercise of the awards is deferred until the transfer of the awards or ordinary shares by the trustee to the employee or upon the sale of the awards or ordinary shares. Capital gains on awards granted under the plans are subjected to tax of 25% to be paid by the employee, and the Company is not entitled to a tax deduction. Gains which are not capital gains on awards under the plans are subjected to regular tax rates on individuals, and the Company is entitled to a tax deduction for such gains.

## Notes to the Consolidated Financial Statements

## Note 11 - Shareholders' Equity (cont'd)

## Share based compensation (cont'd)

C. During 2014 and 2015, the Company granted 74,000 and 8,000 RSUs respectively to certain of its directors, employees and consultants under the 2013 Plan. In relation to those grants:

1. The vesting period of the RSUs ranges between 2 to 3 years from the date of grant.
2. The fair value of RSUs is estimated based on the market value of the Company's stock on the date of grant, less an estimate of dividends that will not accrue to RSUs holders prior to vesting.
3. The Company recognizes compensation expenses on these RSUs based on estimated grant date fair value, with the following assumptions:

	<u>2014</u>	<u>2015</u>
Expected dividend yield	2.06%	3.22%
Termination rate	4.35%	0%

**Note 11 - Shareholders' Equity (cont'd)****Share based compensation (cont'd)**

D. On July 28, 2015, the Company granted, in the aggregate, 89,907 options to certain of its directors and employees under the 2013 Plan. In relation to this grant:

1. The exercise price for the options (per ordinary share) was US\$ 26.91 and the Option expiration date was the earlier to occur of: (a) July 28, 2023; and (b) the closing price of the shares falling below US\$ 13.46 at any time after the date of grant. The options vest and become exercisable on the second anniversary of the date of grant.
2. The Company recognizes compensation expenses on these options based on estimated grant date fair value using the Binomial option-pricing model with the following assumptions:

Average Risk-free interest rate (a)	2.08%
Expected dividend yield	2.09%
Average expected volatility (b)	53.01%
Termination rate	9%
Suboptimal factor(c)	3.4

- (a) Risk-free interest rate represents risk free US\$ zero-coupon US Government Bonds at time of grant.
- (b) Expected average volatility represents a weighted average standard deviation rate for the price of the Company's ordinary shares on the NASDAQ National Market.
- (c) Suboptimal factor represents the multiple of the increase in the market share price on the day of grant of the option which, should it come to pass, will lead to exercise of the option by the employee. It is the average suboptimal factor of the Company and similar companies.



**Note 11 - Shareholders' Equity (cont'd)****Share based compensation (cont'd)**

E. On June 8, 2016, the Company granted, in the aggregate, 93,660 options to certain of its directors and employees under the 2013 Plan. In relation to this grant:

1. The exercise price for the options (per ordinary share) was US\$ 28.38 and the Option expiration date was the earlier to occur of: (a) June 8, 2024; and (b) the closing price of the shares falling below US\$ 14.19 at any time after the date of grant. The options vest and become exercisable on the second anniversary of the date of grant.
2. The Company recognizes compensation expenses on these options based on estimated grant date fair value using the Binomial option-pricing model with the following assumptions:

Average Risk-free interest rate (a)	1.58%
Expected dividend yield	2.42%
Average expected volatility (b)	47.90%
Termination rate	9%
Suboptimal factor(c)	3.32

- (a) Risk-free interest rate represents risk free US\$ zero-coupon US Government Bonds at time of grant.
- (b) Expected average volatility represents a weighted average standard deviation rate for the price of the Company's ordinary shares on the NASDAQ National Market.
- (c) Suboptimal factor represents the multiple of the increase in the market share price on the day of grant of the option which, should it come to pass, will lead to exercise of the option by the employee. It is the average suboptimal factor of the Company and similar companies.

**Note 11 - Shareholders' Equity (cont'd)****Share based compensation (cont'd)**

F. On January 30, 2017, the Company granted, in the aggregate, 119,925 options to certain of its directors and employees under the 2013 Plan. In relation to this grant:

1. The exercise price for the options (per ordinary share) was US\$ 39.62 and the Option expiration date was the earlier to occur of: (a) January 30, 2025; and (b) the closing price of the shares falling below US\$ 19.81 at any time after the date of grant. The options vest and become exercisable on the second anniversary of the date of grant.
2. The Company recognizes compensation expenses on these options based on estimated grant date fair value using the Binomial option-pricing model with the following assumptions:

Average Risk-free interest rate (a)	2.35%
Expected dividend yield	2.42%
Average expected volatility (b)	43.71%
Termination rate	9%
Suboptimal factor (c)	3.28

- (a) Risk-free interest rate represents risk free US\$ zero-coupon US Government Bonds at time of grant.
- (b) Expected average volatility represents a weighted average standard deviation rate for the price of the Company's ordinary shares on the NASDAQ National Market.
- (c) Suboptimal factor represents the multiple of the increase in the market share price on the day of grant of the option which, should it come to pass, will lead to exercise of the option by the employee. It is the average suboptimal factor of the Company and similar companies.

**Note 11 - Shareholders' Equity (cont'd)****Share based compensation (cont'd)**

G. On January 30, 2017, the Company granted, in the aggregate, 78,000 RSUs to certain of its directors and employees under the 2013 Plan. In relation to those grants:

1. 50% of the RSUs vest on the second anniversary of the date of the grant and the additional 50% of the RSUs vest on the third anniversary of the date of the grant.
2. The fair value of RSUs is estimated based on the market value of the Company's stock on the date of grant, less an estimate of dividends that will not accrue to RSUs holders prior to vesting.
3. The Company recognizes compensation expenses on these RSUs based on estimated grant date fair value, with the following assumptions:

Expected dividend yield	2.68%
Termination rate	1.74%

## Notes to the Consolidated Financial Statements

## Note 11 - Shareholders' Equity (cont'd)

## Share based compensation (cont'd)

H. The following table summarizes information regarding stock options as at December 31, 2017:

<u>Exercise price</u> <u>US\$</u>	<u>Options outstanding</u>		<u>Options exercisable</u>	
	<u>Number</u> <u>of options</u>	<u>Weighted average</u> <u>remaining</u> <u>contractual life</u> <u>(in years)</u>	<u>Number</u> <u>of options</u>	<u>Weighted average</u> <u>remaining</u> <u>contractual life</u> <u>(in years)</u>
15.28	7,825	2.7	7,825	2.7
26.91	19,582	5.6	19,582	5.6
33.27	19,706	8.3	13,137	8.3
28.38	88,124	6.4	-	-
39.62	114,674	7.1	-	-
	<u>249,911</u>		<u>40,544</u>	

The aggregate intrinsic value of options outstanding as of December 31, 2016 and 2017 is US\$ 4,283 thousand and US\$ 9,175 thousand, respectively.  
The aggregate intrinsic value of options exercisable as of December 31, 2016 and 2017 is US\$ 1,777 thousand and US\$ 1,759 thousand, respectively.  
The total intrinsic value of options exercised during the year ended December 31, 2016 and 2017, is US\$ 1,166 thousand and US\$ 4,194 thousand, respectively.  
The intrinsic value of the options at the date of grant is zero.

## Notes to the Consolidated Financial Statements

## Note 11 - Shareholders' Equity (cont'd)

## Share based compensation (cont'd)

I. The stock option activity under the abovementioned plans is as follows:

	<u>Number of options</u>	<u>Weighted average exercise price US\$</u>	<u>Weighted average grant date fair value US\$</u>
<b>Balance at January 1, 2015</b>	192,130		
Granted	89,907	26.91	10.04
Exercised	(61,711)	15.28	6.54
Forfeited	<u>(5,625)</u>	24.07	9.19
<b>Balance at December 31, 2015</b>	214,701		
Granted*	116,455	29.34	10.96
Exercised	(62,269)	15.28	6.54
Forfeited	<u>(2,882)</u>	29.71	11.79
<b>Balance at December 31, 2016</b>	266,005		
Granted	119,925	39.62	11.89
Exercised	(124,918)	21.46	8.46
Forfeited	<u>(11,101)</u>	33.18	10.87
<b>Balance at December 31, 2017</b>	<u>249,911</u>		
<b>Exercisable at December 31, 2017</b>	<u>40,544</u>		

\* In 2016 the Company granted in the aggregate, 116,455 options. Regarding the grant of 93,660 options, see Note 11E. Regarding the grant of 22,795 options, see Note 3B.

## Notes to the Consolidated Financial Statements

## Note 11 - Shareholders' Equity (cont'd)

## Share based compensation (cont'd)

J. The Restricted Share Units activity under the abovementioned plans is as follows:

	<u>Number of Restricted Share Units</u> US\$	<u>Weighted average grant date fair value</u> US\$
<b>Balance at January 1, 2015</b>	74,000	
Granted	8,000	29.09
Vested	<u>(4,000)</u>	46.07
<b>Balance at December 31, 2015</b>	78,000	
Vested	<u>(35,000)</u>	46.54
<b>Balance at December 31, 2016</b>	43,000	
Granted	78,000	34.90
Vested	<u>(43,000)</u>	42.52
<b>Balance at December 31, 2017</b>	<u>78,000</u>	

The aggregate intrinsic value of RSUs outstanding as of December 31, 2016 and December 31, 2017 is US\$ 1,767 thousand and US\$ 5,469 thousand, respectively.

The aggregate intrinsic value of RSUs vested during the year ended December 31, 2017 is US\$ 2,458 thousand.

## Notes to the Consolidated Financial Statements

## Note 11 - Shareholders' Equity (cont'd)

## Share based compensation (cont'd)

K. During 2015, 2016 and 2017, the Company recorded share-based compensation expenses. The following summarizes the allocation of the stock-based compensation expenses:

	Year ended December 31		
	2015	2016	2017
	US\$ thousands	US\$ thousands	US\$ thousands
Cost of sales	150	180	320
Research and development costs	455	504	832
Selling and marketing expenses	502	366	537
General and administrative expenses	806	500	736
	<u>1,913</u>	<u>1,550</u>	<u>2,425</u>

As of December 31, 2017, there were US\$ 2,420 thousand of unrecognized compensation costs related to outstanding stock options and RSUs to be recognized over a weighted average period of 1.36 years.

The total tax benefit recognized in the consolidated statements of operations related to share based compensation expenses amounted to US\$ 216 thousand for the year ended December 31, 2017.

## Notes to the Consolidated Financial Statements

## Note 12 - Geographic areas and major customers

## A. Information on sales by geographic distribution:

The Company has one operating segment.

Sales are attributed to geographic distribution based on the location of the customer.

	Year ended December 31		
	2015	2016	2017
	US\$ thousands		
North America	54,537	65,590	100,434
Europe	16,331	24,208	20,156
Asia-Pacific	11,870	10,549	5,100
	<u>82,738</u>	<u>100,347</u>	<u>125,690</u>

## B. Sales to single customers exceeding 10% of sales (US\$ thousands):

	Year ended December 31		
	2015	2016	2017
	US\$ thousands		
Customer "A"	*	*	25,888
Customer "B"	16,320	17,366	16,915
Customer "C"	*	11,628	*

\* Less than 10% of sales.

## C. Major Customers - as percentage of net Accounts Receivable balance:

Accounts receivable from significant customers representing 10% or more of the net accounts receivable balance as of December 31, 2016 and 2017, consist of the following customers:

	Year ended December 31	
	2016	2017
	Percentage	
Customer 1	*	30%
Customer 2	*	22%
Customer 3	11%	10%
Customer 4	11%	*

\* Less than 10% of Trade accounts receivable, net.



## Notes to the Consolidated Financial Statements

## Note 12 - Geographic areas and major customers (cont'd)

## D. Information on Long lived assets - Property, Plant and Equipment by geographic areas:

The following table presents the locations of the Company's long lived assets - Property, Plant and Equipment as of December 31, 2016 and 2017:

	Year ended December 31	
	2016	2017
	US\$ thousands	
North America	16	20
Europe	76	225
Israel	3,823	3,876
	<u>3,915</u>	<u>4,121</u>

## Note 13 - Financial Income (Expenses), Net

	Year ended December 31		
	2015	2016	2017
	US\$ thousands		
Interest income	1,026	751	527
Discount on marketable securities, net	(561)	(358)	(217)
Exchange rate differences, net	(148)	(236)	(45)
Bank charges	(97)	(122)	(109)
	<u>220</u>	<u>35</u>	<u>156</u>

**Note 14 - Taxes on Income****A. Measurement of results for tax purposes under the Israeli Income Tax Regulations (Rules for Maintaining Accounting Records of Foreign Invested Companies and Certain Partnerships and Determining Their Taxable Income) - 1986**

As a "foreign invested company" (as defined in the Israeli Law for the Encouragement of Capital Investments-1959), the Company's taxable income or loss is calculated in US Dollars.

**B. Corporate tax rate in Israel**

Taxable income of Israeli companies is subject to tax at the rate of 26.5% in 2014 and 2015, and in January 2016, the regular tax rate in Israel was reduced to 25% as from 2016 and thereafter.

Furthermore, In December 2016, the regular tax rate in Israel was reduced to 23% in two steps. The first step will be to a rate of 24% as from 2017 and the second step will be to a rate of 23% as from 2018 and thereafter.

**C. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereinafter - the "Law")**

1. On December 29, 2010 the Knesset approved the Economic Policy Law for 2011-2012, which includes an amendment to the Law for the Encouragement of Capital Investments – 1959 (hereinafter – "the Amendment to the Law"). The Amendment to the Law is effective from January 1, 2011 and its provisions will apply to preferred income derived or accrued in 2011 and thereafter by a Preferred Company, per the definition of these terms in the Amendment to the Law.

Companies can choose to not be included in the scope of the Amendment to the Law and to stay in the scope of the law before its amendment until the end of the benefits period.

Under the Amendment to the Law, which the Company started applying in 2014, upon an irrevocable election made by a company, a uniform corporate tax rate will apply to all preferred income of such company. Under the law, when the election is made, the uniform tax rate (for 2014 and on) will be 9% in areas in Israel designated as Development Zone A and 16% elsewhere in Israel. The profits of these Preferred Companies will be freely distributable as dividends, subject to a withholding tax of 20%.

In December 2016, under the Amendment to the Law, the uniform tax rate in areas in Israel designated as Development Zone A was reduced to 7.5% as from 2017 and thereafter.

**Note 14 - Taxes on Income (cont'd)****C. Tax benefits under the Israeli Law for the Encouragement of Capital Investments, 1959 (hereinafter - the "Law") (cont'd)**

## 1. (cont'd)

Should the Company derive income from sources other than the "Preferred Enterprise" during the relevant period of benefits, such income will be taxable at the regular corporate tax rates for the applicable year.

2. In the event of distribution by the Company of cash dividends out of its retained earnings that were generated prior to 2014 tax year and were tax exempt due to the "Approved Enterprise" or "Benefited Enterprise" status, the Company would be subjected to a maximum of 25% corporate tax on the amount distributed, and a further 15% withholding tax would be deducted from the amounts distributed to the shareholders.

Out of the Company's retained earnings as of December 31, 2016 and 2017, approximately US\$ 45,405 thousand and US\$ 50,356 thousand respectively are tax-exempt, due to "Approved Enterprise" and "Benefited Enterprise" status. If such tax-exempt income is distributed by cash dividend (including a liquidation dividend), it would be taxed at the reduced corporate tax rate applicable to such profits (up to 25%) and an income tax liability of up to approximately US\$ 11,351 thousand and US\$ 12,589 thousand would be incurred as of December 31, 2016 and 2017, respectively. The Company anticipates that any future dividends distributed pursuant to its dividend policy, will be distributed from income sources which will not impose additional tax liabilities on the Company. The Company intends to reinvest the amount of its tax-exempt income. Accordingly, no deferred income taxes have been provided on income attributable to the Company's "Approved Enterprise" or "Benefited Enterprise". If the Company was to declare a dividend from its tax-exempt income, an income tax expense would be recognized in the period a dividend is declared.

**Note 14 - Taxes on Income (cont'd)****D. Taxation of the subsidiaries**

1. The subsidiary Silicom Connectivity Solutions, Inc. files tax returns to US federal tax authorities and to state tax authorities in the states of New Jersey, California, Virginia, New York and New Mexico.  
On December 22, 2017, the Tax Cuts and Jobs Acts was enacted into law. The new legislation will impact the company by reduction of the corporate income tax rate to 21% effective January 1, 2018.
2. The subsidiary Silicom Denmark is taxed according to the tax laws in Denmark.
3. The Company has not provided for Israeli income and foreign withholding taxes on US\$ 4,043 thousand of its non-Israeli subsidiaries' undistributed earnings as of December 31, 2017. The earnings could become subject to tax if earnings are remitted or deemed remitted as dividends or upon sale of a subsidiary.  
The Company currently has no plans to repatriate those funds and intends to indefinitely reinvest them in its non-Israeli operations. The unrecognized deferred tax liability associated with these temporary differences was approximately US\$ 445 thousand at December 31, 2017.
4. As of December 31, 2017, the net operating loss carry-forwards of the Company's subsidiaries for tax purposes amounted to approximately US\$ 500 thousand. These losses are available to offset any future taxable income.

**E. Tax assessments**

For the Israeli jurisdiction the Company has final tax assessments for all years up to and including the tax year ended December 31, 2012.

For the US Federal jurisdictions, Silicom Inc. has final tax assessments for all years up to and including the tax year ended December 31, 2013. For the New Jersey and California state jurisdictions, Silicom Inc. has final tax assessments for all years up to and including the tax year ended December 31, 2012. For the Virginia state jurisdiction, Silicom Inc. has open tax assessments for the years 2015 through 2017. For the Tennessee state jurisdiction, Silicom Inc. has open tax assessments for the years 2016 through 2017. For the New Mexico, New York and Texas state jurisdictions, Silicom Inc. has open tax assessments for the year 2017.

For the Danish jurisdiction, Silicom Denmark has final tax assessments for all years up to and including the tax year ended August 31, 2013.

## Notes to the Consolidated Financial Statements

## Note 14 - Taxes on Income (cont'd)

## F. Income before income taxes and income taxes expense (benefit) included in the consolidated statements of operations

	Year ended December 31		
	2015	2016	2017
	US\$ thousands		
<u>Income (loss) before income taxes:</u>			
Israel	19,486	15,541	23,226
Foreign jurisdiction	(1,061)	324	2,356
	<u>18,425</u>	<u>15,865</u>	<u>25,582</u>
<u>Current taxes:</u>			
Israel	2,383	2,242	2,379
Foreign jurisdiction	465	720	1,095
	<u>2,848</u>	<u>2,962</u>	<u>3,474</u>
<u>Current tax (benefits) expenses relating to prior years:</u>			
Israel	-	26	12
Foreign jurisdiction	(36)	-	(71)
	<u>(36)</u>	<u>26</u>	<u>(59)</u>
<u>Deferred taxes:</u>			
Israel	(437)	10	549
Foreign jurisdiction	(470)	(270)	(96)
	<u>(907)</u>	<u>(260)</u>	<u>453</u>
Income tax expense	<u>1,905</u>	<u>2,728</u>	<u>3,868</u>

## Notes to the Consolidated Financial Statements

## Note 14 - Taxes on Income (cont'd)

## G. Deferred income taxes

The tax effects of significant items comprising the Company's deferred tax assets are as follows:

	December 31 2016	December 31 2017
	<u>US\$ thousands</u>	<u>US\$ thousands</u>
Deferred tax assets:		
Accrued employee benefits	261	282
Research and development costs	921	846
Tax loss carryforwards	338	111
PPE	15	15
Share based compensation	246	213
Intangible assets	107	110
Other	2	2
Total gross deferred tax assets	<u>1,890</u>	<u>1,579</u>
Deferred tax liabilities:		
Intangible assets	(138)	-
Goodwill	(215)	(680)
Total gross deferred tax liabilities	<u>(353)</u>	<u>(680)</u>
Net deferred tax assets	<u>1,537</u>	<u>899</u>
In Israel	1,338	788
Foreign jurisdictions	199	111
Net deferred tax assets	<u>1,537</u>	<u>899</u>
Non-current deferred tax assets	<u>1,537</u>	<u>899</u>

## Notes to the Consolidated Financial Statements

## Note 14 - Taxes on Income (cont'd)

## H. Reconciliation of the statutory tax expense to actual tax expense

	Year ended December 31		
	2015	2016	2017
	US\$ thousands		
Income before income taxes	18,425	15,865	25,582
Statutory tax rate in Israel	26.5%	25.0%	24.0%
	4,883	3,966	6,140
Increase (decrease) in taxes resulting from:			
Non-deductible operating expenses, net	209	228	364
Non-taxable income	(819)	(84)	(1,114)
Prior year adjustments	(36)	26	(59)
Tax effect due to:			
"Preferred Enterprise" status*	(2,368)	(1,924)	(2,361)
Taxes related to foreign jurisdictions	250	324	632
Changes in tax rate	35	94	162
Creation of deferred taxes for tax losses and benefits from previous years for which deferred taxes were not created in the past	(252)	-	-
Other	3	98	104
Income tax expense	1,905	2,728	3,868

\* The effect of the benefit resulting from the "Preferred Enterprise" status on net earnings per ordinary share is as follows:

	Year ended December 31		
	2015	2016	2017
Basic	0.33	0.26	0.32
Diluted	0.32	0.26	0.31

**Note 14 - Taxes on Income (cont'd)****I Accounting for uncertainty in income taxes**

ASC 740-10 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. This standard prescribes a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. It also requires significant judgment in determining what constitutes an individual tax position as well as assessing the outcome of each tax position.

During 2015, 2016 and 2017 the Company and its subsidiaries did not have any significant unrecognized tax benefits and thus, no related interest and penalties were accrued.

In addition, the Company and its subsidiaries do not expect that the amount of unrecognized tax benefits will change significantly within the next twelve months.