VONAGE HOLDINGS CORP
Form 424B4
May 24, 2006

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**Filed Pursuant to Rule 424(B)(4)**
**Registration No. 333-131659**

**PROSPECTUS**

## 31,250,000 Shares

# Vonage Holdings Corp.

## Common Stock

This is the initial public offering of shares of our common stock. All of the 31,250,000 shares of common stock are being sold by us.

Prior to this offering, there has been no public market for our common stock. The initial public offering price is $17.00 per share. Our common stock has been approved for listing on the New York Stock Exchange under the symbol "VG."

**Investing in our common stock involves a high degree of risk. See "Risk Factors" beginning on page 8 to read about risk factors you should consider before buying shares of our common stock.**

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.**

| | Per Share | Total |
|---|---|---|
| Public offering price | $17.00 | $531,250,000 |
| Underwriting discount | $ 1.02 | $ 31,875,000 |
| Proceeds, before expenses, to us | $15.98 | $499,375,000 |

We have granted the underwriters an option to purchase up to 4,687,500 additional shares of common stock to cover over-allotments.

The underwriters expect to deliver the shares to purchasers on or about May 30, 2006.

**Citigroup** **Deutsche Bank Securities** **UBS Investment Bank**
**Bear, Stearns & Co. Inc.**

**Piper Jaffray** **Thomas Weisel Partners LLC**

Prospectus dated May 23, 2006

**You should rely only on information contained in this prospectus or in any related free writing prospectus filed with the Securities and Exchange Commission and used or referred to in an offering to you of these securities. We have not authorized anyone to provide you with different information. We are not making an offer of these securities in any state where the offer is not permitted. You should not assume that the information contained in this prospectus is accurate as of any date other than the date on the front of this prospectus.**

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Until June 17, 2006 (25 days after the date of this prospectus), all dealers that buy, sell or trade our common stock, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers' obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

# PROSPECTUS SUMMARY

*The following summary is qualified in its entirety by the more detailed information and financial statements and notes appearing elsewhere in this prospectus. Before making an investment, prospective investors should read this entire prospectus carefully, especially the information set forth under the heading "Risk Factors."*

## Our Company

We are a leading provider of broadband telephone services with over 1.6 million subscriber lines as of April 1, 2006. Utilizing our innovative Voice over Internet Protocol, or VoIP, technology platform, we offer feature-rich, low-cost communications services that offer users an experience similar to traditional telephone services. While customers in the United States currently represent over 95% of our subscriber lines, we continue to expand internationally, having launched our service in Canada in November 2004 and in the United Kingdom in May 2005. Since our U.S. launch in October 2002, we have experienced rapid subscriber line growth. For example, we more than tripled our subscriber lines during 2005.

We offer our customers a variety of service plans, each of which has a fixed monthly fee. Each of our service plans includes a full suite of features typically offered by traditional telephone service providers, such as call waiting, caller ID and call forwarding. In addition, we offer several enhanced features at no additional charge that are not typically offered by traditional circuit-switched telephone service providers, such as area code selection, web- and e-mail-based voicemail and an account management website that allows customers to add or change their features online. We also offer a number of premium services for an additional fee, such as toll free numbers, fax numbers and virtual phone numbers. We offer low international per minute calling rates for calls to locations outside the United States, Puerto Rico and Canada. We believe the combination of these factors allows us to offer an attractive value proposition to our customers.

Our customers can make and receive calls using a standard telephone plugged into a portable Vonage-enabled device that can be used almost anywhere a broadband Internet connection is available. We transmit these calls using VoIP technology, which converts voice signals into digital data packets for transmission over the Internet. We provide our service by using our customers' existing broadband Internet connections, eliminating the need for us to build or lease costly "last-mile" connections. In addition, our network is based on internally developed software and industry-standard servers, rather than the more expensive switches used by traditional telephone service providers. This network design enables us to monitor, maintain and expand our network quickly and efficiently while realizing capital and operating cost savings.

We have invested heavily to build a strong brand that helps drive our subscriber growth. During 2005 and the first three months of 2006, we spent an aggregate of $331.7 million on marketing. We employ an integrated marketing strategy that includes extensive television, online, print and radio advertising, a customer referral program and a range of other promotions, all designed to build our brand, attract new customers and retain existing customers. For example, according to Nielsen//NetRatings, an independent Internet media and market research firm, we were the top advertiser on the Internet from January 2005 through the first quarter of 2006 based on estimated spending and impressions. We employ a broad distribution strategy and acquire customers through our websites, our toll free numbers and our presence in leading retail outlets, including Best Buy, Circuit City, CompUSA and RadioShack stores.

We have experienced rapid revenue growth since our inception. Our revenues were $18.7 million in 2003, $79.7 million in 2004, $269.2 million in 2005 and $118.9 million for the three months ended March 31, 2006. While our revenues have grown rapidly, we have experienced increasing net losses, primarily driven by our increase in marketing expenses. For the period from inception through March 31, 2006, our accumulated deficit was $467.4 million. For 2005 and the three months ended March 31, 2006, our net loss was $261.3 million and $85.2 million, respectively, and our marketing expenses were $243.4 million and $88.3 million, respectively. To grow our revenue and customer base and enhance awareness of our brand, we have chosen to spend significant amounts on our marketing activities, and we intend to continue to do so. While this strategy will have the effect of delaying or preventing us from generating net income in the near term, we believe that our focus on growth will better position us as a strong competitor in the long term. As of March 31, 2006, our debt consisted of $253.4 million of convertible notes (principal amount of $253.6 less unamortized discount of $0.2 million) and $24.9 million of capital leases.

**Our Market Opportunity**

VoIP communications are carried as data packets and require a broadband Internet connection that has sufficient bandwidth to deliver the data uninterrupted. As a result, broadband penetration has been a key driver of VoIP's expansion to date. We believe that as broadband adoption becomes even more prevalent worldwide, consumers will increasingly look to use their high-speed Internet connections for more of their voice, video and data communications. Many independent market research analysts believe that the growth rate in new VoIP subscribers over the next few years will exceed the growth rate for new broadband subscribers. For example, several such analysts have estimated that the approximately 0.9 to 1.5 million U.S. or North American consumer VoIP users in 2004 will grow to between 8.2 and 15.3 million by the end of 2007. As a leading provider of broadband telephone services using VoIP, we believe we are well positioned to benefit from the growth expected in this marketplace. However, the VoIP market may not grow as expected, and our business might not benefit from any actual growth that does occur.

**Our Strengths**

We believe we have the following strengths:

- Leading VoIP Market Position and VoIP Brand in the United States
- Attractive Customer Value Proposition
- Innovative, Low-Cost Technology Platform
- Strong Direct and Retail Distribution Channels
- Loyal Customer Base

**Our Strategy**

We believe that our strong brand identity and reputation for quality communications services are instrumental to building our customer base. Our core business strategy is to enhance our brand image and the quality of our services in order to attract new customers. As we build on our leading brand and above-mentioned strengths, our additional business strategies are to:

- Develop Attractive, Innovative Features and Products
- Expand our Direct and Retail Distribution Capabilities
- Continue to Improve the Customer Experience
- Expand into New Geographic Markets

**Our Investors**

Simultaneously with the completion of this offering, all outstanding shares of all series of our convertible preferred stock will automatically convert into shares of common stock. Upon completion of this offering, after giving effect to the conversion of our preferred stock into shares of common stock but not giving effect to the conversion or exercise of other securities convertible into or exercisable for common stock, affiliates of 3i Group plc, Bain Capital, LLC, Institutional Venture Partners, Meritech Capital Partners and New Enterprise Associates collectively will own 70,287,914 shares of common stock, or 45% of our common stock. Jeffrey A. Citron, our principal stockholder, founder, Chairman and Chief Strategist, will own 48,427,617 shares of common stock, or 31% of our common stock. These financial sponsors and Mr. Citron had collectively invested an aggregate of $450.5 million in our company as of March 31, 2006.

**E-911 Initiative**

The U.S. Federal Communications Commission, or FCC, required us to provide enhanced emergency dialing capabilities, or E-911, to all of our U.S. customers by November 28, 2005. We are not currently in compliance with the FCC's order, although approximately 75% of our U.S. subscriber lines were E-911 compliant as of April 1, 2006. Additional progress is being made on a daily basis and we expect to provide E-911 capabilities to nearly all of our remaining subscriber lines within the year. We have requested a waiver from the FCC to provide us with the additional time needed to complete the roll-out. It is possible the FCC will deny our request and subject us to fines or penalties or order us to stop accepting new customers in certain areas until we have rolled out E-911 capability in those areas.

**Risk Factors**

An investment in our common stock involves a high degree of risk. The following risks, as well as the other risks discussed in "Risk Factors," should be carefully considered before participating in this offering:

- our history of net operating losses and our need for cash to finance our growth;
- the competition we face, including from companies with greater financial resources;
- our dependence on our customers' existing broadband connections, which gives us less control over call quality than traditional telephone networks;
- differences between our service and traditional telephone services, including our 911 service;
- uncertainties relating to regulation of VoIP services;
- system disruptions or flaws in our technology;
- our ability to manage our rapid growth; and
- the risk that VoIP does not gain broader acceptance.

**Corporate Information**

We were incorporated in Delaware in May 2000 and changed our name to Vonage Holdings Corp. in February 2001. Our principal executive offices are located at 23 Main Street, Holmdel, NJ 07733. Our telephone number is (732) 528-2600. Our websites are http://www.vonage.com, http://www.vonage.ca and http://www.vonage.co.uk. **Information contained on our websites or that can be accessed through our websites is not part of this prospectus, and investors should not rely on any such information in making the decision whether to purchase our common stock.**

**The Offering**

| | |
|---|---|
| Common stock offered by us | 31,250,000 shares |
| Common stock outstanding after the offering | 155,732,440 shares |
| Over-allotment option | 4,687,500 shares |
| Use of proceeds | We estimate that the net proceeds from our sale of 31,250,000 shares of our common stock in this offering will be approximately $493.7 million. We intend to use these net proceeds to fund the expansion of our business, including funding marketing expenses and operating losses. |
| Dividend policy | We do not intend to pay any cash dividends on our common stock. |
| Directed share programs | We have reserved a portion of our common stock offered in this prospectus for sale to certain of our customers and other persons related to us. See "Underwriting Directed Share Programs" for more information. |
| Risk factors | Investing in our common stock involves a high degree of risk. See "Risk Factors" beginning on page 8 to read about risk factors you should consider before buying shares of our common stock. |
| Proposed symbol | VG |

The number of shares of common stock outstanding after this offering excludes:

16,904,494 shares of common stock issuable upon exercise of currently outstanding options as of March 31, 2006 with exercise prices ranging from $0.70 to $35.00 and having a weighted average exercise price of $7.89 per share;

3,085,715 shares of common stock issuable upon exercise of currently outstanding warrants with exercise prices ranging from $0.70 to $1.40 per share and having a weighted average exercise price of $1.28 per share;

shares of common stock reserved for future grants under our stock option plans which will be determined under a formula set forth in our 2006 Incentive Plan, and will equal approximately 17.65% of the number of shares that are issued and outstanding from time to time. As of March 31, 2006, assuming the conversion of the outstanding shares of preferred stock and sale of the shares in this offering, there would be approximately 27,486,776 shares reserved for grant; and

shares of common stock issuable upon conversion of our convertible notes, which totaled 17,826,424 shares as of March 31, 2006, based on a conversion price of $14.22 per share. Additional shares will be issuable upon conversion if we elect to pay interest on these notes in kind by increasing the principal outstanding under the notes. See "Description of Convertible Notes."

Except as otherwise indicated, all information in this prospectus assumes no exercise of the underwriters' over-allotment option and reflects the conversion of all outstanding shares of our preferred stock into a total of 123,069,420 shares of common stock upon the closing of this offering and reflects a 1 for 2.8 reverse stock split, which took effect on May 18, 2006.

## Summary Consolidated Financial Data

The following table sets forth our summary consolidated financial data. The statement of operations data for the years ended December 31, 2003, 2004 and 2005 and the balance sheet data as of December 31, 2004 and 2005 are derived from our audited consolidated financial statements and related notes included in the back of this prospectus. The balance sheet data as of December 31, 2003 is derived from our audited consolidated financial statements and related notes not included in this prospectus. The statement of operations data for the three months ended March 31, 2005 and 2006 and the balance sheet data as of March 31, 2006 are derived from our unaudited consolidated financial statements included in the back of this prospectus. In the opinion of management, the unaudited consolidated financial statements have been prepared on the same basis as our audited consolidated financial statements and include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the information set forth therein. The results for any interim period are not necessarily indicative of the results that may be expected for a full year.

The results included below and elsewhere in this prospectus are not necessarily indicative of our future performance. You should read this information together with "Capitalization," "Selected Historical Financial Data," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and the related notes included elsewhere in this prospectus.

| | For the Years Ended December 31, | | | For the Three Months Ended March 31, | |
|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2005 | 2006 |
| | | | (dollars in thousands) | | |
| | | | | | (Restated(14)) |
| **Statement of Operations Data:** | | | | | |
| Operating Revenues: | | | | | |
| Telephony services | $ 16,905 | $ 75,864 | $ 258,165 | $ 38,583 | $ 111,658 |
| Customer equipment and shipping | 1,817 | 3,844 | 11,031 | 2,127 | 7,225 |
| | 18,722 | 79,708 | 269,196 | 40,710 | 118,883 |
| Operating Expenses: | | | | | |
| Direct cost of telephony services (excluding depreciation and amortization of $1,388, $2,519, $6,671, $954 and $2,552) | 8,556 | 23,209 | 84,050 | 12,108 | 37,584 |
| Direct cost of goods sold | 4,867 | 18,878 | 40,441 | 11,588 | 17,580 |
| Selling, general and administrative | 19,174 | 49,186 | 154,716 | 20,553 | 52,875 |
| Marketing(1) | 11,819 | 56,075 | 243,404 | 55,436 | 88,288 |
| Depreciation and amortization | 2,367 | 3,907 | 11,122 | 1,610 | 4,959 |
| | 46,783 | 151,255 | 533,733 | 101,295 | 201,286 |
| Loss from operations | (28,061) | (71,547) | (264,537) | (60,585) | (82,403) |
| Net loss | $ (29,974) | $ (69,921) | $ (261,334) | $ (60,002) | $ (85,160) |
| **Statement of Cash Flow Data:** | | | | | |
| Net cash used in operating activities | $ (16,583) | $ (38,600) | $ (189,765) | $ (23,493) | $ (74,559) |
| Net cash provided by (used in) investing activities | (4,933) | (73,707) | (154,638) | 7,896 | 21,770 |
| Net cash provided by financing activities | 34,226 | 141,094 | 434,006 | 148 | 1,851 |

| | December 31, | | | March 31, | Pro forma March 31, |
|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2006(13) |
| | | (dollars in thousands) | | (Restated(14)) | (Restated(14)) |
| **Balance Sheet Data (at period end):** | | | | | |
| Cash, cash equivalents and marketable securities | $ 14,245 | $ 105,768 | $ 266,379 | $ 175,461 | $ 175,461 |
| Property and equipment, net | 9,325 | 16,290 | 103,638 | 118,947 | 118,947 |
| Total assets | 28,311 | 136,493 | 446,882 | 378,197 | 378,197 |
| Convertible notes(2) | | | 247,958 | 253,352 | 253,352 |
| Capital lease obligations | 5 | | 22,431 | 24,907 | 24,907 |
| Total liabilities | 14,038 | 51,045 | 426,940 | 438,790 | 438,790 |
| Total redeemable preferred stock | 51,409 | 192,521 | 388,427 | 388,439 | |
| Total stockholders' deficit | (37,136) | (107,073) | (368,485) | (449,032) | (60,593) |

| | For the Years Ended December 31, | | | For the Three Months Ended March 31, | |
|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2005 | 2006 |
| **Operating and Other Data (unaudited):** | | | | | |
| Gross subscriber line additions(3) | 91,522 | 364,214 | 1,099,641 | 280,123 | 421,890 |
| Net subscriber line additions(4) | 77,936 | 304,849 | 878,472 | 249,333 | 328,279 |
| Subscriber lines(5)(6) | 85,717 | 390,566 | 1,269,038 | 639,899 | 1,597,317 |
| Average monthly customer churn(7) | 2.48% | 1.82% | 2.05% | 1.70% | 2.11% |
| Average monthly revenue per line(8) | $ 33.37 | $ 27.89 | $ 27.03 | $ 26.34 | $ 27.65 |
| Average monthly telephony services revenue per line(9) | $ 30.13 | $ 26.55 | $ 25.93 | $ 24.96 | $ 25.97 |
| Average monthly direct cost of telephony services per line(10) | $ 15.25 | $ 8.12 | $ 8.44 | $ 7.83 | $ 8.74 |
| Marketing cost per gross subscriber line addition(11) | $ 129.14 | $ 153.96 | $ 221.35 | $ 197.90 | $ 209.27 |
| Employees(5)(12) | 189 | 648 | 1,355 | 1,045 | 1,416 |

(1) Marketing expense consists of costs of advertising, which includes online, television, print and radio advertising and direct mail, promotions, sponsorships and inbound and outbound telemarketing; creative and production costs; the costs to serve and track our online advertising; certain amounts we pay to retailers for newspaper insert advertising, product placement and activation commissions; and the cost associated with our customer referral program. Marketing expense does not include the cost of certain customer acquisition activities, such as rebates and promotions, which are accounted for as an offset to revenues, or customer equipment subsidies, which are accounted for as direct cost of goods sold.

(2) As of March 31, 2006, we had convertible notes with a principal amount of $253.6 million before unamortized discount of $0.2 million.

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

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

(5) At end of period.

6

(6)

Subscriber lines include, as of a particular date, all subscriber lines from which a customer can make an outbound telephone call on that date. Our subscriber lines include fax lines, SoftPhones and WiFi phones but do not include our virtual phone numbers or toll free numbers, which only allow inbound telephone calls to customers.

(7)

Average monthly customer churn for a particular period is calculated by dividing the number of customers that terminated during that period by the simple average number of customers during the period and dividing the result by the number of months in the period. The simple average number of customers during the period is the number of customers on the first day of the period, plus the number of customers on the last day of the period, divided by two. Terminations, as used in the calculation of churn statistics, do not include customers terminated during the period if termination occurred within the first 30 days after activation. We monitor churn on a daily basis and use it as an indicator of the level of customer satisfaction. Other companies may calculate churn differently, and their churn data may not be directly comparable to ours. Average monthly customer churn is calculated using the number of customers, not subscriber lines. The number of customers is lower than the number of subscriber lines because some customers have more than one subscriber line.

(8)

Average monthly revenue per line for a particular period is calculated by dividing our total revenue for that period by the simple average number of subscriber lines for the period and dividing the result by the number of months in the period. The simple average number of subscriber lines for the period is the number of subscriber lines on the first day of the period, plus the number of subscriber lines on the last day of the period, divided by two.

(9)

Average monthly telephony services revenue per line for a particular period is calculated by dividing our total telephony services revenue for that period by the simple average number of subscriber lines for the period and dividing the result by the number of months in the period.

(10)

Average monthly direct cost of telephony services per line for a particular period is calculated by dividing our direct cost of telephony services for that period by the simple average number of subscriber lines for the period and dividing the result by the number of months in the period.

(11)

Marketing cost per gross subscriber line addition is calculated by dividing our marketing expense for a particular period by the number of gross subscriber line additions during the period.

(12)

Represents the number of personnel that are on our payroll and excludes temporary or outsourced labor.

(13)

Assumes all redeemable preferred stock was converted on January 1, 2006 into common stock with the exception of the Series A-2 preferred stock warrant which has been reclassified to additional paid-in capital on the balance sheet.

(14)

In December 2005 and January 2006, we issued approximately $249,900 of convertible notes, and an additional $3,600 as the payment of interest in kind in March 2006. Originally, we believed that the convertible notes contained an embedded derivative and accordingly accounted for the embedded derivative by bifurcating the embedded derivative from the convertible notes at the date of issuance and subsequently remeasuring the fair value of the embedded derivative at December 31, 2005 and March 31, 2006. In May 2006, upon further review, we concluded that the convertible notes do not contain an embedded derivative. See "Note 1 to our consolidated financial statements." "Restated" amounts in the Statements of Operations Data reflect the removal of the income attributable to the change in fair value of derivatives embedded within the convertible notes of $13,392 and a reduction to interest expense related to the convertible notes of $1,029. "Restated" amounts in the Balance Sheet Data reflect the removal of the fair value of derivatives embedded within the convertible notes of $8,800 and the removal of the unamortized discount related to embedded derivatives which increased the outstanding amount of the convertible notes by $21,161. The convertible notes also decreased by $212 for the beneficial conversion feature. The impact to the December 31, 2005 consolidated financial statements for these changes was not considered material and accordingly only reclassifications were required.

## RISK FACTORS

*Investing in our common stock involves a high degree of risk. Before you invest in our common stock, you should understand and carefully consider the risks below, as well as all of the other information contained in this prospectus and our financial statements and the related notes included elsewhere in this prospectus. Any of these risks could materially adversely affect our business, financial condition and results of operations and the trading price of our common stock, and you may lose all or part of your investment.*

### Risks Related to Our Business

***We have incurred increasing quarterly losses since our inception, and we expect to continue to incur losses in the future.***

We have incurred losses since our inception, and we expect to continue to incur losses in the future. For the period from our inception through March 31, 2006, our accumulated deficit was $467.4 million. Our quarterly net losses generally have increased each quarter from our inception through the quarter ended March 31, 2006, for which our net loss was $85.2 million. Initially, our net losses were driven principally by start-up costs and the costs of developing our technology. More recently, our net losses have been driven principally by marketing expense, which was $88.3 million for the three months ended March 31, 2006. In order to grow our revenue and customer base, we have chosen to increase our marketing expenditures significantly. We are pursuing growth, rather than profitability, in the near term to capitalize on the current expansion of the broadband and VoIP markets and enhance the future value of our company. This strategy, however, may not be successful, and we may never achieve profitability. In the past, we projected that we would generate net income during future periods, but then generated a net loss. For example, in 2003, we projected that we would generate net income in the first quarter of 2005. However, we generated a net loss of $60.0 million during that quarter, in large part due to our decision to increase our marketing expense. We intend to continue to increase our marketing expense, and we may continue to generate net losses for the foreseeable future. In addition, we will always be required to incur some marketing expense in order to replace customers who terminate our service, or "churn." Further, marketing expense is not the only factor that may contribute to our net losses. For example, interest expense on our convertible notes of at least $12.7 million annually will contribute to our net losses. As a result, even if we significantly reduce our marketing expense, we may continue to incur net losses.

***If we are unable to compete successfully, we could lose market share and revenue.***

The telecommunications industry is highly competitive. We face intense competition from traditional telephone companies, wireless companies, cable companies and alternative voice communication providers. Our principal competitors are the traditional telephone service providers, namely AT&T, Inc. (formerly SBC Communications Inc.), BellSouth Corp., Citizens Communications Corp., Qwest Communications International Inc. and Verizon Communications, Inc., which provide telephone service based on the public switched telephone network. Some of these traditional providers also have added or are planning to add VoIP services to their existing telephone and broadband offerings. We also face, or expect to face, competition from cable companies, such as Cablevision Systems Corp., Charter Communications, Inc., Comcast Corporation, Cox Communications, Inc. and Time Warner Cable (a division of Time Warner Inc.), which have added or are planning to add VoIP services to their existing cable television, voice and broadband offerings. Further, wireless providers, including Cingular Wireless LLC, Sprint Nextel Corporation, T-Mobile USA Inc. and Verizon Wireless, offer services that some customers may prefer over wireline service. In the future, as wireless companies offer more minutes at lower prices, their services may become more attractive to customers as a replacement for wireline service. Some of these providers may be developing a dual mode phone that will be able to use VoIP where broadband access is available and cellular phone service elsewhere, which will pose additional competition to our offerings.

Most traditional wireline and wireless telephone service providers and cable companies are substantially larger and better capitalized than we are and have the advantage of a large existing customer base. Because most of our target customers are already purchasing communications services from one or more of these providers, our success is dependent upon our ability to attract target customers away from their existing providers. Until recently, our target market has been composed largely of early adopters, or people who tend to seek out new technologies and services. Attracting customers away from their existing providers will become more difficult as the early adopter market becomes saturated and mainstream customers make up more of our target market. These competitors could focus their substantial financial resources to develop competing technology that may be more attractive to potential customers than what we offer. Our competitors' financial resources may allow them to offer services at prices below cost or even for free in order to maintain and gain market share or otherwise improve their competitive positions. Our competitors also could use their greater financial resources to offer VoIP services with more attractive service packages that include on-site installation and more robust customer service. In addition, because of the other services our competitors provide, they may choose to offer VoIP services as part of a bundle that includes other products, such as video, high speed Internet access and wireless telephone service, which we do not offer. This bundle may enable our competitors to offer VoIP service at prices with which we may not be able to compete or to offer functionality that integrates VoIP service with their other offerings, both of which may be more desirable to consumers. Any of these competitive factors could make it more difficult for us to attract and retain customers, cause us to lower our prices in order to compete and reduce our market share and revenues.

We also compete against established alternative voice communication providers, such as Skype (a service of eBay Inc.), and face competition from other large, well-capitalized Internet companies, such as America Online, Inc., Google Inc., Microsoft Corporation and Yahoo! Inc., which have recently launched or plan to launch VoIP-enabled instant messaging services. In addition, we compete with independent VoIP service providers. Some of these service providers may choose to sacrifice revenue in order to gain market share and have offered their services at lower prices or for free. In order to compete with such service providers, we may have to significantly reduce our prices, which would delay or prevent our profitability. See "Business Competition."

***Decreasing telecommunications prices may cause us to lower our prices to remain competitive, which could delay or prevent our future profitability.***

Currently, our prices are lower than those of many of our competitors for comparable services. However, domestic and international telecommunications prices have decreased significantly over the last few years, and we anticipate that prices will continue to decrease. Users who select our service offerings to take advantage of our prices may switch to another service provider as the difference between prices diminishes or disappears, and we may be unable to use our price as a distinguishing feature to attract new customers in the future. Such competition or continued price decreases may require us to lower our prices to remain competitive, may result in reduced revenue, a loss of customers or a decrease in our subscriber line growth and may delay or prevent our future profitability.

***If VoIP technology fails to gain acceptance among mainstream consumers, our ability to grow our business will be limited.***

The market for VoIP services has only recently begun to develop and is rapidly evolving. We currently generate all of our revenue from the sale of VoIP services and related products to residential and small office or home office customers. Revenue generated from sales to residential customers will continue to account for most of our revenue for the foreseeable future. We believe that a significant portion of our revenue currently comes from consumers who are early adopters of VoIP technology. However, in order for our business to continue to grow and to become profitable, VoIP technology must gain acceptance among mainstream consumers, who tend to be less technically knowledgeable and more resistant to new technology or unfamiliar services. Because potential VoIP customers need to connect additional hardware at their location and take other technical steps not required for the use of traditional telephone service, mainstream consumers may be reluctant to use our service. If mainstream consumers choose not to adopt our technology, our ability to grow our business will be limited.

***Certain aspects of our service are not the same as traditional telephone service, which may limit the acceptance of our services by mainstream consumers and our potential for growth.***

Certain aspects of our service are not the same as traditional telephone service. Our continued growth is dependent on the adoption of our services by mainstream customers, so these differences are becoming increasingly important. For example:

- Both our new E-911 and emergency calling services are different, in significant respects, from the 911 service associated with traditional wireline and wireless telephone providers and, in certain cases, with other VoIP providers.

- Our customers may experience lower call quality than they are used to from traditional wireline telephone companies, including static, echoes and delays in transmissions.

- Our customers may experience higher dropped-call rates than they are used to from traditional wireline telephone companies.

- Customers who obtain new phone numbers from us do not appear in the phone book and their phone numbers are not available through directory assistance services offered by traditional telephone companies.

- Our customers cannot accept collect calls.

- In the event of a power loss or Internet access interruption experienced by a customer, our service is interrupted. Unlike some of our competitors, we have not installed batteries at customer premises to provide emergency power for our customers' equipment if they lose power, although we do have backup power systems for our network equipment and service platform.

If customers do not accept the differences between our service and traditional telephone service, they may choose to remain with their current telephone service provider or may choose to return to service provided by traditional telephone companies.

***Our emergency and new E-911 calling services are different from those offered by traditional wireline telephone companies and may expose us to significant liability.***

Both our emergency calling service and our new E-911 calling service are different, in significant respects, from the emergency calling services offered by traditional wireline telephone companies. In each case, those differences may cause significant delays, or even failures, in callers' receipt of the emergency assistance they need.

Traditional wireline telephone companies route emergency calls over a dedicated infrastructure directly to an emergency services dispatcher at the public safety answering point, or PSAP, in the caller's area. Generally, the dispatcher automatically receives the caller's phone number and actual location information. While our new E-911 service being deployed in the United States is designed to route calls in a fashion similar to traditional wireline services, our new E-911 capabilities are not yet available in all locations. In addition, the only location information that our E-911 service can transmit to a dispatcher at a PSAP is the information that our customers have registered with us. A customer's registered location may be different from the customer's actual location at the time of the call because customers can use their Vonage-enabled devices to make calls almost anywhere a broadband connection is available.

We are currently deploying E-911 service that is comparable to the emergency calling services provided to customers of traditional wireline telephone companies in the same area. For those customers located in an E-911 area, emergency calls are routed, subject to the limitations discussed

below, directly to an emergency services dispatcher at the PSAP in the area of the customer's registered location. The dispatcher will have automatic access to the customer's telephone number and registered location information. However, if a customer places an emergency call using the customer's Vonage-enabled device in a location different from the one registered with us, the emergency call will be routed to a PSAP in the customer's registered location, not the customer's actual location at the time of the call. Every time a customer moves his or her Vonage-enabled device to a new location, the customer's registered location information must be updated and verified. Until that takes place, the customer will have to verbally advise the emergency dispatcher of his or her actual location at the time of the call and wait for the call to be transferred, if possible, to the appropriate local emergency response center before emergency assistance can be dispatched.

In some cases, even under our new 911 service, emergency calls may be routed to a PSAP in the area of the customer's registered location, but such PSAP will not be capable of receiving our transmission of the caller's registered location information and, in some cases, the caller's phone number. Where the emergency call center is unable to process the information, the caller is provided a service that is similar to the basic 911 services offered to some wireline telephone customers. In these instances, the emergency caller may be required to verbally advise the operator of their location at the time of the call and, in some cases, a call back number so that the call can be handled or forwarded to an appropriate emergency dispatcher.

The emergency calls of customers located in areas where we are currently unable to provide either E-911 or the basic 911 described above are either routed directly to the PSAP in the area of the customer's location or supported by a national call center that is run by a third-party provider and operates 24 hours a day, seven days a week. In these cases, a caller must provide the operator with his or her physical location and call back number. If a customer reaches the call center, the operator will coordinate connecting the caller to the appropriate PSAP or emergency services provider. Our E-911 service does not support the calls of our WiFi phone and SoftPhone users. The emergency calls of our WiFi phone and SoftPhone users are supported by the national call center.

If one of our customers experiences a broadband or power outage, or if a network failure were to occur, the customer will not be able to reach an emergency services provider.

Delays our customers encounter when making emergency services calls and any inability of the answering point to automatically recognize the caller's location or telephone number can have devastating consequences. Customers have attempted, and may in the future attempt, to hold us responsible for any loss, damage, personal injury or death suffered as a result. Some traditional phone companies also may be unable to provide the precise location or the caller's telephone number when their customers place emergency calls. However, traditional phone companies are covered by legislation exempting them from liability for failures of emergency calling services and we are not. This liability could be significant. In addition, we have lost, and may in the future lose, existing and prospective customers because of the limitations inherent in our emergency calling services. Any of these factors could cause us to lose revenues, incur greater expenses or cause our reputation or financial results to suffer.

***Flaws in our technology and systems could cause delays or interruptions of service, damage our reputation, cause us to lose customers and limit our growth.***

Although we have designed our service network to reduce the possibility of disruptions or other outages, our service may be disrupted by problems with our technology and systems, such as malfunctions in our software or other facilities and overloading of our network. Our customers have experienced interruptions in the past and may experience interruptions in the future as a result of these types of problems. Interruptions have in the past and may in the future cause us to lose customers and offer substantial customer credits, which could adversely affect our revenue and profitability. For example, during 2005 our service was significantly impaired on two separate occasions. In March 2005, a problem during a software upgrade to our call processing system caused most of our customers to experience intermittent service for several hours. In August 2005, one of our third-party carriers experienced an outage of approximately 90 seconds, which caused a failure in some of our gateways. As a result, during a period of several hours, approximately two out of three outbound calls from our customers to the public switched telephone network experienced an "all circuits busy" condition. We have since had other outages that affected smaller groups of customers at various times. In addition, because our systems and our customers' ability to use our services are Internet-dependent, our services may be subject to "hacker attacks" from the Internet, which could have a significant impact on our systems and services. If service interruptions adversely affect the perceived reliability of our service, we may have difficulty attracting and retaining customers and our brand reputation and growth may suffer.

***Our ability to provide our service is dependent upon third-party facilities and equipment, the failure of which could cause delays or interruptions of our service, damage our reputation, cause us to lose customers and limit our growth.***

Our success depends on our ability to provide quality and reliable service, which is in part dependent upon the proper functioning of facilities and equipment owned and operated by third parties and is, therefore, beyond our control. Unlike traditional wireline telephone service or wireless service, our service requires our customers to have an operative broadband Internet connection and an electrical power supply, which are provided by the customer's Internet service provider and electric utility company, respectively, and not by us. The quality of some broadband Internet connections may be too poor for customers to use our services properly. In addition, if there is any interruption to a customer's broadband Internet service or electrical power supply, that customer will be unable to make or receive calls, including emergency calls, using our service. We also outsource several of our network functions to third-party providers. For example, we outsource the maintenance of our regional data connection points, which are the facilities at which our network interconnects with the public switched telephone network. If our third-party service providers fail to maintain these facilities properly, or fail to respond quickly to problems, our customers may experience service interruptions. Our customers have experienced such interruptions in the past and will experience interruptions in the future. In addition, our new E-911 service is currently dependent upon several third-party providers. Interruptions in service from these vendors could cause failures in our customers' access to E-911 services. Interruptions in our service caused by third-party facilities have in the past caused and may in the future cause us to lose customers, or cause us to offer substantial customer credits, which could adversely affect our revenue and profitability. If interruptions adversely affect the perceived reliability of our service, we may have difficulty attracting new customers and our brand, reputation and growth will be negatively impacted.

***We may not be able to maintain adequate customer care during periods of growth or in connection with our addition of new and complex Vonage-enabled devices, which could adversely affect our ability to grow and cause our financial results to be negatively impacted.***

Good customer care is important to acquiring and retaining customers. At some points in the past, we have not been able to expand our customer care operations quickly enough to meet the needs of our greatly increased customer base, and the quality of our customer care has suffered. For example, in the first quarter of 2005, our customers experienced longer than acceptable hold times when they called us for assistance. In the first quarter of 2006, our average monthly customer churn rate increased to 2.11% from 1.90% in the prior quarter. We believe this increase was due to our rapid growth and inability to hire enough qualified customer care employees which led to less than satisfactory customer care during the quarter, which we are working to address. In the future, as we broaden our Vonage-enabled device offerings and our customers build increasingly complex home networking environments, we will face additional challenges in training our customer care staff. We face a high turnover rate among our customer care employees. We continue to hire and train customer care representatives at a rapid rate in order to meet the needs of our growing customer base. If we are unable to hire, train and retain sufficient personnel to provide adequate customer care, we may experience slower growth, increased costs and higher churn levels, which would cause our financial results to be negatively impacted.

***If we are unable to improve our process for local number portability provisioning, our growth may be negatively impacted.***

We support local number portability for our customers, which allows our customers to retain their existing telephone numbers when subscribing to our services. Transferring numbers is a manual process that in the past could have taken us 20 business days or longer, although we have taken steps to automate this process to reduce the delay. A new Vonage customer must maintain both Vonage service and the customer's existing telephone service during the transferring process. By comparison, transferring wireless telephone numbers among wireless service providers generally takes several hours, and transferring wireline telephone numbers among traditional wireline service providers generally takes a few days. The additional delay that we experience is due to our reliance on the telephone company from which the customer is transferring and to the lack of full automation in our process. Further, because we are not a regulated telecommunications provider, we must rely on the telephone companies, over whom we have no control, to transfer numbers. We also rely on two third parties who have contractual obligations to us to facilitate the transfer of customers' telephone numbers. Local number portability is considered an important feature by many potential customers, and if we fail to reduce related delays, we may experience increased difficulty in acquiring new customers.

***A higher rate of customer terminations would negatively impact our business by reducing our revenue or requiring us to spend more money to grow our customer base.***

Our rate of customer terminations, or average monthly customer churn, was 2.11% for the three months ended March 31, 2006. During those three months, approximately 77,000 of our customers terminated. Our churn rate could increase in the future if customers are not satisfied with our service. Other factors, including increased competition from other providers, also influence our churn rate.

Because of churn, we have to acquire new customers on an ongoing basis just to maintain our existing level of customers and revenues. As a result, marketing expense is an ongoing requirement of our business. If our churn rate increases, we will have to acquire even more new customers in order to maintain our existing revenues. We incur significant costs to acquire new customers, and those costs are an important factor in determining our net losses and achieving future profitability. Therefore, if we are unsuccessful in retaining customers or are required to spend significant amounts to acquire new customers beyond those budgeted, our revenue could decrease and our net losses could increase.

***We may require significant capital to pursue our growth strategy, but we may not be able to obtain additional financing on favorable terms or at all.***

We intend to continue spending substantial amounts on marketing and product development in order to grow our business. We may need to obtain additional financing to pursue this business strategy, to respond to new competitive pressures or to respond to opportunities to acquire complementary businesses or technologies. Our significant losses to date may prevent us from obtaining additional funds on favorable terms or at all. For the three months ended March 31, 2006, we recorded a net loss of $85.2 million. Because of these losses and our limited tangible assets, we do not fit traditional credit lending criteria, which, in particular, could make it difficult for us to obtain loans or to access the capital markets. For example, we discussed a revolving credit facility with commercial banks in the summer of 2005. As a result of those discussions, we believe most commercial lenders will require us to very significantly reduce our loss from operations before they will lend us money. In addition, the terms of our outstanding convertible notes provide for additional shares to be issued upon conversion if we sell shares of our common stock after our initial public offering at a price that is less than the average trading price of our common stock over the 10-day period prior to any such sale, which might further limit our access to the capital markets. A failure to obtain additional financing could adversely affect our ability to grow and maintain our business.

***As a result of being a public company, we will incur increased costs that may place a strain on our resources or divert our management's attention from other business concerns.***

As a public company, we will incur additional legal, accounting and other expenses that we do not incur as a private company. The Exchange Act will require us to file annual, quarterly and current reports with respect to our business and financial condition, which will require us to incur legal and accounting expenses. The Sarbanes-Oxley Act will require us to maintain effective disclosure controls and procedures and internal controls for financial reporting. In order to maintain and improve the effectiveness of our disclosure controls and procedures and internal control over financial reporting, significant resources and management oversight will be required. We expect the corporate governance rules and regulations of the SEC and the New York Stock Exchange will increase our legal and financial compliance costs and make some activities more time consuming and costly. These requirements may place a strain on our systems and resources and may divert our management's attention from other business concerns, which could have a material adverse effect on our business, financial condition and results of operations. In addition, we are hiring and will continue to hire additional legal, accounting and financial staff with appropriate public company experience and technical accounting knowledge, which will increase our operating expenses in future periods.

We also expect these rules and regulations to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers.

***Our rapid growth has placed substantial demands on our management and operations. If we fail to hire and train additional personnel or improve our controls and procedures to respond to this growth, our business, operating results and financial position could be harmed.***

Our business and operations have expanded rapidly since our inception in May 2000. For example, during the 12 months ended December 31, 2005, the number of our employees more than doubled, growing from 648 to 1,355, and we experienced high turnover among our customer care employees. To support our expanded customer base effectively and meet our growth objectives for the future, we must continue to successfully hire, train, motivate and retain our employees. We expect that significant further expansion will be necessary. In addition, in order to manage our expanded operations, we will need to continue to improve our management, operational and financial controls and our reporting systems and procedures. All of these measures will require significant expenditures and will demand the attention of management. If we are not able to hire, train and retain the necessary personnel, or if these operational and reporting improvements are not implemented successfully, we may have to make significant additional expenditures and further draw management attention away from running our business to address these issues. The quality of our services could suffer, which could negatively affect our brand, operating results and financial position.

***Because much of our potential success and value lies in our use of internally developed systems and software, if we fail to protect them, it could negatively affect us.***

Our ability to compete effectively is dependent in large part upon the maintenance and protection of systems and software that we have developed internally. While we have several pending patent applications, we cannot patent much of the technology that is important to our business. In addition, our pending patent applications may not be successful. To date, we have relied on copyright, trademark and trade secret laws, as well as confidentiality procedures and licensing arrangements, to establish and protect our rights to this technology. We typically enter into confidentiality or license agreements with our employees, consultants, customers and vendors in an effort to control access to and distribution of technology, software, documentation and other information. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use this technology without authorization. Policing unauthorized use of this technology is difficult. The steps we take may not prevent misappropriation of the technology we rely on. In addition, effective protection may be unavailable or limited in some jurisdictions outside the United States, Canada and the United Kingdom. Litigation may be necessary in the future to enforce or protect our rights or to determine the validity and scope of the rights of others. That litigation could cause us to incur substantial costs and divert resources away from our daily business, which in turn could materially adversely affect our business.

***We may be subject to damaging and disruptive intellectual property litigation.***

We have been named as a defendant in three suits currently pending that relate to alleged patent infringement. See "Business Legal Proceedings Patent Litigation." In addition, we have been subject to other infringement claims in the past and may be subject to infringement claims in the future. We may be unaware of filed patent applications and issued patents that could relate to our products and services. Intellectual property litigation could:

- be time-consuming and expensive;
- divert attention and resources away from our daily business;
- impede or prevent delivery of our products and services; and
- require us to pay significant royalties, licensing fees and damages.

Parties making claims of infringement may be able to obtain injunctive or other equitable relief that could effectively block our ability to provide our services and could cause us to pay substantial damages. In the event of a successful claim of infringement, we may need to obtain one or more licenses from third parties, which may not be available at a reasonable cost, if at all. The defense of any lawsuit could result in time-consuming and expensive litigation, regardless of the merits of such claims, and could also result in damages, license fees, royalty payments and restrictions on our ability to provide our services, any of which could harm our business.

***Our service requires an operative broadband connection, and if the adoption of broadband does not progress as expected, the market for our services will not grow and we may not be able to grow our business and increase our revenue.***

Use of our service requires that the user be a subscriber to an existing broadband Internet service, most typically provided through a cable or digital subscriber line, or DSL, connection. Although the number of broadband subscribers worldwide has grown significantly over the last five years, this service has not yet been adopted by a majority of consumers. If the adoption of broadband services does not continue to grow, the market for our services may not grow. As a result, we may not be able to increase our revenue and become profitable.

***Future disruptive new technologies could have a negative effect on our businesses.***

VoIP technology, which our business is based upon, did not exist and was not commercially viable until relatively recently. VoIP technology is having a disruptive effect on traditional telephone companies, whose businesses are based on other technologies. We also are subject to the risk of future disruptive technologies. If new technologies develop that are able to deliver competing voice services at lower prices, better or mor