Palo Alto Networks Inc
Form 10-Q
March 04, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended January 31, 2013
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 001-35594

Palo Alto Networks, Inc.
(Exact name of registrant as specified in its charter)

Delaware	20-2530195
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3300 Olcott Street
Santa Clara, California 95054
(Address of principal executive office, including zip code)
(408) 753-4000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x
The number of shares outstanding of the registrant's common stock as of February 28, 2013 was 69,131,653.

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PART I

ITEM 1. FINANCIAL STATEMENTS

PALO ALTO NETWORKS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited, in thousands, except per share data)

	January 31, 2013	July 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$187,924	$322,642
Short-term investments	149,520	—
Accounts receivable, net of allowance for doubtful accounts of $157 and $164 at January 31, 2013 and July 31, 2012, respectively	68,586	45,642
Prepaid expenses and other current assets	20,644	13,373
Total current assets	426,674	381,657
Property and equipment, net	25,980	20,979
Long-term investments	30,871	—
Other assets	6,624	5,168
Total assets	$490,149	$407,804
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$10,769	$9,214
Accrued liabilities	16,567	15,189
Accrued compensation	24,223	11,307
Deferred revenue	117,437	86,296
Total current liabilities	168,996	122,006
Deferred revenue—non-current	70,746	49,512
Other long-term liabilities	6,887	7,215
Commitments and contingencies (Note 5)		
Stockholders’ equity:		
Preferred stock; $0.0001 par value; 100,000 shares authorized; none issued and outstanding at January 31, 2013 and July 31, 2012	—	—
Common stock, $0.0001 par value; 1,000,000 shares authorized; 68,896 and 67,852 shares issued and outstanding at January 31, 2013 and July 31, 2012, respectively	7	7
Additional paid-in capital	329,680	309,092
Accumulated other comprehensive loss	(11)	—
Accumulated deficit	(86,156)	(80,028)
Total stockholders’ equity	243,520	229,071
Total liabilities and stockholders’ equity	$490,149	$407,804

See notes to condensed consolidated financial statements.

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PALO ALTO NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited, in thousands, except per share data)

	Three Months Ended January 31,		Six Months Ended January 31,	
	2013	2012	2013	2012
Revenue:				
Product	$61,944	$38,638	$117,458	$81,499
Services	34,555	18,045	64,975	32,297
Total revenue	96,499	56,683	182,433	113,796
Cost of revenue:				
Product	16,636	10,248	31,052	20,558
Services	10,982	5,265	20,756	9,795
Total cost of revenue	27,618	15,513	51,808	30,353
Total gross profit	68,881	41,170	130,625	83,443
Operating expenses:				
Research and development	15,495	8,514	28,807	16,362
Sales and marketing	45,796	25,612	88,403	47,980
General and administrative	9,747	5,768	18,703	10,925
Total operating expenses	71,038	39,894	135,913	75,267
Operating income (loss)	(2,157)	1,276	(5,288)	8,176
Interest income	116	2	214	4
Other expense, net	(60)	(566)	(230)	(1,030)
Income (loss) before income taxes	(2,101)	712	(5,304)	7,150
Provision for income taxes	512	288	824	2,610
Net income (loss)	$(2,613)	$424	$(6,128)	$4,540
Net income (loss) attributable to common stockholders	$(2,613)	$—	$(6,128)	$—
Net income (loss) per share attributable to common stockholders, basic and diluted	$(0.04)	$0.00	$(0.09)	$0.00
Weighted-average shares used to compute net income (loss) per share attributable to common stockholders, basic and diluted	67,651	17,192	67,225	16,948

See notes to condensed consolidated financial statements.

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PALO ALTO NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited, in thousands)

	Three Months Ended		Six Months Ended	
	January 31,		January 31,	
	2013	2012	2013	2012
Net income (loss)	$(2,613)	$424	$(6,128)	$4,540
Other comprehensive income (loss):				
Unrealized gains (losses) on investments	16	—	(11)	—
Comprehensive income (loss)	$(2,597)	$424	$(6,139)	$4,540

See notes to condensed consolidated financial statements.

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PALO ALTO NETWORKS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	Six Months Ended January 31, 2013	2012
Cash flows from operating activities		
Net income (loss)	$(6,128)	$4,540
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	4,468	2,474
Amortization of investment premiums, net of accretion of purchase discounts	822	—
Share-based compensation for equity based awards	17,030	3,499
Excess tax benefit from share-based compensation	(106)	—
Change in fair value of preferred stock warrants	—	958
Changes in operating assets and liabilities:		
Accounts receivable, net	(22,944)	5,604
Prepaid expenses and other assets	(7,290)	(5,094)
Accounts payable	1,716	(1,165)
Accrued and other liabilities	17,640	5,657
Deferred revenue	52,375	30,653
Reimbursement of cost of leasehold improvements	—	577
Net cash provided by operating activities	57,583	47,703
Cash flows from investing activities		
Purchase of property, equipment, and other assets	(10,236)	(7,063)
Purchase of investments	(252,633)	—
Proceeds from sales of investments	13,491	—
Proceeds from maturities of investments	57,150	—
Net cash used in investing activities	(192,228)	(7,063)
Cash flows from financing activities		
Excess tax benefit from share-based compensation	106	—
Change in restricted cash	—	1,221
Proceeds from exercise of stock options	2,554	469
Proceeds from settlement of note receivable	—	38
Payments of initial public offering costs	(2,698)	—
Repurchase of restricted common stock from employees	(35)	(63)
Net cash provided by (used in) financing activities	(73)	1,665
Net increase (decrease) in cash and cash equivalents	(134,718)	42,305
Cash and cash equivalents—beginning of period	322,642	40,517
Cash and cash equivalents—end of period	$187,924	$82,822
Supplemental disclosures of cash flow information		
Cash paid for income taxes	$1,017	$548
Cash paid for interest	$46	$9
Supplemental disclosures of non-cash investing and financing activities		
Change in liability for early exercise of stock options, net of vested portion	$(738)	$(415)
Issuance of preferred stock upon exercise of warrant	$—	$3,026

See notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Description of Business and Summary of Significant Accounting Policies

Description of Business

Palo Alto Networks, Inc., located in Santa Clara, California, was incorporated in March 2005 under the laws of the State of Delaware and commenced operations in April 2005. We offer a next-generation network security platform that allows enterprises, service providers, and government entities to secure their networks and safely enable the increasingly complex and rapidly growing number of applications running on their networks. The core of our platform is our Next-Generation Firewall that delivers application, user, and content visibility and control integrated within the firewall through our proprietary operating system, hardware, and software architecture. We primarily sell our products and services to end-customers through distributors, resellers, and strategic partners (collectively partners), and infrequently directly to end-customers, who are supported by our sales and marketing organization in the Americas, in Europe, the Middle East, and Africa (EMEA), and in Asia Pacific and Japan (APAC).

Initial Public Offering

In July 2012, we completed our initial public offering whereby 6,200,000 shares of common stock were sold to the public at a price of $42.00 per share. We sold 4,687,000 common shares and selling stockholders sold 1,513,000 common shares. In connection with the exercise of the underwriters' over-allotment option, 930,000 additional shares of common stock were sold to the public at the initial offering price of $42.00 per share. We received aggregate proceeds of $219,400,000 from the initial public offering and the underwriters' over-allotment option, net of underwriters' discounts and commissions, but before deducting offering expenses of approximately $4,000,000. Upon the closing of the initial public offering, all shares of our outstanding redeemable convertible preferred stock automatically converted into 41,305,000 shares of common stock.

Secondary Offering

In October 2012, we completed our secondary offering whereby certain stockholders of our company sold 4,800,000 shares of common stock to the public at a price of $63.00 per share. The aggregate offering price for shares sold in the offering was approximately $290,304,000, net of underwriting discounts and commissions. We did not receive any proceeds from the sale of shares in this offering. Offering expenses were paid by the stockholders who sold shares of common stock in the offering.

Basis of Presentation and Consolidation

The condensed consolidated financial statements include the accounts of the Company, and its wholly owned subsidiaries (collectively, the "Company," "we," "us," or "our"). All significant intercompany balances and transactions have been eliminated in consolidation.

Summary of Significant Accounting Policies

There have been no material changes to our significant accounting policies as compared to those described in our Annual Report on Form 10-K for the fiscal year ended July 31, 2012 except as disclosed below.

Investments

We classify our investments as available-for-sale at the time of purchase since it is our intent that these investments are available for current operations, and include these investments on our balance sheet as either short-term or long-term investments depending on their maturity. Investments not considered cash equivalents and with maturities one year or less from the condensed consolidated balance sheet date are classified as short-term investments. Investments with maturities greater than one year from the condensed consolidated balance sheet date are classified as long-term investments.

Investments are considered impaired when a decline in fair value is judged to be other-than-temporary. We consult with our investment managers and consider available quantitative and qualitative evidence in evaluating potential impairment of our investments on a quarterly basis. If the cost of an individual investment exceeds its fair value, we evaluate, among other factors, general market conditions, the duration and extent to which the fair value is less than cost, and our intent and ability to hold the investment. Once a decline in fair value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis in the investment is established.

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Warranties

We generally provide a one-year warranty on hardware and a three-month warranty on software. We accrue for potential warranty claims as a component of cost of product revenues based on historical experience and other data. Accrued warranty is recorded in accrued liabilities on the condensed consolidated balance sheets and is reviewed periodically for adequacy. To date, we have not accrued any significant costs associated with our warranty.

Recent Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2011-05, Presentation of Comprehensive Income. The standard requires entities to have more detailed reporting of comprehensive income. The guidance was effective for us in the first quarter of fiscal 2013 and applied retrospectively. Our adoption of this guidance did not impact our condensed consolidated financial position, results of operations, or cash flows.

2. Fair Value Measurements

We categorize assets and liabilities recorded at fair value on our condensed consolidated balance sheets based upon the level of judgment associated with inputs used to measure their fair value. The categories are as follows:

- Level 1—Inputs are unadjusted quoted prices in active markets for identical assets or liabilities.
- Level 2—Inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the assets or liabilities, either directly or indirectly through market corroboration, for substantially the full term of the financial instruments.
- Level 3—Inputs are unobservable inputs based on our own assumptions used to measure assets and liabilities at fair value. The inputs require significant management judgment or estimation.

The following table presents the fair value of our financial assets and liabilities using the above input categories (in thousands):

	January 31, 2013				July 31, 2012			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Cash equivalents:								
U.S. government and agency securities	$—	$96,839	$—	$96,839	$—	$—	$—	$—
Money market funds	27,101	—	—	27,101	250,005	—	—	250,005
Total cash equivalents	27,101	96,839	—	123,940	250,005	—	—	250,005
Short-term investments:								
Corporate debt securities	—	24,379	—	24,379	—	—	—	—
U.S. government and agency securities	—	125,141	—	125,141	—	—	—	—
Total short-term investments	—	149,520	—	149,520	—	—	—	—
Long-term investments:								
Corporate debt securities	—	24,371	—	24,371	—	—	—	—
U.S. government and agency securities	—	6,500	—	6,500	—	—	—	—
Total long-term investments	—	30,871	—	30,871	—	—	—	—
Other assets:								

Restricted cash	1,221	—	—	1,221	1,221	—	—	1,221
Total other assets	1,221	—	—	1,221	1,221	—	—	1,221
Total assets measured at fair value	$28,322	$277,230	$—	$305,552	$251,226	$—	$—	$251,226

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3. Investments

Investments consist of the following (in thousands):

	January 31, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Corporate debt securities	$48,757	$25	$(32)	$48,750
U.S. government and agency securities	228,484	8	(12)	228,480
Money market funds	27,101	—	—	27,101
Total investments	$304,342	$33	$(44)	$304,331

Investments in an unrealized loss position at January 31, 2013 consist of the following (in thousands):

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate debt securities	$30,791	$(32)	$—	$—	$30,791	$(32)
U.S. government and agency securities	129,783	(12)	—	—	129,783	(12)
Total	$160,574	$(44)	$—	$—	$160,574	$(44)

Unrealized losses related to these investments are primarily due to interest rate fluctuations as opposed to credit quality. In addition, we do not intend to sell and it is not more likely than not that we would be required to sell these investments before recovery of their amortized cost basis, which may be at maturity. As a result, we do not consider these investments to be other-than-temporarily impaired at January 31, 2013.

The amortized cost and fair value of our investments at January 31, 2013, by contractual years-to-maturity, are as follows (in thousands):

	Amortized Cost	Fair Value
Due within one year	$246,344	$246,359
Due within one to two years	30,897	30,871
Instruments not due at a single maturity date	27,101	27,101
Total	$304,342	$304,331

4. Intangible Assets

Intangible assets included in other assets consisted of the following (in thousands):

	January 31, 2013	July 31, 2012
Acquired intellectual property	$1,046	$546
Less: amortization	(89)	(63)
Total	$957	$483

Amortization expense was $13,000 and $26,000 for the three and six month periods ended January 31, 2013, respectively, and $8,000 and $14,000 for the three and six month periods ended January 31, 2012, respectively.

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The following table summarizes estimated future amortization expense of intangible assets as of January 31, 2013 (in thousands):

Years ending July 31:	Amount
Remaining 2013	$84
2014	168
2015	168
2016	168
2017	149
2018 and thereafter	220
Total	$957

5. Commitments and Contingencies

Leases

In September 2012, we entered into two lease agreements for space in Santa Clara, California with lease inception dates of November 2012 and August 2013. Both leases expire in July 2023 and allow for two separate five-year options to extend the lease term. Payments under these leases will be approximately $94,400,000 over the lease term. Each lease has a seven month rent holiday, which was included in the determination of rent expense.

The aggregate future non-cancelable minimum rental payments on our operating leases and the minimum purchase commitments of products and components with our independent contract manufacturer or suppliers at January 31, 2013 are as follows (in thousands):

	Payments Due by Period				
	Total	Less Than 1 Year	1 - 3 Years	3- 5 Years	More Than 5 Years
		(in thousands)			
Operating lease obligations	$107,196	$5,284	$21,838	$22,695	$57,379
Purchase obligations	21,275	21,275	—	—	—
Total	$128,471	$26,559	$21,838	$22,695	$57,379

Litigation

Beginning in January 2009, Fortinet, Inc. began filing a series of complaints against us in the U.S. District Court for the Northern District of California alleging, among other claims, patent infringement. In January 2011, we entered into a settlement agreement with Fortinet to the mutual satisfaction of both parties. Under the terms of the settlement agreement, we agreed to pay Fortinet $6,000,000 over a period of three years. We recorded the cost related to the settlement as of October 31, 2010. As of January 31, 2013, $1,000,000 remained payable under this settlement and is included in accrued liabilities in our condensed consolidated statement of financial position.

In December 2011, Juniper Networks, Inc. filed a complaint against us in the United States District Court for the District of Delaware alleging patent infringement. The complaint seeks preliminary and permanent injunctions against infringement, treble damages, and attorney's fees. On February 9, 2012, we filed a response to the complaint, which denied all claims and asserted that the claimant's patents were invalid. On February 28, 2012, Juniper filed a motion to strike our defense of invalidity based on the legal doctrine of "assignor estoppel." On March 23, 2012, we filed a brief in opposition to that motion. Juniper filed a brief in response on April 2, 2012. On August 2, 2012, the District Court issued an order granting Juniper’s motion as to one of the patents in suit (the ’634 patent) but denying Juniper’s motion as to the five other patents in suit. On September 4, 2012, Juniper filed a motion to amend its complaint to allege that our appliances infringe two additional U.S. patents but also to withdraw its allegations as to a previously-asserted patent. This amended complaint was officially filed on September 25, 2012, pursuant to a stipulation between the parties. Juniper now alleges that our appliances infringe seven of its patents. On September 13, 2012, we filed with the U.S. Patent and Trademark Office requests for inter partes reexamination of five of the six patents asserted by Juniper in its original complaint. We did not file a request for reexamination on the withdrawn patent. On October 12, 2012, we filed an answer to Juniper’s amended complaint, which denied that we infringed Juniper’s patents and asserted that Juniper’s patents were invalid. On October 19 and

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December 3, 2012, the U.S. Patent and Trademark Office granted our requests for reexamination for three patents, rejecting a number of the claims asserted in the litigation, and on November 15 and 26, 2012, the U.S. Patent and Trademark Office denied our requests for reexamination as to two other patents. We have the opportunity to seek review of these denials within the U.S. Patent and Trademark Office.

A trial date has been scheduled for February 24, 2014, and we are vigorously defending ourselves from such claims. Given the early stage in the litigation, we are unable to estimate a possible loss or range of possible loss.

In addition to the above matter, we are subject to legal proceedings, claims, and litigation arising in the ordinary course of business, including intellectual property litigation. Such matters are subject to many uncertainties and outcomes are not predictable with assurance. We accrue for contingencies when we believe that a loss is probable and that we can reasonably estimate the amount of any such loss. We have made an assessment of the probability of incurring any such losses and whether or not those losses are estimable.

To the extent there is a reasonable possibility that a loss exceeding amounts already recognized may be incurred and the amount of such additional loss would be material, we will either disclose the estimated additional loss or state that such an estimate cannot be made. We do not currently believe that it is reasonably possible that additional losses in connection with litigation arising in the ordinary course of business would be material.

6. Equity Award Plans

A summary of the activity under our stock plans and changes during the reporting periods and a summary of information related to options exercisable and options and restricted stock units (RSUs) vested and expected to vest are presented below (in thousands, except per share amounts):

	Options Outstanding			
	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Balance—July 31, 2012	14,225	$9.46	8.3	$678,248
Options granted	90	55.36		
Options forfeited	(452)	10.22		
Options repurchased	—	—		
Options exercised	(1,066)	2.58		
Balance—January 31, 2013	12,797	10.33	7.9	$576,249
Options vested and expected to vest—January 31, 2013	12,113	$10.06	7.9	$548,719
Options exercisable—January 31, 2013	4,877	$4.42	6.6	$248,434

	RSUs Outstanding			
	Number of Shares	Weighted-Average Grant-Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Balance—July 31, 2012	—	$—	0.0	$—

RSUs granted	1,596	56.48		
RSUs vested	—	—		
RSUs forfeited	(16)	59.42		
Balance—January 31, 2013	1,580	$56.45	1.8	$87,469
RSUs vested and expected to vest—January 31, 2013	1,389	$56.45	1.8	$76,895

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The following table summarizes the assumptions relating to our stock options as follows:

	Three Months Ended January 31,		Six Months Ended January 31,	
	2013	2012	2013	2012
Risk-free interest rate	1.0%	1.1%	1.0%	0.7% - 1.1%
Expected term	6 years	6 years	6 years	4 - 6 years
Volatility	50%	49%	50%	49% - 50%
Dividend yield	—%	—%	—%	—%

During the three and six month periods ended January 31, 2013, compensation expense recognized in connection with the 2012 Employee Stock Purchase Plan was $1,467,000 and $2,811,000, respectively.

Share-based compensation expense is included in costs and expenses as follows (in thousands):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2013	2012	2013	2012
Cost of revenue	$825	$141	$1,435	$248
Research and development	1,973	440	3,663	765
Sales and marketing	3,935	630	8,233	1,107
General and administrative	2,021	839	3,765	1,379
Total	$8,754	$2,050	$17,096	$3,499

At January 31, 2013, total compensation cost related to unvested share-based awards granted to employees under our stock plans but not yet recognized was $126,028,000, net of estimated forfeitures. This cost is expected to be amortized on a straight-line basis over a weighted-average period of three years. Future grants will increase the amount of compensation expense to be recorded in these periods.

In the first quarter of fiscal 2013, we modified the terms of certain share-based awards and as a result, in the three and six month periods ended January 31, 2013, we recorded compensation expense within sales and marketing expense of $461,000 and $1,861,000, respectively.

7. Income Taxes

Our provision for income taxes for the three and six month periods ended January 31, 2013 reflects an effective tax rate of negative 24% and negative 16%, respectively, and primarily consists of foreign income and withholding taxes.

Our provision for income taxes for the three and six month periods ended January 31, 2012 reflected an effective tax rate of 40% and 37%, respectively, and primarily consisted of U.S. federal alternative minimum tax, state income taxes, and foreign income and withholding taxes.

8. Net Income (Loss) Per Share

We compute net income (loss) per share of common stock using the two-class method required for participating securities. Immediately prior to the completion of our initial public offering on July 19, 2012, all shares of outstanding redeemable convertible preferred stock were automatically converted to common stock. Prior to their conversion, we considered all series of our redeemable convertible preferred stock to be participating securities as the holders were entitled to participate in common stock dividends with common stock on an as-converted basis. The holders of our redeemable convertible preferred stock were also entitled to non-cumulative dividends prior and in preference to common stock and did not have a contractual obligation to share in the losses of the Company. Additionally, we consider shares issued upon the early exercise of options subject to repurchase and unvested restricted shares to be participating securities because holders of such shares have non-forfeitable dividend rights in the event of our declaration of a dividend for common shares. In accordance with the two-class method, earnings allocated to these participating securities, which include participation rights in undistributed earnings with common stock, are subtracted from net income to determine net income (loss) attributable to common stockholders.

Basic net income (loss) per common share is computed by dividing net income (loss) attributable to common stockholders by basic weighted-average shares outstanding during the period. All participating securities are excluded from basic weighted-average shares outstanding. In computing diluted net income (loss) attributable to common stockholders, undistributed earnings are re-

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allocated to reflect the potential impact of dilutive securities. Diluted net income (loss) per share attributable to common stockholders is computed by dividing net income (loss) attributable to common stockholders by diluted weighted-average shares outstanding, including potentially dilutive securities.

The following table presents the computation of basic and diluted net income (loss) per share of common stock (in thousands, except per share data):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2013	2012	2013	2012
Net income (loss) used to compute net income (loss) per share:				
Net income (loss)	$(2,613)	$424	$(6,128)	$4,540
Less: undistributed earnings allocated to participating securities	—	(424)	—	(4,540)
Net income (loss) attributable to common stockholders	$(2,613)	$—	$(6,128)	$—
Weighted-average shares used to compute net income (loss) per share, basic and diluted	67,651	17,192	67,225	16,948
Net income (loss) per share attributable to common stockholders, basic and diluted	$(0.04)	$0.00	$(0.09)	$0.00

The following outstanding options and RSUs were excluded from the computation of diluted net income (loss) per common share applicable to common stockholders for the periods presented as their effect would have been antidilutive (in thousands):

	January 31, 2013	January 31, 2012
Options to purchase common stock	12,797	11,834
RSUs	1,580	—

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q. The following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, among other things, statements regarding:

- our ability to extend our leadership position in next-generation network security;
- trends in revenue, cost of revenue, gross margin, cash flows, operating expenses, interest and other income, income taxes, investments and liquidity;
- the sufficiency of our existing cash and investments to meet our cash needs for at least the next 12 months;
- our ability to reorganize our corporate structure to more closely align with the international nature of our business and realize any reduction in our overall effective tax rate as a result of such reorganization;

as well as other statements regarding our future operations, financial condition and prospects, and business strategies. Forward-looking statements generally can be identified by words such as "anticipates," "believes," "estimates," "expects," "intends," "plans," "predicts," "projects," "will be," "will continue," "will likely result," and similar expressions. These forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties, which could cause our actual results to differ materially from those reflected in the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this Quarterly Report on Form 10-Q, and in particular, the risks discussed under the caption "Risk Factors" in Part II, Item 1A of this report and those discussed in other documents we file with the Securities and Exchange Commission. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements, except as required by law. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

Overview

We have pioneered the next generation of network security with our innovative platform that allows enterprises, service providers, and government entities to secure their networks and safely enable the increasingly complex and rapidly growing number of applications running on their networks. The core of our platform is our Next-Generation Firewall, which delivers application, user, and content visibility and control integrated within the firewall through our proprietary hardware and software architecture. Our products and services can address a broad range of our end-customers' network security requirements, from the data center to the network perimeter, as well as the distributed enterprise, which includes branch offices and a growing number of mobile devices.

We were founded in 2005 to address the limitations that exist in legacy approaches to network security and to restore the firewall as the most strategic point of network control. From 2005 to 2007, our activities were focused on research and development, which resulted in the commercial release of our first product, the PA-4000 Series, as well as our first subscription service, Threat Prevention, in 2007. Since then, we have continued to innovate and consistently introduce new products and services, including the PA-5000 Series and GlobalProtect subscription service in March 2011, the PA-200 and free WildFire modern malware detection subscription service in November 2011, and most recently, the VM-Series, PA-3000 Series, M-100 management appliance, and paid WildFire modern malware prevention subscription service in November 2012.

We derive revenue from sales of our products and services, which together comprise our platform. Product revenue is primarily generated from sales of our Next-Generation Firewall. All of our products incorporate our proprietary PAN-OS operating system, which provides a consistent set of capabilities across our entire product line. Our products are designed for different performance requirements throughout an organization, from branch offices to large data centers. Our platform can be centrally managed across an organization with our Panorama product. Services revenue includes sales from subscriptions and support and maintenance. Our Threat Prevention, URL Filtering, GlobalProtect, and WildFire subscriptions provide our end-customers with real-time access to the latest antivirus, intrusion prevention, web filtering, and modern malware prevention capabilities across fixed and mobile devices. When end-customers purchase a product, they typically purchase one or more of our subscriptions for additional functionality, as well as support and maintenance in order to receive ongoing security updates, upgrades, bug fixes, and repairs. Sales of these services increase our deferred revenue balance and contribute significantly to our positive cash flow provided by operating activities.

We maintain a field sales force that works closely with our channel partners in developing sales opportunities. We use a two-tier, indirect fulfillment model whereby we sell our products and services to our global distributor channel partners, which, in turn, sell our products and services to our reseller network, which then sell to our end-customers. Our channel partners purchase our products and services at a discount to our list prices before reselling them to our end-customers. Our channel partners generally receive an order from an end-customer prior to placing an order with us and generally do not stock appliances.

We had more than 11,000 end-customers in over 100 countries as of January 31, 2013. Our end-customers represent a broad range of industries including education, energy, financial services, healthcare, Internet and media, manufacturing, public sector, and telecommunications. During the second quarter of fiscal 2013, 63% of our revenue was generated from the Americas, 25% from

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Europe, the Middle East, and Africa (EMEA), and 12% from Asia Pacific and Japan (APAC). As of January 31, 2013, we had more than 940 employees.

We have experienced rapid growth and increased demand for our products in recent periods. For the second quarter of fiscal 2013 and 2012, revenues were $96.5 million and $56.7 million, respectively, representing year-over-year growth of 70%.

We believe that the growth of our business and our short and long term success are dependent upon many factors, including our ability to extend our technology leadership, grow our base of end-customers, expand deployment of our platform within existing end-customers, and focus on end-customer satisfaction. While these areas present significant opportunities for us, they also pose challenges and risks that we must successfully address in order to sustain the growth of our business and improve our operating results.

To manage any future growth effectively, we must continue to improve and expand our information technology and financial infrastructure, our operating and administrative systems and controls, and our ability to manage headcount, capital, and processes in an efficient manner. Additionally, we face intense competition in our market, and to succeed, we need to innovate and offer products that are differentiated from existing infrastructure products, as well as effectively hire, retain, train, and motivate qualified personnel and senior management. If we are unable to successfully address these challenges, our business, operating results, and prospects could be adversely affected.

On July 25, 2012, we closed our initial public offering (IPO), in which 7,130,000 shares of our common stock were sold to the public (inclusive of 5,617,000 shares of common stock sold by us). The public offering price of the shares sold in the IPO was $42.00 per share. The total gross proceeds from the offering were $299.5 million. After deducting underwriting discounts and commissions, offering expenses payable by us, and net proceeds received by the selling stockholders, the aggregate net proceeds received by us totaled approximately $215.4 million.

On October 23, 2012, we closed our secondary offering, in which certain stockholders of our company sold 4,800,000 shares of our common stock at a price to the public of $63.00 per share. The aggregate offering price for shares sold in the offering was approximately $290.3 million, net of underwriting discounts and commissions. We did not receive any proceeds from the sale of shares in this offering. Offering expenses were paid by the stockholders who sold shares of common stock in the offering.

Key Financial Metrics

We monitor the key financial metrics set forth below to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts, and assess operational efficiencies. We discuss revenue, gross margin, and the components of operating income (loss) and margin below under "—Financial Overview" and "—Results of Operations." Deferred revenue, cash flow provided by operating activities, and free cash flow are discussed immediately below the following table.

	January 31, 2013	July 31, 2012
	(dollars in thousands)	
Total deferred revenue	$ 188,183	$ 135,808

	Three Months Ended January 31,		Six Months Ended January 31,	
	2013	2012	2013	2012
	(dollars in thousands)			
Total revenue	$ 96,499	$ 56,683	$ 182,433	$ 113,796

Year-over-year percentage increase	70.2 %	109.5 %	60.3 %	141.0 %
Gross margin percentage	71.4 %	72.6 %	71.6 %	73.3 %
Operating income (loss)	$(2,157)	$1,276	$(5,288)	$8,176
Operating margin percentage	(2.2)%	2.3 %	(2.9)%	7.2 %
Cash flow provided by operating activities			$57,583	$47,703
Free cash flow (non-GAAP)			$47,347	$40,640

- Deferred Revenue. Our deferred revenue consists of amounts that have been invoiced but that have not yet been recognized as revenue as of the period end. The majority of our deferred revenue balance consists of subscription and support and maintenance revenue that is recognized ratably over the contractual service period. We monitor our deferred revenue balance because it represents a significant portion of revenue to be recognized in future periods.

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- Cash Flow Provided by Operating Activities. We monitor cash flow provided by operating activities as a measure of our overall business performance. Our cash flow provided by operating activities is driven in large part by sales of our products and from up-front payments for both subscription and support and maintenance. Monitoring cash flow provided by operating activities enables us to analyze our financial performance without the non-cash effects of certain items such as depreciation, amortization, and share-based compensation costs, thereby allowing us to better understand and manage the cash needs of our business.

- Free Cash Flow. We define free cash flow, a non-GAAP financial measure, as cash provided by operating activities less purchases of property, equipment, and other assets. We consider free cash flow to be a liquidity measure that provides useful information to management and investors about the amount of cash generated by the business that, after the purchases of property, equipment, and other assets, can be used for strategic opportunities, including investing in our business, making strategic acquisitions, and strengthening the balance sheet.

	Six Months Ended January 31,	
	2013	2012
	(in thousands)	
Cash Flow:		
Cash flow provided by operating activities	$57,583	$47,703
Less: purchase of property, equipment, and other assets	10,236	7,063
Free cash flow (non-GAAP)	$47,347	$40,640
Net cash used in investing activities	$(192,228)	$(7,063)
Net cash provided by (used in) financing activities	$(73)	$1,665

Financial Overview

Revenue

We derive revenue from sales of our products and services. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectability is reasonably assured.

Our total revenue is comprised of the following:

- Product Revenue. The substantial majority of our product revenue is derived from sales of our appliances. Product revenue also includes revenue derived from software licenses of Panorama and Virtual Systems Upgrades. We recognize product revenue at the time of shipment, provided that all other revenue recognition criteria have been met. As a percentage of total revenue, we expect our product revenue to vary from quarter-to-quarter based on seasonal and cyclical factors.

- Services Revenue. Services revenue is derived primarily from Threat Prevention, URL Filtering, GlobalProtect, and WildFire subscriptions and support and maintenance. Our subscriptions are priced as a percentage of the appliance’s list price. Our contractual subscription and support and maintenance terms are typically one to three years. We recognize revenue from subscriptions and support and maintenance over the contractual service period. As a percentage of total revenue, we expect our services revenue to remain at consistent levels or increase over the long term as we introduce new subscriptions, renew existing services contracts, and expand our end-customer base.

Cost of Revenue

Our total cost of revenue consists of cost of product revenue and cost of services revenue. Personnel costs associated with our operations and global customer support organizations consist of salaries, bonuses, and share-based compensation. Allocated costs consist of certain facilities, depreciation, benefits, recruiting, and information technology costs allocated based on headcount.

- Cost of Product Revenue. Cost of product revenue primarily includes costs paid to our third-party contract manufacturer. Our cost of product revenue also includes product testing costs, allocated costs, warranty costs, shipping costs, and personnel costs associated with logistics and quality control. We expect our cost of product revenue to increase as our product revenue increases.

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- Cost of Services Revenue. Cost of services revenue includes personnel costs for our global customer support organization, allocated costs, and URL filtering database service fees. We expect our cost of services revenue to increase as our end-customer base grows.

Gross Margin

Gross margin, or gross profit as a percentage of revenue, has been and will continue to be affected by a variety of factors, including the average sales price of our products, manufacturing costs, the mix of products sold, and the mix of revenue between products and services. For sales of our products, our higher throughput firewall products generally have higher gross margins than our lower throughput firewall products within each product series. For sales of our services, our subscriptions typically have higher gross margins than our support and maintenance. We expect our gross margins to fluctuate over time depending on the factors described above.

Operating Expenses

Our operating expenses consist of research and development, sales and marketing, and general and administrative expense. Personnel costs are the most significant component of operating expenses and consist of salaries, benefits, bonuses, share-based compensation, and with regard to sales and marketing expense, sales commissions. We expect operating expenses to increase in absolute dollars, although they may fluctuate as a percentage of revenue from period to period, as we continue to grow in response to demand for our products and services. As of January 31, 2013, we expect to recognize approximately $126.0 million of share-based compensation expense over a weighted-average period of three years, excluding additional share-based compensation expense related to any future grants of share-based awards. Share-based compensation expense, net of forfeitures, is recognized on a straight-line basis over the requisite service periods of the awards.

- Research and Development. Research and development expense consists primarily of personnel costs. Research and development expense also includes prototype related expenses and allocated costs. We expect research and development expense to increase in absolute dollars as we continue to invest in our future products and services, although our research and development expense may fluctuate as a percentage of total revenue.

- Sales and Marketing. Sales and marketing expense consists primarily of personnel costs including commission costs. We expense commission costs as incurred. Sales and marketing expense also includes costs for market development programs, promotional and other marketing costs, travel costs, office equipment and software, depreciation of capital equipment, professional services, and allocated costs. In the last 12 months, we have significantly increased the size of our sales force and have also substantially grown our local sales presence internationally. We expect sales and marketing expense to continue to increase in absolute dollars as we increase the size of our sales and marketing organizations to increase touch points with end-customers and to expand our international presence, although our sales and marketing expense may fluctuate as a percentage of total revenue.

- General and Administrative. General and administrative expense consists of personnel costs as well as professional services. General and administrative personnel include our executive, finance, human resources, and legal organizations. Professional services consist primarily of legal, auditing, accounting, and other consulting costs. We expect general and administrative expense to increase in absolute dollars due to additional legal fees and costs associated with pending litigation, accounting, insurance, investor relations, and other costs associated with being a public company, although our general and administrative expense may fluctuate as a percentage of total revenue. Refer to the discussion under “Legal Proceedings” included in Part II, Item 1 of this Quarterly Report on Form 10-Q for information related to pending litigation.

Interest Income

Interest income consists of income earned on our cash and cash equivalents and investments. We expect interest income will increase as we grow our cash and investments portfolio depending on our average investment balances during the period, types and mix of investments, and market interest rates.

Other Income (Expense), Net

Other income (expense), net consists primarily of the change in fair value of our preferred stock warrant liability. Convertible preferred stock warrants were classified as a liability on our condensed consolidated balance sheets and remeasured to fair value at each balance sheet date with the corresponding change recorded as other expense. These warrants were exercised during the second quarter of fiscal 2012, and therefore, we will no longer incur any charges related to these warrants. We expect other expense to remain at a consistent level in the near term.

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Provision for Income Taxes

Provision for income taxes consists primarily of federal and state income taxes in the United States, income taxes in foreign jurisdictions in which we conduct business, and foreign withholding taxes. We maintain a full valuation allowance for domestic deferred tax assets including net operating loss carryforwards and research and development and other tax credits. We expect the provision for income taxes to increase in absolute dollars in future years.

We have begun to reorganize our corporate structure and intercompany relationships to more closely align with the international nature of our business activities. This proposed corporate structure may allow us to reduce our overall effective tax rate over the long term through changes in international procurement and sales operations.

Results of Operations

The following tables summarize our results of operations for the periods presented and as a percentage of our total revenue for those periods. The period-to-period comparison of results is not necessarily indicative of results for future periods.

	Three Months Ended January 31,		Six Months Ended January 31,	
	2013	2012	2013	2012
	(in thousands)			
Condensed Consolidated Statements of Operations Data:				
Revenue:				
Product	$61,944	$38,638	$117,458	$81,499
Services	34,555	18,045	64,975	32,297
Total revenue	96,499	56,683	182,433	113,796
Cost of revenue:				
Product	16,636	10,248	31,052	20,558
Services	10,982	5,265	20,756	9,795
Total cost of revenue	27,618	15,513	51,808	30,353
Total gross profit	68,881	41,170	130,625	83,443
Operating expenses:				
Research and development	15,495	8,514	28,807	16,362
Sales and marketing	45,796	25,612	88,403	47,980
General and administrative	9,747	5,768	18,703	10,925
Total operating expenses	71,038	39,894	135,913	75,267
Operating income (loss)	(2,157)	1,276	(5,288)	8,176
Interest income	116	2	214	4
Other income (expense), net	(60)	(566)	(230)	(1,030)
Income (loss) before income taxes	(2,101)	712	(5,304)	7,150
Provision for income taxes	512	288	824	2,610
Net income (loss)	$(2,613)	$424	$(6,128)	$4,540

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	Three Months Ended January 31,				Six Months Ended January 31,			
	2013		2012		2013		2012	
	(as a percentage of revenue)							
Condensed Consolidated Statements of Operations Data:								
Revenue:								
Product	64.2	%	68.2	%	64.4	%	71.6	%
Services	35.8	%	31.8	%	35.6	%	28.4	%
Total revenue	100.0	%	100.0	%	100.0	%	100.0	%
Cost of revenue:								
Product	17.2	%	18.1	%	17.0	%	18.1	%
Services	11.4	%	9.3	%	11.4	%	8.6	%
Total cost of revenue	28.6	%	27.4	%	28.4	%	26.7	%
Total gross profit	71.4	%	72.6	%	71.6	%	73.3	%
Operating expenses:								
Research and development	16.1	%	15.0	%	15.8	%	14.4	%
Sales and marketing	47.5	%	45.2	%	48.5	%	42.2	%
General and administrative	10.0	%	10.1	%	10.2	%	9.5	%
Total operating expenses	73.6	%	70.3	%	74.5	%	66.1	%
Operating income (loss)	(2.2	)%	2.3	%	(2.9	)%	7.2	%
Interest income	0.1	%	—	%	0.1	%	—	%
Other income (expense), net	(0.1	)%	(1.0	)%	(0.1	)%	(0.9	)%
Income (loss) before income taxes	(2.2	)%	1.3	%	(2.9	)%	6.3	%
Provision for income taxes	0.5	%	0.5	%	0.5	%	2.3	%
Net income (loss)	(2.7	)%	0.8	%	(3.4	)%	4.0	%

Comparison of the Three and Six Month Periods Ended January 31, 2013 and 2012

Revenue

	Three Months Ended January 31,					Six Months Ended January 31,				
	2013	2012	Change			2013	2012	Change		
	Amount	Amount	Amount	%		Amount	Amount	Amount	%	
	(dollars in thousands)									
Revenue:										
Product	$61,944	$38,638	$23,306	60.3	%	$117,458	$81,499	$35,959	44.1	%
Services	34,555	18,045	16,510	91.5	%	64,975	32,297	32,678	101.2	%
Total revenue	$96,499	$56,683	$39,816	70.2	%	$182,433	$113,796	$68,637	60.3	%
Revenue by geographic theater:										
Americas	$60,279	$33,341	$26,938	80.8	%	$114,936	$70,552	$44,384	62.9	%
EMEA	24,217	15,759	8,458	53.7	%	43,894	30,368	13,526	44.5	%
APAC	12,003	7,583	4,420	58.3	%	23,603	12,876	10,727	83.3	%
Total revenue	$96,499	$56,683	$39,816	70.2	%	$182,433	$113,796	$68,637	60.3	%

Total revenue increased $39.8 million, or 70%, for the three month period ended January 31, 2013 compared to the three month period ended January 31, 2012. The revenue growth reflects the increasing demand for our product and service offerings. The increase in product revenue was primarily driven by an aggregate increase of more than 50% in product unit volume. A significant portion of the product revenue increase was in our PA-5000 Series firewalls and newly introduced PA-3000 Series firewalls. The increase in services revenue was primarily driven by new end-customers and, to a lesser extent, additional sales of subscription and support and

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maintenance services to our existing end-customer base. Our total number of end-customers increased to more than 11,000 at January 31, 2013 from more than 6,000 at January 31, 2012.

Total revenue increased $68.6 million, or 60%, for the six month period ended January 31, 2013 compared to the six month period ended January 31, 2012. The revenue growth reflects the increasing demand for our product and service offerings. The increase in product revenue was primarily driven by an aggregate increase of more than 60% in product unit volume. A significant portion of the product revenue increase was in our PA-5000 Series firewalls and newly introduced PA-3000 Series firewalls. The increase in services revenue was primarily driven by new end-customers and, to a lesser extent, additional sales of subscription and support and maintenance services to our existing end-customer base.

With respect to geographic theaters, the Americas contributed the largest portion of the increase in revenue for the three and six months periods ended January 31, 2013 due to its larger and more established sales force compared to our other theaters. Revenue from both EMEA and APAC increased during three and six month periods ended January 31, 2013 primarily due to our investment in increasing the size of our sales force and number of partners in these theaters.

Cost of Revenue and Gross Margin

	Three Months Ended January 31,				Six Months Ended January 31,			
	2013		2012		2013		2012	
	Amount	Gross Margin	Amount	Gross Margin	Amount	Gross Margin	Amount	Gross Margin
	(dollars in thousands)							
Cost of revenue:								
Product	$16,636		$10,248		$31,052		$20,558	
Services	10,982		5,265		20,756		9,795	
Total cost of revenue	$27,618		$15,513		$51,808		$30,353	
Gross profit:								
Product	$45,308	73.1 %	$28,390	73.5 %	$86,406	73.6 %	$60,941	74.8 %
Services	23,573	68.2 %	12,780	70.8 %	44,219	68.1 %	22,502	69.7 %
Total gross profit	$68,881	71.4 %	$41,170	72.6 %	$130,625	71.6 %	$83,443	73.3 %

Gross margin decreased 120 basis points for the three month period ended January 31, 2013 compared to the three month period ended January 31, 2012. The decrease of 40 basis points in product margin was primarily due to the introduction of the PA-3000 Series firewalls, which will have lower product margins until volume and related cost savings increase. The decrease of 260 basis points in services margin was primarily due to an increase in personnel and other costs to expand our customer service capabilities to support our growing end-customer base, partially offset by higher margin subscriptions sales, while the mix in services revenue was largely unchanged on a period-over-period basis.

Gross margin decreased 170 basis points for the six month period ended January 31, 2013 compared to the six month period ended January 31, 2012. The decrease of 120 basis points in product margin was primarily due to lower average selling prices and changes in our product mix as a result of introducing our PA-200, which is a lower throughput firewall product and has lower product margin than our higher throughput products. The decrease of 160 basis points in services margin was primarily due to an increase in personnel and other costs to expand our customer service capabilities to support our growing end-customer base, partially offset by higher margin subscriptions sales, while the mix in services revenue was largely unchanged on a period-over-period basis.

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Operating Expenses

	Three Months Ended January 31,				Six Months Ended January 31,			
	2013 Amount	2012 Amount	Change Amount	%	2013 Amount	2012 Amount	Change Amount	%
	(dollars in thousands)							
Operating expenses:								
Research and development	$15,495	$8,514	$6,981	82.0 %	$28,807	$16,362	$12,445	76.1 %
Sales and marketing	45,796	25,612	20,184	78.8 %	88,403	47,980	40,423	84.2 %
General and administrative	9,747	5,768	3,979	69.0 %	18,703	10,925	7,778	71.2 %
Total operating expenses	$71,038	$39,894	$31,144	78.1 %	$135,913	$75,267	$60,646	80.6 %
Includes share-based compensation of:								
Research and development	$1,973	$440	$1,533	348.4 %	$3,663	$765	$2,898	378.8 %
Sales and marketing	3,935	630	3,305	524.6 %	8,233	1,107	7,126	643.7 %
General and administrative	2,021	839	1,182	140.9 %	3,765	1,379	2,386	173.0 %
Total	$7,929	$1,909	$6,020	315.3 %	$15,661	$3,251	$12,410	381.7 %

Research and development expense increased $7.0 million, or 82%, for the three month period ended January 31, 2013 compared to the three month period ended January 31, 2012, primarily due to an increase in personnel costs of $5.1 million as we increased our headcount to support continued investment in our future product and service offerings and an increase in allocated costs of $1.1 million. The remaining increase was primarily due to an increase in development costs.

Research and development expense increased $12.4 million, or 76%, for the six month period ended January 31, 2013 compared to the six month period ended January 31, 2012, primarily due to an increase in personnel costs of $9.1 million as we increased our headcount to support continued investment in our future product and service offerings and an increase in allocated costs of $1.6 million. The remaining increase was primarily due to an increase in development costs.

Sales and marketing expense increased $20.2 million, or 79%, for the three month period ended January 31, 2013 compared to the three month period ended January 31, 2012, primarily due to an increase in personnel costs of $13.2 million largely due to an increase in headcount and share-based compensation. Additionally, marketing activity increased $2.3 million related to demand generation activities, trade shows, and other marketing activities. The remaining increase was primarily due to an increase in allocated costs and travel and entertainment cost, and office equipment and software costs in support of our sales efforts.

Sales and marketing expense increased $40.4 million, or 84%, for the six month period ended January 31, 2013 compared to the six month period ended January 31, 2012, primarily due to an increase in personnel costs of $25.7 million largely due to an increase in headcount and a charge of $1.9 million for share-based compensation due to modification of terms of certain share-based awards for a former employee. Additionally, marketing activity increased $5.3 million related to demand generation activities, trade shows, and other marketing activities. The remaining increase was primarily due to an increase in allocated costs, travel and entertainment costs, and office equipment and software costs in support of our sales efforts.

General and administrative expense increased $4.0 million, or 69%, for the three month period ended January 31, 2013 compared to the three month period ended January 31, 2012, primarily due to an increase in personnel costs of $2.5 million. The remaining increase was primarily due to an increase in professional services costs related to overall growth to support the business and building our infrastructure to satisfy the increased regulatory requirements of being a public company and an increase in allocated costs.

General and administrative expense increased $7.8 million, or 71%, for the six month period ended January 31, 2013 compared to the six month period ended January 31, 2012 primarily due to an increase in personnel costs of $4.3 million and an increase in professional services costs of $1.8 million primarily related to overall growth to support the business and building our infrastructure to

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satisfy the increased regulatory requirements of being a public company. The remaining increase was primarily due to an increase in allocated costs.

Other Expense, Net

	Three Months Ended January 31,		Six Months Ended January 31,	
	2013	2012	2013	2012
	(dollars in thousands)			
Other expense, net	$60	$566	$230	$1,030

Other expense, net consisted primarily of the change in fair value of our preferred stock warrant liability for the three and six months periods ended January 31, 2012. The change in other expense, net was primarily due to the elimination of the expense related to preferred stock warrant liability as a result of exercise of these warrants by the holders in December 2011 and January 2012. At the time of exercise, we issued 197,000 shares of Series A redeemable convertible preferred stock and 24,000 shares of Series B redeemable convertible preferred stock, all of which converted to common stock at the time of our IPO. We do not expect to incur expenses related to these warrants in future periods.

Provision for Income Taxes

	Three Months Ended January 31,		Six Months Ended January 31,	
	2013	2012	2013	2012
	(dollars in thousands)			
Provision for income taxes	$512	$288	$824	$2,610
Effective tax rate	(24.4)%	40.4%	(15.5)%	36.5%

We recorded an income tax provision for the three month period ended January 31, 2013, primarily due to foreign income taxes and withholding taxes. The provision for income taxes increased for the three month period ended January 31, 2013 compared to the three months ended January 31, 2012, primarily due to foreign income taxes as a result of an increase in foreign taxable income.

We recorded an income tax provision for the six month period ended January 31, 2013, primarily due to foreign income taxes and withholding taxes. The provision for income taxes decreased for the six month period ended January 31, 2013 compared to the six month period ended January 31, 2012, primarily due to a decrease in income before income taxes, partially offset by an increase in foreign income taxes as a result of an increase in foreign taxable income and an increase in withholding taxes.

Liquidity and Capital Resources

	January 31, 2013	July 31, 2012
	(in thousands)	
Cash and cash equivalents	$187,924	$322,642
Investments	180,391	—
	$368,315	$322,642

Six Months Ended January 31,

	2013	2012
	(in thousands)	
Cash provided by operating activities	$57,583	$47,703
Cash used in investing activities	(192,228)	(7,063)
Cash provided by (used in) financing activities	(73)	1,665
Net increase in cash and cash equivalents	$(134,718)	$42,305

At January 31, 2013, our cash and cash equivalents and investments of $368.3 million were held for working capital purposes, of which approximately $7.9 million was held outside of the United States and not presently available to fund domestic operations and obligations. If we were to repatriate cash held outside of the United States, it could be subject to U.S. income taxes, less any previously paid foreign income taxes.

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Prior to fiscal 2010, we financed our operations primarily through private sales of equity securities. More recently we have financed our operations through cash generated from operations and our IPO. On July 25, 2012, we closed our IPO, in which 7,130,000 shares of common stock were sold to the public (inclusive of 5,617,259 shares of common stock sold by us). The public offering price of the shares sold in the IPO was $42.00 per share. The total gross proceeds from the offering were $299.5 million. After deducting underwriting discounts and commissions, offering expenses payable by us, and net proceeds received by the selling stockholders, the aggregate net proceeds received by us totaled approximately $215.4 million. In March 2012, we allowed our unused $10 million line of credit to expire. We believe that our cash flow from operations with existing cash and cash equivalents will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our growth rate, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the introduction of new and enhanced products and services offerings, the costs to ensure access to adequate manufacturing capacity, and the continuing market acceptance of our products. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional capital when desired, our business, operating results, and financial condition would be adversely affected.

Operating Activities

Our primary source of cash from operating activities has been from cash collections from our customers. We expect cash inflows from operating activities to be affected by increases in sales and timing of collections. Our primary uses of cash from operating activities have been for personnel costs and purchases from our contract manufacturer. We expect cash outflows from operating activities to be affected by increases in sales and increases in personnel costs as we grow our business. Cash provided by operating activities for the six month period ended January 31, 2013 and six month period ended January 31, 2012 was $57.6 million and $47.7 million, respectively.

For the six month period ended January 31, 2013, operating activities provided $57.6 million in cash as a result of net loss of $6.1 million, non-cash charges of $22.2 million and a net change of $41.5 million in our net operating assets and liabilities. Non-cash charges included share-based compensation, depreciation and amortization, amortization of investment premiums, net of accretion of purchase discounts, and the excess tax benefit from share-based compensation. The net change in our net operating assets and liabilities was primarily due to a $52.4 million increase in deferred revenue as a result of increases in sales of subscriptions and support and maintenance and a $17.6 million increase in accrued and other liabilities as a result of increases in business activity, partially offset by a $22.9 million increase in accounts receivable and a $7.3 million increase in prepaid expenses and other assets. Our day's sales outstanding, or DSO, defined as the number of days it takes to turn our average quarterly accounts receivable into cash based on a 90 day average, was 58 days at January 31, 2013.

For the six month period ended January 31, 2012, operating activities provided $47.7 million in cash as a result of a net income of $4.5 million, non-cash charges of $6.9 million as well as a net change of $36.2 million in our net operating assets and liabilities. Non-cash charges included share-based compensation, depreciation and amortization, and the change in fair value of our preferred stock warrant liability. The net change in our operating assets and liabilities was primarily the result of a $30.7 million increase in deferred revenue as a result of increases in sales of subscriptions and support and maintenance, a $5.7 million increase in accrued compensation and other liabilities primarily as a result of increases in business activity, and a $5.6 million decrease in accounts receivable. These increases were partially offset by a $5.1 million increase in prepaid expenses and other assets and a $1.2 million decrease in accounts payable. Our DSO was 47 days at January 31, 2012.

Investing Activities

Our investing activities have consisted of purchases of property, equipment, and other assets and purchases, sales, and maturities of investments. We expect to continue to make such purchases as our business grows.

For the six month period ended January 31, 2013, cash used in investing activities was $192.2 million, primarily as a result of $252.6 million in purchases of short-term and long-term investments to shift the mix of investments from money market funds to higher yield corporate notes and bonds, and U.S. government agency securities and capital expenditures to purchase property, equipment, and other assets of $10.2 million, partially offset by proceeds from sales and maturities of investments.

For the six month period ended January 31, 2012, cash used in investing activities was $7.1 million, primarily as a result of capital expenditures to purchase property, equipment, and other assets.

Financing Activities

Our financing activities have primarily consisted of proceeds from the sale of our common stock in our IPO and redeemable convertible preferred stock and proceeds from the exercises of stock options.

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For the six month period ended January 31, 2013, cash used in financing activities was $0.1 million, primarily as a result of payments of costs related to our initial public offering, and partially offset by proceeds from the exercises of stock options.

For the six month period ended January 31, 2012, financing activities provided $1.7 million in cash, primarily as a result of changes in restricted cash and proceeds from the exercises of stock options.

Contractual Obligations and Commitments

The following summarizes our contractual obligations and commitments as of January 31, 2013:

	Payments Due by Period				
	Total	Less Than 1 Year	1 - 3 Years	3- 5 Years	More Than 5 Years
		(in thousands)			