Proto Labs Inc
Form 10-Q
August 01, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2017

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: 001-35435

Proto Labs, Inc.

(Exact name of registrant as specified in its charter)

Minnesota	**41-1939628**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
5540 Pioneer Creek Drive	
Maple Plain, Minnesota	**55359**
(Address of principal executive offices)	(Zip Code)

(763) 479-3680

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date: 26,613,012 shares of Common Stock, par value $0.001 per share, were outstanding at July 27, 2017.

Proto Labs, Inc.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Proto Labs, Inc. Consolidated Balance Sheets (In thousands, except share and per share amounts)

	June 30, 2017 (Unaudited)	December 31, 2016
Assets		
Current assets		
Cash and cash equivalents	$ 99,196	$ 68,795
Short-term marketable securities	48,272	39,477
Accounts receivable, net of allowance for doubtful accounts of $522 and $442 as of June 30, 2017 and December 31, 2016, respectively	42,211	34,060
Inventory	9,327	9,310
Prepaid expenses and other current assets	5,915	5,697
Income taxes receivable	-	445
Total current assets	204,921	157,784
Property and equipment, net	146,364	139,474
Goodwill	28,916	28,916
Other intangible assets, net	2,367	2,655
Long-term marketable securities	69,435	84,479
Other long-term assets	2,650	933
Total assets	$ 454,653	$ 414,241
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable	$ 14,147	$ 11,322
Accrued compensation	10,990	7,670
Accrued liabilities and other	4,530	4,435

Income taxes payable	1,383	-
Total current liabilities	31,050	23,427
Long-term deferred tax liabilities	8,613	7,003
Other long-term liabilities	4,186	3,978
Total liabilities	43,849	34,408
Shareholders' equity		
Preferred stock, $0.001 par value, authorized 10,000,000 shares; issued and outstanding 0 shares as of each of June 30, 2017 and December 31, 2016	-	-
Common stock, $0.001 par value, authorized 150,000,000 shares; issued and outstanding 26,586,152 and 26,504,868 shares as of June 30, 2017 and December 31, 2016, respectively	27	26
Additional paid-in capital	220,975	213,857
Retained earnings	197,206	176,703
Accumulated other comprehensive loss	(7,404)	(10,753)
Total shareholders' equity	410,804	379,833
Total liabilities and shareholders' equity	$ 454,653	$ 414,241

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

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Proto Labs, Inc.
Consolidated Statements of Comprehensive Income
(In thousands, except share and per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	**2016**	**2017**	**2016**
Statements of Operations:				
Revenue	$82,040	$74,961	$162,207	$147,529
Cost of revenue	35,671	32,715	70,565	65,629
Gross profit	46,369	42,246	91,642	81,900
Operating expenses				
Marketing and sales	14,630	11,453	27,617	22,395
Research and development	6,084	5,816	11,907	11,134
General and administrative	9,253	10,126	18,034	18,377
Total operating expenses	29,967	27,395	57,558	51,906
Income from operations	16,402	14,851	34,084	29,994
Other income, net	1,173	1,092	1,488	1,717
Income before income taxes	17,575	15,943	35,572	31,711
Provision for income taxes	5,489	5,252	11,286	10,358
Net income	$12,086	$10,691	$24,286	$21,353
Net income per share:				
Basic	$0.46	$0.41	$0.91	$0.81
Diluted	$0.45	$0.40	$0.91	$0.80
Shares used to compute net income per share:				
Basic	26,541,978	26,368,001	26,554,262	26,295,074
Diluted	26,649,152	26,561,148	26,710,217	26,526,629
Comprehensive Income (net of tax)				
Comprehensive income	$14,250	$8,547	$27,635	$19,953

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

Proto Labs, Inc.
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Six Months Ended June 30,	
	2017	**2016**
Operating activities		
Net income	$24,286	$21,353
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,700	8,147
Stock-based compensation expense	3,958	3,541
Deferred taxes	1,608	403
Loss on impairment of assets	-	455
Amortization of held-to-maturity securities	592	590
Other	77	(1,095)
Changes in operating assets and liabilities:		
Accounts receivable	(6,914)	1,201
Inventories	175	(187)
Prepaid expenses and other	(775)	(1,146)
Income taxes	1,769	5,984
Accounts payable	2,534	(1,368)
Accrued liabilities and other	3,417	600
Net cash provided by operating activities	39,427	38,478
Investing activities		
Purchases of property and equipment	(13,301)	(22,416)
Purchases of marketable securities	(20,037)	(38,304)
Proceeds from maturities of marketable securities	25,194	28,759
Purchases of other investments	(514)	-
Net cash used in investing activities	(8,658)	(31,961)
Financing activities		
Acquisition-related contingent consideration	-	(400)
Proceeds from exercises of stock options and other	3,791	3,729
Repurchases of common stock	(4,410)	-
Net cash (used in) provided by financing activities	(619)	3,329
Effect of exchange rate changes on cash and cash equivalents	251	(168)
Net increase in cash and cash equivalents	30,401	9,678
Cash and cash equivalents, beginning of period	68,795	47,653

Cash and cash equivalents, end of period	$99,196	$57,331

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

Note 1 – Basis of Presentation

The unaudited interim Consolidated Financial Statements of Proto Labs, Inc. (Proto Labs, the Company, we, us or our) have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, the accompanying financial statements reflect all adjustments necessary for a fair presentation of the Company’s statements of financial position, results of operations and cash flows for the periods presented. Except as otherwise disclosed herein, these adjustments consist of normal, recurring items. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole.

The preparation of the financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures at the date of the financial statements and during the reporting period. Actual results could materially differ from these estimates. For further information, refer to the audited Consolidated Financial Statements and Notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016 as filed with the Securities and Exchange Commission (SEC) on February 22, 2017.

The accompanying Consolidated Balance Sheet as of December 31, 2016 was derived from the audited Consolidated Financial Statements but does not include all disclosures required by U.S. GAAP for a full set of financial statements. This Form 10-Q should be read in conjunction with the Company’s Consolidated Financial Statements and Notes included in the Annual Report on Form 10-K filed on February 22, 2017 as referenced above.

Note 2 – Recent Accounting Pronouncements

Recently Adopted Accounting Pronouncements

During the first quarter of 2017, the Company adopted the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2016-09, *Employee Share-Based Payment Accounting*, which is intended to simplify several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, statutory tax withholding requirements, and classification in the statement of cash flows. As a result of the adoption, the amount in excess tax benefits from stock-based compensation is recorded in our provision for income taxes. For the three and six months ended June 30, 2017, the amount recorded in the provision for income taxes was $0.1 million and $0.2 million, respectively. Historically, these amounts were recorded as additional paid-in capital as required by the accounting pronouncements in force during the periods presented. In addition, for each period presented, cash flows related to excess tax benefits are now classified as an operating activity along with other income tax cash flows. Retrospective application of the cash flow presentation requirements resulted in an increase to net cash provided by operations and a decrease to net cash provided by financing activities of $1.9 million for the six months ended June 30, 2016.

Recently Issued Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*. This ASU is a comprehensive new revenue recognition model that requires a company to recognize revenue from the transfer of goods or services to customers in an amount that reflects the consideration that the entity expects to receive in exchange for those goods or services. The Company is required to adopt the new pronouncement using one of two retrospective application methods.

On July 9, 2015, the FASB voted to approve a deferral of the effective date of ASU 2014-09 by one year to December 15, 2017 for annual reporting periods beginning after that date. The Company expects to adopt the new revenue standard using the modified retrospective approach. As of June 30, 2017, the Company has identified revenue streams and continues to review individual contracts. Based on this review, the Company expects to recognize revenue over time for the majority of contracts. While the Company is still evaluating the impact of the amended guidance, it does not expect the impact to the timing or amount of revenue recognized to be material. The Company expects to quantify and disclose the expected impact, if any, of adopting this amended guidance in its Annual Report on Form 10-K for the year ending December 31, 2017.

In February 2016, the FASB issued ASU 2016-02, *Leases*, which introduces the balance sheet recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous guidance. The guidance will be effective for annual reporting periods beginning after December 15, 2018 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of the future adoption of this standard on its consolidated financial statements, but does not expect the impact to be material.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows*, which is intended to reduce diversity in how companies present and classify certain cash receipts and cash payments in the statement of cash flows. This guidance will be effective for annual reporting periods beginning after December 15, 2017 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of the future adoption of this guidance on its consolidated financial statements, but does not expect the impact to be material.

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other,* which is intended to simplify the subsequent measurement of goodwill. This guidance will be effective for impairment tests in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of future adoption of this guidance on its consolidated financial statements, but does not expect the impact to be material.

In January 2017, the FASB issued ASU 2017-01, *Business Combinations,* which is intended to clarify the definition of a business to assist with evaluating whether transactions should be accounted for as acquisitions or disposals of assets or businesses. This guidance will be effective for annual reporting periods beginning after December 15, 2017 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of the future adoption of this guidance on its consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, *Compensation – Stock Compensation*, which is intended to provide clarity and reduce diversity in practice as well as cost and complexity when applying the guidance to a change to the terms or conditions of a share-based payment award. This guidance will be effective for annual reporting periods beginning after December 15, 2017 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of the future adoption of this guidance on its consolidated financial statements.

Note 3 – Net Income per Common Share

Basic net income per share is computed based on the weighted-average number of common shares outstanding. Diluted net income per share is computed based on the weighted-average number of common shares outstanding, increased by the number of additional shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of shares the Company could have repurchased from the proceeds from issuance of the potentially dilutive shares. Potentially dilutive shares of common stock include stock options, restricted stock units and restricted stock awards granted under stock-based compensation plans and shares committed to be purchased under the employee stock purchase plan. Performance stock units (PSUs) are excluded from the calculation of dilutive potential common shares until the performance conditions have been satisfied.

The table below sets forth the computation of basic and diluted net income per share:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands, except share and per share amounts)	**2017**	**2016**	**2017**	**2016**

Net income	$12,086	$10,691	$24,286	$21,353
Basic - weighted-average shares outstanding:	26,541,978	26,368,001	26,554,262	26,295,074
Effect of dilutive securities:				
Employee stock options and other	107,174	193,147	155,955	231,555
Diluted - weighted-average shares outstanding:	26,649,152	26,561,148	26,710,217	26,526,629
Net income per share:				
Basic	$0.46	$0.41	$0.91	$0.81
Diluted	$0.45	$0.40	$0.91	$0.80

Note 4 – Goodwill and Other Intangible Assets

There were no changes in the carrying amount of Goodwill during the three and six months ended June 30, 2017.

Intangible Assets other than Goodwill at June 30, 2017 and December 31, 2016 were as follows:

	June 30, 2017			**December 31, 2016**			**Useful**	**Weighted Average Useful Life**
(in thousands)	**Gross**	**Accumulated Amortization**	**Net**	**Gross**	**Accumulated Amortization**	**Net**	**Life (in years)**	**Remaining (in years)**
Intangible Assets with finite lives:								
Marketing assets	$930	$ (295)	$635	$930	$ (248)	$682	10.0	6.8
Non-compete agreement	190	(190)	-	190	(190)	-	2.0	-
Trade secrets	250	(158)	92	250	(133)	117	5.0	1.8
Internally developed software	680	(680)	-	680	(604)	76	3.0	-
Customer relationships	2,530	(890)	1,640	2,530	(750)	1,780	9.0	5.8
Total intangible assets	$4,580	$ (2,213)	$2,367	$4,580	$ (1,925)	$2,655		

Amortization expense for intangible assets was $0.1 million and $0.2 million for the three months ended June 30, 2017 and 2016, respectively, and $0.3 million and $0.4 million for the six months ended June 30, 2017 and 2016, respectively.

Estimated aggregated amortization expense based on the current carrying value of the amortizable intangible assets is as follows:

(in thousands)	Estimated Amortization Expense
Remaining 2017	$ 212
2018	424
2019	391
2020	374
2021	374
Thereafter	592
Total estimated amortization expense	$ 2,367

Note 5 – Fair Value Measurements

ASC 820, *Fair Value Measuremen*t (ASC 820), defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy that requires classification based on observable and unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1—Quoted prices in active markets for identical assets or liabilities.

Level 2—Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company's cash consists of bank deposits. The Company's cash equivalents measured at fair value consist of money market mutual funds. The Company determines the fair value of these investments using Level 1 inputs.

The following table summarizes financial assets as of June 30, 2017 and December 31, 2016 measured at fair value on a recurring basis:

	June 30, 2017			**December 31, 2016**		
(in thousands)	**Level 1**	**Level 2**	**Level 3**	**Level 1**	**Level 2**	**Level 3**
Financial Assets:						
Cash and cash equivalents						
Money market mutual fund	$16,655	$ -	$ -	$11,771	$ -	$ -
Total	$16,655	$ -	$ -	$11,771	$ -	$ -

Note 6 – Marketable Securities

The Company invests in short-term and long-term agency, municipal, corporate and other debt securities. The securities are categorized as held-to-maturity and are recorded at amortized cost. Categorization as held-to-maturity is based on the Company's ability and intent to hold these securities to maturity. Information regarding the Company's short-term and long-term marketable securities as of June 30, 2017 and December 31, 2016 is as follows:

	June 30, 2017			
(in thousands)	**Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
U.S. municipal securities	$38,522	$ 22	$ (59)	$38,485
Corporate debt securities	33,899	2	(98)	33,803
U.S. government agency securities	38,349	-	(136)	38,212
Certificates of deposit/time deposits	6,937	3	(26)	6,914
Total marketable securities	$117,707	$ 27	$ (319)	$117,415

	December 31, 2016			
(in thousands)	**Cost**	**Unrealized Gains**	**Unrealized Losses**	**Fair Value**
U.S. municipal securities	$46,578	$ 1	$ (187)	$46,392
Corporate debt securities	38,490	2	(147)	38,345
U.S. government agency securities	31,706	1	(141)	31,566
Certificates of deposit/time deposits	7,182	12	(22)	7,172
Total marketable securities	$123,956	$ 16	$ (497)	$123,475

Fair values for the corporate debt securities are primarily determined based on quoted market prices (Level 1). Fair values for the U.S. municipal securities, U.S. government agency securities and certificates of deposit are primarily determined using dealer quotes or quoted market prices for similar securities (Level 2).

The Company tests for other-than-temporary losses on a quarterly basis and has considered the unrealized losses indicated above to be temporary in nature. In reaching this conclusion, the Company considered the credit quality of the issuers of the debt securities as well as the Company's intent to hold the investments to maturity and recover the full principal.

Classification of marketable securities as current or non-current is based upon the security’s maturity date as of the date of these financial statements.

The June 30, 2017 balance of held-to-maturity debt securities by contractual maturity is shown in the following table at amortized cost. Actual maturities may differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

(in thousands)	**June 30, 2017**
Due in one year or less	$48,272
Due after one year through five years	69,435
Total marketable securities	$117,707

Note 7 – Inventory

Inventory consists primarily of raw materials, which are recorded at the lower of cost or market using the average-cost method, which approximates first-in, first-out (FIFO) cost. The Company periodically reviews its inventory for slow-moving, damaged and discontinued items and provides allowances to reduce such items identified to their recoverable amounts.

The Company's inventory consisted of the following as of the dates indicated:

(in thousands)	**June 30, 2017**	**December 31, 2016**
Raw materials	$8,357	$ 8,057
Work in process	1,356	1,531
Total inventory	9,713	9,588
Allowance for obsolescence	(386)	(278)
Inventory, net of allowance	$9,327	$ 9,310

Note 8 – Stock-Based Compensation

Under the Company’s 2012 Long-Term Incentive Plan, as amended (the 2012 Plan), the Company has the ability to grant stock options, stock appreciation rights (SARs), restricted stock, restricted stock units, other stock-based awards and cash incentive awards. Awards under the 2012 Plan have a maximum term of ten years from the date of grant. The compensation committee may provide that the vesting or payment of any award will be subject to the attainment of specified performance measures in addition to the satisfaction of any continued service requirements and the compensation committee will determine whether such measures have been achieved. The per-share exercise price of stock options and SARs granted under the 2012 Plan generally may not be less than the fair market value of a share of our common stock on the date of the grant.

Employee Stock Purchase Plan

The Company’s 2012 Employee Stock Purchase Plan (ESPP) allows eligible employees to purchase a variable number of shares of the Company’s common stock each offering period at a discount through payroll deductions of up to 15 percent of their eligible compensation, subject to plan limitations. The ESPP provides for six-month offering periods with a single purchase period ending May 15 and November 15, respectively. At the end of each offering period, employees are able to purchase shares at 85 percent of the lower of the fair market value of the Company’s common stock on the first trading day of the offering period or on the last trading day of the offering period.

Stock-Based Compensation Expense

Stock-based compensation expense was $2.2 million and $1.8 million for the three months ended June 30, 2017 and 2016, respectively, and $4.0 million and $3.5 million for the six months ended June 30, 2017 and 2016, respectively.

Stock Options

The following table summarizes stock option activity during the six months ended June 30, 2017:

	Stock Options	Weighted-Average Exercise Price
Options outstanding at December 31, 2016	569,639	$ 45.00
Granted	43,095	58.35
Exercised	(88,114)	31.71
Forfeited	(16,943)	58.17
Options outstanding at June 30, 2017	507,677	$ 48.00
Exercisable at June 30, 2017	318,140	$ 40.42

The outstanding options generally have a term of ten years. For employees, options granted become exercisable ratably over the vesting period, which is generally a five-year period beginning on the first anniversary of the grant date, subject to the employee’s continuing service to the Company. For directors, options generally become exercisable in full on the first anniversary of the grant date.

The weighted-average grant date fair value of options that were granted during the six months ended June 30, 2017 was $27.57.

The following table provides the assumptions used in the Black-Scholes pricing model valuation of options during the six months ended June 30, 2017 and 2016:

	Six Months Ended June 30,	
	2017	2016
Risk-free interest rate	2.24%	1.53 - 1.68%
Expected life (years)	6.50	6.50
Expected volatility	44.68%	44.38 - 45.93%
Expected dividend yield	0%	0%

As of June 30, 2017, there was $4.8 million of unrecognized compensation expense related to unvested stock options, which is expected to be recognized over a weighted-average period of 3.0 years.

Restricted Stock

Restricted stock awards are share-settled awards and restrictions lapse ratably over the vesting period, which is generally a five-year period, beginning on the first anniversary of the grant date, subject to the employee's continuing service to the Company. For directors, restrictions generally lapse in full on the first anniversary of the grant date.

The following table summarizes restricted stock activity during the six months ended June 30, 2017:

	Restricted Stock	**Weighted-Average Grant Date Fair Value Per Share**
Restricted stock at December 31, 2016	215,105	$ 62.78
Granted	197,649	61.60
Restrictions lapsed	(55,139)	63.61
Forfeited	(9,570)	63.76
Restricted stock at June 30, 2017	348,045	$ 61.95

As of June 30, 2017, there was $20.4 million of unrecognized compensation expense related to non-vested restricted stock, which is expected to be recognized over a weighted-average period of 4.0 years.

Performance Stock

PSUs are expressed in terms of a target number of PSUs, with anywhere between 0 percent and 150 percent of that target number capable of being earned and vesting at the end of a three-year performance period depending on the Company's performance in the final year of the performance period and the award recipient's continued employment. As of June 30, 2017, the Company is accruing stock-based compensation expense for the PSUs at 100 percent.

The following table summarizes performance stock activity during the six months ended June 30, 2017:

	Performance Stock	**Weighted-Average Grant Date Fair Value Per Share**
Performance stock at December 31, 2016	-	$ -
Granted	25,707	58.35
Restrictions lapsed	-	-
Forfeited	-	-
Performance stock at June 30, 2017	25,707	$ 58.35

Employee Stock Purchase Plan

The following table presents the assumptions used to estimate the fair value of the ESPP during the six months ended June 30, 2017 and 2016:

	Six Months Ended June 30,	
	2017	**2016**
Risk-free interest rate	0.59% - 0.97%	0.39 - 0.56%
Expected life (months)	6.00	6.00

Expected volatility	34.51% -	39.51%	29.41 -	49.13%
Expected dividend yield	0%		0%	

Note 9 – Accumulated Other Comprehensive Loss

Other comprehensive loss is comprised entirely of foreign currency translation adjustments. The following table presents the changes in accumulated other comprehensive loss balances during the three and six months ended June 30, 2017 and 2016:

(in thousands)	**Three Months Ended June 30, 2017**	**2016**	**Six Months Ended June 30, 2017**	**2016**
Foreign currency translation adjustments				
Balance at beginning of period	$(9,568)	$(4,468)	$(10,753)	$(5,212)
Other comprehensive income (loss) before reclassifications	2,164	(2,144)	3,349	(1,400)
Amounts reclassified from accumulated other comprehensive income	-	-	-	-
Net current-period other comprehensive income (loss)	2,164	(2,144)	3,349	(1,400)
Balance at end of period	$(7,404)	$(6,612)	$(7,404)	$(6,612)

Note 10 – Income Taxes

The Company is subject to income tax in multiple jurisdictions and the use of estimates is required to determine the provision for income taxes. For the three months ended June 30, 2017 and 2016, the Company recorded an income tax provision of $5.5 million and $5.3 million, respectively. For the six months ended June 30, 2017 and 2016, the Company recorded an income tax provision of $11.3 million and $10.4 million, respectively. The income tax provision is based on the estimated annual effective tax rate for the year applied to pre-tax income. The effective income tax rate for the three months ended June 30, 2017 was 31.2 percent compared to 32.9 percent in the same period of the prior year. The effective income tax rate for the six months ended June 30, 2017 was 31.7 percent compared to 32.7 percent in the same period of the prior year.

The effective income tax rate for the three and six months ended June 30, 2017 differs from the U.S. federal statutory rate of 35.0 percent due primarily to the mix of income earned in domestic and foreign tax jurisdictions and deductions for which the Company qualifies.

The Company had reserves against unrecognized tax benefits totaling $4.0 million and $3.8 million at June 30, 2017 and December 31, 2016, respectively, all of which, if recognized, would affect the Company’s effective tax rate. The Company recognizes interest and penalties related to income tax matters in income tax expense, and reports the liability in current or long-term income taxes payable as appropriate.

Note 11 – Segment Reporting

The Company’s reportable segments are based on the internal reporting used by the Company’s Chief Executive Officer, who is the chief operating decision maker (CODM), to assess operating performance and make decisions about the allocation of resources. The Corporate Unallocated and Japan category includes non-reportable segments, as well as research and development and general and administrative costs that the Company does not allocate directly to its operating segments.

Intercompany transactions primarily relate to intercontinental activity and have been eliminated and are excluded from the reported amounts. The difference between income from operations and pre-tax income relates to foreign currency-related gains and losses and interest income on cash balances and investments, which are not allocated to business segments.

Revenue and income from operations by reportable segment for the three and six months ended June 30, 2017 and 2016 were as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands)	**2017**	**2016**	**2017**	**2016**
Revenue:				
United States	$63,353	$55,323	$123,529	$109,791
Europe	16,131	17,276	33,130	32,907
Japan	2,556	2,362	5,548	4,831
Total revenue	$82,040	$74,961	$162,207	$147,529

(in thousands)	Three Months Ended June 30, 2017	2016	Six Months Ended June 30, 2017	2016
Income from Operations:				
United States	$25,723	$21,528	$50,069	$43,632
Europe	2,335	3,431	6,375	5,815
Corporate Unallocated and Japan	(11,656)	(10,108)	(22,360)	(19,453)
Total Income from Operations	$16,402	$14,851	$34,084	$29,994

Total long-lived assets at June 30, 2017 and December 31, 2016 were as follows:

(in thousands)	June 30, 2017	December 31, 2016
Total long-lived assets:		
United States	$110,078	$108,650
Europe	28,736	23,199
Japan	7,550	7,625
Total Assets	$146,364	$139,474

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 unaudited consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2016.

Forward-Looking Statements

Statements contained in this report regarding matters that are not historical or current facts are "forward-looking statements" within the meaning of The Private Securities Litigation Reform Act of 1995. In some cases, you can identify forward-looking statements by the following words: "may," "will," "could," "would," "should," "expect," "intend," "p "anticipate," "believe," "estimate," "predict," "project," "potential," "continue," "ongoing" or the negative of these terms or otl comparable terminology, although not all forward-looking statements contain these words. These statements involve known and unknown risks, uncertainties and other factors that may cause our results to be materially different than those expressed or implied in such statements. Certain of these risk factors and others are described in Item 1A. "Risk Factors" of our most recent Annual Report on Form 10-K as filed with the SEC. Other unknown or unpredictable factors also could have material adverse effects on our future results. We cannot guarantee future results, levels of activity, performance or achievements. Accordingly, you should not place undue reliance on these forward-looking statements. Finally, we expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

Overview

We are an e-commerce driven digital manufacturer of quick-turn, on-demand injection-molded, CNC-machined and 3D-printed custom parts for prototyping and short-run production. We provide "Real Parts, Really Fast" to product developers and engineers worldwide, who are under increasing pressure to bring their finished products to market faster than their competition. We believe custom parts manufacturing has historically been an underserved market due to the inefficiencies inherent in the quotation, equipment set-up and non-recurring engineering processes required to produce custom parts. Our proprietary technology eliminates most of the time-consuming and expensive skilled labor conventionally required to quote and manufacture parts in low volumes, and our customers conduct nearly all of their business with us over the Internet. We target our products to the millions of product developers and engineers who use three-dimensional computer-aided design (3D CAD) software to design products across a diverse range of end-markets.

Our primary manufacturing product lines currently include Injection Molding, CNC Machining and 3D Printing. We continually seek to expand the range of sizes and geometric complexity of the parts we can make with these manufacturing processes, extend the variety of materials we are able to support and identify additional manufacturing processes to which we can apply our technology in order to better serve the evolving preferences and needs of product developers and engineers.

Injection Molding

Our Injection Molding product line uses our proprietary 3D CAD-to-CNC machining technology for the automated design and manufacture of thermoplastic or liquid silicone injection molds, which are then used to produce custom injection-molded parts utilizing commercially available equipment. Our Injection Molding product line is used for prototype, on-demand and short-run production. Prototype quantities typically range from 25 to 100 parts. Because we retain possession of the molds, customers who need low-volume production often come back to Proto Labs' Injection Molding product line for additional quantities typically ranging up to 10,000 parts or more. They do so to support pilot production for product testing or while their tooling for high-volume production is being prepared, because they need on-demand manufacturing due to disruptions in their manufacturing process, because their product will only be released in a limited quantity, because demand for their product is unpredictable, or because they need end-of-life production support. These additional part orders typically occur on approximately half of the molds that we make, usually accounting for approximately half of our total Injection Molding revenue.

CNC Machining

Our CNC Machining product line uses our proprietary 3D CAD-to-CNC machining technology on commercially available CNC machines to cut plastic or metal blocks or bars into one or more custom parts based on the 3D CAD model uploaded by the product developer or engineer. Our efficiencies derive from the automation of the programming of these machines and a proprietary fixturing process. The CNC Machining product line is well suited to produce small quantities, typically in the range of one to 200 parts.

3D Printing

Our 3D Printing product line includes stereolithography (SL), selective laser sintering (SLS), direct metal laser sintering (DMLS) and PolyJet processes, which offers customers a wide-variety of high-quality, precision rapid prototyping and low-volume production. These processes create parts with a high level of accuracy, detail, strength and durability. 3D Printing is well suited to produce small quantities, typically in the range of one to 50 parts.

Key Financial Measures and Trends

Revenue

The Company's operations are conducted in three geographic operating segments in the United States, Europe and Japan, which we believe are three of the largest geographic markets where product developers and engineers are located. Revenue within our United States and Europe markets is derived from our Injection Molding, CNC Machining and 3D Printing product lines. Revenue within our Japan market is derived from our Injection Molding and CNC Machining product lines. Our historical and current efforts to increase revenue have been directed at gaining new customers and selling to our existing customer base by:

- increasing marketing and selling activities;
- offering additional product lines such as 3D Printing through our acquisition of FineLine Prototyping, Inc. in April 2014 and expanded through our acquisition of certain assets, including shares of select subsidiaries, of Alphaform AG (Alphaform) in October 2015;
- improving the usability of our product lines such as our web-centric applications;
- expanding the breadth and scope of our products, for example, by adding more sizes and materials to our offerings such as liquid silicone rubber (LSR);
- expanding the breadth of manufacturing capabilities, for example, by adding rapid overmolding and insert molding technology to our Injection Molding product line and PolyJet technology to our 3D printing product line; and
- adding a suite of capabilities designed to address the on-demand needs of the low-volume, high-mix product segment.

During the three months ended June 30, 2017, we served 16,174 unique product developers and engineers who purchased our products through our web-based customer interface, an increase of 18.8% over the same period in 2016. During the six months ended June 30, 2017, we served 24,255 unique product developers and engineers who purchased our products through our web-based customer interface, an increase of 19.3% over the same period in 2016. The information does not include 3D Printing and Injection Molding customers resulting from the Alphaform acquisition who do not utilize our web-based interface.

Cost of Revenue, Gross Profit and Gross Margin

Cost of revenue consists primarily of raw materials, employee compensation, benefits, stock-based compensation, equipment depreciation, facilities costs and overhead allocations associated with the manufacturing process for molds and custom parts. We expect cost of revenue to increase in absolute dollars, but remain relatively constant as a percentage of total revenue.

We define gross profit as our revenue less our cost of revenue, and we define gross margin as gross profit expressed as a percentage of revenue. Our gross profit and gross margin are affected by many factors, including our pricing, sales volume and manufacturing costs, the costs associated with increasing production capacity, the mix between sales by product line, the mix between domestic and foreign revenue sources, and foreign currency exchange rates.

Operating Expenses

Operating expenses consist of marketing and sales, research and development and general and administrative expenses. Personnel-related costs are the most significant component in each of these categories.

Our recent growth in operating expenses is mainly due to higher headcounts to support our growth and expansion, and we expect that trend to continue. Our business strategy is to continue to be a leading online and technology-enabled manufacturer of quick-turn, on-demand injection-molded, CNC-machined, CNC-turned and 3D-printed custom parts for prototyping and low-volume production. In order to achieve our goals, we anticipate continued substantial investments in technology and personnel, resulting in increased operating expenses.

Marketing and sales. Marketing and sales expense consists primarily of employee compensation, benefits, commissions, stock-based compensation, marketing programs such as electronic, print and pay-per-click advertising, trade shows and other related overhead. We expect sales and marketing expense to increase in the future as we increase the number of marketing and sales professionals and marketing programs targeted to increase our customer base.

Research and development. Research and development expense consists primarily of employee compensation, benefits, stock-based compensation, depreciation on equipment and other related overhead. All of our research and development costs have been expensed as incurred. We expect research and development expense to increase in the future as we seek to enhance and expand our product line offerings.

General and administrative. General and administrative expense consists primarily of employee compensation, benefits, stock-based compensation, professional service fees related to accounting, tax and legal and other related overhead. We expect general and administrative expense to increase in the future as we continue to grow and expand as a global organization.

Other Income, net

Other income, net primarily consists of foreign currency-related gains and losses and interest income on cash balances and investments. Our foreign currency-related gains and losses will vary depending upon movements in underlying exchange rates. Our interest income will vary each reporting period depending on our average cash balances during the period, composition of our marketable security portfolio and the current level of interest rates.

Provision for Income Taxes

Provision for income taxes is comprised of federal, state, local and foreign taxes based on pre-tax income. We expect income taxes to increase as our taxable income increases and we expect our effective tax rate to remain relatively constant.

Results of Operations

The following table summarizes our results of operations and the related changes for the periods indicated. The results below are not necessarily indicative of the results for future periods.

	Three Months Ended June 30,		**Change**		**Six Months Ended June 30,**		**Change**	
(dollars in thousands)	**2017**	**2016**	**$**	**%**	**2017**	**2016**	**$**	**%**

Revenue	$82,040	100.0%	$74,961	100.0%	$7,079	9.4	$162,207	100.0%	$147,529	100.0%	$14,678
Cost of revenue	35,671	43.5	32,715	43.6	2,956	9.0	70,565	43.5	65,629	44.5	4,936
Gross profit	46,369	56.5	42,246	56.4	4,123	9.8	91,642	56.5	81,900	55.5	9,742
Operating expenses:											
Marketing and sales	14,630	17.8	11,453	15.2	3,177	27.7	27,617	17.0	22,395	15.2	5,222
Research and development	6,084	7.4	5,816	7.8	268	4.6	11,907	7.3	11,134	7.5	773
General and administrative	9,253	11.3	10,126	13.5	(873)	(8.6)	18,034	11.1	18,377	12.5	(343)
Total operating expenses	29,967	36.5	27,395	36.5	2,572	9.4	57,558	35.4	51,906	35.2	