Carbonite Inc
Form 10-Q
August 05, 2014
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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 June 30, 2014

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: 001-35264

CARBONITE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**33-1111329**
(State or other jurisdiction of incorporation)	**(I.R.S. Employer Identification No.)**
177 Huntington Avenue Boston, Massachusetts	**02115**
(Address of principal executive offices)	**(Zip Code)**

(617) 587-1100

(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 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 x
Non-accelerated filer ¨ (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

As of July 31, 2014, there were 26,881,340 shares of the registrant s Common Stock, par value $0.01 per share, outstanding.

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CARBONITE, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Carbonite, Inc.

Condensed Consolidated Balance Sheets

(Unaudited)

	June 30, 2014	December 31, 2013
	(in thousands, except share and per share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 57,356	$ 50,392
Marketable securities	15,002	14,994
Trade accounts receivable, less allowances for doubtful accounts of $146 and $93	2,248	1,876
Prepaid expenses and other current assets	3,629	3,122
Total current assets	78,235	70,384
Property and equipment, net	20,630	22,111
Other assets	1,064	1,177
Acquired intangible assets, net	3,494	3,953
Goodwill	11,536	11,536
Total assets	$ 114,959	$ 109,161
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,869	$ 3,810
Accrued expenses	8,658	8,156
Current portion of deferred revenue	73,334	69,498
Total current liabilities	85,861	81,464
Deferred revenue, net of current portion	14,337	14,502
Other long-term liabilities	1,209	374
Total liabilities	101,407	96,340
Commitments and contingencies (Note 9)		
Stockholders equity:		
Preferred stock, $0.01 par value; 6,000,000 shares authorized; no shares issued		
	268	265

Common stock, $0.01 par value; 45,000,000 shares authorized at June 30, 2014 and December 31, 2013; 26,848,201 and 26,539,975 shares outstanding at June 30, 2014 and December 31, 2013, respectively				
Additional paid-in capital		146,815		142,557
Treasury stock, at cost (2,009 shares)		(22)		(22)
Accumulated other comprehensive loss		(13)		(1)
Accumulated deficit		(133,496)		(129,978)
Total stockholders equity		13,552		12,821
Total liabilities and stockholders equity	$	114,959	$	109,161

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

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Carbonite, Inc.

Condensed Consolidated Statements of Operations

(Unaudited)

(in thousands, except share and per share amounts)	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Revenue	$ 30,295	$ 26,216	$ 59,433	$ 50,724
Cost of revenue	9,721	8,455	18,982	17,293
Gross profit	20,574	17,761	40,451	33,431
Operating expenses:				
Research and development	6,153	4,901	11,575	10,377
General and administrative	3,831	3,528	7,351	8,305
Sales and marketing	13,132	11,511	25,005	24,193
Restructuring charges	5	126	8	272
Total operating expenses	23,121	20,066	43,939	43,147
Loss from operations	(2,547)	(2,305)	(3,488)	(9,716)
Interest and other income (expense), net	21	(2)	(10)	
Loss before income taxes	(2,526)	(2,307)	(3,498)	(9,716)
Provision for income taxes	(10)	(10)	(20)	(20)
Net loss	$ (2,536)	$ (2,317)	$ (3,518)	$ (9,736)
Basic and diluted net loss per share	$ (0.09)	$ (0.09)	$ (0.13)	$ (0.38)
Weighted-average number of common shares used in computing basic and diluted net loss per share	26,768,786	26,014,409	26,676,485	25,951,899

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

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Carbonite, Inc.

Condensed Consolidated Statements of Comprehensive Loss

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	**2013**	**2014**	**2013**
(in thousands)				
Net loss	$ (2,536)	$ (2,317)	$ (3,518)	$ (9,736)
Other comprehensive income (loss):				
Net unrealized loss on marketable securities	(6)	(14)	(8)	(12)
Foreign currency translation adjustments	20	(1)	(5)	(4)
Total other comprehensive income (loss)	14	(15)	(13)	(16)
Total comprehensive loss	$ (2,522)	$ (2,332)	$ (3,531)	$ (9,752)

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

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Carbonite, Inc.

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)	Six Months Ended June 30, 2014	2013
Operating activities		
Net loss	$ (3,518)	$ (9,736)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	6,296	6,319
Accretion of discount on marketable securities	(12)	(8)
Stock-based compensation expense	2,854	2,484
Provision for reserves on accounts receivable	53	10
Non-cash restructuring charge		173
Changes in assets and liabilities:		
Accounts receivable	(425)	(594)
Prepaid expenses and other current assets	(507)	68
Other assets	113	(94)
Accounts payable	759	(1,714)
Accrued expenses	481	4,206
Other long-term liabilities	835	50
Deferred revenue	3,671	6,026
Net cash provided by operating activities	10,600	7,190
Investing activities		
Purchases of property and equipment	(5,040)	(5,345)
Proceeds from maturities of marketable securities	6,000	5,000
Purchases of marketable securities	(6,000)	(5,000)
Net cash used in investing activities	(5,040)	(5,345)
Financing activities		
Proceeds from exercise of stock options	1,408	1,368
Net cash provided by financing activities	1,408	1,368
Effect of currency exchange rate changes on cash	(4)	(4)
Net increase in cash and cash equivalents	6,964	3,209
Cash and cash equivalents, beginning of period	50,392	40,341
Cash and cash equivalents, end of period	$ 57,356	$ 43,550

Non cash investing activities		
Acquisition of property and equipment included in accounts payable and accrued expenses	(684)	(1,586)

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

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Carbonite, Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Nature of Business

Carbonite, Inc. (the Company) was incorporated in the State of Delaware on February 10, 2005, and is a provider of hybrid backup and recovery solutions. Our solutions provide advanced features packaged in an easy-to-use, cost effective and secure manner that are designed to address the specific needs of small and medium-sized business, or SMBs, and are also attractive to consumers and larger enterprises.

2. Summary of Significant Accounting Policies

Principles of Consolidation

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

The accompanying unaudited interim condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC), the instructions to Form 10-Q, and the provisions of Regulation S-X pertaining to interim financial statements. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements and the notes thereto, included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2013, as filed with the SEC on March 5, 2014.

In the opinion of management, the condensed consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the Company s financial position for the periods presented. The results for the periods presented are not necessarily indicative of future results.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Although the Company regularly assesses these estimates, actual results could differ materially from these estimates. Changes in estimates are recorded in the period in which they become known. The Company bases its estimates on historical experience and various other assumptions that it believes to be reasonable under the circumstances. Actual results may differ from management s estimates if past experience or other assumptions do not turn out to be substantially accurate, even if such assumptions are reasonable when made.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk primarily consist of cash and cash equivalents, marketable securities, and accounts receivable. The Company maintains its cash and cash equivalents and marketable securities with high-quality financial institutions and, consequently, the Company believes that such funds are subject to minimal credit risk. Cash equivalents and marketable securities consist of investment grade debt securities or money market funds investing in such securities.

The Company sells its services primarily to small businesses and consumers. Payment for the majority of the Company s sales occurs via credit card. The Company regularly reviews its accounts receivable related to customers billed on traditional credit terms and provides an allowance for expected credit losses. Due to these factors, no additional credit risk beyond amounts provided for collection losses is believed by management to be probable in the Company s accounts receivable. The Company had one customer that represented 10% or more of the Company s accounts receivable balance at June 30, 2014. At December 31, 2013, no customer represented 10% or more of the Company s accounts receivable balance. No customer accounted for 10% or more of the Company s revenue for the three and six month periods ended June 30, 2014 and June 30, 2013.

Revenue Recognition

The Company derives revenue from hybrid backup and recovery solutions subscription services. These services are standalone independent service solutions, which are generally contracted for a one-to three-year term. Subscription arrangements include access to use the Company s services via the internet. The Company recognizes revenue in accordance with ASC 605-10, *Overall Revenue Recognition.* Subscription revenue is recognized ratably on a daily basis upon activation of service over the subscription period, when persuasive evidence of an arrangement with a customer exists, the subscription period has been activated, the price is fixed or determinable, and collection is reasonably assured. Deferred revenues represent payments received from customers for subscription services prior to recognizing the revenue related to those payments.

Cash Equivalents and Marketable Securities

The Company considers all highly liquid investments purchased with an original purchase maturity of three months or less to be the equivalent of cash for the purpose of balance sheet and statement of cash flows presentation.

Short-term investments in marketable securities are classified as available-for-sale and are recorded at fair value. Realized gains and losses and declines in value judged to be other-than-temporary are included in income based on the specific identification method. Unrealized gains and losses (excluding other-than-temporary impairments) are reported as a component of accumulated other comprehensive income (loss). As of June 30, 2014, the total cost basis of our marketable securities was $15.0 million.

The Company reviews its investments for other-than-temporary impairment whenever evidence indicates that an investment s carrying amount is not recoverable within a reasonable period of time.

Business Combinations

In accordance with ASC 805, *Business Combinations*, the Company allocates the purchase price of acquired companies to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values. Determining these fair values requires management to make significant estimates and assumptions, especially with respect to intangible assets.

The fair value of identifiable intangible assets is based on detailed valuations that use information and assumptions provided by management, which reflect management s best estimates of inputs and assumptions that a market participant would use. The Company s identifiable intangible assets acquired consist of developed technology, customer relationships, tradenames, and non-compete agreements. Developed technology consists of products that have reached technological feasibility and tradenames represent acquired company and product names. Customer relationships represent the underlying relationships and agreements with customers of the acquired company s installed base. Non-compete agreements represent the protection against the loss of business and resultant cash flows from direct competition. The Company estimates the useful lives of its intangible assets based upon the expected period over which the Company anticipates generating economic benefits from the related intangible asset.

Goodwill and Acquired Intangible Assets

The Company records goodwill when consideration paid in a business acquisition exceeds the fair value of the net tangible assets and the identified intangible assets acquired. The Company s estimates of fair value are based upon assumptions believed to be reasonable at that time, but that are inherently uncertain and unpredictable. Assumptions may be incomplete or inaccurate, and unanticipated events or circumstances may occur, which may affect the accuracy or validity of such assumptions, estimates or actual results. Goodwill is not amortized, but rather is tested for impairment annually or more frequently if facts and circumstances warrant a review. The Company performs its assessment for impairment of goodwill on an annual basis and it has determined that there is a single reporting unit for the purpose of conducting this annual goodwill impairment assessment. For purposes of assessing potential impairment, the Company estimates the fair value of the reporting unit (based on the Company s market capitalization) and compares this amount to the carrying value of the reporting unit (as reflected by the Company s total stockholders equity). If the Company determines that the carrying value of the reporting unit exceeds its fair value, an impairment charge would be required. The Company s annual goodwill impairment test is at November 30th of each year.

Intangible assets acquired in a business combination are recorded under the acquisition method of accounting at their estimated fair values at the date of acquisition. The Company amortizes acquired intangible assets over their estimated useful lives based on the pattern of consumption of the economic benefits or, if that pattern cannot be readily determined, on a straight-line basis. The Company reviews its intangible assets with definite lives for impairment when events or changes in circumstances indicate that the related carrying amount may not be recoverable.

Internal-use Software and Website Development

The Company follows the guidance of ASC 350-40, *Internal Use Software* and ASC 350-50, *Website Development Costs*, in accounting for its software and website development costs. The costs incurred in the preliminary stages of development are expensed

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as incurred. Once an application has reached the development stage, internal and external costs, if direct and incremental, are capitalized until the application is substantially complete and ready for its intended use, at which point the costs are amortized over the estimated useful life of the software. As of June 30, 2014, the Company capitalized $0.3 million of costs associated with internal-use software and capitalized no such costs as of December 31, 2013. As the software has not yet been placed in service, there was no amortization of capitalized amounts as of June 30, 2014 and December 31, 2013.

Income Taxes

The Company provides for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates in effect when the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance to reflect the uncertainty associated with their ultimate realization.

The Company accounts for uncertain tax positions recognized in the consolidated financial statements by prescribing a more-likely-than-not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

Segment Information

Operating segments are defined as components of an enterprise engaging in business activities for which discrete financial information is available and regularly reviewed by the chief operating decision maker in deciding how to allocate resources and in assessing performance. The Company views its operations and manages its business as a single segment for purposes of assessing performance and making operating decisions. The Company does not disclose geographic information for revenue and long-lived assets as revenue and long-lived assets located outside the United States do not exceed 10% of total revenue and total assets.

Accounting for Stock-Based Compensation

Stock-based compensation is recognized as an expense in the financial statements based on the grant date fair value of the stock awards granted. The Company expenses the fair value of the stock awards over the applicable service period on a straight line basis. The grant date fair value of options granted is calculated using the Black-Scholes option-pricing model, which requires the use of subjective assumptions including volatility, expected term, risk-free interest rate, and expected dividend yield.

Recently Issued and Adopted Accounting Standards

Effective January 1, 2013, the Company adopted ASU 2013-02, *Comprehensive Income: Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income*. This standard requires centralized disclosure of amounts reclassified from Accumulated Other Comprehensive Income (AOCI) to net income with presentation either parenthetically on the face of the financial statements or in the notes, amounts, and their source reclassified out of each component of AOCI and the income statement line item affected by the reclassification. The adoption of this guidance did not have an effect on the Company s consolidated financial statements.

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3. Net Loss per Share

The Company calculates basic and diluted net loss per share of common stock by dividing the net loss by the weighted average number of unrestricted common shares outstanding for the period. The following potentially dilutive common stock equivalents have been excluded from the computation of diluted weighted-average shares outstanding as of June 30, 2014 and 2013 as they would be anti-dilutive due to the Company s net losses (in thousands):

	As of June 30,	
	2014	**2013**
Options to purchase common stock	3,384	3,716
Warrant		11
Restricted Stock Units	437	
Total	3,821	3,727

4. Fair Value of Financial Instruments

The Company applies the guidance in ASC 820, *Fair Value Measurements and Disclosures*, (ASC 820), which provides that fair value is based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In order to increase consistency and comparability in fair value measurements, ASC 820 establishes a fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels, which are described below:

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

Level 2: Other inputs that are observable directly or indirectly, such as quoted prices for similar assets and liabilities or market corroborated inputs.

Level 3: Unobservable inputs are used when little or no market data is available, which requires the Company to develop its own assumptions about how market participants would value the assets or liabilities. The fair value hierarchy gives the lowest priority to Level 3 inputs.

In determining fair value, the Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible in its assessment of fair value.

The Company s assets and liabilities that are measured at fair value on a recurring basis, by level, within the fair value hierarchy are summarized as follows (in thousands):

	June 30, 2014				December 31, 2013			
	Level 1	**Level 2**	**Level 3**	**Total**	**Level 1**	**Level 2**	**Level 3**	**Total**
Assets:								
Cash equivalents money market funds	$ 15,643	$	$	$ 15,643	$ 15,644	$	$	$ 15,644

Marketable securities U.S. treasury securities and time deposits		15,002		15,002		14,994		14,994
Total	$ 15,643	$ 15,002	$	$ 30,645	$ 15,644	$ 14,994	$	$ 30,638

The Company s marketable securities are classified as Level 2 within the fair value hierarchy as they are valued using professional pricing sources for comparable instruments, rather than direct observations of quoted prices in active markets.

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5. Goodwill and Acquired Intangible Assets

At both June 30, 2014 and December 31, 2013, the carrying amount of goodwill was $11.5 million. Goodwill is not amortized. The Company reviews goodwill for impairment at least annually in the fourth quarter, or on an interim basis if an event or circumstance occurs indicating the potential for impairment. To date, the Company has had no impairments of goodwill.

Purchased intangible assets consist of the following (in thousands):

		June 30, 2014			December 31, 2013		
	Weighted-Average Estimated Useful Life (in years)	**Gross Carrying Value**	**Accumulated Amortization**	**Net Carrying Value**	**Gross Carrying Value**	**Accumulated Amortization**	**Net Carrying Value**
Developed technology	7.1	$ 2,980	$ 980	$ 2,000	$ 2,980	$ 761	$ 2,219
Customer relationships	6.5	1,580	562	1,018	1,580	401	1,179
Tradenames	8.0	400	84	316	400	58	342
Non-compete agreements	3.8	380	220	160	380	167	213
		$ 5,340	$ 1,846	$ 3,494	$ 5,340	$ 1,387	$ 3,953

The Company recorded amortization expense of $0.2 million for each of the three month periods ended June 30, 2014 and June 30, 2013, and $0.5 million for each of the six month periods ended June 30, 2014 and June 30, 2013. Amortization relating to developed technology is recorded within cost of revenue, amortization of customer relationships is recorded within sales and marketing expenses, and amortization of trade names and non-compete agreements is recorded within general and administrative expenses. Future estimated amortization expense of acquired intangibles as of June 30, 2014 is as follows (in thousands):

Remainder of 2014	$ 431
2015	830
2016	608
2017	483
2018	463
Thereafter	679
	$ 3,494

6. Accrued Expenses

Accrued expenses consist of the following (in thousands):

	June 30, 2014	December 31, 2013
Accrued media spend	$ 1,920	$ 2,989
Accrued compensation	1,628	1,201
Accrued other expenses	5,110	3,966
Total accrued expenses	$ 8,658	$ 8,156

7. Stock-based Awards

The Company s 2005 Stock Incentive Plan (the 2005 Plan) provided for granting of incentive stock options, non-qualified options, restricted stock, or other awards to the Company s employees, officers, directors, and outside consultants up to an aggregate of 3,601,551 shares of the Company s common stock. In conjunction with the effectiveness of the 2011 Equity Award Plan (the 2011 Plan), the Company s Board of Directors voted that no further stock options or other equity-based awards would be granted under the 2005 Plan.

The Company s 2011 Plan provides for the issuance of stock options, restricted stock, restricted stock units, and other stock-based awards to the employees, officers, directors, and consultants of the Company or its subsidiaries. In connection with the approval of the 2011 Plan, the Company reserved 1,662,000 shares of common stock for issuance thereunder. On January 1st of each year, beginning January 1, 2012, the number of shares reserved under the 2011 Plan increased or will increase by the lesser of 1,500,000 shares, 4.0% of the outstanding shares of common stock and common stock equivalents, or another amount determined by the Company s Board of Directors. As of June 30, 2014, 1,252,889 shares of common stock were available for future grant under the 2011 Plan.

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Stock-based awards granted to employees generally vest over a three- or four-year period, and, in the case of stock options, expire ten years from the date of grant. Certain awards provide for accelerated vesting if there is a change of control, as defined in the 2005 Plan or 2011 Plan, as applicable. The Company has generally granted stock options at exercise prices not less than the fair market value of its common stock on the date of grant.

Stock Options

The following summarizes stock option activity under stock incentive plans for the six months ended June 30, 2014:

	Number of Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands) (2)
Outstanding at December 31, 2013	3,321,784	$ 9.97		7,738
Granted	547,000	10.43		
Exercised	(300,960)	4.66		
Cancelled	(184,230)	10.51		
Outstanding at June 30, 2014	3,383,594	$ 10.48	8.05	$ 6,450
Exercisable as of June 30, 2014	1,392,203	$ 9.93	7.14	$ 3,255
Vested and expected to vest as of June 30, 2014 (1)	2,951,989	$ 10.42	7.93	$ 5,775

(1) Represents the number of vested stock options as of June 30, 2014, plus the number of unvested stock options expected to vest as of June 30, 2014, based on the unvested stock options outstanding at June 30, 2014, adjusted for estimated forfeitures.

(2) The aggregate intrinsic value is calculated as the positive difference, if any, between the exercise price of the underlying stock options and the fair market value of the Company s common stock on June 30, 2014.

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The Company estimates the fair value of stock options on the date of grant using the Black-Scholes option-pricing model. The determination of the fair value of stock option awards on the date of grant using this option-pricing model is affected by the Company s stock price, as well as a number of complex and highly subjective variables, including expected stock price volatility, expected term of an award, risk-free interest rate, and expected dividend yield. The assumptions used to estimate the fair value of the stock options were as follows:

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Weighted-average fair value of common stock	$ 10.60	$ 9.92
Risk-free interest rate	2.06%	0.95% to 1.01%
Expected dividend yield	%	%
Expected volatility	52%	54%
Expected term (in years)	5.8 to 6.3	5.8 to 6.1

Restricted Stock Units

The Company recognizes non-cash compensation expense over the vesting term of restricted stock units. The fair value is measured based upon the number of units and the closing price of the Company s common stock underlying such units on the dates of grant. During the three and six months ended June 30, 2014, the Company granted 333,611 and 459,861 restricted stock units, respectively. Upon vesting and settlement, each restricted stock unit entitles the holder to receive one share of common stock. Total stock-based compensation expense recognized for the restricted stock units was $0.1 million for the six months ended June 30, 2014.

The following table summarizes restricted stock unit activity for the six months ended June 30, 2014:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested as of December 31, 2013		$
Restricted stock units granted	459,861	10.77
Restricted stock units vested	(7,266)	10.17
Restricted stock units cancelled	(15,544)	10.47
Unvested restricted stock units as of June 30, 2014	437,051	$ 10.79

Stock-based Compensation Expense

Stock-based compensation is reflected in the consolidated statement of operations as follows (in thousands):

	Three Months Ended June 30,	Six Months Ended June 30,

	2014	2013	2014	2013
Cost of revenues	$ 126	$ 164	$ 243	$ 296
Research and development	504	162	764	398
General and administrative	707	514	1,359	1,164
Sales and marketing	260	325	488	626
Total stock-based compensation expense	$ 1,597	$ 1,165	$ 2,854	$ 2,484

8. Income Taxes

For each of the three months ended June 30, 2014 and 2013, the Company recorded a deferred tax provision of $10 thousand related to tax amortization of goodwill. For each of the six month periods ended June 30, 2014 and 2013, the Company recorded a deferred tax provision of $20 thousand related to the tax amortization of goodwill.

The Company has evaluated the positive and negative evidence bearing upon the realizability of its deferred tax assets. As required by the provisions of ASC 740, *Accounting for Uncertainty in Income Taxes*, management has determined that it is more-likely-than-not that the Company will not utilize the benefits of federal and state deferred tax assets for financial reporting purposes. Accordingly, the deferred tax assets have been fully reserved at June 30, 2014 and December 31, 2013.

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The statute of limitations for assessment by the Internal Revenue Service (IRS) and state tax authorities is open for tax years ending December 31, 2010, 2011, 2012, and 2013 although carryforward attributes that were generated prior to tax year 2010 may still be adjusted upon examination by the IRS or state tax authorities if they either have been or will be used in a future period. There are currently no federal or state audits in progress.

9. Commitments and Contingencies

Operating Leases

The Company leases various facilities under leases that expire at varying dates through 2024. Certain of these leases contain renewal options, and require the Company to pay operating costs, including property taxes, insurance, and maintenance.

The Company has lease agreements to rent office space in Boston, Massachusetts (corporate headquarters), Lewiston, Maine, and Sunnyvale, California. The Company has lease agreements to rent data center space in Wakefield, Massachusetts, Phoenix, Arizona, and Chandler, Arizona. The Company also maintains a hosting service agreement with a third-party data center vendor in Somerville, Massachusetts, that is subject to annual renewal and a 120 day cancellation right. The terms of several of these leases include escalating rent and free rent periods. Accordingly, the Company recorded a deferred rent liability related to the free rent and escalating rent payments, such that rent is being recognized on a straight-line basis over the terms of the leases. At June 30, 2014 and December 31, 2013, $1.4 million and $0.5 million, respectively, is included in accrued expenses and other long-term liabilities related to the deferred rent.

In May 2014, the Company entered into a lease agreement for its new corporate headquarters in Boston, Massachusetts. The initial term of the lease of ten years and one month expires on December 31, 2024, and the Company has the option to extend the original term of the lease for one successive five year period. Upon execution of the lease agreement, the Company was required to post a security deposit of $0.8 million, which the Company will maintain as a letter of credit. The Company s landlord can draw against this letter of credit in the event of default by the Company. The facility was made available to the Company to begin its build-out on June 1, 2014, and as such, the Company began recording rent expense at that time. In accordance with the lease, the Company will receive a tenant improvement allowance throughout the build-out period. The rent expense is recorded net of the allowance over the term of the lease. The leasehold improvements associated with the initial build-out will be amortized over the initial term of the lease beginning on the date the facility is first occupied. Any additional leasehold improvements made during the course of occupancy will be amortized over the shorter of the useful life or remaining life of the lease.

Future non-cancellable minimum lease payments under all operating leases as of June 30, 2014, are as follows (in thousands):

	Office Leases	**Data Center Leases**	**Total**
Remainder of 2014	$ 1,008	$ 1,159	$ 2,167
2015	2,769	2,396	5,165
2016	3,476	856	4,332
2017	2,081	820	2,901
2018	2,181	271	2,452

Thereafter	12,652		12,652
	$ 24,167	$ 5,502	$ 29,669

At June 30, 2014, the Company subleased certain office space to third parties that is included in the above table. Total sublease income under contractual terms is $1.5 million, with both the sublease and the underlying lease expiring in December 2016.

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Other Non-cancellable Commitments

As of June 30, 2014, the Company had non-cancellable commitments to vendors primarily consisting of advertising, marketing and broadband services contracts, as follows (in thousands):

	Commitments
Remainder of 2014	$ 6,042
2015	1,028
2016	526
2017	469
2018	150
	$ 8,215

Litigation

In August 2010, Oasis Research, LLC (Oasis Research), a non-practicing entity, filed a lawsuit against the Company and several of its competitors and other online technology companies in the U.S. District Court for the Eastern District of Texas, alleging that the Company s cloud backup storage services, and the other companies products or services, infringe certain of Oasis Research s patents. Oasis Research sought an award for damages in an unspecified amount. A trial was held in March 2013 and a jury verdict was returned against Oasis Research that found all of the asserted patents invalid. The court has not yet entered a judgment against Oasis Research and the parties are awaiting decision on certain post-trial motions. The Company is not able to assess with certainty the outcome of this lawsuit or the amount or range of potential damages or future payments associated with this lawsuit at this time.

In the ordinary course of business, the Company is involved in litigation incidental to its business; however, the Company s management is not aware of any other pending legal proceeding or other loss contingency, whether asserted or unasserted, affecting the Company, for which it might become liable, or the outcome of which management expects to have a material impact on the Company.

10. Retirement Plan

The Company has a 401(k) defined contribution savings plan for its employees who meet certain employment status. The plan allows participants to defer a portion of their annual compensation on a pre-tax basis. Effective January 1, 2012, the Company elected to make a matching contribution of up to 4% of each employee s wages. For each of the three months ended June 30, 2014 and 2013, the total expense for the Company s matching contributions to the plan were $0.2 million. For the six month periods ended June 30, 2014 and 2013, the total expense for the Company s matching contributions to the plan were $0.4 million and $0.3 million, respectively.

11. Revolving Credit Facility

The Company has a revolving line of credit under which the Company may borrow up to $25 million through September 30, 2014. Advances under the line of credit bear interest on the outstanding daily balance, at an annual rate equal to the lender s prime reference rate plus 0.25%. The Company has pledged its accounts receivable, equipment, and shares of its subsidiaries to the lender to collateralize its obligations under the credit facility, and has also agreed not to grant a security interest in or pledge its intellectual property to any third party. The credit facility contains customary events of default, conditions to borrowings and restrictive covenants, including restrictions on the Company s ability to dispose of assets, make acquisitions, incur additional debt, incur liens, make distributions to stockholders, make investments, or enter into certain types of related party transactions. The credit facility also includes financial and other covenants including covenants to maintain a minimum current ratio, a minimum number of total customers, and a requirement that the majority of the Company s cash and investments be held with the bank or one of its affiliates. To date, the Company has not borrowed any amounts under this $25 million revolving line of credit.

12. Restructuring

In November 2012, the Company adopted a plan to restructure its workforce in China. Activities related to this effort were initiated in the third quarter of 2012 and were substantially complete by the end of the second quarter of 2014. The execution of the restructuring of the workforce resulted in total charges of $0.3 million, and required cash outlays of $0.3 million. The total charges consisted of $0.2 million attributable to termination benefits and $0.1 million to consulting fees. These expenses have been recorded through the restructuring line within the Company s consolidated statements of operations.

As of June 30, 2014 and December 31 2013, the Company had no amounts accrued related to restructuring.

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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 and our Annual Report on Form 10-K for the fiscal year ended December 31, 2013, as filed on March 5, 2014 with the Securities and Exchange Commission.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act. Forward-looking statements are often identified by the use of words such as, but not limited to, anticipate, believe, can, continue, could, estimate, expect, intend, may, will, plan, project, seek, should, target, will, would, and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included in this Quarterly Report on Form 10-Q. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Overview

We are a provider of hybrid backup and recovery solutions. Our solutions provide advanced features packaged in an easy-to-use, cost-effective and secure manner, and are designed to address the specific needs of small and medium-sized businesses, or SMBs, and are also attractive to consumers and larger enterprises.

While we historically focused on the consumer market for our solutions, we have shifted our attention to the SMB market. In October 2012, we acquired Zmanda, Inc. in order to enhance our SMB solutions by introducing hybrid solutions that backup databases and file systems to the cloud or to local disk enabling SMBs to obtain all of their backup solutions from one vendor.

We derive our revenue from subscription fees. We generally charge customers the full subscription amount at the beginning of each subscription period. Our tiered business offerings provide a fixed amount of cloud storage for an unlimited number of connected devices and customers can purchase additional cloud storage at any time after the commencement of a subscription. For consumers, we offer three different annual cloud backup solutions, each including unlimited storage for one computer.

We invest in customer acquisition because we believe that the market for our backup and business continuity solutions is in the early stage of development. Our sales model is designed to sell large volumes of our solutions to SMBs globally both directly and through our sales network, including through distributors, value-added resellers, volume resellers, and major retailers. Our inside sales force supplements our channel efforts by, for example, following up on leads generated by our marketing programs and actively working to fulfill sales through our channel relationships. We support our go-to-market network with a marketing approach that leverages our established brand in order to drive market awareness and demand generation among the broad population of SMBs and consumers.

As we grow our business we continue to invest in additional storage and infrastructure. Our operating costs continue to grow as our customers store more data, principally as a result of our investment in customer acquisition and research and development. We expect to continue to devote substantial resources to customer acquisition, improving our technologies, and expanding our solutions. In addition, we expect to invest heavily in our operations to support anticipated growth and public company reporting and compliance obligations. We defer revenue over our customers subscription periods, but expense marketing costs as incurred. As a result of these factors, we expect to continue to incur GAAP operating losses on an annual basis for the foreseeable future.

Our Business Model

We evaluate the profitability of a customer relationship over its lifecycle because of the nature of our business model. We generally incur customer acquisition costs and capital equipment costs in advance of subscriptions while recognizing revenue ratably

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over the terms of the subscriptions. As a result, a customer relationship may not be profitable or result in positive cash flow at the beginning of the subscription period, even though it may be profitable or result in positive cash flow over the life of the customer relationship. While we offer monthly, annual and multi-year subscription plans, a significant majority of our customers are currently on annual subscription plans. The annual or multi-year commitments of our customers enhance management s visibility of our revenue and charging customers at the beginning of the subscription period provides working capital. We typically generate positive cash flow during the first year of a multi-year subscription as we charge the subscription fee for the entire period at the beginning of the subscription.

Key Business Metrics

Our management regularly reviews a number of financial and operating metrics, including the following key metrics, to evaluate our business:

Bookings. We calculate bookings as revenue recognized during a particular period plus the change in total deferred revenue (excluding deferred revenue recorded in connection with acquisitions) during the same period. Our management uses this measure as a proxy for cash receipts. Bookings represent the aggregate dollar value of customer subscriptions received by us during a period. We initially record a subscription fee as deferred revenue and then recognize it ratably, on a daily basis, over the life of the subscription period.

Annual retention rate. We calculate annual retention rate as the percentage of customers on the last day of the prior year who remain customers on the last day of the current year, or for quarterly presentations, the percentage of customers on the last day of the comparable quarter in the prior year who remain customers on the last day of the current quarter. Our management uses these measures to determine the stability of our customer base and to evaluate the lifetime value of our customer relationships.

Renewal rate. We define renewal rate for a period as the percentage of customers who renew annual or multi-year subscriptions that expire during the period presented. Our management uses this measure to monitor trends in customer renewal activity.

Free cash flow. We calculate free cash flow as net cash provided by (used in) operating activities, less purchases of property and equipment, adjusted for the payments related to corporate headquarter relocation and the cash portion of the lease exit charge, as appropriate. Our management uses this measure to evaluate our operating results.

Subscription renewals may vary during the year based on the date of our customers original subscriptions. As we recognize subscription revenue ratably over the subscription period, this generally has not resulted in a material seasonal impact on our revenue, but may result in material monthly and quarterly variances in one or more of the key business metrics described above.

Performance Highlights

The following table presents our performance highlights for the three and six months ended June 30, 2014 and 2013:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(in thousands, except percentage data)			
Key metrics:				
Bookings	30,618	27,423	63,104	56,750
Annual retention rate	83%	85%	83%	85%
Renewal rate	80%	81%	80%	81%
Free cash flow	$ 1,470	$ 1,191	$ 5,713	$ 1,845

Our bookings increased over the periods presented and we continue to invest in customer acquisition in an effort to drive continued growth in bookings, with bookings for our small business solutions representing 30% of total bookings for the second quarter of 2014, up from 24% in the second quarter of 2013.

Our free cash flow has improved by $0.3 million and $3.9 million over the three and six month periods ended June 30, 2014, respectively, compared to the corresponding periods in 2013, principally driven by growth in bookings and increased efficiencies in our business model.

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Key Components of our Consolidated Statements of Operations

Revenue

We derive our revenue principally from subscription fees related to our services. We typically charge a customer s credit card or invoice a customer the full price of the subscription at the commencement of the subscription period and at each renewal date, unless the customer decides not to renew the subscription. We initially record a customer subscription fee as deferred revenue and then recognize it ratably, on a daily basis, over the life of the subscription period.

Cost of revenue

Cost of revenue consists primarily of costs associated with our data center operations and customer support centers, including wages and benefits for personnel, depreciation of equipment, amortization of developed technology, rent, utilities and broadband, equipment maintenance, software license fees, and allocated overhead. The expenses related to hosting our services and supporting our customers are related to the number of customers and the complexity of our services and hosting infrastructure. We have also experienced a downward trend in the cost of storage equipment and broadband service, which we expect will continue in the future. We expect these expenses to increase in absolute dollars as we continue to increase the volume of customer data that we store and the complexity of our services, but decrease as a percentage of revenue.

Gross margin

Our gross margins have expanded as the result of introducing higher priced solutions targeting both SMBs and consumers, price increases on our solutions, a downward trend in the cost of storage equipment and services, and efficiencies of our customer support personnel in supporting our customers. We expect the gross margin trend to continue.

Operating expenses

Research and development. Research and development expenses consist primarily of wages and benefits for development personnel, consulting fees, rent, and depreciation. We have focused our research and development efforts on both improving ease of use, functionality and technological scalability of our existing solutions and developing new solutions. The majority of our research and development employees are located at our corporate headquarters in the U.S. We expect that research and development expenses will increase in absolute dollars on an annual basis as we continue to enhance and expand our services, but decrease as a percentage of revenue over time, as we expect to grow our revenue at a faster rate.

General and administrative. General and administrative expenses consist primarily of wages and benefits for management, finance, accounting, human resources, legal and other administrative personnel, legal and accounting fees, insurance, and other corporate expenses. We expect that general and administrative expenses will increase in absolute dollars on an annual basis as we continue to add personnel and enhance our internal information systems in connection with the anticipated growth of our business and as we continue to incur costs related to operating as a public company.

Sales and marketing. Sales and marketing expenses consist primarily of advertising costs, wages, commissions and benefits for sales and marketing personnel, creative expenses for advertising programs, credit card fees, commissions paid to third-party partners and affiliates, and the cost of providing free trials. The largest component of sales and marketing expense is advertising for customer acquisition, which includes television, radio, and online advertisements, as well as the costs associated with cooperative marketing programs developed with our channel partners, promotional events, and web seminars. Online search costs consist primarily of pay-per-click payments to search engine operators. Advertising costs and sales commissions are expensed as incurred. To date, marketing and advertising costs have been incurred principally in the U.S., but we may increase our marketing and advertising expenditures in other countries. We expect that we will continue to commit significant resources to our sales and marketing efforts to grow our business and awareness of our brand and solutions. We expect that sales and marketing expenses will continue to increase in absolute dollars on an annual basis, but decrease as a percentage of revenue, as we expect to grow our revenue at a faster rate.

Restructuring charges. Restructuring charges consist of charges incurred related to the restructuring of our China operations, which is substantially completed.

Critical Accounting Policies

Our financial statements are prepared in accordance with accounting principles generally accepted in the U.S., or GAAP. The preparation of our financial statements and related disclosures requires us to make estimates, assumptions, and judgments that affect the reported amount of assets, liabilities, revenue, costs and expenses, and related disclosures. We base our estimates and assumptions on historical experience and other factors that we believe to be reasonable under the circumstances, but all such estimates and assumptions are inherently uncertain and unpredictable. We evaluate our estimates and assumptions on an ongoing basis. Actual results may differ from those estimates and assumptions, and it is possible that other professionals, applying their own judgment to the same facts and circumstances, could develop and support alternative estimates and assumptions that would result in material changes to our operating results and financial condition.

We consider the assumptions and estimates associated with revenue recognition, business combinations, goodwill and acquired intangible assets, income taxes and stock-based compensation to be our critical accounting policies and estimates. There have been no material changes to our critical accounting policies since December 31, 2013. For further information on our critical and other significant accounting policies, see the notes to the condensed consolidated financial statements appearing elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K, as filed on March 5, 2014 with the Securities and Exchange Commission.

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Results of Operations

The following table sets forth, for the periods presented, data from our consolidated statements of operations as a percentage of revenue that each line item represents. The period-to-period comparison of financial results is not necessarily indicative of future results. The information contained in the table below should be read in conjunction with financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(% of revenue)			
Consolidated statements of operations data:				
Revenue	100.0%	100.0%	100.0%	100.0%
Cost of revenue	32.1	32.3	31.9	34.1
Gross profit	67.9	67.7	68.1	65.9
Operating expenses:				
Research and development	20.3	18.7	19.5	20.5
General and administrative	12.6	13.4	12.4	16.4
Sales and marketing	43.4	43.9	42.1	47.7
Restructuring charges	0.0	0.5	0.0	0.5
Total operating expenses	76.3	76.5	74.0	85.1
Loss from operations	(8.4)	(8.8)	(5.9)	(19.2)
Loss before income taxes	(8.4)	(8.8)	(5.9)	(19.2)
Provision for income taxes				
Net loss	(8.4)%	(8.8)%	(5.9)%	(19.2)%

Comparison of the Three Months and Six Months Ended June 30, 2014 and 2013

Revenue

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014	2013	Change		2014	2013	Change	
	(in thousands, except percentage data)							
Revenue	$ 30,295	$ 26,216	$ 4,079	15.6%	$ 59,433	$ 50,724	$ 8,709	17.2%

Revenue increased for the three and six month periods ended June 30, 2014 as compared to the three and six month periods ended June 30, 2013, primarily due to increases in the average selling prices for our SMB and consumer solutions.

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Cost of revenue, gross profit, and gross margin

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014	2013	Change		2014	2013	Change	
	(in thousands, except percentage data)							
Cost of revenue	$ 9,721	$ 8,455	$ 1,266	15.0%	$ 18,982	$ 17,293	$ 1,689	9.8%
Percent of revenue	32.1%	32.3%			31.9%	34.1%		
Components of cost of revenue:								
Personnel related costs	$ 3,247	$ 2,439	$ 808	33.1%	$ 6,048	$ 5,214	$ 834	16.0%
Hosting and depreciation costs	5,447	4,986	461	9.2%	10,918	10,059	859	8.5%
Third-party outsourcing costs, software, amortization and other	1,027	1,030	(3)	(0.3%)	2,016	2,020	(4)	(0.2%)
Total cost of revenue:	$ 9,721	$ 8,455	$ 1,266	15.0%	$ 18,982	$ 17,293	$ 1,689	9.8%
Gross profit	$ 20,574	$ 17,761	$ 2,813	15.8%	$ 40,451	$ 33,431	$ 7,020	21.0%
Gross margin	67.9%	67.7%			68.1%	65.9%		

Our gross margin improvement for the three and six months ended June 30, 2014 compared to the three and six months ended June 30, 2013 was driven by sales growth of higher margin SMB products and efficiencies realized in our data centers. The increase in absolute dollars of total costs is due primarily to an increase in our headcount as we continue to grow as well as storage costs associated with storing a larger volume of customer data.

Operating expenses

Research and development

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014	2013	Change		2014	2013	Change	
	(in thousands, except percentage data)							
Research and development	$ 6,153	$ 4,901	$ 1,252	25.5%	$ 11,575	$ 10,377	$ 1,198	11.5%
Percent of revenue	20.3%	18.7%			19.5%	20.5%		
Components of costs of research and development:								
Personnel related costs	$ 4,874	$ 3,587	$ 1,287	35.9%	$ 9,077	$ 7,995	$ 1,082	13.5%
Third-party outsourcing costs	741	427	314	73.5%	1,397	850	547	64.4%
Hosting, independent contractors and other	538	887	(349)	(39.3%)	1,101	1,532	(431)	(28.1%)
Total research and development:	$ 6,153	$ 4,901	$ 1,252	25.5%	$ 11,575	$ 10,377	$ 1,198	11.5%

Research and development expenses increased for the three and six months ended June 30, 2014 as compared to the three and six months ended June 30, 2013, primarily as a result of an increase in personnel related costs associated with additional research and development headcount as we develop new products to bring to market.

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General and administrative

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014	2013	Change		2014	2013	Change	
	(in thousands, except percentage data)							
General and administrative	$ 3,831	$ 3,528	$ 303	8.6%	$ 7,351	$ 8,305	$ (954)	(11.5%)
Percent of revenue	12.6%	13.4%			12.4%	16.4%		
Components of general and administrative:								
Personnel related costs	$ 2,494	$ 1,734	$ 760	43.8%	$ 4,644	$ 3,701	$ 943	25.5%
Professional fees	797	1,183	(386)	(32.6%)	1,609	3,210	(1,601)	(49.9%)
Sales tax, consulting and other	540	611	(71)	(11.6%)	1,098	1,394	(296)	(21.2%)
Total general and administrative:	$ 3,831	$ 3,528	$ 303	8.6%	$ 7,351	$ 8,305	$ (954)	(11.5%)

General and administrative expenses remained consistent for the three month period ended June 30, 2014 as compared to the three month period ended June 30, 2013 as a result of increased personnel related costs associated with increased headcount, offset by decreased legal costs and sales tax accruals for uncollected sales tax.

General and administrative expenses decreased for the six month period ended June 30, 2014 as compared to the six month period ended June 30, 2013 as a result of decreased legal costs, offset by increased personnel related costs associated with increased headcount.

Sales and marketing

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014	2013	Change		2014	2013	Change	
	(in thousands, except percentage data)							
Sales and marketing	$ 13,132	$ 11,511	$ 1,621	14.1%	$ 25,005	$ 24,193	$ 812	3.4%
Percent of revenue	43.4%	43.9%			42.1%	47.7%		
Components of sales and marketing:								
Personnel related costs	$ 3,366	$ 2,048	$ 1,318	64.4%	$ 6,013	$ 4,478	$ 1,535	34.3%
Advertising costs	5,328	6,140	(812)	(13.2%)	10,748	13,474	$ (2,726)	(20.2%)
Costs of credit card transactions and offering free trials	1,563	1,350	213	15.8%	3,067	2,799	268	9.6%
Outside commissions, agency fees and other	2,875	1,973	902	45.7%	5,177	3,442	1,735	50.4%
Total sales and marketing:	$ 13,132	$ 11,511	$ 1,621	14.1%	$ 25,005	$ 24,193	$ 812	3.4%

Sales and marketing expenses increased for the three and six months ended June 30, 2014 as compared to the three and six months ended June 30, 2013, primarily due to increased personnel related costs associated with increased headcount on our sales team, partially offset by decreased advertising related costs related to reduction in our traditional radio and television advertising spend.

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Other Financial Data

In addition to our results discussed above determined under GAAP, we believe that bookings, annual retention rate, renewal rate, and free cash flow are useful to investors in evaluating our operating performance. Management considers these financial and operating metrics critical to understanding our business, reviewing our historical performance, measuring and identifying current and future trends, and for planning purposes. Securities analysts also frequently use bookings and free cash flow as supplemental measures to evaluate the overall performances of companies.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(in thousands, except percentage data)			
Key metrics:				
Bookings (1)	30,618	27,423	63,104	56,750
Annual retention rate (2)	83%	85%	83%	85%
Renewal rate (3)	80%	81%	80%	81%
Free cash flow (4)	$ 1,470	$ 1,191	$ 5,713	$ 1,845

(1) We define bookings as revenue recognized during the period plus the change in total deferred revenue (excluding deferred revenue recorded in connection with acquisitions) during the same period.
(2) We define annual retention rate as the percentage of customers on the last day of the prior year who remain customers on the last day of the current year, or for quarterly presentations, the percentage of customers on the last day of the comparable quarter in the prior year who remain customers on the last day of the current quarter.
(3) We define renewal rate for a period as the percentage of customers who renew annual or multi-year subscriptions that expire during the period presented.
(4) We define free cash flow as net cash provided by (used in) operating activities, less purchases of property and equipment, and adjusted for the payments related to corporate headquarter relocation and the cash portion of the lease exit charge, as appropriate.

Bookings and free cash flow are financial data that are not calculated in accordance with GAAP. The tables below provide reconciliation of bookings and free cash flow to revenue and cash provided by (used in) operating activities, respectively, the most directly comparable financial measures calculated and presented in accordance with GAAP.

Our management uses annual retention rate to determine the stability of our customer base and to evaluate the lifetime value of our customer relationships. As customers annual and multi-year subscriptions come up for renewal throughout the calendar year based on the dates of their original subscriptions, measuring retention on a trailing twelve month basis at the end of each quarter provides our management with useful and timely information about the stability of our customer base. Management uses renewal rate to monitor trends in customer renewal activity.

Our management uses bookings as a proxy for cash receipts. Bookings represent the aggregate dollar value of customer subscriptions received by us during a period. We initially record a subscription fee as deferred revenue and then recognize it ratably, on a daily basis, over the life of the subscription period. Management uses free cash flow as a measure of our operating performance; for planning purposes, including the preparation of our annual operating budget; to allocate resources to enhance the financial performance of our business; to evaluate the effectiveness of our business strategies; to provide consistency and comparability with past financial performance; to determine capital requirements; to facilitate a comparison of our results with those of other companies; and in communications with our board of directors concerning our financial performance. We also use free cash flow as a factor when determining management s incentive compensation. Management believes that the use of free cash flow provides consistency and comparability with our past financial performance, facilitates period to period comparisons of operations, and also facilitates comparisons with other peer companies, many of which use similar non-GAAP financial measures to supplement their GAAP results.

Although bookings and free cash flow are frequently used by investors and securities analysts in their evaluations of companies, bookings and free cash flow have limitations as analytical tools, and you should not consider them in isolation or as substitutes for analysis of our results of operations as reported under GAAP. Some of these limitations are:

- bookings does not reflect our receipt of payment from customers;
- free cash flow does not reflect our future requirements for contractual commitments to vendors;
- free cash flow does not reflect the non-cash component of employee compensation or depreciation and amortization of property and equipment; and

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other companies in our industry may calculate bookings or free cash flow or similarly titled measures differently than we do, limiting their usefulness as comparative measures.

The following tables present reconciliations of our bookings and free cash flow to revenue and cash provided by operating activities, respectively, the most directly comparable financial measures calculated and presented in accordance with GAAP.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(in thousands)			
Revenue	$ 30,295	$ 26,216	$ 59,433	$ 50,724
Add change in deferred revenue	323	1,207	3,671	6,026
Bookings	$ 30,618	$ 27,423	$ 63,104	$ 56,750

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(in thousands)			
Cash provided by operating activities	$ 3,275	$ 3,405	$ 10,600	$ 7,190
Add cash payments related to corporate headquarter relocation	90		153	
Subtract capital expenditures	(1,895)	(2,214)	(5,040)	(5,345)
Free cash flow	$ 1,470	$ 1,191	$ 5,713	$ 1,845

Liquidity and Capital Resources

As of June 30, 2014, we had cash and cash equivalents and marketable securities of $72.4 million, which consisted of cash, money market funds, U.S. agency and treasury securities, and certificates of deposit. We have available borrowings under our revolving credit facility of $25 million, which we can draw down on through September 30, 2014.

Sources of funds

We believe, based on our current operating plan, that our existing cash and cash equivalents, marketable securities, cash provided by operations, and borrowings available under our revolving credit facility will be sufficient to meet our anticipated cash needs for at least the next 12 months.

From time to time, we may explore additional financing sources to develop or enhance our solutions, to fund expansion, to respond to competitive pressures, to acquire or to invest in complementary products, businesses or technologies, or to lower our cost of capital, which could include equity, equity-linked, and debt financing. There can be no assurance that any additional financing will be available to us on acceptable terms, if at all. If we raise additional funds through the issuance of equity or convertible debt or other equity-linked securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock.

Our revolving credit facility allows us to borrow up to $25 million through September 30, 2014. Advances under the credit facility bear interest on the outstanding daily balance, at an annual rate equal to the lender s prime reference rate plus 0.25%. We have pledged our accounts receivable, equipment, and shares of our subsidiaries to the lender to collateralize our obligations under the credit facility. We have also agreed not to grant a security interest in or pledge our intellectual property to any third party. The credit facility contains customary events of default, conditions to borrowings and restrictive covenants, including restrictions on our ability to dispose of assets, make acquisitions, incur additional debt, incur liens, make distributions to our stockholders, make investments, or enter into certain types of related party transactions. The credit facility also includes financial and other covenants including covenants to maintain a minimum current ratio, a minimum number of total customers, and a restriction as to where we may hold the majority of our cash and investments. To date, we have not drawn down on our revolving credit facility. Any inability to meet our debt service obligations could adversely affect our financial position and liquidity.

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Uses of funds

We have increased our operating and capital expenditures in connection with the growth in our operations and the increase in our personnel, and we anticipate that we will continue to increase such expenditures in the future. Our future capital requirements may vary materially from those now planned and will depend on many factors, including:

- the levels of advertising and promotion required to acquire and retain customers;
- expansion of our data center infrastructure necessary to support our growth;
- growth of our operations in the U.S. and worldwide;
- our development and introduction of new solutions; and
- the expansion of our sales, customer support, research and development, and marketing organizations.

Future capital expenditures will focus on acquiring additional data storage and hosting capacity and general corporate infrastructure. We are not currently party to any purchase contracts related to future capital expenditures, other than short-term purchase orders.

Cash flows

The following table summarizes our net cash inflows (outflows) for the six months ended June 30, 2014 and 2013.

	Six Months Ended June 30,	
	2014	**2013**
	(in thousands)	
Net cash provided by operating activities	$ 10,600	$ 7,190
Net cash used in investing activities	(5,040)	(5,345)
Net cash provided by financing activities	1,408	1,368

Operating activities

Our cash flows from operating activities are significantly influenced by the amount of our net loss, growth in subscription sales and customer growth, changes in working capital accounts, the timing of prepayments and payments to vendors, add-backs of non-cash expense items such as depreciation and amortization, and stock-based compensation expense.

In the six months ended June 30, 2014, cash provided by operating activities was $10.6 million, which was primarily driven by a $3.7 million increase in deferred revenue associated with the increase in subscription sales and customer growth. Net cash inflows from operating activities included non-cash charges of $9.2 million, including $6.3 million of depreciation and amortization and $2.9 million of stock based compensation. These cash inflows were partially offset by our net loss of $3.5 million.

In the six months ended June 30, 2013, cash provided by operating activities was $7.2 million, which was primarily driven by a $6.0 million increase in deferred revenue associated with the increase in subscription sales and customer growth. Net cash inflows from operating activities included other changes in working capital of $2.0 million, due primarily to the timing of payments and customer receipts and non-cash charges of $9.0 million, including $6.3 million of depreciation and amortization, $2.5 million of stock based compensation, and $0.2 million of restructuring charges. These cash inflows were partially offset by our net loss of $9.7 million.

Investing activities

In the six months ended June 30, 2014, cash used in investing activities was $5.0 million, consisting of capital expenditures of $5.0 million.

In the six months ended June 30, 2013, cash used in investing activities was $5.3 million, consisting of capital expenditures primarily for server equipment and other data center infrastructure.

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Financing activities

In the six months ended June 30, 2014 and June 30, 2013, cash provided by financing activities was $1.4 million consisting of net proceeds from the exercise of stock options.

Off-balance sheet arrangements

As of June 30, 2014, we did not have any off-balance sheet arrangements.

Contractual obligations

The following table summarizes our contractual obligations at June 30, 2014 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

	Payment Due by Period				
	Total	**Less Than 1 Year**	**1-3 Years**	**3-5 Years**	**More Than 5 Years**
			(in thousands)		
Office lease obligations	$ 24,167	$ 2,155	$ 6,133	$ 4,317	$ 11,562
Hosting facility lease obligations	5,502	2,488	2,328	686	
Other purchase commitments	8,215	6,439	1,549	227	
Total	$ 37,884				