STRATASYS INC
Form 10-Q
November 10, 2008

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

# FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

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: 1-13400

# STRATASYS, INC.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware<br>(State or other jurisdiction of incorporation or organization) | 36-3658792<br>(I.R.S. Employer Identification No.) |
| 7665 Commerce Way, Eden Prairie, Minnesota<br>(Address of principal executive offices) | 55344<br>(Zip Code) |

(952) 937-3000
(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 [ ü ] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerate 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 [ ü ] |
| Non-accelerated filer [ ]<br>(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 [ ü ]

As of November 3, 2008 the Registrant had 20,216,897 shares of common stock, $.01 par value issued and outstanding.

**Stratasys, Inc.**

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**Consolidated Balance Sheets**

| | September 30, 2008 (unaudited) | December 31, 2007 |
|---|---|---|
| **ASSETS** | | |
| **Current assets** | | |

| | | |
|---|---|---|
| Cash and cash equivalents | $ 16,914,916 | $ 16,211,771 |
| Short-term investments | 6,058,366 | 27,257,592 |
| Accounts receivable, less allowance for returns and doubtful accounts of $1,088,316 in 2008 and $1,205,621 in 2007 | 31,493,285 | 26,307,053 |
| Inventories, net | 19,770,800 | 12,771,235 |
| Net investment in sales-type leases | 5,417,846 | 3,256,953 |
| Prepaid expenses and other current assets | 2,801,944 | 2,507,316 |
| Deferred income taxes | 711,000 | 711,000 |
| Total current assets | 83,168,157 | 89,022,920 |
| **Property and equipment, net** | 29,154,778 | 26,577,362 |
| **Other assets** | | |
| Intangible assets, net | 8,411,960 | 8,063,319 |
| Net investment in sales-type leases | 2,609,972 | 4,101,682 |
| Deferred income taxes | 786,000 | 719,000 |
| Long-term investments - available for sale securities | 1,940,000 | - |
| Long-term investments | 17,444,352 | 17,965,489 |
| Other | 1,623,873 | 2,307,250 |
| Total other assets | 32,816,157 | 33,156,740 |
| **Total Assets** | **$ 145,139,092** | **$ 148,757,022** |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| **Current liabilities** | | |
| Accounts payable and other current liabilities | $ 12,834,173 | $ 13,959,022 |
| Unearned revenues | 12,093,827 | 10,964,471 |
| Total current liabilities | 24,928,000 | 24,923,493 |
| **Stockholders' equity** | | |
| Common stock, $.01 par value, authorized 30,000,000 shares, issued 25,906,026 shares in 2008 and 25,610,654 shares in 2007 | 259,060 | 256,108 |
| Capital in excess of par value | 91,232,771 | 87,023,541 |
| Retained earnings | 67,888,374 | 56,284,182 |
| Accumulated other comprehensive income (loss) | (164,688) | 172,073 |
| Less cost of treasury stock, 5,687,631 shares in 2008 and 4,600,056 shares in 2007 | (39,004,425) | (19,902,375) |
| Total stockholders' equity | 120,211,092 | 123,833,529 |
| **Total Liabilities and Stockholders' Equity** | **$ 145,139,092** | **$ 148,757,022** |

*The accompanying notes are an integral part of these financial statements*



## STRATASYS, INC. AND SUBSIDIARIES

**CONSOLIDATED FINANCIAL STATEMENTS**

**Consolidated Statements of Operations and Comprehensive Income (Unaudited)**

| | Three Months Ended September 30, 2008 | Three Months Ended September 30, 2007 | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 |
|---|---|---|---|---|
| Net Sales | | | | |
| Product | $ 23,965,510 | $ 20,690,590 | $ 73,919,081 | $ 64,579,560 |
| Services | 6,603,918 | 5,772,882 | 18,632,957 | 17,452,266 |
| | 30,569,428 | 26,463,472 | 92,552,038 | 82,031,826 |
| Cost of goods sold | | | | |
| Product | 12,048,155 | 9,787,018 | 34,512,079 | 29,145,219 |
| Services | 2,706,835 | 3,187,655 | 7,553,275 | 9,091,199 |
| | 14,754,990 | 12,974,673 | 42,065,354 | 38,236,418 |
| **Gross profit** | **15,814,438** | **13,488,799** | **50,486,684** | **43,795,408** |
| Costs and expenses | | | | |
| Research and development | 2,100,349 | 1,964,619 | 6,841,822 | 5,571,254 |
| Selling, general and administrative | 8,415,988 | 7,435,325 | 27,004,811 | 24,667,240 |
| | 10,516,337 | 9,399,944 | 33,846,633 | 30,238,494 |
| **Operating income** | **5,298,101** | **4,088,855** | **16,640,051** | **13,556,914** |
| Other income (expense) | | | | |
| Interest income, net | 498,831 | 629,074 | 1,646,730 | 1,730,733 |
| Foreign currency transaction losses | (83,794) | (101,250) | (299,620) | (346,518) |
| Other | (33,560) | (2,651) | (286,592) | 35,330 |
| | 381,477 | 525,173 | 1,060,518 | 1,419,545 |
| Income before income taxes | 5,679,578 | 4,614,028 | 17,700,569 | 14,976,459 |
| Income taxes | 1,970,011 | 1,377,038 | 6,096,378 | 4,948,472 |
| **Net income** | **$ 3,709,567** | **$ 3,236,990** | **$ 11,604,191** | **$ 10,027,987** |
| **Earnings per common share** | | | | |
| Basic | $ 0.18 | $ 0.15 | $ 0.56 | $ 0.48 |
| Diluted | $ 0.18 | $ 0.15 | $ 0.54 | $ 0.47 |
| **Weighted average number of common shares outstanding** | | | | |
| Basic | 20,616,338 | 20,939,735 | 20,829,338 | 20,693,597 |
| Diluted | 21,021,417 | 21,813,829 | 21,354,073 | 21,519,903 |
| **Comprehensive Income** | | | | |
| Net Income | $ 3,709,567 | $ 3,236,990 | $ 11,604,191 | $ 10,027,987 |
| Other Comprehensive Income (Loss) | | | | |
| Foreign Currency Translation Adjustment | (436,312) | 188,848 | (208,761) | 181,114 |
| Unrealized Loss on Available-for-Sale Securities | - | - | (128,000) | - |
| **Comprehensive Income** | **$ 3,273,255** | **$ 3,425,838** | **$ 11,267,430** | **$ 10,209,101** |

*The accompanying notes are an integral part of these financial statements*



**STRATASYS, INC. AND SUBSIDIARIES**
**CONSOLIDATED FINANCIAL STATEMENTS**

**Consolidated Statements of Cash Flows (Unaudited)**

| | Nine Months Ended September 30, 2008 | 2007 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | $ 11,604,192 | $ 10,027,987 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Deferred income taxes | - | 32,476 |
| Depreciation | 3,491,079 | 2,580,350 |
| Amortization | 1,584,899 | 869,700 |
| Stock based compensation | 956,504 | 723,000 |
| Gain on disposal of property and equipment | (100,135) | - |
| Loss on write-down of investment | 440,000 | - |
| Increase (decrease) in cash attributable to changes in operating assets and liabilities: | | |
| Accounts receivable, net | (5,191,307) | (200,884) |
| Inventories | (6,760,585) | (2,826,344) |
| Net investment in sales-type leases | (669,183) | (586,593) |
| Prepaid expenses | (294,628) | 576,960 |
| Other assets | 683,375 | (212,073) |
| Accounts payable and other current liabilities | (1,082,968) | 2,016,512 |
| Unearned revenues | 1,129,356 | 298,807 |
| Excess tax benefit from stock options | (18,747) | - |
| **Net cash provided by operating activities** | 5,771,852 | 13,299,898 |
| | | |
| **Cash flows from investing activities** | | |
| Proceeds from sale of investments | 19,048,190 | 6,479,027 |
| Proceeds from sale of property and equipment | 296,252 | - |
| Purchases of investments | - | (11,619,938) |
| Acquisition of property and equipment | (6,515,097) | (8,124,591) |
| Acquisition of intangible and other assets | (1,863,549) | (2,465,507) |
| **Net cash provided by (used in) investing activities** | 10,965,795 | (15,731,009) |
| | | |
| **Cash flows from financing activities** | | |
| Proceeds from exercise of stock options and warrants | 3,216,009 | 8,956,176 |
| Excess tax benefit from stock options | 18,747 | - |
| Purchase of treasury stock | (19,104,261) | - |
| **Net cash provided by (used in) financing activities** | (15,869,505) | 8,956,176 |
| | | |
| **Effect of exchange rate changes on cash** | (164,999) | 181,114 |
| **Net increase in cash and cash equivalents** | 703,144 | 6,706,179 |
| **Cash and cash equivalents,** beginning of year | 16,211,771 | 12,509,861 |
| **Cash and cash equivalents,** end of period | $ 16,914,915 | $ 19,216,040 |
| | | |
| Supplemental Disclosures of cash flow information: | | |
| Cash paid for taxes | $ 6,479,089 | $ 6,017,546 |
| Transfer of fixed assets to inventory | 238,980 | 121,050 |

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

## STRATASYS, INC. AND SUBSIDIARIES
### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 Basis of Presentation and Consolidation**

The consolidated interim financial statements include the accounts of Stratasys, Inc. and its wholly-owned subsidiaries (collectively, the Company ). All intercompany accounts and transactions have been eliminated in consolidation. The consolidated interim financial information herein is unaudited; however, such information reflects all adjustments (consisting of normal, recurring adjustments), which are, in the opinion of management, necessary for a fair statement of results for the interim period. The results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year. Certain financial information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The reader is referred to the audited consolidated financial statements and notes thereto for the year ended December 31, 2007, filed as part of the Company s Annual Report on Form 10-K for such year.

**Note 2 Recently Issued Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standard ( SFAS ) No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 establishes 1) a single definition of fair value and a framework for measuring fair value; 2) sets out a fair value hierarchy to be used to classify the source of information used in fair value measurements; and 3) requires new disclosures of assets and liabilities measured at fair value based on their level in the hierarchy. In February 2008, the FASB issued Staff Positions (FSPs) No. 157-1 and No. 157-2, which, respectively, removes leasing transactions from the scope of SFAS No. 157 and defers its effective date for one year relative to certain nonfinancial assets and liabilities.

The application of the definition of fair value and related disclosures of SFAS No.157 (as impacted by these two FSPs) was effective for the Company beginning January 1, 2008 on a prospective basis with respect to fair value measurements of 1) nonfinancial assets and liabilities that are recognized or disclosed at fair value in the Company s financial statements on a recurring basis (at least annually); and 2) all financial assets and liabilities. This adoption did not have a material impact on the Company s consolidated results of operations or financial condition and the disclosures required by it are provided in Note 9 Fair Value Measurements.

The remaining aspects of SFAS No. 157 for which the effective date was deferred under FSP No. 157-2 are currently being evaluated by the Company. Areas impacted by the deferral relate to nonfinancial assets and liabilities that are measured at fair value, but are recognized or disclosed at fair value on a nonrecurring basis. This deferral applies to such items as nonfinancial long-lived asset groups measured at fair value for an impairment assessment. The effects of these remaining aspects of SFAS No. 157 are to be applied by the Company to fair value measurements prospectively beginning January 1, 2009. The Company does not expect them to have a material impact on its consolidated results of operations or financial condition.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS No. 159 ). SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are to be reported in earnings and upfront costs and fees related to items for which the fair value option is elected are recognized in earnings as incurred and not deferred.

SFAS No. 159 also established presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 was effective for financial statements issued for fiscal years beginning after November 15, 2007. At the effective date, an entity may elect the fair value option for eligible items that existed at that date. The entity is then required to report the effect of the first remeasurement to fair value as a cumulative-effect adjustment to the opening balance of retained earnings. The Company did not elect the fair value option for eligible items that existed as of January 1, 2008.



STRATASYS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In September 2007, the FASB s Emerging Issues Task Force reached a consensus on EITF Issue No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities ( EITF No. 07-3 ). EITF No. 07-3 requires nonrefundable advance payments made by the Company for future R&D activities to be capitalized and recognized as an expense as the goods or services are received by the Company. EITF No. 07-3 was effective for new arrangements entered into beginning January 1, 2008. The adoption of EITF No. 07-3 had no impact on the Company s consolidated results of operations or financial condition.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations ( SFAS No. 141R ). SFAS No. 141R provides revised guidance on how acquirers recognize and measure the consideration transferred, identifiable assets acquired, liabilities assumed, noncontrolling interests, and goodwill acquired in a business combination. SFAS No. 141R also expands required disclosures surrounding the nature and financial effects of business combinations. SFAS No. 141R is effective for fiscal years beginning after December 15, 2008. The Company is evaluating the impact of this standard and will evaluate its impact on any acquisitions that would occur after the effective date.

In December 2007, the FASB ratified the Emerging Issues Task Force consensus on EITF Issue No. 07-1, Accounting for Collaborative Arrangements ( EITF No. 07-1 ), which discusses how parties to a collaborative arrangement (which does not establish a legal entity within such arrangement) should account for various activities. The consensus indicates that costs incurred and revenues generated from transactions with third parties (i.e., parties outside of the collaborative arrangement) should be reported by the collaborators on the respective line items in their income statements pursuant to EITF Issue No. 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent. Additionally, the consensus provides that income statement characterization of payments between the participants in a collaborative arrangement should be based upon 1) existing authoritative pronouncements; 2) analogy to such pronouncements if not within their scope; or 3) a reasonable, rational, and consistently applied accounting policy election. EITF No. 07-1 is effective for the Company beginning January 1, 2009 and is to be applied retrospectively to all periods presented for collaborative arrangements existing as of the date of adoption. The Company is currently evaluating the impacts and disclosures of this standard, but would not expect EITF No. 07-1 to have a material impact on its consolidated results of operations or financial condition.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities ( SFAS No. 161 ), which will require increased disclosures about an entity s strategies and objectives for using derivative instruments; the location and amounts of derivative instruments in an entity s financial statements; how derivative instruments and related hedged items are accounted for under SFAS No.133, Accounting for Derivative Instruments and Hedging Activities; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows. Certain disclosures will also be required with respect to derivative features that are credit-risk related. SFAS No. 161 is effective for the Company beginning January 1, 2009 on a prospective basis. The Company does not expect this standard to have a material impact on its consolidated results of operations or financial condition.

**Note 3 Marketable Securities**

The Company invests in tax-free auction rate securities and municipal government bonds, all of which are insured. Classification of marketable securities as current or non-current is dependent upon management s intended holding period, the security s maturity date and liquidity considerations based on market conditions. If management has the intent and ability to hold the securities for longer than one year as of the balance sheet date, they are classified as non-current. The fair value of marketable securities approximates cost, except for certain auction rate securities discussed below.

As the Company reported in its Form 10-K for the year ended December 31, 2007, it finished 2007 with approximately $18.8 million of investments in auction rate securities. As of September 30, 2008, the Company had reduced its investment in such securities to $4.4 million.

Approximately $2.5 million of the Company s auction rate securities held at September 30, 2008, are double A rated, insured by a highly rated insurance company and included in the Balance Sheet caption Long-term investments . The remaining $1.9 million in auction rate securities consists of an investment in a Jefferson County, Alabama, municipal bond that has seen its rating reduced to triple C from triple A. In order to help the Company determine the carrying value of these investments, the Company hired outside consultants to qualitatively and quantitatively evaluate its auction rate securities portfolio.





With the assistance of the outside consultants, the Company s management determined that the investment in the Jefferson Count municipal bond had been impaired and the Company recognized a pre-tax charge of $390,000 included in other income (expense) in the first quarter for the portion of the impairment deemed to be other-than-temporary and a pre-tax fair value adjustment of $195,000 reflected in other comprehensive income (loss) in the first quarter for the portion of the impairment deemed to be temporary. In the third quarter, the Company recorded an additional pre-tax charge of $50,000 included in other income (expense) for additional impairment that was deemed to be other-than-temporary. The carrying value of the investment of approximately $1.9 million is included on the Balance Sheet in the line item Long term investments available for sale securities.

**Note 4 Inventories**

Inventories consisted of the following at September 30, 2008 and December 31, 2007 respectively:

| | 2008 | 2007 |
|---|---|---|
| Raw materials | $ 14,046,488 | $ 6,710,434 |
| Finished goods | 5,724,312 | 6,060,801 |
| Total Inventory | $ 19,770,800 | $ 12,771,235 |

**Note 5 Material Commitments**

The Company has signed material commitments with several vendors for fixed delivery of selected inventory expected to be supplied and used in production in the ensuing twelve-month period. These commitments amount to approximately $13.5 million, some of which contain non-cancellation clauses.

**Note 6 Earnings per Common Share**

The Company complies with the accounting and reporting requirements of SFAS No. 128, Earnings Per Share. The difference between the number of shares used to compute basic earnings per common share and diluted earnings per common share relates to additional shares to be issued upon the assumed exercise of stock options and warrants, net of shares hypothetically repurchased at the average market price with the proceeds of exercise. The additional shares were as follows for the respective periods:

| | Periods Ended September 30, | | | |
|---|---|---|---|---|
| | Three Months | | Nine Months | |
| | 2008 | 2007 | 2008 | 2007 |
| Additional Shares | 405,079 | 874,094 | 524,735 | 826,306 |

A total of 269,000 and 265,000 options were excluded from the dilution calculation for the three and nine-month periods ended September 30, 2008, respectively, since their inclusion would have an anti-dilutive effect.



## STRATASYS, INC. AND SUBSIDIARIES
### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following stock options were exercised for the respective periods:

| | Periods Ended September 30, | | | |
|---|---|---|---|---|
| | Three Months | | Nine Months | |
| | 2008 | 2007 | 2008 | 2007 |
| Proceeds from exercise of stock options | $ 1,152,514 | $ 1,160,078 | $ 3,216,009 | $ 8,350,206 |
| Number of options exercised | 83,200 | 100,022 | 224,900 | 705,212 |
| Weighted average share price | $ 13.85 | $ 11.60 | $ 14.30 | $ 11.84 |
| Tax benefit recognized in stockholders' equity from stock option exercises | $ - | $ 379,854 | $ 41,881 | $ 1,969,835 |

During the quarter ended March 31, 2008, net shares of 59,639 were issued as a result of the exercise of warrants. Stock warrants totaling 139,500 shares were exercised at an average price of $11.99 per share; 79,861 shares were surrendered as payment, in lieu of cash, at an average price of $20.95 per share. No stock warrants were issued during the nine months ended September 30, 2008 or for the nine-month period in the prior year.

During the quarter ended September 30, 2008, the Company repurchased approximately 866,000 shares of common stock for a total of approximately $15.1 million at an average purchase price of $17.45. During the nine months ended September 30, 2008, the Company repurchased approximately 1.1 million shares of common stock for a total of approximately $19.1 million at an average purchase price of $17.53. As of September 30, 2008, the Company has approximately $11 million remaining on the current repurchase authorization.

**Note 7 Stock-Based Compensation**

The Company records compensation expense associated with stock-based awards in accordance with SFAS No. 123 (Revised 2004), Share-Based Payment (SFAS No.123R), as interpreted by SEC Staff Accounting Bulletin (SAB) No. 110. The stock-based compensation expense amount recorded and associated future income tax benefit were as follows for the respective periods:

| | Period Ended September 30, | | | |
|---|---|---|---|---|
| | Three Months | | Nine Months | |
| | 2008 | 2007 | 2008 | 2007 |
| Stock-based compensation expense | $ (321,285) | $ (241,000) | $ (956,503) | $ (723,000) |
| Future income tax benefit | 83,000 | 38,124 | 189,218 | 176,812 |
| | $ (238,285) | $ (202,876) | $ (767,285) | $ (546,188) |

Options for 10,000 shares were granted in the nine months ended September 30, 2008 and no options were granted in the nine months ended September 30, 2007. The income tax benefit reflected pertains only to stock-based compensation expense recorded on nonqualified stock options, net of any tax benefit derived from disqualifying dispositions of incentive stock options in the specific period.

**Note 8 Income Taxes**

The effective tax rate of 34.7% for the three months ended September 30, 2008 is higher than the 29.8% effective rate for the same period in 2007 due to favorable impacts from disqualifying dispositions of incentive stock options and an increase in the estimated research and development credit available during the quarter ended September 30, 2007. The effective tax rate of 34.4% for the nine months ended September 30, 2008 is higher than the 33.0% effective rate for the same year-ago period due to the expiration of the research and development credit, partially offset by the favorable impacts from the manufacturer s tax deduction and tax-free interest income.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the Act ), which included a retroactive reinstatement of the federal research and development credit, was signed into law. The Act extends the federal research and development credit to December 31, 2009, and the Company is in the process of assessing the tax impact of this extension.





In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN No. 48 ). This interpretation, as required to be adopted on January 1, 2007, clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. It prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Implementation of FIN No. 48 on January 1, 2007 resulted in no adjustment to the Company s income tax liability. As of the date of adoption, the total amount of unrecognized tax benefits was $563,000. These unrecognized tax benefits include an estimate for interest and penalties totaling $52,000, both of which the Company classifies as a component of income tax expense.

**Note 9 Fair Value Measurements**

As discussed in Note 2 - Recently Issued Accounting Pronouncements, the Company adopted SFAS No. 157 (as impacted by FSP Nos. 157-1 and 157-2), effective January 1, 2008, with respect to fair value measurements of 1) nonfinancial assets and liabilities that are recognized or disclosed at fair value in the Company s financial statements on a recurring basis (at least annually) and 2) all financial assets and liabilities.

Under SFAS No. 157, fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. SFAS No. 157 also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs market participants would use in valuing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company s assumptions about the factors market participants would use in valuing the asset or liability developed based upon the best information available in the circumstances. The hierarchy is broken down into three levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

***Assets and Liabilities that are Measured at Fair Value on a Recurring Basis:***
For financial assets held by the Company as of January 1, 2008, fair value under SFAS No. 157 (as impacted by FSP Nos. 157-1 and 157-2) principally applied to available-for-sale marketable securities. These items were previously, and will continue to be, marked-to-market at each reporting period; however, the definition of fair value used for these mark-to-markets is now applied using SFAS No. 157. The information in the following paragraphs and tables primarily addresses matters relative to these financial assets. The Company does not have any financial liabilities that are subject to the provisions of SFAS No. 157. Separately, there were no material fair value measurements with respect to nonfinancial assets or liabilities that are recognized or disclosed at fair value in the Company s financial statements on a recurring basis subsequent to the effective date of SFAS No. 157 (as impacted by FSP Nos. 157-1 and 157-2).

The Company uses various valuation techniques, which are primarily based upon the market approach, with respect to its financial assets. As discussed in Note 3 - Marketable Securities, a portion of the auction rate securities held by the Company experienced a significant credit rating reduction. As a result, investments in auction rate securities are valued utilizing a quantitative and qualitative third-party analysis. The Company therefore classifies these securities as Level 3.



## STRATASYS, INC. AND SUBSIDIARIES
### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis that used significant unobservable inputs:

| | | **Auction rate securities** |
|---|---|---|
| Beginning balance (December 31, 2007) | $ | 18,800,000 |
| Total gains or (losses): | | |
| Included in earnings | | (440,000) |
| Included in other comprehensive income | | (195,000) |
| Settlements | | (13,725,000) |
| Transfers in and/or out of Level 3 | | - |
| Ending balance (September 30, 2008) | | 4,440,000 |
| Classified as long-term investments | | (2,500,000) |
| Classified as long-term investments - available for sale securities | $ | 1,940,000 |

***Assets and Liabilities that are Measured at Fair Value on a Nonrecurring Basis:***
During the quarter ended September 30, 2008, the Company had no significant measurements of assets or liabilities at fair value (as defined in SFAS No. 157) on a nonrecurring basis subsequent to their initial recognition. As indicated in Note 2 - Recently Issued Accounting Pronouncements, the aspects of SFAS No. 157 for which the effective date was deferred under FSP No. 157-2 until January 1, 2009 relates to nonfinancial assets and liabilities that are measured at fair value, but are recognized or disclosed at fair value on a nonrecurring basis. This deferral applies to such items as nonfinancial assets and liabilities initially measured at fair value in a business combination (but not measured at fair value in subsequent periods) or nonfinancial long-lived asset groups measured at fair value for an impairment assessment.



**Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.**

**General**

We are a leader in the rapid prototyping ( RP ) and three-dimensional ( 3D ) printing markets. We develop, manufacture, market, and service a family of 3D printers and high-performance RP systems that enable engineers and designers to create physical models, tooling and prototypes out of plastic and other materials directly from a computer-aided design ( CAD ) workstation. Our high-performance systems are used both to create prototype models as well as to produce parts for end-user applications, which is referred to as direct digital manufacturing ( DDM ). We estimate that approximately 30% of the high-end systems that we sell are used for DDM applications. Our 3D printers and high-performance systems can be used in office environments without expensive facility modification. In many industries, the models and prototypes required in product development are produced laboriously by hand-sculpting or machining, a traditional process that can take days or weeks. Our computerized modeling systems use our proprietary technology to make models and prototypes as well as end-use-parts directly from a designer s 3D CAD in a matter of hours. In addition to selling RP systems and 3D printers, through our Paid Parts service we make and sell physical models, tooling and prototypes for RP and DDM applications based on our customers CAD files. We estimate that approximately 30% of our high-end sales are used for DDM applications.

For the quarter ended September 30, 2008, our revenues increased to approximately $30.6 million, a 16% increase over the approximately $26.5 million that we reported in the third quarter of 2007. Revenues derived from products increased 16% in the quarter ended September 30, 2008, as compared with the quarter ended September 30, 2007. The number of units that we shipped in the quarter decreased by approximately 5% to 497 units as compared with 521 units shipped in the third quarter of 2007. Despite a reduction in units shipped during the quarter, revenue increased as a result of the introduction of the 900mc, growth in our Paid Parts service and increased sales of consumables due to the growing installed base of systems. Gross profit increased by 17% to $15.8 million for the third quarter of 2008, when compared to $13.5 million for the same period in the prior year. The gross profit increase was primarily due to growth in our proprietary consumables and a 68% increase in the revenues from our high-end proprietary systems.

In 2007, we discontinued our distribution of Objet and Arcam, which carried a very low gross margin when compared with sales of our proprietary systems. Based on industry reports, we believe that since 2002 we have shipped more total RP systems than any other company in the world. We believe that our consumable sales should increase in future quarters due to the significant expansion of our active installed base over the past several years.

We believe that we are successfully implementing our marketing strategy by addressing the needs of both the high-performance and 3D printing ends of the market. Our sales growth in the first nine months of 2008 was derived from a number of industries, including consumer products, government agencies, educational institutions, electronics, general manufacturing, medical, automotive, and aerospace.

Our strategy for the remainder of 2008 will be to continue to expand our position in the 3D printing market through increased sales of our Dimension product line (our low-cost 3D printers). In February 2008, we introduced the Dimension 1200es SST and BST priced at $34,900 and $26,900, respectively. These replace the Dimension 1200 s and offer the same, more durable ABS plus modeling material as our Dimension Elite. We now have five Dimension models ranging in price from $18,900 to $34,900. With the introduction of the Dimension SST in February 2004, we initiated a highly successful distributor program involving resellers purchasing demonstration systems with extended payment terms on both the Dimension SST and Dimension BST. While the program impacted our accounts receivable days sales outstanding ( DSO ) during portions of the past four years, it proved an effective tool in promoting and selling our systems. Given the success of the program in the past, we offered a similar program in 2008. Again, this program adversely impacted our DSO in the first nine months of 2008 as we expected. However, we believe our distributor program is an integral part of our strategy to expand the 3D printing market.

Our strategy also includes the expansion of our position in the RP market through the growth of our high performance systems, represented principally by our FDM 200mc, 360mc, 400mc, and 900mc, Titan, Vantage and Maxum systems. Prices for our FDM systems now range from $50,000 for the base model 200mc to over $400,000 for the fully equipped 900mc.

We also have opportunities for DDM. DDM involves the manufacture of parts fabricated directly from systems that are subsequently incorporated into the user s end product or process. DDM is particularly attractive in applications that require short-run or low-volume parts that require rapid turn-around, and for which injection mold tooling would not be appropriate due to small volumes.



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An emerging portion of the DDM market segment is the production of fabrication and assembly tools that aid in the customer s production and assembly process. We believe this fabrication and assembly tool market is substantially larger than the $1.1 billion rapid prototyping market we currently serve. In addition, we have seen a growing number of applications for end-use parts.

As our installed base has increased, we have derived an increasing amount of revenue from the sales of consumables, maintenance contracts, and other services that represents recurring revenue for us. We expect that this trend to continue.

During the quarter ended September 30, 2005, we announced that we received a $3.6 million order from a Fortune 500 global manufacturing company to advance our proprietary FDM technology for rapid manufacturing applications. This effort was based around our high-performance systems and resulted in a commercial product, the 900mc. We delivered our first prototype in December 2006. The agreement includes payments to us over four years as R&D milestones are achieved, as well as payments that are dependent upon future deliverables. R&D payments received offset accelerated R&D efforts aimed at rapid manufacturing advances and are not recognized as revenue. During the three months ended March 31, 2008 and six months ended June 30, 2007, we offset approximately $280,000 and $630,000, respectively, of R&D expenses with payments received from this customer. No additional payments were received in the second or third quarter of 2008 as all of our obligations under the original order were met. Based on the success of this new technology, we announced on July 7, 2008 that we received an order in May 2008 from this company for an additional five units, all of which have shipped as of September 30, 2008.

Our balance sheet continues to be strong. As of September 30, 2008, our cash and investment position was $42.4 million, with no debt. We believe that we have adequate liquidity to fund our growth strategy for the remainder of 2008.

Our current and future growth is largely dependent upon our ability to penetrate new markets and develop and market new rapid prototyping and manufacturing systems, materials, applications, and services that meet the needs of our current and prospective customers. Our expense levels are based in part on our expectations of future revenues. While we have adjusted, and will continue to adjust, our expense levels based on both actual and anticipated revenues, fluctuations in revenues in a particular period could adversely impact our operating results. Our ability to implement our strategy for 2008 is subject to numerous uncertainties and risks, many of which are described in this Management s Discussion and Analysis of Financial Condition and Results of Operations, in the section below captioned Forward Looking Statements and Factors That May Affect Future Results of Operations, and in Item 1A, Risk Factors, of our Annual Report on Form 10-K for 2007. We cannot ensure that our efforts will be successful.

**Results of Operations**
*(unaudited)*

The following table sets forth certain consolidated statements of operations data as a percentage of net sales for the periods indicated. All items are included in or derived from our consolidated interim statements of operations.



**Three and Nine Month Periods Ended September 30,**

| | Three Months | | Nine Months | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| Net sales | 100% | 100% | 100% | 100% |
| Cost of sales | 48.3% | 49.0% | 45.5% | 46.6% |
| Gross profit | 51.7% | 51.0% | 54.5% | 53.4% |
| Research and development | 6.9% | 7.4% | 7.4% | 6.8% |
| Selling, general, and administrative | 27.5% | 28.1% | 29.2% | 30.1% |
| Operating income | 17.3% | 15.5% | 18.0% | 16.5% |
| Other income (expense) | 1.2% | 2.0% | 1.1% | 1.7% |
| Income before income taxes | 18.6% | 17.4% | 19.1% | 18.3% |
| Income taxes | 6.4% | 5.2% | 6.6% | 6.0% |
| Net income | 12.1% | 12.2% | 12.5% | 12.2% |

**Net Sales**

Net sales of our products and services and changes in net sales were as follows:

**Three and Nine Month Periods Ended September 30,**

| (In Thousands) | Three Months | | Period-over-period | Nine Months | | Period-over-period |
|---|---|---|---|---|---|---|
| | **2008** | **2007** | **change** | **2008** | **2007** | **change** |
| Products | $ 23,966 | $ 20,691 | 15.8% | $ 73,919 | $ 64,580 | 14.5% |
| Services | 6,604 | 5,773 | 14.4% | 18,633 | 17,452 | 6.8% |
| | $ 30,570 | $ 26,464 | 15.5% | $ 92,552 | $ 82,032 | 12.8% |

For three and nine months ended September 30, 2008 compared to the same year-ago periods, the decrease in unit volume was more than offset by a change in mix that favored high-end proprietary systems as well as higher priced 3D printers. We believe our unit volume was adversely impacted by domestic economic conditions. Several customers have delayed their purchasing decisions due to economic conditions, but we believe we continue to maintain our market leadership position. For three and nine months ended September 30, 2008 compared to the same year-ago periods, Dimension system revenue decreased 2% and increased 4% respectively. For the three and nine months ended September 30, 2008 compared to the same year-ago periods, sales of our high-productivity proprietary systems increased 68% and 48%, respectively, driven by new product introductions over the past twelve months and an expansion in marketing to DDM applications. The growth rate in our high-productivity systems accelerated in the third quarter of 2008 as we began commercial shipments of our 900mc system introduced in December 2007. For three and nine months ended September 30, 2008 compared to the same year-ago periods, revenues from our proprietary consumables increased 20% and 16%, respectively due to our expanding installed base of systems.

Overall service revenue increased 14% and 7% for the three and nine month periods ended September 30, 2008, respectively, compared to the same year-ago period led primarily by growth in our Paid Parts business. Paid parts revenue increased by 22% and 4% for the three and nine month periods ended September 30, 2008, respectively, compared to the same year-ago period. The accelerated third quarter 2008 growth is a result of new marketing initiatives implemented in the third quarter resulting in a 23% increase in new registrations and an increase of 53% in orders from new customers. We believe these initiatives will have a positive impact on the paid parts operations for the remainder of 2008.

North American sales, which include Canada and Mexico, accounted for approximately 54% and 57% of total revenue in the nine months ended September 30, 2008 and 2007, respectively. This decline in sales percentage is primarily due to the discontinuation of the North American product distribution agreements with Arcam and Objet as well as a strengthening of the Euro and other foreign currencies as compared the U.S. Dollar. We recognized no distributed system, consumable and maintenance revenue in the third quarter of 2008 compared to $310,000 in the third quarter of 2007. Distributed related system, consumable and maintenance sales were approximately $188,000 in the first nine months of 2008 compared to $1.6 million in the same year-ago period.



International sales grew 24% and 29% for the three and nine month periods ended September 30, 2008, respectively, compared to the same periods in the prior year. The international increase was led by strong sales for all our products, but particularly our high-end systems in both Europe and the Asia Pacific region.

Whereas we expect to report higher revenues and profits in 2008 over the results achieved in 2007, declining economic conditions could adversely impact our future sales and profitability.

**Gross Profit**

Gross profit and gross profit as a percentage of sales for our products and services, as well as the percentage changes in gross profit were as follows:

**Three and Nine Month Periods Ended September 30,**

| (In Thousands) | Three Months 2008 | Three Months 2007 | Period-over-period change | Nine Months 2008 | Nine Months 2007 | Period-over-period change |
|---|---|---|---|---|---|---|
| **Cost of Sales** | | | | | | |
| Products | $ 11,917 | $ 10,904 | 9.3% | $ 39,407 | $ 35,434 | 11.2% |
| Services | 3,897 | 2,585 | 50.8% | 11,080 | 8,361 | 32.5% |
| Total | $ 15,814 | $ 13,489 | 17.2% | $ 50,487 | $ 43,795 | 15.3% |
| **Costs as Percentage of Sales** | | | | | | |
| Products | 49.7% | $52.7% | | 53.3% | 54.9% | |
| Services | 59.0% | 44.8% | | 59.5% | 47.9% | |
| Total | 51.7% | 51.0% | | 54.5% | 53.4% | |

Total gross profit percentages grew compared to the prior year in both the third quarter and the nine month period due to favorable service gross margins which were partially offset by a decline in product gross margins.

Service gross margins were favorably impacted by a lower cost associated with our maintenance contracts as well as the increase in sales of our paid parts business. Service gross margins in 2007 were negatively impacted by services associated with our distributed products. We incurred no service costs in the third quarter of 2008 associated with distributed products.

Product gross margin for the third quarter was unfavorably impacted by a higher mix of sales weighted towards entry level high-end systems and 3D printers sold to the educational market where we experience a lower average selling price. This lower margin was partially offset by the growth in our proprietary consumables. The product gross margin for the nine month period was less impacted by this unfavorable mix because 3D printer sales to the educational market were not as significant in the first half of the year as compared to the third quarter.

**Operating Expenses**

Operating expenses and operating expense as a percentage of sales, as well as the percentage changes in operating expenses, were as follows:

**Three and Nine Month Periods Ended September 30,**

| (In Thousands) | Three Months 2008 | Three Months 2007 | Period-over-period change | Nine Months 2008 | Nine Months 2007 | Period-over-period change |
|---|---|---|---|---|---|---|
| Research & development | $ 2,100 | $ 1,965 | 6.9% | $ 6,842 | $ 5,571 | 22.8% |
| Selling, general & admin | 8,416 | 7,435 | 13.2% | 27,005 | 24,667 | 9.5% |
| | $ 10,516 | $ 9,400 | 11.9% | $ 33,847 | $ 30,238 | 11.9% |
| Percentage of sales | 34.4% | 35.5% | | 36.6% | 36.4% | |

Research and development expense increased by 7% and 23% for the three and nine months ended September 30, 2008, respectively, compared to the same periods in the prior year, as we remain committed to designing new products and materials, reducing costs on existing products, and improving the quality and reliability of all of our platforms. Increases were primarily the result of increases in engineering headcounts and material spending partially offset by the capitalization of internally developed software during the nine months ended September 30, 2008. While research and development spending increased by 23% for the nine months ended September 30, 2008, it increased by only 7% for the third quarter of 2008 as we slowed our level of investment due to concerns about the economic environment. Capitalized research and development expenditures for the nine months ended September 30, 2008 relating to internally developed software increased to $1.6 million from $1.4 million for the same period in the prior year.



During the quarter ended September 30, 2005, we announced that we received a $3.6 million order from a Fortune 500 global manufacturing company to advance our proprietary FDM technology for rapid manufacturing applications. This effort is based around our high-performance systems. We delivered our first prototype in December 2006. The agreement includes payments to us over four years as R&D milestones are achieved, as well as payments that are dependent upon future deliverables. R&D payments received offset accelerated R&D efforts aimed at rapid manufacturing advances and are not recognized as revenue. During the three months ended March 31, 2008 and six months ended June 30, 2007, we offset approximately $280,000 and $630,000, respectively, of R&D expenses with payments received from this customer. No additional payments were received in the second or third quarter of 2008 as all of our obligations of the original order were met. Based on the success of this new technology, we announced on July 7, 2008 that we received an order in May 2008 from this company for an additional five units, all of which have shipped as of September 30, 2008.

Selling, general and administrative expenses increased $981,000, or 13.2%, for the three months ended September 30, 2008, compared to the same year-ago period. This increase resulted from additional spending to support our growth including spending for process improvements. Selling, general and administrative expenses increased 9.5% for the nine months ended September 30, 2008 compared to the same period in the prior year. The increase resulted from additional spending to support our growth including spending for process improvements. We expect the growth in selling, general and administrative expenses to continue over the remainder of 2008.

**Operating Income**

Operating income and operating income as a percentage of sales, as well as the percentage changes in operating income, were as follows:

**Three and Nine Month Periods Ended September 30,**

| (In Thousands) | Three Months 2008 | Three Months 2007 | Period-over-period change | Nine Months 2008 | Nine Months 2007 | Period-over-period change |
|---|---|---|---|---|---|---|
| Operating income | $ 5,298 | $ 4,089 | 29.6% | $ 16,640 | $ 13,557 | 22.7% |

| | | | | |
|---|---|---|---|---|
| Percentage of sales | 17.3% | 15.5% | 18.0% | 16.5% |

Operating income increased by 30% and 23% for the three and nine months ended September 30, 2008, respectively, compared to the same period in the prior year. These increases are primarily due to the increase in net sales, changes in the product mix and other factors cited above.

**Other Income (Expense)**

Other income (expense) as a percentage of sales and changes in other income (expense) were as follows:

**Three and Nine Month Periods Ended September 30,**

| (In Thousands) | Three Months | | Period-over-period change | Nine Months | | Period-over-period change |
|---|---|---|---|---|---|---|
| | **2008** | **2007** | | **2008** | **2007** | |
| Interest income | $ 499 | $ 629 | (20.7%) | $ 1,647 | $ 1,731 | (4.9%) |
| Foreign currency transaction losses | (84) | (101) | (16.8%) | (300) | (347) | (13.5%) |
| Other | (34) | (3) | 1,033.3% | (287) | 35 | (920.0%) |
| | $ 381 | $ 525 | (27.4%) | $ 1,060 | $ 1,419 | (25.3%) |
| Percentage of sales | 1.2% | 2.0% | | 1.1% | 1.7% | |

Interest income decreased for the three and nine month periods ended September 30, 2008 compared to the same year-ago periods due to a decrease in our cash and investments and lower interest rates. Foreign currency transaction gains and losses are principally due to currency fluctuations between the US dollar and the Euro. We enter into 30-day forward contracts to hedge our foreign currency exposure. We hedged only a portion of our foreign currency exposure and the resulting loss was due to the weakening of the US dollar relative to the Euro. Our strategy is to continue to hedge our estimated Euro denominated accounts receivable position throughout the remainder of 2008. At September 30, 2008, we had approximately €5.8 million in Euro-denominated receivables and a €4.5 million 30-day forward contract.



Other income (expense) for the three months ended September 30, 2008 increased primarily due to a $50,000 charge related to an other-than-temporary impairment of our auction rate securities. Other income (expense) for the nine months ended September 30, 2008 includes a $440,000 charge related to our investment in auction rate securities and we continue to evaluate the carrying value of these securities. Given the current environment, we believe we have been proactive in evaluating the fair value of our cash equivalents and investments. As we reported in our Annual Report on Form 10-K, we finished 2007 with approximately $18.8 million in auction rate securities, but we have reduced our position to $4.4 million as of September 30, 2008.

Approximately $2.5 million of our auction rate securities held at September 30, 2008, are double A rated and insured by a highly rated insurance company. The remaining $1.9 million in auction rate securities is an investment in a Jefferson County, Alabama, municipal bond that has seen its rating reduced to triple C from triple A. In order to help us determine the carrying value of these investments, we hired outside consultants to qualitatively and quantitatively evaluate our auction rate securities portfolio.

With the assistance of the outside consultants, we determined that, as of September 30, 2008, our initial $2.6 million investment in the Jefferson County, Alabama, municipal bond had incurred both a temporary and other-than-temporary impairment. As a result, we took a pre-tax charge of $50,000 and $440,000 for the three and nine month periods ended September 30, 2008, respectively, to "Other income (expense)" for the other-than-temporary impairment and recognized an additional pre-tax fair value adjustment of $195,000 in "Other comprehensive income" for the temporary impairment. The resulting fair value of the Jefferson County, Alabama, municipal bond of approximately $1.9 million is included in the Balance Sheet caption "Long term investments – Available for sale securities."

**Income Taxes**

Income taxes and income taxes as a percentage of net income before income taxes, as well as the percentage changes, were as follows:

**Three and Nine Month Periods Ended September 30,**

| (In Thousands) | Three Months 2008 | Three Months 2007 | Period-over-period change | Nine Months 2008 | Nine Months 2007 | Pe per |
|---|---|---|---|---|---|---|
| Income taxes | $ 1,970 | $ 1,377 | 43.1% | $ 6,096 | $ 4,948 | |
| Percentage of income before taxes | 34.7% | 29.8% | | 34.4% | 33.0% | |

Income tax expense increased with the increase in income before income taxes. The effective tax rate for the three months ended September 30, 2008 is higher than the 2007 period because of favorable impacts from disqualifying dispositions of incentive stock options and an increase in the estimated research and development credit available during the quarter ended September 30, 2007. The effective tax rate of 34.4% for the nine months ended September 30, 2008 is higher than the 33.0% effective rate for the same year-ago period due to the expiration of the research and development credit, partially offset by the favorable impacts from the manufacturer’s tax deduction and tax-free interest income.

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the “Act”), which included a retroactive reinstatement of the federal research and development credit, was signed into law. The Act extends the federal research and development credit to December 31, 2009 and we are in the process of assessing the tax impact of this extension.



**Net Income**

Net income and net income as a percent of sales, as well as the percentage changes in net income, were as follows:

**Three and Nine Month Periods Ended September 30,**

| (In Thousands) | Three Months 2008 | Three Months 2007 | Period-over-period change | Nine Months 2008 | Nine Months 2007 | Period-over-period change |
|---|---|---|---|---|---|---|
| Net income | $ 3,710 | $ 3,237 | 14.6% | $ 11,604 | $ 10,028 | 15.7% |
| Percentage of sales | 12.1% | 12.2% | | 12.5% | 12.2% | |

Net income increased for the three and nine months ended September 30, 2008 compared to the same year-ago periods primarily due to a favorable product mix.



**Liquidity and Capital Resources**
*(unaudited)*

A summary of our consolidated interim statements of cash flows for the nine months ended September 30, 2008 and 2007 are as follows**:**

| (In Thousands) | 2008 | 2007 |
|---|---|---|
| Net income | $ 11,604 | $ 10,028 |

| | | |
|---|---|---|
| Deferred income taxes | - | 32 |
| Depreciation and amortization | 5,076 | 3,450 |
| Gain on sale of equipment | (100) | - |
| Loss on impariment of investment | 440 | - |
| Stock-based compensation | 953 | 723 |
| Changes in operating assets and liabilities | (12,205) | (933) |
| Net cash provided by operating activities | 5,768 | 13,300 |
| | | |
| Net cash provided by (used in) investing activities | 10,966 | (15,731) |
| Net cash provided by (used in) financing activities | (15,866) | 8,956 |
| Effect of exchange rate changes on cash | (165) | 181 |
| Net increase in cash and cash equivalents | 703 | 6,706 |
| Cash and cash equivalents, beginning of period | 16,212 | 12,510 |
| Cash and cash equivalents, end of period | $ 16,915 | $ 19,216 |

We decreased our cash, cash equivalents and investment balances to $42.4 million at September 30, 2008, from $61.4 million at December 31, 2007. We increased our long-term investments, consisting principally of municipal bonds and illiquid auction rate securities, to $19.4 million compared to $18.0 million at December 31, 2007. The $1.4 million increase is primarily due to $1.9 million of auction rate securities being classified as long-term at September 30, 2008, partially offset by maturities of municipal bonds during the quarter ended September 30, 2008.

In the nine months ended September 30, 2008, net cash provided by our operating activities amounted to approximately $5.8 million compared with cash provided by operations of approximately $13.3 million during the comparable 2007 period. We generated cash from our net income, as adjusted to exclude the effects of non-cash charges. However, cash was used by changes in operating assets and liabilities, principally a $6.8 million increase in inventory and a $5.2 million increase in accounts receivable.

Our net accounts receivable balance increased to approximately $31.5 million at September 30, 2008 from approximately $26.3 million as of December 31, 2007. This increase was principally due to sales growth, high volume of shipments in the last month of the third quarter and a larger portion of our sales from international markets that typically operate with longer receivable terms. We believe that we have recorded adequate allowances for any collectibility issues in our accounts receivable balance.

At September 30, 2008, our inventory balance increased significantly to $19.8 million compared with approximately $12.8 million at December 31, 2007. The increase is primarily due to:

- a build up of Dimension 3D printer systems in anticipation of additional demand in order to provide for differences in our forecast mix versus actual demand;
- an increase in inventory to support new product introductions;
- increases in consumable inventory from opportunistic purchases and to meet anticipated increases in future customer demand; and
- last-time purchases of components to support future sales of legacy systems and to provide maintenance on the existing installed base.



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A significant portion of our inventory is dedicated to fulfilling our service contract and warranty obligations. As we have introduced several new products over the last several quarters, there are many more platforms and models to service than in the past, which increases the requirement to maintain spare parts inventory. With the introduction of these new products, older products have been discontinued. However, inventory for these discontinued products is still required to fulfill our service contracts. Our procedures for dealing with this inventory are more fully explained in the section below captioned Critical Accounting Policies.

Our investing activities provided cash of approximately $11 million as we reinvested proceeds received upon maturity of investments into United States Treasury money market funds that qualify as cash equivalents. For the nine months ended September 30, 2008, we received cash of approximately $19 million from the sale of investments and used cash for fixed asset additions of approximately $6.5 million. Much of the capital expenditures in 2008 have been for equipment required by the growing components of our business, including manufacturing fixtures for new products, consumable manufacturing, Paid Parts, and improvements to our facilities as we renovate portions of our buildings to increase operating efficiency. Net cash was used for the acquisition of intangible assets and other investments including patents and capitalized software.

During the three months ended September 30, 2008, our financing activities used cash of approximately $15.9 million, principally for repurchasing our common stock. During the nine months ended September 30, 2008, we repurchased approximately 1.1 million shares for approximately $19.1 million at an average purchase price of $17.53. For the remainder of 2008, we expect to use our cash as follows:

- for improvements to our facilities;
- for the continuation of our leasing program;
- for working capital purposes;
- for information systems (I/S) and infrastructure enhancements;
- for new product and materials development;
- for sustaining engineering;
- for the acquisition of equipment, including production equipment, tooling, and computers;
- for the purchase of intangible assets, including patents;
- for increased selling and marketing activities, especially as they relate to the continued market and channel development;
- for acquisitions and/or strategic alliances; and
- for our common stock buyback program

While we believe that the primary source of liquidity during the remainder of 2008 will be derived from current cash balances and cash flows from operations, we have maintained a line of credit for the lesser of $4.0 million or a defined borrowing base.

As of September 30, 2008, we had gross accounts receivable of approximately $32.6 million less an allowance of approximately $1.1 million for returns and doubtful accounts. Over our history, bad debt expense has generally been small as a percentage of sales. However, at September 30, 2008, large balances were concentrated with certain international distributors. Default by one or more of these distributors could result in a significant charge against our current reported earnings. We have reviewed our policies that govern credit and collections, and will continue to monitor them in light of their current payment status and economic conditions. While we can give no assurances, we believe that most, if not all, of the accounts receivable balances will ultimately be collected. For further information, see the section below captioned Critical Accounting Policies.

Our total current assets amounted to approximately $83.2 million at September 30, 2008, most of which consisted of cash and cash equivalents, investments, inventories and accounts receivable. Total current liabilities amounted to approximately $24.9 million and we have no debt . We believe that we have adequate resources to fund our foreseeable future operations and growth.



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**Inflation**

We believe that inflation has not had a material effect on our operations or on our financial condition during the three most recent fiscal years and at current quarter.

**Foreign Currency Transactions**

We invoice sales to certain European distributors in Euros. Our reported results are therefore subject to fluctuations based upon changes in the exchange rates of that currency in relation to the United States dollar. In the nine months ended September 30, 2008 and 2007, the net loss on foreign currency transactions amounted to approximately $300,000 and $346,000, respectively. During the quarter ended September 30, 2008, we hedged between €3.8 million and €4.6 million of our accounts receivable that were denominated in Euros. The hedge resulted in a currency translation gain of approximately $676,000 for that period. Our strategy is to hedge the majority of our Euro-denominated accounts receivable position throughout the remainder of 2008 on a month-to-month basis. We will continue to monitor our exposure to currency fluctuations. Instruments to hedge our risks may include foreign currency forward, swap, and option contracts. These instruments will be used to selectively manage risks, but there can be no assurance that we will be fully protected against material foreign currency fluctuations. We expect to continue to derive most of our sales from regions where the transactions are negotiated, invoiced, and paid in US dollars. Fluctuations in the currency exchange rates in these other countries may therefore reduce the demand for our products by increasing the price of our products in the currency of countries in which the local currency has declined in value.

**Critical Accounting Policies**

We have prepared our consolidated interim financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America. This has required us to make estimates, judgments, and assumptions that affected the amounts we reported.

We have identified several critical accounting policies that required us to make assumptions about matters that were uncertain at the time of our estimates. Had we used different estimates and assumptions, the amounts we recorded could have been significantly different. Additionally, if we had used different assumptions or different conditions existed, our financial condition or results of operations could have been materially different. The critical accounting policies that were affected by the estimates, assumptions, and judgments used in the preparation of our consolidated interim financial statements are described in our Annual Report on Form 10-K for 2007.

**Forward-looking Statements and Factors That May Affect Future Results of Operations**

All statements herein that are not historical facts or that include such words as “expect”, “anticipate”, “project”, “estimate” or “believe” or other similar words are forward-looking statements that we deem to be covered by and to qualify for the safe harbor protection covered by the Private Securities Litigation Reform Act of 1995 (the “1995 Act”). Investors and prospective investors in our Company should understand that several factors govern whether any forward-looking statement herein will be or can be achieved. Any one of these factors could cause actual results to differ materially from those projected herein.

These forward-looking statements include the expected increases in net sales of RP and 3D printing systems, services and consumables, and our ability to maintain our gross margins on these sales. The forward-looking statements include our assumptions about the size of the RP and 3D printing market, and our ability to penetrate, compete, and successfully sell our products in these markets. They include our plans and objectives to introduce new products, to control expenses, to improve the quality and reliability of our systems, to respond to new or existing competitive products, and to improve profitability. The forward-looking statements included herein are based on current expectations that involve a number of risks and uncertainties, some of which are described in Item 1A, “Risk Factors,” in our Annual Report on Form 10-K for 2007. These forward-looking statements are based on assumptions, among others, that we will be able to:

- continue to introduce new RP and 3D printing systems and materials acceptable to the market, and to continue to improve our existing technology and software in our current product offerings;



- successfully develop the 3D printing market with our Dimension BST, Dimension SST and Dimension Elite systems, and that the market will accept these systems;
- successfully develop and introduce high-performance systems to serve both the RP and DDM markets;
- maintain our revenues and gross margins on our present products;
- control our operating expenses;
- expand our manufacturing capabilities to meet the expected demand generated by 3D printers, Paid Parts, and our consumable products;
- successfully commercialize new materials, and that the market will accept these new materials; and
- recruit, retain, and develop employees with the necessary skills to produce, create, commercialize, market, and sell our products.

Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, geopolitical, competitive, market and technological conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of those assumptions could prove inaccurate, and therefore there is and can be no assurance that the results contemplated in any such forward-looking statement will be realized. The impact of actual experience and business developments may cause us to alter our marketing plans, our capital expenditure budgets, or our engineering, selling, manufacturing or other budgets, which may in turn affect our results of operations or the success of our new product development and introduction. We may not be able to alter our plans or budgets in a timely manner, resulting in reduced profitability or losses.

Due to the factors noted above and elsewhere in this Management's Discussion and Analysis of Financial Condition and Results of Operations, our future earnings and stock price may be subject to significant volatility, particularly on a quarterly basis. Additionally, we may not learn of revenue or earnings shortfalls until late in a fiscal quarter, since we frequently receive a significant number of orders very late in a quarter. This could result in an immediate and adverse effect on the trading price of our common stock. Past financial performance should not be considered a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

**Interest Rate Risk**

Our cash and cash equivalent investments are invested exclusively in short-term money market and sweep instruments with maturities of less than 90 days and are subject to limited interest rate risk. A 10% change in interest rates would not have a material effect on our financial condition or results of operations. Our short and long-term investments are invested in auction rate securities, municipal government bonds, and certificates of deposit that bear interest at rates of 2.1% to 6.8%. An immediate 10% change in interest rates would have no material effect on our financial condition or results of operations.

**Foreign Currency Exchange Rate Risk**

We have not historically hedged sales from or expenses incurred by our European operations that have a functional currency in Euros. Therefore, a hypothetical 10% change in the exchange rates between the U.S. dollar and the Euro could increase or decrease our income before taxes by less than $0.4 million for the continued maintenance of our European facility. In the quarter ended September 30, 2008 we hedged between €3.8 million and €4.6 million of our accounts receivable balances that were denominated in Euros. A hypothetical 10% change in the exchange rates between the US dollar and the Euro could increase or decrease income before taxes by between $0.7 million and $1.1 million.



**Item 4. Controls and Procedures.**

*Disclosure Controls and Procedures.* Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report (the "Evaluation Date"). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded as of the evaluation date that our disclosure controls and procedures were effective such that the information relating to us required to be disclosed in our Securities and Exchange Commission ("SEC") reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

*Internal Control over Financial Reporting.* Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we are responsible for establishing and maintaining an effective system of internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934). Our management has conducted an assessment of our internal control over financial reporting based on the framework established by the committee of Sponsoring

Organizations of the Treadway Commission in Internal Control  Integrated Framework. There have not been any changes in our internal control over financial reporting identified in connection with the assessment that occurred during the third quarter of 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased under the Plans or Programs |
|---|---|---|---|---|
| Month #1 (July 2008) | --- | --- | --- | $ 26,047,178 |
| Month #2 (August 2008) | 706,416 | $ 17.79 | 706,416 | $ 13,460,813 |
| Month #3 (September 2008) | 160,060 | $ 15.96 | 160,060 | $ 10,901,526 |
| Total | 866,476 | $ 17.45 | 866,476 | $ 10,901,526 |

**Item 6. Exhibits**

(a) Exhibits.

31.1 Certification of the Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a).

31.2 Certification of the Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a).

32.1 Certification of the Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350.

32.2 Certification of the Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350.



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 10, 2008

**Stratasys, Inc.**

By: /s/ Robert F. Gallagher
Robert F. Gallagher
Chief Financial Officer