FOX FACTORY HOLDING CORP
Form 10-Q
November 06, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2013

OR

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

Commission File Number: 001-36040

Fox Factory Holding Corp.

(Exact Name of Registrant as Specified in Its Charter)

Delaware **(State or Other Jurisdiction of** **Incorporation or Organization)**	**26-1647258** **(I.R.S. Employer** **Identification No.)**
915 Disc Drive **Scotts Valley, CA** **(Address of Principal Executive Offices)**	**95066** **(Zip Code)**

(831) 274-6500

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

As of November 6, 2013, there were 36,317,087 shares of the Registrant s common stock outstanding.

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Fox Factory Holding Corp.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Fox Factory Holding Corp.

Condensed Consolidated Balance Sheets

(in thousands, except share and per share data)

	As of September 30, 2013 (unaudited)	As of December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$ 3,496	$ 15
Accounts receivable (net of allowance for doubtful accounts of $352 and $440 at September 30, 2013 and December 31, 2012, respectively)	39,246	25,224
Inventory	46,393	34,255
Prepaids and other current assets	2,506	2,242
Deferred tax assets	3,350	3,405
Total current assets	94,991	65,141
Property and equipment, net	12,540	11,789
Loan fees, net	755	
Loan fees, net related party		1,665
Goodwill	31,372	31,372
Intangibles, net	28,130	32,153
Total assets	$ 167,788	$ 142,120
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 22,429	$ 19,551
Accrued expenses	12,052	10,156
Liability reserve for uncertain tax positions	7,320	7,292
Current portion of long-term debt related party		3,000
Total current liabilities	41,801	39,999
Line of credit	24,500	
Line of credit related party		750
Long-term debt, less current portion related party		55,500
Deferred rent	1,010	1,132
Deferred tax liabilities	13,890	15,155

Total liabilities		81,201		112,536
Commitments and contingencies (Note 9)				
Stockholders equity				
Common stock, $0.001 par value 69,675,000 authorized as of September 30, 2013 and December 31, 2012; 36,317,087 and 33,459,944 shares issued and outstanding as of September 30, 2013 and December 31, 2012, respectively;		36		33
Additional paid-in capital		86,963		49,169
Accumulated other comprehensive income		12		1
Accumulated deficit		(424)		(19,619)
Total stockholders equity		86,587		29,584
Total liabilities and stockholders equity	$	167,788	$	142,120

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

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Fox Factory Holding Corp.

Condensed Consolidated Statements of Income

(in thousands, except per share data)

(unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	**2012**	**2013**	**2012**
Sales	$ 82,293	$ 72,864	$ 207,487	$ 179,256
Cost of sales	56,960	52,745	146,074	129,592
Gross profit	25,333	20,119	61,413	49,664
Operating expenses:				
Sales and marketing	3,621	3,150	10,382	9,288
Research and development	2,500	2,427	7,442	7,196
General and administrative	3,098	2,223	8,588	7,069
Amortization of purchased intangibles	1,341	1,341	4,023	3,974
Total operating expenses	10,560	9,141	30,435	27,527
Income from operations	14,773	10,978	30,978	22,137
Other expense, net:				
Interest expense	(2,015)	(1,424)	(3,968)	(2,294)
Other income (expense), net	38	14	19	(287)
Other expense, net	(1,977)	(1,410)	(3,949)	(2,581)
Income before income taxes	12,796	9,568	27,029	19,556
Provision for income taxes	2,872	4,099	7,834	7,131
Net income	$ 9,924	$ 5,469	$ 19,195	$ 12,425
Earnings per share:				
Basic	$ 0.28	$ 0.16	$ 0.56	$ 0.39
Diluted	$ 0.27	$ 0.16	$ 0.55	$ 0.39
Weighted average shares used to compute earnings per share:				
Basic	35,013	33,465	33,983	31,588
Diluted	36,423	33,718	35,108	31,906

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

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Fox Factory Holding Corp.

Condensed Consolidated Statements of Comprehensive Income

(in thousands)

(unaudited)

	For the three months ended September 30, 2013	For the three months ended September 30, 2012	For the nine months ended September 30, 2013	For the nine months ended September 30, 2012
Net income	$ 9,924	$ 5,469	$ 19,195	$ 12,425
Other comprehensive income:				
Foreign currency translation adjustments	(10)	5	11	5
Other comprehensive income	(10)	5	11	5
Comprehensive income	$ 9,914	$ 5,474	$ 19,206	$ 12,430

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

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Fox Factory Holding Corp.

Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	For the nine months ended September 30, 2013	2012
OPERATING ACTIVITIES:		
Net income	$ 19,195	$ 12,425
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	5,757	5,320
Provision for doubtful accounts	(88)	85
Stock-based compensation	1,675	1,733
Excess tax benefit from exercise of stock options		(5,755)
(Gain) loss on disposal of property and equipment	(7)	250
Write-off of unamortized loan origination costs from related party debt	1,405	
Deferred taxes	(1,182)	(1,472)
City of Watsonville loan credit		(4)
Changes in operating assets and liabilities:		
Accounts receivable	(13,934)	(15,156)
Inventory	(12,138)	(11,165)
Income taxes receivable		6,458
Prepaids and other current assets	(264)	(113)
Other assets	284	(1,332)
Accounts payable	2,605	8,120
Accrued expenses	1,896	755
Deferred rent	(122)	693
Net cash provided by operating activities	5,082	842
INVESTING ACTIVITIES:		
Purchases of property and equipment	(2,485)	(3,882)
Proceeds from sale of property and equipment	7	
Purchase of intangible assets		(835)
Net cash used in investing activities	(2,478)	(4,717)
FINANCING ACTIVITIES:		
Payments for deferred offering costs of initial public offering	(3,462)	
Proceeds from initial public offering, net of underwriter fees	39,857	
Proceeds from equity issuance		7,204
Excess tax benefit from exercise of stock options		5,755

Dividends paid		(67,000)
Proceeds from line of credit, net of origination fees of $779	27,721	
Payments on line of credit	(4,000)	
Proceeds from related party line of credit	31,858	29,135
Payments on related party line of credit	(32,608)	(16,335)
Proceeds from issuance of related party debt		60,000
Repayment of related party debt	(58,500)	(14,589)
Net cash provided by financing activities	866	4,170
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	11	5
CHANGE IN CASH AND CASH EQUIVALENTS	3,481	300
CASH AND CASH EQUIVALENTS Beginning of period	15	114
CASH AND CASH EQUIVALENTS End of period	$ 3,496	$ 414
SUPPLEMENTAL DISCLOSURES OF OTHER CASH FLOW INFORMATION:		
Cash paid for income taxes	$ 7,027	$ 2,145
Cash paid for interest	$ 2,446	$ 1,729
Deferred offering costs recorded in accounts payable	$ 273	$

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

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Fox Factory Holding Corp.

Notes to Condensed Consolidated Financial Statements

(unaudited)

1. Description of Business and Basis of Presentation

Fox Factory Holding Corp. (the Company) is a designer, manufacturer and marketer of high end suspension products for mountain bikes and powered vehicles, which includes all-terrain vehicles, snowmobiles and other off-road vehicles. The Company acts both as a tier one supplier to leading action sports original equipment manufacturers (OEM) and provides aftermarket products to retailers and distributors (AM).

Initial Public Offering On August 13, 2013, the Company completed the initial public offering (IPO) of its common stock pursuant to a registration statement on Form S-1. In the IPO, the Company sold 2,857,143 shares of common stock and the selling stockholders sold a total of 7,000,000 shares of common stock (including the shares sold pursuant to the exercise of the option granted to the underwriters) at an initial public offering price to the public of $15.00 per share. The Company received net proceeds from the IPO of approximately $36.1 million from its sale of 2,857,143 shares of common stock after deducting underwriting discounts and commissions and offering expenses. The Company did not receive any proceeds from the sale of shares by the selling stockholders. The Company used the net proceeds it received to pay down related party debt under its Prior Credit Facility (see Note 8 Debt).

Basis of Presentation The accompanying condensed consolidated financial statements are unaudited. These unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and applicable rules and regulations of the Securities and Exchange Commission (SEC) regarding interim financial reporting. 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. Accordingly, these interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements contained in the Company s Prospectus filed with the SEC pursuant to Rule 424(b) under the Securities Act of 1933, as amended (the Securities Act) on August 8, 2013 (the Prospectus). The condensed consolidated balance sheet as of December 31, 2012, included herein was derived from the audited consolidated financial statements as of that date, but does not include all disclosures required by GAAP, including notes to the financial statements.

The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and, in the opinion of management, include all adjustments (consisting primarily of normal recurring adjustments) necessary for the fair presentation of the interim periods presented.

Principles of Consolidation These condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

2. Summary of Significant Accounting Policies

Use of Estimates The preparation of the Company s condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. These estimates are based on information available as of the date of the financial statements; therefore, actual results could differ from management s estimates.

Certain Significant Risks and Uncertainties The Company is subject to those risks common in manufacture-driven markets, including, but not limited to, competitive forces, dependence on key personnel, customer demand for its products, the successful protection of its proprietary technologies, compliance with government regulations, and the possibility of not being able to obtain additional financing when needed.

Concentration of Credit Risk Financial instruments, which potentially subject the Company to significant concentrations of credit risk, consist primarily of cash and accounts receivable. A significant portion of the Company s cash is held at one large financial institution. The Company has not experienced any losses in such accounts.

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The Company mitigates its credit risk with respect to accounts receivable by performing ongoing credit evaluations and monitoring of its customers accounts receivable balances. The following customers accounted for 10% or more of the Company s accounts receivable balance:

	As of September 30, 2013	As of December 31, 2012
Customer A	18%	13%
Customer B	11%	12%
Customer C	12%	11%

The following customers accounted for 10% or more of total sales:

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Customer A	17%	11%	18%	13%
Customer B	*	11%	*	*

* Represents less than 10%

The Company depends on a limited number of vendors to supply component parts for its products. The Company purchased approximately 54 % and 57% of its product components for the three months ended September 30, 2013 and 2012, respectively, from ten vendors. The Company purchased approximately 53% and 56% of its product components for the nine months ended September 30, 2013 and 2012, respectively, from ten vendors. At September 30, 2013 and December 31, 2012 amounts due to these vendors represented approximately 45% and 43% of accounts payable, respectively.

Warranties The Company offers limited warranties on its products for one to two years. The Company recognizes estimated costs related to warranty activities as a component of cost of sales upon product shipment. The estimates are based upon historical product failure rates and historical costs incurred in correcting product failures. The recorded amount is adjusted from time to time for specifically identified warranty exposures. Actual warranty expenses are charged against the Company s estimated warranty liability when incurred. Factors that affect the Company s liability include the number of units, historical and anticipated rates of warranty claims, and the cost per claim.

3. Inventory

Inventory consisted of the following (in thousands):

	As of September 30, 2013	As of December 31, 2012
Raw materials	$ 33,177	$ 25,822
Work-in-process	2,058	1,460
Finished goods	11,158	6,973

Total inventory	$	46,393	$	34,255

4. Property and Equipment, net

Property and equipment consisted of the following (in thousands):

	As of September 30, 2013		As of December 31, 2012	
Machinery and manufacturing equipment	$	12,677	$	11,099
Office equipment and furniture		4,048		4,095
Transportation equipment		1,472		1,315
Leasehold improvements		5,287		4,729
Total		23,484		21,238
Accumulated depreciation and amortization		(10,944)		(9,449)
Net property and equipment	$	12,540	$	11,789

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Depreciation and amortization expense of property and equipment was approximately $0.6 million and $0.5 for the three months ended September 30, 2013 and 2012, respectively, and approximately $1.7 million and $1.3 million for the nine months ended September 30, 2013 and 2012, respectively.

5. Intangible Assets, net

Intangible assets, excluding goodwill, are comprised of the following (dollars in thousands):

	Gross carrying amount	Accumulated amortization	Net carrying amount	Weighted average life (years)
September 30, 2013:				
Customer relationships OEM	$ 7,400	$ (3,546)	$ 3,854	11
Customer relationships AM	4,300	(3,091)	1,209	7
Core technology	32,500	(23,359)	9,141	7
Patents	835	(209)	626	5
Total	45,035	(30,205)	14,830	
Trademarks, not subject to amortization			13,300	
Total			$ 28,130	
December 31, 2012:				
Customer relationships OEM	$ 7,400	$ (3,083)	$ 4,317	11
Customer relationships AM	4,300	(2,688)	1,612	7
Core technology	32,500	(20,313)	12,187	7
Patents	835	(98)	737	5
Total	45,035	(26,182)	18,853	
Trademarks, not subject to amortization			13,300	
Total			$ 32,153	

Amortization of intangibles was approximately $1.3 million and $1.3 million for the three months ended September 30, 2013 and 2012, respectively and $4.0 million and $4.0 million for the nine months ended September 30, 2013 and 2012, respectively.

6. Accrued Expenses

Accrued expenses consisted of the following (in thousands):

	As of September 30, 2013	As of December 31, 2012
Payroll and related expenses	$ 5,866	$ 5,256

Warranty	4,172	4,582
Related party Compass(1)		292
Income tax payable	1,999	9
Other accrued expenses	15	17
Total	$ 12,052	$ 10,156

(1) Amount relates to interest and management fees payable to Compass.

The Company s warranty liability is included as a component of accrued liabilities in the condensed consolidated balance sheets. Activity related to warranties is as follows (in thousands):

	For the three months ended September 30,		**For the nine months ended September 30,**	
	2013	**2012**	**2013**	**2012**
Beginning warranty liability	$ 3,995	$ 2,857	$ 4,582	$ 2,799
Charge to cost of sales	1,432	1,948	3,119	3,377
Costs incurred	(1,255)	(872)	(3,529)	(2,243)
Ending warranty liability	$ 4,172	$ 3,933	$ 4,172	$ 3,933

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7. Related Party Transactions

During fiscal year 2008, the Company entered into a credit agreement with its majority stockholder, Compass Group Diversified Holdings LLC, (Compass) which provided a revolving line of credit facility and a term loan facility (Prior Credit Facility). Amounts outstanding under the Prior Credit Facility were $0 and $59.3 million as of September 30, 2013 and December 31, 2012, respectively. Interest expense on the Prior Credit Facility was approximately $0.5 million and $1.3 million for the three months ended September 30, 2013 and 2012, respectively and $2.2 million and $1.8 million for the nine months ended September 30, 2013 and 2012, respectively. In addition, there were annual management fees of $0.1 million paid to an affiliate of Compass for the three months ended September 30, 2013 and 2012 and $0.3 million and $0.4 million for the nine months ended September 30, 2013 and 2012, respectively. In August 2013, the Company repaid all loans to the majority stockholder and cancelled the management fee arrangement.

Fox Factory, Inc. has a triple-net building lease for its manufacturing and office facilities in Watsonville, California. The building is owned by Robert Fox, a founder, director, and minority stockholder of the Company. The term of the lease ends June 30, 2018, with monthly rental payments, which are adjusted annually for a cost-of-living increase based upon the consumer price index. Rent expense under this lease was $0.3 million and $0.3 million for each of the three months ended September 30, 2013 and 2012, respectively, and $0.9 million and $0.8 million for the nine months ended September 30, 2013 and 2012, respectively.

8. Debt

2013 Credit Facility

In the third quarter of 2013, in connection with its IPO, the Company entered into a new revolving credit facility with SunTrust Bank and the other lenders named therein (2013 Credit Facility) and borrowed $28.5 million thereunder. Of such borrowings, $21.6 million was used to pay off the Company s remaining indebtedness that was then due under the Prior Credit Facility, and the remaining amount of such borrowings was used to pay IPO related fees and expenses and provide additional working capital.

The 2013 Credit Facility provides for interest at a rate based on the London Interbank Offered Rate, or LIBOR, plus a margin ranging from 1.50% to 2.50%, or based on the prime rate offered by SunTrust Bank plus a margin ranging from 0.50% to 1.50%. The 2013 Credit Facility is secured, subject to permitted liens and other agreed upon exceptions, by a first-priority lien on and perfected security interest in substantially all of the Company s and its subsidiary s assets including accounts receivable and a pledge of the equity in its operating subsidiary. In addition, the 2013 Credit Facility requires that the Company satisfy a maximum total leverage ratio and a fixed charge coverage ratio. The 2013 Credit Facility contains customary representations and warranties and customary events of default, as well as certain affirmative and negative covenants, including restrictions on: indebtedness; liens; mergers, consolidations and acquisitions; sales of assets; engaging in business other than our current business and those reasonably related thereto; investments; dividends; redemptions and distributions; affiliate transactions; and other restrictions. The Company was in compliance with the covenants of the 2013 Credit Facility as of September 30, 2013. The balance at September 30, 2013 was classified as a long-term liability based on the maturity date of the 2013 Credit Facility.

The following table summarizes the 2013 Credit Facility (dollars in thousands):

		As of September 30, 2013
Amount outstanding	$	24,500
Available borrowing capacity	$	35,500
Maximum borrowing capacity	$	60,000
Interest rate at period end		2.13%
Maturity date		August 7, 2018

Prior Credit Facility Repayment

During fiscal year 2008, the Company entered into the Prior Credit Facility with its majority stockholder, Compass. At December 31, 2012, the Prior Credit Facility, as amended, provided for a $30 million revolving line of credit and Term A loan borrowings of $60.0 million at a fluctuating interest rate between 3.50% and 5.50% above either LIBOR or the Prime Rate, respectively, whichever was more favorable for the Company. The Company s obligations under the Prior Credit Facility with Compass were collateralized by the Company s right, title and interest in the Company s net assets except for certain excluded intangible assets as defined in the collateral agreement with Compass.

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In August 2013, in connection with its IPO and entering into the 2013 Credit Facility, the Company repaid all indebtedness due under the Prior Credit Facility and the Prior Credit Facility was terminated. In connection with terminating the Prior Credit Facility, the Company recognized in the third quarter of 2013 a non-cash expense of approximately $1.4 million related to unamortized loan origination costs.

Amounts outstanding under the Prior Credit Facility consisted of the following (in thousands):

	As of September 30, 2013		As of December 31, 2012	
Line of credit	$		$	750
Term A Loan	$		$	58,500
Less current portion				(3,000)
Long-term debt less current portion	$		$	55,500

The Prior Credit Facility contained financial covenants, with which the Company was in compliance as of agreement termination in August 2013 and at December 31, 2012. The line of credit carried an interest rate of 6.75% as of December 31, 2012. The balance under the line of credit at December 31, 2012 was classified as a long term liability as the maturity date was June 18, 2018.

9. Commitments and Contingencies

Operating Leases The Company has operating lease agreements for office, research and development, and sales and marketing space that expire at various dates. The Company recognizes rent expense on a straight-line basis over the lease term and records the difference between cash rent payments and the recognition of rent expense as a deferred rent liability. Rent expense was $0.7 million and $0.7 million for the three months ended September 30, 2013 and 2012, respectively and $2.0 million and $2.0 million for the nine months ended September 30, 2013 and 2012, respectively. See Note 7, for additional information on related party operating leases.

Indemnification Agreements In the ordinary course of business, the Company may provide indemnifications of varying scope and terms to customers, vendors, lessors, business partners, and other parties with respect to certain matters, including, but not limited to, losses arising out of breach of such agreements, services to be provided by the Company or from intellectual property infringement claims made by third parties. In addition, the Company has entered into indemnification agreements with directors and certain officers and employees that will require the Company, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors, officers or employees. While the outcome of these matters cannot be predicted with certainty, the Company does not believe that the outcome of any claims under indemnification arrangements will have a material effect on the Company s condensed consolidated balance sheet, condensed consolidated statement of income, condensed consolidated statement of comprehensive income, or condensed consolidated statement of cash flows.

10. Stock-Based Compensation

Equity Incentive Plans The Company has outstanding awards under the following equity incentive plans: the 2008 Stock Option Plan (the 2008 Plan), the 2008 Non-Statutory Stock Option Plan (the 2008 Non Statutory Plan) and the

2013 Omnibus Plan, (the 2013 Plan). All outstanding stock awards under the 2008 Plan and 2008 Non Statutory Plan will continue to be governed by their existing terms. No further awards will be granted pursuant to the 2008 Plan or the 2008 Non Statutory Plan. Under the 2013 Plan, the Company has the ability to issue incentive stock options (ISOs), non-statutory stock options (NSOs), stock appreciation rights, restricted stock awards (RSAs), restricted stock units (RSUs), performance units and/or performance shares.

The equity incentive plans are administered by the board of directors (Board) of the Company or, if established by the Board, the Compensation Committee of the Board, which has the authority to determine the type of incentive award, as well as the terms and conditions of the awards, including (i) the number of shares of common stock subject to the award; (ii) when the award becomes exercisable; (iii) the award s exercise price (if applicable); and (iv) the duration of the award. Awards have various vesting schedules. Options granted under the plans have vesting periods ranging from one to five years and expire no later than 10 years from the date of grant. RSUs generally vest over a four-year period with 25% vesting at the end of one year and the remaining vesting annually thereafter.

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Restricted Stock Units The Company began granting RSUs to its employees and directors in August 2013. The cost of the RSUs is determined using the fair value of the Company s common stock on the date of grant. Stock-based compensation expense is amortized on a straight-line basis over the requisite service period.

The Company granted 504,669 RSUs during the three and nine months ended September 30, 2013. The Company recorded stock-based compensation expense related to RSUs of approximately $0.3 million and for the three and nine months ended September 30, 2013, respectively. As of September 30, 2013, the Company had approximately $8.5 million of unrecognized stock-based compensation expense related to RSUs, which will be recognized over the remaining weighted-average vesting period of approximately 3.7 years.

Stock Option Plans Stock option activity under the Plans was as follows:

	Number of shares outstanding	Weighted-average exercise price	Weighted average remaining contractual life (years)	Aggregate intrinsic value (in thousands)
Balance at December 31, 2012	2,501,885	$ 4.88	9	$ 6,828
Options granted (weighted average fair value of $2.59 per share)	9,290	7.59		
Balance at September 30, 2013	2,511,175	$ 4.88	8	$ 35,841
Options vested and expected to vest September 30, 2013	2,511,175	$ 4.88	8	$ 35,841
Options exercisable September 30, 2013	1,401,299	$ 4.38	8	$ 20,867

Aggregate intrinsic value represents the difference between the closing price of the Company s common stock on the Nasdaq Stock Exchange and the exercise price of outstanding, in-the-money options. The total intrinsic value of options exercised was approximately $11.3 million for the nine months ended September 30, 2012.

Valuation Assumptions The fair value of options on the date of grant is estimated using the Black-Scholes option-pricing model using the single-option award approach with the weighted average assumptions set forth below. The Company estimates the expected term of options granted by taking the average of the vesting term and the contractual term of the option. Estimated volatilities are based on an analysis of comparable companies and the Company s leverage. The Company bases the risk-free interest rate on the implied yield currently available on U.S. Treasury strips maturing at the expected option term. Although the Company paid a dividend in 2012, the Company does not intend to pay cash dividends in the future, as such, expected dividends are zero. Expected forfeitures are based on the Company s historical experience.

The assumptions used to value stock options granted to employees and to members of the board of directors were as follows:

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	**2012**	**2013**	**2012**
Expected term (years)			5.5	5.5-6.5
Volatility			36%	35-36%
Risk-free interest rate			0.79%	0.61-1.36%
Dividend yield				

Stock-Based Compensation Stock based compensation expense consists of expenses for stock options and RSUs. The following table summarizes the allocation of stock-based compensation in the accompanying consolidated statements of income (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	**2012**	**2013**	**2012**
Cost of sales	$ 8	$	$ 16	$
Sales and marketing	38	44	114	115
Research and development	12	6	41	20
General and administrative	489	331	1,504	1,598
Total	$ 547	$ 381	$ 1,675	$ 1,733

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11. Earnings Per Share

Earnings Per Share Basic earnings per share is computed by dividing net income for the period by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income for the period by the weighted average number of shares of common stock and potentially dilutive common stock outstanding during the period. Potentially dilutive common shares include shares issuable upon the exercise of outstanding stock options and RSUs, which are reflected in diluted earnings per share by application of the treasury stock method.

The following table presents the calculation of basic and diluted earnings per share (in thousands except earnings per share):

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	**2012**	**2013**	**2012**
Net income	$ 9,924	$ 5,469	$ 19,195	$ 12,425
Weighted average shares used to compute basic earnings per share	35,013	33,465	33,983	31,588
Dilutive effect of employee stock plans	1,410	253	1,125	318
Weighted average shares used to compute diluted earnings per share	36,423	33,718	35,108	31,906
Earnings per share:				
Basic	$ 0.28	$ 0.16	$ 0.56	$ 0.39
Diluted	$ 0.27	$ 0.16	$ 0.55	$ 0.39

The Company did not exclude any potentially dilutive shares from the calculation of diluted earnings per share for the three months ended September 30, 2013 or the nine months ended September 30, 2013 and 2012, as none of these shares would have been antidilutive. The Company excluded 99,000 options from the calculation for the three months ended September 30, 2012, as they were antidilutive.

12. Income Taxes

The provision for income taxes for the three months ended September 30, 2013 and 2012 was $2.9 million and $4.1 million, respectively. Effective tax rates were 22.4% and 42.8% for the three months ended September 30, 2013 and 2012, respectively. The provision for income taxes for the nine months ended September 30, 2013 and 2012 was $7.8 million and $7.1 million, respectively. Effective tax rates were 29.0% and 36.5% for the nine months ended September 30, 2013 and 2012, respectively. The decrease in the effective tax rates for the three and nine months ended September 30, 2013 were primarily caused by a benefit in the three months ended September 30, 2013, from the expiration of the statute of limitations that allowed the Company to release a liability for unrecognized tax benefits relating to the uncertainty of amortization and depreciation expenses which were incurred from Compass acquisition of the Company in 2008.

13. Segments

The Company has determined that it has a single operating and reportable segment. The Company considers operating segments to be components of the Company in which separate financial information is available that is evaluated regularly by the Company s chief operating decision maker in deciding how to allocate resources and in assessing performance. The chief operating decision maker for the Company is the Chief Executive Officer. The Chief Executive Officer reviews financial information presented on a consolidated basis for purposes of allocating resources and evaluating financial performance. The following table summarizes total sales generated by geographic location of the customer (in thousands):

	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
United States	$ 27,005	$ 22,498	$ 72,358	$ 64,263
International	55,288	50,366	135,129	114,993
Total Sales	$ 82,293	$ 72,864	$ 207,487	$ 179,256

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The Company s long-lived assets by geographic location are as follows:

	September 30, 2013	December 31, 2012
United States	$ 11,761	$ 11,429
International	779	360
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