SolarWinds, Inc.
Form 10-Q
August 06, 2014

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

or

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

For the transition period from to

Commission File Number: 001-34358

SOLARWINDS, INC.
(Exact name of registrant as specified in its charter)

Delaware	73-1559348
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

7171 Southwest Parkway
Building 400
Austin, Texas 78735
(512) 682.9300
(Address and telephone number of principal executive offices)

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. ý Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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). ý Yes ¨ No

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

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

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

On August 4, 2014, 75,392,696 shares of common stock, par value $0.001 per share, were outstanding.

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Safe Harbor Cautionary Statement

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and the Private Securities Litigation Reform Act of 1995. Such statements may be signified by terms such as “believes,” “continues,” “expects,” “intends,” “may,” “could,” “shoul “will,” “would” or similar expressions and the negatives of those terms. In this report, forward-looking statements include statements regarding our financial projections, future financial performance and plans and objectives for future operations including, without limitation, the following:

- expectations regarding our plans and strategies to grow our business and expand our market presence, including internationally;
- expectations regarding our financial condition and results of operations, including revenue, operating income, non-GAAP operating margin, cash flows and effective income tax rate;
- expectations regarding our international earnings and investment of those earnings in international operations;
- expectations concerning the integration of acquisitions;
- expectations concerning future acquisitions;
- our market opportunities and our ability to take advantage of such market opportunities, the demand for IT management products in various markets and factors contributing to such demand;
- our sales and marketing efforts and our expectations about the results of those efforts;
- expectations regarding investment plans and our expectations about the results of those efforts;
- expectations regarding our capital expenditures;
- our research and development plans;
- our equity compensation plans and practices;
- our future borrowings and our beliefs regarding the sufficiency of our cash and cash equivalents, cash flows from operating activities and borrowing capacity; and
- expectations regarding the outcome of legal proceedings in which we are involved.

Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially and adversely different from any future results, performance or achievements expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, the following: (a) the inability to generate significant volumes of sales leads from Internet search engines, marketing campaigns and traffic to our websites; (b) the inability to expand our sales operations effectively; (c) the inability to increase sales to existing customers and to attract new customers; (d) SolarWinds' ability to successfully identify, complete, and integrate acquisitions; (e) the possibility that general economic conditions or uncertainty cause information technology spending to be reduced or purchasing decisions to be delayed; (f) the timing and success of new product introductions and product upgrades by SolarWinds or its competitors; (g) the presence or absence of occasional large customer orders, including in particular those placed by the U.S. federal government; (h) the possibility that our operating income could fluctuate and may decline as a percentage of revenue as we make further expenditures to expand our operations in order to support additional growth in our business; (i) potential foreign exchange gains and losses related to expenses and sales denominated in currencies other than the functional currency of an associated entity; and (j) such other risks and uncertainties described more fully under Risk Factors and Management’s Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the year ended December 31, 2013 and our quarterly reports on Form 10-Q and other documents we file with the Securities and Exchange Commission ("SEC"). Given these risks and uncertainties, you should not place undue reliance on these forward-looking statements. Also, forward-looking statements represent our management’s beliefs and assumptions only as of the date of this quarterly report on Form 10-Q. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially and adversely from those anticipated in these forward-looking statements, even if new information becomes available in the future.

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PART I: FINANCIAL INFORMATION
Item 1. Financial Statements
SolarWinds, Inc.
Condensed Consolidated Balance Sheets
(In thousands, except share and per share information)
(Unaudited)

	June 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$187,217	$165,973
Short-term investments	14,911	19,327
Accounts receivable, net of allowances of $809 and $473 as of June 30, 2014 and December 31, 2013, respectively	41,785	45,694
Income tax receivable	1,010	1,535
Deferred taxes	8,415	5,410
Prepaid and other current assets	7,274	4,846
Total current assets	260,612	242,785
Property and equipment, net	22,329	9,213
Long-term investments	5,144	11,012
Deferred taxes	549	478
Goodwill	372,980	317,054
Intangible assets and other, net	121,684	125,800
Total assets	$783,298	$706,342
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$5,605	$7,187
Accrued liabilities and other	30,774	17,716
Income taxes payable	1,913	563
Current portion of deferred revenue	137,795	128,328
Current debt obligation	40,000	40,000
Total current liabilities	216,087	193,794
Long-term liabilities:		
Deferred revenue, net of current portion	8,346	6,863
Non-current deferred taxes	6,072	4,975
Other long-term liabilities	22,735	16,816
Total liabilities	253,240	222,448
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock, $0.001 par value: 123,000,000 shares authorized and 75,425,742 and 75,009,620 shares issued and outstanding as of June 30, 2014 and December 31, 2013, respectively	75	75
Additional paid-in capital	252,589	236,481
Accumulated other comprehensive income	1,984	2,953
Accumulated earnings	275,410	244,385
Total stockholders' equity	530,058	483,894
Total liabilities and stockholders' equity	$783,298	$706,342

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

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SolarWinds, Inc.
Condensed Consolidated Statements of Income
(In thousands, except per share information)
(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Revenue:				
License	$37,636	$31,217	$73,987	$61,942
Maintenance and other	58,035	45,373	112,956	87,558
Subscription	5,833	929	10,470	929
Total revenue	101,504	77,519	197,413	150,429
Cost of license revenue	4,112	2,856	8,221	5,617
Cost of maintenance and other revenue	3,875	2,766	7,331	5,636
Cost of subscription revenue	2,911	535	5,374	535
Gross profit	90,606	71,362	176,487	138,641
Operating expenses:				
Sales and marketing	35,254	20,276	69,234	40,576
Research and development	13,883	8,218	28,023	16,064
General and administrative	23,263	11,554	39,192	21,375
Total operating expenses	72,400	40,048	136,449	78,015
Operating income	18,206	31,314	40,038	60,626
Other income (expense):				
Interest income	83	110	161	233
Interest expense	(216)	—	(435)	—
Other income (expense), net	13	(340)	208	(491)
Total other income (expense)	(120)	(230)	(66)	(258)
Income before income taxes	18,086	31,084	39,972	60,368
Income tax expense	4,707	8,287	8,947	14,572
Net income	$13,379	$22,797	$31,025	$45,796
Net income per share:				
Basic earnings per share	$0.18	$0.30	$0.41	$0.61
Diluted earnings per share	$0.18	$0.30	$0.41	$0.60
Weighted-average shares used to compute net income per share:				
Shares used in computation of basic earnings per share	75,411	75,250	75,308	75,117
Shares used in computation of diluted earnings per share	76,296	76,592	76,245	76,625

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

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SolarWinds, Inc.
Condensed Consolidated Statements of Comprehensive Income
(In thousands)
(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Net income	$13,379	$22,797	$31,025	$45,796
Other comprehensive income (loss):				
Foreign currency translation adjustment	(927)	901	(974)	(1,411)
Unrealized gains (losses) on investments, net of income tax expense (benefit) of $2 and $(65) for the three months ended June 30, 2014 and 2013, respectively and $3 and $(41) for the six months ended June 30, 2014 and 2013, respectively	3	(121)	5	(76)
Other comprehensive income (loss)	(924)	780	(969)	(1,487)
Comprehensive income	$12,455	$23,577	$30,056	$44,309

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

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SolarWinds, Inc.
Condensed Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Six months ended June 30,	
	2014	2013
Cash flows from operating activities		
Net income	$31,025	$45,796
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	17,722	10,876
Provision for doubtful accounts	473	127
Stock-based compensation expense	18,799	11,542
Deferred taxes	(4,492)	(2,874)
Excess tax benefit from stock-based compensation	(3,401)	(6,246)
Premium on investments	—	(613)
Other non-cash expenses	1,133	738
Changes in operating assets and liabilities, net of assets acquired and liabilities assumed in business combinations:		
Accounts receivable	3,524	(101)
Income taxes receivable	3,078	(36)
Prepaid and other assets	(2,574)	405
Accounts payable	(1,857)	(686)
Accrued liabilities and other	12,116	(5,049)
Income taxes payable	1,017	7,073
Deferred revenue	10,638	10,409
Other long-term liabilities	6,343	238
Net cash provided by operating activities	93,544	71,599
Cash flows from investing activities		
Purchases of investments	—	(17,288)
Maturities of investments	10,015	31,495
Purchases of property and equipment	(14,316)	(1,746)
Purchases of intangible assets	(185)	(171)
Acquisition of businesses, net of cash acquired	(63,996)	(120,868)
Net cash used in investing activities	(68,482)	(108,578)
Cash flows from financing activities		
Repurchase of common stock	(9,844)	(4,499)
Exercise of stock options	4,128	5,390
Excess tax benefit from stock-based compensation	3,401	6,246
Net cash provided by (used in) financing activities	(2,315)	7,137
Effect of exchange rate changes on cash and cash equivalents	(1,503)	(966)
Net increase (decrease) in cash and cash equivalents	21,244	(30,808)
Cash and cash equivalents		
Beginning of period	165,973	179,702
End of period	$187,217	$148,894
Supplemental disclosure of cash flow information		
Cash paid for interest	$330	$—
Cash paid for income taxes	$8,940	$10,223
Non-cash investing transactions		
Purchases of property and equipment included in accrued liabilities	$486	$—

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

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SolarWinds, Inc.
Notes to Condensed Consolidated Financial Statements (Unaudited)
1. Summary of Significant Accounting Policies
Organization and Nature of Operations
SolarWinds, Inc., a Delaware corporation, and its subsidiaries (“we” or “us”) design, develop, market, sell and support enterprise-class information technology, or IT, infrastructure management software to IT professionals in organizations of all sizes. Our product offerings range from individual software tools to more comprehensive software products that solve problems encountered every day by IT professionals. Our products are designed to help IT professionals efficiently and effectively manage their networks, systems and application infrastructure.
Basis of Presentation
We prepared our interim condensed consolidated financial statements in conformity with United States of America generally accepted accounting principles, or GAAP, and the reporting regulations of the Securities and Exchange Commission, or the SEC. They do not include all of the information and footnotes required by GAAP for complete financial statements. The accompanying condensed consolidated financial statements include our accounts and the accounts of our wholly owned subsidiaries. We have eliminated all intercompany balances and transactions.
We have made estimates and judgments affecting the amounts reported in our condensed consolidated financial statements and the accompanying notes. The actual results that we experience may differ materially from our estimates. The accounting estimates that require our most significant, difficult and subjective judgments include:

- the valuation of goodwill, intangibles, long-lived assets and contingent consideration, including accrued earnouts;
- revenue recognition;
- stock-based compensation;
- income taxes; and
- loss contingencies.

The interim financial information is unaudited, but reflects all normal adjustments that are, in our opinion, necessary to provide a fair statement of results for the interim periods presented. This interim information should be read in conjunction with the audited consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2013.
Certain reclassifications have been made to prior periods' financial statements to conform to the current period presentation. These reclassifications did not result in any change in previously reported net income, total assets or shareholders' equity.
Recent Accounting Pronouncements
In May 2014, the Financial Accounting Standards Board, or FASB, and the International Accounting Standards Board, or IASB, issued a converged standard to provide updated guidance on recognizing revenue from contracts with customers. The new guidance replaces the existing revenue recognition guidance under GAAP including most industry-specific guidance, including the software revenue recognition guidance that we currently follow. The new guidance includes a five-step process for companies to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In addition, the standard enhances the disclosure requirements regarding revenue and specifies the accounting for some costs to obtain or fulfill a contract with a customer. The updated accounting guidance is effective for interim and annual periods beginning after December 15, 2016. Early adoption is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. We will adopt the updated guidance in the first quarter of fiscal year 2017. We are still evaluating transition methods and the impact of the new revenue recognition guidance.
Fair Value Measurements
We apply the authoritative guidance on fair value measurements for financial assets and liabilities that are measured at fair value on a recurring basis and non-financial assets and liabilities, such as goodwill, intangible assets and property, plant and equipment that are measured at fair value on a non-recurring basis.

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The guidance establishes a three-tiered fair value hierarchy that prioritizes inputs to valuation techniques used in fair value calculations. The three levels of inputs are defined as follows:

Level 1: Unadjusted quoted prices for identical assets or liabilities in active markets accessible by us.

Level 2: Inputs that are observable in the marketplace other than those inputs classified as Level 1.

Level 3: Inputs that are unobservable in the marketplace and significant to the valuation.

We determine the fair value of our available-for-sale securities based on inputs obtained from multiple pricing vendors, who may use quoted prices in active markets for identical assets (Level 1 inputs) or inputs other than quoted prices that are observable either directly or indirectly (Level 2 inputs) in determining fair value. However, we classify all of our available-for-sale securities as being valued using Level 2 inputs. The valuation techniques used to determine the fair value of our financial instruments having Level 2 inputs are derived from unadjusted, non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models. Our procedures include controls to ensure that appropriate fair values are recorded by a review of the valuation methods and assumptions.

See Note 4 for a summary of our financial instruments accounted for at fair value on a recurring basis. The carrying amounts reported in our condensed consolidated balance sheets for cash, accounts receivable, accounts payable and other accrued expenses approximate fair value due to relatively short periods to maturity.

Accumulated Other Comprehensive Income (Loss)

Changes in accumulated other comprehensive income by component for the six months ended June 30, 2014 are summarized below:

(in thousands)	Unrealized Gain on Available-for-Sale Investments, net of tax	Foreign Currency Translation Adjustments	Accumulated Other Comprehensive Income
Balance at December 31, 2013	$ 12	$2,941	$2,953
Other comprehensive gain (loss) before reclassification	5	(974)	(969)
Amount reclassified from accumulated other comprehensive income (loss)	—	—	—
Net current period other comprehensive income (loss)	5	(974)	(969)
Balance at June 30, 2014	$ 17	$1,967	$1,984

2. Acquisitions

Pingdom Acquisition

In June 2014, we acquired Pingdom AB, or Pingdom, a provider of website monitoring and performance management solutions, for closing cash consideration of approximately $67.3 million in cash, including $3.1 million of cash acquired. The acquisition increased our product offerings and we believe will allow us to leverage the opportunity associated with performance management for critical websites and web applications. The acquisition was financed with available cash and we incurred $1.4 million in acquisition related costs, which are included in general and administrative expense for the three months ended June 30, 2014. The weighted average amortization period for the intangible assets is 4.8 years. Goodwill is not deductible for tax purposes.

The initial determination of the fair value of the assets acquired and liabilities assumed, which includes approximately $56.0 million of goodwill and $11.2 million of intangible assets, is based on a preliminary valuation and the estimates and assumptions for these items are subject to change as we obtain additional information during the measurement period. Subsequent changes to the purchase price or other fair value adjustments determined during the measurement period will be recorded as an adjustment to goodwill.

The amounts of revenue and net loss related to the Pingdom acquisition included in our condensed consolidated financial statements from the effective date of the acquisition for the three months ended June 30, 2014 are insignificant. We recognize revenue on the acquired products in accordance with our revenue recognition policy as described in Note 1 in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. Pro forma information for the acquisition has not been provided because the impact of the historical financials on our revenue, net income and earnings per share is not material.

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The following table reflects the changes in goodwill for the six months ended June 30, 2014:

(in thousands)	
Balance at December 31, 2013	$317,054
Acquisitions	55,969
Foreign currency translation and other adjustments	(43)
Balance at June 30, 2014	$372,980

Goodwill and indefinite-lived intangibles are assessed at the consolidated level for impairment in the fourth quarter of each year or more frequently if events or changes in circumstances indicate that impairment may exist. We evaluate long-lived assets, including identifiable definite-lived intangibles and other assets, for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. As of June 30, 2014, there were no indicators of impairment identified as a result of our review of events and circumstances related to our goodwill, indefinite-lived intangible assets or long-lived assets.

3. Investments

Our cash and cash equivalents as of June 30, 2014 and December 31, 2013 consisted of demand deposit accounts and money market funds. The following table summarizes our cash and cash equivalents:

(in thousands)	June 30, 2014	December 31, 2013
Demand deposit accounts	$122,092	$128,630
Money market funds	65,125	37,343
Total cash and cash equivalents	$187,217	$165,973

Our short-term and long-term investments as of June 30, 2014 and December 31, 2013 consisted of available-for-sale securities, such as corporate bonds and municipal bonds. The following table summarizes our short-term and long-term available-for-sale securities as of June 30, 2014 and December 31, 2013:

	June 30, 2014				December 31, 2013			
(in thousands)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Short-term investments:								
Available-for-sale securities:								
Corporate bonds	$13,869	$17	$—	$13,886	$18,257	$21	$—	$18,278
Municipal bonds	1,025	—	—	1,025	1,048	1	—	1,049
Total short-term investments	$14,894	$17	$—	$14,911	$19,305	$22	$—	$19,327
Long-term investments:								
Available-for-sale securities:								
Corporate bonds	$5,136	$8	$—	$5,144	$11,015	$8	$(11)	$11,012
Total long-term investments	$5,136	$8	$—	$5,144	$11,015	$8	$(11)	$11,012

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The following table summarizes the fair value of our available-for-sale securities with unrealized losses aggregated by type of investment instrument and length of time those securities have been in a continuous unrealized loss position:

(in thousands)	Less Than 12 Months Fair Value	Less Than 12 Months Gross Unrealized Losses	12 Months or Greater Fair Value	12 Months or Greater Gross Unrealized Losses	Total Fair Value	Total Gross Unrealized Losses
As of December 31, 2013						
Corporate bonds	$6,104	$(11)	$—	$—	$6,104	$(11)
	$6,104	$(11)	$—	$—	$6,104	$(11)

There were no available-for-sale securities with unrealized losses at June 30, 2014.

The following table summarizes the contractual underlying maturities of our available-for-sale securities as of June 30, 2014:

(in thousands)	Cost	Fair Value
Due in one year or less	$14,894	$14,911
Due after one year through five years	5,136	5,144
	$20,030	$20,055

4. Fair Value Measurements

The following table summarizes the fair value of our financial assets that were measured on a recurring basis as of June 30, 2014 and December 31, 2013. We did not have any financial liabilities as of June 30, 2014 or December 31, 2013.

	Fair Value Measurements at June 30, 2014 Using				Fair Value Measurements at December 31, 2013 Using			
(in thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:								
Cash equivalents:								
Money market funds	$65,125	$—	$—	$65,125	$37,343	$—	$—	$37,343
Total cash equivalents	65,125	—	—	65,125	37,343	—	—	37,343
Short-term investments:								
Corporate bonds	—	13,886	—	13,886	—	18,278	—	18,278
Municipal bonds	—	1,025	—	1,025	—	1,049	—	1,049
Total short-term investments	—	14,911	—	14,911	—	19,327	—	19,327
Long-term investments:								
Corporate bonds	—	5,144	—	5,144	—	11,012	—	11,012
Total long-term investments	—	5,144	—	5,144	—	11,012	—	11,012
Total assets	$65,125	$20,055	$—	$85,180	$37,343	$30,339	$—	$67,682

There have been no transfers between fair value measurement levels during the six months ended June 30, 2014.

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5. Credit Agreement

On October 4, 2013, we entered into a Credit Agreement with a syndicated group of lenders that provides for an unsecured $125.0 million five-year revolving credit facility that is comprised of revolving loans and swingline loans. The credit facility includes a $30.0 million letter of credit sub-facility and a $15.0 million swingline sub-facility available on same-day notice. Available borrowings under the credit facility are reduced by the amount of any outstanding borrowings on the sub-facilities. We may also, subject to certain requirements, request an increase in the facility up to an additional $75.0 million for a maximum aggregate commitment of $200.0 million. The proceeds from the facility may be used for general corporate purposes, including, without limitation, to finance acquisitions.

Loans under the credit agreement will bear interest at either (i) the one-, three-, or six-month per annum London Interbank Offered Rate ("LIBOR"), multiplied by the statutory reserve adjustment plus a margin, based on our consolidated total leverage ratio, ranging from 1.25% and 2.00% or (ii) the base rate, which is defined as the highest of (a) the agent's prime rate, (b) the federal funds rate plus 0.50% or (c) LIBOR for a period of one month plus 1.00% plus a margin, based on our consolidated total leverage ratio, ranging from 0.25% to 1.00%. Commitment fees are payable quarterly in arrears at rates between 0.20% and 0.35% per year also based on our consolidated total leverage ratio. Subject to certain conditions stated in the Credit Agreement, we may borrow, prepay and re-borrow amounts under the revolving credit facility at any time during the term of the Credit Agreement.

Our obligations under the Credit Agreement are guaranteed by SolarWinds Worldwide, LLC, or SolarWinds Worldwide, our principal domestic operating subsidiary and our future domestic subsidiaries, subject to certain exceptions, pursuant to the guaranty agreement, dated as of October 4, 2013, by SolarWinds Worldwide in favor of and for the benefit of the lenders.

The Credit Agreement contains customary affirmative and negative covenants, including covenants that limit or restrict our ability to, among other things, incur indebtedness, grant liens, make investments, merge or consolidate, dispose of assets, pay dividends or make distributions, make acquisitions and enter into certain transactions with affiliates, in each case subject to customary exceptions for a credit facility of this size and type. We are also required to maintain compliance with a consolidated total leverage ratio and a consolidated interest coverage ratio.

On October 4, 2013, we borrowed $40.0 million at an interest rate of approximately 1.4% under a revolving loan under the Credit Agreement that was used to finance a portion of the consideration paid upon the acquisition of Confio Corporation, or Confio. On June 30, 2014, the borrowings remained outstanding under the facility and we were in compliance with all covenants associated with the Credit Agreement.

In August 2014, we repaid the $40.0 million of outstanding borrowings under a revolving loan under the Credit Agreement. The facility remains outstanding through the term of the agreement.

6. Earnings Per Share

We computed basic earnings per share using the weighted-average number of our common shares outstanding during the reporting period. We adjusted diluted earnings per share for the after-tax impact of incremental shares that would be available for issuance upon the assumed exercise of stock options and vesting of restricted stock units using the treasury stock method.

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A reconciliation of the number of shares in the calculation of basic and diluted earnings per share follows:

	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
(in thousands)				
Basic earnings per share				
Numerator:				
Net income	$13,379	$22,797	$31,025	$45,796
Denominator:				
Weighted-average common shares outstanding used in computing basic earnings per share	75,411	75,250	75,308	75,117
Diluted earnings per share				
Numerator:				
Net income	$13,379	$22,797	$31,025	$45,796
Denominator:				
Weighted-average shares used in computing basic earnings per share	75,411	75,250	75,308	75,117
Add options and restricted stock units to purchase common stock	885	1,342	937	1,508
Weighted-average shares used in computing diluted earnings per share	76,296	76,592	76,245	76,625

Dilution from assumed exercises of stock options and vesting of restricted stock units is dependent upon several factors, including the market price of our common stock. The following stock-based incentive awards were outstanding but were not included in the computation of diluted earnings per share because the average market price of the underlying stock did not exceed the sum of the exercise price, unrecognized compensation expense and the excess tax benefit and thus the results would have been antidilutive:

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2014	2013	2014	2013
Antidilutive shares	2,094	1,062	2,018	616

The calculation of diluted earnings per share requires us to make certain assumptions related to the use of proceeds that would be received upon the assumed exercise of stock options and vesting of restricted stock units. These assumed proceeds include the excess tax benefit that we receive upon assumed exercises of stock options and vesting of restricted stock units.

On July 29, 2013, we announced that our Board of Directors approved a share repurchase program, authorizing us to purchase up to $50.0 million of our outstanding common stock in the open market, including pursuant to a Rule 10b5-1 plan, or in privately negotiated transactions. During the six months ended June 30, 2014, we repurchased 0.1 million shares of our common stock for an aggregate purchase price of $5.4 million. Shares were retired upon repurchase. Our share repurchase program concluded on July 31, 2014.

7. Income Taxes

For the three months ended June 30, 2014 and 2013, we recorded income tax expense of $4.7 million and $8.3 million, respectively, resulting in an effective tax rate of 26.0% and 26.7%, respectively. For the six months ended June 30, 2014 and 2013, we recorded income tax expense of $8.9 million and $14.6 million, respectively, resulting in an effective tax rate of 22.4% and 24.1%, respectively. The decrease in the effective tax rate for the six months ended June 30, 2014 compared to the same period in 2013 was primarily attributable to an increase in international earnings as a percentage of total earnings, which are generally taxed at lower tax rates, partially offset by the expiration of the U.S. federal research and experimental tax credit.

We recognize interest and penalties related to unrecognized tax benefits in the provision for income taxes. In the three and six months ended June 30, 2014 and 2013, interest and penalties recorded were not significant. As of June 30, 2014, we had an insignificant amount accrued for interest and penalties related to unrecognized tax benefits.

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We file U.S., state and foreign income tax returns in jurisdictions with varying statutes of limitations. The 2008 through 2013 tax years generally remain open and subject to examination by federal and foreign tax authorities. The 2007 through 2013 tax years generally remain open and subject to examination by the state tax authorities. During the second quarter of 2014, we reached a final agreement with the U.S. Internal Revenue Service, or IRS, on tax matters related to the IRS's examination of the 2008, 2009 and 2010 tax years. As a result of this settlement with the IRS, we recorded an insignificant impact to the income tax provision and income tax liability during the second quarter of 2014. We are also under audit by the Indian Taxing Authority for the 2012 tax year. We are not currently under audit in any other taxing jurisdictions. We do not believe that it is reasonably possible that our unrecognized tax benefits will significantly change in the next twelve months.

8. Commitments and Contingencies

Leases

In April 2014, we moved into our new corporate headquarters in Austin, Texas, which has an initial lease term of thirteen years. In connection with the lease, the property owner provided a tenant improvement allowance of $8.0 million for leasehold improvements. In the initial year of the lease, our new facility will consist of approximately 172,000 square feet. We will occupy the remaining building space in the second year, which will increase our total square feet to approximately 230,000. Our base rent will be approximately $3.0 million in the first year and approximately $5.3 million in the second year with annual escalations of approximately 2.25% thereafter.

In the six months ended June 30, 2014, we received lease incentives of $7.1 million relating to tenant improvement allowances for leasehold improvements. The lease incentive liability will be amortized on a straight-line basis over the term of the lease as an offset to rent expense.

In May 2014, we ceased using our former corporate headquarters and recognized a loss in the second quarter of 2014 for the estimated fair value of our remaining obligation of $6.8 million. The lease abandonment costs are recorded in the condensed consolidated statements of income in general and administrative expenses.

Other Commitments

In connection with our acquisition of Pingdom, we will incur an additional $10.0 million of compensation expense contingent upon fulfillment of specified future employment conditions. The compensation expense will be recognized as general and administrative expense ratably over the requisite service period of twelve months and is expected to be paid in full during the second quarter of fiscal year 2015.

Legal Proceedings

From time to time, we have been and may be involved in various legal proceedings arising in our ordinary course of business. In the opinion of management, there was not at least a reasonable possibility we may have incurred a material loss, or a material loss in excess of a recorded accrual, with respect to loss contingencies. However, the outcome of litigation is inherently uncertain. Therefore, although management considers the likelihood of such an outcome to be remote, if one or more of these legal matters were resolved against us in the same reporting period for amounts in excess of management's expectations, our condensed consolidated financial statements could be materially adversely affected.

9. Subsidiary Guarantor

In November 2013, we filed an automatic shelf registration statement with the SEC, which enables us to offer and sell from time to time, in one or more offerings, an unspecified amount of common stock, preferred stock, depositary shares, debt securities, warrants, purchase contracts, purchase units or any combination thereof and is intended to give us flexibility to take advantage of financing opportunities as needed or deemed desirable in light of market conditions. Debt securities sold by us may be fully and unconditionally guaranteed on an unsecured basis by SolarWinds Worldwide. The guarantee is subject to release under certain customary circumstances. The indenture governing any debt securities that may be issued by SolarWinds, Inc. provides that the guarantees may be automatically and unconditionally released only upon the following circumstances: 1) the guarantor is sold or sells all of its assets in compliance with the terms of the indenture; and 2) the requirements under the terms of the indenture for defeasance or covenant defeasance or satisfaction and discharge have been satisfied. SolarWinds, Inc. has no independent assets or operations, and any other direct subsidiaries of SolarWinds, Inc. other than SolarWinds Worldwide are minor. The guarantee by SolarWinds Worldwide of any debt securities to be offered pursuant to the automatic shelf registration statement from time to time will be full and unconditional. There are no restrictions on the ability of SolarWinds,

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Inc. to obtain funds from SolarWinds Worldwide through dividends, loans or advances other than certain restrictions on intercompany indebtedness as set forth in the Credit Agreement.

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Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the Condensed Consolidated Financial Statements and related notes thereto included elsewhere in this quarterly report on Form 10-Q. In addition to historical condensed consolidated financial information, the following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially and adversely from those anticipated in the forward-looking statements. Please see the section entitled "Safe Harbor Cautionary Statement" above and the risk factors discussed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 for a discussion of the uncertainties, risks and assumptions associated with these statements.

Overview

We design, develop, market, sell and support powerful yet easy-to-use enterprise-class IT infrastructure management software to IT professionals in organizations of all sizes. Our product offerings range from individual software tools to more comprehensive software products that solve problems encountered every day by IT professionals and help to enable efficient and effective management of their network, systems and application infrastructure. Our products are ready-to-use, featuring intuitive and easily customized user interfaces and built-in workflows. Most of our products can be downloaded directly from our websites and installed and configured by our end-users in a matter of hours. Our customers include small- and mid-size businesses, large enterprises, managed service providers, and local, state and federal government entities that have purchased our products.

Key Financial Highlights

Key financial highlights for the first half of 2014 include the following:

- Total revenue was $197.4 million in the first half of 2014 compared to $150.4 million in the first half of 2013, representing an increase of 31.2%;
- Combined maintenance and subscription revenue in the first half of 2014 was $123.4 million compared to $88.5 million in the first half of 2013, representing 39.5% year-over-year growth in recurring revenue;
- Net income was $31.0 million in the first half of 2014 compared to $45.8 million in the first half of 2013, representing a decrease of 32.3%;
- Net income was $0.41 per share on a fully diluted basis for the first half of 2014 compared to $0.60 per share on a fully diluted basis for the first half of 2013, resulting in a decrease of 31.7%; and
- Cash flow from operating activities was $93.5 million in the first half of 2014 compared to $71.6 million in the first half of 2013, representing an increase of 30.6%.

In 2013 and the first half of 2014, we invested across our business and, in particular, in areas that we believe are an important foundation for our long term growth such as:

- We continued investing in product development allowing us to accelerate new product releases and enhancements for our products. We released key new versions of our network and systems and application management products, which continued to improve the usability and add features our customers rely on daily. We also built upon our managed service provider suite of products with the addition of N-able Help Desk Manager;
- We invested in brand awareness in markets that we have entered more recently, such as security and systems management, and geographies where we believe there exist key opportunities, like Germany, UK, Australia and Brazil. This investment was designed to place us front and center as companies search for information and solutions for their IT management challenges; and
- We invested in the expansion of our facilities and IT infrastructure to support the growth of our operations.

We are committed to our business model and have continued to focus on ways to leverage and refine our model. We have made investments in our business over the last several quarters and believe that we are beginning to see the impact of those efforts in the acceleration of total revenue. Our strategic focus in 2014 is centered around the following initiatives:

- Improving the competitive positioning of our products by investing in new product features and infrastructure;
- Acquiring and internally developing products that will expand our presence in our current markets or new markets;
- Expanding our web presence, brand awareness and improving our communication with prospects and our current

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customer base both domestically and internationally;

- Increasing our presence in several key geographic markets including Asia-Pacific, Latin America, Europe, Middle East and Africa by expanding our product portfolio, localizing marketing material and establishing new relationships with distributors and resellers;
- Accelerating the rate at which we are selling additional products into our install base; and
- Expanding our international operations company-wide at lower cost locations to drive our competitive advantage.

We expect to continue to generate solid growth while delivering strong operating income and to increase our cash flows from operating activities with our disciplined approach to investing in our business combined with our large market opportunity.

Acquisitions

We have made multiple acquisitions of businesses as part of our growth strategy and expect to continue to pursue acquisitions that will enable us to enter new markets, or new segments of our existing markets, by bringing new product offerings to market more quickly than we can develop them.

In the second quarter of 2014, we acquired Pingdom, a provider of website monitoring and performance management solutions. The acquisition increased our product offerings and we believe will allow us to leverage the opportunity associated with performance management for critical websites and web applications. Pingdom is based in Vasteras, Sweden.

We account for our acquisitions using the acquisition method of accounting. Accordingly, the financial results of our acquisitions are included in our condensed consolidated financial results since the applicable acquisition dates. See Note 2, Acquisitions, in the Notes to the Condensed Consolidated Financial Statements for additional details.

Key Business Metrics

We review a number of key business metrics to help us monitor the performance of our business model and to identify trends affecting our business. The measures that we believe are the primary indicators of our quarterly and annual performance are as follows:

Revenue Growth

Revenue growth includes the growth in our license, maintenance and subscription revenue, which are critical to our long-term success. We have employed a differentiated business model for marketing and selling high volumes of enterprise-class software, which is focused on revenue growth at high operating margins. We regularly review our total revenue growth to measure the success of our investments and strategic business decisions. We have built a financial and operational model that focuses on the long-term value of our customer relationships. After the initial new license or subscription purchase, our goal is to create opportunities for sales of additional products, license or subscription upgrades and renewal purchases from the customer. This is an important component of our financial model and future revenue growth. This model is based on the premise that we will be able to deliver ongoing value to our customers and maintain a long-term financial relationship with the users of our IT management products. Our recurring revenue, which consists of maintenance and subscription revenue, is reflective of the relationship we have built with our customers. Our revenue growth percentages were 31.2% and 21.6% for the first half of 2014 and 2013, respectively, as compared to the same periods of the previous years. We expect our total revenue growth to be approximately 25-27% for the fiscal year 2014.

Non-GAAP Operating Income and Non-GAAP Operating Margin

Our management uses non-GAAP operating income and non-GAAP operating margin as key measures of our performance. Because our non-GAAP operating income excludes certain items such as amortization of intangible assets, stock-based compensation and related employer-paid payroll taxes, certain acquisition related adjustments and restructuring charges that may not be indicative of our core business, we believe that this measure provides us with additional useful information to measure and understand our performance, particularly with respect to changes in performance from period to period. We use non-GAAP operating income and non-GAAP operating margin in the preparation of our budgets and to measure and monitor our performance. Non-GAAP operating income and non-GAAP operating margin is not determined in accordance with GAAP and is not a substitute for, or superior to, financial measures determined in accordance with GAAP. We increased our investments in the business in the last half of 2013 and during the first half of 2014 and we expect our non-GAAP operating margin to be approximately

42% for fiscal year 2014.
For further discussion regarding non-GAAP financial measures including non-GAAP operating income, see “Non-GAAP Financial Measures” below.

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Opportunities, Trends and Uncertainties

Businesses, governments and other organizations are increasingly relying on networks, systems, and applications to execute their operations, facilitate their internal and external communications and transact business with their customers and partners. The size of these networks, the number of applications and servers, and the complexity of physical and virtual server environments are increasing as organizations place more reliance on them. In addition, business initiatives to capture, store, and analyze an increasing amount of organizational data are creating new IT management challenges. Furthermore, the adoption of cloud computing technologies, which is shifting a growing number of critical workloads off premises, is also creating new IT management complexities and placing increasing importance on the performance of IT assets as compute resources become more distributed. The development and evolution of cloud computing technologies is also allowing a growing number of small and medium-sized organizations to rely upon third parties, known as managed service providers, or MSPs, for their IT management needs. These MSPs need powerful, yet easy-to-use and affordable solutions in order to address a wide range of IT management issues for the thousands of small and medium-sized organizations they serve.

In order to address these challenges, we offer a cohesive portfolio of powerful, yet easy-to-use and affordably priced IT management products spanning networks, systems, application and web performance management. This includes software that we have either developed or acquired that allows IT professionals to manage the performance, health, and configurations of network devices, firewalls, applications, websites and web applications, physical and virtual servers, storage devices, as well as software for log and security information management. It also includes software that provides IT professionals with mobile and remote access to their IT infrastructure and software to help them track and resolve IT issues along with their IT assets. Lastly, our portfolio includes a set of cloud-based remote monitoring and management products that allow MSPs to remotely access and address a broad range of IT issues faced by their customers in order to ensure the performance and security of their networks, desktops, servers, and other proprietary systems. We believe that IT-related trends and the limitations of existing offerings present a significant market opportunity for our products and starting in 2013, we began to increase our investment as a percentage of revenue to take advantage of this market opportunity. We expect our revenue to continue to grow as we capitalize on these and other market opportunities through acquisitions and development. Our ability to grow revenue will depend on a number of factors and assumptions, many of which are outside of our control. Further, any revenue growth and operating synergies of our acquired products and businesses depends on our ability to successfully integrate those products and businesses and may be lower than expected if we are unable to do so in the future.

In the second quarter of 2014, we recognized 27.5% of our revenue from sales by our international subsidiaries, which includes all subsidiaries outside of North America. We believe there is a substantial opportunity for additional sales of our software in the Europe, Middle East and Africa, or EMEA, region, the Asian-Pacific region, and the Latin American region. We intend to increase our sales, marketing and support operations in these regions. However, we believe there is significant uncertainty regarding the economic conditions in certain of these geographic regions. While we believe that any difficult economic conditions may adversely affect the sales of our products, this could also offer us an opportunity to market and sell our products to mid-size businesses and enterprise customers at compelling prices compared to the prices of some competing products.

We expect the U.S. federal government to continue to be a significant market opportunity, as we believe the ease of deployment, power and scalability of our products gives us a competitive advantage to sell to various agencies and departments of the U.S. federal government. The U.S. federal government new business sales, including both direct sales and sales through distributors and resellers, were 6.7% of our total new business sales in both the second quarter of 2014 and the first half of 2014 as compared to 9.8% of our total new business sales in the second quarter of 2013 and 7.7% of our new business sales in the first half of 2013. We have experienced and continue to expect inconsistency in the buying pattern of the U.S. federal government for larger transactions with our products. We believe that many of our larger transactions, both new licenses and maintenance renewals, with the U.S. federal government are dependent on specific projects that may not be continued at the same scale in the future due to budgetary cuts or other reasons, and the reduction or cancellation of specific projects such as these could result in our sales to the U.S. federal government growing less rapidly than expected or even decreasing. In addition, our sales, both new licenses and maintenance renewals, to the U.S. federal government are largely dependent on systems integrators, distributors and resellers whose purchases from us have been difficult to predict.

Key Components of Our Results of Operations

Sources of Revenue

Our revenue is primarily comprised of license, maintenance and subscription revenue.

License, Maintenance and Other Revenue. We primarily license our software under perpetual licenses, which ordinarily include one year of maintenance as part of the initial purchase price of the product. License revenue reflects the revenue recognized from sales of new perpetual licenses and upgrades of license size to our software. We have experienced annual growth in license revenue. Maintenance revenue is an important source of our future revenue. Customers can renew, and

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generally have renewed, their maintenance agreements at our standard list maintenance renewal pricing for their software products. Current customers with maintenance agreements are entitled to receive unspecified upgrades or enhancements when and if they become available. We have experienced strong and consistent annual and quarterly growth in maintenance and other revenue. Because our maintenance base has continued to grow each year due to new license sales, high customer retention and acquisitions, we expect maintenance revenue to continue to increase in absolute dollars in future periods.

Subscription Revenue. We primarily derive subscription revenue from fees received from our MSP customers for time-based license arrangements and software-as-a-service, or SaaS, offerings. We also include the fees from sales of the Pingdom cloud products, acquired in late June 2014, in our subscription revenue. We currently sell our subscription products separately from our perpetual license offerings.

Cost of Revenue

Cost of revenue primarily consists of amortization of acquired developed product technologies, personnel costs related to providing technical support services and royalty fees and server and hosting fees. Personnel costs include salaries, bonuses and stock-based compensation and related employer-paid payroll taxes for technical support personnel, as well as an allocation of our facilities, information technology, employee benefit and other overhead costs. We allocate stock-based compensation expense and related employer-paid payroll taxes to personnel costs based on the expense category in which the option or restricted stock unit holder works. We allocate overhead, such as rent, computer and other technology costs, and employee benefit costs to personnel costs in each expense category based on worldwide headcount in that category.

The amortization of developed product technologies can vary significantly each period based on the size and timing of our acquisitions. We expect our cost of revenue to increase in absolute dollars and to fluctuate as a percentage of revenue as we acquire additional companies or technologies and as we increase our headcount to support new customers and product offerings.

Operating Expenses

We classify our operating expenses into three categories: sales and marketing, research and development and general and administrative.

Our operating expenses primarily consist of personnel costs, contract research and development costs, marketing program costs and legal, accounting, consulting and other professional service fees. Personnel costs for each category of operating expenses primarily include employee compensation costs and facility overhead costs. We include restructuring charges related to severance and relocation in the employee's respective department.

Our operating expenses increased in absolute dollars and as a percentage of revenue in the first half of 2014 compared to the first half of 2013, as we have continued to build infrastructure and add employees through acquisitions and organic growth across all departments in order to accelerate and support our growth. We increased our investment in product development, marketing and sales in late 2013 for initiatives we believe are important to our long-term goals. These investments are focused on the development of new products and strategic releases to our current products and streamlining our demand generation process in our marketing and sales organizations. The number of full-time employees as of June 30, 2014 was 1,492, as compared to 1,142 as of June 30, 2013.

We expect our operating expenses to continue to increase in absolute dollars as we make long-term investments in our business both domestically and internationally. Our operating expenses in future periods may increase in absolute dollars and fluctuate as a percentage of revenue as a result of any future acquisitions and any further decisions to increase our investment in our business. In addition, we intend to continue to grant equity awards to our current executives and employees and those who join us in the future through acquisitions or otherwise, which will result in additional stock-based compensation expense.

Sales and Marketing. Sales and marketing expenses primarily consist of personnel costs for our sales, marketing and business development employees and executives, commissions earned by our sales personnel, the cost of marketing programs such as paid search, search engine optimization and management, trade shows, website maintenance and design and the cost of business development programs. We will continue to hire sales personnel in the United States and in our international sales offices to drive new license sales growth. We also expect to continue to invest in our websites, online user community site, brand awareness initiatives and marketing programs to drive customer downloads and support our new product launches.

Research and Development. Research and development expenses primarily consist of personnel costs for our product development employees and executives and, to a lesser extent, contractor fees. We have devoted our development efforts primarily to expanding our product line and increasing the functionality and enhancing the ease-of-use of our software products. We have significantly increased our research and development employee headcount through the continued expansion of our research and development centers in the Czech Republic and India and through acquisitions. We expect to continue to invest in our research and development activities by hiring engineers in our international locations and supplementing our

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internal research and development activities with additional contract services, which will allow us to continue our research and development growth strategy internationally.

General and Administrative. General and administrative expenses primarily consist of personnel costs for our executive, finance, legal, human resources and other administrative personnel and the amortization of acquired intangible assets. Legal, accounting and other professional service fees, restructuring charges, along with general corporate expenses are also recorded in general and administrative expenses. Restructuring charges include the expenses related to the closing of certain offices such as severance, relocation and the estimated costs of exiting and terminating facility lease commitments. We expect to incur higher administrative costs in future periods as our business continues to grow both organically and through acquisitions.

Other Income (Expense)

Other income (expense) primarily consists of interest income, interest expense, transactional foreign exchange gains (losses), foreign exchange contracts gains (losses) and grant income.

Income Tax Expense

Income tax expense primarily consists of corporate income taxes related to profits resulting from the sale of our software offerings by our four entities that sell our software, one in the United States, one in Canada, one in Ireland and one in Sweden. The rate of taxation on income earned by our U.S. entity is higher than the rate of taxation on income earned by our Canadian, Irish and Swedish entities. If our international income, as a percentage of total income, increases as we expect, then our effective income tax rate should correspondingly decline. However, our effective tax rate may be affected by many other factors, such as changes in tax laws, regulations or rates, new interpretations of existing laws or regulations, the impact of accounting for stock-based compensation, the impact of accounting for business combinations, the impact of accounting for uncertain tax positions, changes in our international structure, shifts in the amount of taxable income earned in the United States, as compared with other regions in the world, and changes in overall levels of income before tax.

We benefited from the tax credit incentives under the U.S. research and experimentation credit extended to taxpayers engaged in qualified research and experimental activities while carrying on a trade or business. The tax credit expired on December 31, 2013, and if not renewed under similar terms as in prior years the result could have a material impact on our financial results.

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

The following table sets forth our condensed consolidated statements of income data for the periods indicated:

	Three months ended June 30,				
	2014	% of Revenue	2013	% of Revenue	Change
	(in thousands)		(in thousands)		(in thousands)
Revenue:					
License	$37,636	37.1 %	$ 31,217	40.3 %	$ 6,419
Maintenance and other	58,035	57.2	45,373	58.5	12,662
Subscription	5,833	5.7	929	1.2	4,904
Total revenue	101,504	100.0	77,519	100.0	23,985
Cost of revenue	10,898	10.7	6,157	7.9	4,741
Gross profit	90,606	89.3	71,362	92.1	19,244
Operating expenses:					
Sales and marketing	35,254	34.7	20,276	26.2	14,978
Research and development	13,883	13.7	8,218	10.6	5,665
General and administrative	23,263	22.9	11,554	14.9	11,709
Total operating expenses	72,400	71.3	40,048	51.7	32,352
Operating income	18,206	17.9	31,314	40.4	(13,108)
Other income (expense):					
Interest income	83	0.1	110	0.1	(27)
Interest expense	(216)	(0.2)	—	—	(216)
Other income (expense), net	13	—	(340)	(0.4)	353
Total other income (expense)	(120)	(0.1)	(230)	(0.3)	110
Income before income taxes	18,086	17.8	31,084	40.1	(12,998)
Income tax expense	4,707	4.6	8,287	10.7	(3,580)
Net income	$13,379	13.2 %	$ 22,797	29.4 %	$ (9,418)

Revenue

Revenue increased $24.0 million, or 30.9%, in the quarter ended June 30, 2014 compared to the quarter ended June 30, 2013. Total revenue by product group was $60.3 million and $54.0 million for network management, $31.7 million and $21.9 million for systems and application management and $9.4 million and $1.7 million for our MSP products for the quarters ended June 30, 2014 and 2013, respectively.

Our revenue from our international subsidiaries was 27.5% and 26.2% of total revenue in the second quarter of 2014 and 2013, respectively. Other than the United States, no single country accounted for 10% or more of our total revenues during these periods. We expect international sales as a percentage of our total sales in 2014 to increase slightly as compared to 2013. We plan to continue expanding our sales and marketing efforts outside of the U.S.

License, Maintenance and Other Revenue

License revenue increased $6.4 million primarily due to increased sales of our systems and application management products and due to increased sales of our MSP and network management products.

In the fourth quarter of 2013, we changed the methodology for calculating our average transaction size and product transaction volume growth metrics. We now calculate these metrics using commercial transactions only and excluding any transactions that consist solely of our transactional products sold on a stand-alone basis or our MSP products. In addition, we no longer calculate these metrics using a trailing 12-month average. We have recalculated the metrics disclosed below from prior period filings based on the new methodology.

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Our commercial product transaction growth was 17.2% in the second quarter of 2014 as compared to the second quarter of 2013. The overall growth in commercial product transactions in the second quarter of 2014 was attributed to increased sales of our systems and application management and network management products.

In the second quarter of 2014, the commercial average size for new license transactions was approximately $8,200 as compared to approximately $7,600 in the second quarter of 2013. The increase in our commercial average transaction size was primarily due to a greater number of larger transactions, particularly transactions of $20,000 or more, across our network and systems management product portfolios during the second quarter of 2014 as compared to the second quarter of 2013.

Maintenance and other revenue increased $12.7 million due to a growing maintenance renewal customer base and an increase in new license sales, which drives new maintenance revenue. We have maintained high customer retention and have continued to increase our renewal base each quarter as we have begun to renew and recognize the maintenance revenue associated with our acquired products.

Subscription Revenue

Subscription revenue increased $4.9 million primarily due to the growth of sales of our MSP products introduced as a result of our acquisition of N-able Technologies International, Inc., or N-able, in the second quarter of 2013. N-central, N-able's flagship product for MSPs, along with other products which complement N-central had a strong performance as we transitioned N-able into a primarily subscription model and invested in their business.

Cost of Revenue

Cost of revenue increased $4.7 million, or 77.0%, in the quarter ended June 30, 2014 compared to the quarter ended June 30, 2013. Cost of license revenue increased by $1.3 million in the second quarter of 2014 compared to the second quarter of 2013, primarily due to the amortization of acquired product technologies associated with our acquisitions in 2013 and 2012. Cost of maintenance revenue also increased $1.1 million primarily due to increased personnel costs, which include stock-based compensation expense, to support new customers, additional product offerings from acquisitions and internal product development.

Cost of subscription revenue increased by $2.4 million in the second quarter of 2014 compared to the second quarter of 2013, primarily due to increased amortization of acquired developed product technologies, personnel costs and other direct costs, including royalty fees and hosting and server fees, related to our subscription products and services.

Operating Expenses

Sales and Marketing. Sales and marketing expenses increased $15.0 million, or 73.9%, in the quarter ended June 30, 2014 compared to the quarter ended June 30, 2013. Our sales and marketing personnel costs, which include stock-based compensation expense, increased $10.4 million. We have increased employee headcount in our sales, marketing and maintenance renewal teams as a result of organic growth and through the acquisitions of N-able and Confio. Marketing program costs increased $4.0 million due to the increased investment around demand generation and brand awareness. Our sales expense as a percentage of revenue increased slightly in the second quarter of 2014 as compared to the same period in 2013 primarily due to the acquisitions of N-able and Confio.

Research and Development. Research and development expenses increased $5.7 million, or 68.9%, in the quarter ended June 30, 2014 compared to the quarter ended June 30, 2013 due to our increased investment in product development. In order to support the ongoing development of new products and our current products, we continued to increase the size of our Czech Republic and India research and development centers during 2013 and the first half of 2014 and supplemented our internal product development activities with additional contract services. We also increased our research and development headcount through the acquisition of N-able in the second quarter of 2013 and through the acquisition of Confio in the fourth quarter of 2013. Due to this growth, our personnel costs, which include stock-based compensation expense, increased by $3.8 million and contract services increased $1.7 million in the second quarter of 2014 as compared to the second quarter of 2013. Contract services increased due to additional product development work that was completed by our offshore development vendors.

General and Administrative. General and administrative expenses increased $11.7 million, or 101.3%, in the quarter ended June 30, 2014 compared to the quarter ended June 30, 2013. This increase was primarily due to a $6.8 million lease abandonment charge for the estimated fair value of our remaining obligation under the operating lease of our former corporate headquarters. See Note 8, Commitments and Contingencies, in the Notes to the Condensed

Consolidated Financial Statements in Item 1 of Part I, for additional information regarding the lease abandonment charge. In addition, personnel costs, which include stock-based compensation expense increased $3.1 million, amortization of acquired intangibles increased $0.7 million and acquisition related costs increased $0.7 million.

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Income Tax Expense

Our income tax expense decreased by $3.6 million in the quarter ended June 30, 2014 as compared to the same period in 2013. Our effective tax rate decreased from 26.7% in the quarter ended June 30, 2013 to 26.0% in the quarter ended June 30, 2014. These decreases were primarily attributable to an increase in international earnings as a percentage of total earnings, which are generally taxed at lower tax rates, partially offset by the expiration of the U.S. federal research and experimental tax credit.

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

The following table sets forth our condensed consolidated statements of income data for the periods indicated:

	Six months ended June 30,								
	2014		% of Revenue		2013		% of Revenue		Change	
	(in thousands)				(in thousands)				(in thousands)	
Revenue:										
License	$73,987		37.5	%	$ 61,942		41.2	%	$ 12,045	
Maintenance and other	112,956		57.2		87,558		58.2		25,398	
Subscription	10,470		5.3		929		0.6		9,541	
Total revenue	197,413		100.0		150,429		100.0		46,984	
Cost of revenue	20,926		10.6		11,788		7.8		9,138	
Gross profit	176,487		89.4		138,641		92.2		37,846	
Operating expenses:										
Sales and marketing	69,234		35.1		40,576		27.0		28,658	
Research and development	28,023		14.2		16,064		10.7		11,959	
General and administrative	39,192		19.9		21,375		14.2		17,817	
Total operating expenses	136,449		69.1		78,015		51.9		58,434	
Operating income	40,038		20.3		60,626		40.3		(20,588	)
Other income (expense):										
Interest income	161		0.1		233		0.2		(72	)
Interest expense	(435	)	(0.2	)	—		—		(435	)
Other income (expense), net	208		0.1		(491	)	(0.3	)	699	
Total other income (expense)	(66	)	—		(258	)	(0.2	)	192	
Income before income taxes	39,972		20.2		60,368		40.1		(20,396	)
Income tax expense	8,947		4.5		14,572		9.7		(5,625	)
Net income	$31,025		15.7	%	$ 45,796		30.4	%	$ (14,771	)

Revenue

Revenue increased $47.0 million, or 31.2%, in the six months ended June 30, 2014 compared to the six months ended June 30, 2013. Total revenue by product group was $118.5 million and $105.6 million for network management, $61.5 million and $43.1 million for systems and application management and $17.4 million and $1.7 million for our MSP products for the six months ended June 30, 2014 and 2013, respectively.

Our revenue from our international subsidiaries was 27.8% and 26.7% of total revenue in the first half of 2014 and 2013, respectively. Other than the United States, no single country accounted for 10% or more of our total revenues during these periods. We expect international sales as a percentage of our total sales in 2014 to increase slightly as compared to 2013. We plan to continue expanding our sales and marketing efforts outside of the U.S.

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License, Maintenance and Other Revenue

License revenue increased $12.0 million primarily due to increased sales of our systems and application management products and due to increased sales of our MSP and network management products.

In the fourth quarter of 2013, we changed the methodology for calculating our average transaction size and product transaction volume growth metrics. We now calculate these metrics using commercial transactions only and excluding any transactions that consist solely of our transactional products sold on a stand-alone basis or our MSP products. In addition, we no longer calculate these metrics using a trailing 12-month average. We have recalculated the metrics disclosed below from prior period filings based on the new methodology.

Our commercial product transaction growth was 10.2% in the first half of 2014 as compared to the first half of 2013. The overall growth in commercial product transaction volume is attributed to increased sales of our systems and application management and network management products in the first half of 2014.

In the first half of 2014, the commercial average transaction size for new license sales, was approximately $7,900 as compared to approximately $7,400 in the first half of 2013. The increase in our average transaction size was primarily due to a greater number or larger transactions, particularly transactions of $20,000 or more, across our network management and systems and application management product portfolios during the first half of 2014 as compared to the first half of 2013.

Maintenance and other revenue increased $25.4 million due to a growing maintenance renewal customer base and an increase in new license sales, which drives new maintenance revenue. We have maintained high customer retention and have continued to increase our renewal base each quarter as we have begun to renew and recognize the maintenance revenue associated with our acquired products.

Subscription Revenue

Subscription revenue increased $9.5 million primarily due to the growth of sales of our MSP products introduced as a result of our acquisition of N-able in the second quarter of 2013. N-Central, N-able's flagship product for MSP's, along with other products which complement N-central had a strong performance as we transitioned N-able into a subscription model and invested in their business.

Cost of Revenue

Cost of revenue increased $9.1 million, or 77.5%, in the six months ended June 30, 2014 compared to the six months ended June 30, 2013. Cost of license revenue increased by $2.6 million in the first half of 2014 compared to the first half of 2013, primarily due to the amortization of acquired product technologies associated with our acquisitions in 2013 and 2012. Cost of maintenance revenue also increased $1.7 million primarily due to increased personnel costs, which include stock-based compensation expense, to support new customers, additional product offerings from acquisitions and internal product development.

Cost of subscription revenue increased by $4.8 million in the first half of 2014 compared to the first half of 2013, primarily due to increased amortization of acquired developed product technologies, personnel costs and other direct costs, including royalty fees and hosting and server fees, related to our subscription products and services.

Operating Expenses

Sales and Marketing. Sales and marketing expenses increased $28.7 million, or 70.6%, in the six months ended June 30, 2014 compared to the six months ended June 30, 2013. Our sales and marketing personnel costs, which include stock-based compensation expense, increased $19.5 million. We have increased employee headcount in our sales, marketing and maintenance renewal teams as a result of organic growth and through the acquisitions of N-able and Confio. Marketing program costs increased $7.9 million due to the increased investment around demand generation and brand awareness. Our sales expense as a percentage of revenue increased slightly in the first half of 2014 as compared to the same period in 2013 primarily due to the acquisitions of N-able and Confio.

Research and Development. Research and development expenses increased $12.0 million, or 74.4%, in the six months ended June 30, 2014 compared to the six months ended June 30, 2013 due to our increased investment in product development. In order to support the ongoing development of new products and our current products, we continued to increase the size of our Czech Republic and India research and development centers during 2013 and the first half of 2014 and supplemented our internal product development activities with additional contract services. We also increased our research and development headcount through the acquisition of N-able in the second quarter of 2013 and through the acquisition of Confio in the fourth quarter of 2013. Due to this growth, our personnel costs, which include stock-based compensation expense, increased by $7.9 million and contract services increased $3.6 million in the first half of 2014 as compared to the first half of 2013. Contract services increased due to additional product development work that was completed by our offshore development vendors.

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General and Administrative. General and administrative expenses increased $17.8 million, or 83.4%, in the six months ended June 30, 2014 compared to the six months ended June 30, 2013. This increase was due to a $7.3 million increase in personnel costs, which include stock-based compensation expense, a $1.4 million increase in amortization of acquired intangibles and a $0.7 million increase in acquisition related costs. In addition, we recorded a $6.8 million lease abandonment charge in the second quarter of 2014 for the estimated fair value of our remaining obligation under the operating lease of our former corporate headquarters. See Note 8, Commitments and Contingencies, in the Notes to the Condensed Consolidated Financial Statements in Item 1 of Part I, for additional information regarding the lease abandonment charge.

Income Tax Expense

Our income tax expense decreased by $5.6 million in the six months ended June 30, 2014 as compared to the same period in 2013. Our effective tax rate decreased from 24.1% in the six months ended June 30, 2013 to 22.4% in the six months ended June 30, 2014. These decreases were primarily attributable to an increase in international earnings as a percentage of total earnings, which are generally taxed at lower tax rates, partially offset by the expiration of the U.S. federal research and experimental tax credit.

Non-GAAP Financial Measures

In addition to disclosing financial measures prepared in accordance with GAAP, this Form 10-Q includes the following financial measures which are non-GAAP financial measures under SEC rules: (i) non-GAAP operating income; (ii) non-GAAP net income; and (iii) non-GAAP diluted earnings per share. Each of these financial measures excludes the impact of certain items and therefore has not been calculated in accordance with GAAP. In this report, these non-GAAP financial measures typically exclude stock-based compensation expense and related employer-paid payroll taxes; amortization of intangible assets; acquisition related adjustments, including contingent consideration fair value adjustments due to the changes in probability assumptions of achieving the earnout criteria and due to the passage of time; and restructuring charges. Each of these non-GAAP adjustments is described in more detail below. In addition to these adjustments, management may include or exclude additional items from these or similar non-GAAP financial measures in future periods to the extent that management believes such items may not be indicative of our core business. A reconciliation of each of these non-GAAP financial measures to its most comparable GAAP financial measure is also included below.

We believe that these non-GAAP financial measures provide meaningful supplemental information regarding our operating results because they exclude certain amounts that our management and Board of Directors do not consider part of core operating results when assessing our operational performance, allocating resources, preparing annual budgets and determining employee incentive compensation. Accordingly, these non-GAAP financial measures may provide insight to investors into the motivation and decision-making of management in operating the business. In addition, by comparing our non-GAAP financial measures in different historical periods, our investors can evaluate our operating results without the additional variations of certain items that may not be indicative of our core operations, including stock-based compensation expense, which is a non-cash expense that we believe is not a key measure of our operations.

While we believe that these non-GAAP financial measures provide useful supplemental information, there are limitations associated with the use of these non-GAAP financial measures. These non-GAAP financial measures are not prepared in accordance with GAAP, do not reflect a comprehensive system of accounting and may not be comparable to similarly titled measures of other companies due to potential differences in their financing and accounting methods, the book value of their assets, their capital structures, the method by which their assets were acquired and the manner in which they define non-GAAP measures. Items such as the amortization of intangible assets, stock-based compensation expense and related employer-paid payroll taxes, acquisition related adjustments and restructuring charges, as well as the related tax impacts of these items can have a material impact on operating and net income. As a result, these non-GAAP financial measures have limitations and should not be considered in isolation from, or as a substitute for, their most comparable GAAP measures. We compensate for these limitations by using these non-GAAP financial measures as supplements to GAAP financial measures and by reconciling the non-GAAP financial measures to their most comparable GAAP financial measure. Investors are encouraged to review the reconciliations of these non-GAAP financial measures to their most comparable GAAP financial measures below.

For a detailed explanation of the adjustments made to comparable GAAP financial measures, the reasons why management uses these measures and the usefulness of these measures, see footnotes (1)—(6) below.

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Non-GAAP Operating Income and Non-GAAP Operating Margin

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands, except percentages)	2014	2013	2014	2013
GAAP operating income	$18,206	$31,314	$40,038	$60,626
Amortization of intangible assets (1)	7,587	4,535	15,146	8,973
Stock-based compensation expense and related employer-paid payroll taxes (2)	8,607	5,257	19,401	12,203
Acquisition related adjustments (3)	1,398	554	1,395	604
Restructuring charges (4)	6,907	483	7,481	483
Non-GAAP operating income	$42,705	$42,143	$83,461	$82,889
GAAP operating margin	17.9 %	40.4 %	20.3 %	40.3 %
Non-GAAP operating margin	42.1 %	54.4 %	42.3 %	55.1 %

Non-GAAP operating income for the three and six months ended June 30, 2014 increased slightly as compared to the same periods in 2013 primarily due to increases in stock-based compensation expense, restructuring charges and amortization of intangible assets, offset by a decrease in GAAP operating income. Stock-based compensation expense and related employer-paid payroll taxes increased primarily due to share-based incentive awards issued to employees for retention and, to a lesser extent, the addition of employees through acquisitions and organic growth. Our restructuring charges primarily consist of lease abandonment charges and accelerated depreciation on leasehold improvements and furniture related to the closing of certain offices. In the second quarter of 2014, we recorded a $6.8 million lease abandonment charge for the estimated fair value of our remaining obligation under the operating lease of our former corporate headquarters. See Note 8, Commitments and Contingencies, in the Notes to the Condensed Consolidated Financial Statements in Item 1 of Part I, for additional information regarding the lease abandonment charge. Amortization of intangible assets increased in the second quarter and the first half of 2014 as compared to the same periods in 2013 primarily due to increases in intangible assets resulting from the acquisitions that were completed in 2013 and 2014. Our acquisition related adjustments fluctuate due to variations in the legal and accounting fees and restructuring costs associated with each of our acquisitions.

Non-GAAP Net Income and Non-GAAP Diluted Earnings Per Share

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands, except per share information)	2014	2013	2014	2013
GAAP net income	$13,379	$22,797	$31,025	$45,796
Amortization of intangible assets (1)	7,587	4,535	15,146	8,973
Stock-based compensation expense and related employer-paid payroll taxes (2)	8,607	5,257	19,401	12,203
Acquisition related adjustments (3)	1,398	556	1,395	608
Restructuring charges (4)	6,907	483	7,481	483
Tax benefits associated with above adjustments (5)	(6,409)	(2,897)	(11,831)	(6,125)
Non-GAAP net income	$31,469	$30,731	$62,617	$61,938
Weighted-average number of shares used in computing diluted earnings per share	76,296	76,592	76,245	76,625
GAAP diluted earnings per share	$0.18	$0.30	$0.41	$0.60
Non-GAAP diluted earnings per share (6)	$0.41	$0.40	$0.82	$0.81

Non-GAAP net income for the three and six months ended June 30, 2014 increased slightly as compared to the same periods in 2013 primarily due to increases in the adjustments discussed above in the calculation of non-GAAP operating income offset by decreases in the corresponding GAAP net income. Other adjustments to non-GAAP net income include fair value adjustments due to the passage of time related to contingent consideration included in acquisition related costs and the tax

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benefits associated with the excluded items. Non-GAAP diluted earnings per share remained consistent for the second quarter and the first half of 2014 as compared to the same periods in 2013.

Non-GAAP Footnotes:

(1) Amortization of Intangible Assets. We provide non-GAAP information that excludes expenses for the amortization of intangible assets that primarily relate to purchased intangible assets associated with our acquisitions. We believe that eliminating this expense from our non-GAAP measures is useful to investors, because the amortization of intangible assets can be inconsistent in amount and frequency and is significantly impacted by the timing and magnitude of our acquisition transactions, which also vary in frequency from period to period. Accordingly, we analyze the performance of our operations in each period without regard to such expenses.

(2) Stock-Based Compensation Expense and Related Employer-Paid Payroll Taxes. We provide non-GAAP information that excludes expenses for stock-based compensation and related employer-paid payroll taxes. We believe the exclusion of these items allows for financial results that are more indicative of our continuing operations. We believe that the exclusion of stock-based compensation expense provides for a better comparison of our operating results to prior periods and to our peer companies as the calculations of stock-based compensation vary from period to period and company to company due to different valuation methodologies, subjective assumptions and the variety of award types. Employer-paid payroll taxes on stock-based compensation is dependent on our stock price and the timing of the taxable events related to the equity awards, over which our management has little control, and does not correlate to the core operation of our business. Because of these unique characteristics of stock-based compensation and the related employer-paid payroll taxes, management excludes these expenses when analyzing the organization’s business performance.

(3) Acquisition Related Adjustments. We exclude certain expense items resulting from acquisitions including the following, when applicable: (i) amortization of purchased intangible assets associated with our acquisitions (see Note 1 for further discussion); (ii) legal, accounting and advisory fees to the extent associated with acquisitions; (iii) changes in fair value of contingent consideration; (iv) costs related to due diligence and integrating the acquired businesses; (v) deferred compensation expense related to acquisitions; and (vi) restructuring costs, including adjustments related to changes in estimates, related to acquisitions. We consider these adjustments, to some extent, to be unpredictable and dependent on a significant number of factors that are outside of our control. Furthermore, acquisitions result in non-continuing operating expenses, which would not otherwise have been incurred by us in the normal course of our organic business operations, with respect to each acquisition. We believe that providing non-GAAP information for acquisition related expense items in addition to the corresponding GAAP information allows the users of our financial statements to better review and understand the historical and current results of our continuing operations, and also facilitates comparisons to our historical results and results of less acquisitive peer companies, both with and without such adjustments.

(4) Restructuring Charges. We provide non-GAAP information that excludes restructuring charges such as severance, relocation and benefits and the estimated costs of exiting and terminating facility lease commitments, including accelerated depreciation on leasehold improvements and fixed assets, as they relate to our corporate restructuring and exit activities. These restructuring charges are inconsistent in amount and are significantly impacted by the timing and nature of these events. Therefore, although we may incur these types of expenses in the future, we believe that eliminating these charges for purposes of calculating the non-GAAP financial measures facilitates a more meaningful evaluation of our current operating performance and comparisons to our past operating performance.

(5) Income Tax Effect of Non-GAAP Exclusions. We believe providing financial information with and without the income tax effect of excluding items related to our non-GAAP financial measures provide our management and users of the financial statements with better clarity regarding the ongoing performance and future liquidity of our business.

(6) Non-GAAP Diluted Earnings Per Share Item. We provide non-GAAP diluted earnings per share. The non-GAAP diluted earnings per share amount was calculated based on our non-GAAP net income and the shares used in the computation of GAAP diluted earnings per share.

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Liquidity and Capital Resources

Cash and cash equivalents and short-term and long-term investments were $207.3 million as of June 30, 2014. Our international subsidiaries held approximately $72.6 million of cash and cash equivalents of which 71.3% was held in Euros as of June 30, 2014. We expect our international cash and cash equivalents to continue to increase as a percentage of our consolidated cash and cash equivalents. We currently intend that the earnings generated by our international operations will be invested indefinitely in those operations and we do not expect to repatriate those earnings to our domestic operations. If we were to try and repatriate these earnings, we would incur a U.S. federal income tax liability that is not currently accrued in our condensed consolidated financial statements.

Our available cash and cash equivalents are primarily held in bank deposits and money market funds at June 30, 2014. Our short-term and long-term investments, classified as available-for-sale securities, consist of corporate bonds and municipal bonds held in investment accounts in the United States.

Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds. The balances held in our demand deposit accounts in the United States may exceed the Federal Deposit Insurance Corporation, or FDIC, insurance limits. While we monitor the balances in our accounts and adjust the balances as appropriate, these balances could be impacted by adverse conditions in the financial markets or by failure of the underlying depository institutions or guarantors. We strive to maintain our cash deposits, money market funds and investments with multiple financial institutions of reputable credit quality and, therefore, bear minimal credit risk. We actively monitor the third party depository institutions that hold our cash, cash equivalents and investments. To date, we have experienced no loss or lack of access to our invested cash, cash equivalents, and investments; however, we can provide no assurances that access to our funds will not be impacted by future adverse conditions.

Summarized cash flow information is as follows:

	Six Months Ended June 30,	
(in thousands)	2014	2013
Net cash provided by operating activities	$93,544	$71,599
Net cash used in investing activities	(68,482)	(108,578)
Net cash provided by (used in) financing activities	(2,315)	7,137
Effect of exchange rate changes	(1,503)	(966)
Net increase (decrease) in cash and cash equivalents	21,244	(30,808)

Operating Activities

Cash provided by operating activities is comprised of net income, adjustments primarily related to non-cash operating activities and changes in operating assets and liabilities. Adjustments for non-cash expenses were $30.2 million and $14.2 million for the six months ended June 30, 2014 and 2013, respectively. These adjustments primarily consist of stock-based compensation expense, depreciation and amortization, deferred taxes and excess tax benefits related to employee stock-based awards. Stock-based compensation expense reduced income before income taxes by $18.8 million and $11.5 million in the six months ended June 30, 2014 and 2013, respectively.

The change in cash flows relating to operating activities resulted from changes in operating assets and liabilities and is primarily driven by the sales of our software and maintenance renewals. The significant changes in operating assets and liabilities include the following:

- Accrued liabilities and other increased to $30.8 million at June 30, 2014 as compared to $17.7 million at December 31, 2013, resulting in an increase in operating liabilities and reflecting a cash inflow of $12.1 million for the six months ended June 30, 2014. This increase in accrued liabilities and resulting cash inflow was primarily related to the lease abandonment liability recorded in the second quarter of 2014 related to our remaining obligation under the operating lease of our former corporate headquarters. See Note 8, Commitments and Contingencies, in the Notes to the Condensed Consolidated Financial Statements in Item 1 of Part I, for additional information regarding the lease abandonment charge. For the six months ended June 30, 2013, net cash provided by operating activities decreased $5.0 million primarily due to a decrease in accrued liabilities during the period as compared to the respective prior period.
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Deferred revenue increased to $146.1 million at June 30, 2014 as compared to $135.2 million at December 31, 2013, resulting in an increase in operating liabilities and reflecting a cash inflow of $10.6 million for the six months ended June 30, 2014. For the six months ended June 30, 2013, net cash provided by operating activities increased $10.4 million due to an increase in deferred revenue during the period as compared to the respective prior period.

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Deferred revenue primarily consists of billings and payments received in advance of revenue recognition from maintenance fees.

- Other long-term liabilities increased to $22.7 million at June 30, 2014 as compared to $16.8 million at December 31, 2013, resulting in an increase in operating liabilities and reflecting a cash inflow of $6.3 million for the six months ended June 30, 2014. This increase in other long-term liabilities and resulting cash inflow was primarily related to the lease incentive liability recorded for the tenant improvement allowance received related to our new corporate headquarters. See Note 8, Commitments and Contingencies, in the Notes to the Condensed Consolidated Financial Statements in Item 1 of Part I, for additional information regarding our lease for our new corporate headquarters. For the six months ended June 30, 2013, net cash provided by operating activities increased $0.2 million primarily due to an increase in other long-term liabilities during the period as compared to the respective prior period related to lease abandonment liabilities recorded related to the closing of certain offices.
- Changes in our income tax receivable and payable balances are also significant components of our cash flows from operating activities. Net cash provided by operating activities was reduced by income tax payments of $8.9 million and $10.2 million in the six months ended June 30, 2014 and 2013, respectively.
- Accounts receivable decreased to $41.8 million at June 30, 2014 as compared to $45.7 million at December 31, 2013 resulting in a decrease in operating assets and reflecting a cash inflow of $3.5 million for the six months ended June 30, 2014. The increase in accounts receivable for the six months ended June 30, 2013 as compared to December 31, 2012 resulted in a cash outflow of $0.1 million for the six months ended June 30, 2013. Our accounts receivable balance fluctuates from period to period depending on the timing of our sales, cash collections and changes to our allowance for doubtful accounts, which affects our cash flow from operating activities. Our accounts receivable balance represents trade receivables from customers, including resellers and distributors, when we have provided software licenses and/or software maintenance agreements or software subscription agreements and we have not yet received payment. We have historically had insignificant write-offs related to bad debts. The allowance for doubtful accounts was $0.8 million and $0.3 million at June 30, 2014 and 2013, respectively. We use days sales outstanding, or DSO, calculated on a quarterly basis, as a measurement of the quality and status of our receivables. We define DSO as (a) accounts receivable divided by (b) total revenue for the most recent quarter, multiplied by (c) the number of days in the quarter. Our DSO was 37.5 days and 42.0 days at June 30, 2014 and 2013, respectively.

Investing Activities

Net cash used in investing activities for the six months ended June 30, 2014 was primarily related to $64.0 million of cash used for the acquisition of Pingdom (refer to Note 2, Acquisitions, in the Notes to the Condensed Consolidated Financial Statements in Item 1 of Part I, for additional details), $14.3 million of cash used to purchase property and equipment, offset by $10.0 million of proceeds from maturities of investments. The purchases of property and equipment primarily relate to leasehold improvements and other additions for our new corporate headquarters. We received $7.1 million in tenant improvement allowances related to the purchase of leasehold improvements during the first half of 2014. For the six months ended June 30, 2013, net cash used in investing activities was primarily related to $120.9 million of cash used for the acquisition of N-able, $17.3 million of cash used to purchase available-for-sale securities, offset by $31.5 million of proceeds from maturities of investments.

We expect our capital expenditures for the remaining six months of 2014 to be approximately $3 to $5 million, primarily related to our expected growth and expansion of our domestic and international office locations.

Financing Activities

Net cash used in financing activities for the six months ended June 30, 2014 was due to repurchases of common stock of $9.8 million, offset by $4.1 million of proceeds from the exercise of employee stock options and the excess tax benefit related to stock-based awards of $3.4 million, which is a reduction in cash payments related to income taxes.

On July 29, 2013, we announced that our Board of Directors approved a share repurchase program, authorizing us to purchase up to $50.0 million of our outstanding common stock in the open market, including pursuant to a Rule 10b5-1 plan, or in privately negotiated transactions. During the six months ended June 30, 2014, we repurchased 0.1 million shares of our common stock for an aggregate purchase price of $5.4 million. Since the inception of the share repurchase program, we have repurchased 1.0 million shares of our common stock for an aggregate purchase price of $38.0 million. Shares were retired upon repurchase. Our share repurchase program concluded on July 31, 2014.

In addition, for the six months ended June 30, 2014, we withheld and retired shares of common stock to satisfy $4.4 million of minimum statutory withholding tax requirements that we pay in cash to the appropriate taxing authorities on behalf of our employees related to the settlement of restricted stock units during the period. These shares are treated as common stock repurchases in our condensed consolidated financial statements as of June 30, 2014.

Net cash provided by financing activities for the six months ended June 30, 2013 was primarily due to the excess tax benefit related to stock option exercises of $6.2 million, which is a reduction in cash payments related to income taxes, and $5.4 million of proceeds from the exercise of employee stock options. In addition, we withheld and retired shares of common stock to satisfy $4.5 million of minimum statutory withholding tax requirements that we pay in cash to the appropriate taxing authorities on behalf of our employees related to the settlement of restricted stock units during the period. These shares are treated as common stock repurchases in our condensed consolidated financial statements as of June 30, 2013.

Anticipated Cash Flows

We believe that our existing cash and cash equivalents, our cash flows from operating activities and our borrowing capacity under our Credit Agreement will be sufficient to fund our operations and our commitments for capital expenditures for at least the next 12 months.

Our Credit Agreement, which we entered on October 4, 2013 with a syndicated group of lenders, provides for an unsecured $125.0 million five-year revolving credit facility that is comprised of revolving loans and swingline loans and, subject to certain requirements, may be increased up to an additional $75.0 million for a maximum aggregate commitment of $200.0 million. In August 2014, we repaid the $40.0 million of outstanding borrowings under a revolving loan under the Credit Agreement. The facility remains outstanding through October 4, 2018. See Note 5, Credit Agreement, in the Notes to Condensed Consolidated Financial Statements, for additional information regarding our Credit Agreement.

Although we are not currently a party to any material definitive agreement regarding potential investments in, or acquisitions of, complementary businesses, applications or technologies, we may enter into these types of arrangements, which could reduce our cash and cash equivalents, require us to seek additional equity or debt financing or repatriate cash generated by our international operations that would cause us to incur a U.S. federal income tax liability. Additional funds from financing arrangements may not be available on terms favorable to us or at all.

Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our sales and marketing activities, the timing and extent of spending to support product development efforts and expansion into new territories, the timing of any acquisitions to expand our business, the timing of expansions to our office facilities, the timing of introductions of new software products and enhancements to existing software products, and the continuing market acceptance of our software offerings. We expect to continue to pursue acquisitions that will enable us to enter new markets or new segments of our existing markets by bringing new product offerings to market more quickly than we can develop them.

In November 2013, we filed an automatic shelf registration statement with the SEC, which enables us to offer and sell from time to time, in one or more offerings, an unspecified amount of common stock, preferred stock, depositary shares, debt securities, warrants, purchase contracts, purchase units or any combination thereof and is intended to give us flexibility to take advantage of financing opportunities as needed or deemed desirable in light of market conditions. Debt securities sold by us may be fully and unconditionally guaranteed on an unsecured basis by SolarWinds Worldwide, LLC, our principal operating subsidiary. The specific terms of any offerings of securities under the automatic shelf registration statement will be provided in one or more supplements to the prospectus to be filed by us in connection with any future offering.

Contractual Obligations and Commitments

As of June 30, 2014, there have been no material changes in our contractual obligations and commitments that were disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

Critical Accounting Policies and Estimates

Our condensed consolidated financial statements are prepared in conformity with United States of America generally accepted accounting principles, or GAAP, and require our management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many instances, we could reasonably use different accounting estimates, and in some instances, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are differences between our estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected, perhaps materially.

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In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application, while in other cases, management's judgment is required in selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. We believe that these accounting policies requiring significant management judgment and estimates are critical to understanding our historical and future performance, as these policies relate to the more significant areas of our financial results. These critical accounting policies are:

- Valuation of goodwill, intangibles, long-lived assets and contingent consideration, including accrued earnouts;
- Revenue recognition;
- Stock-based compensation;
- Income taxes; and
- Loss contingencies.

A full description of our critical accounting policies that involve significant management judgment appears in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 filed with the Securities and Exchange Commission on February 14, 2014 under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies and Estimates." There have been no material changes to our critical accounting policies and estimates since that time.

Recent Accounting Pronouncements

See Note 1, Summary of Significant Accounting Polices, in the Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q, for a full description of recent accounting pronouncements, which is incorporated herein by reference.

Off-Balance Sheet Arrangements

During the first half of 2014, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities, that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

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Item 3: Quantitative and Qualitative Disclosures About Market Risk

We are exposed to certain financial market risks, including the following:

Interest Rate Risk

We had cash and cash equivalents of $187.2 million and $166.0 million at June 30, 2014 and December 31, 2013, respectively. We also had total short-term and long-term investments classified as available-for-sale securities of $20.1 million and $30.3 million at June 30, 2014 and December 31, 2013, respectively. Our cash and cash equivalents consist primarily of bank demand deposits and money market funds, and our available-for-sale securities consist of corporate bonds and municipal bonds held in investment accounts in the United States. We hold cash, cash equivalents and available-for-sale securities for working capital purposes. Our investments are made for capital preservation purposes, and we do not enter into investments for trading or speculative purposes.

We do not have material exposure to market risk with respect to our cash and cash equivalents, as these consist primarily of highly liquid investments purchased with original maturities of three months or less at June 30, 2014. Our portfolio of available-for-sale securities classified as investments is subject to market risk due to changes in interest rates. Changes in interest rates could impact our future investment income, or we may suffer losses in principal if we are forced to sell securities that decline in market value due to changes in interest rates. However, because we classify our investment securities as "available for sale," no gains or losses are recognized due to changes in interest rates unless such securities are sold prior to maturity or declines in fair value are determined to be other-than-temporary.

We have interest rate risk relating to the associated interest expense under our Credit Agreement, which has the option to be indexed to Wells Fargo Bank's prime rate, the federal funds rate or LIBOR. However, due to the short-term nature and notional amount of our variable rate obligations, a hypothetical increase of 100 basis points on an annual basis would not have a material impact on our interest expense or cash flows. See Note 5, Credit Agreement, in the Notes to Condensed Consolidated Financial Statements, for additional information regarding our Credit Agreement.

Foreign Currency Risk

As a global company, we face exposure to adverse movements in foreign currency exchange rates. Our revenue from our international subsidiaries was approximately 27.8% of our total revenue for the six months ended June 30, 2014. The foreign currencies that we invoice and on which we collect are primarily the Euro, British Pound Sterling and Australian Dollar. Expenses incurred by our international subsidiaries are, generally, denominated in the local currency of the subsidiary. Our condensed consolidated statements of income are translated into U.S. dollars at the average exchange rates in each applicable period. To the extent the U.S. dollar strengthens against foreign currencies, the translation of these foreign currency denominated transactions results in reduced revenues, operating expenses and net income for our international operations. Similarly, our revenues, operating expenses and net income will increase for our international operations if the U.S. dollar weakens against foreign currencies.

We utilize purchased foreign currency forward contracts to minimize our foreign exchange exposure on certain foreign balance sheet positions denominated in currencies other than the Euro. We do not enter into any derivative financial instruments for trading or speculative purposes. Our objective in managing our exposure to foreign currency exchange rate fluctuations is to reduce the impact of adverse fluctuations in such exchange rates on our earnings and cash flow. The notional amounts and currencies underlying our foreign currency forward contracts will fluctuate period to period as they are principally dependent on the balances of the balance sheet positions that are denominated in currencies other than the Euro held by our global entities. There can be no assurance that our foreign currency hedging activities will substantially offset the impact of fluctuation in currency exchange rates on our results of operations and functional positions. As of June 30, 2014, we did not have any forward contracts outstanding and while we do not have a formal policy to settle all derivatives prior to the end of each quarter, our current practice is to do so. The effect of derivative instruments on our condensed consolidated statements of income was insignificant for the first half of 2014.

We are exposed to credit-related losses in the event of non-performance by counterparties to derivative financial instruments, but we do not expect any counterparties to fail to meet their obligations given their high credit ratings. In addition, we diversify this risk across several counterparties and actively monitor their ratings.

We are also exposed to foreign exchange rate fluctuations as we translate or remeasure the financial statements of our foreign subsidiaries into U.S. dollars in consolidation. If there is a change in foreign currency exchange rates, the conversion of the foreign subsidiaries' financial statements into U.S dollars will lead to remeasurement gains and losses recorded in income, or translation gains or losses that are recorded as a component of accumulated other comprehensive income (loss).

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Item 4: Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer, our Chief Financial Officer and Chief Accounting Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2014. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2014, our Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer concluded that, as of such date, our disclosure controls and procedures were effective at a reasonable assurance level.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings
From time to time, we have been and may be involved in various legal proceedings and claims arising in our ordinary course of business. At this time, neither we nor any of our subsidiaries is a party to, and none of our respective property is the subject of, any material legal proceeding. However, the outcome of legal proceedings and claims brought against us are subject to significant uncertainty. Therefore, if one or more of these legal matters were resolved against us in the same reporting period for amounts in excess of management's expectations, our consolidated financial statements for a particular period could be materially adversely affected. See the risk factor "Litigation exposure related to our pending and any future litigation could adversely affect our results of operations, profitability and cash flows" in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013 under the heading "Risk Factors."

Item 1A. Risk Factors
There have been no material changes from the risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
Issuer Purchases of Equity Securities

Period	Number of Shares Purchased	Average Price Paid Per Share (1)	Total Number of Shares Purchased as Part of a Publicly Announced Plan or Program (2)	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plan or Program (in thousands) (1), (2)
April 1-30, 2014	2,100	$39.70	2,100	$14,665
May 1-31, 2014	36,936	38.29	36,936	13,251
June 1-30, 2014	31,073	39.08	31,073	12,037
Total	70,109	38.68	70,109	12,037

(1) Amounts exclude fees and commissions associated with the share repurchases.

(2) On July 29, 2013, we announced that our Board of Directors approved a share repurchase program, authorizing us to purchase up to $50.0 million of our outstanding common stock in the open market, including pursuant to a Rule 10b5-1 plan, or in privately negotiated transactions. Shares were retired upon repurchase. Our share repurchase program concluded on July 31, 2014.

Item 6. Exhibits
See the Exhibit Index following the signature page to this Quarterly Report on Form 10-Q for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.

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SOLARWINDS, INC.
SIGNATURE

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.

	SOLARWINDS, INC.
Dated: August 6, 2014	By: /s/ JASON REAM
	Jason Ream Executive Vice President, Finance and Chief Financial Officer (on behalf of the Registrant and as principal financial officer)

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EXHIBIT INDEX

Exhibit No.	Exhibit Description	Provided Herewith	Incorporated by Reference Form	SEC File No.	Exhibit	Filing Date
2.1	Agreement and Plan of Merger and Reorganization dated as of May 17, 2013 by and among SolarWinds Worldwide, LLC, North Acquisition Corp., N-able Technologies International, Inc., the Equity Holder Representatives and U.S. Bank, National Association*		8-K	001-34358	2.1	5/28/2013
2.2	Agreement and Plan of Merger and Reorganization dated as of October 1, 2013 by and among SolarWinds Worldwide, LLC, Optimus Acquisition Corp., Confio Corporation, the Equity Holder Representative and U.S. Bank, National Association*		8-K	001-34358	2.1	10/7/2013
3.1	Amended and Restated Certificate of Incorporation of the Registrant		S-1/A	333-162661	3.1	11/5/2009
3.2	Amended and Restated Bylaws of the Registrant		8-K	001-34358	3.1	9/24/2013
31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	**				
31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	**				
31.3	Certification of Chief Accounting Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	**				
32.1	Certifications of Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	***				
101.INS	XBRL Instance Document	**				
101.SCH	XBRL Taxonomy Extension Schema Document	**				
101.CAL		**				

	XBRL Taxonomy Calculation Linkbase Document	
101.DEF	XBRL Taxonomy Definition Linkbase Document	**
101.LAB	XBRL Taxonomy Label Linkbase Document	**
101.PRE	XBRL Taxonomy Presentation Linkbase Document	**

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* Schedules and exhibits have been omitted pursuant to Item 601(b)(2) of Regulation S-K. SolarWinds, Inc. hereby undertakes to furnish supplementally copies of any of the omitted schedules and exhibits upon request by the Securities and Exchange Commission.

** Filed herewith

*** Furnished herewith