BLUCORA, INC.
Form 10-Q
November 01, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

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: 000-25131

BLUCORA, INC.

(Exact name of registrant as specified in its charter)

Delaware	**91-1718107**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
601 108th Avenue NE, Suite 1200 Bellevue, Washington	**98004**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (425) 201-6100

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. x Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). x 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. (Check One):

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at October 26, 2012**
Common Stock, Par Value $0.0001	40,743,534

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

BLUCORA, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share data and par value)

	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 96,407	$ 81,897
Short-term investments, available-for-sale	54,010	211,654
Accounts receivable, net of allowance of $23 and $10	35,243	25,019
Other receivables, net	1,274	542
Prepaid expenses and other current assets, net	4,514	1,958
Total current assets	191,448	321,070
Property and equipment, net	6,587	5,277
Goodwill	230,980	44,815
Other intangible assets, net	137,959	1,315
Deferred tax asset, net	19,369	19,102
Other long-term assets	4,382	3,560
Total assets	$ 590,725	$ 395,139
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	36,954	$ 28,947
Accrued expenses and other current liabilities	12,372	10,250
Short-term portion of long-term debt, net of discount of $142 and $0	2,233	
Derivative instruments	10,951	
Total current liabilities	62,510	39,197
Long-term liabilities:		
Long-term debt, net of discount of $517 and $0	71,604	
Deferred tax liability	48,149	21
Other long-term liabilities	2,205	816
Total long-term liabilities	121,958	837
Total liabilities	184,468	40,034
Commitments and contingencies (Note 8)		
Stockholders equity:		
Common stock, par value, $0.0001 authorized, 900,000,000 shares; issued and outstanding, 40,633,000 and 39,533,570 shares	4	4
Additional paid-in capital	1,386,741	1,353,971
Accumulated deficit	(980,196)	(998,902)
Accumulated other comprehensive income (loss)	(292)	32

Total stockholders equity		406,257		355,105
Total liabilities and stockholders equity	$	590,725	$	395,139

See accompanying notes to Unaudited Condensed Consolidated Financial Statements.

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BLUCORA, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands, except per share data)

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Revenues:	$ 92,870	$ 56,257	$ 309,449	$ 162,199
Cost of sales (includes amortization of acquired intangible assets of $2,014, $518, $5,605, and $2,248)	69,973	38,755	193,747	108,008
Gross profit	22,897	17,502	115,702	54,191
Expenses and other income:				
Engineering and technology	2,410	1,806	7,431	5,254
Sales and marketing	7,741	4,888	36,053	16,757
General and administrative	5,283	6,513	21,705	16,643
Depreciation	560	475	1,627	1,689
Amortization of intangible assets	3,169		8,450	
Other loss, net	5,196	456	7,681	274
Total expenses and other loss	24,359	14,138	82,947	40,617
Income (loss) from continuing operations before income taxes	(1,462)	3,364	32,755	13,574
Income tax expense	(936)	(1,289)	(14,049)	(4,927)
Income (loss) from continuing operations	(2,398)	2,075	18,706	8,647
Discontinued operations:				
Loss from discontinued operations, net of taxes				(2,253)
Loss on sale of discontinued operations, net of taxes				(7,674)
Net income (loss)	$ (2,398)	$ 2,075	$ 18,706	$ (1,280)
Income (loss) per share Basic				
Income (loss) from continuing operations	(0.06)	$ 0.05	$ 0.47	$ 0.23
Loss from discontinued operations				(0.06)
Loss on sale of discontinued operations				(0.20)
Basic net income (loss) per share	$ (0.06)	$ 0.05	$ 0.47	$ (0.03)
Weighted average shares outstanding used in computing basic income (loss) per share	40,511	38,568	40,108	37,451
Income (loss) per share Diluted				
Income (loss) from continuing operations	(0.06)	$ 0.05	$ 0.45	$ 0.23
Loss from discontinued operations				(0.06)
Loss on sale of discontinued operations				(0.20)
Diluted net income (loss) per share	$ (0.06)	$ 0.05	$ 0.45	$ (0.03)
Weighted average shares outstanding used in computing diluted income (loss) per share	40,511	39,158	41,425	38,131
Other comprehensive income (loss):				
Net income (loss)	$ (2,398)	$ 2,075	$ 18,706	$ (1,280)
Unrealized gain on investments, available-for-sale	9	17		28

Unrealized loss on derivative instrument	(20)		(298)	
Reclassification adjustment for realized gain on investments, available-for-sale, net, included in net income			(26)	
Other comprehensive income (loss)	(11)	17	(324)	28
Comprehensive income (loss)	$ (2,409)	$ 2,092	$ 18,382	$ (1,252)

See accompanying notes to Unaudited Condensed Consolidated Financial Statements.

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BLUCORA, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Operating activities:		
Net income (loss)	$ 18,706	$ (1,280)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss from sale of discontinued operations		7,674
Loss from discontinued operations		2,253
Depreciation and amortization of intangible assets	16,950	6,190
Stock-based compensation	6,637	4,488
Warrant-related stock-based compensation	4,286	1,932
Excess tax benefits from stock-based award activity	(20,882)	
Deferred income taxes	(7,398)	2
Unrealized amortization of premium on investments, net	(335)	285
Amortization of debt origination costs	746	
Accretion of debt discount	294	
Loss on derivative instrument	4,274	
Earn-out contingent liability adjustments		2,000
Gain on resolution of contingent liability		(1,500)
Other	(21)	(8)
Changes in operating assets and liabilities:		
Accounts receivable	(907)	(882)
Other receivables	504	(1,118)
Prepaid expenses and other current assets	705	849
Deferred tax assets and other long-term assets	(612)	(150)
Accounts payable	(2,344)	5,981
Accrued expenses and other current and long-term liabilities	18,357	(13,660)
Net cash provided by operating activities of continuing operations	38,960	13,056
Investing activities:		
Business acquisition, net of cash acquired	(279,386)	
Purchases of property and equipment	(2,776)	(2,507)
Change in restricted cash	168	409
Proceeds from sales of investments	184,934	
Proceeds from maturities of investments	32,125	83,141
Purchases of investments	(59,076)	(204,777)
Net cash used by investing activities of continuing operations	(124,011)	(123,734)
Financing activities:		
Proceeds from loan, net of debt issuance costs of $2,343 and debt discount of $953	96,704	
Repayment of debt	(25,504)	
Excess tax benefits from stock-based award activity	20,882	
Proceeds from stock option exercises	7,812	16,287
Proceeds from issuance of stock through employee stock purchase plan	601	377
Tax payments from shares withheld upon vesting of restricted stock units	(934)	(1,388)
Earn-out payments for business acquisitions		(423)
Repayment of capital lease obligation		(221)
Proceeds from sale of common stock		7,000

Net cash provided by financing activities of continuing operations	99,561	21,632
Discontinued operations:		
Net cash used by operating activities of discontinued operations		(6,156)
Net cash used by investing activities of discontinued operations		(638)
Net cash used by discontinued operations		(6,794)
Net increase (decrease) in cash and cash equivalents	14,510	(95,840)
Cash and cash equivalents:		
Beginning of period	81,897	155,645
End of period	$ 96,407	$ 59,805
Non-cash items:		
Supplemental disclosure of non-cash financing activities:		
Contingent earn-out consideration from acquisition		(2,000)

See accompanying notes to Unaudited Condensed Consolidated Financial Statements.

BLUCORA, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. The Company and Basis of Presentation

Description of the business: Blucora, Inc. (the ***Company*** or ***Blucora***) operates two primary businesses: an internet search business and an online tax preparation business. The Company s search business, InfoSpace, consists primarily of a B2B offering that provides our search technology, aggregated content, and services to our distribution partners. The search business also offers search services directly to consumers through our own internet search properties. The tax preparation business consists of the operations of the TaxACT tax preparation software and online service business that the Company acquired on January 31, 2012.

The InfoSpace search business primarily offers search services through the web properties of its distribution partners, which are generally private-labeled and customized to address the unique requirements of each distribution partner. The search business also distributes aggregated search content through its own websites, such as Dogpile.com and WebCrawler.com. The search business does not generate its own search content, but instead aggregates search content from a number of content providers. Some of these content providers, such as Google and Yahoo!, pay the Company to distribute their content, and those providers are referred to as Search Customers.

On January 31, 2012, the Company acquired TaxACT Holdings, Inc. (***TaxACT Holdings***) and its wholly-owned subsidiary, 2nd Story Software, Inc. (***2nd Story***), which operates the TaxACT tax preparation online service and software business. The TaxACT business consists of an online tax preparation service for individuals, tax preparation software for individuals and professional tax preparers, and ancillary services. The majority of the TaxACT business s revenue is generated by the online service at www.taxact.com. As a highly seasonal business, almost all of the TaxACT revenue is generated in the first four months of the calendar year.

As a result of the acquisition of the TaxACT business, the Company has determined that it has two reporting segments: Search and Tax Preparation. The Search segment is the InfoSpace business and the Tax Preparation segment is the TaxACT business. Unless the context indicates otherwise, the Company uses the term search to represent search services and uses the term tax preparation to represent services and products sold through the TaxACT business (see Note 12: Segment Information).

2. Summary of Significant Accounting Policies

The Company s critical accounting policies and methodologies during the third quarter of 2012 include those described in its Annual Report on Form 10-K for the year ended December 31, 2011, along with those presented below.

Tax Preparation Revenue Recognition: The Company derives revenue from the sale of tax preparation online services, ancillary service offerings, tax preparation packaged software products, and multiple elements arrangements that may include a combination of these items. Ancillary service offerings include tax preparation support services, data archive services, bank or reloadable pre-paid debit card services, and e-filing services. These revenues are recorded in the Tax Preparation segment. The Company recognizes revenue for the Tax Preparation segment when all four revenue recognition criteria have been met: persuasive evidence of an arrangement exists, the Company has delivered the product or performed the service, the fee is fixed or determinable, and collectability is probable. Determining whether and when these criteria have been satisfied involves exercising judgment and using estimates and assumptions that can have an impact on the timing and amount of revenue that the Company recognizes.

The Company s service revenue consists primarily of hosted tax preparation online services, tax preparation support services, data archive services, and e-filing services. The Company recognizes revenue from these services as the services are performed and the four revenue recognition criteria described above are met.

The Company recognizes revenue from the sale of its packaged software products when legal title transfers. This is generally when its customers download products from the Web or when the products ship.

The bank or reloadable prepaid debit card services are offered to taxpayers as an option to receive their tax refunds in the form of a prepaid bank card or to have the fees for the product and/or services purchased by the customers deducted from their refunds. Revenue for this fee is recognized when the four revenue recognition criteria described above are met; for some arrangements that is upon filing and for other arrangements that is upon cash receipt.

For products and/or services that consist of multiple elements, the Company must: (1) determine whether and when each element has been delivered; (2) determine the fair value of each element using the selling price hierarchy of vendor-specific objective evidence (VSOE) of fair value if available, third-party evidence (TPE) of fair value if VSOE is not available, and estimated selling price (ESP) if neither VSOE nor TPE is available; and (3) allocate the total price among the various elements based on the relative selling price method. Once the Company has allocated the total price among the various elements, it recognizes revenue when the revenue recognition criteria described above are met for each element.

VSOE generally exists when the Company sells the deliverable separately and is normally able to establish VSOE for all deliverables in these multiple element arrangements; however, in certain limited instances VSOE cannot be established. This may be because the Company infrequently sells each element separately, or has a limited sales history. When VSOE cannot be established the Company attempts to establish a selling price for each element based on TPE. TPE is determined based on competitor prices for similar deliverables when sold separately. When the Company is unable to establish selling price using VSOE or TPE, it uses ESP in its allocation of arrangement consideration. ESP is the estimated price at which the Company would sell a product or service if it were sold on a stand-alone basis. The Company determines ESP for a product or service by considering multiple factors including, but not limited to, historical stand-alone sales, pricing practices, market conditions, competitive landscape, internal costs, and gross margin objectives.

In some situations, the Company receives advance payments from its customers. The Company defers revenue associated with these advance payments and recognizes the allocated consideration for each element when the Company ships the products or performs the services, as appropriate. Advance payments related to data archive services are deferred and recognized over the related contractual term.

Debt Issuance Costs and Debt Discount: Debt issuance costs and debt discounts are deferred and amortized as interest expense under the effective interest method over the contractual term of the related debt, adjusted for prepayments.

Hedging: The Company uses a derivative financial instrument in the form of an interest rate swap agreement for the purpose of minimizing exposure to changes in interest rates. This swap agreement is accounted for as a cash flow hedge and changes in the fair value of the hedge instrument are included in other comprehensive income.

3. Acquisition

TaxACT Holdings. On January 31, 2012, the Company acquired all of the outstanding stock of TaxACT Holdings and its wholly-owned subsidiary, 2nd Story, which operates the TaxACT tax preparation software and online service business. The Company paid $287.5 million in cash for this acquisition, less certain transaction expenses, and subject to certain specified working capital adjustments. The acquisition of the TaxACT business was funded from the Company s cash reserves and from the net proceeds of a $105 million credit facility (of which $100 million was drawn). See Note 9 for further discussion of the credit facility. The acquisition was intended to diversify the Company s business model and expand its operations. Under the acquisition method, assets acquired and liabilities assumed are recorded at their fair values as of the acquisition date. Any excess of the purchase price over the fair values of the net assets acquired is recorded as goodwill. Preliminary valuations are as follows (in thousands):

	Fair Value
Tangible assets acquired	$ 21,666
Liabilities assumed	15,898
Identifiable net assets acquired	$ 5,768
Fair value adjustments to intangible assets	
Customer relationships	$ 101,400
Proprietary technology	29,800
Trade name	19,499
Fair value of intangible assets acquired	$ 150,699
Purchase price:	
Cash paid	$ 287,500
Less identifiable net assets acquired	(5,768)
Plus deferred tax liability related to intangible assets	55,132

Less fair value of intangible assets acquired	(150,699)
Excess of purchase price over net assets acquired, allocated to goodwill	$ 186,165

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The preliminary fair value determinations for assets acquired and liabilities assumed for this acquisition were based upon a preliminary valuation and certain of our estimates and assumptions are subject to change as we obtain additional information for our estimates in future periods. The primary areas of the acquisition accounting that are not yet finalized relate to income and non-income based taxes and the related indemnification assets. The Company recorded acquisition costs of $305,000 in 2011 and $18,000 and $1.1 million in the three and nine months ended September 30, 2012, respectively, which were recognized in general and administrative expenses. The Company incurred $2.3 million of debt origination costs related to the credit facility used to help fund the acquisition, which the Company plans to amortize to interest expense over the term of the credit facility. The Company did not assume any equity awards or plans from 2nd Story. Following the completion of the acquisition, the Company issued 380,000 options and 167,000 RSUs to 2nd Story s employees as an incentive for future services and at levels consistent with other employee awards.

The Company s estimates of the economic lives of the acquired assets are eight years for the customer relationships, four years for the proprietary technology, approximately three years for the personal property assets, and the trade name is estimated to have an indefinite-life. The Company plans to amortize the assets over their respective estimated lives. The goodwill and the trade name will be tested for impairment at least annually.

The gross contractual amount of trade accounts receivable acquired was $9.4 million, all of which has been collected. The Company recorded a fair value of $304,000 for deferred revenue associated with the TaxACT business s data storage and retrieval service, which 2nd Story, prior to the acquisition, had recorded at $5.1 million as of the acquisition date.

Since the acquisition date, the Company has included in its consolidated results the financial results of operations of the TaxACT business, which included total revenue of $60.9 million and a contribution to the Tax Preparation segment income of $32.5 million.

Pro Forma Financial Information of Acquisitions (unaudited)

The financial information in the table below summarizes the combined results of operations of Blucora and 2nd Story on a pro forma basis, as though they had been combined as of the beginning of each period presented. This pro forma financial information is presented for informational purposes only and is not necessarily indicative of the results of operations that would have been achieved had the acquisition occurred at the beginning of each period presented. The pro forma revenues and income from continuing operations for the three and nine months ended September 30, 2012 and 2011 combines the historical results of operations of the Company and 2nd Story for the quarters ended September 30, 2011, June 30, 2011, and March 31, 2011, and combines the historical results of the Company for the quarters ended September 30, 2012, June 30, 2012, and March 31, 2012 with the results of 2nd Story for the month ended January 31, 2012.

The following amounts are in thousands:

	Three months ended September 30,		Nine months ended September 30,	
	2012	**2011**	**2012**	**2011**
Revenues	$ 92,870	$ 58,261	$ 330,339	$ 238,776
Income (loss) from continuing operations	$ (2,398)	$ 4,936	$ 22,999	$ 13,666

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Goodwill

The goodwill arising from the acquisition consists largely of the ability to attract new customers and develop new technologies post acquisition, which do not qualify for separate recognition. The Company does not expect that any of the goodwill arising from the acquisition will be deductible for tax purposes. The following summarizes the Company s goodwill activity in the first nine months of 2012 by segment (in thousands):

	Search	Tax Preparation	Total
Goodwill January 1, 2012	$ 44,815	$	$ 44,815
New acquisitions		186,165	186,165
Goodwill September 30, 2012	$ 44,815	$ 186,165	$ 230,980

The following summarizes the change in other indefinite-lived intangible assets in the first nine months of 2012 by segment (in thousands):

	Search	Tax Preparation	Total
Other indefinite-lived intangible assets January 1, 2012	$ 283	$	$ 283
New acquisitions		19,499	19,499
Other indefinite-lived intangible assets September 30, 2012	$ 283	$ 19,499	$ 19,782

4. Fair Value Measures

The Company measures its investments at fair value under accounting principles generally accepted in the Unites States of America (***GAAP***). Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company measures its cash equivalents, available-for-sale investments, and derivative instruments at fair value. The cash equivalents and available-for-sale investments are valued within Level 2 in the fair value hierarchy because the Company values its cash equivalents and marketable securities using alternative pricing sources utilizing market observable inputs. The Company classifies its interest rate swap derivative within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments. The Company classifies its warrant derivative within Level 3 because it is valued using the Black-Scholes valuation model, which has significant unobservable inputs. Those unobservable inputs reflect the Company s assumptions, consistent with reasonably available assumptions made by other market participants. This valuation requires significant judgment.

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The fair value hierarchy of the Company s financial assets and liabilities carried at fair value and measured on a recurring basis is as follows (in thousands):

	September 30, 2012	Fair value measurements at the reporting date using Quoted prices in active markets using identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Cash equivalents:				
U.S. government securities	$ 22,623	$	$ 22,623	$
Money market and other funds	24,201		24,201	
Commercial paper	10,074		10,074	
Time deposits	1,990		1,990	
Taxable municipal bonds	3,052		3,052	
Total cash equivalents	61,940		61,940	
Available-for-sale securities:				
U.S. government securities	27,264		27,264	
Commercial paper	4,595		4,595	
Time deposits	5,713		5,713	
Taxable municipal bonds	16,438		16,438	
Total available-for-sale securities	54,010		54,010	
Total assets	115,950		115,950	
Liabilities				
Derivative instruments				
Warrant (see Note 6)	(10,492)			(10,492)
Interest rate swap (see Note 9)	(459)		(459)	
Total liabilities	(10,951)		(459)	(10,492)
Total assets and liabilities at fair value	$ 104,999	$	$ 115,491	$ (10,492)

	December 31, 2011	Fair value measurements at the reporting date using Quoted prices in active markets using identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Cash equivalents:				
Money market funds	$ 32,637	$	$ 32,637	$
Commercial paper	20,000		20,000	

Total cash equivalents	52,637		52,637	
Available-for-sale securities:				
U.S. government securities	162,170		162,170	
Commercial paper	49,484		49,484	
Total available-for-sale securities	211,654		211,654	
Total assets at fair value	$ 264,291	$	$ 264,291	$

Maturity information was as follows for investments classified as available-for-sale at September 30, 2012 (in thousands):

	Amortized Cost	**Gross unrealized gains**	**Gross unrealized losses**	**Fair Value**
Within one year	$ 54,000	$ 14	$ (4)	$ 54,010
Greater than one year				
Total	$ 54,000	$ 14	$ (4)	$ 54,010

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Maturity information was as follows for investments classified as available-for-sale at December 31, 2011 (in thousands):

	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Within one year	$ 211,622	$ 34	$ (2)	$ 211,654
Greater than one year				
Total	$ 211,622	$ 34	$ (2)	$ 211,654

In the nine months ended September 30, 2012 and at December 31, 2011, the Company did not measure the fair value of any of its assets or liabilities other than cash equivalents, available-for-sale investments, and the derivative instruments. The Company s management considers the carrying values of accounts receivable, other receivables, prepaid expenses and other current assets, accounts payable, accrued expenses, and other current liabilities to approximate fair values primarily due to their short-term nature.

5. Accumulated Other Comprehensive Income

The components of accumulated other comprehensive income were as follows (in thousands):

	September 30, 2012	December 31, 2011
Unrealized gain on available-for-sale securities	$ 6	$ 32
Unrealized loss on derivative instrument	(298)	
Accumulated other comprehensive income (loss)	$ (292)	$ 32

6. Stock-Based Compensation

The Company has included the following amounts for stock-based compensation expense, including the cost related to restricted stock units (***RSUs***), stock options, and market stock units (***MSUs***, a form of share price performance-based restricted stock unit) granted under the Company s equity award plans including the Company s employee stock purchase plan (***ESPP***) and the warrant issued in August 2011 (the ***Warrant***) (for further information, see Note 5: Stockholders Equity, in the Company s Annual Report on Form 10-K for the year ended December 31, 2011), in the accompanying unaudited condensed consolidated statements of comprehensive income (loss) for the three and nine months ended September 30, 2012 and 2011 (in thousands):

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Services cost of sales	$ 183	$ 37	$ 331	$ 234
Engineering and technology	332	251	894	684
Sales and marketing	587	177	1,389	829
General and administrative	1,093	2,584	8,309	4,673
Discontinued operations				(159)
Total	$ 2,195	$ 3,049	$ 10,923	$ 6,261
Excluded and capitalized as part of internal-use software	$ 21	$ 44	$ 66	$ 197

The stock based compensation expense for three and nine months ended September 30, 2011 includes $1.9 million fair value classified to general and administrative expenses for the Warrant issued in August 2011. The acquisition of the TaxACT business on January 31, 2012 fulfilled the Warrant agreement s remaining performance condition and extended the Warrant s expiration date. The extension of the Warrant s term was a modification that resulted in a $4.3 million charge to stock-based compensation expense equal to the increase in the Warrant s fair value and was recognized in general and administrative expenses in the first quarter of 2012. Additionally, subsequent to the modification, the Company treated the award as a derivative instrument, and the modification date fair value previously recognized in paid in capital was classified as a current liability. The Warrant s fair value will be determined each reporting period until settled, with gains or losses related to the change in fair value recorded in other income (loss), net. The Company recorded a loss in other loss, net of $4.3 million from derivative instruments relating to the Warrant in the three and nine months ended September 30, 2012. The Company recorded $8.6 million in total expense relating to the modification and change in fair value for the Warrant for the nine months ended September 30, 2012.

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In October 2011, the Company granted 200,000 stock options to a non-employee consultant who performed acquisition-related activities, and the award s vesting was predicated on completing a qualified acquisition under the terms of the award. As a qualified acquisition did not occur in 2011, no expense was recorded for the year ended December 31, 2011. The expense for that award was recognized in the nine months ended September 30, 2012 due to the completion of the acquisition of the TaxACT business on January 31, 2012, which constituted a qualifying acquisition. The vesting of the award resulted in a charge of $903,000 to stock-based compensation expense in the nine months ended September 30, 2012 and was classified to general and administrative expenses.

The total intrinsic value and net shares issued for RSUs vested, MSUs vested, options exercised, and shares purchased pursuant to the ESPP during the three and nine months ended September 30, 2012 and 2011 is presented below (in thousands):

	Three months ended September 30,				Nine months ended September 30,			
	2012		2011		2012		2011	
	Intrinsic value	Net shares issued	Intrinsic value	Net shares issued	Intrinsic value	Net shares issued	Intrinsic value	Net shares issued
RSUs vested	$ 356	18	$ 857	67	$ 3,258	191	$ 4,598	362
MSUs vested					511	30		
Options exercised	1,335	243	814	504	2,832	817	2,300	2,053
Shares purchased pursuant to ESPP	178	38	58	24	277	62	100	54
Total	$ 1,869	299	$ 1,729	595	$ 6,878	1,100	$ 6,998	2,469

To determine the stock-based compensation expense or derivative gain or loss that was recognized with respect to RSUs, the Warrant, and stock options in the three and nine months ended September 30, 2012 and 2011, the Company used the fair value at date of grant for RSUs, the Monte Carlo valuation method for the market stock unit grants, and the Black-Scholes-Merton option-pricing model for employee and non-employee stock option grants and the Warrant, basing expected volatility on historical volatility adjusted for special dividends for all awards. The following weighted-average inputs were used for stock option grants and the Warrant:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Employee stock option grants:				
Risk-free interest rate	0.38%	0.64%	0.47%	1.05%
Expected dividend yield	0%	0%	0%	0%
Expected volatility	44%	46%	44%	47%
Expected life	3.3 years	3.3 years	3.1 years	3.0 years
Non-employee stock option grant:				
Risk-free interest rate			0.26%	
Expected dividend yield			0%	
Expected volatility			38-41%	
Expected remaining life			1.6 2.2 years	
Market stock unit grants:				
Risk-free interest rate		0.15%		0.15%
Blucora expected dividend yield		0%		0%
iShares Russell 2000 Index expected dividend yield		1.08%		1.08%
Blucora closing stock price		$ 8.74		$ 8.74
iShares Russell 2000 Index closing price		$ 82.29		$ 82.29
Blucora expected volatility		37.4%		37.4%
iShares Russell 2000 Index expected volatility		20.3%		20.3%
Measurement period		1.0 years		1.0 years
Warrant grant:				
Risk-free interest rate	0.68%	0.46%	0.68% -0.89%	0.46%
Expected dividend yield	0%	0%	0%	0%
Expected volatility	47%	39%	46 48%	39%

Remaining contractual term	4.9 years	2.0 years	5.4 - 4.9 years	2.0 years

7. Net Income per Share

Basic net income per share is computed using the weighted average number of common shares outstanding during the period. Diluted net income per share is computed using the weighted average number of common shares outstanding plus the

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number of potentially dilutive shares outstanding during the period. Potentially dilutive shares consist of the incremental common shares issuable upon the exercise of outstanding stock options and the Warrant and vesting of unvested RSUs and MSUs, using the treasury stock method. Performance-based stock options for which performance has not yet been achieved are excluded from the calculation of potentially dilutive shares. Potentially dilutive shares are excluded from the computation of earnings per share if their effect is antidilutive. The treasury stock method calculates the dilutive effect for awards with an exercise price less than the average stock price during the period presented (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Weighted average common shares outstanding, basic	40,511	38,568	40,108	37,451
Dilutive stock options, RSUs, MSUs, and the Warrant		590	1,317	680
Weighted average common shares outstanding, diluted	40,511	39,158	41,425	38,131
Antidilutive awards with an exercise price less than the average price during the applicable period excluded from dilutive share calculation	26	1,145	246	788
Outstanding awards with an exercise price greater than the average price during the applicable period not included in dilutive share calculation	655	3,046	848	3,057
Outstanding awards with performance conditions not completed during the applicable period not included in dilutive share calculation	190		157	
Outstanding awards excluded from dilutive share calculation due to anti-dilutive effect of a loss from continuing operations	5,000			

8. Commitments and Contingencies

The Company s contractual commitments changed from the commitments and obligations disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2011 due to the acquisition of the TaxACT business and signing of a new office lease on July 19, 2012. The Company s contractual commitments are as follows for the remainder of 2012 as of September 30, 2012, and for the following years ending December 31 (in thousands):

	2012	2013	2014	2015	2016	2017	Thereafter	Total
Operating lease commitments	$ 497	$ 1,520	$ 1,149	$ 1,186	$ 1,222	$ 1,259	$ 3,649	$ 10,482
Less sublease income	(22)	(36)						(58)
Net lease payments required	475	1,484	1,149	1,186	$ 1,222	1,259	3,649	10,424
Purchase commitments	488	882	300	142	92	61		1,965
Debt commitments		4,750	9,500	13,062	14,250	32,934		74,496
Total	$ 963	$ 7,116	$ 10,949	$ 14,390	$ 15,564	$ 34,254	$ 3,649	$ 86,885

Litigation

From time to time the Company is subject to various legal proceedings or claims that arise in the ordinary course of business. Although the Company cannot predict the outcome of these matters with certainty, the Company s management does not believe that the disposition of these ordinary course matters will have a material adverse effect on the Company s financial position, results of operations, or cash flows.

9. Debt

On January 31, 2012 in conjunction with closing the Company s acquisition of the TaxACT business, 2nd Story entered into an agreement with a syndicate of lenders for a $105 million credit facility. 2nd Story s obligations under the credit agreement are guaranteed by TaxACT Holdings, a direct subsidiary of the Company and the direct parent of 2nd Story, and are secured by the assets of the TaxACT business and the 2nd Story equity owned by TaxACT Holdings. Under this credit agreement, 2nd Story borrowed $95 million of term debt and has access to various forms of revolving debt. Subject to certain limitations, the amount of revolving debt available to 2nd Story through this credit agreement is $10 million, of which $5 million was borrowed under the agreement.

The $95 million term loan requires quarterly principal payments and matures on January 31, 2017. The interest rate on amounts borrowed under the term loan and the revolving loan is variable and payable as of the end of each interest period or, if

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more frequent, quarterly, based upon, at the election of 2nd Story, the Alternate Base Rate or the LIBOR Rate, plus the Applicable Margin (as such terms are defined in the credit agreement). The Applicable Margin is dependent on the consolidated Total Leverage Ratio (as defined in the credit agreement) of TaxACT Holdings and ranges from 2.0% to 3.5% for borrowings tied to the Alternative Base Rate and 3.0% to 4.5% for borrowings tied to the LIBOR Rate.

A portion of any excess cash flows, as the term is defined in the credit agreement, must be used to make a mandatory prepayment on the term loan within ninety days of June 30, 2013 and thereafter within 90 days of June 30th in succeeding years in the event that the leverage ratio is more than two-to-one on June 30th of that year. 2nd Story made a mandatory principal prepayment of $504,000 in the three months ended September 30, 2012 based upon excess cash flows. Amounts outstanding under the term loan may be prepaid without penalty. On February 10, 2012, 2nd Story repaid the $5 million outstanding under the revolving credit facility. On March 13, 2012 and May 1, 2012, 2nd Story prepaid $20 million, in two equal payments, of the balance outstanding under the term loan. The remaining amount of debt outstanding under the term loan as of September 30, 2012 was $74.5 million. The credit agreement covenants limit 2nd Story and its parent, TaxACT Holdings, from, in certain circumstances, incurring additional indebtedness, incurring liens, paying dividends to the Company, making capital expenditures over stipulated maximums, allowing the consolidated Total Leverage Ratio (as defined in the credit agreement) to exceed stipulated levels over the debt term, and allowing the Fixed Charge Coverage Ratio to be less than stipulated levels.

Additionally, the Company was required to hedge a portion of the interest rate risk associated with the term debt 90 days after its inception, and that requirement was met on May 1, 2012 by the purchase of an interest rate swap with a financial institution which fixed the LIBOR Rate portion at 0.85% for $37.5 million of the amount outstanding under the term loan. The swap s terms are scheduled to fix the interest rate on a declining amount outstanding under the term loan, approximating half of the debt balance, until the credit agreement s termination on January 31, 2017.

10. Derivative Instruments and Hedging Activities

During the quarter ended September 30, 2012, the interest rate swap purchased by 2nd Story, as further described in Note 9, was intended to reduce the risk that the Company s cash flows and earnings will be adversely affected by interest rate fluctuations. The Company recognizes derivative instruments as either assets or liabilities on its unaudited condensed consolidated balance sheets at fair value. The Company records changes in the fair value of the derivatives as gains or losses in the unaudited consolidated statements of comprehensive income in other loss (income), net, or to accumulated other comprehensive income in the unaudited consolidated balance sheets.

The fair values of outstanding derivative instruments were as follows (in thousands):

		Fair value of derivative instruments	
	Balance sheet location	**As of September 30, 2012**	**As of December 31, 2011**
Derivative liabilities			
Derivative designated as a hedging instrument:			
Interest rate contract (interest rate swap)	Current liabilities - derivative instruments	$ 459	$
Derivative not designated as a hedging instrument:			
Equity contract (the Warrant)	Current liabilities - derivative instruments	10,492	
Total derivative liabilities		$ 10,951	$

The derivative instrument in a hedging relationship had no effect on income for any and all periods presented.

The effect of the derivative instrument not designated as hedging instruments on income is summarized below (in thousands):

Derivative not designated as hedging instrument	Location	Losses recognized in other loss, net Three months ended September 30, 2012	2011	Nine months ended September 30, 2012	2011
Equity contract (the Warrant)	Derivative instruments	$ 4,335	$	$ 4,274	$

11. Income Taxes

The Company provides income taxes for the various jurisdictions in which it operates. The income tax expense or benefit reflects the income tax effects of financial reporting income, permanent differences between financial reporting income and taxable income, and the effects of the change in the valuation allowance applied to its deferred tax assets. At the end of each quarterly reporting period, the Company estimates the income, permanent differences, changes in the deferred tax assets and the related change to its valuation allowance, and the effective income tax rate that it expects for the full year.

Each quarterly reporting period, the Company applies the expected effective income tax rate to financial reporting income recorded in its financial statements on a year-to-date basis and records the change in expected income taxes as income tax expense or benefit. The Company reflects the tax effect of any tax law changes and certain other discrete events in the period in which they occur.

The expected annual effective tax rate may vary during each quarterly reporting period due to a number of factors, including the effects from any forecasted permanent differences between financial reporting and tax reporting, enactment of tax legislation in the various jurisdictions in which the Company operates, and certain other discrete events.

As discussed in Note 8 to the Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2011, the Company has a valuation allowance against deferred tax assets of net operating losses that arose from excess tax benefits for stock-based compensation. The Company currently provides a valuation allowance against deferred tax assets when it is more likely than not that some portion, or all, of its deferred tax assets, will not be realized.

The Company recorded income tax expense from continuing operations of $1.0 million and $14.0 million in the three and nine months ended September 30, 2012, respectively. The Company recorded income tax expense from continuing operations of $1.3 million and $4.9 million in the three and nine months ended September 30, 2011, respectively. In the three and nine months ended September 30, 2012, income tax expense differed from the taxes at the statutory rates primarily due to the non-deductible loss on the derivative and to non-deductible stock compensation. In the three and nine months ended September 30, 2011, income tax expense did not significantly differ from the taxes at the statutory rates.

During the quarter ended September 30, 2012, there were no material changes to the unrecognized tax benefits, the total amount of unrecognized tax benefits that would affect the effective tax rate if recognized, the amount of interest and penalties recognized in connection with the unrecognized tax benefits, and the tax years that remain subject to examination. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease within the next 12 months.

12. Segment Information

The Company changed its operational structure as a result of the January 2012 acquisition of the TaxACT business. The Search segment is the InfoSpace business and the Tax Preparation segment is the TaxACT business. The Company s chief executive officer is its chief operating decision maker and reviews financial information presented on a disaggregated basis. This information is used for purposes of allocating resources and evaluating financial performance.

The Company presents revenue and cost of sales for each of the two segments. Search segment cost of sales consists primarily of revenue sharing arrangements with the Company s distribution partners and usage-based content fees. Tax Preparation segment cost of sales consists primarily of royalties, payment processing fees for customer transactions, and bank service fees.

The Company does not allocate certain general, administrative, and overhead costs, or stock-based compensation, depreciation, amortization of intangible assets, other loss (income), net, income tax expense, or results from discontinued operations to the reportable segments. Such amounts are reflected in the table below under the heading Corporate. The Company does not account for, and does not report to management, its assets or capital expenditures by segment other than goodwill and intangible assets used for impairment analysis purposes.

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Information on reportable segments currently presented to the Company s chief operating decision maker and a reconciliation to consolidated net income for the three and nine months ended September 30, 2012 and 2011 are presented below (in thousands):

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Search				
Revenue	$ 91,408	$ 56,257	$ 248,511	$ 162,199
Cost of revenue	65,203	36,329	176,545	99,031
Operating expense	9,849	9,119	27,159	29,730
Search segment income	16,356	10,809	44,807	33,438
Search segment margin	18%	19%	18%	21%
Tax Preparation				
Revenue	1,462		60,938	
Cost of revenue	292		4,410	
Operating expense	2,731		24,000	
Tax Preparation segment income	(1,561)		32,528	
Tax Preparation segment margin	(107)%		53%	
Total Segment				
Total segment revenue	92,870	$ 56,257	309,449	$ 162,199
Total segment cost of revenue	65,495	36,329	180,955	99,031
Total segment operating expenses	12,580	9,119	51,159	29,730
Total segment income	14,795	10,809	77,335	33,438
Total segment margin	16%	19%	25%	21%
Corporate				
Operating expense	2,695	2,307	9,026	6,980
Stock-based compensation	2,195	3,049	10,923	6,420
Depreciation	988	1,115	2,895	3,942
Amortization of intangible assets	5,183	518	14,055	2,248
Other loss, net	5,196	456	7,681	274
Income tax expense	936	1,289	14,049	4,927
Loss from discontinued operations, net of tax				9,927
Total corporate	17,193	8,734	58,629	34,718
Net income (loss)	$ (2,398)	$ 2,075	$ 18,706	$ (1,280)

13. Discontinued Operations

On June 22, 2011, the Company sold its Mercantila e-commerce business to Zoo Stores, Inc. The results of operations from the business are reflected in the unaudited condensed consolidated financial statements as discontinued operations for all periods presented. Revenue, loss before taxes, income tax benefit, and loss from discontinued operations, net of taxes, and loss on sale of discontinued operations, net of taxes, for the three and nine months ended September 30, 2011 are presented below (in thousands):

	Three months ended September 30, 2011	Nine months ended September 30, 2011
Revenue from discontinued operations	$	$ 16,894

Loss from discontinued operations before taxes	$		$	(3,506)
Income tax benefit			$	1,253
Loss from discontinued operations, net of taxes	$		$	(2,253)
Loss on sale of discontinued operations, net of an income tax benefit of $5,092	$		$	(7,674)

Loss from discontinued operations includes previously unallocated depreciation, amortization, stock-based compensation expense, income taxes, and other corporate expenses that were attributable to the e-commerce business.

14. Recent Accounting Pronouncements

Changes to GAAP are established by the Financial Accounting Standards Board (***FASB***) in the form of accounting standards updates (***ASUs***) to the FASB s Accounting Standards Codification. The Company considers the applicability and impact of all recent ASUs.

In July 2012, the FASB issued an ASU to simplify how entities test indefinite-lived intangible assets for impairment to improve consistency in impairment testing requirements among long-lived asset categories. The ASU permits an assessment of qualitative factors to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. For assets for which this assessment concludes it is more likely than not that the fair value is more than its carrying value, this ASU eliminates the requirement to perform quantitative impairment testing as outlined in the previously issued standards. The new guidance is effective for the Company beginning October 1, 2012. The Company does not expect the adoption of this ASU to materially impact its consolidated condensed financial statements.

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

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The statements in this report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements include, but are not limited to: statements regarding projections of our future financial performance; trends in our businesses; our future business plans and growth strategy, including our plans to expand, develop, or acquire particular operations, businesses, or assets; and the sufficiency of our cash balances and cash generated from operating, investing, and financing activities for our future liquidity and capital resource needs.

Forward-looking statements are subject to known and unknown risks, uncertainties, and other factors that may cause our results, levels of activity, performance, achievements, prospects, and other characterizations of future events or circumstances, to be materially different from those expressed or implied by such forward-looking statements. These risks, uncertainties, and other factors include, among others, those identified under Part II, Item 1A, Risk Factors and elsewhere in this report. You should not rely on forward-looking statements included herein, which speak only as of the date of this Quarterly Report on Form 10-Q or the date specified herein. We do not undertake any obligation to update publicly any forward-looking statement to reflect new information, events, or circumstances after the date of this Quarterly Report on Form 10-Q or to reflect the occurrence of unanticipated events.

Overview

Blucora owns and operates two primary businesses: the InfoSpace online search business and the TaxACT tax preparation software and online service business. The InfoSpace business is primarily a B2B service that provides search technology, aggregated search content, and monetization solutions to partner sites. InfoSpace also offers search services directly to consumers through its owned internet search properties. Blucora acquired the TaxACT tax preparation business on January 31, 2012. The TaxACT business consists of an online tax preparation service for individuals, tax preparation software for individuals and professional tax preparers, and ancillary financial services. Following the acquisition of the TaxACT business, we determined that we have two reporting segments: Search and Tax Preparation.

Search

The majority of the Company s revenues are generated by our Search segment. Our Search business primarily offers search services through the web properties of its distribution partners, which are generally private-labeled and customized to address the unique requirements of each distribution partner. The Search business also distributes aggregated search content through its own websites, such as Dogpile.com and WebCrawler.com. The InfoSpace search business does not generate its own search content, but instead aggregates search content from a number of content providers. Our metasearch technology selects search results from several search engine content providers, including Google, Yahoo!, and Bing, among others, and aggregates, filters, and prioritizes the results. This combination provides a more relevant search results page and leverages the investments made by our search engine content providers to continually improve the user experience. Some of these content providers, such as Google and Yahoo!, pay the Company to distribute their content, and those providers are referred to as Search Customers.

Revenue from our Search segment is generated primarily as a result of end users of our services clicking on paid search results displayed on our own branded websites or those of our distribution partners. These paid search results are provided to us by our Search Customers. The Search Customer that provided the paid search result receives a fee from the advertiser who paid for the click and the Search Customer pays us a portion of that fee. If the click originated from one of our distribution partners web properties, we share a portion of the fee we receive with the partner. Revenue is recognized in the period in which such paid clicks occur and is based on the amounts earned and remitted to us by our Search Customers for such clicks. Revenue from Google accounts for approximately 90% of our Search segment revenue for the three months ended September 30, 2012.

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Tax Preparation

Our Tax Preparation segment generates its revenue through three primary methods: the sale of state and upgraded federal income tax preparation services and software to consumers and small businesses, the sale of ancillary services to consumers, and the sale of its professional edition income tax preparation software to professional tax preparers. The majority of the TaxACT business s revenue is generated by the online service at www.taxact.com and, as a highly seasonal business, almost all of that revenue is generated in the first four months of the calendar year. The TaxACT business s basic federal tax preparation online software service is free for everyone, meaning that any taxpayer can use the services to file his or her federal income taxes without paying for upgraded services. This free offer differentiates TaxACT s offerings from many of its competitors who have limited free software and/or services offerings. The TaxACT business generates revenue from a percentage of these free users who choose to upgrade for a fee to the deluxe product and ancillary services and/or to file their state income tax returns, which are not free, with TaxACT. The ancillary services include, among other things, taxpayer phone support, data archiving, a deferred payment option, a bank card product, and e-filing services for professional tax preparers. TaxACT is the generally accepted value player in the digital do it yourself space, offering comparable software and/or services at a lower cost to the end-user compared to larger competitors. This, coupled with its free for everyone offer, provides TaxACT a valuable marketing position. TaxACT s professional tax preparer software allows professional tax preparers to file individual returns for their clients. Revenue from professional tax preparers has historically constituted a relatively small percentage of the TaxACT business s overall revenue, and requires relatively modest incremental development costs as the basic software is substantially similar to the consumer-facing software and online service.

Use of Cash

As of September 30, 2012, we had $150.4 million in cash, cash equivalents, and short term investments. We may use these amounts in the future on investment in our current businesses, in acquiring new businesses or assets, or for repayment of debt. Such businesses or assets may not be related to search or tax preparation, and such acquisitions will result in us incurring further transaction related costs.

Overview of Third Quarter 2012 Operating Results

The following is an overview of our operating results for the third quarter 2012 compared to the third quarter 2011. A more detailed comparison of our operating results for these periods is included under the heading Results of Operations for the Three and Nine Months Ended September 30, 2012 and 2011 in this Management s Discussion and Analysis of Financial Condition and Results of Operations.

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Several of our key operating financial measures for the quarters ended September 30, 2012 and 2011 in total dollars (in thousands) and as a percentage of associated revenue are presented below:

	Three months ended September 30, 2012		2011	
Revenues	$ 92,870		$ 56,257	
		% of total revenues		% of total revenues
Gross profit	$ 22,897	24.7%	$ 17,502	31.1%
Net income (loss)	$ (2,398)	(2.6)%	$ 2,075	3.7%
Adjusted EBITDA(1)	$ 12,100	13.0%	$ 8,502	15.1%
Non-GAAP net income (1)	$ 10,421	11.2%	$ 6,845	12.2%
		% of search services revenue		% of search services revenue
Search Revenue:				
Revenue from distribution partners		88%		81%
Revenue from existing distribution partners (launched prior to the then-current year)		75%		76%
Revenue from new distribution partners (launched during the then-current year)		13%		5%
Revenue from owned and operated properties		12%		19%
Tax Preparation Revenue:				
Revenue	$ 1,462		$	

(1) Adjusted EBITDA and Non-GAAP net income are non-GAAP measures, defined below in Non-GAAP Financial Measures.

The increase in our revenues is primarily due to the increase in our search services revenue for the third quarter 2012 as compared to the third quarter 2011. The increase in search services revenue was primarily due to an increase of revenue generated by our distribution partners. We generated 48% and 49% of our search services revenue through our top five distribution partners for the three months ended September 30, 2012 and 2011, respectively. The web properties of our top five distribution partners for the third quarter 2012 generated 49% of our search services revenue in the third quarter of 2011.

The net loss for the third quarter of 2012 is primarily due to a $4.3 million loss on the Warrant which is classified as a derivative instrument. The Warrant is recorded at its fair value each reporting period based upon several factors, including Blucora s stock price. Gains and losses on the Warrant are non-deductible for tax purposes and may cause volatility in Blucora s effective income tax rate, increasing it in periods when we record a loss on the Warrant and decreasing it when we record a gain on the Warrant. See Note 4: Fair Value Measures, Note 6: Stock-Based Compensation, and Note 10: Derivative Instruments and Heading Activities to the Unaudited Condensed Consolidated Financial Statements in Part I, Item I of this report for further information.

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Results of Operations for the Three and Nine Months Ended September 30, 2012 and 2011

Business Segment Results

The following information presents the results of operations of our two reporting segments. Segment expenses do not include certain costs such as certain general, administrative, and overhead costs, stock-based compensation, depreciation, amortization of intangible assets, other loss, net, income tax expense, or results from discontinued operations to the reportable segments.

Search

Search segment results are as follows (in thousands):

	Three months ended September 30,		Change from	Nine months ended September 30,		Change from
	2012	2011	2011	2012	2011	2011
Revenue	$ 91,408	$ 56,257	$ 35,151	$ 248,511	$ 162,199	$ 86,312
Cost of revenue	65,203	36,329	28,874	176,545	99,031	77,514
Operating expense	9,849	9,119	730	27,159	29,730	(2,571)
Segment income	$ 16,356	$ 10,809	$ 5,547	$ 44,807	$ 33,438	$ 11,369
Segment margin	17.9%	19.2%		18.0%	20.6%	

Our ability to increase the revenue generated from our distribution partners web properties is dependent on our ability to attract and retain distribution partners, which relies on providing a satisfying end user experience and an attractive monetization proposition to our distribution partners. Our ability to slow the decline in our online search services revenue in our metasearch engine sites and our installed application user base (from our 2010 acquisition of Make the Web Better) relies in part on our ability to attract and retain end users by providing a satisfying user experience. We manage our online direct marketing initiatives by projecting a desired return on our marketing expenditures and attempting to market according to that projected return. Revenue growth for our online direct marketing initiatives is dependent on our ability to execute to that projected return.

In recent periods we experienced an overall growth in our revenue generated from our distribution partners, both existing and new, highlighted by a $35.3 million (78%) increase in revenue from distribution partners for the third quarter 2012 as compared to the third quarter 2011, and a $93.3 million (74%) increase in revenue for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011. Additionally, revenue from new distribution partners (launched during the current year) increased by $9.1 million and $15.5 million for the three and nine months ended September 30, 2012 as compared to the same periods in 2011. While we expect to continue year-over-year growth, it will be challenging to maintain the recent growth rates and therefore we expect slowing over the near-term. Conversely, we have experienced an overall decline in revenue generated through our owned and operated properties. This trend is primarily a result of the expected user attrition of our metasearch installed application base from our 2010 acquisition of Make the Web Better, resulting in fewer paid clicks from these sites, and a decrease in revenue from our metasearch engine sites, partially offset in recent periods by an increase in revenue generated through our online direct marketing initiatives.

We expect that search services revenue from searches conducted by end users on sites of our distribution partners will continue to represent the dominant majority of our search services revenue for the foreseeable future. Our owned and operated metasearch services are affected by seasonal fluctuations in Internet usage, which generally decline in the summer months, although revenue from these sites makes up a proportionally smaller portion of our revenue, so seasonal impacts have become less meaningful, and are expected to become a smaller portion over time.

The search segment s cost of revenue primarily consists of amounts paid under our revenue sharing arrangements with our distribution partners and usage-based content fees. The increase in cost of revenue for the third quarter 2012 as compared to the third quarter 2011 and for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 is primarily due to an increase in the revenue generated from our distribution partners web properties, with the resulting increase in shared revenue.

The search segments cost of revenue will increase if search services revenue generated through our distribution partners web properties increases at a greater rate than revenue generated through our owned and operated web properties. In addition, cost of revenue from distribution can be impacted by the mix of revenue generated by distribution partners. We expect that revenue from searches conducted by end users on sites of our distribution partners will continue to be an increasing majority of our search services revenue.

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The increase in search segment operating expense for the third quarter 2012 as compared to the third quarter 2011 was primarily due to an increase in spending on our online direct marketing initiatives. The decrease in search segment operating expense for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 is primarily due to a decrease in spending on our online direct marketing initiatives.

Tax Preparation

Tax Preparation segment results are as follows (in thousands):

	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Revenue	$ 1,462	$	$ 60,938	$
Cost of revenue	292		4,410	
Operating expense	2,731		24,000	
Segment income (loss)	$ (1,561)	$	$ 32,528	$
Segment margin	(106.8)%		53.4%	

The Tax Preparation segment is new this year due to the acquisition of the TaxACT business on January 31, 2012. Unless otherwise indicated, the year-to-date figures in this quarterly report reflect the results from the date of the acquisition through September 30, 2012.

The Tax Preparation segment is highly seasonal; almost all of its annual revenue is generated in the first four months of the calendar year, as are the majority of the variable costs related to such revenue, such as payment processing fees, royalties, and advertising and marketing expenses. As a result, revenue declined in the third quarter and will further decline in the fourth quarters, while fixed costs remain relatively constant.

The Tax Preparation segment cost of revenue primarily consists of royalties, payment processing fees for customer transactions, and bank service fees. Operating expenses for the tax preparation segment consists primarily of personnel related costs and marketing expenses.

Consolidated Results

Cost of sales. Cost of sales consists of the Search and Tax Preparation segments cost of revenue, amortization of acquired intangible assets, and certain costs associated with customer service and the operation of the data centers that serve our businesses, which include personnel expenses (which include salaries, benefits and other employee related costs, and stock-based compensation expense), bandwidth costs, and depreciation. Cost of sales in total dollars (in thousands) and as a percentage of total revenues for the three and nine months ended September 2012 and 2011 are presented below:

	Three months ended September 30, 2012	Three months ended September 30, 2011	Change from 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011	Change from 2011
Search segment cost of revenue	$ 65,203	$ 36,329	$ 28,874	$ 176,545	$ 99,031	$ 77,514
Tax Preparation segment cost of revenue	292		292	4,410		4,410
Amortization of acquired intangible assets	2,014	518	1,496	5,605	2,248	3,357
Data center operations	1,853	1,231	622	5,588	4,242	1,346
Depreciation	428	640	(212)	1,268	2,253	(985)
Other	183	37	146	331	234	97
Total cost of sales	$ 69,973	$ 38,755	$ 31,218	$ 193,747	$ 108,008	$ 85,739
Percentage of revenues	75.3%	68.9%		62.6%	66.6%	

The dollar increase for expenses not related to segment costs of sales for the third quarter 2012 as compared to the third quarter ended 2011 was primarily attributable to an increase in amortization of acquired intangible assets primarily attributable to TaxACT assets acquired and an increase of $518,000 in personnel costs in data center operations, which was primarily attributable to TaxACT operations.

The dollar increase for expenses not related to segment costs of sales for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 was primarily attributable to an increase in amortization of acquired intangible assets primarily attributable to TaxACT assets acquired, an increase of $711,000 in personnel costs in data center operations and an increase of $578,000 in contractor expenses, which were both primarily attributable to TaxACT operations. These increases were partially offset by the decrease in depreciation expense relating to data center equipment reaching the end of its estimated useful life in 2011.

Engineering and technology expenses. Engineering and technology expenses are associated with the research, development, support, and ongoing enhancements of our offerings, including personnel expenses (which include salaries, stock-based compensation expense, and benefits and other employee related costs), software support and maintenance, and professional service fees. Engineering and technology expenses in total dollars (in thousands) and as a percentage of total revenues for the three and nine months ended September 30, 2012 and 2011 are presented below:

	Three month ended September 30,		Change from	Nine month ended September 30,		Change from
	2012	2011	2011	2012	2011	2011
Engineering and technology expenses	$ 2,410	$ 1,806	$ 604	$ 7,431	$ 5,254	$ 2,177
Percentage of revenues	2.6%	3.2%		2.4%	3.2%	

The dollar increase for the third quarter 2012 as compared to the third quarter ended 2011 was primarily attributable to an increase of $625,000 in personnel costs, which was primarily attributable to TaxACT operations.

The dollar increase for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 was primarily attributable to an increase of $2.6 million in personnel costs, which was primarily attributable to TaxACT operations.

Sales and marketing expenses. Sales and marketing expenses consist principally of marketing expenses associated with our tax preparation business (which includes the following channels: television, radio, online banner ads, and email), our owned and operated web search properties (which consist of traffic acquisition, including our online direct marketing initiatives, which involve the purchase of online advertisements that drive traffic to an owned and operated website, agency fees, brand promotion expense, and market research expense), personnel costs (which include salaries, stock-based compensation expense, and benefits and other employee related costs), and the cost of temporary help and contractors to augment our staffing. Sales and marketing expenses in total dollars (in thousands) and as a percentage of total revenues for the three and nine months ended September 30, 2012 and 2011 are presented below:

	Three month ended September 30,		Change from	Nine month ended September 30,		Change from
	2012	2011	2011	2012	2011	2011
Sales and marketing expenses	$ 7,741	$ 4,888	$ 2,853	$ 36,053	$ 16,757	$ 19,296
Percentage of revenues	8.3%	8.7%		11.7%	10.3%	

The dollar increase for the third quarter 2012 as compared to the third quarter 2011 was primarily attributable to an increase in personnel costs of $1.4 million, which was primarily attributable to TaxACT operations, as well as an increase of $1.3 million in advertising costs, primarily due to an increase in advertising expense associated with our search direct marketing initiatives.

The dollar increase for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011 was primarily attributable to an increase of $15.6 million in advertising costs, primarily due to the TaxACT business s marketing costs, partially offset by an decrease in advertising expense associated with our search direct marketing initiatives as well as an increase in personnel costs of $3.1 million, which was primarily attributable to TaxACT operations. The increase in personnel costs included an increase of $560,000 related to stock compensation primarily related to options and RSUs issued to 2nd Story employees, as an incentive for future services, at date of acquisition.

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General and administrative expenses. General and administrative expenses consist primarily of personnel expenses (which include salaries, stock-based compensation expense, and benefits and other employee related costs), professional service fees (which include legal, audit, and tax fees), general business development and management expenses, occupancy and general office expenses, taxes, insurance expenses, and certain legal settlements. General and administrative expenses in total dollars (in thousands) and as a percentage of total revenues for the three and nine months ended September 30, 2012 and 2011are presented below:

Three month ended September 30,		Change from	Nine month ended September 30,	Change from 2011
2012	2011	2011	2012	