Proto Labs Inc
Form 10-Q
August 04, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016

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: 001-35435

Proto Labs, Inc.

(Exact name of registrant as specified in its charter)

Minnesota	**41-1939628**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
5540 Pioneer Creek Drive **Maple Plain, Minnesota**	**55359**
(Address of principal executive offices)	(Zip Code)

(763) 479-3680

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 26,420,518 shares of Common Stock, par value $0.001 per share, were outstanding at July 27, 2016.

Proto Labs, Inc.

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Proto Labs, Inc.
Consolidated Balance Sheets
(In thousands, except share and per share amounts)

	June 30, 2016 (Unaudited)	December 31, 2015
Assets		
Current assets		
Cash and cash equivalents	$ 57,331	$ 47,653
Short-term marketable securities	39,216	33,201
Accounts receivable, net of allowance for doubtful accounts of $397 and $330 as of June 30, 2016 and December 31, 2015, respectively	34,486	36,125
Inventory	9,901	9,771
Prepaid expenses and other current assets	5,468	5,224
Income taxes receivable	2,005	6,028
Total current assets	148,407	138,002
Property and equipment, net	138,685	125,475
Goodwill	28,916	28,916
Other intangible assets, net	2,980	3,337
Long-term marketable securities	67,730	64,789
Other long-term assets	1,305	517
Total assets	$ 388,023	$ 361,036
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable	$ 11,435	$ 13,643
Accrued compensation	9,753	9,993
Accrued liabilities and other	2,491	2,626
Total current liabilities	23,679	26,262
Long-term deferred tax liabilities	4,632	4,240
Other long-term liabilities	2,928	2,889
Total liabilities	31,239	33,391
Shareholders' equity		
Preferred stock, $0.001 par value, authorized 10,000,000 shares; issued and outstanding 0 shares as of each of June 30, 2016 and December 31, 2015	-	-

Common stock, $0.001 par value, authorized 150,000,000 shares; issued and outstanding 26,415,690 and 26,200,718 shares as of June 30, 2016 and December 31, 2015, respectively	26	26
Additional paid-in capital	208,021	198,835
Retained earnings	155,349	133,996
Accumulated other comprehensive loss	(6,612)	(5,212)
Total shareholders' equity	356,784	327,645
Total liabilities and shareholders' equity	$ 388,023	$ 361,036

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

Proto Labs, Inc.
Consolidated Statements of Comprehensive Income
(In thousands, except share and per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	**2015**	**2016**	**2015**
Statements of Operations:				
Revenue	$74,961	$63,969	$147,529	$122,505
Cost of revenue	32,715	26,419	65,629	49,701
Gross profit	42,246	37,550	81,900	72,804
Operating expenses				
Marketing and sales	11,453	9,502	22,395	18,356
Research and development	5,816	4,397	11,134	8,711
General and administrative	10,126	6,304	18,377	12,549
Total operating expenses	27,395	20,203	51,906	39,616
Income from operations	14,851	17,347	29,994	33,188
Other income (expense), net	1,092	(36)	1,717	(493)
Income before income taxes	15,943	17,311	31,711	32,695
Provision for income taxes	5,252	5,625	10,358	10,556
Net income	$10,691	$11,686	$21,353	$22,139
Net income per share:				
Basic	$0.41	$0.45	$0.81	$0.86
Diluted	$0.40	$0.44	$0.80	$0.84
Shares used to compute net income per share:				
Basic	26,368,001	25,921,111	26,295,074	25,885,888
Diluted	26,561,148	26,277,503	26,526,629	26,245,135
Comprehensive Income (net of tax)				
Comprehensive income	$8,547	$12,960	$19,953	$22,338

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

Proto Labs, Inc.
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Six Months Ended June 30, 2016	2015
Operating activities		
Net income	$21,353	$22,139
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,147	6,940
Stock-based compensation expense	3,541	2,909
Deferred taxes	403	620
Excess tax benefit from stock-based compensation	(1,916)	(989)
Loss on impairment of assets	455	-
Amortization of held-to-maturity securities	590	632
Other	(1,095)	-
Changes in operating assets and liabilities:		
Accounts receivable	1,201	(5,219)
Inventories	(187)	(663)
Prepaid expenses and other	(1,146)	(469)
Income taxes	5,984	(3,687)
Accounts payable	(1,368)	3,377
Accrued liabilities and other	600	2,243
Net cash provided by operating activities	36,562	27,833
Investing activities		
Purchases of property and equipment	(22,416)	(15,717)
Purchases of marketable securities	(38,304)	(25,389)
Proceeds from maturities of marketable securities	28,759	24,109
Net cash used in investing activities	(31,961)	(16,997)
Financing activities		
Payments on debt	-	(77)
Acquisition-related contingent consideration	(400)	(1,000)
Proceeds from exercises of stock options and other	3,729	2,207
Excess tax benefit from stock-based compensation	1,916	989
Net cash provided by financing activities	5,245	2,119
Effect of exchange rate changes on cash and cash equivalents	(168)	40
Net increase in cash and cash equivalents	9,678	12,995
Cash and cash equivalents, beginning of period	47,653	43,329
Cash and cash equivalents, end of period	$57,331	$56,324

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

Note 1 – Basis of Presentation

The unaudited interim Consolidated Financial Statements of Proto Labs, Inc. (Proto Labs, the Company, we, us or our) have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, the accompanying financial statements reflect all adjustments necessary for a fair presentation of the Company's statements of financial position, results of operations and cash flows for the periods presented. Except as otherwise disclosed herein, these adjustments consist of normal, recurring items. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole.

The preparation of the financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures at the date of the financial statements and during the reporting period. Actual results could materially differ from these estimates. For further information, refer to the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 as filed with the Securities and Exchange Commission (SEC) on February 26, 2016.

The accompanying Consolidated Balance Sheet as of December 31, 2015 was derived from the audited Consolidated Financial Statements but does not include all disclosures required by U.S. GAAP for a full set of financial statements. This Form 10-Q should be read in conjunction with the Company's Consolidated Financial Statements and Notes included in the Annual Report on Form 10-K filed on February 26, 2016 as referenced above.

Note 2 – Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. This ASU is a comprehensive new revenue recognition model that requires a company to recognize revenue from the transfer of goods or services to customers in an amount that reflects the consideration that the entity expects to receive in exchange for those goods or services. The Company is required to adopt the new pronouncement using one of two retrospective application methods.

On July 9, 2015, the FASB voted to approve a deferral of the effective date of ASU 2014-09 by one year to December 15, 2017 for annual reporting periods beginning after that date. The Company is evaluating the application method and the impact of this new standard on its financial statements, but does not expect the impact to be material.

In February 2016, the FASB issued ASU 2016-02, Leases, which introduces the balance sheet recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous guidance. The guidance will be effective for annual reporting periods beginning after December 15, 2018 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of the future adoption of this standard on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Employee Share-Based Payment Accounting, which is intended to simplify several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, statutory tax withholding requirements, and classification in the statement of cash flows. This guidance will be effective for annual reporting periods beginning after December 15, 2016 and interim periods within those fiscal years with early adoption permitted. The Company is currently evaluating the impact this new guidance will have on its consolidated financial statements.

Note 3 – Net Income per Common Share

Basic net income per share is computed based on the weighted-average number of common shares outstanding. Diluted net income per share is computed based on the weighted-average number of common shares outstanding, increased by the number of additional shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of shares the Company could have repurchased from the proceeds from issuance of the potentially dilutive shares. Potentially dilutive shares of common stock include stock options, restricted stock units and restricted stock awards granted under stock-based compensation plans and shares committed to be purchased under the employee stock purchase plan.

The table below sets forth the computation of basic and diluted net income per share:

(in thousands, except share and per share amounts)	Three Months Ended June 30, 2016	2015	Six Months Ended June 30, 2016	2015
Net income	$10,691	$11,686	$21,353	$22,139
Basic - weighted-average shares outstanding:	26,368,001	25,921,111	26,295,074	25,885,888
Effect of dilutive securities:				
Employee stock options and other	193,147	356,392	231,555	359,247
Diluted - weighted-average shares outstanding:	26,561,148	26,277,503	26,526,629	26,245,135
Net income per share:				
Basic	$0.41	$0.45	$0.81	$0.86
Diluted	$0.40	$0.44	$0.80	$0.84

Note 4 – Goodwill and Other Intangible Assets

There were no changes in the carrying amount of Goodwill during the six months ended June 30, 2016.

Intangible assets other than Goodwill at June 30, 2016 and December 31, 2015 were as follows:

	June 30, 2016			December 31, 2015				Weighted Average Useful Life
		Accumulated			Accumulated		Useful Life	Remaining
(in thousands)	Gross	Amortization	Net	Gross	Amortization	Net	(in years)	(in years)
Intangible Assets with finite lives:								
Marketing assets	$930	$ (201)	$729	$930	$ (155)	$775	10.0	7.8
Non-compete agreement	190	(190)	-	190	(158)	32	2.0	-
Trade secrets	250	(108)	142	250	(83)	167	5.0	2.8
Internally developed software	680	(492)	188	680	(378)	302	3.0	0.8
Customer relationships	2,530	(609)	1,921	2,530	(469)	2,061	9.0	6.8

Total intangible assets	$4,580	$ (1,600)	$2,980	$4,580	$ (1,243)	$3,337

Amortization expense for intangible assets in each of the three and six months ended June 30, 2016 and 2015 was $0.2 million and $0.4 million, respectively.

Estimated aggregated amortization expense based on the current carrying value of the amortizable intangible assets is as follows:

(in thousands)	**Estimated Amortization Expense**
Remaining 2016	$ 325
2017	500
2018	424
2019	391
2020	374
Thereafter	966
Total estimated amortization expense	$ 2,980

Note 5 – Fair Value Measurements

ASC 820, *Fair Value Measuremen*t (ASC 820), defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy that requires classification based on observable and unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1—Quoted prices in active markets for identical assets or liabilities.

Level 2—Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company's cash consists of bank deposits. The Company's cash equivalents measured at fair value consist of money market mutual funds. The Company determines the fair value of these investments using Level 1 inputs.

A summary of financial assets as of June 30, 2016 and December 31, 2015 measured at fair value on a recurring basis is as follows:

	June 30, 2016			**December 31, 2015**		
(in thousands)	**Level 1**	**Level 2**	**Level 3**	**Level 1**	**Level 2**	**Level 3**
Financial Assets:						
Cash and cash equivalents						
Money market mutual fund	$5,773	$ -	$ -	$11,896	$ -	$ -
Total	$5,773	$ -	$ -	$11,896	$ -	$ -

Note 6 – Marketable Securities

The Company invests in short-term and long-term agency, municipal, corporate and other debt securities. The securities are categorized as held-to-maturity and are recorded at amortized cost. Categorization as held-to-maturity is based on the Company's ability and intent to hold these securities to maturity. Information regarding the Company's short-term and long-term marketable securities as of June 30, 2016 and December 31, 2015 is as follows:

(in thousands)	**June 30, 2016** Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. municipal securities	$42,171	$ 56	$ (4)	$42,223
Corporate debt securities	29,488	47	(13)	29,522
U.S. government agency securities	28,848	17	(6)	28,859
Certificates of deposit/time deposits	6,439	29	-	6,468
Total marketable securities	$106,946	$ 149	$ (23)	$107,072

(in thousands)	**December 31, 2015** Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. municipal securities	$35,667	$ 8	$ (56)	$35,619
Corporate debt securities	28,133	-	(114)	28,019
U.S. government agency securities	26,784	2	(99)	26,687
Certificates of deposit/time deposits	5,909	2	(11)	5,900
Commercial paper	1,497	-	(2)	1,495
Total marketable securities	$97,990	$ 12	$ (282)	$97,720

Fair values for the corporate debt securities are primarily determined based on quoted market prices (Level 1). Fair values for the U.S. municipal securities, U.S. government agency securities and certificates of deposit are primarily determined using dealer quotes or quoted market prices for similar securities (Level 2).

The Company tests for other-than-temporary losses on a quarterly basis and has considered the unrealized losses indicated above, which are the result of changes in interest rates, to be temporary in nature. In reaching this conclusion, the Company considered the credit quality of the issuers of the debt securities as well as the Company's intent to hold the investments to maturity and recover the full principal.

Classification of marketable securities as current or non-current is based upon the security's maturity date as of the date of these financial statements.

The June 30, 2016 balance of held-to-maturity debt securities by contractual maturity is shown in the following table at amortized cost. Actual maturities may differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

(in thousands)	**June 30, 2016**
Due in one year or less	$39,216
Due after one year through five years	67,730
Total marketable securities	$106,946

Note 7 – Inventory

Inventory consists primarily of raw materials, which are recorded at the lower of cost or market using the average-cost method, which approximates first-in, first-out (FIFO) cost. The Company periodically reviews its inventory for slow-moving, damaged and discontinued items and provides allowances to reduce such items identified to their recoverable amounts.

The Company's inventory consisted of the following as of the dates indicated:

(in thousands)	June 30, 2016	December 31, 2015
Raw materials	$8,761	$ 8,589
Work in process	1,491	1,529
Total inventory	10,252	10,118
Allowance for obsolescence	(351)	(347)
Inventory, net of allowance	$9,901	$ 9,771

Note 8 – Stock-Based Compensation

Under the Company's 2012 Long-Term Incentive Plan, as amended (2012 Plan), the Company has the ability to grant stock options, stock appreciation rights (SARs), restricted stock, stock units, other stock-based awards and cash incentive awards. Awards under the 2012 Plan have a maximum term of ten years from the date of grant. The compensation committee may provide that the vesting or payment of any award will be subject to the attainment of specified performance measures in addition to the satisfaction of any continued service requirements and the compensation committee will determine whether such measures have been achieved. The per-share exercise price of stock options and SARs granted under the 2012 Plan generally may not be less than the fair market value of a share of our common stock on the date of the grant.

Employee Stock Purchase Plan

The Company's 2012 Employee Stock Purchase Plan (ESPP) allows eligible employees to purchase shares of the Company's common stock at a discount through payroll deductions of up to 15 percent of their eligible compensation, subject to plan limitations. The ESPP provides for six-month offering periods ending May 15 and November 15, respectively. At the end of each offering period, employees are able to purchase shares at 85 percent of the lower of the fair market value of the Company's common stock on the first trading day of the offering period or on the last trading day of the offering period.

Stock-Based Compensation Expense

Stock-based compensation expense was $1.8 million and $1.6 million for the three months ended June 30, 2016 and 2015, respectively, and $3.5 million and $2.9 million for the six months ended June 30, 2016 and 2015, respectively.

Stock Options

The following table summarizes stock option activity during the six months ended June 30, 2016:

	Stock Options	**Weighted-Average Exercise Price**
Options outstanding at December 31, 2015	766,042	$ 36.52
Granted	113,645	58.12
Exercised	(159,029)	17.38
Forfeited	(55,481)	59.22
Options outstanding at June 30, 2016	665,177	$ 42.89
Exercisable at June 30, 2016	394,999	$ 32.36

The outstanding options generally have a term of ten years. For employees, options granted become exercisable ratably over the vesting period, which is generally a five-year period beginning on the first anniversary of the grant date, subject to the employee's continuing service to the Company. For directors, options generally become exercisable in full on the first anniversary of the grant date.

The weighted-average grant date fair value of options that were granted during the six months ended June 30, 2016 was $26.62.

The following table provides the assumptions used in the Black-Scholes pricing model valuation of options during the six months ended June 30, 2016 and 2015, respectively:

	Six Months Ended June 30,					
	2016			**2015**		
Risk-free interest rate	1.53	-	1.68%	1.69	-	1.77%
Expected life (years)		6.50		5.50	-	6.50
Expected volatility	44.38	-	45.93%	46.80	-	47.23%
Expected dividend yield		0%			0%	

As of June 30, 2016, there was $6.8 million of unrecognized compensation expense related to unvested stock options, which is expected to be recognized over a weighted-average period of 3.4 years.

Restricted Stock

Restricted stock awards are share-settled awards and restrictions lapse ratably over the vesting period, which is generally a five-year period, beginning on the first anniversary of the grant date, subject to the employee's continuing service to the Company. For directors, restrictions generally lapse in full on the first anniversary of the grant date.

The following table summarizes restricted stock activity during the three months ended June 30, 2016:

	Restricted Stock	Weighted-Average Grant Date Fair Value Per Share
Restricted stock at December 31, 2015	124,393	$ 68.97
Granted	159,705	59.43
Restrictions lapsed	(40,713)	67.84
Forfeited	(15,120)	64.10
Restricted stock at June 30, 2016	228,265	$ 62.82

As of June 30, 2016, there was $13.5 million of unrecognized compensation expense related to non-vested restricted stock, which is expected to be recognized over a weighted-average period of 4.1 years.

Employee Stock Purchase Plan

The following table presents the assumptions used to estimate the fair value of the ESPP during the six months ended June 30, 2016 and 2015, respectively:

	Six Months Ended June 30,					
	2016			2015		
Risk-free interest rate	0.39	-	0.56%	0.08	-	0.10%
Expected life (months)		6.00			6.00	
Expected volatility	29.41	-	49.13%	33.68	-	37.64%
Expected dividend yield		0%			0%	

Note 9 – Accumulated Other Comprehensive Income (Loss)

Other comprehensive income (loss) is comprised entirely of foreign currency translation adjustments. The following table presents the changes in accumulated other comprehensive income (loss) balances during the three and six months ended June 30, 2016 and 2015, respectively:

(in thousands)	Three Months Ended June 30, 2016	2015	Six Months Ended June 30, 2016	2015
Foreign currency translation adjustments				
Balance at beginning of period	$(4,468)	$(4,004)	$(5,212)	$(2,929)
Other comprehensive loss before reclassifications	(2,144)	1,274	(1,400)	199
Amounts reclassified from accumulated other comprehensive income (loss)	-	-	-	-
Net current-period other comprehensive loss	(2,144)	1,274	(1,400)	199
Balance at end of period	$(6,612)	$(2,730)	$(6,612)	$(2,730)

Note 10 – Income Taxes

The Company is subject to income tax in multiple jurisdictions and the use of estimates is required to determine the provision for income taxes. For the three months ended June 30, 2016 and 2015, the Company recorded an income tax provision of $5.3 million and $5.6 million, respectively. For the six months ended June 30, 2016 and 2015, the Company recorded an income tax provision of $10.4 million and $10.6 million, respectively. The income tax provision is based on the estimated annual effective tax rate for the year applied to pre-tax income. The effective income tax rate for the three months ended June 30, 2016 was 32.9 percent compared to 32.5 percent in the same period of the prior year. The effective income tax rate for the six months ended June 30, 2016 was 32.7 percent compared with 32.3 percent in the same period of the prior year.

The effective income tax rate for the three and six months ended June 30, 2016 differs from the U.S. federal statutory rate of 35 percent due primarily to the mix of income earned in domestic and foreign tax jurisdictions and deductions for which the Company qualifies.

The Company has reserves against unrecognized tax benefits totaling $2.9 million and $2.8 million at June 30, 2016 and December 31, 2015, respectively, all of which, if recognized, would affect the Company's effective tax rate. The Company recognizes interest and penalties related to income tax matters in income tax expense, and reports the liability in current or long-term income taxes payable as appropriate.

Note 11 – Revenue and Geographic Information

The Company's revenue is primarily derived from its Injection Molding (Protomold), CNC Machining (Firstcut) and 3D Printing (Fineline) product lines. Total revenue by product line is as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands)	**2016**	**2015**	**2016**	**2015**
Revenue:				
Injection Molding (Protomold)	$44,762	$39,932	$87,931	$77,550
CNC Machining (Firstcut)	19,854	18,585	38,729	34,955
3D Printing (Fineline)	9,099	5,452	18,209	10,000
Other	1,246	-	2,660	-
Total revenue	$74,961	$63,969	$147,529	$122,505

Revenue to external customers based on the billing location of the end user customer and long-lived assets by geographic region are as follows:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
(in thousands)	**2016**	**2015**	**2016**	**2015**
Revenue:				
United States	$51,852	$49,298	$102,419	$94,143
International	23,109	14,671	45,110	28,362
Total revenue	$74,961	$63,969	$147,529	$122,505

(in thousands)	June 30, 2016	December 31, 2015
Long-lived assets:		
United States	$109,740	$98,633
International	28,945	26,842
Total long-lived assets	$138,685	$125,475

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2015.

Forward-Looking Statements

Statements contained in this report regarding matters that are not historical or current facts are “forward-looking statements” within the meaning of The Private Securities Litigation Reform Act of 1995. In some cases, you can identify forward-looking statements by the following words: “may,” “will,” “could,” “would,” “should,” “expect,” “intend,” “p “anticipate,” “believe,” “estimate,” “predict,” “project,” “potential,” “continue,” “ongoing” or the negative of these terms or ot comparable terminology, although not all forward-looking statements contain these words. These statements involve known and unknown risks, uncertainties and other factors that may cause our results to be materially different than those expressed or implied in such statements. Certain of these risk factors and others are described in Item 1A. “Risk Factors” of our most recent Annual Report on Form 10-K as filed with the SEC. Other unknown or unpredictable factors also could have material adverse effects on our future results. We cannot guarantee future results, levels of activity, performance or achievements. Accordingly, you should not place undue reliance on these forward-looking statements. Finally, we expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

Overview

We are a leading online and technology-enabled manufacturer of quick-turn, on-demand 3D printed, CNC-machined and injection-molded custom parts for prototyping and low-volume production. We provide “Real Parts, Really Fast” to product developers and engineers worldwide, who are under increasing pressure to bring their finished products to market faster than their competition. We believe custom parts manufacturing has historically been an underserved market due to the inefficiencies inherent in the quotation, equipment set-up and non-recurring engineering processes required to produce custom parts. Our proprietary technology eliminates most of the time-consuming and expensive skilled labor conventionally required to quote and manufacture parts. Our customers conduct nearly all of their business with us over the Internet. We target our products to the millions of product developers and engineers who use three-dimensional computer-aided design (3D CAD) software to design products across a diverse range of end-markets.

Our primary manufacturing product lines currently include Injection Molding (Protomold), CNC Machining (Firstcut) and 3D Printing (Fineline). We continually seek to expand the range of size and geometric complexity of the parts we can make with these manufacturing processes, to extend the variety of materials we are able to support and to identify additional manufacturing processes to which we can apply our technology in order to better serve the evolving preferences and needs of product developers and engineers.

Injection Molding (Protomold)

Our Injection Molding (Protomold) product line uses our 3D CAD-to-CNC machining technology for the automated design and manufacture of thermoplastic, metal, or liquid silicone injection molds, which are then used to produce custom injection-molded parts on commercially available equipment. Our Injection Molding (Protomold) product line is used for prototype, on-demand and low-volume production. Prototype quantities typically range from 25 to 100 parts. Because we retain possession of the molds, customers who need low-volume production often come back to Proto Labs' Injection Molding product line for additional quantities typically ranging up to 10,000 parts or more. They do so to support pilot production while their tooling for high-volume production is being prepared, because they need on-demand manufacturing due to disruptions in their manufacturing process, because their product will only be released in a limited quantity, or because they need end-of-life production support. These additional part orders typically occur on approximately half of the molds that we make, typically accounting for approximately half of our total Injection Molding (Protomold) revenue.

CNC Machining (Firstcut)

Our CNC Machining (Firstcut) product line uses commercially available CNC machines to cut plastic or metal blocks or bars into one or more custom parts based on the 3D CAD model uploaded by the product developer or engineer. Our efficiencies derive from the automation of the programming of these machines and a proprietary fixturing process. The CNC Machining (Firstcut) product line is well suited to produce small quantities, typically in the range of one to 200 parts.

3D Printing (Fineline)

Our 3D Printing (Fineline) includes stereolithography (SL), selective laser sintering (SLS) and direct metal laser sintering (DMLS) processes, which offers customers a wide-variety of high-quality, precision rapid prototyping and low volume production. These processes create parts with a high level of accuracy, detail, strength and durability. 3D Printing is well suited to produce small quantities, typically in the range of one to 50 parts.

Key Financial Measures and Trends

Revenue

The Company's operations are conducted in three geographic markets consisting of the United States, Europe and Japan, which we believe are three of the largest geographic markets where product developers and engineers are located. Revenue within each of our United States and Europe markets is derived from our Injection Molding (Protomold), CNC Machining (Firstcut) and 3D Printing (Fineline) product lines. Revenue within our Japan market is derived from our Injection Molding (Protomold) and CNC Machining (Firstcut) product lines. Our historical and current efforts to increase revenue have been directed at gaining new customers and selling to our existing customer base by:

- increasing marketing and selling activities;
- introducing our CNC Machining (Firstcut) product line in 2007;
- expanding internationally, including the opening of our Japanese plant in 2009;
- offering additional product lines such as 3D Printing (Fineline), through our acquisition of FineLine Prototyping, Inc. (FineLine) in April 2014 and expanded through our acquisition of certain assets, including shares of select subsidiaries, of Alphaform AG (Alphaform) in October 2015;
- improving the usability of our product lines such as our web-centric applications; and
- expanding the breadth and scope of our products, for example, by adding more sizes and materials to our offerings such as liquid silicone rubber (LSR).

Excluding product developers and engineers gained through the acquisition of Alphaform, we served 13,519 unique product developers and engineers during the three months ended June 30, 2016, an increase of 14.4% over the same period in 2015. We served 20,240 unique product developers and engineers during the six months ended June 30, 2016, an increase of 17.7% over the same period in 2015.

Cost of Revenue, Gross Profit and Gross Margin

Cost of revenue consists primarily of raw materials, employee compensation, benefits, stock-based compensation, equipment depreciation, facilities costs and overhead allocations associated with the manufacturing process for molds and custom parts. We expect cost of revenue to increase in absolute dollars, but remain relatively constant as a percentage of total revenue.

We define gross profit as our revenue less our cost of revenue, and we define gross margin as gross profit expressed as a percentage of revenue. Our gross profit and gross margin are affected by many factors, including our pricing, sales volume and manufacturing costs, the costs associated with increasing production capacity, the mix between sales by product line, the mix between domestic and foreign revenue sources, and foreign exchange rates.

Operating Expenses

Operating expenses consist of marketing and sales, research and development and general and administrative expenses. Personnel-related costs are the most significant component of the marketing and sales, research and development and general and administrative expense categories.

Our recent growth in operating expenses is mainly due to higher headcounts to support our growth and expansion, and we expect that trend to continue. Our business strategy is to continue to be a leading online and technology-enabled manufacturer of quick-turn, on-demand 3D printed, CNC-machined, CNC-turned and injection-molded custom parts for prototyping and low-volume production. In order to achieve our goals, we anticipate continued substantial investments in technology and personnel, resulting in increased operating expenses.

Marketing and sales. Marketing and sales expense consists primarily of employee compensation, benefits, commissions, stock-based compensation, marketing programs such as print and pay-per-click advertising, trade shows, direct mail and other related overhead. We expect sales and marketing expense to increase in the future as we increase the number of marketing and sales professionals and marketing programs targeted to increase our customer base.

Research and development. Research and development expense consists primarily of employee compensation, benefits, stock-based compensation, depreciation on equipment, outside services and other related overhead. All of our research and development costs have been expensed as incurred. We expect research and development expense to increase in the future as we seek to enhance and expand our product line offerings.

General and administrative. General and administrative expense consists primarily of employee compensation, benefits, stock-based compensation, professional service fees related to accounting, tax and legal and other related overhead. We expect general and administrative expense to increase in the future as we continue to grow and expand as a global organization.

Other Income (Expense), Net

Other income (expense), net primarily consists of foreign currency-related gains and losses and interest income on cash balances and investments. Our foreign currency-related gains and losses will vary depending upon movements in underlying exchange rates. Our interest income will vary each reporting period depending on our average cash balances during the period, composition of our marketable security portfolio and the current level of interest rates.

Provision for Income Taxes

Provision for income taxes is comprised of federal, state, local and foreign taxes based on pre-tax income. We expect income taxes to increase as our taxable income increases and we expect our effective tax rate to remain relatively constant.

Results of Operations

The following table summarizes our results of operations and the related changes for the periods indicated. The results below are not necessarily indicative of the results for future periods.

	Three Months Ended June 30,				Change		Six Months Ended June 30,				Change
(dollars in thousands)	2016		2015		$	%	2016		2015		$
Revenue	$74,961	100.0%	$63,969	100.0%	$10,992	17.2%	$147,529	100.0%	$122,505	100.0%	$25,024
Cost of revenue	32,715	43.6	26,419	41.3	6,296	23.8	65,629	44.5	49,701	40.6	15,928
Gross profit	42,246	56.4	37,550	58.7	4,696	12.5	81,900	55.5	72,804	59.4	9,096
Operating expenses:											
Marketing and sales	11,453	15.2	9,502	14.8	1,951	20.5	22,395	15.2	18,356	15.0	4,039
Research and development	5,816	7.8	4,397	6.9	1,419	32.3	11,134	7.5	8,711	7.1	