

SPS COMMERCE INC
Form 10-Q
October 28, 2016
Table of Contents

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: September 30, 2016

**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 001-34702

SPS COMMERCE, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware
(State or Other Jurisdiction of

41-2015127
(I.R.S. Employer

Incorporation or Organization)

Identification No.)

333 South Seventh Street, Suite 1000, Minneapolis, MN 55402

(Address of Principal Executive Offices, Including Zip Code)

(612) 435-9400

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 (§229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes 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.

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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

The number of shares of the registrant's common stock, par value \$0.001 per share, outstanding at October 24, 2016 was 17,039,452 shares.

Table of Contents**SPS COMMERCE, INC.****QUARTERLY REPORT ON FORM 10-Q****INDEX**

| | Page |
|---|-------------|
| <u>PART I. FINANCIAL INFORMATION</u> | |
| Item 1. <u>Financial Statements</u> | |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2016 (unaudited) and December 31, 2015</u> | 3 |
| <u>Condensed Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2016 and 2015 (unaudited)</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015 (unaudited)</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements (unaudited)</u> | 6 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 16 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 25 |
| Item 4. <u>Controls and Procedures</u> | 25 |
| <u>PART II. OTHER INFORMATION</u> | |
| Item 1. <u>Legal Proceedings</u> | 26 |
| Item 1A. <u>Risk Factors</u> | 26 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 26 |
| Item 3. <u>Defaults Upon Senior Securities</u> | 26 |
| Item 4. <u>Mine Safety Disclosures</u> | 26 |
| Item 5. <u>Other Information</u> | 26 |
| Item 6. <u>Exhibits</u> | 26 |
| <u>Signatures</u> | 27 |
| SPECIAL NOTE REGARDING FORWARD-LOOKING INFORMATION | |

This Quarterly Report on Form 10-Q contains forward-looking statements regarding us, our business prospects and our results of operations that are subject to certain risks and uncertainties posed by many factors and events that could cause our actual business, prospects and results of operations to differ materially from those that may be anticipated by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those described under the heading *Risk Factors* included in our Annual Report on Form 10-K for the year ended December 31, 2015 as filed with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. We expressly disclaim any intent or obligation to update or revise any forward-looking statements, whether as a result of new

information, future events or otherwise. Readers are urged to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the Commission that advise interested parties of the risks and factors that may affect our business.

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****SPS COMMERCE, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(Unaudited; in thousands, except share amounts)

| | September 30, 2016 | December 31, 2015 |
|---|-------------------------------|------------------------------|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 109,635 | \$ 121,538 |
| Short-term marketable securities | 15,616 | 7,517 |
| Accounts receivable, less allowance for doubtful accounts of \$481 and \$446, respectively | 21,361 | 17,615 |
| Deferred costs | 18,647 | 15,086 |
| Other current assets | 7,323 | 5,030 |
| Total current assets | 172,582 | 166,786 |
| PROPERTY AND EQUIPMENT, net | 14,830 | 13,620 |
| GOODWILL | 51,005 | 33,848 |
| INTANGIBLE ASSETS, net | 21,338 | 15,081 |
| MARKETABLE SECURITIES, non-current | 12,529 | 14,950 |
| OTHER ASSETS | | |
| Deferred costs, non-current | 5,893 | 5,260 |
| Deferred income tax asset, non-current | 11,967 | 11,149 |
| Other non-current assets | 2,130 | 1,037 |
| Total assets | \$ 292,274 | \$ 261,731 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 2,442 | \$ 2,163 |
| Accrued compensation | 11,796 | 11,150 |
| Accrued expenses | 2,509 | 1,987 |
| Deferred revenue | 12,157 | 7,740 |
| Deferred rent | 1,330 | 1,194 |
| Total current liabilities | 30,234 | 24,234 |
| OTHER LIABILITIES | | |

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| | | |
|--|------------|------------|
| Deferred revenue, non-current | 10,962 | 11,005 |
| Deferred rent, non-current | 3,900 | 4,307 |
| Deferred income tax liability, non-current | 2,368 | |
| Total liabilities | 47,464 | 39,546 |
| COMMITMENTS and CONTINGENCIES | | |
| STOCKHOLDERS EQUITY | | |
| Preferred stock, \$0.001 par value; 5,000,000 shares authorized; 0 shares issued and outstanding | | |
| Common stock, \$0.001 par value; 55,000,000 shares authorized; 17,039,014 and 16,723,994 shares issued and outstanding, respectively | 17 | 17 |
| Additional paid-in capital | 281,536 | 265,265 |
| Accumulated deficit | (35,544) | (39,449) |
| Accumulated other comprehensive loss | (1,199) | (3,648) |
| Total stockholders equity | 244,810 | 222,185 |
| Total liabilities and stockholders equity | \$ 292,274 | \$ 261,731 |

See accompanying notes to these condensed consolidated financial statements.

Table of Contents

SPS COMMERCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited; in thousands, except per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|--|-----------|------------------------------------|------------|
| | 2016 | 2015 | 2016 | 2015 |
| Revenues | \$ 49,284 | \$ 40,354 | \$ 142,234 | \$ 116,170 |
| Cost of revenues | 16,171 | 12,700 | 47,024 | 36,607 |
| Gross profit | 33,113 | 27,654 | 95,210 | 79,563 |
| Operating expenses | | | | |
| Sales and marketing | 16,526 | 13,795 | 49,092 | 41,640 |
| Research and development | 5,574 | 4,494 | 16,185 | 13,058 |
| General and administrative | 7,149 | 6,276 | 21,516 | 18,149 |
| Amortization of intangible assets | 1,194 | 829 | 3,553 | 2,507 |
| Total operating expenses | 30,443 | 25,394 | 90,346 | 75,354 |
| Income from operations | 2,670 | 2,260 | 4,864 | 4,209 |
| Other income (expense) | | | | |
| Interest income, net | 112 | 49 | 408 | 123 |
| Other income (expense), net | 947 | (86) | 866 | (255) |
| Total other income (expense), net | 1,059 | (37) | 1,274 | (132) |
| Income before income taxes | 3,729 | 2,223 | 6,138 | 4,077 |
| Income tax expense | (1,220) | (953) | (2,233) | (1,570) |
| Net income | \$ 2,509 | \$ 1,270 | \$ 3,905 | \$ 2,507 |
| Net income per share | | | | |
| Basic | \$ 0.15 | \$ 0.08 | \$ 0.23 | \$ 0.15 |
| Diluted | \$ 0.14 | \$ 0.07 | \$ 0.23 | \$ 0.15 |
| Weighted average common shares used to compute net income per share | | | | |
| Basic | 17,001 | 16,605 | 16,916 | 16,525 |
| Diluted | 17,341 | 17,054 | 17,185 | 17,040 |
| Other comprehensive income (loss) | | | | |
| Foreign currency translation adjustments | 443 | (1,733) | 2,408 | (4,310) |

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| | | | | |
|---------------------------------------|----------|----------|----------|------------|
| Unrealized gain (loss) on investments | (58) | 13 | 41 | 19 |
| Comprehensive income (loss) | \$ 2,894 | \$ (450) | \$ 6,354 | \$ (1,784) |

See accompanying notes to these condensed consolidated financial statements.

Table of Contents**SPS COMMERCE, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited; in thousands)

| | Nine Months Ended September 30, | |
|---|--|-----------------|
| | 2016 | 2015 |
| Cash flows from operating activities | | |
| Net income | \$ 3,905 | \$ 2,507 |
| Reconciliation of net income to net cash provided by operating activities | | |
| Deferred income taxes | (818) | 277 |
| Share-based earn-out liability | (1,103) | |
| Depreciation and amortization of property and equipment | 4,883 | 4,693 |
| Amortization of intangible assets | 3,553 | 2,507 |
| Provision for doubtful accounts | 977 | 846 |
| Stock-based compensation | 6,004 | 4,756 |
| Changes in assets and liabilities | | |
| Accounts receivable | (3,879) | (3,427) |
| Deferred costs | (4,194) | (2,904) |
| Other current and non-current assets | (2,840) | (2,056) |
| Accounts payable | (90) | (1,494) |
| Accrued compensation | 173 | 93 |
| Accrued expenses | 126 | (104) |
| Deferred revenue | 3,927 | 1,615 |
| Deferred rent | (271) | (431) |
| Net cash provided by operating activities | 10,353 | 6,878 |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (5,972) | (6,504) |
| Purchases of marketable securities | (18,137) | (17,509) |
| Maturities of marketable securities | 12,500 | |
| Business acquisitions, net of cash acquired | (18,062) | |
| Net cash used in investing activities | (29,671) | (24,013) |
| Cash flows from financing activities | | |
| Net proceeds from exercise of options to purchase common stock | 3,520 | 3,273 |
| Excess tax benefit from exercise of options to purchase common stock | 2,710 | 1,179 |
| Net proceeds from employee stock purchase plan | 786 | 741 |
| Net cash provided by financing activities | 7,016 | 5,193 |
| Effect of foreign currency exchange rate changes | 399 | (966) |

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| | | |
|--|------------|------------|
| Net decrease in cash and cash equivalents | (11,903) | (12,908) |
| Cash and cash equivalents at beginning of period | 121,538 | 130,795 |
| Cash and cash equivalents at end of period | \$ 109,635 | \$ 117,887 |

See accompanying notes to these condensed consolidated financial statements.

Table of Contents

SPS COMMERCE, INC.

Notes to Condensed Consolidated Financial Statements (Unaudited)

NOTE A General

Business Description

We are a leading provider of cloud-based supply chain management solutions, providing network-proven integrations and comprehensive retail performance analytics to thousands of customers worldwide. We provide our solutions through the SPS Commerce platform, a cloud-based product suite that improves the way suppliers, retailers, distributors and other customers manage and fulfill orders. We derive the majority of our revenues from thousands of monthly recurring subscriptions from businesses that utilize our solutions.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of SPS Commerce, Inc. and its subsidiaries. All intercompany accounts and transactions have been eliminated in the condensed consolidated financial statements, which have been prepared in conformity with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, these condensed consolidated financial statements do not include all of the information and notes required by GAAP. We have included all normal recurring adjustments considered necessary to give a fair statement of our financial position, results of operations and cash flows for the interim periods shown. Operating results for these interim periods are not necessarily indicative of the results to be expected for the full year. The December 31, 2015 condensed consolidated balance sheet data was derived from our audited financial statements at that date. For further information, refer to the consolidated financial statements and accompanying notes for the year ended December 31, 2015 included in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on February 24, 2016.

Use of Estimates

Preparing financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Significant Accounting Policies

During the nine months ended September 30, 2016, there were no material changes in our significant accounting policies. See Note A to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the Securities and Exchange Commission on February 24, 2016, for additional information regarding our significant accounting policies.

Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers accounting requirements for the recognition of revenue

from contracts with customers. This guidance will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. These new requirements are effective for annual reporting periods beginning after December 15, 2017, and interim periods within those annual periods. We do not believe the new revenue recognition standard will materially impact our recognition of the primary fees received from customers for our cloud-based supply chain solutions. We believe the adoption of the new standard could impact our accounting for certain upfront set-up fees, but we are in the process of determining the financial statement impact and are currently unable to estimate the impact on our consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, *Balance Sheet Classification of Deferred Taxes*, which amends the guidance requiring companies to separate deferred income tax liabilities and assets into current and non-current amounts in a classified statement of financial position. This accounting guidance simplifies the presentation of deferred income taxes, such that deferred tax liabilities and assets be classified as non-current in a classified statement of financial position. This accounting guidance is effective for us beginning in the first quarter of 2017, but we elected to early adopt this guidance prospectively as of December 31, 2015. As a result, we have classified all deferred tax liabilities and assets as non-current in the condensed consolidated balance sheet at September 30, 2016.

Table of Contents

In February 2016, the FASB issued ASU 2016-02, *Leases* which will supersede the existing lease guidance and will require all leases with a term greater than 12 months to be recognized in the statements of financial position and eliminate current real estate-specific lease guidance, while maintaining substantially similar classification criteria for distinguishing between finance leases and operating leases. This standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted. We believe the adoption of the new lease accounting standard will materially impact our consolidated financial statements by increasing our non-current assets and non-current liabilities on our consolidated balance sheets in order to record the right of use assets and related lease liabilities for our existing operating leases. We are in the process of determining the financial statement impact and are currently unable to estimate the impact on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*, which will simplify the income tax consequences, accounting for forfeitures and classification on the statements of consolidated cash flows. This standard is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016, with early adoption permitted. We are currently evaluating the impact this guidance will have on the consolidated financial statements and related disclosures.

NOTE B Business Acquisitions**Toolbox Solutions, Inc.**

On January 5, 2016, we completed our acquisition of all of the outstanding common shares of Toolbox Solutions, Inc., (Toolbox Solutions) a privately held company providing point-of-sale analytics and category management services to retailers and consumer packaged goods suppliers in North America. This acquisition expands our retail network and strengthens our analytics offerings. Pursuant to the share purchase agreement, we paid \$18.1 million in cash and issued \$3.3 million in stock, or 48,668 shares of common stock, to the shareholders of Toolbox Solutions. The purchase agreement also allows the sellers to receive up to 16,222 additional shares of common stock, which could become payable contingent upon the completion of certain revenue milestones. See Note C for subsequent measurements of this contingent liability.

Purchase Price Allocation

We accounted for the acquisition as a business combination. We allocated the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values as of the acquisition date. We engaged a third-party valuation firm to assist us in the determination of the value of the purchased intangible assets. The excess of the purchase price over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. Goodwill is attributed to a trained workforce and other buyer-specific value resulting from expected synergies, including long-term cost savings, which are not included in the fair values of identifiable assets.

The purchase price consists of the following (in thousands):

| | |
|---|-----------|
| Cash | \$ 18,062 |
| Estimated net working capital adjustments to be received from sellers | (58) |
| SPS Commerce, Inc. common stock | 3,251 |
| Fair value of share-based earn-out liability | 1,043 |

\$ 22,298

The final purchase price is subject to a net working capital adjustment to be determined by SPS Commerce and the sellers, pursuant to the terms of the purchase agreement. The number of shares of our common stock issued for the acquisition was 48,668 shares as calculated according to the terms of the purchase agreement. The fair value of the shares issued was determined using an volume weighted average trading price of our common stock over a 30-day period ending five days prior to the acquisition date.

Table of Contents

The following table summarizes the estimated fair values of the assets acquired, net of cash acquired of \$359,000, and liabilities assumed at the acquisition date (in thousands):

| | |
|-------------------------------|-----------|
| Current assets | \$ 1,254 |
| Property and equipment | 56 |
| Goodwill | 15,689 |
| Intangible assets | 9,070 |
| Current liabilities | (1,249) |
| Deferred revenue | (301) |
| Deferred income tax liability | (2,221) |
| | \$ 22,298 |

Purchased Intangible Assets

The following table summarizes the estimated fair value of the purchased intangible assets and their estimated useful lives:

| Purchased Intangible Assets | Estimated Fair Value (in thousands) | Estimated Life (in years) |
|-----------------------------|---|------------------------------------|
| Subscriber relationships | \$ 7,400 | 8 |
| Developed technology | 1,200 | 4 |
| Trade names | 70 | 1 |
| Non-competition agreements | 400 | 5 |
| Total | \$ 9,070 | |

The fair values of purchased intangible assets are preliminary and are subject to adjustment as additional information becomes available about the facts and circumstances that existed at the acquisition date. The purchased intangible assets are being amortized on a straight-line basis over their estimated useful lives. Amortization expense for the period from January 5, 2016 through September 30, 2016 was \$1.1 million.

Acquisition-Related Costs and Post-Acquisition Operating Results

Acquisition-related costs were \$147,000 and are included in our condensed consolidated statements of comprehensive income (loss) for the nine months ended September 30, 2016. No acquisition-related costs were incurred during the three months ended September 30, 2016. The operating results of Toolbox Solutions have been included in our condensed consolidated financial statements from January 5, 2016, the closing date of the acquisition. For the three months ended September 30, 2016 and the period from January 5, 2016 through September 30, 2016, approximately \$2.2 million and \$5.7 million of our revenues, respectively were derived from Toolbox Solutions products and services. The amount of operating income or loss from Toolbox Solutions was not separately identifiable due to our

integration.

Pro Forma Financial Information

The pro forma financial information in the table below presents the combined operating results of SPS Commerce and Toolbox Solutions as if the acquisition had occurred on January 1, 2015. The pro forma information includes the historical operating results of each company and pro forma adjustments for the approximate \$1.5 million of annual amortization expense related to purchased intangible assets and the additional impact on the provision or benefit for income taxes, resulting from the combined income and intangible amortization expense, using our statutory blended income tax rate of 26.5%.

Table of Contents

| (in thousands, except per share data) | Nine Months Ended September 30, | |
|---------------------------------------|------------------------------------|------------|
| | 2016 | 2015 |
| Pro forma total revenue | \$ 142,464 | \$ 122,133 |
| Pro forma net income | 4,171 | 568 |
| Pro forma net income per share | | |
| Basic | 0.25 | 0.03 |
| Diluted | 0.24 | 0.03 |

The pro forma financial information is presented for informational purposes only and is not necessarily indicative of the results of operations that would have actually been reported had the acquisition occurred on January 1, 2015, nor is it necessarily indicative of our results of operations for any future periods.

NOTE C Financial Instruments

We invest primarily in money market funds, highly liquid debt instruments of the U.S. government, and U.S. corporate debt securities. All highly liquid investments with original maturities of 90 days or less are classified as cash equivalents. All investments with original maturities greater than 90 days and remaining maturities less than one year from the balance sheet date are classified as short-term marketable securities. Investments with remaining maturities of more than one year from the balance sheet date are classified as marketable securities, non-current. Short-term marketable securities and marketable securities, non-current, are also classified as available-for-sale. We intend to hold marketable securities until maturity; however, we may sell these securities at any time for use in current operations or for other purposes.

Our fixed income investments are carried at fair value and unrealized gains and losses on these investments are included in other comprehensive income (loss) in the condensed consolidated statements of comprehensive income (loss). Realized gains or losses are included in other income (expense) in the condensed consolidated statements of comprehensive income (loss). When a determination has been made that an other-than-temporary decline in fair value has occurred, the amount of the decline that is related to a credit loss is realized and is included in other income (expense), net in the condensed consolidated statements of comprehensive income (loss).

Cash equivalents and marketable securities, consisted of the following (in thousands):

| | September 30, 2016 | | | Fair Value |
|-------------------------------|--------------------|------------------|-------------------|------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | |
| Cash equivalents: | | | | |
| Money market funds | \$ 68,262 | \$ | \$ | \$ 68,262 |
| Marketable securities: | | | | |
| Corporate bonds | 15,680 | 14 | (49) | 15,645 |
| Commercial paper | 2,497 | 3 | | 2,500 |
| U.S. treasury securities | 7,488 | 12 | | 7,500 |
| U.S. agency obligations | 2,498 | 3 | | 2,501 |
| | \$ 96,425 | \$ 32 | \$ (49) | \$ 96,408 |

| | |
|----------------------|------------------|
| Due within one year | \$ 83,879 |
| Due within two years | 12,529 |
| Total | \$ 96,408 |

Table of Contents

| | December 31, 2015 | | |
|-------------------------------|-------------------|---------------------|----------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses |
| | | | Fair Value |
| Cash equivalents: | | | |
| Money market funds | \$ 79,717 | \$ | \$ 79,717 |
| Marketable securities: | | | |
| Corporate bonds | 10,042 | | (34) |
| Commercial paper | 2,499 | 1 | |
| U.S. treasury securities | 7,489 | | (27) |
| U.S. agency obligations | 2,497 | 1 | |
| | \$ 102,244 | \$ 2 | \$ (61) |
| Due within one year | | | \$ 87,235 |
| Due within two years | | | 14,950 |
| Total | | | \$ 102,185 |

We do not believe any of the unrealized losses represent an other-than-temporary impairment based on our valuation of available evidence as of September 30, 2016. We expect to receive the full principal and interest on all of these cash equivalents and marketable securities.

Fair Value Measurements

We measure certain financial assets at fair value on a recurring basis based on a fair value hierarchy that requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of inputs that may be used to measure fair value are:

Level 1 – quoted prices in active markets for identical assets or liabilities

Level 2 – observable inputs other than Level 1 prices, such as (a) quoted prices for similar assets or liabilities, (b) quoted prices in markets with insufficient volume or infrequent transactions (less active markets), or (c) model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 – unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

Level 1 Measurements

Our cash equivalents held in money market funds are measured at fair value using level 1 inputs.

Level 2 Measurements

Our available-for-sale U.S. treasury securities, U.S. agency obligations, commercial paper and corporate debt securities are measured at fair value using level 2 inputs. We obtain the fair values of our level 2 available-for-sale securities from a professional pricing service.

Level 3 Measurements

As discussed in Note B, Business Acquisitions, we recorded a share-based earn-out liability in connection with our acquisition of Toolbox Solutions. The valuation technique used to measure the fair value of the earn-out liability is based on the present value of probability-weighted future cash flows related to the contingent earn-out criteria and the fair value of our common stock on each reporting date. While the fair value of our common stock is an observable input, the probability-weighted future cash flows related to the outcome of the earn-out represent a significant unobservable input to the valuation methodology. Accordingly, we have classified the earn-out liability as a Level 3 measurement. During the third quarter, we reevaluated the probability that these revenue milestones will be achieved and determined it to be highly unlikely based on performance to date and future expectations. Accordingly, the fair value of the related contingent consideration liability has been reduced to zero. During the three and nine months ended September 30, 2016, we recognized income of \$1.0 million and \$1.1 million respectively, in other income, net and interest income, net in our condensed consolidated statements of comprehensive income (loss) due to the remeasurement of the earn-out liability to fair value.

Table of Contents

The following table presents information about our financial assets that are measured at fair value on a recurring basis and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value (in thousands):

| | Level 1 | Level 2 | Level 3 | Total |
|--------------------------------------|------------------|------------------|-----------|------------------|
| Assets at September 30, 2016: | | | | |
| Cash and cash equivalents: | | | | |
| Money market funds | \$ 68,262 | \$ | \$ | \$ 68,262 |
| Marketable securities: | | | | |
| Corporate bonds | | 15,645 | | 15,645 |
| Commercial paper | | 2,500 | | 2,500 |
| U.S. treasury securities | | 7,501 | | 7,501 |
| U.S. agency obligations | | 2,500 | | 2,500 |
| Total Assets | \$ 68,262 | \$ 28,146 | \$ | \$ 96,408 |
| Assets at December 31, 2015: | | | | |
| Cash and cash equivalents: | | | | |
| Money market funds | \$ 79,717 | \$ | \$ | \$ 79,717 |
| Marketable securities: | | | | |
| Corporate bonds | | 10,008 | | 10,008 |
| Commercial paper | | 2,500 | | 2,500 |
| U.S. treasury securities | | 7,462 | | 7,462 |
| U.S. agency obligations | | 2,498 | | 2,498 |
| | \$ 79,717 | \$ 22,468 | \$ | \$ 102,185 |

We classify our cash and cash equivalents and marketable securities within Level 1 or Level 2 because we use quoted market prices or alternative pricing sources and models utilizing market observable inputs to determine their fair value.

NOTE D Goodwill and Intangible Assets, net

The change in goodwill for the nine months ended September 30, 2016 was due to the acquisition of Toolbox Solutions (see Note B) of \$15.7 million, as well as the effect of foreign currency translation.

Intangible assets, net included the following (in thousands):

| | September 30, 2016 | | | December 31, 2015 | | |
|----------------------------|--------------------|--------------------------|-----------|-------------------|--------------------------|-----------|
| | Carrying Amount | Accumulated Amortization | Net | Carrying Amount | Accumulated Amortization | Net |
| Subscriber relationships | \$ 34,385 | \$ (14,779) | \$ 19,606 | \$ 26,337 | \$ (11,856) | \$ 14,481 |
| Non-competition agreements | 2,267 | (1,780) | 487 | 1,834 | (1,653) | 181 |

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| | | | | | | |
|----------------------|-----------|-------------|-----------|-----------|-------------|-----------|
| Technology and other | 2,212 | (967) | 1,245 | 819 | (400) | 419 |
| | \$ 38,864 | \$ (17,526) | \$ 21,338 | \$ 28,990 | \$ (13,909) | \$ 15,081 |

Table of Contents

At September 30, 2016, future amortization expense for intangible assets was as follows (in thousands):

| | |
|-------------------|-----------|
| Remainder of 2016 | \$ 1,196 |
| 2017 | 4,442 |
| 2018 | 3,850 |
| 2019 | 3,558 |
| 2020 | 3,221 |
| Thereafter | 5,071 |
| | \$ 21,338 |

NOTE E Commitments and Contingencies*Operating Leases*

At September 30, 2016, our future minimum payments under operating leases were as follows (in thousands):

| | |
|-------------------|-----------|
| Remainder of 2016 | \$ 884 |
| 2017 | 3,319 |
| 2018 | 3,248 |
| 2019 | 3,357 |
| 2020 | 1,858 |
| Thereafter | 2,196 |
| | \$ 14,862 |

NOTE F Stock-Based Compensation

Our equity compensation plans provide for the grant of incentive and nonqualified stock options, as well as other stock-based awards including restricted stock and restricted stock units, to employees, non-employee directors and other consultants who provide services to us. Restricted stock awards result in the issuance of new shares when granted. For other stock-based awards, new shares are issued when the award is exercised, vested or released according to the terms of the agreement. In February 2016, 1,003,439 additional shares were reserved for future issuance under our 2010 Equity Incentive Plan. At September 30, 2016, there were approximately 3.9 million shares available for grant under approved equity compensation plans.

We recorded stock-based compensation expense of \$2.0 million and \$6.0 million for the three and nine months ended September 30, 2016 and \$1.6 million and \$4.8 million for the three and nine months ended September 30, 2015, respectively. This expense was allocated as follows (in thousands):

| | |
|-------------------------------------|----------------------|
| Three Months Ended September 30, | Nine Months Ended |
|-------------------------------------|----------------------|

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| | 2016 | 2015 | September 30, | |
|--|----------|----------|---------------|----------|
| | | | 2016 | 2015 |
| Cost of revenues | \$ 319 | \$ 256 | \$ 916 | \$ 716 |
| Operating expenses | | | | |
| Sales and marketing | 620 | 466 | 1,913 | 1,490 |
| Research and development | 143 | 178 | 422 | 486 |
| General and administrative | 930 | 710 | 2,753 | 2,064 |
| Total stock-based compensation expense | \$ 2,012 | \$ 1,610 | \$ 6,004 | \$ 4,756 |

At September 30, 2016, there was approximately \$15.6 million of unrecognized stock-based compensation expense under our equity compensation plans, which is expected to be recognized on a straight-line basis over a weighted average period of 2.7 years.

Table of Contents*Stock Options*

Stock options generally vest over four years and have a contractual term of seven to ten years from the date of grant. Our stock option activity was as follows:

| | Options (#) | Weighted Average Exercise Price (\$/share) |
|-----------------------------------|----------------|--|
| Outstanding at December 31, 2015 | 943,103 | \$ 37.91 |
| Granted | 340,045 | 48.56 |
| Exercised | (193,015) | (18.24) |
| Forfeited | (43,093) | (55.31) |
| Outstanding at September 30, 2016 | 1,047,040 | 55.56 |

Of the total outstanding options at September 30, 2016, 578,813 were exercisable with a weighted average exercise price of \$36.88 per share. The total outstanding options had a weighted average remaining contractual life of 4.8 years.

The weighted average grant date fair value of options granted during the first nine months of 2016 was \$16.12 and this was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

| | |
|-------------------------|-------|
| Volatility | 37.9% |
| Dividend yield | 0% |
| Life (in years) | 4.5 |
| Risk-free interest rate | 1.19% |

Restricted Stock Units and Awards

Restricted stock units vest over four years and, upon vesting, the holder is entitled to receive shares of our common stock. With restricted stock awards, shares of our common stock are issued when the award is granted and the restrictions lapse over one year.

Our restricted stock units activity was as follows:

| | Restricted Stock Units (#) | Weighted Average Grant Date Fair Value (\$/share) |
|----------------------------------|----------------------------------|---|
| Outstanding at December 31, 2015 | 140,565 | \$ 56.88 |

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| | | |
|-----------------------------------|----------|-------|
| Granted | 115,567 | 48.28 |
| Vested and common stock issued | (52,000) | 48.17 |
| Forfeited | (14,047) | 55.28 |
| Outstanding at September 30, 2016 | 190,085 | 54.15 |

The number of restricted stock units outstanding at September 30, 2016 included 24,995 units that have vested, but for which shares of common stock have not yet been issued pursuant to the terms of the agreement.

Table of Contents

Our restricted stock awards activity was as follows:

| | Restricted Stock Awards (#) | Weighted Average Grant Date Fair Value (\$/share) |
|-----------------------------------|-----------------------------------|---|
| Outstanding at December 31, 2015 | 1,032 | \$ 67.39 |
| Restricted common stock issued | 6,078 | 52.27 |
| Restrictions lapsed Forfeited | (4,068) | 56.10 |
| Outstanding at September 30, 2016 | 3,042 | 52.28 |

Employee Stock Purchase Plan

Our employee stock purchase plan allows participating employees to purchase shares of our common stock at a discount through payroll deductions. The plan is available to all employees subject to certain eligibility requirements. Participating employees may purchase common stock, on a voluntary after tax basis, at a price that is the lower of 85% of the fair market value of one share of common stock at the beginning or end of each stock purchase period. The plan consists of two six-month offering periods, beginning on January 1 and July 1 of each calendar year, respectively. A total of 1.1 million shares of common stock are reserved for issuance under the plan.

For the offering period that began on January 1, 2016 and ended on June 30, 2016, we withheld approximately \$794,000 from employees participating in the plan. On June 30, 2016, approximately \$786,000 of these funds were used to purchase 15,260 shares on behalf of the employees participating in the plan. The remaining funds are expected to be refunded to employees pursuant to the requirements of the plan. For the offering period that began on July 1, 2016 and will end on December 31, 2016, we have withheld approximately \$523,000 as of September 30, 2016 from employees participating in the plan.

For the three and nine months ended September 30, 2016, we recorded approximately \$148,000 and \$384,000, respectively, of stock-based compensation expense associated with the employee stock purchase plan. The fair value was estimated based on the market price of our common stock at the beginning of each offering period and using the Black-Scholes option pricing model with the following weighted-average assumptions:

| | |
|-------------------------|-------|
| Volatility | 36.7% |
| Dividend yield | 0% |
| Life (in years) | 0.5 |
| Risk-free interest rate | 0.43% |

NOTE G Income Taxes

We record our interim provision for income taxes by applying our estimated annual effective tax rate to our year-to-date pretax income and adjust the provision for discrete tax items recorded in the period. Differences between our effective tax rate and statutory tax rates are primarily due to the impact of permanently non-deductible expenses partially offset by the federal research and development credit.

As of September 30, 2016 we do not have any unrecognized tax benefits nor any accrued interest or tax penalties.

NOTE H Net Income Per Share

Basic net income per share has been computed using the weighted average number of shares of common stock outstanding during each period. Diluted net income per share also includes the impact of our outstanding potential common shares, including options and restricted stock units. Potential common shares that are anti-dilutive are excluded from the calculation of diluted net income per share.

Table of Contents

The following table presents the components of the computation of basic and diluted net income per share for the periods indicated (in thousands, except per share amounts):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|----------|
| | 2016 | 2015 | 2016 | 2015 |
| Numerator | | | | |
| Net income | \$ 2,509 | \$ 1,270 | \$ 3,905 | \$ 2,507 |
| Denominator | | | | |
| Weighted average common shares outstanding, basic | 17,001 | 16,605 | 16,916 | 16,525 |
| Options to purchase common stock | 295 | 420 | 253 | 487 |
| Restricted stock units | 44 | 28 | 16 | 25 |
| Employee stock purchase plan | 1 | 1 | | 3 |
| Weighted average common shares outstanding, diluted | 17,341 | 17,054 | 17,185 | 17,040 |
| Net income per share | | | | |
| Basic | \$ 0.15 | \$ 0.08 | \$ 0.23 | \$ 0.15 |
| Diluted | \$ 0.14 | \$ 0.07 | \$ 0.23 | \$ 0.15 |

The effect of approximately 4,353 and 2,000 outstanding potential common shares was excluded from the calculation of diluted net income per share for the three and nine months ended September 30, 2016 and 2015, respectively, as they were anti-dilutive.

Table of Contents

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

We are a leading provider of cloud-based supply chain management solutions, providing network-proven integrations and comprehensive retail performance analytics to thousands of customers worldwide. We provide our solutions through the SPS Commerce platform, a cloud-based product suite that improves the way suppliers, retailers, distributors and other customers manage and fulfill orders. We derive the majority of our revenues from thousands of monthly recurring subscriptions from businesses that utilize our solutions.

We plan to continue to grow our business by further penetrating the supply chain management market, increasing revenues from our customers as their businesses grow, expanding our distribution channels, expanding our international presence and, from time to time, developing new solutions and applications. We also intend to selectively pursue acquisitions that will add customers, allow us to expand into new regions or allow us to offer new functionalities.

For the three months ended September 30, 2016, our revenues were \$49.3 million, an increase of 22% from the comparable period in 2015, and represented our 63rd consecutive quarter of increased revenues. Total operating expenses increased 20% for the same period in 2016 from 2015. Similar results were experienced for the nine months ended September 30, 2016 with increased revenues of 22% and increased operating expenses of 20% compared to the same period in 2015.

On January 5, 2016, we entered into a share purchase agreement with Toolbox Solutions, Inc. (Toolbox Solutions), a privately-held information services company specializing in the collection, analysis and distribution of point-of-sale data used by retailers and suppliers to improve their supply chain efficiencies. Under the share purchase agreement, we purchased and acquired all of the outstanding common shares of Toolbox Solutions for \$18.1 million in cash, 48,668 shares of our common stock, and a share-based earn-out liability at an original fair value of \$1.0 million. We also assumed certain liabilities of Toolbox Solutions. This acquisition allows us to expand our point-of-sale analytic offerings, expand our base of recurring revenue customers and add suppliers to our network. See Note B to our condensed consolidated financial statements included in this Quarterly Report on Form 10-Q for additional information regarding the acquisition of Toolbox Solutions.

Key Financial Terms and Metrics

We have several key financial terms and metrics, including annualized average recurring revenues per recurring revenue customer, which we also refer to as wallet share. During the nine months ended September 30, 2016, there were no changes in the definitions of our key financial terms and metrics, which are discussed in more detail under the heading *Management's Discussion and Analysis of Financial Condition and Results of Operations* included in our Annual Report on Form 10-K for the year ended December 31, 2015 as filed with the Securities and Exchange Commission on February 24, 2016.

To supplement our financial statements, we also provide investors with Adjusted EBITDA and non-GAAP income per share, both of which are non-GAAP financial measures. We believe that these non-GAAP measures provide useful information to management and investors regarding certain financial and business trends relating to our financial condition and results of operations. Our management uses these non-GAAP measures to compare the company's performance to that of prior periods for trend analyses and planning purposes. Adjusted EBITDA is also used for purposes of determining executive and senior management incentive compensation. These measures are also presented to our board of directors.

These non-GAAP measures should not be considered a substitute for, or superior to, financial measures calculated in accordance with U.S. generally accepted accounting principles (GAAP). These non-GAAP financial measures exclude significant expenses and income that are required by GAAP to be recorded in our financial statements and are subject to inherent limitations. Investors should review the reconciliations of non-GAAP financial measures to the comparable GAAP financial measures that are included in this *Management s Discussion and Analysis of Financial Condition and Results of Operations*.

Critical Accounting Policies and Estimates

This discussion of our financial condition and results of operations is based upon our condensed consolidated financial statements, which are prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. On an ongoing basis, we evaluate our estimates and assumptions. We base our estimates of the carrying value of certain assets and liabilities on historical experience and on various other assumptions that we believe to be reasonable. Our actual results may differ from these estimates under different assumptions or conditions.

Table of Contents

A critical accounting policy is one that is both material to the presentation of our financial statements and requires us to make difficult, subjective or complex judgments for uncertain matters that could have a material effect on our financial condition and results of operations. Accordingly, we believe that our policies for revenue recognition, the allowance for doubtful accounts, income taxes, stock-based compensation and the valuation of goodwill and purchased intangible assets are the most critical to aid in fully understanding and evaluating our financial condition and results of operations.

During the nine months ended September 30, 2016, there were no changes in our significant accounting policies or estimates. See Note A to our condensed consolidated financial statements included in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the Securities and Exchange Commission on February 24, 2016, for additional information regarding our accounting policies.

Table of Contents**Results of Operations**

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015

The following table presents our results of operations for the periods indicated (dollars in thousands):

| | Three Months Ended September 30, | | 2015 | | Change | |
|-----------------------------------|----------------------------------|--------------|--------------|--------|---------|-----------|
| | 2016 | % of revenue | % of revenue | | \$ | % |
| Revenues | \$ 49,284 | 100.0% | \$ 40,354 | 100.0% | 8,930 | 22.1 |
| Cost of revenues | 16,171 | 32.8 | 12,700 | 31.5 | 3,471 | 27.3 |
| Gross profit | 33,113 | 67.2 | 27,654 | 68.5 | 5,459 | 19.7 |
| Operating expenses | | | | | | |
| Sales and marketing | 16,526 | 33.5 | 13,795 | 34.2 | 2,731 | 19.8 |
| Research and development | 5,574 | 11.3 | 4,494 | 11.1 | 1,080 | 24.0 |
| General and administrative | 7,149 | 14.5 | 6,276 | 15.6 | 873 | 13.9 |
| Amortization of intangible assets | 1,194 | 2.4 | 829 | 2.1 | 365 | 44.0 |
| Total operating expenses | 30,443 | 61.8 | 25,394 | 62.9 | 5,049 | 19.9 |
| Income from operations | 2,670 | 5.4 | 2,260 | 5.6 | 410 | 18.1 |
| Other income (expense) | | | | | | |
| Interest income, net | 112 | 0.2 | 49 | 0.1 | 63 | 128.6 |
| Other expense, net | 947 | 1.9 | (86) | (0.2) | (1,033) | (1,201.2) |
| Total other income (expense), net | 1,059 | 2.1 | (37) | (0.1) | (1,096) | (2,962.2) |
| Income before income taxes | 3,729 | 7.6 | 2,223 | 5.5 | 1,506 | 67.7 |
| Income tax expense | (1,220) | (2.5) | (953) | (2.4) | 267 | 28.0 |
| Net income | \$ 2,509 | 5.1 | \$ 1,270 | 3.1 | 1,239 | 97.6 |

Due to rounding, totals may not equal the sum of the line items in the table above.

Revenues. Revenues for the three months ended September 30, 2016 increased \$8.9 million, or 22%, to \$49.3 million from \$40.4 million for the same period in 2015. The increase in revenues resulted from two primary factors: the increase in recurring revenue customers and the increase in annualized average recurring revenues per recurring revenue customer, which we also refer to as wallet share.

Annualized average recurring revenues per recurring revenue customer, or wallet share, increased 15% to \$7,399 for the three months ended September 30, 2016 from \$6,436 for the same period in 2015. This increase in wallet share was primarily attributable to increased usage of our solutions by our recurring revenue customers and growth in larger customers.

The number of recurring revenue customers increased 6% to 24,583 at September 30, 2016 from 23,092 at September 30, 2015.

Recurring revenues from recurring revenue customers accounted for 92% of our total revenues, respectively, for the three months ended September 30, 2016, compared to 91% for the same period in 2015. We anticipate that the number of recurring revenue customers and wallet share will continue to increase as we increase the number of solutions we offer and increase the penetration of those solutions across our customer base.

Cost of Revenues. Cost of revenues for the three months ended September 30, 2016 increased \$3.5 million, or 27%, to \$16.2 million from \$12.7 million for the same period in 2015. The increase in cost of revenues for the three-month period in 2016 was primarily due to increased headcount, which resulted in higher personnel-related costs of approximately \$2.5 million and higher occupancy costs of approximately \$223,000 compared to the same period in 2015. We also incurred higher software and cloud-based subscription costs of \$617,000 as compared to the same period in 2015 for continued investment in the infrastructure supporting our solutions. As a percentage of revenues, cost of revenues were 33% for the three months ended September 30, 2016, compared to 32% for the same period in 2015. Going forward, we anticipate that cost of revenues will increase in absolute dollars as we continue to expand our business.

Table of Contents

Sales and Marketing Expenses. Sales and marketing expenses for the three months ended September 30, 2016 increased \$2.7 million, or 20%, to \$16.5 million from \$13.8 million for the same period in 2015. The increase in sales and marketing expenses for the three-month period in 2016 was due to increased headcount, which resulted in higher personnel-related costs of approximately \$2.1 million and higher stock-based compensation of approximately \$155,000. We also incurred higher variable compensation of approximately \$253,000 earned by sales personnel and referral partners from new business and higher promotional costs of approximately \$126,000, partially offset by a decrease in depreciation expense of \$125,000. As a percentage of revenues, sales and marketing expenses were 34% for the three months ended September 30, 2016, compared to 34% for the same period in 2015. As we expand our business, we will continue to add resources to our sales and marketing efforts over time, and we expect that these expenses will continue to increase in absolute dollars.

Research and Development Expenses. Research and development expenses for the three months ended September 30, 2016 increased \$1.1 million, or 24%, to \$5.6 million from \$4.5 million for the same period in 2015. The increase in research and development expenses for the three-month period in 2016 was primarily due to increased headcount, which resulted in higher personnel costs of approximately \$951,000 compared to the same period in 2015. We also incurred higher software and cloud-based subscription costs of \$120,000 as compared to the same period in 2015 for continued investment in the infrastructure supporting our solutions. As a percentage of revenues, research and development expenses were 11% for the three months ended September 30, 2016 compared to 11% for the same period in 2015. As we enhance and expand our solutions and applications, we expect that research and development expenses will continue to increase in absolute dollars.

General and Administrative Expenses. General and administrative expenses for the three months ended September 30, 2016 increased \$872,000, or 14%, to \$7.2 million from \$6.3 million for the same period in 2015. The increase in general and administrative expenses for the three-month period in 2016 was due to higher stock based compensation expenses of approximately \$220,000 compared to the same period in 2015. We also incurred higher software subscription costs of approximately \$309,000, higher hardware and associated maintenance fees of \$104,000, higher bad debt expense of \$57,000 as well as increased legal, audit and tax fees of \$59,000 primarily related to the Toolbox Solutions acquisition compared to the same period in 2015. As a percentage of revenues, general and administrative expenses were 15% for the three months ended September 30, 2016, compared to 16% for the same period in 2015. Going forward, we expect that general and administrative expenses will continue to increase in absolute dollars as we expand our business.

Amortization of Intangible Assets. Amortization of intangible assets for the three months ended September 30, 2016 increased \$365,000, or 44%, to \$1.2 million from \$829,000 for the same period in 2015 primarily due to the acquisition of Toolbox Solutions in 2016.

Total Other Income (Expense), net. Total other income (expense), net for the three months ended September 30, 2016 included \$1.0 million for an adjustment for the fair value of the Toolbox Solutions share-based earn-out liability due to the change in our estimate of probability of attainment.

Income Tax Expense. We recorded income tax expense of \$1.2 million for the three months ended September 30, 2016. We recorded income tax expense of \$953,000 for the three months ended September 30, 2015. The increase in income tax expense for the three-month period ended September 30, 2016 was primarily due to the increase in pretax book income. For the full year 2016, we expect that our annual effective income tax rate will be approximately 40%.

Table of Contents

Adjusted EBITDA. Adjusted EBITDA, which is a non-GAAP measure of financial performance, consists of net income plus depreciation and amortization, interest expense, interest income, income tax expense, stock-based compensation expense and other adjustments as necessary for a fair presentation. The other adjustment is the impact of the fair value adjustment for the Toolbox Solutions share-based earn-out liability. The following table provides a reconciliation of net income to Adjusted EBITDA (in thousands):

| | Three Months Ended September 30, | |
|---|-------------------------------------|-----------------|
| | 2016 | 2015 |
| Net income | \$ 2,509 | \$ 1,270 |
| Depreciation and amortization of property and equipment | 1,624 | 1,584 |
| Amortization of intangible assets | 1,194 | 829 |
| Interest income, net | (112) | (49) |
| Income tax expense | 1,220 | 953 |
| Other | (1,034) | |
| EBITDA | 5,401 | 4,587 |
| Stock-based compensation expense | 2,012 | 1,610 |
| Adjusted EBITDA | \$ 7,413 | \$ 6,197 |

Non-GAAP Income per Share. Non-GAAP income per share, which is also a non-GAAP measure of financial performance, consists of net income plus stock-based compensation expense and amortization expense related to intangible assets divided by the weighted average number of shares of common stock outstanding during each period. The other adjustment is the impact of the fair value adjustment for the Toolbox Solutions share-based earn-out liability. The following table provides a reconciliation of net income to non-GAAP income per share (in thousands, except per share amounts):

| | Three Months Ended September 30, | |
|--|-------------------------------------|-----------------|
| | 2016 | 2015 |
| Net income | \$ 2,509 | \$ 1,270 |
| Stock-based compensation expense | 2,012 | 1,610 |
| Amortization of intangible assets | 1,194 | 829 |
| Other | (1,034) | |
| Non-GAAP income | \$ 4,681 | \$ 3,709 |
| Shares used to compute non-GAAP income per share | | |
| Basic | 17,001 | 16,605 |
| Diluted | 17,341 | 17,054 |

| | | |
|---------------------------|---------|---------|
| Non-GAAP income per share | | |
| Basic | \$ 0.28 | \$ 0.22 |
| Diluted | \$ 0.27 | \$ 0.22 |

Table of Contents*Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015*

The following table presents our results of operations for the periods indicated (dollars in thousands):

| | Nine Months Ended September 30, | | 2015 | | Change | |
|-----------------------------------|---------------------------------|--------------|--------------|--------|--------|-----------|
| | 2016 | % of revenue | % of revenue | | \$ | % |
| Revenues | \$ 142,234 | 100.0% | \$ 116,170 | 100.0% | 26,064 | 22.4 |
| Cost of revenues | 47,024 | 33.1 | 36,607 | 31.5 | 10,417 | 28.5 |
| Gross profit | 95,210 | 66.9 | 79,563 | 68.5 | 15,647 | 19.7 |
| Operating expenses | | | | | | |
| Sales and marketing | 49,092 | 34.5 | 41,640 | 35.8 | 7,452 | 17.9 |
| Research and development | 16,185 | 11.4 | 13,058 | 11.2 | 3,127 | 23.9 |
| General and administrative | 21,516 | 15.1 | 18,149 | 15.6 | 3,367 | 18.6 |
| Amortization of intangible assets | 3,553 | 2.5 | 2,507 | 2.2 | 1,046 | 41.7 |
| Total operating expenses | 90,346 | 63.5 | 75,354 | 64.9 | 14,992 | 19.9 |
| Income from operations | 4,864 | 3.4 | 4,209 | 3.6 | 655 | 15.6 |
| Other income (expense) | | | | | | |
| Interest income, net | 408 | 0.3 | 123 | 0.1 | 285 | 231.7 |
| Other expense, net | 866 | 0.6 | (255) | (0.2) | 1,121 | (439.6) |
| Total other income (expense), net | 1,274 | 0.9 | (132) | (0.1) | 1,406 | (1,065.2) |
| Income before income taxes | 6,138 | 4.3 | 4,077 | 3.5 | 2,061 | 50.6 |
| Income tax expense | (2,233) | (1.6) | (1,570) | (1.4) | (663) | 42.2 |
| Net income | \$ 3,905 | 2.7 | \$ 2,507 | 2.2 | 1,398 | 55.8 |

Due to rounding, totals may not equal the sum of the line items in the table above.

Revenues. Revenues for the nine months ended September 30, 2016 increased \$26.1 million, or 22%, to \$142.2 million from \$116.2 million for the same period in 2015. The increase in revenues resulted from two primary factors: the increase in recurring revenue customers and the increase in annualized average recurring revenues per recurring revenue customer, which we also refer to as wallet share.

Annualized average recurring revenues per recurring revenue customer, or wallet share, increased 16% to \$7,227 for the nine months ended September 30, 2016 from \$6,229 for the same period in 2015. This

increase in wallet share was primarily attributable to increased fees resulting from increased usage of our solutions by our recurring revenue customers and growth in larger customers.

The number of recurring revenue customers increased 6% to 24,583 at September 30, 2016 from 23,092 at September 30, 2015.

Recurring revenues from recurring revenue customers accounted for 92% of our total revenues, respectively, for the nine months ended September 30, 2016, compared to 91% for the same period in 2015. We anticipate that the number of recurring revenue customers and wallet share will continue to increase as we increase the number of solutions we offer and increase the penetration of those solutions across our customer base.

Cost of Revenues. Cost of revenues for the nine months ended September 30, 2016 increased \$10.4 million, or 28%, to \$47.0 million from \$36.6 million for the same period in 2015. The increase in cost of revenues for the nine-month period in 2016 was primarily due to increased headcount, which resulted in higher personnel-related costs of approximately \$7.3 million, higher occupancy costs of approximately \$629,000 and higher stock based compensation expense of approximately \$200,000 compared to the same period in 2015. We also incurred increases in software and cloud-based subscription costs of \$1.5 million, depreciation expense of \$467,000 and network costs of \$164,000 as compared to the same period in 2015 for continued investment in the infrastructure supporting our solutions. As a percentage of revenues, cost of revenues were 33% for the nine months ended September 30, 2016, compared to 32% for the same period in 2015. Going forward, we anticipate that cost of revenues will increase in absolute dollars as we continue to expand our business.

Table of Contents

Sales and Marketing Expenses. Sales and marketing expenses for the nine months ended September 30, 2016 increased \$7.5 million, or 18%, to \$49.1 million from \$41.6 million for the same period in 2015. The increase in sales and marketing expenses for the nine-month period in 2016 was due to increased headcount, which resulted in higher personnel-related costs of approximately \$5.9 million and higher stock based compensation expense of approximately \$423,000. We also incurred higher variable compensation of approximately \$828,000 earned by sales personnel and referral partners from new business and higher promotional costs of \$461,000 compared to the same period in 2015, partially offset by a decrease in depreciation expense of \$458,000. As a percentage of revenues, sales and marketing expenses were 35% for the nine months ended September 30, 2016, compared to 36% for the same period in 2015. As we expand our business, we will continue to add resources to our sales and marketing efforts over time, and we expect that these expenses will continue to increase in absolute dollars.

Research and Development Expenses. Research and development expenses for the nine months ended September 30, 2016 increased \$3.1 million, or 24%, to \$16.2 million from \$13.1 million for the same period in 2015. The increase in research and development expenses for the nine-month period in 2016 was primarily due to increased headcount, which resulted in higher personnel costs of approximately \$2.8 million compared to the same period in 2015. We also incurred higher software and cloud-based subscription costs of \$332,000 as compared to the same period in 2015 for continued investment in the infrastructure supporting our solutions. As a percentage of revenues, research and development expenses were 11% for the nine months ended September 30, 2016 compared to 11% for the same period in 2015. As we enhance and expand our solutions and applications, we expect that research and development expenses will continue to increase in absolute dollars.

General and Administrative Expenses. General and administrative expenses for the nine months ended September 30, 2016 increased \$3.4 million, or 19%, to \$21.5 million from \$18.1 million for the same period in 2015. The increase in general and administrative expenses for the nine-month period in 2016 was due to increased headcount, which resulted in higher personnel-related costs of approximately \$1.2 million and higher stock based compensation expenses of approximately \$690,000 compared to the same period in 2015. We also incurred higher software subscription costs of approximately \$542,000, higher consulting expenses of \$305,000, higher legal and audit fees of approximately \$277,000 primarily due to the acquisition of Toolbox Solutions and higher credit card fees of approximately \$203,000 due to increase in customers paying by credit card compared to the same period in 2015. As a percentage of revenues, general and administrative expenses were 15% for the nine months ended September 30, 2016, compared to 16% for the same period in 2015. Going forward, we expect that general and administrative expenses will continue to increase in absolute dollars as we expand our business.

Amortization of Intangible Assets. Amortization of intangible assets for the nine months ended September 30, 2016 increased \$1.0 million, or 42%, to \$3.6 million from \$2.5 million for the same period in 2015 primarily due to the acquisition of Toolbox Solutions in 2016.

Total Other Income (Expense), net. Total other income (expense), net for the nine months ended September 30, 2016 included \$1.0 million for an adjustment to the balance of the Toolbox Solutions share-based earn-out liability due to the change in our estimate of probability of attainment.

Income Tax Expense. We recorded income tax expense of \$2.2 million for the nine months ended September 30, 2016. We recorded income tax expense of \$1.6 million for nine months ended September 30, 2015. The increase in income tax expense for the nine-month period in 2016 was primarily due to increased pretax book income. For the full year 2016, we expect that our annual effective income tax rate will be approximately 40%.

Table of Contents

Adjusted EBITDA. Adjusted EBITDA, which is a non-GAAP measure of financial performance, consists of net income plus depreciation and amortization, interest expense, interest income, income tax expense, stock-based compensation expense and other adjustments as necessary for a fair presentation. The other adjustment is the impact of the fair value adjustment for the Toolbox Solutions share-based earn-out liability. The following table provides a reconciliation of net income to Adjusted EBITDA (in thousands):

| | Nine Months Ended September 30, | |
|---|------------------------------------|------------------|
| | 2016 | 2015 |
| Net income | \$ 3,905 | \$ 2,507 |
| Depreciation and amortization of property and equipment | 4,883 | 4,693 |
| Amortization of intangible assets | 3,553 | 2,507 |
| Interest income, net | (408) | (123) |
| Income tax expense | 2,233 | 1,570 |
| Other | (1,106) | |
| EBITDA | 13,060 | 11,154 |
| Stock-based compensation expense | 6,004 | 4,756 |
| Adjusted EBITDA | \$ 19,064 | \$ 15,910 |

Non-GAAP Income per Share. Non-GAAP income per share, which is also a non-GAAP measure of financial performance, consists of net income plus stock-based compensation expense and amortization expense related to intangible assets divided by the weighted average number of shares of common stock outstanding during each period. The other adjustment is the impact of the fair value adjustment for the Toolbox Solutions share-based earn-out liability. The following table provides a reconciliation of net income to non-GAAP income per share (in thousands, except per share amounts):

| | Nine Months Ended September 30, | |
|--|------------------------------------|-----------------|
| | 2016 | 2015 |
| Net income | \$ 3,905 | \$ 2,507 |
| Stock-based compensation expense | 6,004 | 4,756 |
| Amortization of intangible assets | 3,553 | 2,507 |
| Other | (1,106) | |
| Non-GAAP income | \$ 12,356 | \$ 9,770 |
| Shares used to compute non-GAAP income per share | | |
| Basic | 16,916 | 16,525 |
| Diluted | 17,185 | 17,040 |

| | | |
|---------------------------|---------|---------|
| Non-GAAP income per share | | |
| Basic | \$ 0.73 | \$ 0.59 |
| Diluted | \$ 0.72 | \$ 0.57 |

Liquidity and Capital Resources

At September 30, 2016, our principal sources of liquidity were cash, cash equivalents and marketable securities of \$137.8 million and accounts receivable, net of allowance for doubtful accounts, of \$21.4 million. Marketable securities are invested in accordance with our investment policy, with a goal of maintaining liquidity and capital preservation. Our cash equivalents and marketable securities are held in highly liquid money market funds, commercial paper, federal agency securities, and corporate debt securities.

Table of Contents

Net Cash Flows from Operating Activities

Net cash provided by operating activities was \$10.4 million and \$6.9 million for the nine months ended September 30, 2016 and 2015, respectively. The increase in operating cash flows as compared to the same period in 2015 was primarily due to the increase in deferred revenue due to increased new business in 2016 and due to cash collected for post-acquisition for annual Toolbox Solutions contracts invoiced prior to acquisition and the timing of payments for accounts payable, accrued compensation and accrued expenses, somewhat offset by the timing of payments for accounts receivable and the increases in deferred costs for expenses related to increased implementation resources and commission payments for new business and other current and non-current assets for prepayments of discounted cloud based and security subscription-based services.

Net Cash Flows from Investing Activities

Net cash used in investing activities was \$29.7 and \$24.0 million for the nine months ended September 30, 2016 and 2015, respectively. The increase in net cash used in investing activities as compared to the same period in 2015 was primarily due to the acquisition of Toolbox Solutions for \$18.1 million. For the nine months ended September 30, 2016 and 2015, we purchased marketable securities, net of maturities, of \$5.6 million and \$17.5 million, respectively and had capital expenditures of \$6.0 million and \$6.5 million, respectively. Our capital expenditures are for supporting our business growth and existing customer base, as well as for our internal use such as equipment for our employees.

Net Cash Flows from Financing Activities

Net cash provided by financing activities was \$7.0 million and \$5.2 million for the nine months ended September 30, 2016 and 2015, respectively, from the exercise of stock options, excess tax benefit from the exercise of stock options and proceeds from employee stock purchase plan.

Effect of Foreign Currency Exchange Rate Changes

Our results of operations and cash flows were not materially affected by fluctuations in foreign currency exchange rates. We maintain approximately 11% of our total cash and cash equivalents outside of the United States in foreign currencies, primarily in Australian and Canadian dollars. We believe that a significant change in foreign currency exchange rates or an inability to access these funds would not affect our ability to meet our operational needs.

Adequacy of Capital Resources

Our future capital requirements may vary significantly from those now planned and will depend on many factors, including:

costs to develop and implement new solutions and applications, if any;

sales and marketing resources needed to further penetrate our market and gain acceptance of new solutions and applications that we may develop;

expansion of our operations in the United States and internationally;

response of competitors to our solutions and applications; and,

use of capital for acquisitions, if any.

Historically, we have experienced increases in our expenditures consistent with the growth in our operations and personnel, and we anticipate that our expenditures will continue to increase as we expand our business.

We believe our cash, cash equivalents, marketable securities and our cash flows from operations will be sufficient to meet our working capital and capital expenditure requirements for at least the next twelve months.

Inflation and changing prices did not have a material effect on our business during the nine months ended September 30, 2016 and we do not expect that inflation or changing prices will materially affect our business in the foreseeable future.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt. Additionally, we are not a party to any derivative contracts or synthetic leases.

Table of Contents*Contractual and Commercial Commitment Summary*

Our contractual obligations and commercial commitments as of September 30, 2016 are summarized below:

| Contractual Obligations | Total | Payments Due By Period (in thousands) | | | |
|-----------------------------|-----------|---------------------------------------|-----------|-----------|----------------------|
| | | Less Than 1 Year | 1-3 Years | 3-5 Years | More Than 5 Years |
| Operating lease obligations | \$ 14,862 | \$ 884 | \$ 6,567 | \$ 5,215 | \$ 2,196 |

Item 3. Quantitative and Qualitative Disclosures About Market Risk*Interest Rate Sensitivity Risk*

The principal objectives of our investment activities are to preserve principal, provide liquidity and maximize income consistent with minimizing risk of material loss. We are exposed to market risk related to changes in interest rates. However, based on the nature and current level of our investments (primarily cash and cash equivalents, which approximate fair value due to their short maturities, and marketable securities), we believe there is no material risk exposure. We do not enter into investments for trading or speculative purposes.

We did not have any outstanding debt as of September 30, 2016. Therefore, we do not have any material risk to interest rate fluctuations.

Foreign Currency Exchange Risk

We have revenue, expenses, assets and liabilities that are denominated in currencies other than the U.S. dollar, primarily the Australian and Canadian dollars. As we expand internationally, our results of operations and cash flows will be impacted by foreign currency fluctuations. We have not used any forward contracts or currency borrowings to hedge our exposure to foreign currency exchange risk, although we may do so in the future.

Item 4. Controls and Procedures*Evaluation of Disclosure Controls and Procedures*

As of the end of the period covered by this Quarterly Report on Form 10-Q, our management has evaluated, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Disclosure controls and procedures are designed to ensure that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2016.

In the first quarter of 2016, we acquired the net assets of Toolbox Solutions. Toolbox Solutions represented approximately 10% of our total consolidated assets and 4% of our consolidated revenues for both the three and nine months ended September 30, 2016, respectively. The scope of our assessment of the effectiveness of internal control over financial reporting does not include Toolbox Solutions. This exclusion is in accordance with the SEC's general guidance that an assessment of a recently acquired business may be omitted from our scope in the year of acquisition.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently subject to any material legal proceedings. From time to time, we may be named as a defendant in legal actions or otherwise be subject to claims arising from our normal business activities. Any such actions, even those that lack merit, could result in the expenditure of significant financial and managerial resources. We believe that we have obtained adequate insurance coverage or rights to indemnification in connection with potential legal proceedings that may arise.

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed under the heading *Risk Factors* in our Annual Report on Form 10-K for the year ended December 31, 2015 as filed with the Securities and Exchange Commission on February 24, 2016.

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

Not Applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

Not Applicable.

Item 6. Exhibits

The exhibits filed as part of this Quarterly Report on Form 10-Q are listed in the Exhibit Index immediately following the signatures to this report.

Table of Contents

SIGNATURES

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

Dated: October 28, 2016

SPS COMMERCE, INC.

/s/ KIMBERLY K. NELSON

Kimberly K. Nelson

Executive Vice President and Chief Financial Officer

(principal financial and accounting officer)

Table of Contents

EXHIBIT INDEX

Exhibit

Number

Description

| | |
|------|--|
| 3.1 | Certificate of Incorporation (incorporated by reference to Exhibit 4.1 to our Registration Statement on Form S-3 (File No. 333-182097) filed with the Commission on September 13, 2012). |
| 3.2 | Bylaws (incorporated by reference to Exhibit 3.2 to our Registration Statement on Form S-1/A (File No. 333-163476) filed with the Commission on March 5, 2010). |
| 31.1 | Certification of Principal Executive Officer pursuant to Rules 13a-14(a) under the Securities Exchange Act of 1934, as amended (filed herewith). |
| 31.2 | Certification of Principal Financial Officer pursuant to Rules 13a-14(a) under the Securities Exchange Act of 1934, as amended (filed herewith). |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Sec. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith). |
| 101 | Interactive Data Files Pursuant to Rule 405 of Regulation S-T (filed herewith). |

** Indicates management contract or compensatory plan or arrangement.