

SPS COMMERCE INC
Form 10-Q
October 26, 2018
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, 2018

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 41-2015127
(State or Other Jurisdiction of (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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for

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such shorter period that the registrant was required to submit such files). Yes No

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

Large Accelerated Filer	Accelerated Filer
Non-Accelerated Filer	Smaller Reporting Company
Emerging growth company	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 19, 2018 was 17,664,624 shares.

SPS COMMERCE, INC.

QUARTERLY REPORT ON FORM 10-Q

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Unless the context otherwise requires, for purposes of the Quarterly Report on Form 10-Q, the words “we,” “us,” “our,” the “Company” and “SPS” refer to SPS Commerce, Inc.

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, 2017 as filed with the Securities and Exchange Commission (“SEC”). 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 SEC that advise interested parties of the risks and factors that may affect our business.

PART I. – FINANCIAL INFORMATION

Item 1. Financial Statements

SPS COMMERCE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited; in thousands, except shares and per share amounts)

	September 30, 2018	December 31, 2017
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 144,748	\$ 123,127
Short-term investments	44,654	40,192
Accounts receivable, less allowance for doubtful accounts of \$1,199 and \$763, respectively	27,289	24,897
Deferred costs	33,134	29,966
Other current assets	6,613	6,149
Total current assets	256,438	224,331
PROPERTY AND EQUIPMENT, net	19,368	16,856
GOODWILL	50,502	51,613
INTANGIBLE ASSETS, net	13,491	16,529
INVESTMENTS	4,921	5,206
OTHER ASSETS		
Deferred costs	10,597	9,967
Deferred income tax asset	11,433	13,697
Other assets	1,710	1,539
Total assets	\$ 368,460	\$ 339,738
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 3,853	\$ 4,463
Accrued compensation	15,498	15,228
Accrued expenses	3,976	4,712
Deferred revenue	24,948	17,863
Deferred rent	1,399	1,679
Total current liabilities	49,674	43,945
OTHER LIABILITIES		
Deferred revenue	2,685	2,731
Deferred rent	3,979	3,064
Deferred income tax liability	1,551	1,887
Total liabilities	57,889	51,627
COMMITMENTS and CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Preferred stock, \$0.001 par value; 5,000,000 shares authorized; 0 shares issued and outstanding	—	—
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Common stock, \$0.001 par value; 55,000,000 shares authorized; 17,644,364 and 17,249,153 shares issued; and 17,302,572 and 17,127,006 outstanding, respectively		
Treasury stock, at cost; 341,792 and 122,147 shares, respectively	(19,682)	(5,815)
Additional paid-in capital	323,539	301,863
Retained earnings (accumulated deficit)	8,120	(8,611)
Accumulated other comprehensive (loss) income	(1,424)	657
Total stockholders' equity	310,571	288,111
Total liabilities and stockholders' equity	\$ 368,460	\$ 339,738

See accompanying notes to these condensed consolidated financial statements.

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SPS COMMERCE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited; in thousands, except per share amounts)

	Three Months		Nine Months Ended	
	Ended September 30, 2018	2017	September 30, 2018	2017
Revenues	\$62,868	\$56,057	\$183,051	\$162,028
Cost of revenues	20,411	18,645	60,571	54,166
Gross profit	42,457	37,412	122,480	107,862
Operating expenses				
Sales and marketing	16,952	17,638	54,023	52,981
Research and development	5,146	6,549	15,571	17,023
General and administrative	11,174	8,743	31,278	24,709
Amortization of intangible assets	928	1,128	3,086	3,460
Total operating expenses	34,200	34,058	103,958	98,173
Income from operations	8,257	3,354	18,522	9,689
Other income (expense)				
Interest income, net	628	272	1,589	704
Other expense, net	(219)	(195)	(541)	(356)
Total other income, net	409	77	1,048	348
Income before income taxes	8,666	3,431	19,570	10,037
Income tax expense	605	1,255	2,839	2,908
Net income	\$8,061	\$2,176	\$16,731	\$7,129
Net income per share				
Basic	\$0.47	\$0.13	\$0.97	\$0.42
Diluted	\$0.45	\$0.13	\$0.95	\$0.41
Weighted average common shares used to compute net income per share				
Basic	17,219	17,223	17,167	17,192
Diluted	17,741	17,410	17,557	17,394
Other comprehensive income				
Foreign currency translation adjustments	76	1,779	(2,155)	4,291
Unrealized gain on investments, net of tax of \$41, \$10, \$88 and \$0	123	17	264	—
Reclassification of unrealized (gain) loss on investments into earnings, net of tax of (\$11), \$44, (\$64) and \$29	(33)	72	(191)	48
Comprehensive income	\$8,227	\$4,044	\$14,649	\$11,468

See accompanying notes to these condensed consolidated financial statements.

SPS COMMERCE, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited; in thousands)

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities		
Net income	\$ 16,731	\$ 7,129
Reconciliation of net income to net cash provided by operating activities		
Deferred income taxes	1,934	2,240
Depreciation and amortization of property and equipment	6,308	5,261
Amortization of intangible assets	3,086	3,460
Provision for doubtful accounts	1,780	1,365
Stock-based compensation	9,978	6,833
Other, net	(255)	(19)
Changes in assets and liabilities		
Accounts receivable	(4,279)	(4,476)
Deferred costs	(3,813)	(5,188)
Other current and non-current assets	(681)	1,135
Accounts payable	382	632
Accrued compensation	(592)	(1,517)
Accrued expenses	(718)	469
Deferred revenue	7,039	5,270
Deferred rent	647	(622)
Net cash provided by operating activities	37,547	21,972
Cash flows from investing activities		
Purchases of property and equipment	(9,875)	(5,242)
Purchases of investments	(64,434)	(29,819)
Maturities of investments	60,000	23,029
Acquisitions of businesses and intangible assets, net of cash acquired	(381)	(500)
Net cash used in investing activities	(14,690)	(12,532)
Cash flows from financing activities		
Repurchases of common stock	(13,867)	—
Net proceeds from exercise of options to purchase common stock	11,800	1,307
Net proceeds from employee stock purchase plan	836	1,011
Net cash (used in) provided by financing activities	(1,231)	2,318
Effect of foreign currency exchange rate changes	(5)	1,349
Net increase in cash and cash equivalents	21,621	13,107
Cash and cash equivalents at beginning of period	123,127	115,877
Cash and cash equivalents at end of period	\$ 144,748	\$ 128,984

See accompanying notes to these condensed consolidated financial statements.

SPS COMMERCE, INC. AND SUBSIDIARIES

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 fulfillment, sourcing, and item assortment management solutions, along with 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 retailers, suppliers, distributors and logistics firms orchestrate the sourcing, set up of new vendors and items and fulfillment of products that consumers buy. 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 unaudited 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 unaudited 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 provide a fair presentation 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. For further information, refer to the consolidated financial statements and accompanying notes for the year ended December 31, 2017 included in our Annual Report on Form 10-K as filed with the SEC on February 26, 2018.

Effective January 1, 2018, we adopted the requirements of Accounting Standards Update (“ASU”) No. 2014-09 (“ASU 2014-09”), Revenue from Contracts with Customers (Topic 606), on a retrospective basis as discussed in this Note A. All amounts and disclosures set forth in this Form 10-Q have been updated to comply with the new standards.

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.

Recently Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU 2014-09 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 in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This guidance replaced most existing revenue recognition guidance in GAAP. Topic 606 also includes Subtopic 340-40, Other Assets and Deferred Costs – Contracts with Customers, which requires the deferral of

incremental costs of obtaining a contract with a customer. Collectively, we refer to Topic 606 and Subtopic 340-40 as the “new standard.” These requirements are effective for annual reporting periods beginning after December 15, 2017, and interim periods within those annual periods.

We adopted the new standard effective January 1, 2018, on a retrospective basis. The new standard did not impact our recognition of the recurring revenue received from customers for our cloud-based supply chain solutions; however, the adoption of the new standard impacted our accounting for certain upfront set-up fees, the periods over which the related revenues are recognized and the timing of revenue recognition for these set-up fees. The adoption of the new standard also impacted our accounting for certain costs to obtain our contracts, specifically related to the periods over which commissions are recognized as well as the timing of cost recognition.

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Selected condensed consolidated balance sheet line items, which reflect the adoption of ASU 2014-09 are as follows (in thousands):

	December 31, 2017		
	As previously reported		
	reported	Adjustments	As adjusted
ASSETS			
Deferred costs	\$25,091	\$ 4,875	\$ 29,966
Deferred costs, non-current	6,770	3,197	9,967
Deferred income tax asset	17,551	(3,854)	13,697
LIABILITIES			
Accrued compensation	15,886	(658)	15,228
Deferred revenue	16,407	1,456	17,863
Deferred revenue, non-current	10,602	(7,871)	2,731
STOCKHOLDERS' EQUITY			
Accumulated deficit	(19,902)	11,291	(8,611)

Selected unaudited condensed consolidated statement of operations line items, which reflect the adoption of ASU 2014-09 are as follows (in thousands):

	For the three months ended September 30, 2017		
	As previously reported		
	reported	Adjustments	As adjusted
Revenues	56,150	(93)	56,057
Operating expenses			
Sales and marketing	18,239	(601)	17,638
Income from operations	2,846	508	3,354
Income tax expense	1,058	197	1,255
Net income	\$1,865	\$ 311	\$ 2,176
Net income per share			
Basic	\$0.11	\$ 0.02	\$0.13
Diluted	\$0.11	\$ 0.02	\$0.13

For the nine months ended
September 30, 2017
As
previously
reported Adjustments

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			As adjusted
Revenues	162,366	(338)	162,028
Operating expenses			
Sales and marketing	54,059	(1,078)	52,981
Income from operations	8,949	740	9,689
Income tax expense	2,636	272	2,908
Net income	\$6,661	\$ 468	\$7,129
Net income per share			
Basic	\$0.39	\$ 0.03	\$0.42
Diluted	\$0.38	\$ 0.03	\$0.41

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Selected unaudited condensed consolidated statement of cash flows line items, which reflect the adoption of ASU 2014-09 are as follows (in thousands):

	For the nine months ended September 30, 2017		
	As previously		As
	reported	Adjustments	adjusted
Cash flows from operating activities			
Net income	\$6,661	\$ 468	\$7,129
Reconciliation of net income to net cash provided by operating activities			
Deferred income taxes	1,968	272	2,240
Changes in assets and liabilities			
Deferred costs	(4,487)	(701)	(5,188)
Accrued compensation	(1,140)	(377)	(1,517)
Deferred revenue	4,932	338	5,270
Net cash provided by operating activities	21,972	—	21,972

In March 2018, we adopted FASB ASU 2018-05, Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118, which updates the income tax accounting in U.S. GAAP to reflect the SEC interpretive guidance released on December 22, 2017, when the Tax Cuts and Jobs Act (the “Tax Act”) was signed into law. Additional information regarding the adoption of this standard is contained in Note F.

Accounting Pronouncements Not Yet Adopted

In February 2016, the FASB issued ASU 2016-02, Leases, which will supersede 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 will adopt the new standard on January 1, 2019 and use the effective date as our date of initial application. Consequently, financial information will not be updated and the disclosures required under the new standard will not be provided for dates and periods before January 1, 2019. The new standard provides several optional practical expedients in transition. We expect to elect the ‘package of practical expedients’, which permits us not to reassess under the new standard our prior conclusions about lease identification, lease classification and initial direct costs. We do not expect to elect the use-of hindsight or the practical expedient pertaining to land easements; the latter not being applicable to us. The new standard also provides practical expedients for an entity’s ongoing accounting. We currently expect to elect the short-term lease recognition exemption for all leases that qualify which means we will not recognize right-of-use (“ROU”) assets or lease liabilities for these leases, and this includes not recognizing ROU assets or lease liabilities for existing short-term leases of those assets in transition. We also currently expect to elect the

practical expedient to not separate lease and non-lease components for all leases.

We expect that this standard will have a material effect on our financial statements. While we continue to assess all of the effects of adoption, we currently believe the most significant effects relate to the recognition of new ROU assets and lease liabilities on our balance sheet for our existing operating leases. We are in the process of determining the financial statement impact and are currently unable to estimate the extent of the impact on our consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220), which allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Act and requires certain disclosures regarding stranded tax effects in accumulated other comprehensive income. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted during interim or annual periods. We believe the adoption of this standard will not have a material impact on our consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350), which simplifies the test for goodwill impairment by eliminating step two from the goodwill impairment test. Under the new guidance, an entity should recognize an impairment charge for the amount based on the excess of a reporting unit's carrying amount over its fair value. The impairment charge will be limited to the amount of goodwill allocated to that reporting unit. This guidance is effective for annual and interim impairment tests performed in periods beginning after December 15, 2019 on a prospective basis, and earlier adoption is permitted for

goodwill impairment tests performed on testing dates after January 1, 2017. We believe the adoption of this standard will not have a material impact on our consolidated financial statements.

Significant Accounting Policies

Except for the accounting policies for revenue recognition and deferred commissions that were updated as a result of adopting ASU 2014-09, there were no material changes in our significant accounting policies during the nine months ended September 30, 2018. See Note A to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC on February 26, 2018, for additional information regarding our significant accounting policies.

Revenue Recognition

We derive our revenues primarily from the following revenue streams (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Recurring revenues:				
Fulfillment	\$48,482	\$41,962	\$140,326	\$120,754
Analytics	8,750	8,679	25,639	25,517
Other	1,412	1,257	3,969	3,721
Recurring Revenues	58,644	51,898	169,934	149,992
One-time revenues	4,224	4,159	13,117	12,036
	\$62,868	\$56,057	\$183,051	\$162,028

Revenues are recognized when our services are made available to our customers, in an amount that reflects the consideration we are contractually and legally entitled to in exchange for those services.

We determine revenue recognition through the following steps:

- Identification of the contract, or contracts, with a customer
- Identification of the performance obligations in the contract
- Determination of the transaction price
- Allocation of the transaction price to the performance obligations in the contract
- Recognition of revenue when, or as, we satisfy a performance obligation

Recurring Revenues

Recurring revenues consists of recurring subscriptions from customers that utilize our Fulfillment, Analytics and Other cloud-based supply chain management solutions. Revenue for these solutions is generally recognized on a ratable basis over the contract term beginning on the date that our service is made available to the customer. Our contracts with our recurring revenue customers are recurring in nature, ranging from monthly to annual, and generally allow the customer to cancel the contract for any reason with 30 to 90 days' notice. Timing of billings varies by customer and by contract type and are either in advance or within 30 days of the service being performed.

The deferred revenue liabilities for recurring revenue contracts are for one year or less and recognized on a ratable basis over the contract term. We have applied the optional exemption under ASC 606-10-50-14(a) and will not disclose information about the remaining performance obligations for contracts which have original durations of one year or less.

One-time Revenues

One-time revenues consist of set-up fees from customers and miscellaneous one-time fees.

Set-up fees are specific for each connection a customer has with a trading partner and many of our customers have connections with numerous trading partners. Set-up fees related to our cloud-based supply chain management solutions are nonrefundable upfront fees that are necessary for our customers to utilize our cloud-based services. These set-up fees do not provide any standalone value to our customers. Except for our Analytics platform, we have determined the set-up fees represent a material renewal option right to our customers as they will not be incurred again upon renewal. These set-up fees and related costs are deferred and recognized ratably

over two years, which is the estimated connection life between the customer and the trading partner. For our Analytics platform, we have determined the set-up fees do not represent a material customer renewal right and, as such, are deferred and recognized ratably over the estimated initial contract term, which is one year.

The table below presents the activity of the portion of the deferred revenue liability relating to set-up fees (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Balances, at beginning of period	\$9,886	\$10,280	\$10,031	\$9,995
Invoiced set-up fees	2,697	2,450	7,807	8,063
Amortized set-up fees	(2,596)	(2,634)	(7,851)	(7,962)
Balances, at end of period	\$9,987	\$10,096	\$9,987	\$10,096

The entire balance of set-up fees will be recognized within two years and, as such, current amounts will be recognized in the next 1-12 months and long-term amounts will be recognized in the next 13-24 months.

Miscellaneous one-time fees consist of professional services and testing and certification. The deferred revenue liability for these one-time fees are for one year or less and recognized at the time service is provided. We have applied the optional exemption under ASC 606-10-50-14(a) and will not disclose information about the remaining performance obligations for contracts which have original durations of one year or less.

Deferred Costs

Deferred costs consist of costs to obtain customer contracts, such as commissions paid to sales personnel and to third-party partners for customer referrals, and costs to fulfill customer contracts, such as customer implementation costs.

Sales commissions relating to recurring revenues are considered incremental and recoverable costs of obtaining a contract with our customer. These commissions are calculated based on estimated annual recurring revenue to be generated over the customer's initial contract year. These costs are deferred and amortized over the expected period of benefit which we have determined to be two years. Amortization expense is included in sales and marketing expenses in the accompanying condensed consolidated statements of operations.

The table below presents the activity of deferred costs and amortization of set-up fees (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Balances, at beginning of period	\$42,544	\$35,332	\$39,933	\$32,117
Incurred deferred costs	12,391	11,294	36,807	32,142

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Amortized deferred costs	(11,204)	(9,316)	(33,009)	(26,949)
Balances, at end of period	\$43,731	\$37,310	\$43,731	\$37,310

There was no impairment loss in relation to the costs capitalized for the periods presented.

NOTE B – Financial Instruments

We invest primarily in money market funds, certificates of deposit, 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 investments. Investments with remaining maturities of more than one year from the balance sheet date are classified as long-term investments.

Our short- and long-term marketable securities are 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. Consequently, we may or may not keep securities with stated holding periods to maturity.

Our marketable securities are carried at fair value and unrealized gains and losses on these investments, net of taxes, are included in accumulated other comprehensive loss in the condensed consolidated balance sheets. Realized gains or losses are included in other income (expense), net, in the condensed consolidated statements of comprehensive income. 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.

Cash equivalents and short- and long-term investments consisted of the following (in thousands):

	September 30, 2018		
	Amortized	Unrealized	Fair
	Cost	Gains (Losses)	Value
Cash equivalents:			
Money market funds	\$ 121,594	\$ —	\$ 121,594
Certificate of deposit	7,224	—	7,224
Marketable securities:			
Corporate bonds	12,642	51	12,693
Commercial paper	17,323	57	17,380
U.S. treasury securities	12,300	(22)	12,278
	\$ 171,083	\$ 86	\$ 171,169
Due within one year			\$ 166,248
Due within two years			4,921
Total			\$ 171,169

	December 31, 2017		
	Amortized	Unrealized	Fair
	Cost	Gains (Losses)	Value
Cash equivalents:			
Money market funds	\$ 104,544	\$ —	\$ 104,544
Certificate of deposit	7,814	—	7,814
Marketable securities:			
Corporate bonds	17,758	(57)	17,701
Commercial paper	7,456	20	7,476
U.S. treasury securities	12,381	26	12,407
	\$ 149,953	\$ (11)	\$ 149,942
Due within one year			\$ 144,736
Due within two years			5,206
Total			\$ 149,942

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, 2018. We expect to receive the full principal and interest on all of these cash equivalents, certificate of deposit 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. We obtain the fair values of our level 2 available-for-sale securities from a professional pricing service.

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

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):

	September 30, 2018			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents:				
Money market funds	\$121,594	\$—	\$ —	\$121,594
Certificate of deposit	7,224	—	—	7,224
Marketable securities:				
Corporate bonds	—	12,693	—	12,693
Commercial paper	—	17,380	—	17,380
U.S. treasury securities	—	12,278	—	12,278
Total	\$128,818	\$42,351	\$ —	\$171,169

	December 31, 2017			
	Level 1	Level 2	Level 3	Total
Assets:				
Cash equivalents:				
Money market funds	\$104,544	\$—	\$ —	\$104,544
Certificate of deposit	7,814	—	—	7,814
Marketable securities:				
Corporate bonds	—	17,700	—	17,700
Commercial paper	—	7,477	—	7,477
U.S. treasury securities	—	12,407	—	12,407
Total	\$112,358	\$37,584	\$ —	\$149,942

NOTE C – Goodwill and Intangible Assets, net

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The changes in the net carrying amount of goodwill for the nine months ended September 30, 2018 are as follows (in thousands):

	2018
Balances, January 1	\$51,613
Goodwill acquired during the period	—
Foreign currency translation adjustments	(1,111)
Balances, September 30	\$50,502

Intangible assets subject to amortization primarily include subscriber relationships, non-competition agreements and acquired technology and are amortized over their respective useful lives (ranging from 1 to 9 years). Intangible assets, net of amortization, included the following (in thousands):

	September 30, 2018			
	Carrying	Accumulated	Foreign	
	Amount	Amortization	Currency	Net
			Translation	
Subscriber relationships	\$35,512	\$ (22,710)	\$ (64)	\$12,738
Non-competition agreements	2,560	(2,204)	\$ (13)	343
Technology and other	2,289	(1,859)	\$ (20)	410
	\$40,361	\$ (26,773)	\$ (97)	\$13,491

	December 31, 2017			
	Carrying	Accumulated	Foreign	
	Amount	Amortization	Currency	Net
			Translation	
Subscriber relationships	\$34,350	\$ (19,592)	\$ 614	\$15,372
Non-competition agreements	2,499	(2,058)	45	486
Technology and other	2,130	(1,518)	59	671
	\$38,979	\$ (23,168)	\$ 718	\$16,529

Total amortization expense for intangible assets during the three months ended September 30, 2018 and 2017 was \$0.9 million and \$1.1 million, respectively. Total amortization expense for intangible assets during the nine months ended September 30, 2018 and 2017 was \$3.1 million and \$3.5 million, respectively. The estimated annual amortization expense related to intangible assets subject to amortization for the next five years is as follows (in thousands):

Remainder of 2018	\$930
2019	3,716
2020	3,361
2021	2,521
2022	1,449
Thereafter	1,514
	\$13,491

NOTE D – Commitments and Contingencies

Operating Leases

At September 30, 2018, our future minimum payments under operating leases were as follows (in thousands):

Remainder of 2018	\$1,012
2019	4,146
2020	3,476
2021	4,345
2022	4,035
Thereafter	8,671
	\$25,685

NOTE E – Stock-Based Compensation

Our equity compensation plans provide for the grant of incentive and nonqualified stock options, restricted stock awards, restricted stock units and performance stock units to employees, non-employee directors and other consultants who provide services to us. We also provide an employee stock purchase plan and 401(k) stock match.

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 January 2018, 1,027,620 additional shares

were reserved for future issuance under our 2010 Equity Incentive Plan. At September 30, 2018, there were approximately 5.3 million shares available for grant under approved equity compensation plans.

We recognize stock-based compensation expense on a straight-line basis over the vesting period, except for expense relating to retirement-eligible employees, which is recognized immediately upon the employee becoming retirement-eligible.

We recorded stock-based compensation expense of \$3.3 million and \$10.0 million for the three and nine months ended September 30, 2018 and \$2.3 million and \$6.8 million for the three and nine months ended September 30, 2017, respectively. This expense was allocated in the condensed consolidated statements of comprehensive income as follows (in thousands):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Cost of revenues	\$535	\$494	\$1,587	\$1,414
Operating expenses				
Sales and marketing	691	565	2,054	1,656
Research and development	287	241	973	698
General and administrative	1,753	1,047	5,364	3,065
Total stock-based compensation expense	\$3,266	\$2,347	\$9,978	\$6,833

Stock-based compensation expense by plan type was as follows (in thousands):

	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2017	
Stock options	\$677	\$943	\$2,670	\$2,817
Performance share units	74	—	960	—
Restricted stock units	1,976	1,173	4,727	3,334
Restricted stock awards	137	79	352	238
Employee stock purchase plan	109	152	332	444
401(k) stock match	293	—	937	—
Total stock-based compensation expense	\$3,266	\$2,347	\$9,978	\$6,833

As of September 30, 2018, there was approximately \$14.3 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 2.6 years.

Stock Options

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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, 2017	1,097,331	\$ 47.60
Granted	181,472	59.88
Exercised	(286,237)	41.23
Forfeited	(60,270)	56.71
Outstanding at September 30, 2018	932,296	51.35

Of the total outstanding options at September 30, 2018, 594,300 were exercisable with a weighted average exercise price of \$48.92 per share. The total outstanding options had a weighted average remaining contractual life of 3.3 years.

The weighted average grant date fair value of options granted during the first nine months of 2018 was \$19.48. This was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

Volatility	34.9%
Dividend yield	0 %
Life (in years)	4.4
Risk-free interest rate	2.53%

Performance Share Units and Restricted Stock Units and Awards

In February 2017, our executive officers were granted performance share unit (“PSU”) awards with vesting contingent on successful attainment of pre-determined revenue targets over the course of a three-year performance period (fiscal years 2017 – 2019). The fair value is measured as the number of performance shares expected to be earned multiplied by the grant date fair value of our shares. The number of performance shares expected to vest during the current service period is estimated and the fair value of those shares is recognized over the remaining service period less any amounts already recognized.

In February 2018, our executive officers were granted PSU awards with vesting contingent on the Company’s total shareholder return as compared to indexed total shareholder return over the course of a three-year performance period (fiscal years 2018 – 2020). The grant date fair value was estimated using a Monte Carlo simulation that utilizes multiple input variables that determine the probability of satisfying the performance conditions stipulated in the award and calculates the fair market value for the performance stock units granted. Expense is recognized on a straight-line basis over the vesting period, regardless of whether the market condition is satisfied.

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.

Activity for our performance share units and restricted stock units was as follows:

	Performance Share and Restricted Stock Units (#)	Weighted Average Grant Date Fair Value (\$/share)
Outstanding at December 31, 2017	321,912	\$ 55.16
Granted	156,933	63.09
Vested and common stock issued	(81,427)	56.32
Forfeited	(34,318)	54.91
Outstanding at September 30, 2018	363,100	58.35

The number of restricted stock units outstanding at September 30, 2018 included 38,321 units that have vested, but for which shares of common stock have not yet been issued pursuant to the terms of the agreement.

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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 awards activity was as follows:

	Restricted Stock Awards (#)	Weighted Average Grant Date Fair Value (\$/share)
Outstanding at December 31, 2017	1,368	\$ 58.29
Restricted common stock issued	7,304	74.43
Restrictions lapsed	(5,016)	70.03
Forfeited	—	—
Outstanding at September 30, 2018	3,656	74.43

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 1.0 million shares of common stock are reserved for issuance under the plan.

For the offering period that began on January 1, 2018 and ended on June 30, 2018, we withheld \$0.8 million from employees participating in the plan which were used to purchase 20,243 shares. For the offering period that began on July 1, 2018 and will end on December 31, 2018, we have withheld \$0.5 million as of September 30, 2018 from employees participating in the plan.

The fair value was estimated based on the market price of our common stock at the beginning of the offering period using the Black-Scholes option pricing model with the following assumptions:

Volatility	26.5%
Dividend yield	0%
Life (in years)	0.5
Risk-free interest rate	1.50%

401(k) Stock Match

We sponsor a 401(k) retirement savings plan for our U.S. employees where employees can contribute up to 100% of their compensation, subject to the limits established by law. In 2018, we increased our match to 50% of the employee's elective deferrals, up to the first 6% of the employee's pre-tax compensation for each pay period. A portion of our match is in company stock, which is purchased from the open market by our plan provider and immediately deposited into the employee's 401(k) account.

NOTE F – 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 credits. Additionally, excess tax benefits generated upon settlement or exercise of stock awards are recognized as a reduction to income tax expense as a discrete tax item in the quarter that the event occurs creating potentially significant fluctuation in tax expense by quarter and by year. Our provisions for income taxes include current foreign and state income tax expense, as well as deferred tax expense.

As of September 30, 2018 we do not have any unrecognized tax benefits nor any accrued interest or tax penalties.

Tax Act

The Tax Act, which was enacted on December 22, 2017, included broad and complex changes to the U.S tax code. The Tax Act reduced the corporate federal income tax rate to 21.0% effective January 1, 2018 and established a mandatory tax on previously untaxed foreign earnings and profits (“E&P”). The Tax Act expanded the deduction limits on executive compensation under Section 162(m) and included transition rules for previously awarded compensation.

We have completed our evaluation of the impact of the Tax Act on previously untaxed foreign E&P and the deferred tax liability for withholding taxes on dividends. We have also completed our evaluation of the impact of the expanded Section 162(m) limitations and related transition rules on our deferred tax assets related to stock compensation. As a result of our evaluation, there was no material adjustment to our previously calculated discrete income tax expense relating to the Tax Act.

NOTE G – 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.

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, 2018		September 30, 2017	
	2018		2017	
Numerator				
Net income	\$8,061	\$2,176	\$16,731	\$7,129
Denominator				
Weighted average common shares outstanding, basic	17,219	17,223	17,167	17,192
Options to purchase common stock	395	152	293	169
Restricted stock units	127	35	97	33
Weighted average common shares outstanding, diluted	17,741	17,410	17,557	17,394
Net income per share				
Basic	\$0.47	\$0.13	\$0.97	\$0.42
Diluted	\$0.45	\$0.13	\$0.95	\$0.41
Antidilutive shares (in thousands)	—	267	27	267

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 fulfillment, sourcing and item assortment management solutions, along with 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 retailers, suppliers, distributors and logistics firms orchestrate the sourcing, set up of new vendors and items and fulfillment of products that consumers buy. 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, 2018, our revenues were \$62.9 million, an increase of 12% from the comparable period in 2017, and represented our 71st consecutive quarter of increased revenues. Total operating expenses increased less than 1% for the same period in 2018 from 2017. For the nine months ended September 30, 2018, revenues increased 13% and operating expenses increased 6% compared to the same period in 2017.

Key Financial Terms and Metrics

We use several key financial terms and metrics to analyze our business, including annualized average recurring revenues per recurring revenue customer, which we also refer to as wallet share. During the three and nine months ended September 30, 2018, 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, 2017 as filed with the SEC on February 26, 2018.

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 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 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.

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 relating to 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 and income taxes are the most critical to fully understand and evaluate our financial condition and results of operations.

During the three and nine months ended September 30, 2018, there were no changes in our significant accounting policies or estimates, except for the adoptions of ASU No. 2014-09 and ASU No. 2018-05 as detailed in Note A. 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, 2017, as filed with the SEC on February 26, 2018, for additional information regarding our accounting policies.

Results of Operations

Three months ended September 30, 2018 Compared to Three months ended September 30, 2017

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

	Three Months Ended September 30,				Change	
	2018	% of revenue	2017	% of revenue	\$	%
Revenues	\$62,868	100.0	% \$56,057	100.0	% \$6,811	12.2 %
Cost of revenues	20,411	32.5	18,645	33.3	1,766	9.5
Gross profit	42,457	67.5	37,412	66.7	5,045	13.5
Operating expenses						
Sales and marketing	16,952	26.9	17,638	31.5	(686)	(3.9)
Research and development	5,146	8.2	6,549	11.7	(1,403)	(21.4)
General and administrative	11,174	17.8	8,743	15.6	2,431	27.8
Amortization of intangible assets	928	1.5	1,128	2.0	(200)	(17.7)
Total operating expenses	34,200	54.4	34,058	60.8	142	0.4
Income from operations	8,257	13.1	3,354	5.9	4,903	146.2
Other income (expense)						
Interest income, net	628	1.0	272	0.5	356	130.9
Other income (expense), net	(219)	(0.3)	(195)	(0.3)	(24)	(12.3)
Total other income, net	409	0.7	77	0.2	332	431.2
Income before income taxes	8,666	13.8	3,431	6.1	5,235	152.6
Income tax expense	605	1.0	1,255	2.2	(650)	(51.8)
Net income	\$8,061	12.8	% \$2,176	3.9	% \$5,885	270.5 %

Revenues. Revenues for the three months ended September 30, 2018 increased \$6.8 million, or 12%, to \$62.9 million from \$56.1 million for the same period in 2017. The increase in revenues resulted from two primary factors: an increase in recurring revenue customers and an increase in annualized average recurring revenues per recurring revenue customer, which we also refer to as wallet share.

•The number of recurring revenue customers increased 6% to 26,869 at September 30, 2018 from 25,359 at September 30, 2017.

•Wallet share increased 8% to \$8,838 for the three months ended September 30, 2018 from \$8,219 for the same period in 2017. This increase was primarily attributable to increased usage of our solutions by our recurring revenue customers.

Recurring revenues from recurring revenue customers accounted for 93% of our total revenues for the three months ended September 30, 2018 and 2017. 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, 2018 increased \$1.8 million, or 10%, to \$20.4 million from \$18.6 million for the same period in 2017. The increase was primarily due to an increase in personnel-related costs of approximately \$1.2 million, driven by increased salaries and benefits due to business growth and by increased contract labor, and due to an increase in depreciation expense of \$0.3 million driven by continued investment in the infrastructure supporting our platform. As a percentage of revenues, cost of revenues was 33% for the three months ended September 30, 2018 and 2017.

Sales and Marketing Expenses. Sales and marketing expenses for the three months ended September 30, 2018 decreased \$0.7 million, or 4%, to \$16.9 million from \$17.6 million for the same period in 2017. The decrease was primarily driven by a \$1.5 million decrease in personnel-related costs, due to decreased headcount which reduced salaries and benefits, offset by an increase of \$0.5 million in variable compensation earned by sales personnel and referral partners as a result of new business, and by a \$0.3 million increase in promotional expenses. As a percentage of revenues, sales and marketing expenses were 27% and 32% for the three months ended September 30, 2018 and 2017, respectively.

Research and Development Expenses. Research and development expenses for the three months ended September 30, 2018 decreased \$1.4 million, or 21%, to \$5.1 million from \$6.5 million for the same period in 2017. The decrease was primarily due to a \$1.4 million decrease in personnel-related costs, due to an increase of internally developed capitalized software, which reduces personnel expenses, and by decreases in salaries and benefits, due to decreases in headcount. As a percentage of revenues, research and development expenses were 8% and 12% for the three months ended September 30, 2018 and 2017, respectively.

General and Administrative Expenses. General and administrative expenses for the three months ended September 30, 2018 increased \$2.4 million, or 28%, to \$11.2 million from \$8.8 million for the same period in 2017. This increase was primarily driven by an increase of \$1.1 million in personnel-related costs due to headcount growth and an increase of \$0.7 million in stock-based compensation expense due to headcount growth and stock grants made to retirement-eligible employees which results in immediate expensing. Additionally, there was an increase of \$0.6 million in other general and administrative expenses, as a result of continued growth in the business. As a percentage of revenues, general and administrative expenses were 18% and 16% for the three months ended September 30, 2018 and 2017, respectively.

Other Income (Expense), net. Other income (expense), net, for the three months ended September 30, 2018 increased \$0.3 million over the same period in 2017 primarily due to an increase of interest income from investments, as a result of additional cash being invested.

Income Tax Expense. We recorded income tax expense of \$0.6 million for the three months ended September 30, 2018 compared to income tax expense of \$1.3 million for the same period in 2017. The decrease was primarily due to a reduction in the overall effective tax rate in 2018, as a result of the Tax Act and due to discrete tax benefits. The decreases were partially offset by increased pre-tax income. Discrete tax benefits increased \$1.8 million, primarily due to excess tax deductions on stock activity. Under ASU 2016-09, excess tax benefits generated upon the settlement or exercise of stock awards are no longer recognized as additional paid-in capital but are instead recognized as a reduction to income tax expense. As a result of recording these excess tax benefits in income tax expense, we expect that our annual effective income tax rate will be more volatile than it has been historically.

Adjusted EBITDA. Adjusted EBITDA, which is a non-GAAP measure of financial performance, consists of net income adjusted for depreciation and amortization, interest expense, interest income, income tax expense and stock-based compensation expense. The following table provides a reconciliation of net income to Adjusted EBITDA (in thousands):

	Three Months Ended September 30,	
	2018	2017
Net income	\$8,061	\$2,176

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Depreciation and amortization of property and equipment	2,132	1,830
Amortization of intangible assets	928	1,128
Interest income, net	(628)	(272)
Income tax expense	605	1,255
Stock-based compensation expense	3,266	2,347
Adjusted EBITDA	\$14,364	\$8,464

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, amortization expense related to intangible assets and income tax effects of adjustments divided by the weighted average number of shares of common stock outstanding during each period. 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,	
	2018	2017
Net income	\$8,061	\$2,176
Stock-based compensation expense	3,266	2,347
Amortization of intangible assets	928	1,128
Income tax effects of adjustments	(3,008)	(1,254)
Non-GAAP income	\$9,247	\$4,397
Shares used to compute Non-GAAP income per share		
Basic	17,219	17,223
Diluted	17,741	17,410
Non-GAAP income per share		
Basic	\$0.54	\$0.26
Diluted	\$0.52	\$0.25

Nine Months Ended September 30, 2018 Compared to Nine Months Ended September 30, 2017

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

	Nine Months Ended September 30,				Change	
	2018	% of revenue	2017	% of revenue	\$	%
Revenues	\$ 183,051	100.0	\$ 162,028	100.0	\$ 21,023	13.0
Cost of revenues	60,571	33.1	54,166	33.4	6,405	11.8
Gross profit	122,480	66.9	107,862	66.6	14,618	13.6
Operating expenses						
Sales and marketing	54,023	29.5	52,981	32.7	1,042	2.0
Research and development	15,571	8.5	17,023	10.5	(1,452)	(8.5)
General and administrative	31,278	17.1	24,709	15.3	6,569	26.6
Amortization of intangible assets	3,086	1.7	3,460	2.1	(374)	(10.8)
Total operating expenses	103,958	56.8	98,173	60.6	5,785	5.9
Income from operations	18,522	10.1	9,689	6.0	8,833	91.2
Other income (expense)						
Interest income, net	1,589	0.9	704	0.4	885	125.7
Other income (expense), net	(541)	(0.3)	(356)	(0.2)	(185)	(52.0)
Total other income, net	1,048	0.6	348	0.2	700	201.1
Income before income taxes	19,570	10.7	10,037	6.2	9,533	95.0

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Income tax expense	2,839	1.6	2,908	1.8	(69)	(2.4)
Net income	\$ 16,731	9.1	% \$ 7,129	4.4	% \$ 9,602	134.7%

Revenues. Revenues for the nine months ended September 30, 2018 increased \$21.0 million, or 13%, to \$183.1 million from \$162.0 million for the same period in 2017. 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.

•The number of recurring revenue customers increased 6% to 26,869 at September 30, 2018 from 25,359 at September 30, 2017.

•Wallet share increased 8% to \$8,612 for the nine months ended September 30, 2018 from \$7,973 for the same period in 2017. This increase was primarily attributable to increased usage of our solutions by our recurring revenue customers.

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Recurring revenues from recurring revenue customers accounted for 93% of our total revenues for the nine months ended September 30, 2018, consistent with the same period in 2017. 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, 2018 increased \$6.4 million, or 12%, to \$60.6 million from \$54.2 million for the same period in 2017. The increase was primarily due to an increase in personnel-related costs of approximately \$5.2 million, driven by increased salaries and benefits due to continued business growth and by increased contract labor, and due to an increase in depreciation expense of \$1.1 million, driven by continued investment in infrastructure supporting our platform. As a percentage of revenues, cost of revenues was 33% for the nine months ended September 30, 2018 and 2017.

Sales and Marketing Expenses. Sales and marketing expenses for the nine months ended September 30, 2018 increased \$1.0 million, or 2%, to \$54.0 million from \$53.0 million for the same period in 2017. The increase was due to an increase of \$1.6 million in variable compensation earned by sales personnel and referral partners, as a result of new business, partially offset by an \$0.6 million decrease in personnel expenses, due to decreased headcount which reduced salaries and benefits. As a percentage of revenues, sales and marketing expenses were 30% and 33% for the nine months ended September 30, 2018 and 2017, respectively.

Research and Development Expenses. Research and development expenses for the nine months ended September 30, 2018 decreased \$1.4 million, or 8%, to \$15.6 million from \$17.0 million for the same period in 2017. The decrease was primarily due to decreases in personnel-related costs of \$1.9 million, due to an increase of internally developed capitalized software which reduces personnel expenses. These decreases were offset by increases in software subscriptions of \$0.3 million and stock-based compensation of \$0.3 million, both of which were consistent with business growth. As a percentage of revenues, research and development expenses were 9% and 10% for the nine months ended September 30, 2018 and 2017, respectively.

General and Administrative Expenses. General and administrative expenses for the nine months ended September 30, 2018 increased \$6.6 million, or 27%, to \$31.3 million from \$24.7 million for the same period in 2017. The increase was primarily due to an increase of \$2.3 million in personnel-related costs due to headcount growth and an increase of \$2.3 million in stock-based compensation due to headcount growth and stock grants made to retirement-eligible employees which results in immediate expensing. Additionally, other expenses increased by \$2.0 million, primarily driven by business growth which resulted in increased costs of software subscriptions, credit card fees and bad debt expense. As a percentage of revenues, general and administrative expenses were 17% and 15% for the nine months ended September 30, 2018 and 2017 respectively.

Other Income (Expense), net. Other income (expense), net, for the nine months ended September 30, 2018 increased \$0.7 million over the same period in 2017 primarily due to an increase in interest income from investments.

Income Tax Expense. We recorded income tax expense of \$2.8 million for the nine months ended September 30, 2018 compared to income tax expense of \$2.9 million for the same period in 2017. The decrease was primarily due to a reduction in overall effective tax rate in 2018 as compared to 2017 due to the Tax Act, offset by increased pre-tax income. In addition, discrete tax benefits increased \$1.6 million for the nine months ended September 30, 2018 compared to the same period in 2017. The increase is primarily due to a \$1.0 million increase from stock activity and due to a \$0.6 million increase in research and development tax credits. Under ASU 2016-09, excess tax benefits generated upon the settlement or exercise of stock awards are no longer recognized as additional paid-in capital but are instead recognized as a reduction to income tax expense. As a result of recording these excess tax benefits in income tax expense, we expect that our annual effective income tax rate will be more volatile than it has been historically.

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Adjusted EBITDA. Adjusted EBITDA, which is a non-GAAP measure of financial performance, consists of net income adjusted for depreciation and amortization, interest expense, interest income, income tax expense and stock-based compensation expense. The following table provides a reconciliation of net income to Adjusted EBITDA (in thousands):

	Nine Months Ended September 30,	
	2018	2017
Net income	\$ 16,731	\$ 7,129
Depreciation and amortization of property and equipment	6,308	5,261
Amortization of intangible assets	3,086	3,460
Interest income, net	(1,589)	(705)
Income tax expense	2,839	2,908
Stock-based compensation expense	9,978	6,833
Adjusted EBITDA	\$ 37,353	\$ 24,886

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, amortization expense related to intangible assets and income tax effects of adjustments divided by the weighted average number of shares of common stock outstanding during each period. 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,	
	2018	2017
Net income	\$16,731	\$7,129
Stock-based compensation expense	9,978	6,833
Amortization of intangible assets	3,086	3,460
Income tax effects of adjustments	(5,188)	(4,609)
Non-GAAP income	\$24,607	\$12,813
Shares used to compute Non-GAAP income per share		
Basic	17,167	17,192
Diluted	17,557	17,394
Non-GAAP income per share		
Basic	\$1.43	\$0.75
Diluted	\$1.40	\$0.74

Liquidity and Capital Resources

At September 30, 2018, our principal sources of liquidity were cash, cash equivalents, certificates of deposit and marketable securities of \$194.3 million and accounts receivable, net of allowance for doubtful accounts, of \$27.3 million. Certificates of deposit and 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.

Net Cash Flows from Operating Activities

Net cash provided by operating activities was \$37.6 million and \$22.0 million for the nine months ended September 30, 2018 and 2017, respectively. The increase was primarily due to increased net income as a result of continued revenue growth and reduction in operating expenses, primarily from personnel-related expenses.

Net Cash Flows from Investing Activities

Net cash used in investing activities was \$14.7 million and \$12.5 million for the nine months ended September 30, 2018 and 2017, respectively. The increase was primarily due to increased capital expenditures, offset by net maturities of investments compared to net purchases of investments for the same period in 2017. 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 financing activities resulted in cash used of \$1.2 million and cash provided of \$2.3 million for the nine months ended September 30, 2018 and 2017, respectively. The decrease was primarily due to \$13.9 million of common stock repurchases offset by \$11.8 million of proceeds from stock-based compensation plans for the nine months ended September 30, 2018 compared to \$2.3 million of proceeds from stock activity for the same period in 2017.

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 6% of our total cash and cash equivalents outside of the U.S. 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, certificates of deposit, 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, 2018 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.

Contractual and Commercial Commitment Summary

Our contractual obligations and commercial commitments as of September 30, 2018 are summarized below:

		Payments Due By Period (in thousands)			
		Less Than	1-3 Years	3-5 Years	More Than 5 Years
Contractual Obligations	Total	1 Year	Years	Years	Years
Operating lease obligations	\$25,685	\$1,012	\$7,622	\$8,380	\$8,671

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, certificates of deposit 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, 2018. 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 dollar and Canadian dollar. As of September 30, 2018, we maintained approximately 6% of our total cash and cash equivalents outside of the U.S. in foreign currencies. 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. As we expand internationally, our results of operations and cash flows may be impacted by changes in foreign currency exchange rates, and would be adversely impacted when the U.S. dollar appreciates relative to other foreign currencies. 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 SEC'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, 2018.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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, 2017 as filed with the SEC on February 26, 2018.

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

(c) Share Repurchases

The following table presents the total number of shares of our common stock that we purchased during the third quarter of 2018, the average price paid per share, the number of shares that we purchased as part of our publicly announced repurchase program and the approximate dollar value of shares that still could be repurchased at the end of the applicable period.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program ⁽¹⁾	Approximate Dollar Value of Shares that May Yet be Purchased Under the Program ⁽¹⁾
July 1 -31, 2018	26,251	\$ 76.11	26,251	\$30,318,000
August 1 - 31, 2018	—	—	—	30,318,000
September 1 - 30, 2018	—	—	—	30,318,000
Total third quarter 2018	26,251	\$ 76.11	26,251	\$30,318,000

(1) Pursuant to a \$50.0 million share repurchase program that was authorized by our board of directors on November 2, 2017. There is no expiration date governing the period over which we can repurchase shares under the November 2017 share repurchase program.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Mine Safety Disclosures

Not Applicable.

Item 5. Other Information

Not Applicable.

Item 6. Exhibits

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 SEC on September 13, 2012).
- 3.2 Amended and Restated Bylaws (incorporated by reference to Exhibit 3.1 to our Current Report on Form 8-K (File No. 001-34702) filed with the SEC on October 12, 2017).
- 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).

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 26, 2018 SPS COMMERCE, INC.

/s/ KIMBERLY K. NELSON
Kimberly K. Nelson
Executive Vice President and Chief Financial Officer

(principal financial and accounting officer)