SolarWinds, Inc.
Form 10-Q
November 04, 2014
Table of Contents

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

or

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

For the transition period from to

Commission File Number: 001-34358

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ý Yes ¨ No

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

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

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

On October 30, 2014, 75,637,278 shares of common stock, par value $0.001 per share, were outstanding.

SOLARWINDS, INC.
Table of Contents

Table of Contents

Safe Harbor Cautionary Statement

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

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

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

Table of Contents

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

	September 30, 2014	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$195,203	$165,973
Short-term investments	14,394	19,327
Accounts receivable, net of allowances of $717 and $473 as of September 30, 2014 and December 31, 2013, respectively	47,698	45,694
Income tax receivable	195	1,535
Deferred taxes	8,860	5,410
Prepaid and other current assets	6,490	4,846
Total current assets	272,840	242,785
Property and equipment, net	22,735	9,213
Long-term investments	5,189	11,012
Deferred taxes	514	478
Goodwill	366,700	317,054
Intangible assets and other, net	112,238	125,800
Total assets	$780,216	$706,342
Liabilities and stockholders’ equity		
Current liabilities:		
Accounts payable	$7,451	$7,187
Accrued liabilities and other	31,784	17,716
Income taxes payable	4,953	563
Current portion of deferred revenue	146,830	128,328
Current debt obligation	—	40,000
Total current liabilities	191,018	193,794
Long-term liabilities:		
Deferred revenue, net of current portion	8,550	6,863
Non-current deferred taxes	4,348	4,975
Other long-term liabilities	22,625	16,816
Total liabilities	226,541	222,448
Commitments and contingencies (Note 8)		
Stockholders’ equity:		
Common stock, $0.001 par value: 123,000,000 shares authorized and 75,628,926 and 75,009,620 shares issued and outstanding as of September 30, 2014 and December 31, 2013, respectively	76	75
Additional paid-in capital	261,617	236,481
Accumulated other comprehensive income (loss)	(7,549)	2,953
Accumulated earnings	299,531	244,385
Total stockholders’ equity	553,675	483,894
Total liabilities and stockholders’ equity	$780,216	$706,342

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

4

Table of Contents

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

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Revenue:				
License	$42,756	$34,358	$116,743	$96,300
Maintenance and other	61,844	50,283	174,800	137,841
Subscription	8,262	3,222	18,732	4,151
Total revenue	112,862	87,863	310,275	238,292
Cost of license revenue	4,100	2,646	12,321	8,263
Cost of maintenance and other revenue	3,965	2,942	11,296	8,578
Cost of subscription revenue	3,513	1,511	8,887	2,046
Gross profit	101,284	80,764	277,771	219,405
Operating expenses:				
Sales and marketing	37,538	25,962	106,772	66,538
Research and development	13,761	9,558	41,784	25,622
General and administrative	18,274	13,383	57,466	34,758
Total operating expenses	69,573	48,903	206,022	126,918
Operating income	31,711	31,861	71,749	92,487
Other income (expense):				
Interest income	85	91	246	324
Interest expense	(142)	—	(577)	—
Other income (expense), net	238	(6)	446	(497)
Total other income (expense)	181	85	115	(173)
Income before income taxes	31,892	31,946	71,864	92,314
Income tax expense	7,771	9,123	16,718	23,695
Net income	$24,121	$22,823	$55,146	$68,619
Net income per share:				
Basic earnings per share	$0.32	$0.30	$0.73	$0.91
Diluted earnings per share	$0.32	$0.30	$0.72	$0.90
Weighted-average shares used to compute net income per share:				
Shares used in computation of basic earnings per share	75,508	75,371	75,375	75,202
Shares used in computation of diluted earnings per share	76,463	76,466	76,321	76,580

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

Table of Contents

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

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Net income	$24,121	$22,823	$55,146	$68,619
Other comprehensive income (loss):				
Foreign currency translation adjustment	(9,514)	3,611	(10,488)	2,200
Unrealized gains (losses) on investments, net of income tax expense (benefit) of $(10) and $27 for the three months ended September 30, 2014 and 2013, respectively and $(7) and $(14) for the nine months ended September 30, 2014 and 2013, respectively	(19)	51	(14)	(25)
Other comprehensive income (loss)	(9,533)	3,662	(10,502)	2,175
Comprehensive income	$14,588	$26,485	$44,644	$70,794

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

6

Table of Contents

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

	Nine months ended September 30,	
	2014	2013
Cash flows from operating activities		
Net income	$55,146	$68,619
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	27,140	17,727
Provision for doubtful accounts	439	261
Stock-based compensation expense	27,429	17,143
Deferred taxes	(6,387)	(4,393)
Excess tax benefit from stock-based compensation	(5,309)	(7,746)
Premium on investments	(90)	(607)
Other non-cash expenses	1,025	822
Changes in operating assets and liabilities, net of assets acquired and liabilities assumed in business combinations:		
Accounts receivable	(3,059)	(9,706)
Income taxes receivable	3,884	133
Prepaid and other assets	(1,906)	(236)
Accounts payable	48	968
Accrued liabilities and other	14,271	(3,596)
Income taxes payable	6,252	11,989
Deferred revenue	22,939	21,991
Other long-term liabilities	6,022	234
Net cash provided by operating activities	147,844	113,603
Cash flows from investing activities		
Purchases of investments	(3,001)	(17,288)
Maturities of investments	13,488	38,674
Purchases of property and equipment	(16,840)	(2,963)
Purchases of intangible assets and other long-term investments	(199)	(8,249)
Acquisition of businesses, net of cash acquired	(63,700)	(120,868)
Other investing activities	—	579
Net cash used in investing activities	(70,252)	(110,115)
Cash flows from financing activities		
Repurchase of common stock	(13,223)	(18,351)
Exercise of stock options	6,049	8,124
Excess tax benefit from stock-based compensation	5,309	7,746
Repayments of borrowings from credit agreement	(40,000)	—
Net cash used in financing activities	(41,865)	(2,481)
Effect of exchange rate changes on cash and cash equivalents	(6,497)	2,122
Net increase in cash and cash equivalents	29,230	3,129
Cash and cash equivalents		
Beginning of period	165,973	179,702
End of period	$195,203	$182,831
Supplemental disclosure of cash flow information		
Cash paid for interest	$521	$—

Cash paid for income taxes	$12,763	$15,737

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

Table of Contents

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

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

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

Table of Contents

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

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

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

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

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

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

Accumulated Other Comprehensive Income (Loss)

Changes in accumulated other comprehensive income (loss) by component for the nine months ended September 30, 2014 are summarized below:

(in thousands)	Unrealized Gain on Available-for-Sale Investments, net of tax	Foreign Currency Translation Adjustments	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2013	$ 12	$2,941	$2,953
Other comprehensive gain (loss) before reclassification	(14)	(10,488)	(10,502)
Amount reclassified from accumulated other comprehensive income (loss)	—	—	—
Net current period other comprehensive income (loss)	(14)	(10,488)	(10,502)
Balance at September 30, 2014	$ (2)	$(7,547)	$(7,549)

2. Acquisitions

Pingdom Acquisition

In June 2014, we acquired Pingdom AB, or Pingdom, a provider of website monitoring and performance management solutions, for closing cash consideration of approximately $67.0 million in cash, including $3.1 million of cash acquired. The acquisition increased our product offerings and we believe will allow us to leverage the opportunity associated with performance management for critical websites and web applications. The acquisition was financed with available cash and we incurred $1.1 million in acquisition related costs, which are included in general and administrative expense for the nine months ended September 30, 2014.

The consideration paid was allocated to the assets acquired and liabilities assumed based on their estimated fair values and resulted in the recognition of approximately $55.7 million of goodwill and $11.2 million of intangible assets. The weighted average amortization period for the intangible assets is 4.8 years. Goodwill is not deductible for tax purposes.

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

9

Table of Contents

The following table reflects the changes in goodwill for the nine months ended September 30, 2014:

(in thousands)	
Balance at December 31, 2013	$317,054
Acquisitions	55,673
Foreign currency translation and other adjustments	(6,027)
Balance at September 30, 2014	$366,700

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

3. Investments

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

(in thousands)	September 30, 2014	December 31, 2013
Demand deposit accounts	$132,862	$128,630
Money market funds	62,341	37,343
Total cash and cash equivalents	$195,203	$165,973

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

	September 30, 2014				December 31, 2013			
(in thousands)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Short-term investments:								
Available-for-sale securities:								
Corporate bonds	$14,387	$8	$(1)	$14,394	$18,257	$21	$—	$18,278
Municipal bonds	—	—	—	—	1,048	1	—	1,049
Total short-term investments	$14,387	$8	$(1)	$14,394	$19,305	$22	$—	$19,327
Long-term investments:								
Available-for-sale securities:								
Corporate bonds	$5,199	$—	$(10)	$5,189	$11,015	$8	$(11)	$11,012
Total long-term investments	$5,199	$—	$(10)	$5,189	$11,015	$8	$(11)	$11,012

Table of Contents

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

	Less Than 12 Months		12 Months or Greater		Total	
(in thousands)	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
As of September 30, 2014						
Corporate bonds	$5,117	$(11)	$—	$—	$5,117	$(11)
	$5,117	$(11)	$—	$—	$5,117	$(11)

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

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

(in thousands)	Cost	Fair Value
Due in one year or less	$14,387	$14,394
Due after one year through five years	5,199	5,189
	$19,586	$19,583

Table of Contents

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

(in thousands)	Fair Value Measurements at September 30, 2014 Using				Fair Value Measurements at December 31, 2013 Using			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Assets:								
Cash equivalents:								
Money market funds	$62,341	$—	$—	$62,341	$37,343	$—	$—	$37,343
Total cash equivalents	62,341	—	—	62,341	37,343	—	—	37,343
Short-term investments:								
Corporate bonds	—	14,394	—	14,394	—	18,278	—	18,278
Municipal bonds	—	—	—	—	—	1,049	—	1,049
Total short-term investments	—	14,394	—	14,394	—	19,327	—	19,327
Long-term investments:								
Corporate bonds	—	5,189	—	5,189	—	11,012	—	11,012
Total long-term investments	—	5,189	—	5,189	—	11,012	—	11,012
Total assets	$62,341	$ 19,583	$—	$81,924	$37,343	$ 30,339	$—	$67,682

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

5. Credit Agreement
On October 4, 2013, we entered into a Credit Agreement with a syndicated group of lenders that provides for an unsecured $125.0 million five-year revolving credit facility that is comprised of revolving loans and swingline loans. The credit facility includes a $30.0 million letter of credit sub-facility and a $15.0 million swingline sub-facility available on same-day notice. Available borrowings under the credit facility are reduced by the amount of any outstanding borrowings on the sub-facilities. We may also, subject to certain requirements, request an increase in the facility up to an additional $75.0 million for a maximum aggregate commitment of $200.0 million. The proceeds from the facility may be used for general corporate purposes, including, without limitation, to finance acquisitions.
Loans under the credit agreement will bear interest at either (i) the one-, three-, or six-month per annum London Interbank Offered Rate ("LIBOR"), multiplied by the statutory reserve adjustment plus a margin, based on our consolidated total leverage ratio, ranging from 1.25% and 2.00% or (ii) the base rate, which is defined as the highest of (a) the agent's prime rate, (b) the federal funds rate plus 0.50% or (c) LIBOR for a period of one month plus 1.00% plus a margin, based on our consolidated total leverage ratio, ranging from 0.25% to 1.00%. Commitment fees are payable quarterly in arrears at rates between 0.20% and 0.35% per year also based on our consolidated total leverage ratio. Subject to certain conditions stated in the Credit Agreement, we may borrow, prepay and re-borrow amounts

under the revolving credit facility at any time during the term of the Credit Agreement.

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

Table of Contents

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

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

6. Earnings Per Share

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
(in thousands)				
Basic earnings per share				
Numerator:				
Net income	$24,121	$22,823	$55,146	$68,619
Denominator:				
Weighted-average common shares outstanding used in computing basic earnings per share	75,508	75,371	75,375	75,202
Diluted earnings per share				
Numerator:				
Net income	$24,121	$22,823	$55,146	$68,619
Denominator:				
Weighted-average shares used in computing basic earnings per share	75,508	75,371	75,375	75,202
Add options and restricted stock units to purchase common stock	955	1,095	946	1,378
Weighted-average shares used in computing diluted earnings per share	76,463	76,466	76,321	76,580

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

	Three months ended September 30,		Nine months ended September 30,	
(in thousands)	2014	2013	2014	2013
Antidilutive shares	1,804	1,530	2,022	864

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

13

Table of Contents

On July 29, 2013, we announced that our Board of Directors approved a share repurchase program, authorizing us to purchase up to $50.0 million of our outstanding common stock. Our share repurchase program expired on July 31, 2014. Purchases under our share repurchase program were made in the open market pursuant to a Rule 10b5-1 plan. During the nine months ended September 30, 2014, we repurchased 0.2 million shares of our common stock for an aggregate purchase price of $7.5 million. Shares were retired upon repurchase.

7. Income Taxes

For the three months ended September 30, 2014 and 2013, we recorded income tax expense of $7.8 million and $9.1 million, respectively, resulting in an effective tax rate of 24.4% and 28.6%, respectively. For the nine months ended September 30, 2014 and 2013, we recorded income tax expense of $16.7 million and $23.7 million, respectively, resulting in an effective tax rate of 23.3% and 25.7%, respectively. The decrease in the effective tax rate for the nine months ended September 30, 2014 compared to the same period in 2013 was primarily attributable to an increase in international earnings as a percentage of total earnings, which are generally taxed at lower tax rates, partially offset by the expiration of the U.S. federal research and experimental tax credit.

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

We file U.S., state and foreign income tax returns in jurisdictions with varying statutes of limitations. The 2008 through 2013 tax years generally remain open and subject to examination by federal and foreign tax authorities. The 2007 through 2013 tax years generally remain open and subject to examination by the state tax authorities. During the second quarter of 2014, the U.S. Internal Revenue Service, or IRS, concluded its examination of the 2008, 2009 and 2010 tax years. As a result of the IRS examination closure, we recorded an insignificant impact to the income tax provision and income tax liability during the second quarter of 2014. We are also under audit by the Indian Taxing Authority for the 2012 tax year. We are not currently under audit in any other taxing jurisdictions.

8. Commitments and Contingencies

Leases

In April 2014, we moved into our new corporate headquarters in Austin, Texas, which has an initial lease term of thirteen years. In connection with the lease, the property owner provided a tenant improvement allowance of $8.0 million for leasehold improvements. In the nine months ended September 30, 2014, we received lease incentives of $7.1 million relating to tenant improvement allowances for leasehold improvements. The lease incentive liability will be amortized on a straight-line basis over the term of the lease as an offset to rent expense.

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

Other Commitments

In connection with our acquisition of Pingdom, in the second quarter of fiscal year 2014, we began to incur, and will continue to incur, an additional $10.0 million of compensation expense contingent upon fulfillment of specified future employment conditions. The compensation expense is recognized as general and administrative expense ratably over the requisite service period of twelve months and is expected to be paid in full during the second quarter of fiscal year 2015.

Legal Proceedings

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

14

Table of Contents

9. Subsidiary Guarantor

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

Table of Contents

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

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

Overview

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

Key Financial Highlights

Key financial highlights for the first three quarters of 2014 include the following:

- Total revenue was $310.3 million in the first three quarters of 2014 compared to $238.3 million in the first three quarters of 2013, representing an increase of 30.2%;
- Combined maintenance and subscription revenue in the first three quarters of 2014 was $193.5 million compared to $142.0 million in the first three quarters of 2013, representing 36.3% year-over-year growth in recurring revenue;
- Net income was $55.1 million in the first three quarters of 2014 compared to $68.6 million in the first three quarters of 2013, representing a decrease of 19.6%;
- Net income was $0.72 per share on a fully diluted basis for the first three quarters of 2014 compared to $0.90 per share on a fully diluted basis for the first three quarters of 2013, resulting in a decrease of 20.0%; and
- Cash flow from operating activities was $147.8 million in the first three quarters of 2014 compared to $113.6 million in the first three quarters of 2013, representing an increase of 30.1%.

In 2013 and the first three quarters of 2014, we invested across our business and, in particular, invested in areas that we believe are an important foundation for our long term growth. For example:

- We increased our investment in our sales function in an effort to better convert the demand that we capture through our marketing activities, to expand our sales efforts within our existing customer base and to expand our sales team focused on the MSP market;
- We increased our investment in our marketing programs, team and systems, in an effort to increase the awareness of SolarWinds and our products as well as to better capture demand, and specifically to accomplish those goals more consistently for our different products and in our different geographies;
- We increased our investment in product development in an effort to accelerate new product releases and enhancements for our products in order to improve the usability and add features our customers rely on daily; and
- We invested in the expansion of our facilities and IT infrastructure to support the growth of our operations.

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

- Improving the competitive positioning of our products by investing in new product features and infrastructure;
- Acquiring and internally developing products that will expand our presence in our current markets or new markets;

Table of Contents

- Expanding our web presence, brand awareness and improving our communication with prospects and our current customer base both domestically and internationally;
- Increasing our presence in several key geographic markets including Asia-Pacific, Latin America, Europe, Middle East and Africa through demand generation activity, marketing awareness, localized marketing material and new relationships with distributors and resellers;
- Accelerating the rate at which we are selling additional products into our install base; and
- Expanding our international operations company-wide at lower cost locations to drive our competitive advantage.

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

Acquisitions

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

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

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

Key Business Metrics

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

Revenue Growth

Revenue growth includes the growth in our license, maintenance and subscription revenue, which are critical to our long-term success. We have employed a differentiated business model for marketing and selling high volumes of enterprise-class software, which is focused on revenue growth at high operating margins. We have built a financial and operational model that focuses on the long-term value of our customer relationships. After the initial new license or subscription purchase, our goal is to create opportunities for sales of additional products, license or subscription upgrades and renewal purchases from the customer. This is an important component of our financial model and future revenue growth. This model is based on the premise that we will be able to deliver ongoing value to our customers and maintain a long-term financial relationship with the users of our IT management products. Our recurring revenue, which consists of maintenance and subscription revenue, is reflective of the relationship we have built with our customers. We regularly review our total revenue growth to measure the success of our investments and strategic business decisions. Our year over year revenue growth percentages were 30.2% and 21.9% for the first three quarters of 2014 and 2013, respectively. We expect our total revenue growth to be approximately 27-28% for the fiscal year 2014.

Non-GAAP Operating Income and Non-GAAP Operating Margin

Our management uses non-GAAP operating income and non-GAAP operating margin as key measures of our performance. Because our non-GAAP operating income excludes certain items such as amortization of intangible assets, stock-based compensation and related employer-paid payroll taxes, certain acquisition related adjustments and restructuring charges that may not be indicative of our core business, we believe that this measure provides us with additional useful information to measure and understand our performance, particularly with respect to changes in performance from period to period. We use non-GAAP operating income and non-GAAP operating margin in the preparation of our budgets and to measure and monitor our performance. Non-GAAP operating income and non-GAAP operating margin is not determined in accordance with GAAP and is not a substitute for, or superior to, financial measures determined in accordance with GAAP. We increased our investments in the business in the last half of 2013 and during the first three quarters of 2014 and we expect our non-GAAP operating margin to be approximately 42.5% for fiscal year 2014.

Table of Contents

For further discussion regarding non-GAAP financial measures including non-GAAP operating income, see "Non-GAAP Financial Measures" below.

Opportunities, Trends and Uncertainties

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

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

In the third quarter of 2014, we recognized 25.9% of our revenue from sales by our international subsidiaries, which includes all subsidiaries outside of North America. We believe there is a substantial opportunity for additional sales of our software in the Europe, Middle East and Africa, or EMEA, region, the Asian-Pacific region, and the Latin American region. We intend to increase our sales, marketing and support operations in these regions. However, we believe there is significant uncertainty regarding the economic conditions in certain of these geographic regions. While we believe that any difficult economic conditions may adversely affect the sales of our products, this could also offer us an opportunity to market and sell our products to mid-size businesses and enterprise customers at compelling prices compared to the prices of some competing products.

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

Key Components of Our Results of Operations

Sources of Revenue

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

License, Maintenance and Other Revenue. We primarily license our software under perpetual licenses, which ordinarily include one year of maintenance as part of the initial purchase price of the product. License revenue reflects the revenue recognized from sales of new perpetual licenses and upgrades of license size to our software. We have experienced annual growth in license revenue. Maintenance revenue is an important source of our future revenue. Customers can renew, and generally have renewed, their maintenance agreements at our standard list maintenance renewal pricing for their software products. Current customers with maintenance agreements are entitled to receive unspecified upgrades or enhancements when and if they become available. We have experienced strong and consistent annual and quarterly growth in maintenance and other revenue. Because our maintenance base has continued to grow each year due to new license sales, high customer retention and acquisitions, we expect maintenance revenue to continue to increase in absolute dollars in future periods.

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

Cost of Revenue

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

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

Operating Expenses

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

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

Our operating expenses increased in absolute dollars and as a percentage of revenue in the first three quarters of 2014 compared to the first three quarters of 2013, as we have continued to build infrastructure and add employees through acquisitions and organic growth across all departments in order to accelerate and support our growth. We increased our investment in product development, marketing and sales in late 2013 for initiatives we believe are important to our long-term goals. These investments are focused on the development of new products and strategic releases to our current products and streamlining our demand generation process in our marketing and sales organizations. The number of full-time employees as of September 30, 2014 was 1,589, as compared to 1,203 as of September 30, 2013.

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

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

Research and Development. Research and development expenses primarily consist of personnel costs for our product development employees and executives and, to a lesser extent, contractor fees. We have devoted our development efforts primarily to expanding our product line and increasing the functionality and enhancing the ease-of-use of our software products. We have significantly increased our research and development employee headcount through the continued expansion

Table of Contents

of our research and development centers in the Czech Republic and India and through acquisitions. We expect to continue to invest in our research and development activities by hiring engineers in our international locations and supplementing our internal research and development activities with additional contract services, which will allow us to continue our research and development growth strategy internationally.

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

Other Income (Expense)

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

Income Tax Expense

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

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

Table of Contents

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

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

	Three months ended September 30,				
	2014	% of Revenue	2013	% of Revenue	Change
	(in thousands)		(in thousands)		(in thousands)
Revenue:					
License	$42,756	37.9 %	$ 34,358	39.1 %	$ 8,398
Maintenance and other	61,844	54.8	50,283	57.2	11,561
Subscription	8,262	7.3	3,222	3.7	5,040
Total revenue	112,862	100.0	87,863	100.0	24,999
Cost of revenue	11,578	10.3	7,099	8.1	4,479
Gross profit	101,284	89.7	80,764	91.9	20,520
Operating expenses:					
Sales and marketing	37,538	33.3	25,962	29.5	11,576
Research and development	13,761	12.2	9,558	10.9	4,203
General and administrative	18,274	16.2	13,383	15.2	4,891
Total operating expenses	69,573	61.6	48,903	55.7	20,670
Operating income	31,711	28.1	31,861	36.3	(150)
Other income (expense):					
Interest income	85	0.1	91	0.1	(6)
Interest expense	(142)	(0.1)	—	—	(142)
Other income (expense), net	238	0.2	(6)	—	244
Total other income (expense)	181	0.2	85	0.1	96
Income before income taxes	31,892	28.3	31,946	36.4	(54)
Income tax expense	7,771	6.9	9,123	10.4	(1,352)
Net income	$24,121	21.4 %	$ 22,823	26.0 %	$ 1,298

Revenue

Revenue increased $25.0 million, or 28.5%, in the quarter ended September 30, 2014 compared to the quarter ended September 30, 2013. Total revenue by product group was $66.4 million and $57.8 million for network management, $34.8 million and $23.8 million for systems and application management and $11.6 million and $6.3 million for our MSP and subscription products for the quarters ended September 30, 2014 and 2013, respectively.

Our revenue from our international subsidiaries was 25.9% of total revenue in both the third quarter of 2014 and 2013. Other than the United States, no single country accounted for 10% or more of our total revenues during these periods. We expect international sales as a percentage of our total sales in 2014 to increase slightly as compared to 2013. We plan to continue expanding our sales and marketing efforts outside of the U.S.

License, Maintenance and Other Revenue

License revenue increased $8.4 million primarily due to increased sales of our systems and application management products and network management products.

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

Table of Contents

Our commercial core product transaction volume growth was 24.6% in the third quarter of 2014 as compared to the third quarter of 2013. The overall growth in commercial core product transaction volume in the third quarter of 2014 was attributed to increased sales of our systems and application management and network management products.

In the third quarter of 2014 and 2013, the commercial core average size for new license transactions was approximately $7,900. Our commercial core average transaction size was consistent year over year due to a similar number of products sold on each transaction along with a comparable number of larger transactions.

Maintenance and other revenue increased $11.6 million due to a growing maintenance renewal customer base and an increase in new license sales, which drives new maintenance revenue. We have maintained high customer retention and have continued to increase our renewal base each quarter as we have begun to renew and recognize the maintenance revenue associated with our acquired products.

Subscription Revenue

Subscription revenue increased $5.0 million primarily due to the growth in sales of subscriptions of our MSP products and to a lesser extent, our Pingdom cloud products.

Cost of Revenue

Cost of revenue increased $4.5 million, or 63.1%, in the quarter ended September 30, 2014 compared to the quarter ended September 30, 2013. Cost of license revenue increased by $1.5 million in the third quarter of 2014 compared to the third quarter of 2013, primarily due to the amortization of acquired product technologies associated with our acquisitions. Cost of maintenance revenue also increased $1.0 million primarily due to increased personnel costs, which include stock-based compensation expense, to support new customers, additional product offerings from acquisitions and internal product development.

Cost of subscription revenue increased by $2.0 million in the third quarter of 2014 compared to the third quarter of 2013, primarily due to increased amortization of acquired developed product technologies, personnel costs and other direct costs, including royalty fees and hosting and server fees, related to our subscription products and services.

Operating Expenses

Sales and Marketing. Sales and marketing expenses increased $11.6 million, or 44.6%, in the quarter ended September 30, 2014 compared to the quarter ended September 30, 2013. Our sales and marketing personnel costs, which include stock-based compensation expense, increased $8.2 million. We have increased employee headcount in our sales, marketing and maintenance renewal teams as a result of organic growth and through acquisitions. Marketing program costs increased $3.3 million due to the increased investment around demand generation and brand awareness. Our sales expense as a percentage of revenue increased slightly in the third quarter of 2014 as compared to the same period in 2013 primarily due to our 2013 acquisitions.

Research and Development. Research and development expenses increased $4.2 million, or 44.0%, in the quarter ended September 30, 2014 compared to the quarter ended September 30, 2013 due to our increased investment in product development. In order to support the ongoing development of new products and our current products, we continued to increase the size of our Czech Republic and India research and development centers during 2013 and the first three quarters of 2014 and supplemented our internal product development activities with additional contract services. We also increased our research and development headcount through our acquisitions. Due to this growth, our personnel costs, which include stock-based compensation expense, increased by $3.0 million and contract services increased $1.0 million in the third quarter of 2014 as compared to the third quarter of 2013. Contract services increased due to additional product development work that was completed by our offshore development vendors.

General and Administrative. General and administrative expenses increased $4.9 million, or 36.5%, in the quarter ended September 30, 2014 compared to the quarter ended September 30, 2013. This increase was primarily due to a $2.9 million increase in personnel costs, which include stock-based compensation expense and a $2.1 million increase in acquisition related costs.

Income Tax Expense

Our income tax expense decreased by $1.4 million in the quarter ended September 30, 2014 as compared to the same period in 2013. Our effective tax rate decreased from 28.6% in the quarter ended September 30, 2013 to 24.4% in the quarter ended September 30, 2014. These decreases were primarily attributable to an increase in international earnings as a percentage of total earnings, which are generally taxed at lower tax rates, partially offset by the expiration of the

U.S. federal research and experimental tax credit.

Table of Contents

Comparison of the Nine Months Ended September 30, 2014 and 2013

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

	Nine months ended September 30,				
	2014	% of Revenue	2013	% of Revenue	Change
	(in thousands)		(in thousands)		(in thousands)
Revenue:					
License	$116,743	37.6 %	$ 96,300	40.4 %	$ 20,443
Maintenance and other	174,800	56.3	137,841	57.8	36,959
Subscription	18,732	6.0	4,151	1.7	14,581
Total revenue	310,275	100.0	238,292	100.0	71,983
Cost of revenue	32,504	10.5	18,887	7.9	13,617
Gross profit	277,771	89.5	219,405	92.1	58,366
Operating expenses:					
Sales and marketing	106,772	34.4	66,538	27.9	40,234
Research and development	41,784	13.5	25,622	10.8	16,162
General and administrative	57,466	18.5	34,758	14.6	22,708
Total operating expenses	206,022	66.4	126,918	53.3	79,104
Operating income	71,749	23.1	92,487	38.8	(20,738)
Other income (expense):					
Interest income	246	0.1	324	0.1	(78)
Interest expense	(577)	(0.2)	—	—	(577)
Other income (expense), net	446	0.1	(497)	(0.2)	943
Total other income (expense)	115	—	(173)	(0.1)	288
Income before income taxes	71,864	23.2	92,314	38.7	(20,450)
Income tax expense	16,718	5.4	23,695	9.9	(6,977)
Net income	$55,146	17.8 %	$ 68,619	28.8 %	