

SolarWinds, Inc.
Form 10-Q
November 09, 2015
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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, 2015

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
(State or other jurisdiction of
incorporation or organization)
7171 Southwest Parkway
Building 400
Austin, Texas 78735
(512) 682.9300

73-1559348
(I.R.S. Employer
Identification No.)

(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. 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). Yes No

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

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

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

On November 3, 2015, 71,765,135 shares of common stock, par value \$0.001 per share, were outstanding.

SOLARWINDS, INC.

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The SolarWinds, Pingdom and Librato marks are the exclusive property of SolarWinds, Inc. or its affiliates, are registered with the U.S. Patent and Trademark Office, and may be registered or pending registration in other countries. All other SolarWinds trademarks, service marks, and logos may be common law marks, registered or pending registration in the United States or in other countries. All other trademarks mentioned herein are used for identification purposes only and may be or are trademarks or registered trademarks of their respective companies.

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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,” “should,” “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 proposed acquisition by Thoma Bravo and Silver Lake Partners;
- 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) risks related to our proposed acquisition by Thoma Bravo and Silver Lake Partners, (b) the inability to generate significant volumes of sales leads from Internet search engines, marketing campaigns and traffic to our websites; (c) the inability to expand our sales operations effectively; (d) the inability to increase sales to existing customers and to attract new customers; (e) the presence or absence of occasional large customer orders, including in particular those placed by the U.S. federal government; (f) the ability to successfully identify, complete, and integrate acquisitions; (g) the possibility that general economic conditions or uncertainty cause information technology spending to be reduced or purchasing decisions to be delayed; (h) the timing and success of new product introductions and product upgrades by SolarWinds or its competitors; (i) 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; (j) potential foreign exchange gains and losses related to expenses and sales denominated in currencies other than the functional currency of an associated entity; and (k) 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, 2014 and our quarterly reports on Form 10-Q, including Item 1A of Part II of this quarterly report on Form 10-Q, and other documents we file with the Securities and Exchange Commission. 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.

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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, 2015	December 31, 2014
Assets		
Current assets:		
Cash and cash equivalents	\$172,591	\$237,942
Short-term investments	20,945	12,384
Accounts receivable, net of allowances of \$513 and \$1,088 as of September 30, 2015 and December 31, 2014, respectively	54,268	50,791
Income tax receivable	260	128
Deferred taxes	9,415	8,350
Prepaid and other current assets	8,483	6,492
Total current assets	265,962	316,087
Property and equipment, net	34,009	23,614
Long-term investments	5,643	17,423
Deferred taxes	2,163	830
Goodwill	432,409	363,585
Intangible assets, net	77,500	93,046
Other assets, net	10,071	10,447
Total assets	\$827,757	\$825,032
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$6,450	\$6,829
Accrued liabilities and other	24,427	35,276
Income taxes payable	4,598	2,351
Current portion of deferred revenue	177,727	154,799
Current debt obligation	90,000	—
Total current liabilities	303,202	199,255
Long-term liabilities:		
Deferred revenue, net of current portion	10,806	8,609
Non-current deferred taxes	3,710	5,319
Other long-term liabilities	26,224	22,990
Total liabilities	343,942	236,173
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Common stock, \$0.001 par value: 123,000,000 shares authorized and 71,744,028 and 75,911,349 shares issued and outstanding as of September 30, 2015 and December 31, 2014, respectively	72	76
Additional paid-in capital	117,260	279,584
Accumulated other comprehensive loss	(23,339)	(13,299)
Accumulated earnings	389,822	322,498
Total stockholders' equity	483,815	588,859
Total liabilities and stockholders' equity	\$827,757	\$825,032

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
Revenue:				
License	\$45,283	\$42,756	\$126,236	\$116,743
Maintenance and other	71,526	61,844	202,811	174,800
Subscription	14,816	8,262	38,446	18,732
Total revenue	131,625	112,862	367,493	310,275
Cost of license revenue	4,367	4,100	12,953	12,321
Cost of maintenance and other revenue	4,748	3,965	13,015	11,296
Cost of subscription revenue	5,382	3,513	14,529	8,887
Gross profit	117,128	101,284	326,996	277,771
Operating expenses:				
Sales and marketing	44,532	37,538	131,117	106,772
Research and development	17,454	13,761	48,957	41,784
General and administrative	18,618	18,274	58,355	57,466
Total operating expenses	80,604	69,573	238,429	206,022
Operating income	36,524	31,711	88,567	71,749
Other income (expense):				
Interest income	96	85	313	246
Interest expense	(279)	(142)	(470)	(577)
Other income, net	538	238	2,991	446
Total other income	355	181	2,834	115
Income before income taxes	36,879	31,892	91,401	71,864
Income tax expense	9,866	7,771	24,077	16,718
Net income	\$27,013	\$24,121	\$67,324	\$55,146
Net income per share:				
Basic earnings per share	\$0.37	\$0.32	\$0.89	\$0.73
Diluted earnings per share	\$0.36	\$0.32	\$0.88	\$0.72
Weighted average shares used to compute net income per share:				
Shares used in computation of basic earnings per share	73,808	75,508	75,496	75,375
Shares used in computation of diluted earnings per share	74,476	76,463	76,354	76,321

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

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

	Three months ended September 30,		Nine months ended September 30,	
	2015	2014	2015	2014
Net income	\$27,013	\$24,121	\$67,324	\$55,146
Other comprehensive income (loss):				
Foreign currency translation adjustment	1,657	(9,514	) (10,065	) (10,488
Unrealized gains (losses) on investments, net of income tax expense (benefit) of \$7 and \$(10) for the three months ended September 30, 2015 and 2014, respectively, and \$13 and \$(7) 13 for the nine months ended September 30, 2015 and 2014, respectively		(19	) 25	(14
Other comprehensive income (loss)	1,670	(9,533	) (10,040	) (10,502
Comprehensive income	\$28,683	\$14,588	\$57,284	\$44,644

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

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SolarWinds, Inc.

Condensed Consolidated Statements of Cash Flows

(In thousands)

(Unaudited)

	Nine months ended September 30,	
	2015	2014
Cash flows from operating activities		
Net income	\$67,324	\$55,146
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	30,230	27,140
Provision for doubtful accounts	806	439
Stock-based compensation expense	37,351	27,429
Deferred taxes	1,153	(6,387)
Excess tax benefit from stock-based compensation	(3,915)	(5,309)
Premium on investments	(156)	(90)
Other non-cash expenses	872	1,025
Changes in operating assets and liabilities, net of assets acquired and liabilities assumed in business combinations:		
Accounts receivable	(5,869)	(3,059)
Income taxes receivable	(146)	3,884
Prepaid and other assets	(1,814)	(1,906)
Accounts payable	(1,267)	48
Accrued liabilities and other	(11,696)	14,271
Income taxes payable	6,354	6,252
Deferred revenue	28,308	22,939
Other long-term liabilities	2,762	6,022
Net cash provided by operating activities	150,297	147,844
Cash flows from investing activities		
Purchases of investments	(5,745)	(3,001)
Maturities of investments	8,650	13,488
Purchases of property and equipment	(13,122)	(16,840)
Purchases of intangible assets	(208)	(199)
Acquisition of businesses, net of cash acquired	(90,015)	(63,700)
Net cash used in investing activities	(100,440)	(70,252)
Cash flows from financing activities		
Repurchase of common stock	(210,178)	(13,223)
Exercise of stock options	6,812	6,049
Excess tax benefit from stock-based compensation	3,915	5,309
Proceeds from credit agreement	100,000	—
Repayments of borrowings from credit agreement	(10,000)	(40,000)
Net cash used in financing activities	(109,451)	(41,865)
Effect of exchange rate changes on cash and cash equivalents	(5,757)	(6,497)
Net increase (decrease) in cash and cash equivalents	(65,351)	29,230
Cash and cash equivalents		
Beginning of period	237,942	165,973
End of period	\$172,591	\$195,203
Supplemental disclosure of cash flow information		
Cash paid for interest	\$288	\$521

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Cash paid for income taxes	\$16,218	\$12,763
Non-cash investing transactions		
Purchases of property and equipment included in accounts payable and accrued liabilities	\$2,351	\$—

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

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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,” “us” or “our”) design, develop, market, sell and support enterprise-class information technology, or IT, infrastructure management software to IT and DevOps professionals in organizations of all sizes to manage on-premise, hybrid cloud and public cloud environments. Our product offerings range from individual software tools to more comprehensive software products that solve problems encountered every day by IT and DevOps professionals and help them to efficiently and effectively manage their network, systems, application and website infrastructures.

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, 2014.

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. 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. In August 2015, FASB issued an amendment to the updated accounting guidance to defer the effective date by one year. The updated accounting guidance, as amended, is effective for interim and annual periods beginning after December 15, 2017. Early adoption is permitted only as of interim and annual periods beginning after December 15, 2016. The standard permits the use of either the retrospective or cumulative effect transition method. We expect to adopt the updated guidance in the first quarter of fiscal year 2018. We are still evaluating transition methods and the impact of the new revenue recognition guidance on our consolidated financial statements.

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.

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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, 2015 are summarized below:

(in thousands)	Unrealized Gain (Loss) on Available-for-Sale Investments, net of tax	Foreign Currency Translation Adjustments	Accumulated Other Comprehensive Loss
Balance at December 31, 2014	\$ (45)	\$ (13,254)	\$ (13,299)
Other comprehensive gain (loss) before reclassification	25	(10,065)	(10,040)
Amount reclassified from accumulated other comprehensive income (loss)	—	—	—
Net current period other comprehensive income (loss)	25	(10,065)	(10,040)
Balance at September 30, 2015	\$ (20)	\$ (23,319)	\$ (23,339)

2. Acquisitions

Librato Acquisition

In January 2015, we acquired Librato, Inc., or Librato, a cloud-based infrastructure monitoring company, for approximately \$40.0 million in cash, including \$0.1 million of cash acquired. The acquisition represents another step in our efforts to extend and connect performance management capabilities from on-premise IT infrastructure to cloud-based application environments. The acquisition was financed with available cash and we incurred \$0.7 million in acquisition related costs, which are included in general and administrative expense for the nine months ended September 30, 2015.

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 \$30.9 million of goodwill, \$4.0 million of intangible assets and \$5.2 million of deferred tax assets. The weighted average amortization period for the intangible assets is 5.0 years.

Goodwill for this acquisition is not deductible for tax purposes.

Papertrail Acquisition

In April 2015, we acquired Papertrail Inc., or Papertrail, a cloud-based log management company, for approximately \$41.1 million in cash, including \$0.1 million of cash acquired. By acquiring Papertrail, we extended our ability to help IT professionals, DevOps professionals and developers quickly and easily monitor log data in order to troubleshoot application performance across cloud-based and on-premise infrastructure environments. The acquisition was financed with available cash and we incurred \$0.6 million in acquisition related costs, which are included in general and administrative expense for the nine months ended September 30, 2015.

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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 \$36.9 million of goodwill and \$4.1 million of intangible assets. The weighted average amortization period for the intangible assets is 4.3 years. Goodwill for this acquisition is deductible for tax purposes.

The following table summarizes the fair value of the acquired identifiable intangible assets and weighted average useful lives for our Librato and Papertrail acquisitions:

	Fair Value (in thousands)	Weighted Average Useful Life (in years)
Developed product technologies	\$ 5,390	5
Customer relationships	2,640	4
Non-competition covenant	109	3
Total identifiable intangible assets	\$ 8,139	

For the nine months ended September 30, 2015, the revenue and net loss included in our condensed consolidated financial statements from the effective date of the above acquisitions are \$3.6 million and \$5.8 million, respectively. 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, 2014. Pro forma information for the acquisitions has not been provided because the impact of the historical results of operations of the acquired businesses on our revenue, net income and earnings per share is not material.

The following table reflects the changes in goodwill for the nine months ended September 30, 2015:

(in thousands)	
Balance at December 31, 2014	\$363,585
Acquisitions	74,732
Foreign currency translation and other adjustments	(5,908)
Balance at September 30, 2015	\$432,409

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, 2015, 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, 2015 and December 31, 2014 consisted of bank deposit accounts and money market funds. The following table summarizes our cash and cash equivalents:

	September 30, 2015	December 31, 2014
(in thousands)		
Bank deposit accounts	\$168,781	\$169,387
Money market funds	3,810	68,555
Total cash and cash equivalents	\$172,591	\$237,942

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Our short-term and long-term investments as of September 30, 2015 and December 31, 2014 consisted of available-for-sale securities, such as corporate bonds. The following table summarizes our short-term and long-term available-for-sale securities as of September 30, 2015 and December 31, 2014:

(in thousands)	September 30, 2015				December 31, 2014			
	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	\$20,961	\$2	\$(18)	) \$20,945	\$12,382	\$5	\$(3)	) \$12,384
Total short-term investments	\$20,961	\$2	\$(18)	) \$20,945	\$12,382	\$5	\$(3)	) \$12,384
Long-term investments:								
Available-for-sale securities:								
Corporate bonds	\$5,658	\$—	\$(15)	) \$5,643	\$17,494	\$—	\$(71)	) \$17,423
Total long-term investments	\$5,658	\$—	\$(15)	) \$5,643	\$17,494	\$—	\$(71)	) \$17,423

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:

(in thousands)	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
As of September 30, 2015						
Corporate bonds	\$19,400	\$(34)	) \$—	\$—	\$19,400	\$(34)
	\$19,400	\$(34)	) \$—	\$—	\$19,400	\$(34)
(in thousands)	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
As of December 31, 2014						
Corporate bonds	\$22,021	\$(75)	) \$—	\$—	\$22,021	\$(75)
	\$22,021	\$(75)	) \$—	\$—	\$22,021	\$(75)

The following table summarizes the contractual underlying maturities of our available-for-sale securities as of September 30, 2015:

(in thousands)	Cost	Fair Value
Due in one year or less	\$20,961	\$20,945
Due after one year through five years	5,658	5,643
	\$26,619	\$26,588

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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, 2015 and December 31, 2014. We did not have any financial liabilities as of September 30, 2015 or December 31, 2014.

(in thousands)	Fair Value Measurements at September 30, 2015 Using				Fair Value Measurements at December 31, 2014 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	\$3,810	\$—	\$—	\$3,810	\$68,555	\$—	\$—	\$68,555
Total cash equivalents	3,810	—	—	3,810	68,555	—	—	68,555
Short-term investments:								
Corporate bonds	—	20,945	—	20,945	—	12,384	—	12,384
Total short-term investments	—	20,945	—	20,945	—	12,384	—	12,384
Long-term investments:								
Corporate bonds	—	5,643	—	5,643	—	17,423	—	17,423
Total long-term investments	—	5,643	—	5,643	—	17,423	—	17,423
Total assets	\$3,810	\$26,588	\$—	\$30,398	\$68,555	\$29,807	\$—	\$98,362

There have been no transfers between fair value measurement levels during the nine months ended September 30, 2015.

5. Credit Agreement

On October 4, 2013, we entered into a Credit Agreement with a syndicated group of lenders, Wells Fargo Bank, National Association, as administrative agent for the lenders, and Wells Fargo Securities, LLC (the "Credit Agreement") 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. Pursuant to the Guaranty Agreement, dated as of October 4, 2013, by SolarWinds Worldwide, LLC, or SolarWinds Worldwide, in favor of and for the benefit of the lenders, our obligations under the Credit Agreement are guaranteed by SolarWinds Worldwide, our principal domestic operating subsidiary, and our future domestic subsidiaries, subject to certain exceptions.

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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.

In August 2015, we borrowed \$100.0 million at an interest rate of approximately 1.4% under a revolving loan under the Credit Agreement to finance a portion of our share repurchase program and for general corporate purposes. In September 2015, we repaid \$10.0 million of the outstanding borrowings. As of September 30, 2015, \$90.0 million of the borrowings remained outstanding under the facility and 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,	
	2015	2014	2015	2014
(in thousands)				
Basic earnings per share				
Numerator:				
Net income	\$27,013	\$24,121	\$67,324	\$55,146
Denominator:				
Weighted average common shares outstanding used in computing basic earnings per share	73,808	75,508	75,496	75,375
Diluted earnings per share				
Numerator:				
Net income	\$27,013	\$24,121	\$67,324	\$55,146
Denominator:				
Weighted average common shares outstanding used in computing basic earnings per share	73,808	75,508	75,496	75,375
Add options and restricted stock units to purchase common stock	668	955	858	946
Weighted average common shares outstanding used in computing diluted earnings per share	74,476	76,463	76,354	76,321

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,	
	2015	2014	2015	2014
(in thousands)				
Antidilutive shares	2,411	1,804	1,965	2,022

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.

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In July 2015, we announced that our Board of Directors approved a share repurchase program, authorizing us to purchase up to \$200.0 million of our outstanding common stock in the open market. Our share repurchase program was completed in August 2015. Purchases under our share repurchase program were made in the open market in accordance with Rule 10b-18 of the Exchange Act and were funded using a combination of our cash on hand, cash generated from operations and borrowings under our Credit Agreement. During the three months ended September 30, 2015, we repurchased 5.0 million shares of our common stock for an aggregate purchase price of \$200.1 million, including fees and commissions. Shares were retired upon repurchase.

7. Income Taxes

For the three months ended September 30, 2015 and 2014, we recorded income tax expense of \$9.9 million and \$7.8 million, respectively, resulting in an effective tax rate of 26.8% and 24.4%, respectively. For the nine months ended September 30, 2015 and 2014, we recorded income tax expense of \$24.1 million and \$16.7 million, respectively, resulting in an effective tax rate of 26.3% and 23.3%, respectively. The increase in the effective tax rate for the three and nine months ended September 30, 2015 compared to the same periods in 2014 were generally due to an increase in permanent items that are non-deductible for tax purposes.

We recognize interest and penalties related to unrecognized tax benefits in the provision for income taxes. As of September 30, 2015, we included accrued interest and penalties related to unrecognized tax benefits of approximately \$1.2 million in our condensed consolidated balance sheet.

We file U.S., state and foreign income tax returns in jurisdictions with varying statutes of limitations. The 2011 through 2014 tax years generally remain open and subject to examination by federal tax authorities. The 2010 through 2014 tax years generally remain open and subject to examination by the state tax authorities and foreign tax authorities. During the first quarter of 2015, we were notified that the U.S. Internal Revenue Service, or IRS, would examine tax years 2011 and 2012. The audit by the Indian Tax Authority for the 2012 tax year closed in the first quarter of 2015 with no adjustments. We are also under audit by the Indian Tax Authority for the 2013 and 2014 tax years and by the Canadian Revenue Agency for the 2013 tax year. We are not currently under audit in any other taxing jurisdictions.

On July 27, 2015, in *Altera Corp. v. Commissioner*, the U.S. Tax Court issued an opinion related to the treatment of stock-based compensation expense in an intercompany cost-sharing arrangement. A final decision has yet to be issued by the U.S. Tax Court. At this time, the U.S. Department of the Treasury has not withdrawn the requirement to include stock-based compensation from its regulations. Due to the uncertainty surrounding the status of the current regulations, questions related to the scope of potential tax benefits, and the risk of the U.S. Tax Court's decision being overturned upon appeal, we have not recorded any tax benefit as of September 30, 2015. We will continue to monitor ongoing developments and potential impacts to our consolidated financial statements.

8. Commitments and Contingencies

Leases

In April 2015, we signed an amendment to the lease of our corporate headquarters in Austin, Texas, which extends the lease term of our existing space for an additional year, amends the base rent payable and expands the leased building space to approximately 348,000 square feet beginning in 2017. The amendment increases our expected lease payments by approximately \$2.5 million for the year ending December 31, 2017, \$3.3 million for the year ending December 31, 2018, \$3.4 million for the year ending December 31, 2019 and \$37.4 million for the years ending thereafter through the expiration of the lease in March 2028.

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.

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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 and in one or more offerings, an unspecified amount of common stock, preferred stock, depository 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 prevailing market conditions. Debt securities sold by us may be fully and unconditionally guaranteed on an unsecured basis by SolarWinds Worldwide, LLC, or SolarWinds Worldwide, our principal operating subsidiary. 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.

10. Subsequent Events

Acquisitions

In October 2015, we completed two acquisitions for approximately \$29.8 million in cash. The transactions will be accounted for using the acquisition method of accounting. Accordingly, the results of operations since the respective acquisition dates will be included in our condensed consolidated financial statements for the fourth quarter of 2015. We are in the process of gathering information to allocate the purchase price to the assets acquired and liabilities assumed. All of the assets acquired and liabilities assumed in the transaction will be recognized at their acquisition date fair values.

Merger Agreement

On October 21, 2015, we entered into an Agreement and Plan of Merger (the “Merger Agreement”) with Project Aurora Holdings, LLC (“Parent”), and Project Aurora Merger Corp., a wholly owned subsidiary of Parent (“Merger Subsidiary”), providing for the merger of Merger Subsidiary with and into the Company (the “Merger”), with the Company surviving the Merger as a wholly owned subsidiary of Parent. Parent and Merger Subsidiary were formed by affiliates of private equity investment firms Thoma Bravo (“Thoma Bravo”) and Silver Lake Partners (“Silver Lake”).

Subject to certain exceptions, at the effective time of the Merger (the “Effective Time”), (i) each share of our common stock issued and outstanding as of immediately prior to the Effective Time will be canceled and cease to exist and automatically converted into the right to receive cash in an amount equal to \$60.10, without interest (the “Per Share Price”), (ii) outstanding options, whether vested or unvested, will be canceled and converted into the right to receive the Per Share Price less the applicable exercise price per share and applicable withholding taxes and (iii) restricted stock units (“RSUs”), other than those RSUs granted under our 2015 Performance Incentive Plan (“2015 Plan”) and to certain of our management team members, will vest in full and be converted into the right to receive the Per Share Price less applicable withholding taxes. RSUs issued under our 2015 Plan will be cancelled and converted into the right to receive the Per Share Price less applicable withholding taxes shortly after those RSUs would have vested, if they had not been cancelled immediately prior to the Effective Time, based on the underlying RSU vesting schedule and subject to continued employment of the holders of those RSUs. The vesting of the RSUs held by certain of our officers (excluding those RSUs issued under the 2015 Plan) will accelerate by 50% immediately prior to the Effective Time, and these vested RSUs will be cancelled and converted at the Effective Time into the right to receive the Per Share Price less applicable withholding taxes. The remaining unvested RSUs held by such officers (excluding those RSUs issued under the 2015 Plan) will be cancelled and converted into the right to receive the Per Share Price less applicable withholding taxes shortly after those RSUs would have vested, if they had not been cancelled immediately prior to the Effective Time, based on the underlying RSU vesting schedule.

Consummation of the Merger is subject to customary closing conditions, including, without limitation, the absence of certain legal impediments, the expiration or termination of the required waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, the receipt of foreign antitrust clearance and approval by our stockholders.

The Merger Agreement contains certain termination rights for us and Parent. Upon termination of the Merger Agreement under specified circumstances, we will be required to pay Parent a termination fee of \$159.0 million. Upon termination of the Merger Agreement under other specified circumstances, Parent will be required to pay us a termination fee of \$318.0 million.

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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 Part II, Item IA of this quarterly report on Form 10-Q and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014 for a discussion of the uncertainties, risks and assumptions associated with these statements.

Overview

We design, develop, market, sell and support enterprise-class information technology, or IT, infrastructure management software to IT and DevOps professionals in organizations of all sizes to manage on-premise, hybrid cloud and public cloud environments. Our product offerings range from individual software tools to more comprehensive software products that solve problems encountered every day by IT and DevOps professionals and help them to efficiently and effectively manage their network, systems, application and website infrastructures. We are committed to offering products that are easy to find, easy to buy, easy to use and easy to maintain, while providing the power to address any IT management problem at any scale. Our customers include small- and mid-size businesses, large enterprises, managed service providers, or MSPs, and local, state and national government entities.

Key Financial Highlights

Key financial highlights for the first three quarters of 2015 include the following:

• Total revenue was \$367.5 million for the first three quarters of 2015 compared to \$310.3 million for the first three quarters of 2014, representing an increase of 18.4%;

• Combined maintenance and subscription revenue for the first three quarters of 2015 was \$241.3 million compared to \$193.5 million for the first three quarters of 2014, representing 24.7% year-over-year growth in recurring revenue;

• Operating income was \$88.6 million and operating margin was 24.1% for the first three quarters of 2015 compared to operating income of \$71.7 million and operating margin of 23.1% for the first three quarters of 2014;

• Non-GAAP operating income was \$157.4 million and non-GAAP operating margin was 42.8% for the first three quarters of 2015 compared to non-GAAP operating income of \$134.5 million and non-GAAP operating margin of 43.3% for the first three quarters of 2014;

• Net income was \$67.3 million for the first three quarters of 2015 compared to \$55.1 million for the first three quarters of 2014, representing an increase of 22.1%;

• Net income was \$0.88 per share on a fully diluted basis for the first three quarters of 2015 compared to \$0.72 per share on a fully diluted basis for the first three quarters of 2014, representing an increase of 22.2%; and

• Cash flow from operating activities was \$150.3 million for the first three quarters of 2015 compared to \$147.8 million for the first three quarters of 2014, representing an increase of 1.7%.

In the first three quarters of 2015, we continued to invest in areas that we believe are an important foundation for the long term growth of our business. For example:

• We invested in our marketing programs, teams and systems, in an effort to increase the awareness of SolarWinds and our products and with the intent to better capture demand, and specifically to accomplish those goals more consistently for our different products and in our different geographies;

• We invested in our sales function to expand our sales efforts focused on our existing customer base, in an effort to better convert the demand that we capture through our marketing activities and to expand our sales team focused on the MSP market;

• We invested in product development in an effort to provide new technology and features that enhance the ability of our products to easily solve the problems our customers face on a daily basis; and

• We invested in the expansion of our facilities, general and administrative resources and IT infrastructure to support the

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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 believe our business model can be used to serve customers managing the performance of on-premise, hybrid cloud and public cloud environments. We believe we can expand our market opportunity while applying the key differentiating elements of our business model and continuing to provide powerful and scalable, easy-to-use and affordable software. Our strategic focus in 2015 is centered around the following initiatives:

• Creating the ability to “manage all things IT;”

• Improving the competitive position of our products by investing in new product features and infrastructure to manage performance of technology in on-premise, hybrid cloud and public cloud environments;

• Developing or acquiring products that will expand our presence in our current markets or new markets;

• Expanding our web presence, brand awareness and improving our communication with prospects and our current customer base both domestically and internationally;

• Accelerating the rate at which we sell additional products to our existing install base;

• 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;

• Expanding our international operations company-wide to drive our competitive advantage; and

• Driving high renewal rates from our maintenance and subscription customers by continuing to deliver ongoing value to our customer base.

Pending Merger

On October 21, 2015, we entered into an Agreement and Plan of Merger (the “Merger Agreement”) with Project Aurora Holdings, LLC (“Parent”), and Project Aurora Merger Corp., a wholly owned subsidiary of Parent (“Merger Subsidiary”), providing for the merger of Merger Subsidiary with and into the Company (the “Merger”), with the Company surviving the Merger as a wholly owned subsidiary of Parent. Parent and Merger Subsidiary were formed by affiliates of private equity investment firms Thoma Bravo (“Thoma Bravo”) and Silver Lake Partners (“Silver Lake”).

Subject to certain exceptions, at the effective time of the Merger (the “Effective Time”), (i) each share of our common stock issued and outstanding as of immediately prior to the Effective Time will be canceled and cease to exist and automatically converted into the right to receive cash in an amount equal to \$60.10, without interest (the “Per Share Price”), (ii) outstanding options, whether vested or unvested, will be canceled and converted into the right to receive the Per Share Price less the applicable exercise price per share and applicable withholding taxes and (iii) restricted stock units (“RSUs”), other than those RSUs granted under our 2015 Performance Incentive Plan (“2015 Plan”) and to certain of our management team members, will vest in full and be converted into the right to receive the Per Share Price less applicable withholding taxes. RSUs issued under our 2015 Plan will be cancelled and converted into the right to receive the Per Share Price less applicable withholding taxes shortly after those RSUs would have vested, if they had not been cancelled immediately prior to the Effective Time, based on the underlying RSU vesting schedule and subject to continued employment of the holders of those RSUs. The vesting of the RSUs held by certain of our officers (excluding those RSUs issued under the 2015 Plan) will accelerate by 50% immediately prior to the Effective Time, and these vested RSUs will be cancelled and converted at the Effective Time into the right to receive the Per Share Price less applicable withholding taxes. The remaining unvested RSUs held by such officers (excluding those RSUs issued under the 2015 Plan) will be cancelled and converted into the right to receive the Per Share Price less applicable withholding taxes shortly after those RSUs would have vested, if they had not been cancelled immediately prior to the Effective Time, based on the underlying RSU vesting schedule.

Parent and Merger Subsidiary have secured committed financing, consisting of, as of October 21, 2015, a combination of equity to be provided by investment funds affiliated with Thoma Bravo and Silver Lake, and debt financing from Goldman Sachs Bank USA, the aggregate proceeds of which will be sufficient for Parent and Merger Subsidiary to pay the aggregate merger consideration and all related fees and expenses. Parent and Merger Subsidiary have committed to use their reasonable best efforts to obtain the debt financing on the terms and conditions described in the debt commitment letter entered into as of October 21, 2015. The transaction is not subject to a financing condition.

Consummation of the Merger is subject to customary closing conditions, including, without limitation, the absence of certain legal impediments, the expiration or termination of the required waiting periods under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, the receipt of foreign antitrust clearance and approval by our stockholders.

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We have made customary representations and warranties in the Merger Agreement and have agreed to customary covenants regarding the operation of our business prior to the Effective Time. We are also subject to customary restrictions on our ability to solicit alternative acquisition proposals from third parties and to provide non-public information to, and participate in discussions and engage in negotiations with, third parties regarding alternative acquisition proposals, with customary exceptions for superior proposals.

The Merger Agreement contains certain termination rights for us and Parent. Upon termination of the Merger Agreement under specified circumstances, we will be required to pay Parent a termination fee. If the Merger Agreement is terminated in connection with us entering into an alternate acquisition agreement with respect to a superior proposal or due to our board changing its recommendation, including the failure to act, in support of the Merger, the termination fee payable by us to Parent will be of \$159.0 million. This termination fee will also be payable if: (i) the Merger Agreement is terminated because our stockholders did not vote to adopt the Merger Agreement at the stockholders meeting called to adopt the Merger Agreement, (ii) prior to such vote on the Merger Agreement, an offer or proposal to acquire at least 50% of our stock or assets that was not publicly announced or known at the time the Merger Agreement is signed is publicly announced or becomes known and is not withdrawn, and (iii) within one year of the termination of the Merger Agreement we consummate an acquisition transaction to acquire at least 50% of our stock or assets or enter into an agreement for such a transaction, which we subsequently consummate. In addition, we will be required to reimburse Parent for up to \$5.0 million of its expenses associated with the transaction under circumstances in which we would not be obligated to pay Parent a termination fee if the Merger Agreement is terminated either because the Company's stockholders do not vote to adopt the Merger Agreement, or if we breach our representations, warranties or covenants in a manner that would cause the related closing conditions to not be met. We will also be required to reimburse Parent for up to \$5.0 million of expenses associated with the transaction if the Merger Agreement is terminated because we breach our representations, warranties or covenants in a manner that would cause the related closing conditions to not be met and an offer or proposal to acquire at least 15% of our stock or assets is made to the Company or is publicly announced after the date of the Merger Agreement and is not withdrawn, provided that at the time of termination Parent and Merger Subsidiary were not in material breach of their representations, warranties, covenants or agreements under the Merger Agreement.

Upon termination of the Merger Agreement under other specified circumstances, Parent will be required to pay us a termination fee of \$318.0 million. The termination fee by Parent will become payable if the Merger Agreement is terminated because Parent fails to consummate the Merger after certain conditions are met, if Parent breaches its representations, warranties or covenants in a manner that would cause the related closing conditions to not be met, or if either party terminates because of the termination date described below, and at the time of such termination, we were otherwise entitled to terminate the Merger Agreement for either of the first two reasons above.

In addition to the foregoing termination rights, and subject to certain limitations, (i) we or Parent may terminate the Merger Agreement if the Merger is not consummated by April 18, 2016 and (ii) we and Parent may mutually agree to terminate the Merger Agreement.

Each of Thoma Bravo and Silver Lake has provided us with a limited guaranty in favor of us (the "Limited Guarantees"). The Limited Guarantees guarantee the payment of the termination fee payable by Parent and certain indemnification and reimbursement obligations that may be owed by Parent to us pursuant to the Merger Agreement. The Merger Agreement also generally provides that either party may specifically enforce the other party's obligations under the Merger Agreement, provided that we may only cause Parent to close the transaction if certain conditions are satisfied, including the funding or availability of the debt financing.

The Merger Agreement contains representations and warranties by each of Parent, Merger Subsidiary and us. These representations and warranties were made solely for the benefit of the parties to the Merger Agreement and: should not be treated as categorical statements of fact, but rather as a way of allocating the risk to one of the parties if those statements prove to be inaccurate; may have been qualified in the Merger Agreement by disclosures that were made to the other party in connection with the negotiation of the Merger Agreement; may apply contractual standards of "materiality" that are different from "materiality" under applicable securities laws; and

were made only as of the date of the Merger Agreement or such other date or dates as may be specified in the Merger Agreement.

The foregoing description of the Merger Agreement and the transactions contemplated thereby does not purport to be complete and is subject to, and qualified in its entirety by, the full text of such agreement attached as an exhibit to our Current Report on Form 8-K/A filed with the SEC on October 27, 2015.

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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 internally.

In January 2015, we acquired Librato, Inc., or Librato, a cloud-based infrastructure monitoring company, for approximately \$40.0 million in cash. Librato enables full-stack performance monitoring of infrastructure and applications in public cloud environments or in a company's own data centers. The acquisition of Librato represents another step in our efforts to extend and connect performance management capabilities from on-premise IT infrastructure to cloud-based application environments.

In April 2015, we acquired Papertrail Inc., or Papertrail, a cloud-based log management company, for approximately \$41.1 million in cash. By acquiring Papertrail, we extended our ability to help IT professionals, DevOps professionals and developers quickly and easily monitor log data in order to troubleshoot application performance across cloud-based and on-premise infrastructure environments.

In October 2015, we completed two acquisitions for approximately \$29.8 million in cash.

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, and Note 10, Subsequent Events, in the Notes to the Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q, for further discussion.

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 revenue growth percentages were 18.4% and 30.2% for the first three quarters of 2015 and 2014, respectively.

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. Our GAAP operating margins were 24.1% and 23.1% for the first three quarters of 2015 and 2014, respectively. Our non-GAAP operating margins were 42.8% and 43.3% for the first three quarters of 2015 and 2014, respectively.

For further discussion regarding non-GAAP financial measures including non-GAAP operating income and non-GAAP operating margin, 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

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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. 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 technology performance as compute resources become more distributed. The development and evolution of cloud computing technologies is also allowing a growing number of small and mid-size organizations to rely upon MSPs for their IT management needs, whereby the MSP becomes responsible for managing the performance of the technology infrastructure of that organization.

In order to address these challenges, we offer a cohesive portfolio of powerful, yet easy-to-use and affordably priced IT management products spanning network, system, application and cloud performance management across on-premise, hybrid cloud and public cloud environments. We believe that IT-related trends and the limitations of existing offerings present a significant market opportunity for our products. We expect our revenue to continue to grow as we capitalize on these limitations and other market opportunities through development of new products and acquisitions. 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 from 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.

We believe there is a substantial opportunity for additional sales of our software in the Europe, Middle East and Africa, or EMEA, region, the Asia-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.

In the third quarter of 2015, we recognized 24.7% of our revenue from sales by our international subsidiaries, which includes all subsidiaries outside of North America. We have experienced and may continue to experience fluctuations in foreign exchange rates for some of the international currencies in which we sell our products. The relative strength of the U.S. dollar against most foreign currencies has resulted in reduced revenues for our international subsidiaries upon the translation of foreign currency denominated revenue transactions. If further weakening of these international currencies occurs, we expect revenues in future periods may be adversely affected.

We expect the U.S. federal government will continue to represent a significant market opportunity, as we believe the ease of deployment, and the power and scalability of our products give us a competitive advantage to sell to various agencies and departments of the U.S. federal government. However, we have experienced, and expect to continue to experience, inconsistency in the buying pattern of the U.S. federal government for larger transactions with our products. Many of our larger transactions, both new licenses and maintenance renewals, with the U.S. federal government are dependent on specific projects that 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 annual 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. Subscription revenue includes fees received from our MSP customers for time-based arrangements and fees from subscriptions to our cloud SaaS products. Our cloud products include Pingdom, Librato and Papertrail. We currently sell our subscription products separately from our perpetual license offerings.

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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 overhead costs, such as facilities and technology costs, including related depreciation, employee benefit costs, insurance and other corporate 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 to each expense category based on worldwide headcount in that category. Royalty fees are primarily related to original equipment manufacturer, or OEM, arrangements in our MSP business.

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 cloud technologies that require additional hosting and server costs 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, marketing program costs and legal, accounting, consulting and other professional service fees. We include restructuring charges related to severance and relocation in the employee's respective department.

Our operating expenses increased in absolute dollars and decreased as a percentage of revenue in the first three quarters of 2015 compared to the first three quarters of 2014, as we have continued to add employees, build infrastructure and expand programs through acquisitions and organic growth across all departments in order to support our growth. We continued to invest in product development and marketing and sales for initiatives we believe are important to our long-term goals. These investments focused on the marketing and sales of our existing products and on the expansion of our product portfolio to solve additional problems for our customers. The number of full-time employees as of September 30, 2015 was 1,848, as compared to 1,589 as of September 30, 2014.

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 professional fees associated with the pending Merger, 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, other online advertising, search engine optimization, 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 and subscription sales growth at a rate consistent with our business growth. We also expect to continue to invest in our websites, online user community site, brand awareness initiatives and marketing programs to drive new customer adoption 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 increasing the functionality and enhancing the ease-of-use of our software products and to expanding our product line. Our research and development employee headcount has increased through the continued expansion of our research and development center in the Czech Republic and through acquisitions. We expect to continue to invest in our research and development activities by hiring engineers in our international locations as well as in the United States.

General and Administrative. General and administrative expenses primarily consist of personnel costs for our executive, finance, legal, human resources and other administrative personnel, the amortization of acquired intangible assets, general restructuring charges and acquisition related costs. Legal, accounting and other professional service fees, 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. Acquisition related costs include due diligence and deferred compensation expenses related to our acquisitions. We expect to incur higher administrative costs in future periods as our business continues to grow both organically and through acquisitions.

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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 from the Czech Republic related to the expansion of our facilities.

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 six entities that sell our software, three 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. entities 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, 2014, and if not renewed under similar terms as in prior years, the result could have a material impact on our financial results.

Comparison of the Three Months Ended September 30, 2015 and 2014

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

	Three months ended September 30,		2014	%		Change
	2015	% of Revenue		% of Revenue		
	(in thousands)		(in thousands)			(in thousands)
Revenue:						
License	\$45,283	34.4	% \$ 42,756	37.9	%	\$ 2,527
Maintenance and other	71,526	54.3	61,844	54.8		9,682
Subscription	14,816	11.3	8,262	7.3		6,554
Total revenue	131,625	100.0	112,862	100.0		18,763
Cost of revenue	14,497	11.0	11,578	10.3		2,919
Gross profit	117,128	89.0	101,284	89.7		15,844
Operating expenses:						
Sales and marketing	44,532	33.8	37,538	33.3		6,994
Research and development	17,454	13.3	13,761	12.2		3,693
General and administrative	18,618	14.1	18,274	16.2		344
Total operating expenses	80,604	61.2	69,573	61.6		11,031
Operating income	36,524	27.7	31,711	28.1		4,813
Other income (expense):						
Interest income	96	0.1	85	0.1		11
Interest expense	(279)	(0.2)	(142)	(0.1)		(137)
Other income, net	538	0.4	238	0.2		300
Total other income	355	0.3	181	0.2		174
Income before income taxes	36,879	28.0	31,892	28.3		4,987
Income tax expense	9,866	7.5	7,771	6.9		2,095
Net income	\$27,013	20.5	% \$ 24,121	21.4	%	\$ 2,892

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Revenue

Revenue increased \$18.8 million, or 16.6%, in the quarter ended September 30, 2015 compared to the quarter ended September 30, 2014. Total revenue by product group was \$73.1 million and \$66.4 million for network management, \$40.5 million and \$34.8 million for systems and application management and \$18.0 million and \$11.6 million for our MSP and cloud products for the quarters ended September 30, 2015 and 2014, respectively.

Revenue from our international subsidiaries was 24.7% and 25.9% of total revenue in the third quarter of 2015 and 2014, respectively. Revenue from our international subsidiaries decreased as a percentage of revenue in the third quarter of 2015 as compared to the third quarter of 2014 primarily due to the strengthening of the U.S. dollar against international currencies, which resulted in reduced revenues upon translation. Other than the United States, no single country accounted for 10% or more of our total revenue during these periods.

License, Maintenance and Other Revenue

License revenue increased \$2.5 million, or 5.9%, in the quarter ended September 30, 2015, due to increased sales of our network and systems management products, partially offset by the effect of the weakening of most foreign currencies relative to the U.S. dollar.

While our commercial core product transaction volume decreased 7.4% in the third quarter of 2015 as compared to the third quarter of 2014, the commercial core average transaction size for new license sales increased to approximately \$8,700 in the third quarter of 2015 from approximately \$7,900 in the third quarter of 2014. We calculate our average transaction size and product transaction volume growth using commercial core transactions only, which exclude any transactions that consist solely of our transactional products, our MSP products and our cloud products.

Maintenance and other revenue increased \$9.7 million, or 15.7%, due to a growing maintenance renewal customer base and an increase in new license sales, which drives new maintenance revenue, partially offset by the effect of the weakening of most foreign currencies relative to the U.S. dollar. We have maintained high customer retention and have continued to increase our renewal base each quarter.

Subscription Revenue

Subscription revenue increased \$6.6 million, or 79.3%, primarily due to the growth of subscription sales of our MSP products and the addition of our cloud products combined with high customer retention. These increases were partially offset by the effect of the weakening of most foreign currencies relative to the U.S. dollar.

Cost of Revenue

Cost of revenue increased \$2.9 million, or 25.2%, in the quarter ended September 30, 2015 compared to the quarter ended September 30, 2014.

Cost of License, Maintenance and Other Revenue. Cost of license revenue increased by \$0.3 million in the third quarter of 2015 compared to the third quarter of 2014, primarily due to the amortization of acquired developed product technologies. Cost of maintenance revenue also increased \$0.8 million, primarily due to increased personnel costs, which includes an increase in stock-based compensation expense of \$0.1 million.

Cost of Subscription Revenue. Cost of subscription revenue increased by \$1.9 million in the third quarter of 2015 compared to the third quarter of 2014. The increase was primarily due to a \$0.9 million increase in royalty, hosting and server fees related to our subscription products, a \$0.6 million increase in amortization of acquired developed product technologies and a \$0.4 million increase in personnel costs, which includes a \$0.1 million increase in stock-based compensation expense.

Operating Expenses

Sales and Marketing. Sales and marketing expenses increased \$7.0 million, or 18.6%, in the quarter ended September 30, 2015 compared to the quarter ended September 30, 2014. Marketing program costs increased \$3.7 million due to the increased investment in demand generation and brand awareness in an effort to improve and better capture the demand for our products. Our sales and marketing personnel costs increased \$2.8 million, which includes an increase of \$1.2 million in stock-based compensation expense, primarily due to the increase in headcount on our sales and maintenance renewal teams, and, to a lesser extent, our marketing teams. Our sales expense, which includes maintenance renewals, remained consistent as a percentage of revenue in the third quarter of 2015 as compared to the same period in 2014.

Research and Development. Research and development expenses increased \$3.7 million, or 26.8%, in the quarter ended September 30, 2015 compared to the quarter ended September 30, 2014 due to the addition of product development personnel in order to add new technology, features and functions to our portfolio of products. We increased our research and development headcount through both organic growth and acquisitions. Due to this growth, our personnel costs increased \$4.1 million,

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including a \$1.8 million increase in stock-based compensation expense. This increase was offset by a decrease in contract services of \$0.5 million in the third quarter of 2015 as compared to the third quarter of 2014.

General and Administrative. General and administrative expenses increased \$0.3 million, or 1.9%, in the quarter ended September 30, 2015 compared to the quarter ended September 30, 2014. This increase is primarily due to a \$2.6 million increase in personnel costs, which includes an increase in stock-based compensation expense of \$0.8 million. This increase was offset by a \$2.4 million decrease in acquisition related costs, primarily related to deferred compensation expense.

Income Tax Expense

Our income tax expense increased by \$2.1 million in the quarter ended September 30, 2015 as compared to the same period in 2014. Our effective tax rate increased from 24.4% in the quarter ended September 30, 2014 to 26.8% in the quarter ended September 30, 2015, generally due to an increase in permanent items that are non-deductible for tax purposes.

Comparison of the Nine Months Ended September 30, 2015 and 2014

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

	Nine months ended September 30,		2014	%		Change
	2015	% of Revenue		% of Revenue		
	(in thousands)		(in thousands)			(in thousands)
Revenue:						
License	\$126,236	34.4	% \$116,743	37.6	%	\$9,493
Maintenance and other	202,811	55.2	174,800	56.3		28,011
Subscription	38,446	10.5	18,732	6.0		19,714
Total revenue	367,493	100.0	310,275	100.0		57,218
Cost of revenue	40,497	11.0	32,504	10.5		7,993
Gross profit	326,996	89.0	277,771	89.5		49,225
Operating expenses:						
Sales and marketing	131,117	35.7	106,772	34.4		24,345
Research and development	48,957	13.3	41,784	13.5		7,173
General and administrative	58,355	15.9	57,466	18.5		889
Total operating expenses	238,429	64.9	206,022	66.4		32,407
Operating income	88,567	24.1	71,749	23.1		16,818
Other income (expense):						
Interest income	313	0.1	246	0.1		67
Interest expense	(470)	(0.1)	(577)	(0.2)		107
Other income, net	2,991	0.8	446	0.1		2,545
Total other income	2,834	0.8	115	—		2,719
Income before income taxes	91,401	24.9	71,864	23.2		19,537
Income tax expense	24,077	6.6	16,718	5.4		7,359
Net income	\$67,324	18.3	% \$55,146	17.8	%	\$12,178

Revenue

Revenue increased \$57.2 million, or 18.4%, in the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014. Total revenue by product group was \$206.6 million and \$184.9 million for network management, \$112.6 million and \$96.3 million for systems and application management and \$48.3 million and \$29.1 million for our MSP and cloud products for the nine months ended September 30, 2015 and 2014, respectively.

Revenue from our international subsidiaries was 25.6% and 27.1% of total revenue in the first three quarters of 2015 and 2014, respectively. Revenue from our international subsidiaries decreased as a percentage of revenue in the first three quarters of 2015 as compared to the first three quarters of 2014 primarily due to the strengthening of the U.S. dollar against international

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currencies, which resulted in reduced revenues upon translation. Other than the United States, no single country accounted for 10% or more of our total revenue during these periods.

License, Maintenance and Other Revenue

License revenue increased \$9.5 million, or 8.1%, in the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014, primarily due to increased sales of our network management products, partially offset by the effect of the weakening of most foreign currencies relative to the U.S. dollar.

Our commercial core product transaction volume grew 1.6% in the first three quarters of 2015 compared to the first three quarters of 2014. In the first three quarters of 2015, the commercial core average transaction size for new license sales was approximately \$8,300 as compared to approximately \$7,900 in the first three quarters of 2014. We calculate our average transaction size and product transaction volume growth using commercial core transactions only, which exclude any transactions that consist solely of our transactional products, our MSP products and our cloud products. Maintenance and other revenue increased \$28.0 million, or 16.0%, in the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014, due to a growing maintenance renewal customer base and an increase in new license sales, which drives new maintenance revenue, partially offset by the effect of the weakening of most foreign currencies relative to the U.S. dollar. We have maintained high customer retention and have continued to increase our renewal base each quarter.

Subscription Revenue

Subscription revenue increased \$19.7 million, or 105.2%, primarily due to the growth in sales of subscriptions of our MSP products and the addition of our cloud products combined with high customer retention. These increases were partially offset by the effect of the weakening of most foreign currencies relative to the U.S. dollar.

Cost of Revenue

Cost of revenue increased \$8.0 million, or 24.6%, in the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014.

Cost of License, Maintenance and Other Revenue. Cost of license revenue increased by \$0.6 million in the first three quarters of 2015 compared to the first three quarters of 2014, primarily due to the amortization of acquired developed product technologies. Cost of maintenance revenue increased \$1.7 million primarily due to increased personnel costs, which includes an increase in stock-based compensation expense of \$0.3 million.

Cost of Subscription Revenue. Cost of subscription revenue increased by \$5.6 million in the first three quarters of 2015 compared to the first three quarters of 2014. The increase was primarily due to a \$2.5 million increase in royalty, hosting and server fees related to our subscription products, a \$2.0 million increase in amortization of our acquired developed product technologies and a \$1.1 million increase in personnel costs, which includes a \$0.2 million increase in stock-based compensation expense.

Operating Expenses

Sales and Marketing. Sales and marketing expenses increased \$24.3 million, or 22.8%, in the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014. Marketing program costs increased \$11.9 million due to the increased investment in demand generation and brand awareness in an effort to improve and better capture the demand for our products. Our sales and marketing personnel costs increased \$10.8 million, which includes an increase of \$2.9 million in stock-based compensation expense, primarily due to the increase in headcount on our sales and maintenance renewal teams, and to a lesser extent, our marketing teams. Our sales expense, which includes maintenance renewals, remained consistent as a percentage of revenue in the first three quarters of 2015 as compared to the same period in 2014.

Research and Development. Research and development expenses increased \$7.2 million, or 17.2%, in the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014, primarily due to the addition of product development personnel in order to add new technology, features and functions to our portfolio of products. We increased our research and development headcount through both organic growth and acquisitions. Due to this growth, our personnel costs increased \$9.2 million, including a \$3.6 million increase in stock-based compensation expense, offset by a \$2.2 million decrease in contract services in the first three quarters of 2015 as compared to the first three quarters of 2014.

General and Administrative. General and administrative expenses increased \$0.9 million, or 1.5%, in the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014. This increase was primarily due to a \$5.8 million increase in personnel costs, which includes an increase in stock-based compensation expense of \$3.0 million and a \$1.3 million increase in acquisition related costs, primarily related to deferred compensation expense. In addition, other

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expenses, including professional fees and travel costs, increased \$0.9 million. These increases were offset by a \$7.3 million decrease in lease abandonment charges that were recorded in the second quarter of 2014.

Income Tax Expense

Our income tax expense increased by \$7.4 million in the nine months ended September 30, 2015 as compared to the same period in 2014. Our effective tax rate increased from 23.3% in the nine months ended September 30, 2014 to 26.3% in the nine months ended September 30, 2015, generally due to an increase in permanent items that are non-deductible for tax purposes.

Non-GAAP Financial Measures

In addition to disclosing financial measures prepared in accordance with GAAP, this Form 10-Q includes the following financial measures which are non-GAAP financial measures under SEC rules: (i) non-GAAP operating income and non-GAAP operating margin; (ii) non-GAAP net income; and (iii) non-GAAP diluted earnings per share. Each of these financial measures excludes the impact of certain items and therefore has not been calculated in accordance with GAAP. In this report, these non-GAAP financial measures typically exclude stock-based compensation expense and related employer-paid payroll taxes; amortization of intangible assets; acquisition related adjustments, including contingent consideration fair value adjustments; and restructuring charges. Each of these non-GAAP adjustments is described in more detail below. In addition to these adjustments, management may include or exclude additional items from these or similar non-GAAP financial measures in future periods to the extent that management believes such items may not be indicative of our core business. A reconciliation of each of these non-GAAP financial measures to its most comparable GAAP financial measure is also included below.

We believe that these non-GAAP financial measures provide meaningful supplemental information regarding our operating results because they exclude certain amounts that our management and board of directors do not consider part of core operating results when assessing our operational performance, allocating resources, preparing annual budgets and determining employee incentive compensation. Accordingly, these non-GAAP financial measures may provide insight to investors into the motivation and decision-making of management in operating the business. In addition, by comparing our non-GAAP financial measures in different historical periods, our investors can evaluate our operating results without the additional variations of certain items that may not be indicative of our core operations, including stock-based compensation expense, which is a non-cash expense that we believe is not a key measure of our operations.

While we believe that these non-GAAP financial measures provide useful supplemental information, there are limitations associated with the use of these non-GAAP financial measures. These non-GAAP financial measures are not prepared in accordance with GAAP, do not reflect a comprehensive system of accounting and may not be comparable to similarly titled measures of other companies due to potential differences in their financing and accounting methods, the book value of their assets, their capital structures, the method by which their assets were acquired and the manner in which they define non-GAAP measures. Items such as the amortization of intangible assets, stock-based compensation expense and related employer-paid payroll taxes, acquisition related adjustments and restructuring charges, as well as the related tax impacts of these items can have a material impact on operating and net income. As a result, these non-GAAP financial measures have limitations and should not be considered in isolation from, or as a substitute for, their most comparable GAAP measures. We compensate for these limitations by using these non-GAAP financial measures as supplements to GAAP financial measures and by reconciling the non-GAAP financial measures to their most comparable GAAP financial measure. Investors are encouraged to review the reconciliations of these non-GAAP financial measures to their most comparable GAAP financial measures below. For a detailed explanation of the adjustments made to comparable GAAP financial measures, the reasons why management uses these measures and the usefulness of these measures, see footnotes (1)—(6) below.

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Non-GAAP Operating Income and Non-GAAP Operating Margin

(in thousands, except percentages)	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2015	2014	2015	2014	
GAAP operating income	\$36,524	\$31,711	\$88,567	\$71,749	
Amortization of intangible assets (1)	8,479	7,981	25,099	23,127	
Stock-based compensation expense and related employer-paid payroll taxes (2)	12,803	8,770	38,827	28,171	
Acquisition related adjustments (3)	77	2,510	5,233	3,905	
Restructuring charges (4)	—	25	(327)	7,506)
Non-GAAP operating income	\$57,883	\$50,997	\$157,399	\$134,458	
GAAP operating margin	27.7	% 28.1	% 24.1	% 23.1	%
Non-GAAP operating margin	44.0	% 45.2	% 42.8	% 43.3	%

Non-GAAP operating income increased for the three and nine months ended September 30, 2015 as compared to the same periods in 2014 primarily due to year-over-year increases in the sales of our products offset by the additional investment in our sales and marketing teams.

Stock-based compensation expense and related employer-paid payroll taxes increased in the third quarter and the first three quarters of 2015 as compared to the same periods in 2014, primarily due to increased share-based incentive awards issued to employees and, to a lesser extent, the awards to employees added through organic growth and acquisitions. Our acquisition related adjustments decreased in the three months ended September 30, 2015 and increased in the nine months ended September 30, 2015, primarily due to deferred compensation expense recognized in the respective periods related to acquisitions. Our restructuring charges in the first three quarters of 2014 primarily related to a lease abandonment charge related to our former corporate headquarters.

Non-GAAP Net Income and Non-GAAP Diluted Earnings Per Share

(in thousands, except per share information)	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2015	2014	2015	2014	
GAAP net income	\$27,013	\$24,121	\$67,324	\$55,146	
Amortization of intangible assets (1)	8,479	7,981	25,099	23,127	
Stock-based compensation expense and related employer-paid payroll taxes (2)	12,803	8,770	38,827	28,171	
Acquisition related adjustments (3)	77	2,510	5,233	3,905	
Restructuring charges (4)	—	25	(327)	7,506)
Tax benefits associated with above adjustments (5)	(5,902)	(4,843)	(17,426)	(16,674))
Non-GAAP net income	\$42,470	\$38,564	\$118,730	\$101,181	
Weighted average number of shares used in computing diluted earnings per share	74,476	76,463	76,354	76,321	
GAAP diluted earnings per share	\$0.36	\$0.32	\$0.88	\$0.72	
Non-GAAP diluted earnings per share (6)	\$0.57	\$0.50	\$1.55	\$1.33	

Non-GAAP net income for the three and nine months ended September 30, 2015 increased as compared to the same periods in 2014, primarily due to the increases in non-GAAP operating income discussed above and the income tax effects associated with the non-GAAP adjustments.

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Non-GAAP Footnotes:

(1) Amortization of Intangible Assets. We provide non-GAAP information that excludes expenses for the amortization of intangible assets that primarily relate to purchased intangible assets associated with our acquisitions. We believe that eliminating this expense from our non-GAAP measures is useful to investors, because the amortization of intangible assets can be inconsistent in amount and frequency and is significantly impacted by the timing and magnitude of our acquisition transactions, which also vary in frequency from period to period. Accordingly, we analyze the performance of our operations in each period without regard to such expenses.

(2) Stock-Based Compensation Expense and Related Employer-Paid Payroll Taxes. We provide non-GAAP information that excludes expenses for stock-based compensation and related employer-paid payroll taxes. We believe the exclusion of these items allows for financial results that are more indicative of our continuing operations. We believe that the exclusion of stock-based compensation expense provides for a better comparison of our operating results to prior periods and to our peer companies as the calculations of stock-based compensation vary from period to period and company to company due to different valuation methodologies, subjective assumptions and the variety of award types. Employer-paid payroll taxes on stock-based compensation is dependent on our stock price and the timing of the taxable events related to the equity awards, over which our management has little control, and does not correlate to the core operation of our business. Because of these unique characteristics of stock-based compensation and the related employer-paid payroll taxes, management excludes these expenses when analyzing the organization's business performance.

(3) Acquisition Related Adjustments. We exclude certain expense items resulting from acquisitions including the following, when applicable: (i) amortization of purchased intangible assets associated with our acquisitions (see Note 1 for further discussion); (ii) legal, accounting and advisory fees to the extent associated with acquisitions; (iii) changes in fair value of contingent consideration; (iv) costs related to due diligence and integrating the acquired businesses; (v) deferred compensation expense related to acquisitions; and (vi) restructuring costs, including adjustments related to changes in estimates, related to acquisitions. We consider these adjustments, to some extent, to be unpredictable and dependent on a significant number of factors that are outside of our control. Furthermore, acquisitions result in operating expenses that would not otherwise have been incurred by us in the normal course of our organic business operations, with respect to each acquisition. We believe that providing non-GAAP information for acquisition related expense items in addition to the corresponding GAAP information allows the users of our financial statements to better review and understand the historical and current results of our continuing operations, and also facilitates comparisons to our historical results and results of less acquisitive peer companies, both with and without such adjustments.

(4) Restructuring Charges. We provide non-GAAP information that excludes restructuring charges such as severance, relocation and benefits and the estimated costs of exiting and terminating facility lease commitments, including accelerated depreciation on leasehold improvements and fixed assets, as they relate to our corporate restructuring and exit activities. These restructuring charges are inconsistent in amount and are significantly impacted by the timing and nature of these events. Therefore, although we may incur these types of expenses in the future, we believe that eliminating these charges for purposes of calculating the non-GAAP financial measures facilitates a more meaningful evaluation of our current operating performance and comparisons to our past operating performance.

(5) Income Tax Effect of Non-GAAP Exclusions. We believe providing financial information with and without the income tax effect of excluding items related to our non-GAAP financial measures provide our management and users of the financial statements with better clarity regarding the ongoing performance and future liquidity of our business.

(6) Non-GAAP Diluted Earnings Per Share Item. We provide non-GAAP diluted earnings per share. The non-GAAP diluted earnings per share amount was calculated based on our non-GAAP net income and the shares used in the computation of GAAP diluted earnings per share.

Liquidity and Capital Resources

Cash and cash equivalents and short-term and long-term investments were \$199.2 million as of September 30, 2015. Our international subsidiaries held approximately \$131.0 million of cash and cash equivalents, of which 82.1% was

held in Euros as of September 30, 2015. If we were to repatriate any cash and cash equivalents held by our international subsidiaries to our domestic operations, we would incur a U.S. federal income tax liability that is not currently accrued in our condensed consolidated financial statements.

Our available cash and cash equivalents are primarily held in bank deposits and money market funds at September 30, 2015. Our short-term and long-term investments, classified as available-for-sale securities, consist of corporate bonds held in investment accounts in the United States.

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Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds. The balances held in our demand deposit accounts in the United States may exceed the Federal Deposit Insurance Corporation, or FDIC, insurance limits. While we monitor the balances in our accounts and adjust the balances as appropriate, these balances could be impacted by adverse conditions in the financial markets or by failure of the underlying depository institutions or guarantors. We strive to maintain our cash deposits, money market funds and investments with multiple financial institutions of reputable credit quality and, therefore, bear minimal credit risk. We actively monitor the third party depository institutions that hold our cash, cash equivalents and investments. To date, we have experienced no loss or lack of access to our invested cash, cash equivalents, and investments; however, we can provide no assurances that access to our funds will not be impacted by future adverse conditions.

Summarized cash flow information is as follows:

(in thousands)	Nine Months Ended September 30,	
	2015	2014
Net cash provided by operating activities	\$ 150,297	\$ 147,844
Net cash used in investing activities	(100,440)	(70,252)
Net cash used in financing activities	(109,451)	(41,865)
Effect of exchange rate changes	(5,757)	(6,497)
Net increase (decrease) in cash and cash equivalents	(65,351)	29,230
Operating Activities		

The increase of \$2.5 million in cash provided by operating activities for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 is primarily related to an increase in net income and adjustments to net income for non-cash expenses, such as stock-based compensation and deferred taxes, offset by cash outflows for changes in operating assets and liabilities primarily related to a decrease in accrued liabilities and other. The change in cash flows relating to operating activities resulted from changes in operating assets and liabilities and is primarily driven by the sales of our software and maintenance renewals. The significant changes in operating assets and liabilities include the following:

Deferred revenue increased to \$188.5 million at September 30, 2015 as compared to \$163.4 million at December 31, 2014, resulting in an increase in operating liabilities and reflecting a cash inflow of \$28.3 million for the nine months ended September 30, 2015. The cash inflow resulting from the change in deferred revenue differs from the change in the deferred revenue from the condensed consolidated balance sheets because the cash flow excludes the impact of changes in foreign currency exchange rates used to translate the balances from our foreign subsidiaries' functional currency into U.S. dollars and deferred revenue from acquisitions. Deferred revenue primarily consists of billings and payments received in advance of revenue recognition from maintenance fees.

Accrued liabilities and other decreased to \$24.4 million at September 30, 2015 as compared to \$35.3 million at December 31, 2014, resulting in a decrease in operating liabilities and reflecting a cash outflow of \$11.7 million for the nine months ended September 30, 2015. This decrease in accrued liabilities and resulting cash outflow was primarily a result of a decrease in accrued annual bonuses, along with a decrease in deferred compensation accrued related to acquisitions and payment of the lease termination settlement in the second quarter of 2015 related to our former corporate headquarters.

Changes in our income tax receivable and payable balances are also significant components of our cash flows from operating activities. Net cash provided by operating activities was reduced by income tax payments of \$16.2 million in the nine months ended September 30, 2015 and \$12.8 million in the nine months ended September 30, 2014.

Accounts receivable increased to \$54.3 million at September 30, 2015 as compared to \$50.8 million at December 31, 2014, resulting in an increase in operating assets and reflecting a cash outflow of \$5.9 million for the nine months ended September 30, 2015. Our accounts receivable balance fluctuates from period to period depending on the timing of our sales, cash collections and changes to our allowance for doubtful accounts, which affects our cash flow from operating activities. We have historically had insignificant write-offs related to bad debts. The allowance for doubtful accounts was \$0.5 million and \$0.7 million at September 30, 2015 and 2014, respectively. We use days sales outstanding, or DSO, calculated on a quarterly basis, as a measurement of the quality and status of our receivables.

We define DSO as (a) accounts receivable divided by (b) total revenue for the most recent quarter, multiplied by (c) the number of days in the quarter. Our DSO was 37.9 days and 38.9 days at September 30, 2015 and 2014, respectively.

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Investing Activities

Net cash used in investing activities for the nine months ended September 30, 2015 was primarily related to \$90.0 million of cash used for acquisitions (refer to Note 2, Acquisitions, in the Notes to the Condensed Consolidated Financial Statements in Item 1 of Part I, for additional details) and \$13.1 million of cash used to purchase property and equipment, offset by \$8.7 million of proceeds from maturities of investments. The purchases of property and equipment primarily related to leasehold improvements and purchases of equipment and furniture related to the expansion of our offices in North America. We received \$3.4 million in tenant improvement allowances related to the purchase of leasehold improvements during the first three quarters of 2015.

Net cash used in investing activities for the nine months ended September 30, 2014 was primarily related to \$63.7 million of cash used for the acquisition of Pingdom and \$16.8 million of cash used to purchase property and equipment, offset by \$13.5 million in proceeds from maturities of investments. The purchases of property and equipment primarily related to leasehold improvements and other additions to our new corporate headquarters. We received \$7.1 million in tenant improvement allowances related to the purchase of leasehold improvements during the first three quarters of 2014.

We expect our capital expenditures to be approximately \$3 to \$4 million for the remaining three months of 2015 and approximately \$14 to \$18 million in fiscal year 2016, primarily related to purchases of leasehold improvements, equipment, software and furniture in our domestic and international office locations to support their continued growth.

Financing Activities

Net cash used in financing activities for the nine months ended September 30, 2015 was primarily related to repurchases of common stock of \$210.2 million and the repayment of borrowings under our Credit Agreement of \$10.0 million, offset by \$100.0 million of proceeds received from borrowings under our Credit Agreement.

The stock repurchases were related to 5.0 million shares of our common stock repurchased under our share repurchase program announced in July 2015 for an aggregate purchase price including fees and commissions of \$200.1 million and \$10.1 million for shares withheld and retired to satisfy tax withholding requirements related to the settlement of restricted stock units during the period.

In July 2015, we announced that our Board of Directors had approved a share repurchase program, authorizing us to purchase up to \$200.0 million of our outstanding common stock in the open market. Our share repurchase program was completed in August 2015. Purchases under our share repurchase program were made in the open market in accordance with Rule 10b-18 of the Exchange Act and were funded using a combination of our cash on hand, cash generated from operations and borrowings under our Credit Agreement. Shares were retired upon repurchase.

In August 2015, we borrowed \$100.0 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 our share repurchase program and for general corporate purposes. In September 2015, we repaid \$10.0 million of the outstanding borrowings. See Note 5, Credit Agreement, in the Notes to Condensed Consolidated Financial Statements, for additional information regarding our Credit Agreement.

Net cash used in financing activities for the nine months ended September 30, 2014 was primarily related to the repayment of borrowings under our Credit Agreement of \$40.0 million and repurchases of common stock of \$13.2 million. These repurchases were related to 0.2 million shares of our common stock repurchased under our share repurchase program announced in July 2013 for an aggregate purchase price of \$7.5 million and \$5.7 million of shares withheld and retired for tax withholding requirements on restricted stock units. The cash outflows were offset by \$6.0 million of proceeds from the exercise of employee stock options and the excess tax benefit related to stock option exercises of \$5.3 million, which is a reduction in cash payments related to income taxes.

Anticipated Cash Flows

We believe that our existing cash and cash equivalents, our cash flows from operating activities and our borrowing capacity under our Credit Agreement will be sufficient to fund our operations and our commitments for capital expenditures for at least the next 12 months.

Our Credit Agreement, which we entered into on October 4, 2013 with a syndicated group of lenders, provides for an unsecured \$125.0 million five-year revolving credit facility that is comprised of revolving loans and swingline loans and, subject to certain requirements, may be increased up to an additional \$75.0 million for a maximum aggregate

commitment of \$200.0 million. As of September 30, 2015, \$90.0 million of the borrowings remained outstanding under the facility and we were in compliance with all covenants associated with the Credit Agreement. See Note 5, Credit Agreement, in the Notes to Condensed Consolidated Financial Statements, for additional information regarding our Credit Agreement.

Although we are not currently a party to any material definitive agreement regarding our potential investments in, or acquisitions of, complementary businesses, applications or technologies, we may enter into these types of arrangements, which

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could reduce our cash and cash equivalents, require us to seek additional equity or debt financing or repatriate cash generated by our international operations that would cause us to incur a U.S. federal income tax liability. Additional funds from financing arrangements may not be available on terms favorable to us or at all.

Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our sales and marketing activities, the timing and extent of spending to support product development efforts and expansion into new territories, the timing of any acquisitions to expand our business, the timing of expansions to our office facilities, the timing of introductions of new software products and enhancements to existing software products, and the continuing market acceptance of our software offerings. We 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 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, LLC, our principal operating subsidiary. The specific terms of any offerings of securities under the automatic shelf registration statement will be provided in one or more supplements to the prospectus to be filed by us in connection with any future offering.

Contractual Obligations and Commitments

As of September 30, 2015, with the exception of our operating leases, there have been no material changes in our contractual obligations and commitments that were disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

In April 2015, we signed an amendment to the lease of our corporate headquarters in Austin, Texas to lease additional office space beginning in 2017. The amendment increases our expected lease payments by approximately \$2.5 million for the year ending December 31, 2017, \$3.3 million for the year ending December 31, 2018, \$3.4 million for the year ending December 31, 2019 and \$37.4 million for the years ending thereafter through the expiration of the lease in March 2028. See Note 8, Commitment and Contingencies, in the Notes to the Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q, for further discussion.

Critical Accounting Policies and Estimates

Our condensed consolidated financial statements are prepared in conformity with United States of America generally accepted accounting principles, or GAAP, and require our management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many instances, we could reasonably use different accounting estimates, and in some instances, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are differences between our estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected, perhaps materially.

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application, while in other cases, management's judgment is required in selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. We believe that these accounting policies requiring significant management judgment and estimates are critical to understanding our historical and future performance, as these policies relate to the more significant areas of our financial results. These critical accounting policies are:

- Valuation of goodwill, intangibles, long-lived assets and contingent consideration, including accrued earnouts;
- Revenue recognition;
- Stock-based compensation;
- Income taxes; and
- Loss contingencies.

A full description of our critical accounting policies that involve significant management judgment appears in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014 filed with the Securities and Exchange Commission on February 23, 2015 under the heading “Management’s Discussion and Analysis of Financial Condition and Results of

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Operations—Critical Accounting Policies and Estimates.” There have been no material changes to our critical accounting policies and estimates since that time.

Recent Accounting Pronouncements

See Note 1, Summary of Significant Accounting Policies, in the Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q, for a full description of recent accounting pronouncements, which is incorporated herein by reference.

Off-Balance Sheet Arrangements

During the first three quarters of 2015, we did not have any relationships with unconsolidated organizations or financial partnerships, such as structured finance or special purpose entities, that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

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Item 3: Quantitative and Qualitative Disclosures About Market Risk

We are exposed to certain financial market risks, including the following:

Interest Rate Risk

We had cash and cash equivalents of \$172.6 million and \$237.9 million at September 30, 2015 and December 31, 2014, respectively. We also had total short-term and long-term investments classified as available-for-sale securities of \$26.6 million and \$29.8 million at September 30, 2015 and December 31, 2014, respectively. Our cash and cash equivalents consist primarily of bank deposits and money market funds, and our available-for-sale securities consist of corporate bonds held in investment accounts in the United States. We hold cash, cash equivalents and available-for-sale securities for working capital purposes. Our investments are made for capital preservation purposes, and we do not enter into investments for trading or speculative purposes.

We do not have material exposure to market risk with respect to our cash and cash equivalents, as these consist primarily of highly liquid investments purchased with original maturities of three months or less at September 30, 2015. Our portfolio of available-for-sale securities classified as investments is subject to market risk due to changes in interest rates. Changes in interest rates could impact our future investment income, or we may suffer losses in principal if we are forced to sell securities that decline in market value due to changes in interest rates. However, because we classify our investment securities as “available for sale,” no gains or losses are recognized due to changes in interest rates unless such securities are sold prior to maturity or declines in fair value are determined to be other-than-temporary.

We have interest rate risk relating to the associated interest expense under our Credit Agreement, which has the option to be indexed to Wells Fargo Bank’s prime rate, the federal funds rate or LIBOR. However, due to the short-term nature and notional amount of our variable rate obligations, a hypothetical increase of 100 basis points on an annual basis would not have a material impact on our interest expense or cash flows. See Note 5, Credit Agreement, in the Notes to Condensed Consolidated Financial Statements for additional information regarding our Credit Agreement.

Foreign Currency Risk

As a global company, we face exposure to adverse movements in foreign currency exchange rates. Our revenue from our international subsidiaries was approximately 25.6% of our total revenue for the nine months ended September 30, 2015. The foreign currencies that we invoice and on which we collect are primarily the Euro, British Pound Sterling and Australian Dollar. Expenses incurred by our international subsidiaries are, generally, denominated in the local currency of the subsidiary. Our condensed consolidated statements of income are translated into U.S. dollars at the average exchange rates in each applicable period. To the extent the U.S. dollar strengthens against foreign currencies, the translation of these foreign currency denominated transactions results in reduced revenues, operating expenses and net income for our international operations. Similarly, our revenues, operating expenses and net income will increase for our international operations if the U.S. dollar weakens against foreign currencies.

We utilize purchased foreign currency forward contracts to minimize our foreign exchange exposure on certain foreign balance sheet positions denominated in currencies other than the Euro. We do not enter into any derivative financial instruments for trading or speculative purposes. Our objective in managing our exposure to foreign currency exchange rate fluctuations is to reduce the impact of adverse fluctuations in such exchange rates on our earnings and cash flow. The notional amounts and currencies underlying our foreign currency forward contracts will fluctuate period to period as they are principally dependent on the balances of the balance sheet positions that are denominated in currencies other than the Euro held by our global entities. There can be no assurance that our foreign currency hedging activities will substantially offset the impact of fluctuation in currency exchange rates on our results of operations and functional positions. As of September 30, 2015, we did not have any forward contracts outstanding and while we do not have a formal policy to settle all derivatives prior to the end of each quarter, our current practice is to do so. The effect of derivative instruments on our condensed consolidated statements of income was insignificant for the first three quarters of 2015.

We are exposed to credit-related losses in the event of non-performance by counterparties to derivative financial instruments, but we do not expect any counterparties to fail to meet their obligations given their high credit ratings. In addition, we diversify this risk across several counterparties and actively monitor their ratings.

We are also exposed to foreign exchange rate fluctuations as we translate or remeasure the financial statements of our foreign subsidiaries into U.S. dollars in consolidation. If there is a change in foreign currency exchange rates, the conversion of the foreign subsidiaries' financial statements into U.S dollars will lead to remeasurement gains and losses recorded in income, or translation gains or losses that are recorded as a component of accumulated other comprehensive income (loss).

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Item 4: Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer, our Chief Financial Officer and Chief Accounting Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2015. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2015, our Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer concluded that, as of such date, our disclosure controls and procedures were effective at a reasonable assurance level.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we have been and may be involved in various legal proceedings and claims arising in our ordinary course of business. At this time, neither we nor any of our subsidiaries is a party to, and none of our respective property is the subject of, any material legal proceeding. However, the outcome of legal proceedings and claims brought against us are subject to significant uncertainty. Therefore, 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 consolidated financial statements for a particular period could be materially adversely affected. See the risk factor "Litigation exposure related to our pending and any future litigation could adversely affect our results of operations, profitability and cash flows" in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014 under the heading "Risk Factors."

Item 1A. Risk Factors

If the Merger contemplated by the Merger Agreement does not occur, it could have a material adverse effect on our business, results of operations, financial condition and stock price.

On October 21, 2015, we agreed to merge with a subsidiary of Project Aurora Holdings, LLC, an entity formed by affiliates of private equity investment firms Silver Lake Partners and Thoma Bravo. Completion of the proposed Merger is subject to the satisfaction of various conditions, including the receipt of approvals from our stockholders and from government or regulatory agencies. There is no assurance that all of the various conditions will be satisfied, or that the Merger will be completed on the proposed terms, within the expected timeframe, or at all.

The proposed Merger gives rise to inherent risks that include:

- if the Merger is not completed, the share price of our common stock will change to the extent that the current market price of our stock reflects an assumption that the Merger will be completed;
- the amount of the cash to be paid under the Merger agreement is fixed and will not be adjusted for changes in our business, assets, liabilities, prospects, outlook, financial condition or results of operations or in the event of any change in the market price of, analyst estimates of, or projections relating to, our common stock;
- legal or regulatory proceedings, including regulatory approvals from various domestic and foreign governmental entities (including any conditions, limitations or restrictions placed on these approvals) and the risk that one or more governmental entities may delay or deny approval, or other matters that affect the timing or ability to complete the transaction as contemplated;
- the ability of Thoma Bravo, Silver Lake and their affiliates to obtain the necessary funds to complete the Merger;
- the possibility of disruption to our business, including increased costs and diversion of management time and resources;
- difficulties maintaining business and operational relationships, including relationships with customers, vendors, suppliers, distributors, resellers and other business partners;
- the inability to attract and retain key personnel pending consummation of the proposed Merger;
- potential stockholder litigation relating to the Merger could prevent or delay the Merger or otherwise negatively impact our business and operations;
- the inability to pursue alternative business opportunities or make changes to our business pending the completion of the proposed Merger;
- the requirement to pay a termination fee of \$159.0 million if we terminate the Merger Agreement under certain circumstances;
- developments beyond our control including, but not limited to, changes in domestic or global economic conditions that may affect the timing or success of the proposed Merger; and
- the risk that if the proposed Merger is not completed, the market price of our common stock could decline, investor confidence could decline, stockholder litigation could be brought against us, relationships with customers, suppliers and other business partners may be adversely impacted, we may be unable to retain key personnel, and profitability may be adversely impacted due to costs incurred in connection with the proposed Merger.

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There have been no other material changes from the risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

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

Period	Number of Shares Purchased	Average Price Paid Per Share (1)	Total Number of Shares Purchased as Part of a Publicly Announced Plan or Program (2)	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plan or Program (in thousands) (1), (2)
July 1-31, 2015	1,964,679	\$38.95	1,964,679	\$123,477
August 1-31, 2015	3,003,691	41.11	3,003,691	—
September 1-30, 2015	—	—	—	—
Total	4,968,370	\$40.25	4,968,370	—

(1) Amounts exclude fees and commissions associated with the share repurchases.

In July 2015, we announced that our Board of Directors approved a share repurchase program, authorizing us to purchase up to \$200.0 million of our outstanding common stock in the open market. Our share repurchase program (2) was completed in August 2015. Purchases under our share repurchase program were made in the open market in accordance with Rule 10b-18 under the Exchange Act. The shares were retired upon repurchase.

Item 5. Other Information
Section 13(r) Disclosure

The following activities are disclosed as required by Section 13(r)(1)(D) of the Exchange Act:

During our routine internal quarterly review of transactions, we discovered that we sold certain perpetual license software products and maintenance services through a third party reseller in January 2015 to Bank Melli Iran, an entity designated by the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) as an entity owned or controlled by the Government of Iran and blocked pursuant to Executive Order No. 13382. The transaction was consummated with a third party reseller located in Dubai, United Arab Emirates and we received payment of \$29,733 for the sale of the software and maintenance services. At the time of fulfillment, the name and location of the end user was supplied to us as Bank Melli Iran located in Dubai, United Arab Emirates. Upon further diligence in our internal quarterly review, we recognized that the customer was blocked and immediately ceased providing all ongoing maintenance services, including access to receive updated versions of the software and support services. We therefore have no further obligations to Bank Melli Iran and do not intend to continue providing them with software or services in the future. We have voluntarily filed appropriate disclosure with OFAC and the U.S. Department of Commerce, Bureau of Industry and Security.

Item 6. Exhibits

See the Exhibit Index following the signature page to this Quarterly Report on Form 10-Q for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.

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SOLARWINDS, INC.

SIGNATURE

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.

SOLARWINDS, INC.

Dated: November 9, 2015

By: /s/ JASON REAM

Jason Ream
Executive Vice President, Finance and Chief Financial
Officer
(on behalf of the Registrant and as principal financial
officer)

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EXHIBIT INDEX

Exhibit No.	Exhibit Description	Provided Herewith	Incorporated by Reference			Filing Date
			Form	SEC File No.	Exhibit	
2.1	Agreement and Plan of Merger, dated as of October 21, 2015, by and among Project Aurora Holdings, LLC, Project Aurora Merger Corp., and Registrant		8-K/A	001-34358	2.1	10/27/2015
3.1	Amended and Restated Certificate of Incorporation of the Registrant		S-1/A	333-162661	3.1	11/5/2009
3.2	Amended and Restated Bylaws of the Registrant		8-K	001-34358	3.1	9/24/2013
3.3	Amendment to the Amended and Restated Bylaws of Registrant		8-K	001-34358	3.1	10/21/2015
10.1	Form of Option Award Agreement under 2015 Performance Incentive Plan #	*				
10.2	Form of Restricted Stock Unit Award Agreement under 2015 Performance Incentive Plan #	*				
31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	*				
31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	*				
31.3	Certification of Chief Accounting Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	*				
32.1	Certifications of Chief Executive Officer, Chief Financial Officer and Chief Accounting Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	**				
101.INS	XBRL Instance Document	*				
101.SCH	XBRL Taxonomy Extension Schema Document	*				
101.CAL	XBRL Taxonomy Calculation Linkbase Document	*				
101.DEF	XBRL Taxonomy Definition Linkbase Document	*				

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101.LAB	XBRL Taxonomy Label Linkbase Document	*
101.PRE	XBRL Taxonomy Presentation Linkbase Document	*

Indicates management contract or compensatory plan or arrangement.
* Filed herewith
** Furnished herewith