STAMPS.COM INC
Form 10-Q
November 07, 2014
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
p QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF p 1934

For the quarterly period ended September 30, 2014

OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF ${ }^{\circ} 1934$

For the transition period from $\qquad$ to $\qquad$
Commission file number: 000-26427
Stamps.com Inc.
(Exact name of registrant as specified in its charter)

$$
\begin{array}{ll}
\text { Delaware } & 77-0454966 \\
\text { (State or other jurisdiction of incorporation or organization) } & \text { (I.R.S. Employer Identification No.) }
\end{array}
$$

1990 E. Grand Avenue
El Segundo, California 90245
(Address of principal executive offices, including zip code)
(310) 482-5800
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes p 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 p 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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b 2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer p
Non-accelerated filer o (Do not check if a smaller reporting company) Smaller reporting company o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes - No b
-As of October 31, 2014, there were $15,910,545$ shares of the Registrant's Common Stock issued and outstanding.

STAMPS.COM INC. AND SUBSIDIARIES
FORM 10-Q QUARTERLY REPORT FOR THE QUARTER ENDED SEPTEMBER 30, 2014
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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
STAMPS.COM INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

|  | September <br> 30, <br> 2014 <br> (unaudited) | $\begin{aligned} & \text { December } \\ & 31, \\ & 2013 \end{aligned}$ |
| :---: | :---: | :---: |
| Assets |  |  |
| Current assets: |  |  |
| Cash and cash equivalents | \$ 27,659 | \$66,674 |
| Short-term investments | 4,038 | 6,524 |
| Accounts receivable, net | 10,545 | 17,504 |
| Other current assets | 6,234 | 6,541 |
| Total current assets | 48,476 | 97,243 |
| Property and equipment, net | 30,783 | 29,763 |
| Goodwill | 66,824 | - |
| Intangible assets, net | 20,325 | 1,047 |
| Long-term investments | 12,815 | 14,012 |
| Deferred income taxes. | 44,241 | 40,262 |
| Other assets | 6,948 | 4,791 |
| Total assets | \$ 230,412 | \$187,118 |
| Liabilities and Stockholders' Equity |  |  |
| Current liabilities: |  |  |
| Accounts payable and accrued expenses | \$ 19,365 | \$13,928 |
| Deferred revenue | 1,886 | 1,425 |
| Contingent consideration, current | 5,962 | - |
| Total current liabilities | 27,213 | 15,353 |
| Contingent consideration, long-term | 11,140 | - |
| Total liabilities | 38,353 | 15,353 |
| Commitments and contingencies |  |  |
| Stockholders' equity: |  |  |
| Common stock, \$. 001 par value |  |  |
| Authorized shares: 47,500 in 2014 and 2013 |  |  |
| Issued shares: 28,673 in 2014 and 28,518 in 2013 |  |  |
| Outstanding shares: 15,907 in 2014 and 16,187 in 2013 | 51 | 51 |
| Additional paid-in capital | 673,986 | 668,724 |
| Accumulated deficit | (309,648) | $(337,628)$ |
| Treasury stock, at cost, 12,766 shares in 2014 and 12,331 in 2013 | (172,410 ) | $(159,522)$ |
| Accumulated other comprehensive income | 80 | 140 |
| Total stockholders' equity | 192,059 | 171,765 |
| Total liabilities and stockholders' equity | \$ 230,412 | \$187,118 |

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

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STAMPS.COM INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)
(Unaudited)

## Revenues:

Service
Product
Insurance
PhotoStamps
Other
Total revenues

| Three Months |  |  |  |
| :---: | :---: | :---: | :---: |
| Ended |  | Nine Months Ended |  |
| Septemb |  | Septem |  |
| 2014 | 2013 | 2014 | 2013 |
| \$30,057 | \$24,505 | \$82,621 | \$74,241 |
| 3,875 | 3,885 | 12,443 | 12,436 |
| 2,360 | 1,854 | 6,400 | 5,517 |
| 1,532 | 1,001 | 3,940 | 3,260 |
| 10 | - | 12 | 1 |
| 37,834 | 31,245 | 105,416 | 95,45 |

Cost of revenues (exclusive of amortization of intangible assets, which is included in general and administrative expense):

| Service | 5,123 | 3,833 | 13,941 | 12,403 |
| :--- | :--- | :--- | :--- | :--- |
| Product | 1,285 | 1,315 | 4,119 | 4,322 |
| Insurance | 843 | 659 | 2,248 | 1,976 |
| PhotoStamps | 1,293 | 777 | 3,297 | 2,623 |
| Total cost of revenues | 8,544 | 6,584 | 23,605 | 21,324 |
| Gross profit | 29,290 | 24,661 | 81,811 | 74,131 |
| Operating expenses: |  |  |  |  |
| Sales and marketing | 9,516 | 9,095 | 31,549 | 29,270 |
| Research and development | 3,407 | 2,844 | 9,359 | 8,187 |
| General and administrative | 6,191 | 3,961 | 15,738 | 11,553 |
| Contingent consideration charges | 860 | - | 860 | - |
| Total operating expenses | 19,974 | 15,900 | 57,506 | 49,010 |
| Income from operations | 9,316 | 8,761 | 24,305 | 25,121 |
|  |  |  |  |  |
| Interest and other income, net | 71 | 92 | 296 | 341 |
| Income before income taxes | 9,387 | 8,853 | 24,601 | 25,462 |
| Income tax expense (benefit) | 85 | 90 | $(3,379$ | 180 |
| Net income | $\$ 9,472$ | $\$ 8,763$ | $\$ 27,980$ | $\$ 25,282$ |
| Net income per share | $\$ 0.60$ | $\$ 0.55$ | $\$ 1.75$ | $\$ 1.63$ |
| Basic | $\$ 0.58$ | $\$ 0.53$ | $\$ 1.70$ | $\$ 1.56$ |
| Diluted |  |  |  |  |
| Weighted average shares outstanding | 15,881 | 15,816 | 16,031 | 15,545 |
| Basic | 16,258 | 16,389 | 16,433 | 16,184 |

The accompanying notes are an integral part of these consolidated financial statements.
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STAMPS.COM INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

|  | Three Months <br> Ended <br> September 30, <br> 20142013 |  | Nine Months <br> Ended <br> September 30, <br> 20142013 |  |
| :---: | :---: | :---: | :---: | :---: |
| Net income | \$9,472 | \$8,763 | \$27,980 | \$25,282 |
| Other comprehensive income: |  |  |  |  |
| Unrealized gain (loss) on investments | (37 ) |  | (60 ) | ) (92 |
| Comprehensive income | \$9,435 | \$8,774 | \$27,920 | \$25,190 |

The accompanying notes are an integral part of these consolidated financial statements.
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## Table of Contents <br> STAMPS.COM INC. AND SUBSIDIARIES <br> CONSOLIDATED STATEMENTS OF CASH FLOWS <br> (In thousands) <br> (Unaudited)

$\left.\begin{array}{lll} & \text { Nine Months } \\ & \text { Ended } \\ & \text { September } 30, \\ \text { Operating activities: } & 2014 & 2013 \\ \text { Net income } & & \\ \text { Adjustments to reconcile net income to net cash provided by operating activities: } & & \$ 27,980 \\ \text { Depreciation and amortization } & 3,193 & 1,822 \\ \text { Stock-based compensation expense } & 2,402 & 3,568 \\ \text { Deferred income tax } & (3,979) & - \\ \text { Contingent consideration } & 860 & - \\ \text { Changes in operating assets and liabilities, net of assets and liabilities acquired: } & & \\ \text { Accounts receivable } & 7,567 & 4,969 \\ \text { Other current assets } & 19 & (435 \\ \text { Other assets } & (2,157) & (771 \\ \text { Deferred revenue } & (68 & (128\end{array}\right)$

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

# Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS <br> (UNAUDITED) 

1.Summary of Significant Accounting Policies

Basis of Presentation
We prepared the consolidated financial statements included herein without audit pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with United States ("U.S.") generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to such rules and regulations. We believe that the disclosures are adequate to make the information presented not misleading. We recommend that these financial statements be read in conjunction with the audited financial statements and the notes thereto included in our latest annual report on Form 10-K for the fiscal year ended December 31, 2013, filed with the SEC on March 17, 2014.

In our opinion, these unaudited financial statements contain all adjustments (consisting of normal recurring adjustments) necessary to present fairly our financial position as of September 30, 2014 and December 31, 2013, our results of operations for the three and nine months ended September 30, 2014 and 2013, and our cash flows for the nine months ended September 30, 2014 and 2013. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

## Principles of Consolidation

The consolidated financial statements include the accounts of Stamps.com Inc., Auctane LLC, Interapptive, Inc. and PhotoStamps Inc. In June 2014, we completed our acquisition of $100 \%$ of the outstanding equity of Auctane LLC, the Texas limited liability company that operates ShipStation ("Auctane LLC" or "ShipStation") in a cash and contingent stock transaction. ShipStation, based in Austin, Texas, offers monthly subscription based e-commerce shipping software primarily under the brand ShipStation and Auctane. In August 2014, we completed our acquisition of 100\% of the outstanding equity of Interapptive, Inc., the Missouri corporation that operates ShipWorks ("Interapptive, Inc." or "ShipWorks") in a cash transaction. ShipWorks, based in St Louis, Missouri, offers monthly subscription based e-commerce shipping software. See Note 2 - "Acquisitions" for further discussion of our acquisitions.

Because $100 \%$ of the voting control of Auctane LLC and Interapptive, Inc. is held by us, we have consolidated ShipStation and ShipWorks from the date we obtained control in the accompanying consolidated financial statements. Similarly, due to our $100 \%$ control, PhotoStamps Inc. is also consolidated in the accompanying consolidated financial statements from the date of its inception. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates and Risk Management
The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates, and such differences may be material to the financial statements. Examples include estimates of loss contingencies, promotional coupon redemptions, the number of PhotoStamps retail boxes that will not be redeemed, deferred income taxes, the estimates and assumptions used to calculate the allocation of the purchase price related to our acquisitions, and estimates regarding the useful lives of our building, patents and other amortizable intangible assets.

## Contingencies and Litigation

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We are subject to various routine litigation matters as a claimant and a defendant. We record any amounts recovered in these matters when received. We record liabilities for claims against us when the loss is both probable and estimable. Amounts recorded are based on reviews by outside counsel, in-house counsel and management. Actual results could differ from estimates.

## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS <br> (UNAUDITED)

Fair Value of Financial Instruments
Carrying amounts of certain of our financial instruments, including cash, cash equivalents, accounts receivable and accounts payable, approximate fair value due to their short maturities. The fair values of investments are determined using quoted market prices for those securities or similar financial instruments.

Certain contingent consideration may be payable by us in connection with our acquisition of ShipStation. The fair value of the contingent consideration is determined using a series of options that replicate the pay-off structure of the earn-out provision in the ShipStation transaction, and the value of each of these options was determined using the Black-Scholes-Merton option pricing framework (see Note 2 - "Acquisitions" for further description).

Goodwill
Goodwill represents the excess of the fair value of consideration given over the fair value of the tangible assets, identifiable intangible assets and liabilities assumed in a business combination. We are required to test goodwill for impairment annually and whenever events or circumstances indicate the fair value of a reporting unit may be below its carrying value.

Trademarks, Patents and Intangible Assets
Acquired trademarks, patents and other intangibles include both amortizable and non-amortizable assets and are included in intangible assets, net in the accompanying consolidated balance sheets. Intangible assets are carried at cost less accumulated amortization. Cost associated with internally developed intangible assets is typically expensed as incurred as research and development costs. Amortization of amortizable intangible assets is calculated on a straight-line basis over the estimated useful lives of the assets, ranging from approximately 4 to 17 years.

Property and Equipment
We account for property and equipment at cost less accumulated depreciation and amortization. We compute depreciation using the straight-line method over the estimated useful life of the asset, generally three to five years for furniture, fixtures and equipment and ten to forty years for building and building improvements. We have a policy of capitalizing expenditures that materially increase assets' useful lives and charging ordinary maintenance and repairs to operations as incurred. When property or equipment is disposed of, the cost and related accumulated depreciation and amortization are removed, and any gain or loss is included in operations.

## Income Taxes

We account for income taxes in accordance with Financial Accounting Standards Board ("FASB") ASC Topic No. 740, Income Taxes ("ASC 740"), which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax basis of recorded assets and liabilities. ASC 740 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some or all of the net deferred tax assets will not be realized. We record a valuation allowance to reduce our gross deferred tax assets, which are primarily comprised of U.S. Federal and State tax loss carry-forwards, to the amount that is more likely than not (a likelihood of more than 50 percent) to be realized. In order for us to realize our deferred tax assets, we must be able to generate sufficient taxable income. We evaluate the appropriateness of our deferred tax assets and related valuation allowance in accordance with ASC 740 based on all available positive and negative evidence.

## Revenue Recognition

We recognize revenue from product sales or services rendered, as well as commissions from advertising or sale of products by third party vendors to our customer base when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectability is reasonably assured.

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## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS <br> (UNAUDITED)

Service revenue is primarily derived from monthly subscription and transaction fees and is recognized in the period that services are provided. Product sales, net of return allowances, are recorded when the products are shipped and title passes to customers. Sales of items, including PhotoStamps, sold to customers are made pursuant to a sales contract that provides for transfer of both title and risk of loss upon our delivery to the carrier. Return allowances for expected product returns, which reduce product revenue, are estimated using historical experience. Commissions from the advertising or sale of products by a third party vendor to our customer base are recognized when the revenue is earned and collection is deemed probable.

Customers pay face value for postage purchased for use through our PC Postage software, and the funds are transferred directly from the customers to the United States Postal Service ("USPS"). We do not recognize revenue for this postage, as it is purchased by our customers directly from the USPS.

PhotoStamps revenue, which includes the face value of postage, from the sale of PhotoStamps sheets and rolls is made pursuant to a sales contract that provides for transfer of both title and risk of loss upon our delivery to the carrier.

Sale of PhotoStamps retail boxes are initially recorded as deferred revenue. PhotoStamps revenue related to the sale of these PhotoStamps retail boxes is subsequently recognized when either: 1) the PhotoStamps retail box is redeemed, or 2) the likelihood of the PhotoStamps retail box being redeemed is deemed remote ("breakage") and there is no legal obligation to remit the value of the unredeemed PhotoStamps retail boxes.

On a limited basis, we allow third parties to offer products and promotions to our customer base. These arrangements generally provide payment in the form of a flat fee or revenue sharing arrangements where we receive payment upon customers accessing third party products and services. Total revenue from such advertising arrangements was not significant during the three and nine months ended September 30, 2014 and 2013.

We provide our customers with the opportunity to purchase parcel insurance directly through our solutions. Insurance revenue represents the gross amount charged to the customer for purchasing insurance and the related cost represents the amount paid to our insurance brokers. We recognize revenue on insurance purchases upon the ship date of the insured package.

## PhotoStamps Retail Boxes

We sell PhotoStamps retail boxes that are redeemable for PhotoStamps on our website. The PhotoStamps retail boxes are sold through various third party retail partners. Our PhotoStamps retail boxes are not subject to administrative fees on unredeemed boxes and have no expiration date. PhotoStamps retail box sales are recorded as deferred revenue. We concluded that sufficient company-specific historical evidence existed to determine the period of time after which the likelihood of the PhotoStamps retail boxes being redeemed was remote. Based on our analysis of the redemption data, we estimate that period of time to be 60 months after the sale of our PhotoStamps retail boxes.

We recognize breakage revenue related to our PhotoStamps retail boxes utilizing the redemption recognition method. Under the redemption recognition method, we recognize breakage revenue from unredeemed retail boxes in proportion to the revenue recognized from the retail boxes that have been redeemed. Revenue from our PhotoStamps retail boxes is included in PhotoStamps revenue. PhotoStamps retail box breakage revenue during the third quarter of 2014 and 2013 was not significant to our consolidated financial statements.

## Subsequent Events

We are not aware of any material subsequent events or transactions that have occurred that would require recognition in the financial statements or disclosure in the notes to the consolidated financial statements.

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Table of Contents<br>STAMPS.COM INC AND SUBSIDIARIES<br>NOTES TO CONSOLIDATED FINANCIAL STATEMENTS<br>(UNAUDITED)

## 2. Acquisitions

## ShipStation Acquisition and Contingent Consideration

On June 10, 2014, we acquired $100 \%$ of the outstanding equity of Auctane LLC, which operates ShipStation, in a cash and contingent stock transaction. ShipStation, based in Austin, Texas, offers monthly subscription based e-commerce shipping software primarily under the brand ShipStation and Auctane. ShipStation is a leading web-based shipping software solution that allows online retailers and e-commerce merchants to organize, process, fulfill and ship their orders quickly and easily. ShipStation supports automatic order importing from over 50 shopping carts and marketplaces, including eBay, Amazon, Shopify, Bigcommerce, Volusion, Squarespace and others. ShipStation offers multi-carrier shipping options, and automation features like custom hierarchical rules and product profiles that allow customers to easily and automatically optimize their shipping. Using ShipStation, an online retailer or e-commerce merchant can ship their orders from wherever they sell and however they ship.

We have accounted for the acquisition under the acquisition method of accounting in accordance with the provisions of FASB ASC Topic No. 805 Business Combinations ("ASC 805"). The total purchase price for ShipStation was approximately $\$ 66.2$ million and was comprised of the following (in thousands, except shares):

|  | Fair |
| :--- | ---: |
| Cash Consideration | Value |
| Fair value of performance linked earn-out of up to 768,900 shares of Stamps.com common stock | $\$ 50,000$ |
| (contingent consideration) | 16,242 |
| Total purchase price | $\$ 66,242$ |

The performance linked earn-out payment of Stamps.com shares (or contingent consideration) to former equity members of Auctane LLC is based on the achievement of certain financial measures within a future time period. There are two future periods in which the earn-out payment will be calculated. The first earn-out period is based on the achievement of certain financial measures during the six months ended December 31, 2014. The second earn-out period is based on the achievement of certain financial measure during the twelve months ended December 31, 2015. The range of Stamps.com shares available for the performance linked earn-out for both periods is between 576,675 to 768,900 shares provided a minimum threshold for the financial measures is achieved. The current portion of the contingent consideration represents the estimated fair value of the first earn-out. The fair value of the contingent consideration was determined based on a probability weighted method, which incorporates management's forecasts of financial measures and the likelihood of the financial measure targets being achieved using a series of options that replicate the pay-off structure of the earn-out, and the value of each of these options was determined using the Black-Scholes-Merton option pricing framework.

## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Under the acquisition method of accounting under ASC 805, the total estimated purchase price of the acquired company is allocated to the assets acquired and the liabilities assumed based on their fair values. We have made significant estimates and assumptions in determining the preliminary allocation of the purchase price. The preliminary allocation of purchase consideration is subject to change based on further review of the fair value of the assets acquired and liabilities assumed. The following table is the allocation of the purchase price (in thousands, except years):

Cash and cash equivalents
Trade accounts receivable

|  |  | Weighted <br> Average |
| :--- | :--- | :--- |
|  |  | Estimated <br> Useful |
| Fair | Fair | Life |
| Value | Value | (In Years) |
|  | $\$ 1,118$ <br> 254 |  |
|  | 29 |  |

Other assets 39
Property and equipment 187

## Goodwill

 50,544Identifiable intangible assets:
Trademark $\$ 500$
Developed technology
5,300
Non-compete agreement
400
Customer relationship
9,000
Total identifiable intangible assets
15,200 8
Accrued expenses and other liabilities
(836 )
Deferred revenue
Total purchase price
(264 )
\$66,242

Goodwill represents the excess of the fair value of consideration given over the fair value of the tangible assets, identifiable intangible assets and liabilities assumed in a business combination and the potential synergy of combining the operations of Stamps.com and ShipStation. We expect the entire amount of goodwill recorded in this acquisition will be deducted for tax purposes ratably over a 15 year period. The identified intangible assets consist of trademarks, developed technology, non-compete agreements and customer relationships. The estimated fair values of the trademark and developed technology were determined using the "relief from royalty" method. The estimated fair value of the non-compete was determined using the "with and without" method. The estimated fair value of customer relationship was determined using the "excess earnings" method. The rate utilized to discount net cash flows to their present values was approximately $15 \%$ and was determined after consideration of the overall enterprise rate of return and the relative risk and importance of the assets to the generation of future cash flows. Trademark, developed technology, non-compete and customer relationship will be amortized on a straight-line basis over their estimated useful lives. We expect the amortization of acquired intangibles will be approximately $\$ 500,000$ per quarter for the remaining estimated useful lives.

For the period from June 10, 2014 to June 30, 2014, the acquired ShipStation operations were not material to the Company's consolidated financial results.

Under ASC 805, we are required to re-measure the fair value of the contingent consideration at each reporting period. The fair value of the contingent consideration for the ShipStation acquisition was $\$ 17.1$ million as of September 30, 2014, an increase of $\$ 860,000$ compared to the $\$ 16.2$ million as of June 30, 2014. This increase in fair value resulted in our recording of a contingent consideration charge of $\$ 860,000$ in operating expenses during the third quarter of 2014.

## ShipWorks Acquisition

On August 29, 2014, we acquired $100 \%$ of the outstanding equity of Interapptive Inc, which operates ShipWorks, in a cash transaction. ShipWorks, based in St. Louis, Missouri, offers monthly subscription based e-commerce shipping software that provides simple, powerful and easy to use solutions for online sellers. ShipWorks solutions integrate with over 50 popular online sales and marketplaces systems including eBay, PayPal, Amazon, Yahoo! and others. ShipWorks offers multi-carrier shipping options and features including sending email notifications to buyers, updating online order status, generating reports and many more.

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## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

We have accounted for the acquisition under the acquisition method of accounting in accordance ASC 805. The total purchase price for ShipWorks was approximately $\$ 22.1$ million and was comprised of the following (in thousands, except shares):

|  | Fair |
| :--- | :--- |
|  | Value |
| Cash consideration | $\$ 21,952$ |
| Deferred consideration | 112 |
| Total purchase price | $\$ 22,064$ |

Under the acquisition method of accounting under ASC 805, the total estimated purchase price of the acquired company is allocated to the assets acquired and the liabilities assumed based on their fair values. We have made significant estimates and assumptions in determining the preliminary allocation of the purchase price. The preliminary allocation of purchase consideration is subject to change based on further review of the fair value of the assets acquired and liabilities assumed. The following table is the allocation of the purchase price (in thousands, except years):

|  |  |  | Weighted <br> Average <br> Estimated |
| :--- | :--- | :--- | :--- |
|  |  |  | Fair <br> Useful |
|  | Value | Fair | Life <br> Value <br> (In Years) |
| Cash and cash equivalents |  | $\$ 54$ |  |
| Trade accounts receivable |  | 353 |  |
| Other assets |  | 21 |  |
| Property and equipment |  | 1691 |  |
| Goodwill |  | 16,280 |  |
| Identifiable intangible assets: | $\$ 200$ |  |  |
| Trademark | 1,700 |  |  |
| Developed technology | 700 |  |  |
| Non-compete agreement | 2,300 |  |  |
| Customer relationship |  | 4,900 | 6 |
| Total identifiable intangible assets |  | $(370$ | ) |
| Accrued expenses and other liabilities |  | $(265$ |  |
| Deferred revenue |  | $\$ 22,064$ |  |

Goodwill represents the excess of the fair value of consideration given over the fair value of the tangible assets, identifiable intangible assets and liabilities assumed in a business combination and the potential synergy of combining the operations of Stamps.com and ShipWorks. We expect the entire amount of goodwill recorded in this acquisition will be deducted for tax purposes ratably over a 15 year period. The identified intangible assets consist of trademarks, developed technology, non-compete agreements and customer relationships. The estimated fair values of the trademark and developed technology were determined using the "relief from royalty" method. The estimated fair value of the non-compete was determined using the "with and without" method. The estimated fair value of customer relationship was determined using the "excess earnings" method. The rate utilized to discount net cash flows to their

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present values was approximately $11 \%$ and was determined after consideration of the overall enterprise rate of return and the relative risk and importance of the assets to the generation of future cash flows. Trademark, developed technology, non-compete and customer relationship will be amortized on a straight-line basis over their estimated useful lives. We expect the amortization of acquired intangibles will be approximately $\$ 200,000$ per quarter for the remaining estimated useful lives.

For the period from August 29, 2014 to September 30, 2014, the acquired ShipWorks operations were not material to the Company's consolidated financial results.

## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS <br> (UNAUDITED)

For the three and nine months ended September 30, 2014, the Company incurred approximately $\$ 492,000$ and $\$ 912,000$, respectively in acquisition and integration related corporate development expenses. These costs are included in general and administrative expense on the Company's Consolidated Statements of Income.

Pro-Forma Financial Information
The pro-forma information presented is for illustrative purposes only and is not necessarily indicative of the results of operations that would have been realized if the acquisition had been completed on the date indicated, nor is it indicative of future operating results. The pro-forma financial information does not include any adjustments for operating efficiencies or cost savings.

The following table presents the pro-forma financial information (in thousands, except per share amounts) and assumes the acquisition of ShipStation and ShipWorks occurred on January 1, 2013.

|  | Three Months <br> Ended |  | Nine Months Ended <br> September 30, |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
|  |  |  | September 30, <br> 2014 |  | 2013 |

## 3.Legal Proceedings

On August 11, 2014, PSI Systems, Inc., D/B/A Endicia, filed suit against Auctane, LLC, D/B/A ShipStation (our wholly-owned subsidiary), in the United States District Court for the Western District of Texas, alleging, among other claims, that ShipStation breached its contract with Endicia by violating a customer non-solicit provision. Endicia seeks preliminary and permanent injunctive relief, unspecified damages, attorneys' fees and court costs.

On August 14, 2014, Rapid Enterprises, LLC, D/B/A Express One, filed suit against ShipStation and some of its executives in the Third Judicial District Court for Salt Lake County, Utah, alleging, among other claims, that ShipStation breached its contract with Express One by violating an exclusivity provision. Express One seeks an injunction, damages, attorneys' fees and court costs.

We are also subject to various routine legal proceedings and claims incidental to our business, and we do not believe that these proceedings and claims would reasonably be expected to have a material adverse effect on our financial position, results of operations or cash flows.
4.Net Income per Share

Net income per share represents net income attributable to common stockholders divided by the weighted average number of common shares outstanding during a reported period. The diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock, including stock options
(commonly and hereafter referred to as "common stock equivalents"), were exercised or converted into common stock. Diluted net income per share is calculated by dividing net income during a reported period by the sum of the weighted average number of common shares outstanding plus common stock equivalents for the period.

## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS <br> (UNAUDITED)

The following table reconciles share amounts utilized to calculate basic and diluted net income per share (in thousands, except per share data):

|  | Three Months <br> Ended <br> September 30, |  | Nine Months Ended |  |
| :---: | :---: | :---: | :---: | :---: |
|  |  |  | September 30, |  |
|  | 2014 | 2013 | 2014 | 2013 |
| Net income | \$9,472 | \$8,763 | \$27,980 | \$25,282 |
| Basic - weighted average common shares | 15,881 | 15,816 | 16,031 | 15,545 |
| Diluted effect of common stock equivalents | 377 | 573 | 402 | 639 |
| Diluted - weighted average common shares | 16,258 | 16,389 | 16,433 | 16,184 |
| Earnings per share: |  |  |  |  |
| Basic | \$0.60 | \$0.55 | \$ 1.75 | \$ 1.63 |
| Diluted | \$0.58 | \$0.53 | \$1.70 | \$1.56 |

The calculation of dilutive shares excludes the effect of the following options that are considered anti-dilutive (in thousands):

|  | Three | Nine |  |
| :--- | :--- | :--- | :--- |
|  | Months | Months |  |
|  | Ended | Ended |  |
|  | September | September |  |
|  | 30, | 30 |  |
|  | 2014 | 2013 | 2014 |
| 2013 |  |  |  |
| Anti-dilutive stock option shares | 195 | 43 | 158 | 80

## 5. Stock-Based Employee Compensation

We estimate the fair value of share-based payment awards on the date of grant using an option-pricing model and recognize stock-based compensation expense during each period based on the value of that portion of share-based payment awards that is ultimately expected to vest during the period, reduced for estimated forfeitures. We estimate forfeitures at the time of grant based on historical data and revise, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Compensation expense recognized for all employee stock options granted is recognized using the straight-line method over their respective vesting periods of up to five years.

The following table sets forth the stock-based compensation expense that we recognized for the periods indicated (in thousands):

|  | Three Months <br> Ended | Nine Months <br> Ended |  |
| :--- | :--- | :--- | :--- | :--- |
|  | September 30, September 30, <br> 2014 2013 | 2014 | 2013 |


| Employee stock purchases | 103 | 441 | 219 | 740 |
| :--- | ---: | :---: | :---: | :---: |
| Total stock-based compensation expense | $\$ 460$ | $\$ 1,345$ | $\$ 2,402$ | $\$ 3,568$ |

Stock-based compensation expense relating to:

| Cost of revenues | $\$ 75$ | $\$ 130$ | $\$ 260$ | $\$ 317$ |
| :--- | :---: | :---: | :---: | :---: |
| Sales and marketing | 81 | 260 | 415 | 678 |
| Research and development | 157 | 353 | 557 | 812 |
| General and administrative | 147 | 602 | 1,170 | 1,761 |
| Total stock-based compensation expense | $\$ 460$ | $\$ 1,345$ | $\$ 2,402$ | $\$ 3,568$ |

## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

We use the Black-Scholes option valuation model to estimate the fair value of share-based payment awards on the date of grant, which requires us to make a number of highly complex and subjective assumptions, including stock price volatility, expected term, risk-free interest rates. In the case of options we grant, our assumption of expected volatility is based on the historical volatility of our stock price over the term equal to the expected life of the options. We base the risk-free interest rate on U.S. Treasury zero-coupon issues with a remaining term approximately equal to the expected life of the options assumed at the date of grant. The estimated expected life represents the weighted-average period the stock options are expected to remain outstanding, determined based on an analysis of historical exercise behavior.

The following are the weighted average assumptions used in the Black-Scholes valuation model for the periods indicated:

|  | Three |  | Nine |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
|  | Months |  | Months |  |
|  | Ended |  | Ended |  |
|  | September |  | September |  |

## 6. Goodwill and Intangible Assets

Goodwill represents the excess of the fair value of consideration given over the fair value of the tangible assets, identifiable intangible assets and liabilities assumed in a business combination.

The following table summarizes goodwill acquired in a business combination as of September 30, 2014 (in thousands):

$$
\begin{array}{ll} 
& 2014 \\
\text { Goodwill balance at December 31, } 2013 & \$- \\
\text { Acquisitions (see Note } 2-\text { "Acquisitions") } & 66,824 \\
\text { Goodwill balance at September 30, } 2014 & \$ 66,824
\end{array}
$$

Goodwill will be reviewed for impairment annually during the fourth quarter utilizing a qualitative assessment or a two-step process. We have an option to make a qualitative assessment of a reporting unit's goodwill for impairment. If we choose to perform a qualitative assessment and determine the fair value more likely than not exceeds the carrying value, no further evaluation is necessary. For reporting units where we perform the two-step process, the first step requires us to compare the fair value of each reporting unit, which we primarily determine using an income approach based on the present value of discounted cash flows, to the respective carrying value, which includes goodwill. If the fair value of the reporting unit exceeds its carrying value, the goodwill is not considered impaired. If the carrying value is higher than the fair value, there is an indication that impairment may exist and the second step is required. In step two, the implied fair value of goodwill is calculated as the excess of the fair value of a reporting unit
over the fair values assigned to its assets and liabilities. If the implied fair value of goodwill is less than the carrying value of the reporting unit's goodwill, the difference is recognized as an impairment loss.

We have amortizable and non-amortizable intangible assets consisting of patents, trademarks, lease-in-place intangible assets, developed technology, non-compete agreements and customer relationships.

## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table summarizes our amortizable and non-amortizable intangible assets as of September 30, 2014 (in thousands):

|  | Gross |  | Net |
| :--- | :--- | :--- | :--- |
| Carrying | Accumulated | Carrying |  |
|  | Amount | Amortization | Amount |
| Intangible assets | $\$ 9,378$ | $\$ 8,470$ | $\$ 908$ |
| Intangible assets acquired in 2014 (see Note 2 - "Acquisitions") | 20,100 | 683 | 19,417 |
| Total Intangible assets at September 30, 2014 | $\$ 29,478$ | $\$ 9,153$ | $\$ 20,325$ |

We recorded amortization of intangible assets totaling approximately $\$ 586,000$ and $\$ 719,000$ for the three and nine months ended September 30, 2014, respectively, and approximately $\$ 12,000$ and $\$ 36,000$ for the three and nine months ended September 30, 2013, respectively, which is included in general and administrative expense in our accompanying consolidated statements of income.

As of September 30, 2014, the remaining weighted average amortization period for our amortizable intangible assets is approximately 6.9 years. Our estimated amortization expense for the next five years is as follows (in thousands):

|  | Estimated <br> Amortization <br> 12-Month Period Ending September 30, <br> Expense |
| :--- | :--- |
| $\$ 2015$ | 2,996 |
| 2016 | 2,954 |
| 2017 | 2,935 |
| 2018 | 2,805 |
| 2019 | 2,483 |

## 7.Income Taxes

During the third quarter of 2014, our current income tax expense consisted of federal and state alternative minimum taxes. Our effective income tax rate differs from the statutory income tax rate primarily as a result of our use of net operating losses to offset current federal and state income taxes and the partial release of our valuation allowance. On June 10, 2014 we completed our acquisition of ShipStation and on August 29, 2014 we completed our acquisition of ShipWorks (see Note 2 - "Acquisitions"). Based on these discrete events, we re-evaluated our forecast of our projected taxable income. As a result, we released a portion of our valuation allowance totaling approximately $\$ 3.6$ million and $\$ 345,000$ during the second and third quarter of 2014, respectively. We evaluated the appropriateness of our deferred tax assets and related valuation allowance in accordance with ASC 740 based on all available positive and negative evidence. A valuation allowance is recorded against a portion of our gross deferred tax assets as we have determined the realization of these assets does not meet the more likely than not criteria. In making these determinations, we considered the available positive and negative evidence, including our recent earnings trend, expected future taxable income and the federal and state effective tax rates related to future taxable income.

We recorded corporate alternative minimum U.S. federal and state taxes of approximately $\$ 260,000$ and $\$ 599,000$ during the three and nine months ended September 30, 2014, respectively. The $\$ 345,000$ and $\$ 3.6$ million release of our valuation allowance during the same periods resulted in a total net tax benefit for the three and nine months ended September 30, 2014 of $\$ 85,000$ and $\$ 3.4$ million, respectively. Total net income tax expense for corporate alternative
minimum U.S. federal and state taxes was approximately $\$ 90,000$ and $\$ 180,000$ during the three and nine months ended September 30, 2013, respectively.

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## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS <br> (UNAUDITED)

8. Fair Value Measurements

Financial assets measured at fair value on a recurring basis are classified in one of the three following categories, which are described below:

Level 1 - Valuations based on unadjusted quoted prices for identical assets in an active market
Level 2 - Valuations based on quoted prices in markets where trading occurs infrequently or whose values are based on quoted prices of instruments with similar attributes in active markets

Level 3 - Valuations based on inputs that are unobservable and involve management judgment and our own assumptions about market participants and pricing

The following table summarizes our financial assets measured at fair value on a recurring basis (in thousands):

| Description | $\begin{aligned} & \text { September } \\ & 30, \\ & 2014 \end{aligned}$ | Fair Valu <br> Reporting <br> Quoted <br> Prices <br> in <br> Active <br> Markets <br> for <br> Identical <br> Assets <br> (Level <br> 1) | e Measurem <br> Date Using <br> Significant <br> Other <br> Observable <br> Inputs <br> (Level 2) | nt at <br> Significant <br> Unobservable <br> Inputs <br> (Level 3) |
| :---: | :---: | :---: | :---: | :---: |
| Cash equivalents <br> Available-for-sale debt securities Total | $\begin{array}{r} \$ 27,659 \\ 16,853 \\ \$ 44,512 \end{array}$ | $\begin{aligned} & \$ 27,659 \\ & -\quad \$ 27,659 \end{aligned}$ | $\begin{aligned} & \$- \\ & 16,853 \\ & \$ 16,853 \end{aligned}$ | \$ <br> \$ |
| Description | December <br> 31, <br> 2013 | Fair Value <br> Reporting <br> Quoted <br> Prices <br> in <br> Active <br> Markets <br> for <br> Identical <br> Assets <br> (Level <br> 1) | Measureme Date Using <br> Significant Other Observable Inputs (Level 2) | Significant <br> Unobservable <br> Inputs <br> (Level 3) |
| Cash equivalents | \$ 66,674 | 66,674 | \$ - | \$ |

Available-for-sale debt securities 20,536 - 20,536 -
Total $\quad \$ 87,210 \quad \$ 66,674 \quad \$ 20,536 \quad \$ \quad-$

The fair value of our available-for-sale debt securities included in the Level 2 category is based on the market values obtained from an independent pricing service that were evaluated using pricing models that vary by asset class and may incorporate available trade, bid and other market information and price quotes from well-established independent pricing vendors and broker-dealers.

As of September 30, 2014 we have $\$ 17.1$ million of contingent consideration relating to our acquisition of ShipStation (see Note 2 - "Acquisitions") that required to be measured at fair value.

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## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS <br> (UNAUDITED)

The following table summarizes our contingent consideration measured at fair value on a recurring basis (in thousands):


The following table represents a reconciliation of contingent consideration obligation measured on a recurring basis using significant unobservable inputs (level 3) as of September 30, 2014 (in thousands)

|  | June 30, | Adjustment | September |  |
| :--- | :---: | :---: | :---: | :---: |
|  | 2014 | $(1)$ |  | 30,2014 |
|  | 16,242 | 860 | 17,102 |  |
| Acquisition related contingent consideration | 16,242 | $\$ 860$ | $\$ 17,102$ |  |

(1) This amount represents fair value adjustment during the three months ended September 30, 2014 to the acquisition related contingent consideration for ShipStation (see Note 2 - "Acquisitions").

## 9.Cash Equivalents and Investments

Our cash equivalents and investments consist of money market, asset-backed securities, US government obligations, and public corporate debt securities at September 30, 2014 and December 31, 2013. We consider all highly liquid investments with an original or remaining maturity of three months or less at the date of purchase to be cash equivalents. All of our investments are classified as available for sale and are recorded at market value using the specific identification method. Realized gains and losses are reflected in other income, net using the specific identification method. There was no material realized gain or loss with respect to our investments during the three and nine months ended September 30, 2014. Unrealized gains and losses are included as a separate component of stockholders' equity. We do not intend to sell investments with an amortized cost basis exceeding fair value and it is not likely that we will be required to sell the investments before recovery of their amortized cost bases. We have 6 securities with a total fair value of $\$ 4.3$ million that have unrealized losses of approximately $\$ 8,000$ as of September 30, 2014.

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On at least a quarterly basis, we evaluate our available for sale securities, and record an "other-than-temporary impairment" ("OTTI") if we believe their fair value is less than historical cost and it is probable that we will not collect all contractual cash flows. We did not record any OTTI during the three and nine months ended September 30, 2014, after evaluating a number of factors including, but not limited to:
-How much fair value has declined below amortized cost
-The financial condition of the issuers

- Significant rating agency changes on the issuer

Our intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value

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## Table of Contents <br> STAMPS.COM INC AND SUBSIDIARIES <br> NOTES TO CONSOLIDATED FINANCIAL STATEMENTS <br> (UNAUDITED)

The following tables summarize our cash, cash equivalents and investments as of September 30, 2014 and December 31, 2013 (in thousands):

| Cash and cash equivalents: |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Cash | $\$ 25,784$ | - | - | $\$ 25,784$ |  |
| Money market | 1,875 | - | - | 1,875 |  |
| Cash and cash equivalents | 27,659 | - | - | 27,659 |  |
| Short-term investments: |  |  |  |  |  |
| Corporate bonds and asset backed securities | 4,014 | 25 | $(1$ | $)$ | 4,038 |
| Short-term investments | 4,014 | 25 | $(1$ | $)$ | 4,038 |
| Long-term investments: |  |  |  |  |  |
| Corporate bonds and asset backed securities | 11,260 | 61 | $(8$ | $)$ | 11,313 |
| U.S. government and agency securities | 1,499 | 3 | - | 1,502 |  |
| Long-term investments | 12,759 | 64 | $(8$ | $)$ | 12,815 |
| Cash, cash equivalents and investments | $\$ 44,432$ | 89 | $(9$ | $) \$ 44,512$ |  |


| Cash and cash equivalents: |  |  |  |  |
| :--- | ---: | :--- | :--- | ---: |
| Cash | $\$ 46,792$ | - | - | $\$ 46,792$ |
| Money market | 19,882 | - | - | 19,882 |
| Cash and cash equivalents | 66,674 | - | - | 66,674 |
| Short-term investments: |  |  |  |  |
| Corporate notes and bonds | 6,479 | 45 | - | 6,524 |
| Short-term investments | 6,479 | 45 | - | 6,524 |
| Long-term investments: |  |  |  |  |
| Corporate bonds and asset backed securities | 13,917 | 106 | $(11$ | 14,012 |
| Long-term investments | 13,917 | 106 | $(11$ | $)$ |
| Cash, cash equivalents and investments | $\$ 87,070$ | 151 | $(11$ | $) \$ 87,210$ |

The following table summarizes contractual maturities of our marketable fixed-income securities as of September 30, 2014 (in thousands):

|  |  | Estimated |
| :--- | :--- | :--- |
|  | Amortized | Fair |
|  | Cost | Value |
| Due within one year | $\$ 4,014$ | $\$ 4,038$ |
| Due after one year through five years | 12,759 | 12,815 |
| Due after five years through ten years | - | - |
| Total | $\$ 16,773$ | $\$ 16,853$ |

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ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF 2. OPERATIONS

This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These statements relate to expectations concerning matters that are not historical facts. You can find many (but not all) of these statements by looking for words such as "approximates," "believes," "expects," "seeks," "anticipates," "estimates," "intends," "plans," "would," "could,""should," "will," "may" or other similar expressions We claim the protection of the safe harbor contained in the Private Securities Litigation Reform Act of 1995. We caution investors that any forward-looking statements presented in this report, or that we may make orally or in writing from time to time, are based on beliefs and assumptions made by, and information currently available to, us. Such statements are based on assumptions, and the actual outcome will be affected by known and unknown risks, trends and uncertainties and factors that are beyond our control or ability to predict. Although we believe that our assumptions are reasonable, they are not guarantees of future performance, and some will inevitably prove to be incorrect. As a result, our actual future results may differ from our expectations, and those differences may be material. We are not undertaking any obligation to update any forward-looking statements. Accordingly, investors should use caution in relying on past forward-looking statements, which are based on known results and trends at the time they are made, to anticipate future results or trends.

Please refer to the risk factors under "Item 1A. Risk Factors" of our Form 10-K for the year ended December 31, 2013 as well as those described elsewhere in our public filings. The risks included are not exhaustive, and additional factors could adversely affect our business and financial performance. We operate in a very competitive and rapidly changing environment. New risk factors emerge from time to time, and it is not possible for management to predict all such risk factors, nor can it assess the impact of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. This Report and all subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section.

Stamps.com, NetStamps, PhotoStamps, Hidden Postage, Stamps.com Internet postage and the Stamps.com logo are our trademarks. This report also references trademarks of other entities.

## Overview

Stamps.com® is the leading provider of Internet-based mailing and shipping solutions. Under the Stamps.com branded solutions, our customers use our service to mail and ship a variety of mail pieces, including postcards, envelopes, flats and packages, using a wide range of United States Postal Service ("USPS") mail classes, including First Class Mail®, Priority Mail®, Priority Mail Express ${ }^{\circledR}$, Media Mail®, Parcel Select®, and others. Customers using our service receive discounted postage rates compared to USPS retail on certain mail pieces such as First Class letters and domestic and international Priority Mail and Priority Mail Express packages. Our customers include individuals, small businesses, home offices, medium-size businesses and large enterprises, and within these segments we target both mailers and shippers. We were the first ever USPS-licensed vendor to offer mailing and shipping in a software-only business model in 1999. In addition, we now offer multi-carrier shipping solutions under the brand names ShipStation, Auctane and ShipWorks as a result of our recent acquisitions.

Services and Products
Mailing and Shipping Business

Our mailing and shipping solutions under the Stamps.com brand enable our customers to buy and print USPS approved postage and services with just a personal computer ("PC"), printer and Internet connection, right from their home or office.

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We offer the following mailing and shipping products and services to our customers under the Stamps.com brand:
Mailing and Shipping Services. After completing the registration process, customers can purchase and print postage 24 hours a day, seven days a week, through our software or web interface. Typically, when a customer purchases postage for use through our service, the customer pays the face value of the postage, and the funds are transferred directly from the customer's account to the USPS's account. The customer then draws down their prepaid account balance as they print postage and repurchases postage as necessary. Customers typically pay a monthly subscription fee for access to our service.

Our USPS-approved mailing and shipping service enables users to print "electronic stamps" directly onto envelopes, plain paper, or labels using only a standard personal computer, printer and Internet connection. Our service currently supports a variety of USPS mail classes. Customers can also add to their mail pieces USPS Special Services such as USPS Tracking ${ }^{\text {TM }}$, Signature Confirmation ${ }^{\mathrm{TM}}$, Registered Mail, Certified Mail, Insured Mail, Return Receipt, Collect on Delivery and Restricted Delivery. Our customers can print postage (1) on NetStamps® labels, which can be used just like regular stamps, (2) directly on envelopes, postcards or on other types of mail or labels, in a single step process that saves time and provides a professional look, (3) on plain 8.5 " x 11 " paper or on special labels for packages, and (4) on integrated customs forms for international mail and packages.

For added convenience, our mailing and shipping services incorporate address verification technology that verifies each destination address for mail sent using our service against a database of all known addresses in the United States. Our mailing and shipping service is also integrated with common small business and productivity software applications such as word processing, contact and address management, and accounting and financial applications. We also offer several different versions of NetStamps labels, such as Themed NetStamps labels and Photo NetStamps labels, which allow customers to add stock or custom designs to their postage label.

We offer multiple mailing and shipping service plans with different features and capabilities targeted to meet different customer needs. Our Pro Plan offers a basic set of Stamps.com mailing and shipping features with single-user capability. Our Premiere plan, typically targeted at larger small businesses, adds multiple-user functionality, automated Certified Mail forms, additional reference codes and higher allowable postage balances as compared to our Pro Plan feature set. Our Professional Shipper plan is typically targeted at higher volume shippers such as fulfillment houses, retailers and e-commerce merchants and features direct integration into a customer's order databases, faster label printing speed, the ability to customize and save shipping profiles, and integrations with many of the industry's leading shipping management systems. We have launched shipping integrations with several of these e-commerce focused companies. Our Enterprise plan is typically targeted at organizations with multiple geographic locations and features enhanced reporting that allows a central location, such as a corporate headquarters greater visibility and control over postage expenditures across their network of locations.

Customers typically pay us a monthly service fee ranging from $\$ 15.99$ to $\$ 39.99$ depending on the service plan. In certain circumstances, customers may be on a plan where they do not owe us any monthly service fees. We have an arrangement with the USPS under which if a customer or integration partner prints a certain amount of domestic or international Priority Mail or Priority Mail Express postage, the USPS compensates us directly and the customer can qualify to have their service fees waived or refunded. In addition, we also have plans with service fees less than $\$ 15.99$ which offer more limited functionality and are targeted at retaining customers who print a lower volume of postage.
-Mailing and Shipping Integrations. As part of our mailing and shipping services, we offer back-end integration solutions where we provide the electronic postage for transactions to partners who manage the front-end process. Our software integrates directly into the most popular e-commerce platforms, allowing web store managers to completely automate their order fulfillment process by processing, managing, and shipping orders from virtually any e-commerce source through a single interface without manual data entry. Managers can retrieve order data and print
complete shipping labels for all USPS mail classes, including First Class International®.

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We have an integration partnership with Amazon.com that makes our domestic and international shipping labels available to Amazon.com Marketplace users. The service allows customers to automatically pay for postage using their Marketplace Payments account, to set a default ship-from address so they do not have to type or write it for each shipment, and to automatically populate the ship-to address on the label. Domestic and international mail classes are supported and Marketplace users may request carrier pickup from the USPS. A transaction fee per shipping label printed is charged to merchants who are not Stamps.com subscription customers. In October 2012, Amazon.com launched their own internally developed Marketplace USPS shipping solution system that resulted in a reduction in postage printed through our solution. Amazon's shipping solution is utilized by merchants for certain mail classes while our shipping solution is utilized by merchants for the other mail classes. In addition, we continue to provide the integrated Amazon.com Marketplace solution to Stamps.com subscription customers.

We have an integration partnership with the USPS where we provide electronic postage for shipping transactions generated by Click-N-Ship®, a web-based service available at USPS.com that allows USPS customers to purchase and print shipping labels for domestic and international Priority Mail and Priority Mail Express packages at no additional mark-up over the cost of postage.

Mailing \& Shipping Supplies Store. Our Mailing \& Shipping Supplies Store (our "Supplies Store") is available to our customers from within our mailing and shipping software and sells NetStamps labels, shipping labels, other mailing labels, dedicated postage printers, scales, and other mailing and shipping-focused office supplies. Our Supplies Store features a store catalog, messaging regarding our free or discounted shipping promotions, cross-selling product recommendations during the checkout process, product search capabilities, and same-day shipping of orders with expedited shipping options.

Branded Insurance. We offer Stamps.com branded insurance to our customers so that they may insure their mail or packages in a fully integrated, online process that eliminates any trips to the post office or the need to complete any special forms. Our branded insurance is provided in partnership with Parcel Insurance Plan and is underwritten by Fireman's Fund.

## PhotoStamps

PhotoStamps is a patented form of postage that allows consumers to turn digital photos, designs or images into valid USPS-approved postage. With this product, individuals or businesses can create customized USPS approved postage using pictures of their children, pets, vacations, celebrations, business logos and more. PhotoStamps can be used as regular postage to send letters, postcards or packages. The product is available via our separately-marketed website at www.photostamps.com. Customers upload a digital photograph or image file, customize the look and feel by choosing a border color to complement the photo, select the value of postage, and place the order online. Each sheet includes 20 individual PhotoStamps, and orders arrive via U.S. Mail in a few business days.

When we refer to our mailing and shipping business, we are referring to our Mailing and Shipping Service and Integrations, Mailing \& Shipping Supplies Store and Branded Insurance offering. We do not include our PhotoStamps business when we refer to our mailing and shipping business.

## ShipStation Acquisition

On June 10, 2014, we acquired $100 \%$ of the outstanding equity of Auctane LLC, which operates ShipStation, in a cash and contingent stock transaction. ShipStation, based in Austin, Texas, offers monthly subscription based e-commerce shipping software primarily under the brand ShipStation and Auctane. ShipStation is a leading web-based shipping software solution that allows online retailers and e-commerce merchants to organize, process, fulfill and ship their orders quickly and easily. ShipStation supports automatic order importing from over 50 shopping carts and marketplaces, including eBay, Amazon, Shopify, Bigcommerce, Volusion, Squarespace and others. ShipStation
offers multi-carrier shipping options, and automation features like custom hierarchical rules and product profiles that allow customers to easily and automatically optimize their shipping. Using ShipStation, an online retailer or e-commerce merchant can ship their orders from wherever they sell and however they ship. The acquisition of ShipStation represents a significant strategic investment in our high volume and e-commerce shipping business. Please see Note 2 - "Acquisitions" for further description.

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ShipWorks Acquisition
On August 29, 2014, we acquired $100 \%$ of the outstanding equity of Interapptive Inc, which operates ShipWorks, in a cash transaction. ShipWorks based in St Louis, Missouri, offers monthly subscription based e-commerce shipping software that provides simple, powerful and easy to use solutions for online sellers. ShipWorks solutions integrate with over 50 popular online sales and marketplaces systems including eBay, PayPal, Amazon, Yahoo! and others. ShipWorks offers multi-carrier shipping options and features including sending email notifications to buyers, updating online order status, generating reports and many more.

## Results of Operations

Total revenue in the third quarter of 2014 was $\$ 37.8$ million, an increase of $21 \%$ from $\$ 31.2$ million in the third quarter of 2013. Total revenue during the nine months ended September 30, 2014 was $\$ 105.4$ million, an increase of $10 \%$ from $\$ 95.5$ million in the nine months ended September 30, 2013. Mailing and shipping revenue, which includes service revenue, product revenue and insurance revenue, was $\$ 36.3$ million in the third quarter of 2014, an increase of $20 \%$ from $\$ 30.2$ million in the third quarter of 2013 and was $\$ 101.5$ million in the nine months ended September 30, 2014, an increase of $10 \%$ from $\$ 92.2$ million in the nine months ended September 30, 2013. PhotoStamps revenue in the third quarter of 2014 was $\$ 1.5$ million, an increase of $53 \%$ from $\$ 1.0$ million in the third quarter of 2013 and was $\$ 3.9$ million in the nine months ended September 30, 2014, an increase of $21 \%$ from $\$ 3.3$ million in the nine months ended September 30, 2013.

The following table sets forth the breakdown of revenue for the three and nine months ended September 30, 2014 and 2013 and the resulting percentage change (revenue in thousands):

|  | Three months ended September 30, |  |  | Nine months ended September 30, |  |  | \% |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | \% |  |  |  |  |  |
|  | 2014 | 2013 | Change |  | 2014 | 2013 | Change |  |
| Service revenue | \$30,057 | \$24,505 | 23 | \% | \$82,621 | \$74,241 | 11 | \% |
| Product revenue | 3,875 | 3,885 | - | \% | 12,443 | 12,436 | - | \% |
| Insurance revenue | 2,360 | 1,854 | 27 | \% | 6,400 | 5,517 | 16 | \% |
| Mailing and shipping revenue | 36,292 | 30,244 | 20 | \% | 101,464 | 92,194 | 10 | \% |
| PhotoStamps revenue | 1,532 | 1,001 | 53 | \% | 3,940 | 3,260 | 21 | \% |
| Other revenue | 10 | - | - | \% | 12 | 1 | 1100 | \% |
| Total revenue | \$37,834 | \$31,245 | 21 | \% | \$ 105,416 | \$95,455 | 10 | \% |

Core mailing and shipping revenue in the third quarter of 2014 was $\$ 35.8$ million, an increase of $21 \%$ from $\$ 29.5$ million in the third quarter of 2013. Core mailing and shipping revenue during the nine months ended September 30, 2014 was $\$ 99.8$ million, an increase of $11 \%$ from $\$ 90.0$ million during the nine months ended September 30, 2013. Non-Core mailing and shipping revenue in the third quarter of 2014 was $\$ 506,000$, a decrease of $28 \%$ from the $\$ 698,000$ in the third quarter of 2013. Total Non-Core mailing and shipping revenue during the nine months ended September 30, 2014 was $\$ 1.6$ million, a decrease of $27 \%$ from the $\$ 2.2$ million in the third quarter of 2013.

When we refer to our "Core mailing and shipping business", we are referring to the portion of our mailing and shipping business targeting our small business, enterprise and e-commerce and high volume shipping customers. When we refer to our "Core mailing and shipping revenue", we are referring to the revenue earned from those Core mailing and shipping customers including ShipStation and ShipWorks.

When we refer to our "Non-Core mailing and shipping business", we are referring to the portion of our mailing and shipping business that targets more consumer oriented customers through our "enhanced promotion" marketing channel. In the "enhanced promotion" channel, we work with various companies to advertise our service in a variety of sites on the Internet. These companies typically offer an additional promotion (beyond what we typically offer) directly to the customer in order to get the customer to try our service and we find that this channel attracts more consumer oriented customers. When we refer to our "Non-Core mailing and shipping revenue", we are referring to the revenue earned from the consumer oriented customers in the "Non-Core mailing and shipping business."

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The following table sets forth the breakdown of mailing and shipping revenue, which includes Core mailing and shipping revenue and Non-Core mailing and shipping revenue and the resulting percent change for the periods indicated (revenue in thousands):

|  | Three months ended September 30, |  |  |  | Nine months ended September 30, |  | \% |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | \% |  |  |  |  |  |
|  | 2014 | 2013 | Change |  | 2014 | 2013 | Change |  |
| Core mailing and shipping revenue | \$35,786 | \$29,546 | 21 | \% | \$99,841 | \$89,982 | 11 | \% |
| Non-Core mailing and shipping revenue | 506 | 698 | (28 | \%) | 1,623 | 2,212 | (27 | \%) |
| Mailing and shipping revenue | \$36,292 | \$30,244 | 20 | \% | \$101,464 | \$92,194 | 10 | \% |

The increase in Core mailing and shipping revenue was driven by both an increase in average revenue per paid customer and an increase in paid customers. The average monthly revenue per paid customer in the third quarter of 2014 was $\$ 23.86$, an increase of $12 \%$ compared to $\$ 21.24$ in the third quarter of 2013. Paid customers in the third quarter of 2014 were approximately 500,000 , an increase of $8 \%$ compared to 464,000 in the third quarter of 2013 . We define paid customers for the quarter as ones from whom we successfully collected service fees or otherwise earned revenue from at least once during that quarter.

The following table sets forth the growth in paid customers and average quarterly revenue per paid customer for our Core mailing and shipping business:

|  | Three months ended <br> September 30, |  |  |  |
| :--- | :---: | :---: | :--- | :--- |
|  |  |  | $\%$ |  |
|  | 2014 | 2013 | Change |  |
| Paid customers for the quarter (000s) | 500 | 464 | 8 | $\%$ |
| Average quarterly revenue per paid customer | $\$ 71.59$ | $\$ 63.72$ | 12 | $\%$ |
| Core mailing and shipping revenue (000s) | $\$ 35,786$ | $\$ 29,546$ | 21 | $\%$ |

The increase in paid customers compared to the third quarter last year was primarily driven by (1) a higher number of Stamps.com new paid customers compared to the same period last year as a result of our marketing programs, (2) the addition of new paid ShipStation customers as a result of our acquisition that were not included in the third quarter of the prior year and (3) lower lost customer churn rates in the third quarter compared to the same period in the prior year.

For our Core mailing and shipping business, our average quarterly and monthly Core mailing and shipping revenue per paid customer in the third quarter of 2014 was $\$ 71.59$ and $\$ 23.86$ respectively, which increased $12 \%$ compared with $\$ 63.72$ and $\$ 21.24$, respectively, in the third quarter of 2013.

The increase in average quarterly revenue per paid customer during the third quarter compared to the same period last year was primarily the result of the addition of the new paid customers from our acquisition of ShipStation where the average revenue per user ("ARPU") for those newly acquired customers is materially higher as compared to the ARPU from the existing Stamps.com customers.

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Revenue by Product
The following table shows our revenue and revenue as a percentage of total revenue for the periods indicated (in thousands except percentage):

|  | Three Months |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Ended <br> September 30, |  |  | Nine Months Ended September 30, |  |  |
|  |  |  |  |  |  |  |
|  | 2014 | 2013 |  | 2014 | 2013 |  |
| Total Revenues |  |  |  |  |  |  |
| Service | \$30,057 | \$24,505 |  | \$82,621 | \$74,241 |  |
| Product | 3,875 | 3,885 |  | 12,443 | 12,436 |  |
| Insurance | 2,360 | 1,854 |  | 6,400 | 5,517 |  |
| PhotoStamps | 1,532 | 1,001 |  | 3,940 | 3,260 |  |
| Other | 10 | - |  | 12 | 1 |  |
| Total revenues | \$37,834 | \$31,245 |  | \$ 105,416 | \$95,455 |  |
| Revenue as a percentage of total revenues |  |  |  |  |  |  |
| Service | 79.4 | \% 78.4 | \% | 78.4 | \% 77.8 | \% |
| Product | 10.2 | \% 12.4 | \% | 11.8 | \% 13.0 | \% |
| Insurance | 6.2 | \% 5.9 | \% | 6.1 | \% 5.8 | \% |
| PhotoStamps | 4.0 | \% 3.2 | \% | 3.7 | \% 3.4 | \% |
| Other | 0.0 | \% |  | 0.0 | \% 0.0 | \% |
| Total revenues | 100 | \% 100 | \% | 100 | \% 100 | \% |

Our revenue is derived primarily from five sources: (1) service and transaction fees related to our mailing and shipping services; (2) product revenue from the direct sale of consumables and supplies through our Supplies Store; (3) package insurance revenue from our branded insurance offerings; (4) PhotoStamps revenue from the sale of PhotoStamps postage labels; and (5) other revenue, consisting of advertising revenue derived from advertising programs with our existing customers. The above described revenue includes related revenue from ShipStation and ShipWorks for the period from June 10, 2014 through quarter end and for the period from August 29, 2014 through quarter end, respectively.

Service revenue increased $23 \%$ to $\$ 30.1$ million in the third quarter of 2014 from $\$ 24.5$ million in the third quarter of 2013 and increased $11 \%$ to $\$ 82.6$ million in the nine months ended September 30, 2014 from $\$ 74.2$ million in the nine months ended September 30, 2013. The $23 \%$ increase in service revenue during the third quarter of 2014 consisted of a $24 \%$ increase in service revenue from our Core mailing and shipping business while the service revenue from our Non-Core mailing and shipping business decreased $28 \%$. The $24 \%$ increase in our Core mailing and shipping service revenue consisted of an $8 \%$ increase in paid customers and a $15 \%$ increase in average service revenue per customer. The $11 \%$ increase in service revenue during the nine months ended September 30, 2014 consisted of a $12 \%$ increase in service revenue from our Core mailing and shipping business while the service revenue from our Non-Core mailing and shipping business decreased $27 \%$.

Product revenue remained unchanged at $\$ 3.9$ million in both the third quarter of 2014 and 2013 and remained unchanged at $\$ 12.4$ million both in the nine months ended September 30, 2014 and 2013. Total postage printed by customers using our service was $\$ 394$ million and $\$ 367$ million during the third quarter of 2014 and 2013, respectively, an increase of $8 \%$. Postage printed by customers was $\$ 1.2$ billion and $\$ 1.1$ billion during the nine months ended September 30, 2014 and 2013, respectively, an increase of $4 \%$.

Insurance revenue increased $27 \%$ to $\$ 2.4$ million in the third quarter of 2014 from $\$ 1.9$ million in the third quarter of 2013 and increased $16 \%$ to $\$ 6.4$ million in the nine months ended September 30, 2014 from $\$ 5.5$ million in the nine

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months ended September 30, 2013. The increase in insurance revenue was primarily attributable to increased package insurance purchases as a result of our growth in packages shipped. Growth in packages shipped was attributable to both organic growth through Stamps.com's mailing and shipping solutions as well as our recent acquisitions whose solutions target shipping customers who are more likely than mailing customers to purchase insurance.

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PhotoStamps revenue increased $53 \%$ to $\$ 1.5$ million in the third quarter of 2014 from $\$ 1.0$ million in the third quarter of 2013 and increased $21 \%$ to $\$ 3.9$ million in the nine months ended September 30, 2014 from $\$ 3.3$ million in the nine months ended September 30, 2013. The increase was primary attributable to an increase in high volume business PhotoStamps orders; partially offset by a decrease in PhotoStamps revenue from orders placed through our website. The decrease in revenue from website orders is primarily attributable to a reduction in our PhotoStamps sales and marketing spending in the third quarter of 2014 compared with the third quarter of 2013, and we plan to continue to reduce our sales and marketing spending on PhotoStamps in future periods to maintain or improve profitability in that business.

Total PhotoStamps sheets shipped was approximately 104,000 in the third quarter of 2014, a $102 \%$ increase compared to 52,000 in the third quarter of 2013 and was 259,000 in the nine months ended September 30, 2014, an increase of $43 \%$ compared to 181,000 in the nine months ended September 30, 2013. Average revenue per sheet shipped decreased $24 \%$ in the third quarter of 2014 to $\$ 14.7$ from $\$ 19.4$ in the third quarter of 2013 and decreased $15 \%$ in the nine months ended September 30, 2014 to $\$ 15.2$ from $\$ 18.0$ in the nine months ended September 30, 2013. The increase in sheets shipped and decrease in average revenue per sheet shipped was primarily attributable to increased business orders which sell in larger sheet volumes but typically have a lower price per sheet.

Other revenue consists of commissions from the advertising or sale of products by third party vendors to our customer base was approximately $\$ 10,000$ and $\$ 0$ in the third quarter of 2014 and 2013 , respectively and was approximately $\$ 12,000$ in the nine months ended September 30, 2014 and $\$ 1,000$ in the nine months ended September 30, 2013. Commission revenue from the advertising or sale of products by third party vendors is currently not material to our consolidated financial statements.

## Cost of Revenues

The following table shows cost of revenues and cost of revenues as a percentage of its associated revenue for the periods indicated (in thousands except percentage):

|  | Three Months |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Ended |  | Nine Months Ended |  |  |
|  | September 30, |  | September 30, |  |  |
|  | 2014 | 2013 | 2014 |  | 2013 |
| Cost of Revenues |  |  |  |  |  |
| Service | \$5,123 | \$3,833 | \$ 13,941 |  | \$ 12,403 |
| Product | 1,285 | 1,315 | 4,119 |  | 4,322 |
| Insurance | 843 | 659 | 2,248 |  | 1,976 |
| PhotoStamps | 1,293 | 777 | 3,297 |  | 2,623 |
| Total cost of revenues | \$8,544 | \$6,584 | \$23,605 |  | \$21,324 |
| Cost as percentage of associated revenues |  |  |  |  |  |
| Service | 17.0 \% | 15.6 \% | 16.9 | \% | 16.7 \% |
| Product | 33.2 \% | 33.9 \% | 33.1 | \% | 34.8 \% |
| Insurance | 35.7 \% | 35.5 \% | 35.1 | \% | 35.8 \% |
| PhotoStamps | 84.4 \% | 77.6 \% | 83.7 | \% | 80.5 \% |
| Total cost as a percentage of total revenues | 22.6 \% | 21.1 \% | 22.4 | \% | 22.3 \% |

Cost of service revenue principally consists of the cost of customer service, certain promotional expenses, system operating costs, credit card processing fees and customer misprints that do not qualify for reimbursement from the USPS. Cost of product revenue principally consists of the cost of products sold through our Mailing \& Shipping Supplies Store and the related costs of shipping and handling. The cost of insurance revenue principally consists of parcel insurance offering costs. Cost of PhotoStamps revenue principally consists of the face value of postage,
customer service, image review costs, and printing and fulfillment costs. The cost of service revenue described above includes ShipStation and ShipWorks for the period from June 10, 2014 through quarter end and for the period from August 29, 2014 through quarter end, respectively.

Cost of service revenue increased $34 \%$ to $\$ 5.1$ million in the third quarter of 2014 from $\$ 3.8$ million in the third quarter of 2013 and increased $12 \%$ to $\$ 13.9$ million in the nine months ended September 30, 2014 from $\$ 12.4$ million in the nine months ended September 30, 2013. The increase, both during the third quarter of 2014 and nine months ended September 30, 2014, is primarily attributable to higher customer service costs to support our growing customer base. Promotional expense, which represents a material portion of total cost of service revenue, is expensed in the period in which a customer qualifies for the promotion while the revenue associated with the acquired customer is earned over the customer's lifetime. As a result, promotional expense for newly acquired customers may exceed the revenue earned from those customers in that period. Promotional expense was approximately $\$ 662,000$ in the third quarter of 2014 , an increase of $5 \%$ from $\$ 633,000$ in the third quarter of 2013 , and was approximately $\$ 2.3$ million during the nine months ended September 30, 2014, a decrease of $10 \%$ from $\$ 2.5$ million during the nine months ended September 30, 2013. The increase in our promotional expense during the third quarter of 2014 was primarily due to higher customer acquisition. The decrease in our promotional expense during the nine months ended September 30, 2014 is primarily attributable to lower coupon redemption rates.

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Cost of product revenue remained unchanged at $\$ 1.3$ million in the third quarter of 2014 and 2013 and decreased 5\% to $\$ 4.1$ million in the nine months ended September 30, 2014 from $\$ 4.3$ million in the nine months ended September 30, 2013. The percentage decrease in the cost of product revenue during the nine months ended September 30, 2014 is primarily due to lower fulfillment costs.

Cost of insurance revenue increased $28 \%$ to $\$ 843,000$ in the third quarter of 2014 from $\$ 659,000$ in the third quarter of 2013 and increased $14 \%$ to $\$ 2.2$ million in the nine months ended September 30, 2014 from $\$ 2.0$ million in the nine months ended September 30, 2013. The percentage increase in cost of insurance revenue was consistent with the percentage increase in insurance revenue.

Cost of PhotoStamps revenue increased $66 \%$ to $\$ 1.3$ million in the third quarter of 2014 from $\$ 777,000$ in the third quarter of 2013 and increased $26 \%$ to $\$ 3.3$ million in the nine months ended September 30, 2014 from $\$ 2.6$ million in the nine months ended September 30, 2013. The percentage increase in cost of PhotoStamps revenue is higher compared to the percentage increase in PhotoStamps revenue primarily due to an increase in high volume business orders, which typically have lower gross margins.

## Operating Expenses

The following table outlines the components of our operating expense and their respective percentages of total revenue for the periods indicated (in thousands except percentage):

Operating expenses:
Sales and marketing
Three Months

| Ended | Nine Months Ended |  |  |
| :--- | :---: | :--- | :---: |
| September 30, |  | September 30, |  |
| 2014 | 2013 | 2014 | 2013 |
|  |  |  |  |
| $\$ 9,516$ | $\$ 9,095$ | $\$ 31,549$ | $\$ 29,270$ |
| 3,407 | 2,844 | 9,359 | 8,187 |
| 6,191 | 3,961 | 15,738 | 11,553 |
| 860 | - | 860 | - |
| $\$ 19,974$ | $\$ 15,900$ | $\$ 57,506$ | $\$ 49,010$ |

Operating expenses as a percent of total revenue:
Sales and marketing
Research and development
General and administrative
Contingent consideration charges
Total operating expenses

| 25.2 | $\%$ | 29.1 | $\%$ | 29.9 | $\%$ | 30.7 | $\%$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| 9.0 | $\%$ | 9.1 | $\%$ | 8.9 | $\%$ | 8.6 | $\%$ |
| 16.4 | $\%$ | 12.7 | $\%$ | 14.9 | $\%$ | 12.1 | $\%$ |
| 2.3 | $\%$ | - |  | 0.8 | $\%$ | - |  |
| 52.8 | $\%$ | 50.9 | $\%$ | 54.6 | $\%$ | 51.3 | $\%$ |

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Sales and Marketing
Sales and marketing expense principally consists of spending to acquire new customers and compensation and related expenses for personnel engaged in sales, marketing, and business development activities. Sales and marketing expense increased $5 \%$ to $\$ 9.5$ million in the third quarter of 2014 from $\$ 9.1$ million in the third quarter of 2013 , and increased $8 \%$ to $\$ 31.5$ million in the nine months ended September 30, 2014 from $\$ 29.3$ million in the nine months ended September 30, 2013. Sales and marketing spending in both the third quarter and nine months ended September 30, 2014 in our Core mailing and shipping business increased as we continued to focus on customer acquisition while spending in our Non-Core mailing and shipping and PhotoStamps businesses both decreased compared to 2013. Ongoing marketing programs include the following: customer referral programs, customer re-marketing efforts, direct mail, online advertising, partnerships, telemarketing, and traditional advertising.

## Research and Development

Research and development expense principally consists of compensation for personnel involved in the development of our services, depreciation of equipment and software and expenditures for consulting services and third party software. Research and development expense increased $20 \%$ to $\$ 3.4$ million in the third quarter of 2014 from $\$ 2.8$ million in the third quarter of 2013, and increased $14 \%$ to $\$ 9.4$ million in the nine months ended September 30, 2014 from $\$ 8.2$ million in the nine months ended September 30, 2013. The increase is primarily due to an increase in headcount-related expenses to support our expanded product offerings and technology infrastructure investments.

## General and Administrative

General and administrative expense principally consists of compensation and related costs for executive and administrative personnel, fees for legal and other professional services, depreciation of equipment, software and building used for general corporate purposes and amortization of intangible assets. General and administrative expense increased $56 \%$ to $\$ 6.2$ million in the third quarter of 2014 from $\$ 4.0$ million in the third quarter of 2013, and increased $36 \%$ to $\$ 15.7$ million in the nine months ended September 30, 2014 from $\$ 11.6$ million in the nine months ended September 30, 2013. The increase, both during the third quarter and nine months ended September 30, 2014, is primarily attributable to an increase in headcount related expenses and infrastructure investments to support the growth in the business, increased corporate legal expenses not related to our acquisition and the inclusion of acquisition related corporate development expenses and the amortization of acquired intangibles in the second and third quarter of 2014 that we did not have in the second and third quarter of 2013.

## Contingent consideration charges

Contingent consideration charges is attributable to the change in the fair value of our contingent consideration liability related to the acquisition of ShipStation. Contingent consideration changes was $\$ 860,000$ during the third quarter of 2014. We did not have this charge in the third quarter of 2013. See Note 2 - "Acquisition" for further description of our contingent consideration liability related to the acquisition of ShipStation.

Interest and Other Income, Net
Interest and other income, net primarily consists of interest income from cash equivalents, short-term and long-term investments and rental income from our corporate headquarters in El Segundo, California. Interest and other income, net decreased $23 \%$ to $\$ 71,000$ in the third quarter of 2014 from $\$ 92,000$ in the third quarter of 2013, and decreased $13 \%$ to $\$ 296,000$ in the nine months ended September 30, 2014 from $\$ 341,000$ in the nine months ended September 30, 2013. The decrease, both during the third quarter and nine months ended September 30, 2014 is primarily due to (1) lower yields on our investment balances including certain investments in our portfolio that matured and were replaced with lower yield investments and (2) lower cash and investment balances as a result of the use of cash for the
acquisitions of ShipStation and ShipWorks and share repurchases during the third quarter of 2014.

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Provision for Income Taxes
In the third quarter of 2014, our net income tax benefit consisted of an income tax benefit resulting from a release of a portion of our valuation allowance offset by current income tax expense consisting of federal and state alternative minimum taxes. On June 10, 2014 we completed our acquisition of ShipStation. On August 29, 2014 we completed our acquisition of ShipWorks. Based on these discrete events, we re-evaluated our forecast of our projected taxable income. As a result, we released a portion of our valuation allowance totaling approximately $\$ 3.6$ million and $\$ 345,000$ during the second and third quarter of 2014, respectively. We recorded current income tax expense for alternative minimum federal and state taxes of $\$ 260,000$ and $\$ 599,000$ in the third quarter of 2014 and nine months ended September 30, 2014, respectively. Accordingly, our net income tax benefit in third quarter of 2014 was $\$ 85,000$ compared to alternative minimum income tax expense for federal and state of $\$ 90,000$ in the third quarter of 2013. Net income tax benefit in the nine months ended September 30, 2014 was $\$ 3.4$ million compared to alternative minimum income tax expense for federal and state of $\$ 180,000$ in the nine months ended September 30, 2013.

We continued to evaluate the appropriateness of our deferred tax assets and related valuation allowance in accordance with ASC 740 based on all available positive and negative evidence. As of September 30, 2014, we continued to maintain a valuation allowance for the remainder of our gross deferred tax assets.

We evaluated the appropriateness of our deferred tax assets and related valuation allowance in accordance with ASC 740 based on all available positive and negative evidence, including our recent earning trend, expected future taxable income and the federal and state effective tax rates related to future taxable income.

## Liquidity and Capital Resources

As of September 30, 2014 and December 31, 2013, we had approximately $\$ 45$ million and $\$ 87$ million, respectively, in cash, cash equivalents and short-term and long-term investments. We invest available funds in short-term and long-term securities, including money market funds, corporate bonds, asset backed securities, and US government and agency bonds, and do not engage in hedging or speculative activities.

Net cash provided by operating activities was $\$ 39.6$ million and $\$ 33.2$ million during the nine months ended September 30, 2014 and 2013, respectively. The increase in net cash provided by operating activities was primarily attributable to the growth in our revenue and changes in our operating assets and liabilities.

Net cash used in investing activities was $\$ 68.6$ million and $\$ 5.8$ million during the nine months ended September 30, 2014 and 2013, respectively. The increase in net cash used in investing activities was primarily due to the acquisition of ShipStation and ShipWorks (see Note 2 - "Acquisitions").

Net cash used in financing activities was $\$ 10.0$ million during the nine months ended September 30, 2014 and net cash provided in financing activities was $\$ 8.2$ million during the nine months ended September 30, 2013. The increase in net cash used by financing activities is primarily due to the increase in our stock repurchase program.

We believe our available cash and marketable securities, together with the cash flow from operations, will be sufficient to fund our business for at least the next twelve months.

There have been no material changes to our contractual obligations and commercial commitments included in Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2013.

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Updated Expectations for 2014
We currently expect the following trends for 2014:
-We expect total revenue to be in a range of between $\$ 135$ million to $\$ 150$ million.
-We expect earnings per share to be in the range between $\$ 1.85$ to $\$ 2.25$ per fully diluted share.
We expect year over year percentage growth in Core Mailing and Shipping revenue to be up in a range from the lower to upper teens in 2014 compared to 2013.
-We expect enhanced promotion revenue will be down in 2014 compared to 2013.
We are targeting small business customer acquisition spending in our Core PC Postage business to be up by $5 \%$ to $15 \%$ compared to 2013.

We expect research and development expenses to be higher in 2014 as compared to 2013, primarily related to - expected increased headcount costs to support the growth in our products and services and as a result of our recent acquisitions.

We expect General and Administrative expenses to be higher in 2014 compared to 2013, primarily related to increased headcount costs to support the growth in the business and as a result of our recent acquisitions.
-We expect capital expenditures for our business to be between approximately $\$ 2$ million to $\$ 3$ million in 2014.
As discussed above, our expectations are subject to substantial uncertainty and our results are subject to macro-economic factors and other factors which could cause these trends to be worse than our current expectation or which could cause actual results to be materially different than our current expectations. These expectations are "forward looking statements", are made only as of the date of this Report and are subject to the qualification and limitations on the forward-looking statements discussion on page 19 of this Report.

## Critical Accounting Policies

Management's discussion and analysis of our financial condition and results of operations is based on our unaudited financial statements. The preparation of these financial statements is based on the selection of accounting policies and the application of significant accounting estimates, some of which require management to make judgments, estimates and assumptions that affect the amounts reported in the financial statements and notes. Except as noted below, for more information regarding our critical accounting estimates and policies, see Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations-Critical Accounting Policies and Judgments" of our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC on March 17, 2014.

## Business Combinations

We account for business combinations using the acquisition method of accounting. Under this method, assets and liabilities are recognized at fair value at the date of acquisition. The excess of the purchase price over the fair value of assets acquired and liabilities assumed is recognized as goodwill. Certain adjustments to the assessed fair values of the assets and liabilities made subsequent to the acquisition date, but within the measurement period, which is up to one year, are recorded as adjustments to goodwill. Any adjustments subsequent to the measurement period are recorded in income. Results of operations of the acquired entity are included in our results from the date of the acquisition onward and include amortization expense arising from acquired tangible and intangible assets. We
expense all corporate development costs associated with business combinations.

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SPECIAL NOTICE REGARDING PURCHASES OF MORE THAN 5\% OF OUR STOCK
We currently have federal and state net operating loss ("NOL") carry-forwards. Under Internal Revenue Code Section 382 rules, if a "change of ownership" is triggered, our NOL asset may be impaired. A change in ownership can occur whenever there is a shift in ownership by more than 50 percentage points by one or more " $5 \%$ shareholders" within a three-year period. We estimate that as of September 30, 2014, we were at approximately a $14 \%$ level compared with the $50 \%$ level that would trigger impairment of our NOL asset.

Under our certificate of incorporation, any person, company or investment firm that wishes to become a " $5 \%$ shareholder" (as defined in our certificate of incorporation) must first obtain a waiver from our board of directors. In addition, any person, company or investment firm that is already a " $5 \%$ shareholder" of ours cannot make any additional purchases of our stock without a waiver from our board of directors. The NOL protective provisions contained in our certificate of incorporation (the "NOL Protective Measures") are more specifically described in our Definitive Proxy filed with the Securities and Exchange Commission on April 2, 2008.

On July 22, 2010, our board of directors suspended the NOL Protective Measures by approving a waiver from the NOL Protective Measures to all persons and entities, including companies and investment firms. As a result, our stockholders are now allowed to become " $5 \%$ shareholders" and existing " $5 \%$ shareholders" are allowed to make additional purchases of our stock each without having to comply with the restrictions contained in the NOL Protective Measures. This waiver may be revoked by our board of directors at any time if the board deems the revocation necessary to protect against a Section 382 "change of ownership" that would limit our ability to utilize future NOLs. For complete details about this waiver from the NOL Protective Measures, please see our Form 8-K filed on July 28, 2010

As of October 31, 2014, we had approximately $15,910,545$ million shares outstanding, and therefore ownership of approximately 795,000 shares or more would currently constitute a " $5 \%$ shareholder". We strongly urge that any stockholder contemplating becoming a $5 \%$ or more shareholder contact us before doing so.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We have not used derivative financial instruments in our investment portfolio. None of the instruments in our investment portfolio are held for trading purposes. Our cash equivalents and investments consist of money market, U.S. government obligations, asset-backed securities and public corporate debt securities with weighted average maturities of 460 days at September 30, 2014. Our cash equivalents and investments approximated $\$ 45$ million and had a weighted average interest rate of $0.53 \%$. Interest rate fluctuations impact the carrying value of the portfolio. The fair value of our portfolio of marketable securities would not be significantly affected by either a $10 \%$ increase or decrease in the rates of interest due primarily to the short-term nature of the portfolio. We do not believe that the future market risks related to the above securities will have a material adverse impact on our financial position, results of operations or liquidity.

As we do not have any operations outside of the United States, we are not exposed to foreign currency risks.

## ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures We maintain disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act).

As of the end of the period covered by this Report, our management evaluated, with the participation of our Principal Executive Officer and Principal Financial Officer, the effectiveness of our disclosure controls and procedures as of the
end of the period covered by this report. Based on that evaluation, our Principal Executive Officer and Principal Financial Officer have concluded, as of that time, that our disclosure controls and procedures were effective.

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Changes in Internal Controls
During the quarter ended September 30, 2014, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

## ITEM 1.LEGAL PROCEEDINGS

See Note 3 - "Legal Proceedings" of our Notes to Consolidated Financial Statements, which is incorporated herein by reference.

## ITEM 1A. RISK FACTORS

Except as noted below, we are not aware of any material changes to the risk factors included in Item 1A "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC on March 17, 2014.

We may expand through acquisitions of, or investments in, other companies or technologies, which may result in additional dilution to our stockholders and consume resources that may be necessary to sustain our business.

As part of our business strategy to acquire complementary services, technologies or businesses we may:

- issue additional equity securities that would dilute our stockholders;
- use cash that we may need in the future to operate our business; and
- incur debt that could have terms unfavorable to us or that we might be unable to repay.

Business acquisitions, such as the Auctane LLC and Interapptive, Inc. acquisitions we made during the second and third quarters of 2014, respectively, and which we discuss elsewhere in this Report, also involve risks of unknown liabilities and potential litigation associated with the acquired business. In addition, we may not realize the anticipated benefits of any acquisition, including securing the services of key employees. Incurring unknown liabilities or the failure to realize the anticipated benefits of an acquisition could seriously harm our business.

Pending or future litigation could have a material adverse effect on our financial position or results of operations.
For information concerning material litigation in which we are involved, please see the "Legal Proceedings" note in the Notes to Consolidated Financial Statements contained elsewhere in this Report. Litigation is uncertain, and the outcome of individual cases is often not predictable with any degree of certainty. We establish provisions for loss contingencies for matters in which losses are probable and can be reasonably estimated. Some of the matters pending against us involve potential compensatory or punitive damage claims, or sanctions, that, if awarded could require us to pay damages or make other expenditures in amounts that could exceed any loss provisions we have made or otherwise have a material adverse effect on our financial position or results of operations.

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## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Issuer Purchases of Equity Securities
We did not purchase any of our common stock during the third quarter of 2014.

| Period | Total <br> Number of Shares <br> Purchased | Average <br> Price <br> Paid <br> per <br> Share | Total <br> Number of <br> Shares <br> Purchased <br> as <br> Part of <br> Publicly <br> Announced <br> Plans or <br> Programs <br> (1) | Approximate <br> Dollar <br> Value of <br> Shares That <br> May Yet be <br> Purchased <br> Under the <br> Plans or <br> Programs <br> (in 000's) |
| :---: | :---: | :---: | :---: | :---: |
| July 1, 2014 - July 31, 2014 | - |  |  | \$ 16,265 |
| August 1, 2014 - August 31, 2014 |  |  |  | \$ 16,265 |
| September 1, 2014 - September 30, 2014 |  |  |  | \$ 16,265 |

(1) On October 29, 2014, our Board of Directors approved a new share repurchase program that replaces all prior repurchase programs and authorizes the Company to repurchase up to 1.0 million shares of stock during the next twelve months.

We will consider repurchasing stock in the future by evaluating such factors as the price of the stock, the daily trading volume and the availability of large blocks of stock and any additional constraints related to material inside information we may possess. Our repurchase of any of our shares will be subject to limitations that may be imposed on such repurchases by applicable securities laws and regulations and the rules of The NASDAQ Stock Market. Repurchases may be made in the open market, or in privately negotiated transactions from time to time at our discretion. We have no commitment to make any repurchases.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES
None.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.
ITEM 5. OTHER INFORMATION
None.

## ITEM 6. EXHIBITS

31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1

Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002. *

Certification 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.CALXBRL Taxonomy Extension Calculation Linkbase Document
101.DEF XBRL Taxonomy Extension Definition Linkbase Document
101.LAB XBRL Taxonomy Extension Label Linkbase Document
101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

* Furnished, not filed.

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

STAMPS.COM INC.
(Registrant)
November 7, 2014 By:/s/ KEN MCBRIDE
Ken McBride
Chairman and Chief
Executive Officer
November 7, 2014 By:/s/ KYLE HUEBNER
Kyle Huebner
Co-President and
Chief Financial
Officer

