

STRATASYS INC  
Form 10-Q  
May 09, 2012

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-13400

**STRATASYS, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

36-3658792  
(I.R.S. Employer  
Identification No.)

7665 Commerce Way, Eden Prairie, Minnesota  
(Address of principal executive offices)

55344  
(Zip Code)

(952) 937-3000

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer ☐  
Non-accelerated filer ☐

Accelerated filer ☒  
Smaller reporting company ☐

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(Do not check if a smaller reporting company)

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

As of May 1, 2012 the Registrant had 21,291,065 shares of common stock, \$.01 par value, issued and outstanding.

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**Stratasys, Inc.**

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**STRATASYS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED FINANCIAL STATEMENTS**
**PART I - FINANCIAL INFORMATION**
**Item 1. Financial Statements.**
**Consolidated Balance Sheets**

|   | <b>March 31,<br/>2012<br/>(unaudited)</b> | <b>December 31,<br/>2011</b> |
|---|---|------------------------------|
| <b>ASSETS</b>   |   |                              |
| <b>Current assets</b>   |   |                              |
| Cash and cash equivalents   | \$ 24,427,680                             | \$ 20,092,200                |
| Short-term investments - held to maturity   | 17,621,567                                | 14,602,408                   |
| Accounts receivable, less allowance for doubtful<br>accounts of \$1,010,000 at March 31, 2012<br>and \$1,089,000 at December 31, 2011             | 28,149,480                                | 26,230,289                   |
| Inventories   | 21,619,711                                | 22,771,460                   |
| Net investment in sales-type leases, less allowance<br>for doubtful accounts of \$258,000 at March 31,<br>2012 and \$230,000 at December 31, 2011 | 3,846,831                                 | 3,295,039                    |
| Prepaid expenses and other current assets   | 2,617,025                                 | 3,259,012                    |
| Deferred income taxes   | 2,973,000                                 | 2,973,000                    |
| <b>Total current assets</b>   | <b>101,255,294</b>                        | <b>93,223,408</b>            |
| <b>Property and equipment, net</b>  | <b>41,494,535</b>                         | <b>39,669,433</b>            |
| <b>Other assets</b>   |   |                              |
| Goodwill  | 25,417,558                                | 25,393,967                   |
| Other intangible assets, net  | 25,020,741                                | 25,295,032                   |
| Net investment in sales-type leases   | 5,500,508                                 | 5,494,753                    |
| Long-term investments - held to maturity  | 29,904,534                                | 32,581,472                   |
| Other non-current assets  | 145,332                                   | 112,300                      |
| <b>Total other assets</b>   | <b>85,988,673</b>                         | <b>88,877,524</b>            |
| <b>Total assets</b>   | <b>\$ 228,738,502</b>                     | <b>\$ 221,770,365</b>        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |   |                              |
| <b>Current liabilities</b>  |   |                              |
| Accounts payable and other current liabilities  | \$ 19,404,542                             | \$ 19,368,197                |
| Unearned revenues   | 10,486,025                                | 9,768,610                    |
| <b>Total current liabilities</b>  | <b>29,890,567</b>                         | <b>29,136,807</b>            |
| <b>Non-current liabilities</b>  |   |                              |
| Deferred tax liabilities  | 6,760,000                                 | 6,760,000                    |
| Unearned revenues - long-term   | 2,656,101                                 | 2,562,195                    |
| <b>Total liabilities</b>  | <b>39,306,668</b>                         | <b>38,459,002</b>            |
| <b>Commitments and contingencies</b>  |   |                              |

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| <b>Stockholders' equity</b>  |    |              |                |
|--|----|--------------|----------------|
| Common stock, \$.01 par value, authorized 30,000,000 shares;<br>26,978,696 and 26,933,301 shares issued at March 31,<br>2012 and December 31, 2011, respectively |    |              |                |
|  |    | 269,787      | 269,333        |
| Additional paid-in capital   |    | 119,619,707  | 118,134,006    |
| Retained earnings  |    | 108,534,193  | 104,011,848    |
| Accumulated other comprehensive income (loss)  |    | 12,572       | (99,399)       |
| Treasury stock at cost, 5,687,631 shares at March 31,<br>2012 and December 31, 2011  |    |              |                |
|  |    | (39,004,425) | (39,004,425)   |
| Total stockholders' equity   |    | 189,431,834  | 183,311,363    |
| <b>Total liabilities and stockholders' equity</b>  | \$ | 228,738,502  | \$ 221,770,365 |

See accompanying notes to consolidated financial statements.

**STRATASYS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED FINANCIAL STATEMENTS**
**Consolidated Statements of Operations and Comprehensive Income (Unaudited)**

|   | <b>Three Months Ended March 31,</b> |               |
|---|-------------------------------------|---------------|
|   | <b>2012</b>                         | <b>2011</b>   |
| <b>Net sales</b>                                  |                                     |               |
| Products  | \$ 37,545,792                       | \$ 28,096,205 |
| Services  | 7,418,309                           | 6,481,924     |
|   | 44,964,101                          | 34,578,129    |
| <b>Cost of sales</b>                              |                                     |               |
| Products  | 17,810,559                          | 13,485,265    |
| Services  | 4,198,599                           | 2,842,412     |
|   | 22,009,158                          | 16,327,677    |
| <b>Gross profit</b>                               | 22,954,943                          | 18,250,452    |
| <b>Operating expenses</b>                         |                                     |               |
| Research and development                          | 4,352,160                           | 3,348,093     |
| Selling, general and administrative               | 11,374,792                          | 8,736,231     |
|   | 15,726,952                          | 12,084,324    |
| <b>Operating income</b>                           | 7,227,991                           | 6,166,128     |
| <b>Other income (expense)</b>                     |                                     |               |
| Interest income, net                              | 250,426                             | 205,781       |
| Foreign currency transaction gains (losses), net  | (52,337)                            | (131,115)     |
| Other   | 97,625                              | 1,396,606     |
|   | 295,714                             | 1,471,272     |
| <b>Income before income taxes</b>                 | 7,523,705                           | 7,637,400     |
| Income taxes                                      | 3,001,370                           | 2,647,905     |
| <b>Net income</b>                                 | \$ 4,522,335                        | \$ 4,989,495  |
| <b>Net income per common share</b>                |                                     |               |
| Basic   | \$ 0.21                             | \$ 0.24       |
| Diluted   | 0.21                                | 0.23          |
| <b>Weighted average common shares outstanding</b> |                                     |               |
| Basic   | 21,265,772                          | 21,009,871    |
| Diluted   | 21,802,393                          | 21,647,691    |
| <b>Comprehensive Income</b>                       |                                     |               |
| Net income  | \$ 4,522,335                        | \$ 4,989,495  |
| Other comprehensive income (loss):                |                                     |               |
| Foreign currency translation adjustment           | 111,971                             | 221,641       |
| <b>Comprehensive income</b>                       | \$ 4,634,306                        | \$ 5,211,136  |

See accompanying notes to consolidated financial statements.



**STRATASYS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED FINANCIAL STATEMENTS**
**Consolidated Statements of Cash Flows (Unaudited)**

|  | <b>Three Months Ended March 31,</b> |                      |
|--|-------------------------------------|----------------------|
|  | <b>2012</b>                         | <b>2011</b>          |
| <b>Cash flows from operating activities</b>  |                                     |                      |
| Net income   | \$ 4,522,335                        | \$ 4,989,495         |
| Adjustments to reconcile net income to net cash provided by operating activities:        |                                     |                      |
| Depreciation   | 1,531,418                           | 1,394,348            |
| Amortization   | 1,118,300                           | 759,836              |
| Stock-based compensation   | 480,639                             | 323,598              |
| Excess tax benefit from stock options  | (190,868)                           | (1,866,655)          |
| Gain on disposal of property and equipment   | -                                   | (156,272)            |
| Gain on sale of investment   | -                                   | (1,204,408)          |
| <b>Increase (decrease) in cash attributable to changes in operating and liabilities:</b> |                                     |                      |
| Accounts receivable, net   | (1,919,191)                         | (1,827,967)          |
| Inventories  | 246,870                             | (1,655,279)          |
| Net investment in sales-type leases  | (557,547)                           | (904,723)            |
| Prepaid expenses   | 641,987                             | 598,820              |
| Other assets   | (33,032)                            | 134,615              |
| Accounts payable and other current liabilities   | 226,759                             | 2,164,073            |
| Unearned revenues  | 811,321                             | 857,717              |
| <b>Net cash provided by operating activities</b>   | <b>6,879,445</b>                    | <b>3,607,198</b>     |
| <b>Cash flows from investing activities</b>  |                                     |                      |
| Proceeds from the maturity of investments  | 1,500,000                           | 5,183,352            |
| Proceeds from the sale of investments  | 4,802,917                           | -                    |
| Purchase of investments  | (6,806,435)                         | (3,082,574)          |
| Acquisition of property and equipment  | (2,457,357)                         | (1,250,132)          |
| Acquisition of intangible and other assets   | (706,304)                           | (2,586,064)          |
| <b>Net cash used in investing activities</b>   | <b>(3,667,179)</b>                  | <b>(1,735,418)</b>   |
| <b>Cash flows from financing activities</b>  |                                     |                      |
| Proceeds from exercise of stock options  | 814,648                             | 4,606,743            |
| Excess tax benefit from stock options  | 190,868                             | 1,866,655            |
| <b>Net cash provided by financing activities</b>   | <b>1,005,516</b>                    | <b>6,473,398</b>     |
| <b>Effect of exchange rate changes on cash</b>   | <b>117,698</b>                      | <b>185,194</b>       |
| <b>Net increase in cash and cash equivalents</b>   | <b>4,335,480</b>                    | <b>8,530,372</b>     |
| <b>Cash and cash equivalents, beginning of period</b>                                    | <b>20,092,200</b>                   | <b>27,554,411</b>    |
| <b>Cash and cash equivalents, end of period</b>  | <b>\$ 24,427,680</b>                | <b>\$ 36,084,783</b> |
| <b>Supplemental disclosures of cash flow information:</b>                                |                                     |                      |
| Cash paid for taxes  | \$ 2,391,487                        | \$ 303,282           |
| Transfer of fixed assets to inventory  | 195,050                             | 79,028               |
| Transfer of inventory to fixed assets  | 1,099,929                           | 794,014              |

See accompanying notes to consolidated financial statements.





## STRATASYS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Note 1. Basis of Presentation and Consolidation

The consolidated interim financial statements include the accounts of Stratasys, Inc. and its wholly-owned subsidiaries (collectively, the Company). All intercompany accounts and transactions have been eliminated in consolidation. The consolidated interim financial information herein is unaudited; however, such information reflects all adjustments (consisting of normal, recurring adjustments), which are, in the opinion of management, necessary for a fair statement of results for the interim period. Certain reclassifications have been made to the prior years financial statements to conform to the current year presentation. These reclassifications had no net effect on previously reported results of operations. The results of operations for the three months ended March 31, 2012 are not necessarily indicative of the results to be expected for the full year. Certain financial information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted. The reader is referred to the audited consolidated financial statements and notes thereto for the year ended December 31, 2011, filed as part of the Company's Annual Report on Form 10-K for such year.

#### Note 2. Business Combinations

On May 3, 2011, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with Solidscape, Inc., a Delaware corporation (Solidscape); Granite Acquisition Corporation, a Delaware corporation and the Company's wholly-owned subsidiary (Merger Sub); and the Controlling Stockholders identified in the Merger Agreement, pursuant to which the Company acquired all the outstanding shares of capital stock of Solidscape in a cash-for-stock transaction where all the outstanding shares of capital stock and all in-the-money options to purchase shares of common stock of Solidscape were exchanged for an aggregate purchase price of \$39.1 million. Under the terms of the Merger Agreement, Merger Sub merged with and into Solidscape, with Solidscape surviving as the Company's wholly-owned subsidiary (the Merger). The Merger Agreement was unanimously approved by the Company's board of directors.

The acquisition has been accounted for under the acquisition method of accounting in accordance with ASC Topic 805, *Business Combinations*. The final allocation of the purchase price to assets acquired and liabilities assumed is as follows:

|                                      | <b>Allocation of<br/>Purchase Price</b> |
|--------------------------------------|---|
| Cash and cash equivalents            | \$ 540,489                              |
| Accounts receivable                  | 439,284                                 |
| Inventories                          | 1,577,970                               |
| Other current assets                 | 771,441                                 |
| Deferred income taxes                | 383,000                                 |
| Property and equipment, net          | 364,443                                 |
| Goodwill                             | 24,615,757                              |
| Intangible assets                    | 19,500,000                              |
| Accounts payable & other liabilities | (1,041,681)                             |
| Unearned revenue                     | (154,031)                               |
| Deferred tax liabilities             | (7,897,098)                             |
| Total purchase price                 | \$ 39,099,574                           |

**STRATASYS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The allocation of the purchase price to the net assets acquired and liabilities assumed resulted in the recognition of the following intangible assets:

|                         | <b>Amount</b> | <b>Weighted Average<br/>Life - Years</b> |
|-------------------------|---------------|--|
| Developed technology    | \$ 11,750,000 | 6.7                                      |
| Customer base           | 5,100,000     | 15                                       |
| Trademarks              | 1,150,000     | 15                                       |
| In-process R&D          | 1,150,000     | Indefinite                               |
| Non-compete agreement   | 350,000       | 3  |
| Total intangible assets | \$ 19,500,000 |  |

The fair values of the identified intangible assets were estimated using an income approach. Under the income approach, an intangible asset's fair value is equal to the present value of future economic benefits to be derived from ownership of the asset. Indications of value are developed by discounting future net cash flows to their present value at market-based rates of return. The goodwill recognized as a result of the Solidscape acquisition is primarily attributable to the value of the workforce and corporate synergies. None of the goodwill recognized is expected to be deductible for income tax purposes. The useful life of the intangible assets for amortization purposes was determined with the help of outside consultants considering the period of expected cash flows used to measure the fair value of the intangible assets adjusted as appropriate for the entity-specific factors including legal, regulatory, contractual, competitive economic or other factors that may limit the useful life of intangible assets.

The actual Solidscape net sales and net income included in the Company's Consolidated Statements of Operations for the three months ended March 31, 2012 and the supplemental unaudited pro forma net sales and net income of the combined entity had the acquisition been completed on the first day of the earliest period presented are as follows:

|   | <b>Net Sales</b> | <b>Net Income</b> | <b>Net<br/>Income<br/>Per<br/>Common<br/>Share -<br/>Diluted</b> |
|---|------------------|-------------------|--|
| <b>(Unaudited)</b>  |                  |                   |  |
| Actual for the three months ended March 31, 2012              | \$ 3,390,714     | \$ 151,764        | \$ 0.01  |
| <b>Supplemental pro forma combined results of operations:</b> |                  |                   |  |
| Three months ended March 31, 2011                             | 37,865,383       | 5,282,702         | 0.24   |

**STRATASYS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Adjustments to the supplemental pro forma combined results of operations for the three months ended March 31, 2011 are as follows:

**(Unaudited)**

|  |              |
|--|--------------|
| Net impact of the change in amortization of intangibles                  | \$ 78,488    |
| Add interest on loans and preferred stock no longer incurred post-merger | 288,645      |
| Add management fees no longer incurred post-merger                       | 53,588       |
| Adjust taxes to the blended rate after business combination              | (932,203)    |
|  | \$ (511,482) |

These unaudited pro forma condensed consolidated financial results have been prepared for illustrative purposes only and do not purport to be indicative of the results of operations that actually would have resulted had the acquisition occurred on the first day of the earliest period presented, or of future results of the consolidated entities. The unaudited pro forma condensed consolidated financial information does not reflect any operating efficiencies and cost savings that may be realized from the integration of the acquisition.

**Note 3. Investments**

Classification of investments as current or non-current is dependent upon management's intended holding period, the investment's maturity date and liquidity considerations based on market conditions. These investments are then evaluated and classified as available-for-sale or held-to-maturity in accordance with the provisions of ASC 320, *Investments - Debt and Equity Securities*. This evaluation takes into consideration the Company's past history of holding investments until maturity, projected cash flow estimates, future capital requirements, the existence of credit deterioration of the issuer and the Company's overall investment strategy as established by management and approved by the Company's Board of Directors.

If management has the positive intent and ability to hold its debt securities until maturity, they are classified as held-to-maturity and accounted for using the amortized-cost method. All other securities are classified as available-for-sale and accounted for at fair value with the unrealized gain or loss, net of tax, reported in other comprehensive income. While the Company does not generally hold any investments for trading purposes, the Company did liquidate certain investments during the three months ended March 31, 2012. The Company believes that the liquidation of these investments was an isolated event that is unusual and nonrecurring in nature and was not reasonably anticipated. The net carrying value of liquidated investments was \$4.5 million and the sale resulted in a gain of approximately \$67,000. The Company does not currently hold any investments for trading purposes and had no unrecognized gains or losses related to held-to-maturity investments at March 31, 2011 or December 31, 2011, as the fair value of those investments approximated cost.

The Company invests in certificates of deposit, corporate bonds, tax-free government bonds, and auction rate securities (ARS), all of which are insured. The following is a summary of amounts recorded on the Consolidated Balance Sheet for marketable securities (current and non-current) at March 31, 2012 and December 31, 2011.

**STRATASYS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

|   | <b>March, 31<br/>2012<br/>(unaudited)</b> | <b>December 31,<br/>2011</b> |
|---|---|------------------------------|
| Bonds                                     | \$ 17,621,567                             | \$ 14,602,408                |
| Short-term investments - held to maturity | 17,621,567                                | 14,602,408                   |
| Auction rate securities                   | 2,000,000                                 | 2,000,000                    |
| Bonds                                     | 27,904,534                                | 30,581,472                   |
| Long-term investments - held to maturity  | 29,904,534                                | 32,581,472                   |
| Total investments                         | \$ 47,526,101                             | \$ 47,183,880                |

At March 31, 2012, the Company's investments included:

- approximately \$45.5 million in bonds maturing between July 2012 and September 2016, all of which have ratings between AAA and A3 at March 31, 2012; and
- approximately \$2.0 million of a tax-free ARS, which re-prices approximately every 35 days. The ARS had a rating of A1 at March 31, 2012.

**Note 4. Inventories**

Inventories consisted of the following at March 31, 2012 and December 31, 2011, respectively:

|                 | <b>2012</b>   | <b>2011</b>   |
|-----------------|---------------|---------------|
| Finished goods  | \$ 8,241,814  | \$ 9,805,319  |
| Raw materials   | 13,377,897    | 12,966,141    |
| Total Inventory | \$ 21,619,711 | \$ 22,771,460 |

**Note 5. Material Commitments**

The Company estimates that as of March 31, 2012 and December 31, 2011, it had approximately \$14.8 million and \$23.8 million, respectively, of purchase commitments for inventory from vendors. In addition to purchase commitments for inventory, the Company also has future commitments for leased facilities of approximately \$2.0 million. The Company intends to finance its purchase commitments from existing cash and investments or from cash flows from operations.

**Note 6. Earnings per Common Share**

The Company complies with ASC 260, *Earnings Per Share*, which requires dual presentation of basic and diluted income per common share for all periods presented. Basic net income per share excludes dilution and is computed by dividing net income by the weighted average number of shares outstanding for the periods that have net income. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then share in the income of the Company. The difference between the number of common shares used to compute basic net income per share and diluted net income per share relates to additional common shares that would be issued upon the assumed exercise of stock options and warrants, net of the common shares that would hypothetically be repurchased using the proceeds received from the original exercise.

The additional common shares amounted to 536,621 and 637,820 for the three months ended March 31, 2012 and 2011, respectively. There were no options excluded from the dilution calculation for the three months ended March 31, 2012 and March 31, 2011, since the market price of the Company's common stock exceeded the exercise price of all outstanding options.



**STRATASYS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

The following table provides information relative to stock options that were exercised in the respective periods:

|  | <b>Periods Ended March 31,</b> |                |
|--|--------------------------------|----------------|
|  | <b>2012</b>                    | <b>2011</b>    |
| Proceeds from exercise of stock options                                    | \$ 814,648                     | \$ 4,606,743   |
| Number of options exercised  | 45,395                         | 309,507        |
| Weighted average exercise price  | \$ 17.95                       | \$ 14.88       |
|  |                                |                |
| Tax benefit recognized in stockholders' equity from stock option exercises | \$ (190,868)                   | \$ (2,340,177) |

**Note 7. Stock-Based Compensation**

Stock-based compensation expense, the associated estimated deferred income tax benefit on nonqualified stock options and the current income tax benefit resulting from disqualifying dispositions of incentive stock options were as follows for the respective periods:

|                                  | <b>Periods Ended March 31,</b> |             |
|----------------------------------|--------------------------------|-------------|
|                                  | <b>2012</b>                    | <b>2011</b> |
| Stock-based compensation expense | \$ 480,639                     | \$ 323,598  |
| Income tax benefit               | (183,248)                      | (176,458)   |
|                                  | \$ 297,391                     | \$ 147,140  |

There were no options granted in the three months ended March 31, 2012 or the three months ended March 31, 2011.

**Note 8. Income Taxes**

The Company uses a two-step approach to recognizing and measuring uncertain tax positions (tax contingencies) in accordance with ASC 740, *Income Taxes*. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The Company reevaluates these tax positions quarterly and makes adjustments as required. The Company had unrecognized tax benefits of \$1.7 million and \$1.6 million at March 31, 2012 and December 31, 2011, respectively.

The effective tax rate of 39.9% for the quarter ended March 31, 2012 was higher as compared to the 34.7% effective rate for the same prior-year period. The increase is primarily due to non-deductible expenses related to the Company's current efforts to combine with Objet Ltd. In addition, the federal research credit expired December 31, 2011 and, therefore, was not considered in computing the effective rate for the quarter ended March 31, 2012.

**Note 9. Fair Value Measurements**

Fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. A hierarchy has been established for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available.

## **STRATASYS, INC. AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Observable inputs are inputs market participants would use in valuing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the factors market participants would use in valuing the asset or liability developed based upon the best information available under the circumstances. The hierarchy is broken down into three levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

During the quarter ended March 31, 2012, the Company had no significant measurements of assets or liabilities at fair value on a recurring or nonrecurring basis subsequent to their initial recognition.

#### **Note 10. Foreign Currency Hedge**

The Company invoices sales to certain European distributors in Euros and such receivable balances are subject to fluctuations in the exchange rates of that currency in relation to the United States dollar. The Company's strategy is to hedge most of its Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that its earnings will be adversely affected by changes in currency exchange rates. The Company does not use derivative financial instruments for speculative or trading purposes. The Company enters into 30-day foreign currency forward contracts on the last day of each month and therefore the notional value of the contract equals the fair value at the end of each reporting period. As such, there is no related asset or liability or unrealized gain or loss recorded on the Balance Sheet as of the end of the period. All realized gains and losses related to hedging activities are recorded in current period earnings under the Consolidated Statements of Operations and Comprehensive Income caption "Foreign currency transaction gains (losses), net".

The Company hedged between €5.5 million and €9.8 million for the three months ended March 31, 2012 and between €4.5 million and €5.6 million for the three months ended March 31, 2011 of accounts receivable and cash that was denominated in Euros. The foreign currency forward contracts resulted in a currency translation loss of approximately \$0.3 million and \$0.5 million for the three months ended March 31, 2012 and March 31, 2011, respectively. The resulting gain or loss from foreign currency forward contracts only partially offset the total foreign currency transactions gains or losses that the Company recorded.

The Company will continue to monitor exposure to currency fluctuations. Instruments that may be used to hedge future risks may include foreign currency forward, swap, and option contracts. These instruments may be used to selectively manage risks, but there can be no assurance that the Company will be fully protected against material foreign currency fluctuations.

#### **Note 11. Accounting for Collaborative Arrangements**

In 2008, the Company fulfilled its responsibilities under a three-year, \$3.6 million agreement with a Fortune 500 global manufacturing company to jointly advance its proprietary FDM (Fused Deposition Modeling) technology for rapid manufacturing applications. This agreement entitled the Company to receive reimbursement payments as it achieved specific milestones stated in the agreement. This effort was focused around the Company's high-performance systems and resulted in the commercial release of the Fortus 900mc. Because receipt of these payments represented reimbursements of costs actually incurred under this joint development project, all payments received were recorded as offsets to the research and development expenditures and are therefore not recognized as revenue.

Due to the success of this initial arrangement, the Company is continuing this relationship under similar terms and objectives. During the three months ended March 31, 2012 and March 31, 2011, approximately \$150,000 and \$131,000, respectively, of research and development expenses were offset by payments that were received from that company.



**STRATASYS, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 12. Subsequent Events**

On April 16, 2012, the Company and privately held Objet Ltd., a leading manufacturer of 3D printers for rapid prototyping, announced that the boards of directors of both companies had unanimously approved a definitive merger agreement (the "Merger Agreement") under which the companies would combine in an all-stock transaction.

Under the terms of the agreement, Stratasys will merge with a subsidiary of Objet (the "Merger"), and Stratasys shareholders will receive one Objet ordinary share for each share of Stratasys common stock they own. Upon closing of the transaction, Stratasys shareholders are expected to own 55 percent and Objet shareholders are expected to own 45 percent of the combined company on a fully diluted basis using the treasury stock method.

The combined company, which will operate under the name Stratasys Ltd. and retain the Stratasys ticker symbol, "SSYS", will have dual headquarters in Eden Prairie, Minnesota and Rehovot, Israel, the locations of Stratasys' and Objet's current headquarters, respectively, and will be registered in Israel.

The transaction, which is expected to be completed in the third quarter of 2012, is subject to, among other things, approval by Stratasys shareholders, registration of the Objet ordinary shares issuable to Stratasys shareholders with the Securities and Exchange Commission, the expiration or termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and the satisfaction of regulatory requirements and other customary closing conditions. The approval by the Objet shareholders is required for certain actions related to the Merger. Stratasys and Objet have entered into a voting agreement with the Objet shareholders holding the requisite majority for said actions to secure the vote. The transaction will be taxable to Stratasys shareholders.

In connection with the merger agreement, the Company's board of directors has unanimously adopted a limited duration Rights Agreement (the "Rights Plan") and declared a dividend distribution of one common share purchase right (a "Right") on each outstanding share of its Common Stock. The Rights Plan is designed to ensure that all Stratasys stockholders receive fair and equal treatment in the event that an unsolicited attempt is made to acquire the company. It is intended to provide the board of directors with sufficient time to evaluate alternatives and to maximize value to stockholders.

Further information on the Merger Agreement and Rights Plan is available in our Current Report on Form 8-K dated April 13, 2012 and filed with the SEC on April 17, 2012.

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

### Overview

#### Description of Business

We develop, manufacture, and market a family of 3D printing, rapid prototyping ( RP ) and direct digital manufacturing ( DDM ) systems, which enable engineers and designers to create physical models, tooling, jigs, fixtures, prototypes, and end use parts out of production grade thermoplastic directly from a computer aided design ( CAD ) workstation. Our systems and related consumable products are distributed mainly through a world-wide network of value added resellers and agents that sell and service our products to end users as well as through our OEM Agreement with HP. We also operate a service business that uses our systems to print parts from a customer's CAD file, typically in situations where these customers have not yet purchased a system or do not have enough capacity on their existing systems.

In May 2011, we acquired Solidscape, Inc. for \$39.1 million in cash. Solidscape is a manufacturer of high precision 3D printers and is a proven leader in investment casting applications that require ultra-fine feature detail. This addition provides us with access to markets that we did not previously serve, including the under-penetrated jewelry, dental and precision industrial casting markets. We believe this acquisition provides the potential to expand our technology platform into new applications and will create synergies, particularly in our respective sales channels, manufacturing, and research and development.

On April 16, 2012, Stratasys and privately held Objet Ltd., a leading manufacturer of 3D printers for rapid prototyping, announced that the boards of directors of both companies had unanimously approved a definitive merger agreement (the Merger Agreement ) under which the companies would combine in an all-stock transaction. We believe the Objet technology is complementary to our technology and will create synergies in the respective sales channels. The transaction will position the combined company as a leader within the high-growth 3D printing and direct digital manufacturing industry. Details of the terms of the Merger Agreement and the merger are discussed below under "Developments in Our Business During the Period."

#### Summary of Financial Results

For the quarter ended March 31, 2012, we recorded net income of \$4.5 million, or \$0.21 per diluted share, as compared to net income of \$5.0 million, or \$0.23 per diluted share, for the quarter ended March 31, 2011. Results for the first quarter of 2012 include three months of operations of Solidscape, which was acquired on May 3, 2011.

Our revenues in the first quarter of 2012 increased to \$45.0 million as compared to revenues of \$34.6 million that were reported in the first quarter of 2011. Gross profit of \$23.0 million in the first quarter of 2012 increased as compared to \$18.3 million reported in the prior year.

Our balance sheet continues to be strong. As of March 31, 2012, our cash and investments balance was approximately \$72.0 million, up from \$67.3 million at December 31, 2011. We generated approximately \$6.9 million of cash from operations during the quarter, primarily driven by our net income adjusted for non-cash charges for depreciation, amortization and stock-based compensation. We also have no debt and believe that we have adequate liquidity to fund our growth strategy throughout 2012.

#### Our Market Strategy and Description of Current Conditions

It is our belief that we are successfully implementing our overall marketing strategy in the 3D printing, RP and DDM markets through the expansion of our distribution channel and the introduction of new products.

**Distribution Channel** We use an extensive world-wide reseller network to market and sell our 3D printers, Fortus 3D production systems, and consumable materials, and to provide maintenance service and replacement parts. Most of the reseller outlets have 3D printers available for tradeshow, product demonstrations and other promotional activities. Many of them also enjoy a long-term presence in their respective territories making this distribution model highly effective relative to a direct sales model. In addition to our 3D Printers and 3D production systems, most resellers sell and service a third-party 3D solid CAD software package.

In addition to our reseller network, we have initiated a program to recruit and train a significant number of new selling agents that will focus exclusively on selling our most affordable products. We have now recruited and trained over 90 sales agents in the U.S. who are focused exclusively on selling our uPrint and Mojo 3D printer lines. We expect this initiative, combined with the new low-cost Mojo 3D printing

platform, will drive incremental new volume beginning late in the second quarter of 2012.

In September 2011, we completed the initial term of a Master Original Equipment Manufacturer Agreement (the "OEM Agreement") with Hewlett-Packard Company ("HP"), and are now in an extension term, which currently expires December 31, 2012. Under the OEM Agreement, we are manufacturing a line of FDM ("Fused Deposition Modeling") 3D printers and related accessories and consumables exclusively for HP for resale under the HP DesignJet brand in eight European countries. We believe this distribution channel continues to be a valuable approach to increase sales and enhance awareness of 3D printing.

**3D Printers** We are the unit leader in the commercial 3D printing market and have followed a strategy of moving down the price elasticity curve, evidenced by our introduction of the Mojo, uPrint and uPrint Plus systems. We believe our strategy of offering low-priced 3D printing systems combined with high reliability, ease of use and increased functionality will allow for an increase of 3D printers in the market and continue to make our 3D printers an attractive alternative to our competitors' products. In May 2011, we acquired Solidscape whose 3D printers use Drop-on-Demand thermoplastic ink-jetting technology and high-precision milling to produce extremely high resolution parts with precise details and fine surface finish.

We also believe our lower-priced systems and the expansion of our distribution channel will increase awareness of our technology and products. Lower-priced systems will reduce our margins as a percentage of revenue from the levels we have previously achieved, but we intend to compensate for these lower margins by expanding the market and unit volume for our 3D printers (and related proprietary consumables), thereby substantially increasing the number of 3D printers sold and our overall revenues and profits. Although we believe that there is a large market for our 3D printers, there can be no assurance that we will be able to increase our revenues sufficiently to maintain or increase our profitability.

**RP and DDM Markets** Our strategy in the high-performance market is to expand our installed base of RP and DDM systems by helping customers build stable, strong, accurate and durable parts for functional testing and end-use. We plan to build on our leadership position in this area by offering additional system capabilities and improved material properties. We also have growing opportunities in DDM applications. DDM involves the manufacture of parts fabricated directly from our systems that are subsequently incorporated into the user's end product or production process. DDM is particularly attractive in applications that require short-run or low-volume parts that require rapid turn-around and for which tooling would not be cost effective due to small volumes.

In February 2011, we obtained ISO 9001:2008 certification by maintaining a highly developed quality management system and continually improving its effectiveness in accordance with the ISO requirements. We believe that ISO certification is a key requirement in expanding our products' applicability to the RP and DDM markets that we are focusing on, such as aerospace, defense, medical, and automotive. We will use this certification to demonstrate our ability to consistently provide products that meet customer and applicable regulatory requirements and enhance customer satisfaction through its effective application.

We continued to collaborate with a Fortune 500 global manufacturing company to advance our proprietary FDM technology for direct digital manufacturing applications and expect to maintain this collaboration throughout 2012 for the seventh consecutive year.

**Recurring Revenues** As our installed base of systems has increased, we expect an increasing amount of revenue from the sales of consumables, maintenance contracts, and other services. We have experienced an increase in consumable sales throughout 2011 and into 2012.

**RedEye Paid Parts Service** Our RedEye paid parts service makes and sells physical models, tooling and prototype parts for RP and DDM applications based on our customers' CAD files. We believe that a significant portion of RedEye sales have come from current system users that have had short-term capacity constraints on their own FDM systems. We believe that another part of RedEye sales has come from the rising demand for our technology in DDM applications, because of the production-grade thermoplastics used. To take advantage of the growth we see in our DDM customer base, we are adding staff to our existing sales force that will focus exclusively on large strategic accounts.

### Developments in Our Business During the Period

In May 2012, we introduced the Mojo 3D Printer, which comes in a complete system called a 3D Print Pack. The Mojo 3D Print Pack is the market's lowest-priced, professional-grade complete 3D printing system. Priced at \$9,900 the Mojo 3D Print Pack contains everything needed to produce models, (including material, supplies and a support-removal system). To produce a model, Mojo employs a variation on traditional FDM material extrusion. The ABS material spool and the print head are integrated into a single package, called the QuickPack print engine. To ensure reliability, the print engine is single-use only, and a fresh print head is part of each material change. Modeling operations are controlled with Mojo's preprocessing software, Print Wizard, which helps users manage workflow. Support material removal is also a simple process with the included WaveWash55. It is a self-contained, hands-free support removal system, and it requires no plumbing.

In April 2012, Stratasys and privately held Objet Ltd., a leading manufacturer of 3D printers for rapid prototyping, announced that the boards of directors of both companies had unanimously approved a definitive merger agreement under which the companies would combine in an all-stock transaction. We expect the transaction to position the combined company as a leader within the high-growth 3D printing and direct digital manufacturing industry.

Under the terms of the merger agreement, Stratasys will merge with a subsidiary of Objet, and Stratasys shareholders will receive one Objet ordinary share for each share of Stratasys common stock they own. Upon closing of the transaction, Stratasys shareholders are expected to own 55 percent and Objet shareholders are expected to own 45 percent of the combined company on a fully diluted basis using the treasury stock method.

The combined company, which will operate under the name Stratasys Ltd. and retain the Stratasys ticker symbol, **SSYS**, will have dual headquarters in Eden Prairie, Minnesota and Rehovot, Israel, the locations of Stratasys' and Objet's current headquarters, respectively, and will be registered in Israel.

In February 2012, RedEye obtained AS9100C certification. AS9100 is the quality management system for the aviation, space, and defense industries. AS9100 fully incorporates ISO 9001:2008 while adding nearly 100 additional requirements specific to quality and safety for aerospace. We believe that AS9100C certification in RedEye will help us expand our services' applicability to DDM in the aerospace and defense markets.

In December 2011, we extended our collaborative agreement with a Fortune 500 global manufacturing company to develop new platforms for DDM applications. Due to the success of this arrangement, we are continuing this relationship under similar terms and objectives and have received a purchase order for \$1.9 million expected to be fulfilled in 2012.

In July 2011, we introduced the Fortus 250mc Production System. The Fortus 250mc combines the ease-of-use and affordability of Dimension 3D Printers with the control of Insight Software, used to drive the Fortus line of production systems. With Insight, users will have added control of build speed, part accuracy, and feature detail. The Fortus 250mc uses Stratasys SR-30 soluble support material, which has a faster dissolve time than other soluble support materials.

During the quarter ended June 30, 2011, we signed a modification of our OEM Agreement with HP both expanding the territories and extending the term. The OEM Agreement now includes Austria, Switzerland and Ireland in addition to France, Germany, Italy, Spain and the United Kingdom and extends the expiration date to December 31, 2012.

### Cautionary Note Concerning Factors that May Affect Future Results

Our current and future growth is largely dependent upon our ability to penetrate new markets and develop and market new rapid prototyping and manufacturing systems, materials, applications, and services that meet the needs of our current and prospective customers. Our expense levels are based in part on our expectations of future revenues. While we have adjusted, and will continue to adjust, our expense levels based on both actual and anticipated revenues, fluctuations in revenues in a particular period could adversely impact our operating results. Our ability to continue to implement our strategy in 2012 is subject to numerous uncertainties and risks, many of which are described in this Management's Discussion and Analysis of Financial Condition and Results of Operations, in the section below captioned "Forward Looking Statements and Factors That May Affect Future Results of Operations," and in Item 1A, "Risk Factors," of our Annual Report on Form 10-K for 2011 and our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K filed with the SEC. We cannot ensure that our efforts will be successful.



## Results of Operations

(unaudited)

The following table sets forth certain consolidated statements of operations data as a percentage of net sales for the periods indicated. All items are included in or derived from our consolidated interim statements of operations.

### Three-Month Periods Ended March 31,

|                                      | 2012   | 2011   |
|--------------------------------------|--------|--------|
| Net sales                            | 100.0% | 100.0% |
| Cost of sales                        | 48.9%  | 46.8%  |
| Gross profit                         | 51.1%  | 53.2%  |
| Research and development             | 9.7%   | 9.8%   |
| Selling, general, and administrative | 25.3%  | 25.5%  |
| Operating income                     | 16.1%  | 18.0%  |
| Other income                         | 0.7%   | 4.3%   |
| Income before income taxes           | 16.7%  | 22.3%  |
| Income tax expense                   | 6.7%   | 7.7%   |
| Net income                           | 10.1%  | 14.5%  |

## Net Sales

Our net sales of \$45.0 million in the quarter ended March 31, 2012 increased by 30.0% as compared to net sales of \$34.6 million in the quarter ended March 31, 2011. The following is a breakdown of our revenues by products and services:

### Three- Month Periods Ended March 31,

| (In Thousands) | 2012      | 2011      | Period-over-period change |
|----------------|-----------|-----------|---------------------------|
| Products       | \$ 37,546 | \$ 28,096 | 33.6%                     |
| Services       | 7,418     | 6,482     | 14.4%                     |
|                | \$ 44,964 | \$ 34,578 | 30.0%                     |

Sales derived from products increased \$9.4 million, or 33.6%, in the quarter ended March 31, 2012, as compared with the quarter ended March 31, 2011. System revenue grew by 32.2% as a result of increased sales of our higher priced Fortus 3D production systems and the addition of Solidscape in May 2011. We shipped 822 units in the first quarter of 2012 as compared with 567 units shipped in the first quarter of 2011. The increase in total units shipped as compared to the prior year is primarily due strong unit sales of our new Fortus 250mc, strong HP-branded 3D printer unit sales and the acquisition of Solidscape. Consumable revenue increased 29.6%, primarily driven by acceleration in customer usage, our growing installed base of systems and the acquisition of Solidscape in May 2011.

Sales from our service offerings increased by approximately \$0.9 million, or 14.4%, in the quarter ended March 31, 2012. Maintenance revenue increased by 7.0% for the three months ended March 31, 2012 as compared with the same prior-year period. This increase reflects our growing installed base of systems and strong Fortus system sales, which generally have higher attachment rates for maintenance contracts relative to our 3D printers. Sales from our RedEye paid parts service increased by 24.6% for the three months ended March 31, 2012 as compared to the prior year, primarily resulting from increased new customer business and an increase in average sales price.

Revenues in the Americas region, which includes North and South America, accounted for approximately 52.3% and 54.9% of total revenue for the quarters ended March 31, 2012 and 2011, respectively. Revenues outside the Americas region accounted for approximately 47.7% and 45.1% of total revenues for the quarters ended March 31, 2012 and 2011, respectively.

**Gross Profit****Three-Month Periods Ended March 31,**

(In Thousands)

|          | 2012      | 2011      | Period-over-period change |
|----------|-----------|-----------|---------------------------|
| Products | \$ 19,735 | \$ 14,611 | 35.1%                     |
| Services | 3,220     | 3,639     | -11.5%                    |
| Total    | \$ 22,955 | \$ 18,250 | 25.8%                     |

**Gross Profit as a Percentage of Related Sales**

|          |       |       |  |
|----------|-------|-------|--|
| Products | 52.6% | 52.0% |  |
| Services | 43.4% | 56.1% |  |
| Total    | 51.1% | 52.8% |  |

Gross profit increased by \$4.7 million, or 25.8%, to \$23.0 million in the quarter ended March 31, 2012 as compared with \$18.3 million in the same prior-year period. The increase is primarily attributable to increased sales of our higher-margin Fortus 3D production systems and consumables, as well as the acquisition of Solidscape in May 2011.

Product gross profit increased by 35.1% for the three months ended March 31, 2012 as compared to the same prior-year period. This increase is primarily due to increased volume to cover fixed overhead and a product mix that favored our higher priced Fortus systems, which included the introduction of our new Fortus 250mc 3D production system and the acquisition of Solidscape. The increase in gross profit as a percentage of related sales was primarily due to increased growth in our higher-margin Fortus systems and consumables. This was partially offset by strong growth in HP-branded 3D printers, which have relatively lower gross margin.

Gross profit from services decreased by 11.5% for the three months ended March 31, 2012 as compared to the same prior-year period primarily due to lower margin RedEye paid parts service sales.

**Operating Expenses**

Operating expenses and operating expense as a percentage of sales, as well as the percentage changes in operating expenses were as follows:

**Three-Month Periods Ended March 31,**

(In Thousands)

|                                   | 2012      | 2011      | Period-over-period change |
|-----------------------------------|-----------|-----------|---------------------------|
| Research & development            | \$ 4,352  | \$ 3,348  | 30.0%                     |
| Selling, general & administrative | 11,375    | 8,736     | 30.2%                     |
|                                   | \$ 15,727 | \$ 12,084 | 30.1%                     |
| Percentage of sales               | 35.0%     | 35.2%     |                           |

Research and development expense increased by 30.0% for the three months ended March 31, 2012 as compared to the same prior-year period. The overall increase was driven primarily by new product initiatives within 3D printing, 3D production systems and Solidscape. Capitalized research and development expenditures for the quarter ended March 31, 2012 relating to internally developed software was approximately \$437,000 as compared to \$273,000 for the same prior-year period.

In 2008, we fulfilled our responsibilities under a three-year, \$3.6 million agreement with a Fortune 500 global manufacturing company to jointly advance our proprietary FDM technology for rapid manufacturing applications. This agreement entitled us to receive reimbursement payments as we achieved specific milestones stated in the agreement. This effort was focused around our high-performance systems and resulted in the commercial release of the Fortus 900mc. Because receipt of these payments represented reimbursements of costs actually incurred under this joint development project, all payments received were recorded as offsets to the research and development expenditures and are therefore not recognized as revenue.





Due to the success of this initial arrangement, we are continuing this relationship under similar terms and objectives. During the three months ended March 31, 2012 and March 31, 2011, approximately \$150,000 and \$131,000, respectively, of research and development expenses were offset by payments that were received from that company.

Selling, general and administrative expenses increased by 30.2% for the three months ended March 31, 2012 as compared to the same prior-year period. The increase is primarily due to \$1.0 million in expenses related to our current efforts to combine with Objet Ltd., sales commissions related to our new agent channel and the acquisition of Solidscape in May 2011.

## Operating Income

Operating income and operating income as a percentage of sales, as well as the percentage change in operating income, were as follows:

### Three-Month Periods Ended March 31,

| (In Thousands)      | 2012     | 2011     | Period-over-period change |
|---------------------|----------|----------|---------------------------|
| Operating income    | \$ 7,228 | \$ 6,166 | 17.2%                     |
| Percentage of sales | 16.1%    | 18.0%    |                           |

Operating income increased by \$1.1 million, or 17.2%, in the quarter ended March 31, 2012 as compared with the same prior-year period. The overall increase in operating income was primarily attributable to increased product sales led by our higher-margin Fortus systems and consumables.

## Other Income

Other income as a percentage of sales and changes in other income were as follows:

### Three-Month Periods Ended March 31,

| (In Thousands)                      | 2012   | 2011     | Period-over-period change |
|-------------------------------------|--------|----------|---------------------------|
| Interest income                     | \$ 250 | \$ 206   | 21.4%                     |
| Foreign currency transaction losses | (52)   | (131)    | -60.3%                    |
| Other                               | 98     | 1,396    | -93.0%                    |
|                                     | \$ 296 | \$ 1,471 | -79.9%                    |
| Percentage of sales                 | 0.7%   | 4.3%     |                           |

Interest income increased by 21.4% for the three months ended March 31, 2012 as compared to the same prior-year period. The increase is primarily due to a higher effective interest rate of our investment portfolio.

We invoice sales to certain European distributors in Euros and reported results are therefore subject to fluctuations in the exchange rates of that currency in relation to the United States dollar. Our strategy is to hedge most of our Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that our earnings will be adversely affected by changes in currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes. Instruments to hedge risks may include foreign currency forward, swap, and option contracts. These instruments will be used to selectively manage risks, but there can be no assurance that we will be fully protected against material foreign currency fluctuations.

Other income decreased by \$1.3 million for the three months ended March 31, 2012 as compared to the prior-year period due to a gain on the sale of an equity investment that we maintained in an independent online parts quoting service company in the first quarter of 2011.

## Income Tax Expense

Income taxes and income taxes as a percentage of net income before income taxes, as well as the percentage change, were as follows:

### Three-Month Periods Ended March 31,

| (In Thousands)     | 2012     | 2011     | Period-over-period change |
|--------------------|----------|----------|---------------------------|
| Income tax expense | \$ 3,001 | \$ 2,648 | 13.3%                     |
| Effective tax rate | 39.9%    | 34.7%    |                           |

The effective tax rate of 39.9% for the quarter ended March 31, 2012 was higher as compared to the 34.7% effective rate for the same prior-year period. The increase is primarily due to non-deductible expenses related to our current efforts to combine with Objet Ltd. In addition, the federal research credit expired December 31, 2011 and, therefore, was not considered in computing the effective rate for the quarter ended March 31, 2012.

## Net Income

Net income and net income as a percentage of sales, as well as the percentage change in net income, were as follows:

### Three-Month Periods Ended March 31,

| (In Thousands)      | 2012     | 2011     | Period-over-period change |
|---------------------|----------|----------|---------------------------|
| Net income          | \$ 4,522 | \$ 4,989 | -9.4%                     |
| Percentage of sales | 10.1%    | 14.4%    |                           |

Net income decreased during the three months ended March 31, 2012 as compared to the same prior year periods primarily due to higher research and development costs, expenses related to the pending Objet Ltd. transaction and a \$1.3 million gain on the sale of an equity investment that we maintained in an independent online parts quoting service company in the first quarter of 2011.

**Liquidity and Capital Resources***(unaudited)*

A summary of our consolidated interim statements of cash flows for the three months ended March 31, 2012 and 2011 are as follows:  
(In Thousands)

|  | 2012      | 2011      |
|--|-----------|-----------|
| Net income                                     | \$ 4,522  | \$ 4,989  |
| Depreciation and amortization                  | 2,650     | 2,154     |
| Stock-based compensation                       | 481       | 324       |
| Gain on disposal of property and equipment     | -         | (156)     |
| Gain on sale of investment                     | -         | (1,204)   |
| Changes in operating assets and liabilities    | (774)     | (2,500)   |
| Net cash provided by operating activities      | 6,879     | 3,607     |
| Net cash used in investing activities          | (3,667)   | (1,735)   |
| Net cash provided by financing activities      | 1,006     | 6,473     |
| Effect of exchange rate changes on cash        | 118       | 186       |
| Net increase in cash and cash equivalents      | 4,336     | 8,531     |
| Cash and cash equivalents, beginning of period | 20,092    | 27,554    |
| Cash and cash equivalents, end of period       | \$ 24,428 | \$ 36,085 |

Our cash and cash equivalents balance increased by \$4.3 million to \$24.4 million at March 31, 2012, from \$20.1 million at December 31, 2011. The increase is primarily due to cash provided by operations.

In the three months ended March 31, 2012, net cash provided by our operating activities was \$6.9 million compared to cash provided by operating activities of \$3.6 million during the comparable 2011 period. Our accounts receivable balance increased to \$28.1 million at March 31, 2012 from \$26.2 million as of December 31, 2011. This increase was principally due to sales growth and the acquisition of Solidscape. At March 31, 2012, our inventory balance decreased modestly to \$21.6 million as compared to \$22.8 million at December 31, 2011.

Our investing activities used net cash of \$3.7 million in first three months of 2012 as compared to \$1.7 million in same prior-year period. We used net cash of approximately \$0.5 million in connection with the purchase, maturity and sale of investments during the first three months of 2012 as compared to \$2.1 million net cash received in 2011. We used cash of approximately \$2.5 million for fixed asset additions in the first three months of 2012 as compared to \$1.3 million in the same prior-year period. Net cash used for payments for intangible assets and other investments, including patents and capitalized software, was \$0.7 million during the first three months of 2012 as compared to \$2.6 million for the same prior-year period. Much of the capital expenditures in 2012 have been for equipment required by the ongoing needs of our business, including manufacturing facility improvements and fixtures for new products and consumable manufacturing.

In the three months ended March 31, 2012 and March 31, 2011, net cash provided by financing activities of \$1.0 million and \$6.5 million resulted from the proceeds from the exercise of stock options and adjustment to income taxes payable for excess tax benefits from the exercise of stock options.

For 2012, we expect to use our cash as follows:

- to finance the expenses of our combination with Objet Ltd;
- for improvements to our facilities;
- for the continuation of our leasing program;
- for working capital purposes;
- for information systems and infrastructure enhancements;

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- for new product and materials development;
- for sustaining engineering;

- for the acquisition of equipment, including production equipment, tooling, and computers;
- for the purchase or development of intangible assets, including patents; and
- for increased selling and marketing activities, especially as they relate to the continued market and channel development.

Our total current assets amounted to approximately \$101.3 million at March 31, 2012, most of which consisted of cash and cash equivalents, investments, accounts receivable and inventories. Total current liabilities amounted to approximately \$29.9 million and we have no debt. We believe that we have adequate resources to fund our foreseeable future growth.

### **Inflation**

We believe that inflation has not had a material effect on our operations or on our financial condition during the three most recent fiscal years and during the current quarter.

### **Foreign Currency Transactions**

We invoice sales to certain European distributors in Euros, and reported results are therefore subject to fluctuations in the exchange rates of that currency in relation to the United States dollar. Our strategy is to hedge most of our Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that our earnings will be adversely affected by changes in currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes. We enter into 30-day foreign currency forward contracts on the last day of each month and therefore the notional value of the contract equals the fair value. As such, there is no related asset or liability or unrealized gains or losses recorded on the Balance Sheet as of the end of the period. All realized gains and losses related to hedging activities are recorded in current period earnings under the Statement of Operations caption Foreign currency transactions gains (losses), net.

We hedged between €5.5 million and €9.8 million for the three months ended March 31, 2012 and between €4.5 million and €5.6 million for the three months ended March 31, 2011 of accounts receivable and cash that was denominated in Euros. The foreign currency forward contracts resulted in a currency translation loss of approximately \$0.3 million and \$0.5 million for the three months ended March 31, 2012 and March 31, 2011, respectively. The resulting gain or loss from foreign currency forward contracts only partially offset the total foreign currency transactions gains or losses that we recorded.

We will continue to monitor exposure to currency fluctuations. Instruments to hedge risks may include foreign currency forward, swap, and option contracts. These instruments will be used to selectively manage risks, but there can be no assurance that we will be fully protected against material foreign currency fluctuations.

### **Critical Accounting Policies**

We have prepared our consolidated interim financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America. This has required us to make estimates, judgments, and assumptions that affected the amounts we reported.

We have identified several critical accounting policies that required us to make assumptions about matters that were uncertain at the time of our estimates. Had we used different estimates and assumptions, the amounts we recorded could have been significantly different. Additionally, if we had used different assumptions or if different conditions existed, our financial condition or results of operations could have been materially different. Certain critical accounting policies that were affected by the estimates, assumptions, and judgments used in the preparation of our consolidated interim financial statements are described in our Annual Report on Form 10-K for 2011.

## Forward-looking Statements and Factors That May Affect Future Results of Operations

All statements herein that are not historical facts or that include such words as expects, anticipates, projects, estimates, vision, planning, could, potential, plan, believes, desires, intends, assume or similar words constitute forward-looking statements that we deem to be covered by the safe harbor protection covered by the Private Securities Litigation Reform Act of 1995 (the 1995 Act). Investors and prospective investors in our Company should understand that several factors govern whether any forward-looking statement herein will be or can be achieved. Any one of these factors could cause actual results to differ materially from those projected herein.

These forward-looking statements include statements regarding projected revenue and income in future quarters; the size of the 3D printing market; our objectives for the marketing and sale of our Dimension, Mojo and uPrint 3D Printers; our support removal systems; and our Fortus 3D production systems, particularly for use in direct digital manufacturing (DDM); the demand for our proprietary consumables; the expansion of our paid parts service; and our beliefs with respect to the growth in the demand for our products. Other risks and uncertainties that may affect our business include our ability to penetrate the 3D printing market; the success of our distribution agreement with HP; our ability to achieve the growth rates experienced in preceding quarters; our ability to introduce, produce and market consumable materials, and the market acceptance of these materials; the impact of competitive products and pricing; our timely development of new products and materials and market acceptance of those products and materials; the success of our recent R&D initiative to expand the DDM capabilities of our core FDM technology; and the success of our RedEyeOnDemand™ and other paid parts services. They also include statements about future financial and operating results of our company after the acquisition of Solidscape and anticipated benefits of the acquisition. Actual results may differ from those expressed or implied in our forward-looking statements. Such forward-looking statements involve and are subject to certain risks and uncertainties, which may cause our actual results to differ materially from those discussed in a forward-looking statement. Such risk factors include our ability to successfully integrate and market Solidscape products, our ability to attract and retain management and our ability to protect and defend intellectual property. These statements represent beliefs and expectations only as of the date they were made. We may elect to update forward-looking statements, but we expressly disclaim any obligation to do so, even if our beliefs and expectations change. The forward-looking statements included herein are based on current expectations that involve a number of risks and uncertainties, some of which are described in Item 1A, Risk Factors in our Annual Report on Form 10-K for 2011. These forward-looking statements are based on assumptions, among others, that we will be able to:

- successfully close the proposed transaction with Objet Ltd. and successfully integrated the two businesses;
- continue to introduce new high-performance and 3D printing systems and materials acceptable to the market, and to continue to improve our existing technology and software in our current product offerings;
- successfully develop the 3D printing market with our Dimension BST, Dimension SST, Dimension Elite, Mojo and uPrint systems, and that the market will accept these systems;
- successfully develop the DDM market with our Fortus 360mc, 400mc and 900mc, and that the market will accept these systems;
- successfully integrate acquired businesses;
- control our operating expenses;
- expand our manufacturing capabilities to meet the expected demand generated by our Mojo, uPrint, Dimension BST, Dimension SST and Dimension Elite systems, our consumable products and our Paid Parts service and sales under our OEM Agreement with HP;
- successfully commercialize new materials and gain market acceptance for these new materials; and
- recruit, retain, and develop employees with the necessary skills to produce, create, commercialize, market, and sell our products.

Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, geo-political, competitive, market and technological conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of those assumptions could prove inaccurate, and therefore there is and can be no assurance that the results contemplated in any such forward-looking statement will be realized. The impact of actual experience and business developments may cause us to alter our marketing plans, our capital expenditure budgets, or our engineering, selling, manufacturing or other budgets, which may in turn affect our results of operations or the success of our new product development and introduction. We may not be able to alter our plans or budgets in a timely manner, resulting in reduced profitability or losses.





Due to the factors noted above and elsewhere in this Management's Discussion and Analysis of Financial Condition and Results of Operations, our future earnings and stock price may be subject to significant volatility, particularly on a quarterly basis. Additionally, we may not learn of revenue or earnings shortfalls until late in a fiscal quarter, since we frequently receive a significant number of orders very late in a quarter. This could result in an immediate and adverse effect on the trading price of our common stock. Past financial performance should not be considered a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

#### **Interest Rate Risk**

Our cash and cash equivalent investments are held exclusively in short-term money market and sweep instruments with maturities of less than 90 days. These are subject to limited interest rate risk. A 10% change in interest rates would not have a material effect on our financial condition or results of operations. Our short- and long-term investments are invested in auction rate securities, corporate and municipal bonds and certificates of deposit that bear interest at rates of 0.4% to 6.4%. An immediate 10% change in interest rates would have no material effect on our financial condition or results of operations.

#### **Foreign Currency Exchange Rate Risk**

We have not historically hedged sales from or expenses incurred by our European operations that have a functional currency in Euros. Therefore, a hypothetical 10% change in the exchange rates between the U.S. dollar and the Euro could increase or decrease our income before taxes by less than \$0.4 million for the continued maintenance of our European facility. We hedged between €5.5 million and €9.8 million for the three months ended March 31, 2012 and between €4.5 million and €5.6 million for the three months ended March 31, 2011 of accounts receivable and cash that was denominated in Euros. We believe that a hypothetical 10% change in the exchange rates between the US dollar and the Euro could increase or decrease income before taxes by \$4.0 million.

### **Item 4. Controls and Procedures.**

#### **Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report (the "Evaluation Date"). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective. Disclosure controls and procedures require that the information relating to us required to be disclosed in our Securities and Exchange Commission ("SEC") reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

#### **Internal Control over Financial Reporting**

An evaluation was also performed under the supervision and with the participation of management, including the CEO and CFO, of any change in our internal controls over financial reporting that occurred during the last fiscal quarter and that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting. That evaluation did not identify any changes in our internal control over financial reporting during our most recently completed fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934).

## PART II OTHER INFORMATION

### ITEM 1A. RISK FACTORS

We encourage you to review the discussion of Forward Looking Statements and Factors That May Affect Future Results of Operations appearing in this report at Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our 2011 Form 10-K, which could materially affect our business, financial condition or operating results. The risks described in our 2011 Form 10-K and those set forth below are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition or operating results.

In addition to the risk factors disclosed in 2011 Form 10-K, you should consider the following risk factors. Throughout the following risk factors, Stratasys is referred to as we, us, and our.

***Our pending merger with Objet Ltd. may present certain risks to our business prior to the closing of the merger,***

Pending completion of the merger with Objet Ltd., we will be operating as a separate company, and the pendency of the merger may have certain adverse effects on our business operations, including the following:

- employees may experience uncertainty, which might adversely affect our ability to retain, recruit and motivate key personnel;
- management's attention and other company resources may be directed toward the completion of the merger, including integration planning, and may be diverted from day-to-day business operations, including pursuing other opportunities beneficial to us; and
- vendors, suppliers, customers and other third parties with business relationships with us may seek to terminate and/or renegotiate their relationships as a result of the merger.

***Failure to consummate the merger could negatively impact our future business and financial results and our stock price.***

If the proposed merger with Objet is not consummated, our ongoing financial results may be adversely affected, and without realizing any of the benefits of having consummated the merger, we will be subject to a number of risks, including the following:

- under certain circumstances we would be required to pay a termination fee to Objet of \$28 million (in the case of a change of our board's recommendation upon receipt of a superior acquisition offer) or \$48 million (in the case of any other change in our board's recommendation) and to reimburse Objet for certain expenses incurred by Objet in connection with the merger;
- we will be required to pay significant costs relating to the proposed reorganization and merger, including legal, accounting, filing and possible other fees and mailing, financial printing and other expenses in connection with the transaction whether or not the merger is consummated; and
- the current prices of our common stock may reflect a market assumption that the merger will occur, meaning that a failure to complete the merger could result in a decline in the price of our common stock.

We also could be subject to litigation related to any failure to consummate the merger or to perform our obligations under the merger agreement, or related to any enforcement proceeding commenced against us. If the merger is not consummated, these risks may materialize and may adversely affect our business, financial results and stock price.

***Obtaining required approvals necessary to satisfy the conditions to the completion of the merger may delay or prevent completion of the merger, result in additional expenditures of money and resources and/or reduce the anticipated benefits of the merger.***

The merger is subject to customary closing conditions. These closing conditions include, among others, the receipt of required approvals of our stockholders, the effectiveness of the registration statement on Form F-4 to be filed by Objet regarding the proposed merger, and the expiration or termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the HSR Act ).

We cannot assure you that the required stockholder approval will be obtained or that the required closing conditions will be satisfied. Even if all required consents and approvals are obtained and the closing conditions are satisfied, no assurance can be given as to the terms, conditions and timing of the approvals. If in connection with our filings under the HSR Act, we and Objet agree to any material requirements, limitations, costs or restrictions in order to obtain any approvals required to consummate the merger, these requirements, limitations, costs or restrictions could adversely affect the anticipated benefits of the merger. This could result in a failure to consummate these transactions or have a material adverse effect on the combined company's business and results of operations.

**Item 6. Exhibits**

(a) Exhibits.

|         |   |
|---------|---|
| 3.1     | Amended and Restated Bylaws of Stratasys, Inc. dated April 13, 2012.  |
| 31.1    | Certification of the Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a).                    |
| 31.2    | Certification of the Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a).                    |
| 32.1    | Certification of the Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350. |
| 32.2    | Certification of the Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350. |
| 101.INS | XBRL Instance Document*   |
| 101.SCH | XBRL Taxonomy Extension Schema Document*  |
| 101.CAL | XBRL 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*   |

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\* The XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

**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.

Date: May 9, 2012

**Stratasys, Inc.**

By: /s/ ROBERT F. GALLAGHER  
Robert F. Gallagher  
Chief Financial Officer