CHANNELADVISOR CORP
Form 10-Q
November 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from to

Commission File Number 001-35940

CHANNELADVISOR CORPORATION
(Exact name of registrant as specified in its charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	56-2257867 (I.R.S. Employer Identification No.)
2701 Aerial Center Parkway, Morrisville, NC (Address of principal executive offices)	27560 (Zip Code)

(919) 228-4700
(Registrant’s telephone number, including area code)

N/A
(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 ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Securities Exchange Act of 1934.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes ¨ No ý

The number of outstanding shares of the registrant’s common stock, par value $0.001 per share, as of the close of business on October 28, 2014 was 24,889,830.

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Part I. FINANCIAL INFORMATION
Item 1. Financial Statements
ChannelAdvisor Corporation and Subsidiaries
Condensed Consolidated Balance Sheets
(in thousands, except share and per share data)

	September 30, 2014	December 31, 2013
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$82,280	$104,406
Accounts receivable, net of allowance of $504 and $561 as of September 30, 2014 and December 31, 2013, respectively	12,466	13,951
Prepaid expenses and other current assets	4,509	3,571
Total current assets	99,255	121,928
Property and equipment, net	13,646	9,088
Goodwill	16,106	16,106
Intangible assets, net	374	670
Restricted cash	635	685
Other assets	250	309
Total assets	$130,266	$148,786
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$1,361	$4,237
Accrued expenses	8,029	7,492
Deferred revenue	16,441	14,093
Other current liabilities	2,526	1,723
Total current liabilities	28,357	27,545
Long-term capital leases, net of current portion	2,171	1,558
Other long-term liabilities	2,624	1,903
Total liabilities	33,152	31,006
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000,000 shares authorized, no shares issued and outstanding as of September 30, 2014 and December 31, 2013, respectively	—	—
Common stock, $0.001 par value, 100,000,000 shares authorized, 24,853,614 and 23,643,872 shares issued and outstanding as of September 30, 2014 and December 31, 2013, respectively	25	24
Additional paid-in capital	225,457	218,330
Accumulated other comprehensive loss	(287)	(471)
Accumulated deficit	(128,081)	(100,103)
Total stockholders' equity	97,114	117,780
Total liabilities and stockholders' equity	$130,266	$148,786

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

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ChannelAdvisor Corporation and Subsidiaries
Unaudited Condensed Consolidated Statements of Operations
(in thousands, except share and per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenue	$20,966	$16,620	$61,074	$47,518
Cost of revenue	6,018	4,555	18,169	12,971
Gross profit	14,948	12,065	42,905	34,547
Operating expenses:				
Sales and marketing	13,865	9,316	42,131	26,398
Research and development	4,263	2,991	12,572	8,882
General and administrative	5,677	3,499	15,850	8,641
Total operating expenses	23,805	15,806	70,553	43,921
Loss from operations	(8,857)	(3,741)	(27,648)	(9,374)
Other (expense) income:				
Interest expense, net	(55)	(520)	(157)	(2,606)
Other income, net	(86)	4	(86)	17
Total other (expense) income	(141)	(516)	(243)	(2,589)
Loss before income taxes	(8,998)	(4,257)	(27,891)	(11,963)
Income tax expense	6	35	87	56
Net loss	$(9,004)	$(4,292)	$(27,978)	$(12,019)
Net loss per share:				
Basic and diluted	$(0.36)	$(0.20)	$(1.14)	$(1.13)
Weighted average common shares outstanding:				
Basic and diluted	24,793,869	21,588,578	24,528,263	10,652,921

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

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ChannelAdvisor Corporation and Subsidiaries
Unaudited Condensed Consolidated Statements of Comprehensive Loss
(in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net loss	$(9,004)	$(4,292)	$(27,978)	$(12,019)
Other comprehensive loss:				
Foreign currency translation adjustments	(119)	(38)	184	(196)
Total comprehensive loss	$(9,123)	$(4,330)	$(27,794)	$(12,215)

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

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ChannelAdvisor Corporation and Subsidiaries
Unaudited Condensed Consolidated Statement of Changes in Stockholders’ Equity
(in thousands, except share data)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders’ Equity
	Shares	Amount				
Balance, December 31, 2013	23,643,872	$24	$218,330	$ (471)	$(100,103)	$117,780
Cashless exercise of common stock warrants	664,058	1	(1)	—	—	—
Exercise of stock options	545,684	—	1,827	—	—	1,827
Stock-based compensation expense	—	—	5,301	—	—	5,301
Net loss	—	—	—	—	(27,978)	(27,978)
Foreign currency translation adjustments	—	—	—	184	—	184
Balance, September 30, 2014	24,853,614	$25	$225,457	$ (287)	$(128,081)	$97,114

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

ChannelAdvisor Corporation and Subsidiaries
Unaudited Condensed Consolidated Statements of Cash Flows
(in thousands)

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities		
Net loss	$(27,978)	$(12,019)
Adjustments to reconcile net loss to cash and cash equivalents used in operating activities:		
Depreciation and amortization	4,393	2,619
Bad debt expense	993	221
Change in fair value of preferred stock warrants	—	1,052
Accretion of debt discount	—	449
Stock-based compensation expense	5,301	1,433
Other items, net	107	18
Changes in assets and liabilities:		
Accounts receivable	603	(1,503)
Prepaid expenses and other assets	(869)	63
Restricted cash	51	—
Accounts payable and accrued expenses	(1,668)	2,404
Deferred revenue	2,238	4,227
Cash and cash equivalents used in operating activities	(16,829)	(1,036)
Cash flows from investing activities		
Purchases of property and equipment	(5,400)	(1,990)
Payment of internal-use software development costs	(820)	(962)
Cash and cash equivalents used in investing activities	(6,220)	(2,952)
Cash flows from financing activities		
Proceeds from initial public offering, net of underwriting discounts and commissions	—	86,095
Repayment of debt and capital leases	(1,049)	(919)
Payment of deferred offering costs	—	(2,474)
Proceeds from exercise of stock options	1,827	879
Cash and cash equivalents provided by financing activities	778	83,581
Effect of currency exchange rate changes on cash and cash equivalents	145	(171)
Net (decrease) increase in cash and cash equivalents	(22,126)	79,422
Cash and cash equivalents, beginning of period	104,406	10,865
Cash and cash equivalents, end of period	$82,280	$90,287
Supplemental disclosure of cash flow information		
Cash paid for interest	$228	$1,138
Cash paid for income taxes, net	$53	$89
Supplemental disclosure of noncash investing and financing activities		
Conversion of redeemable convertible preferred stock to common stock	$—	$91,150
Conversion of preferred stock warrants to common stock warrants	$—	$3,632
Deferred offering costs included in accounts payable and accrued expenses	$—	$108
Accrued capital expenditures	$—	$526
Capital lease obligations entered into for the purchase of fixed assets	$2,431	$1,454

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

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ChannelAdvisor Corporation and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements
1. Description of the Business
ChannelAdvisor Corporation ("ChannelAdvisor" or the "Company") was incorporated in the state of Delaware and capitalized in June 2001. The Company began operations in July 2001. ChannelAdvisor is a provider of software-as-a-service, or SaaS, solutions that allow retailers and manufacturers to integrate, manage and monitor their merchandise sales across hundreds of online channels. The Company is headquartered in Morrisville, North Carolina and has international offices in England, Ireland, Germany, Australia, Hong Kong, Brazil and China.
2. Significant Accounting Policies
Principles of Consolidation
The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.
Interim Condensed Consolidated Financial Information
The accompanying condensed consolidated financial statements and footnotes have been prepared in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP") as contained in the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") for interim financial information. In the opinion of management, the interim financial information includes all adjustments of a normal recurring nature necessary for a fair presentation of financial position, the results of operations, comprehensive loss, changes in stockholders' equity and cash flows. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results for the full year or the results for any future periods. These unaudited interim financial statements should be read in conjunction with the audited financial statements and related footnotes for the year ended December 31, 2013, which are included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 27, 2014.
Recent Accounting Pronouncements
In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which provides new guidance for revenue recognition. ASU 2014-09 provides that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 also requires improved disclosures to help users of financial statements better understand the nature, amount, timing, and uncertainty of revenue that is recognized. Entities have the option of using either a full retrospective or modified retrospective approach for the adoption of the standard. ASU 2014-09 will be effective for the Company beginning January 1, 2017 and early adoption is not permitted. The Company is currently evaluating the impact the adoption of ASU 2014-09 will have on its consolidated financial statements.

The Company has reviewed other new accounting pronouncements that were issued as of September 30, 2014 and does not believe that these pronouncements are applicable to the Company, or that they will have a material impact on its financial position or results of operations.
Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Actual results could differ from those estimates.
On an ongoing basis, the Company evaluates its estimates, including those related to the accounts receivable allowance, the useful lives of long-lived assets and other intangible assets, income taxes and assumptions used for purposes of determining stock-based compensation, among others. The Company bases its estimates on historical experience and on various other assumptions that it believes to be reasonable, the results of which form the basis for making judgments about the carrying value of assets and liabilities.

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Revenue Recognition and Deferred Revenue

The majority of the Company’s revenue is derived from subscription fees paid by customers for access to and usage of the Company’s cloud-based SaaS platform for a specified period of time, which is typically one year. A portion of the subscription fee is typically fixed and is based on a specified minimum amount of gross merchandise value (“GMV”) that a customer expects to process through the Company’s platform over the contract term. The remaining portion of the subscription fee is variable and is based on a specified percentage of GMV processed through the Company’s platform in excess of the customer’s specified minimum amount. In addition, other sources of revenue consist primarily of implementation fees, which may include fees for providing launch assistance and training. The Company recognizes revenue when there is persuasive evidence of an arrangement, the service has been provided to the customer, the collection of the fee is reasonably assured and the amount of the fee to be paid by the customer is fixed or determinable. The Company’s contractual arrangements include performance, termination and cancellation provisions, but do not provide for refunds. Customers do not have the contractual right to take possession of the Company’s software at any time.

The Company’s arrangements generally contain multiple elements comprised of subscription and implementation services. The Company evaluates each element in an arrangement to determine whether it represents a separate unit of accounting. An element constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is probable and within the Company’s control. The Company’s implementation services are not sold separately from the subscription and there is no alternative use for them. As such, the Company has determined the implementation services do not have standalone value. Accordingly, subscription and implementation services are combined and recognized as a single unit of accounting.

The Company generally recognizes the fixed portion of subscription fees and implementation fees ratably over the contract term. Recognition begins when the customer has access to the Company’s platform and transactions can be processed, provided all other revenue recognition criteria have been met. Some customers elect a managed-service solution and contract with the Company to manage some or all aspects of the Company’s SaaS solutions on the customer’s behalf for a specified period of time, which is typically one year. Under these managed-service arrangements, customer transactions cannot be processed through the Company’s platform until the completion of the implementation services. As such, revenue is contingent upon the Company’s completion of the implementation services and recognition commences when transactions can be processed on the Company’s platform, provided all other revenue recognition criteria have been satisfied. At that time, the Company recognizes a pro-rata portion of the fees earned since the inception of the arrangement. The balance of the fees is recognized ratably over the remaining contract term.

The Company recognizes the variable portion of subscription fee revenue in the period in which the related GMV is processed, provided all other revenue recognition criteria have been met.

Sales taxes collected from customers and remitted to government authorities are excluded from revenue.

Deferred revenue represents the unearned portion of fixed subscription fees and implementation fees. Deferred amounts are generally recognized within one year. Those amounts that are expected to be recognized in greater than one year are recorded in other long-term liabilities in the accompanying condensed consolidated balance sheets.

Cost of Revenue

Cost of revenue primarily consists of personnel and related costs, including salaries, bonuses, payroll taxes and stock-based compensation, co-location facility costs for the Company’s data centers, depreciation expense for computer equipment directly associated with generating revenue, credit card transaction fees and infrastructure maintenance costs. In addition, the Company allocates a portion of overhead, such as rent, additional depreciation and amortization and employee benefits costs, to cost of revenue based on headcount.

Fair Value of Financial Instruments

The carrying amounts of certain of the Company’s financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate their respective fair values due to their short-term nature. As of September 30, 2014 and December 31, 2013, the Company did not have any assets or liabilities measured at fair value on a recurring or non-recurring basis.

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Concentration of Credit Risk

Financial instruments that subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. All of the Company’s cash and cash equivalents are held at financial institutions that management believes to be of high credit quality. The Company’s cash and cash equivalents accounts exceed federally insured limits. The Company has not experienced any losses on its cash and cash equivalents accounts to date. To manage accounts receivable risk, the Company maintains an allowance for doubtful accounts. The Company did not have any customers that individually comprised a significant concentration of its accounts receivable as of September 30, 2014 and December 31, 2013, or a significant concentration of its revenue for the three and nine months ended September 30, 2014 and 2013.

Accounts Receivable and Allowance for Doubtful Accounts

The Company extends credit to customers without requiring collateral. Accounts receivable are stated at realizable value, net of an allowance for doubtful accounts. The Company utilizes the allowance method to provide for doubtful accounts based on management’s evaluation of the collectability of amounts due. The Company’s estimate is based on historical collection experience and a review of the current status of accounts receivable. Historically, actual write-offs for uncollectible accounts have not significantly differed from the Company’s estimates.

Other Receivables

Under certain customer arrangements, the Company collects and remits monthly activity-based fees incurred on specific channels on the customers’ behalf. The Company records the amounts due from customers as a result of these arrangements as other receivables.

Other receivables of $1.3 million and $1.7 million are included in prepaid expenses and other current assets on the condensed consolidated balance sheets as of September 30, 2014 and December 31, 2013, respectively.

Identifiable Intangible Assets

The Company has acquired intangible assets in connection with business combinations. These assets were recorded at their estimated fair values at the acquisition date and are being amortized over their respective estimated useful lives using the straight-line method. The estimated useful lives used in computing amortization are as follows:

Customer relationships	8.0 years
Proprietary software	8.0 years

Amortization expense associated with the Company's intangible assets was $0.1 million for each of the three months ended September 30, 2014 and 2013 and $0.3 million and $0.5 million for the nine months ended September 30, 2014 and 2013, respectively.

Software Development Costs

The Company capitalizes certain internal-use software development costs, consisting primarily of direct labor associated with creating the internally developed software and third-party consulting fees associated with implementing software purchased for internal use. Software development projects generally include three stages: the preliminary project stage (in which all costs are expensed as incurred), the application development stage (in which certain costs are capitalized) and the post-implementation/operation stage (in which all costs are expensed as incurred). The costs incurred during the application development stage primarily include the costs of designing the application, coding and testing of the system. Capitalized costs are amortized using the straight-line method over the estimated useful life of the software once it is ready for its intended use.

Software development costs of $0.4 million and $0.3 million related to creating internally developed software and implementing software purchased for internal use were capitalized during the nine months ended September 30, 2014 and the year ended December 31, 2013, respectively, and are included in property and equipment in the accompanying condensed consolidated balance sheets. Amortization expense related to capitalized internally developed software was $0.1 million and $24,000 for the three months ended September 30, 2014 and 2013, respectively, and $0.1 million for each of the nine months ended September 30, 2014 and 2013, and is included in cost of revenue or general and administrative expense in the accompanying condensed consolidated statements of operations, depending upon the nature of the software development project. The net book value of capitalized internally developed software was $0.6 million and $0.3 million as of September 30, 2014 and December 31, 2013, respectively.

Software development costs of $0.3 million and $1.8 million related to configuring and implementing hosted third-party software applications that the Company will use in its business operations were capitalized during the nine months ended September 30, 2014 and the year ended December 31, 2013, respectively, and are included in property and equipment in the accompanying condensed consolidated balance sheets. Amortization expense related to hosted third-party software applications was $0.2 million and $8,000 for the three months ended September 30, 2014 and 2013, respectively, and $0.5 million and $8,000 for the nine months ended September 30, 2014 and 2013, respectively, and is included in general and administrative expense in the accompanying condensed consolidated statements of operations. The net book value of hosted third-party software applications was $1.6 million and $1.7 million as of September 30, 2014 and December 31, 2013, respectively.

Income Taxes

Income taxes are accounted for under the liability method of accounting. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, as well as for operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the results of operations in the period that includes the enactment date. The measurement of a deferred tax asset is reduced, if necessary, by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized.

The Company applies the accounting guidance for uncertainties in income taxes, which prescribes a recognition threshold and measurement process for recording uncertain tax positions taken, or expected to be taken, in a tax return. Additionally, the guidance also prescribes the treatment for accounting in interim periods, derecognition, classification and disclosure requirements for uncertain tax positions. The Company accrues for the estimated amount of taxes for uncertain tax positions if it is more likely than not that the Company would be required to pay such additional taxes. An uncertain tax position will be recognized if it is not more likely than not to be sustained.

The Company’s income tax provision for the three and nine months ended September 30, 2014 and 2013 reflects its estimates of the effective tax rates expected to be applicable for the full fiscal years, adjusted for any discrete events that are recorded in the period in which they occur. For the three and nine months ended September 30, 2014 and 2013, the Company’s effective tax rate differs from the federal statutory rate primarily due to changes in the valuation allowance and nondeductible expenses.

For the three and nine months ended September 30, 2014 and 2013, the Company had net operating loss (“NOL”) carryforwards, the benefit of which is dependent on the Company’s ability to generate sufficient taxable income prior to the expiration of the NOL carryforwards. In addition, the maximum annual use of the NOL carryforwards is limited in certain situations, such as a change in stock ownership.

Stock-Based Compensation

The Company accounts for stock-based compensation awards, which include stock options and restricted stock units ("RSUs"), based on the fair value of the award as of the grant date. The Company recognizes stock-based compensation expense using the accelerated attribution method, net of estimated forfeitures, in which compensation cost for each vesting tranche in an award is recognized ratably from the service inception date to the vesting date for that tranche.

The Company uses the Black-Scholes option pricing model for estimating the fair value of stock options. The use of the option valuation model requires the input of the Company's stock price, as well as highly subjective assumptions, including the expected life of the option and the expected stock price volatility based on peer companies. Additionally, the recognition of expense requires the estimation of the number of awards that will ultimately vest and the number of awards that will ultimately be forfeited.

Following the Company’s initial public offering (“IPO”) in May 2013, the fair value of the Company's common stock, for purposes of determining the grant date fair value of option and RSU awards, has been determined by using the closing market price per share of common stock as quoted on the New York Stock Exchange on the date of grant.

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3. Commitments and Contingencies

In June 2014, the Company assigned its previous lease of office space in the United Kingdom to a third party pursuant to an assignment agreement and a transfer agreement. In accordance with the assignment agreement, the Company is not required to collect any payments from the third party and therefore will not recognize any revenue associated with this assignment. All payments associated with the assigned lease will be made directly by the third party to the lessor and appropriate regulatory authorities. However, the Company has guaranteed the lease payments through the remainder of the lease term, which is until February 2022. As of September 30, 2014, the remaining lease payments under this lease totaled $4.2 million. This amount represents the maximum potential liability for future payments under the guarantee and will decrease over time as payments are made by the third party. In the event of default, the indemnity clauses in the transfer agreement govern the Company's ability to pursue and recover damages incurred. During the nine months ended September 30, 2014, the Company recorded a loss of $0.1 million associated with the assigned lease, which has been accounted for as a lease termination. As of September 30, 2014, the Company does not anticipate any default by the third party. Therefore, no liability associated with this transaction has been recorded on the Company's condensed consolidated balance sheet as of September 30, 2014.

In August 2014, the Company entered into a lease agreement for the lease of office space to replace the Company's current corporate headquarters. The building containing the leased space is being constructed, and the lease term will commence on the date that the construction of the leased premises is substantially complete, which is targeted to be October 15, 2015. In the event that the commencement date is delayed beyond October 15, 2015, certain adjustments will be made to the Company's rent obligations under the lease. The initial term of the lease agreement is for seven years following the lease commencement date, and the Company may elect to renew the lease term for two additional five-year periods, subject to certain conditions and notice obligations set forth in the lease agreement. Minimum annual rental payments will be $3.2 million the first lease year, and are scheduled to increase each lease year by 2.75%. Beginning January 1, 2017, the Company will also be obligated to pay its proportionate share of the landlord's operating expenses for the building, subject to certain limitations. Additional information regarding the terms of the lease agreement is set forth in the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on August 20, 2014.

4. Warrants

In 2007 and 2008, the Company issued warrants to purchase 1,616,113 shares of common stock, of which 958,019 and 658,094 have exercise prices per share of $16.00 and $10.96, respectively. The 2007 warrants expired in 2014 and the 2008 warrants expire in 2015. Unexpired warrants may be exercised in whole or in part at any time and include a cashless exercise feature, which allows the holder to receive fewer shares of common stock in exchange for the warrant rather than paying cash to exercise.

In January 2014, the holders of certain of these warrants to purchase common stock executed cashless exercises and received 664,058 shares of common stock in exchange for the warrants. As of September 30, 2014 and December 31, 2013, warrants to purchase 3,743 and 986,784 shares of common stock remained outstanding, respectively.

5. Equity Incentive Plan and Stock-Based Compensation

In May 2013, the Company’s board of directors adopted, and the Company’s stockholders approved, the 2013 Equity Incentive Plan (the “2013 Plan”), pursuant to which the Company initially reserved 1,250,000 shares of its common stock for issuance to its employees, directors and non-employee third parties. The 2013 Plan provides for the grant of incentive stock options to employees, and for the grant of nonqualified stock options, restricted stock awards, RSUs, stock appreciation rights, performance stock awards and other forms of stock compensation to the Company’s employees, directors, and non-employee third parties. The number of shares of common stock reserved for issuance under the 2013 Plan will automatically increase on January 1 each year, for a period of ten years, from January 1, 2014 through January 1, 2023, by 5% of the total number of shares of the Company’s common stock outstanding on December 31 of the preceding calendar year, or a lesser number of shares as may be determined by the Company’s board of directors. Accordingly, on January 1, 2014 the number of shares reserved for issuance under the 2013 Plan increased by 1,182,194 shares. As of September 30, 2014, 1,548,033 shares remained available for future grant under the 2013 Plan. As a result of the adoption of the 2013 Plan, no further grants may be made under the former 2001

Stock Plan, although outstanding awards under the 2001 Stock Plan continue to vest in accordance with their terms until exercised, forfeited or expired.

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Stock-based compensation expense is included in the following line items in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Cost of revenue	$183	$41	$373	$159
Sales and marketing	922	146	1,833	439
Research and development	286	89	584	264
General and administrative	1,143	198	2,511	571
	$2,534	$474	$5,301	$1,433

Stock Option Awards

The following table summarizes the assumptions used for estimating the fair value of stock options granted for the three and nine months ended September 30, 2014 and 2013:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Risk-free interest rate	1.0% - 1.9%	0.3% - 1.7%	0.4% - 2.0%	0.3% - 1.7%
Expected term (years)	6.25	6.06 - 6.25	6.06 - 6.25	5.00 - 6.25
Expected volatility	46% - 54%	49% - 58%	43% - 56%	49% - 59%
Dividend yield	0%	0%	0%	0%

The following table summarizes the stock option activity for the nine months ended September 30, 2014:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding options as of January 1, 2014	2,068,641	$ 6.95		
Granted	62,300	34.03		
Exercised	(546,651)	3.38		
Forfeited	(65,244)	13.26		
Expired	(309)	25.00		
Outstanding options as of September 30, 2014	1,518,737	$ 9.07	7.61	$13,673
Exercisable as of September 30, 2014	762,182	$ 5.57	6.88	$8,645
Vested and expected to vest as of September 30, 2014	1,383,891	$ 8.80	7.54	$12,732

The weighted average grant date fair value for the Company's stock options was $6.51 and $10.56 per share for stock options granted during the three months ended September 30, 2014 and 2013, respectively, and $13.92 and $4.73 per share for stock options granted during the nine months ended September 30, 2014 and 2013, respectively.

The total fair value of stock options vested was $0.4 million and $0.2 million during the three months ended September 30, 2014 and 2013, respectively, and $1.1 million and $0.6 million during the nine months ended September 30, 2014 and 2013, respectively.

The total compensation cost related to nonvested stock options not yet recognized as of September 30, 2014 was $1.6 million and will be recognized over a weighted average period of approximately 1.6 years.

The aggregate intrinsic value of stock options exercised was $2.6 million and $0.7 million during the three months ended September 30, 2014 and 2013, respectively, and $15.3 million and $1.7 million during the nine months ended September 30, 2014 and 2013, respectively.

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Restricted Stock Units

The following table summarizes the RSU activity for the nine months ended September 30, 2014:

	Number of RSUs	Weighted Average Grant-Date Fair Value
Unvested RSUs as of January 1, 2014	—	$ —
Granted	704,144	25.98
Vested	—	—
Forfeited	(12,280)	21.74
Unvested RSUs as of September 30, 2014	691,864	$ 26.05

The total unrecognized compensation cost related to the RSUs as of September 30, 2014 was $11.4 million and will be recognized over a weighted average period of approximately 2.1 years.

6. Net Loss Per Share

The Company uses the two-class method to compute net loss per share because the Company has issued securities, other than common stock, that contractually entitle the holders to participate in dividends and earnings of the Company. The two-class method requires earnings for the period to be allocated between common stock and participating securities based upon their respective rights to receive distributed and undistributed earnings. During the third quarter of 2013, certain shares issued as a result of the early exercise of options, which are subject to repurchase by the Company, were entitled to receive non-forfeitable dividends during the vesting period and as a result were considered participating securities.

Under the two-class method, for periods with net income, basic net income per common share is computed by dividing the net income attributable to common stockholders by the weighted average number of shares of common stock outstanding during the period. Net income attributable to common stockholders is computed by subtracting from net income the portion of current year earnings that the participating securities would have been entitled to receive pursuant to their dividend rights had all of the year’s earnings been distributed. No such adjustment to earnings is made during periods with a net loss, as the holders of the participating securities have no obligation to fund losses. Diluted net loss per common share is computed under the two-class method by using the weighted average number of shares of common stock outstanding, plus, for periods with net income attributable to common stockholders, the potential dilutive effects of stock options, RSUs and warrants. In addition, the Company analyzes the potential dilutive effect of the outstanding participating securities under the “if-converted” method when calculating diluted earnings per share, in which it is assumed that the outstanding participating securities convert into common stock at the beginning of the period. The Company reports the more dilutive of the approaches (two class or “if-converted”) as its diluted net income per share during the period. Due to net losses for the three and nine months ended September 30, 2014 and 2013, basic and diluted loss per share were the same, as the effect of potentially dilutive securities would have been anti-dilutive.

The following securities have been excluded from the calculation of weighted average common shares outstanding because the effect is anti-dilutive for the three and nine months ended September 30, 2014 and 2013:

	Three and Nine Months Ended September 30,	
	2014	2013
Warrants to purchase common stock	3,743	1,625,728
Stock options	1,518,737	2,569,393
Common stock subject to repurchase	—	65,000
RSUs	691,864	—

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7. Segment and Geographic Information

Operating segments are defined as components of an enterprise for which discrete financial information is available that is evaluated regularly by the chief operating decision maker (“CODM”) for purposes of allocating resources and evaluating financial performance. The Company’s CODM reviews financial information presented on a consolidated basis for purposes of allocating resources and evaluating financial performance. As such, the Company’s operations constitute a single operating segment and one reportable segment.

Substantially all assets were held in the United States during the nine months ended September 30, 2014 and 2013.

The following table summarizes revenue by geography for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Domestic	$16,222	$13,147	$47,220	$37,477
International	4,744	3,473	13,854	10,041
Total revenue	$20,966	$16,620	$61,074	$47,518

8. Subsequent Events

On October 31, 2014, the Company’s wholly owned subsidiary ChannelAdvisor UK Limited (“ChannelAdvisor UK”) entered into a Securities Purchase Agreement (the “Purchase Agreement”) pursuant to which ChannelAdvisor UK acquired all of the issued and outstanding shares of E-Tale Holdings Limited, a private limited company organized under the laws of England and Wales (“E-Tale”). Under the Purchase Agreement, ChannelAdvisor UK paid to the shareholders of E-Tale a cash purchase price of $8.2 million, which amount is subject to adjustment as set forth in the Purchase Agreement. A portion of the purchase price has been placed into escrow to secure the indemnification obligations of E-Tale’s shareholders until April 30, 2016. In addition to the purchase price paid at the closing, ChannelAdvisor UK may be obligated to pay up to $4.0 million to the E-Tale shareholders upon the achievement of specified financial targets set forth in the Purchase Agreement. The initial accounting of the business combination is incomplete as of the issuance date of these financial statements. Therefore, the Company is unable to determine or disclose the acquisition date fair value of the assets acquired and liabilities assumed.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements contained in this Quarterly Report on Form 10-Q may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words or phrases "would be," "will allow," "intends to," "will likely result," "are expected to," "will continue," "is anticipated," "estimate," "project," or similar expressions, or the negative of such words or phrases, are intended to identify "forward-looking statements." We have based these forward-looking statements on our current expectations and projections about future events. Because such statements include risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Factors that could cause or contribute to these differences include those below and elsewhere in this Quarterly Report on Form 10-Q, particularly in Part II – Item 1A, "Risk Factors," and our other filings with the Securities and Exchange Commission. Statements made herein are as of the date of the filing of this Form 10-Q with the Securities and Exchange Commission and should not be relied upon as of any subsequent date. Unless otherwise required by applicable law, we do not undertake, and we specifically disclaim, any obligation to update any forward-looking statements to reflect occurrences, developments, unanticipated events or circumstances after the date of such statement.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and related notes that appear in Item 1 of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and related notes for the year ended December 31, 2013, which are included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 27, 2014.

Overview

We are a leading provider of software-as-a-service, or SaaS, solutions that enable our retailer and manufacturer customers to integrate, manage and optimize their merchandise sales across hundreds of online channels. Through our platform, we enable our customers to connect with new and existing sources of demand for their products, including e-commerce marketplaces, such as eBay, Amazon and Newegg, search engines and comparison shopping websites, such as Google, Bing, Nextag and Sears, and emerging channels, such as Facebook and Pinterest. Our suite of solutions, accessed through a standard web browser, provides our customers with a single, integrated user interface to manage their product listings, inventory availability, pricing optimization, search terms, data analytics and other critical functions across these channels. Our proprietary cloud-based technology platform delivers significant breadth, scalability and flexibility to our customers.

We sell subscriptions to our SaaS solutions primarily through our direct sales force. Our customers include the online businesses of traditional retailers, online retailers and brand manufacturers, as well as advertising agencies that use our solutions on behalf of their retailer clients. As of September 30, 2014, we had approximately 2,800 core customers worldwide, including 32% of the top 500 U.S. internet retailers, as identified by Internet Retailer magazine based on their 2013 online sales.

The majority of our revenue is derived from subscription fees paid to us by our customers for access to and usage of our SaaS solutions for a specified contract term, which is usually one year. A portion of the subscription fee is typically fixed and is based on a specified minimum amount of gross merchandise value, or GMV, that a customer expects to process through our platform. The remaining portion of the subscription fee is variable and is based on a specified percentage of GMV processed through our platform in excess of the customer's specified minimum GMV amount.

We do not take title to any of the merchandise processed through our platform and we generally do not collect payments on behalf of our customers. We do not hold any inventory of merchandise and we are not involved in the physical logistics of shipping merchandise to buyers, which is handled by our customers.

We face a variety of challenges and risks, which we will need to address and manage as we pursue our growth strategy. In particular, we will need to continue to innovate in the face of a rapidly changing and increasingly fragmented e-commerce landscape if we are to remain competitive, and we will need to effectively manage our growth, especially related to our international expansion.

Although e-commerce continues to expand as retailers and manufacturers continue to increase their online sales, it is also becoming more complex and fragmented due to the hundreds of channels available to retailers and manufacturers and the rapid pace of change and innovation across those channels. In order to gain consumers' attention in a more crowded and competitive online marketplace, many retailers and an increasing number of manufacturers sell their merchandise through multiple online channels, each with its own rules, requirements and specifications. In particular, third-party marketplaces are an increasingly important driver of growth for a number of large online retailers, and as a result we need to continue to support

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multiple channels in a variety of geographies in order to support our targeted revenue growth. As of September 30, 2014, we supported 40 marketplaces, up from 35 at December 31, 2013.

We believe the growth in e-commerce globally presents an opportunity for retailers and manufacturers to engage in international sales. However, country-specific marketplaces are often the market share leaders in their regions, as is the case for Alibaba in Asia and MercadoLibre in much of Latin America. In order to help our customers capitalize on this potential market opportunity, and to address our customers' needs with respect to cross-border trade, during 2013 and thus far in 2014, we have expanded our presence in the Asia-Pacific and Latin America regions through the opening of offices in China and Brazil. Doing business overseas involves substantial challenges, including management attention and resources needed to adapt to multiple languages, cultures, laws and commercial infrastructure, as further described in this report under the caption "Risks Related to our International Operations." While we do not expect our growth in China to have a material impact on our overall revenue in 2014, we expect it to be a major growth driver over the long-term. For the year ending December 31, 2014, we expect to invest between $4 million and $5 million related to the expansion of our business in China.

Our senior management continuously focuses on these and other trends and challenges, and we believe that our culture of innovation and our history of growth and expansion will contribute to the success of our business. We cannot, however, assure you that we will be successful in addressing and managing the many challenges and risks that we face.

Key Financial and Operating Performance Metrics

We regularly monitor a number of financial and operating metrics in order to measure our performance and project our future performance. These metrics aid us in developing and refining our growth strategies and making strategic decisions.

Core Revenue

Our reported operating results include revenue attributable to the products from two small legacy acquisitions, both of which occurred prior to 2008 and focused on solutions for lower-volume eBay sellers. We do not consider these products to be a core part of our strategic focus going forward. Each of these acquisitions contributed a relatively large number of customers with revenue per customer substantially lower than is characteristic of the rest of our business. We exclude the revenue attributable to these non-core, legacy products in calculating a measure we refer to as core revenue. We anticipate that the revenue associated with these non-core, legacy products will continue to decline over time both in absolute terms and as a percentage of our total revenue.

Number of Core Customers

The number of customers subscribing to our solutions is a primary determinant of our core revenue. We refer to the customers who subscribe to any of our solutions, other than the non-core, legacy products described above, as our core customers. The number of core customers was 2,781 and 2,287 as of September 30, 2014 and 2013, respectively.

Average Revenue per Core Customer

The average revenue generated by our core customers is the other primary determinant of our core revenue. We calculate this metric by dividing our total core revenue for a particular period by the average monthly number of core customers during the period, which is calculated by taking the sum of the number of core customers at the end of each month in the period and dividing by the number of months in the period. We typically calculate average revenue per core customer in absolute dollars on a rolling twelve-month basis, but we may also calculate percentage changes in average revenue per core customer on a quarterly basis in order to help us evaluate our period-over-period performance. Our average revenue per core customer increased 4.2% to $31,375 for the twelve months ended September 30, 2014 as compared to $30,113 for the twelve months ended September 30, 2013.

Subscription Dollar Retention Rate

We believe that our ability to retain our core customers and expand the revenue they generate for us over time is an important component of our growth strategy and reflects the long-term value of our customer relationships. We measure our performance on this basis using a metric we refer to as our subscription dollar retention rate. We calculate this metric for a particular period by establishing the cohort of core customers that had active contracts as of the end of the prior period. We then calculate our subscription dollar retention rate by taking the amount of fixed subscription revenue we recognized for the cohort in the period for which we are reporting the rate and dividing it by the fixed subscription revenue we recognized for the same cohort in the prior period. For this purpose, we do not include any revenue from the non-core, legacy products described above, any variable subscription fees paid by our customers or any implementation fees.

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Although some customers in any given period elect not to renew their contracts with us, our customers that do renew their subscriptions often increase their fixed subscription pricing levels to align with their increasing GMV volumes processed through our platform and may subscribe to additional modules as well. If our subscription dollar retention rate for a period is over 100%, this means that the increased subscription revenue we recognized from customers that renewed their contracts during the period, or whose contracts did not come up for renewal during the period, more than offset the subscription revenue we lost from customers that did not renew their contracts.

For each of the twelve months ended September 30, 2014 and 2013, our subscription dollar retention rate exceeded 100%.

Adjusted EBITDA

Adjusted EBITDA represents our earnings before interest expense, income tax expense and depreciation and amortization, adjusted to eliminate stock-based compensation expense, which is a non-cash item. We believe that the exclusion of the expenses eliminated in calculating adjusted EBITDA can provide a useful measure for period-to-period comparisons of our core business. Accordingly, we believe that adjusted EBITDA provides useful information to investors and others in understanding and evaluating our operating results. However, adjusted EBITDA is not a measure calculated in accordance with U.S. GAAP and should not be considered as an alternative to any measure of financial performance calculated and presented in accordance with U.S. GAAP.

Adjusted EBITDA eliminates the impact of stock-based compensation expense, which we do not consider indicative of our operating performance. Our use of adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation or as a substitute for analysis of our results as reported under U.S. GAAP. Some of these limitations are:

- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future and adjusted EBITDA does not reflect cash capital expenditure requirements for such replacements or for new capital expenditure requirements;
- adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- adjusted EBITDA does not reflect the potentially dilutive impact of equity-based compensation;
- adjusted EBITDA does not reflect interest or tax payments that may represent a reduction in cash available to us; and
- other companies, including companies in our industry, may calculate adjusted EBITDA differently, which reduces its usefulness as a comparative measure.

Because of these and other limitations, you should consider adjusted EBITDA together with U.S. GAAP-based financial performance measures, including various cash flow metrics, net income (loss) and our other U.S. GAAP results. The following table presents a reconciliation of net loss to adjusted EBITDA for each of the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net loss	$(9,004)	$(4,292)	$(27,978)	$(12,019)
Adjustments:				
Interest expense, net	55	520	157	2,606
Income tax expense	6	35	87	56
Depreciation and amortization expense	1,741	886	4,393	2,619
Total adjustments	1,802	1,441	4,637	5,281
EBITDA	(7,202)	(2,851)	(23,341)	(6,738)
Stock-based compensation expense	2,534	474	5,301	1,433
Adjusted EBITDA	$(4,668)	$(2,377)	$(18,040)	$(5,305)

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Components of Operating Results

Revenue

We derive the majority of our revenue from subscription fees paid to us by our customers for access to and usage of our SaaS solutions for a specified contract term, which is usually one year. A portion of the subscription fee is typically fixed and based on a specified minimum amount of GMV that a customer expects to process through our platform. The remaining portion of the subscription fee is variable and is based on a specified percentage of GMV processed through our platform in excess of the customer's specified minimum GMV. In most cases, the specified percentage of excess GMV on which the variable portion of the subscription is based is fixed and does not vary depending on the amount of the excess. We also receive implementation fees, which may include fees for providing launch assistance and training.

The following table shows the percentage of our total revenue attributable to fixed subscription fees plus implementation fees, as compared to the percentage attributable to variable subscription fees, for the three and nine months ended September 30, 2014 and 2013:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2014		2013		2014		2013	
	(as a percentage of total revenue)							
Fixed subscription fees plus implementation fees	78.6	%	70.4	%	75.8	%	67.8	%
Variable subscription fees	21.4		29.6		24.2		32.2	
Total revenue	100.0	%	100.0	%	100.0	%	100.0	%

Because our customer contracts contain both fixed and variable pricing components, changes in GMV between periods do not translate directly or linearly into changes in our revenue. We use customized pricing structures for each of our customers depending upon the individual situation of the customer. For example, some customers may commit to a higher specified minimum GMV amount per month in exchange for a lower fixed percentage fee on that committed GMV. In addition, the percentage fee assessed on the variable GMV in excess of the committed minimum for each customer is typically higher than the fee on the fixed, committed portion. As a result, our overall revenue could increase or decrease even without any change in overall GMV between periods, depending on which customers generated the GMV. In addition, changes in GMV from month to month for any individual customer that are below the specified minimum amount would have no effect on our revenue from that customer, and each customer may alternate between being over the committed amount or under it from month to month. For these reasons, while GMV is an important qualitative and directional indicator, we do not regard it as a useful quantitative measurement of our historic revenues or as a predictor of future revenues.

We recognize fixed subscription fees and implementation fees ratably over the contract period once the contract has been signed by both parties, the customer has access to our platform and transactions can be processed, the fees are fixed or determinable and collection is reasonably assured.

We generally invoice our customers for the fixed portion of the subscription fee in advance, in monthly, quarterly, semi-annual or annual installments. We invoice our customers for the implementation fee at the inception of the arrangement. Fixed subscription and implementation fees that have been invoiced are initially recorded as deferred revenue and are generally recognized ratably over the contract term.

We invoice and recognize revenue from the variable portion of subscription fees in the period in which the related GMV is processed, assuming that the four conditions specified above have been met.

Cost of Revenue

Cost of revenue primarily consists of salaries and personnel-related costs for employees providing services to our customers and supporting our platform infrastructure, including benefits, bonuses and stock-based compensation. Additional expenses include co-location facility costs for our data centers, depreciation expense for computer equipment directly associated with generating revenue, infrastructure maintenance costs, fees we pay to credit card vendors in connection with our customers' payments to us and other direct costs. We plan to continue to expand our capacity to support our growth, which will result in higher cost of revenue in absolute dollars.

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Operating Expenses

Sales and marketing expense. Sales and marketing expense consists primarily of salaries and personnel-related costs for our sales and marketing and customer support employees, including benefits, bonuses, stock-based compensation and commissions. We record expense for commissions at the time of contract signing. Additional expenses include marketing, advertising and promotional event programs, corporate communications and travel.

Research and development expense. Research and development expense consists primarily of salaries and personnel-related costs for our research and development employees, including benefits, bonuses and stock-based compensation. Additional expenses include costs related to the development, quality assurance and testing of new technology and enhancement of our existing platform technology, consulting and travel.

General and administrative expense. General and administrative expense consists primarily of salaries and personnel-related costs for administrative, finance and accounting, information systems, legal and human resource employees, including benefits, bonuses and stock-based compensation. Additional expenses include consulting and professional fees, insurance, bad debt expense, other corporate expenses and travel, as well as costs associated with compliance with the Sarbanes-Oxley Act and other regulations governing public companies, directors' and officers' liability insurance, increased professional services and an enhanced investor relations function now that we are a public company.

Other Income (Expense)

Other income (expense) consists primarily of interest income and interest expense. Interest income represents interest received on our cash and cash equivalents. During the three and nine months ended September 30, 2014, interest expense consisted primarily of interest on our capital leases. During the three and nine months ended September 30, 2013, interest expense consisted primarily of the interest incurred on outstanding borrowings under our credit facilities and subordinated loan, the accretion of the debt discount on our subordinated loan and interest on our capital leases. During the nine months ended September 30, 2013, interest expense also included changes in the fair value of our preferred stock warrant liability.

Other income (expense) also includes the net effect of foreign currency revaluation gains and losses.

Seasonality

Our revenue fluctuates as a result of seasonal variations in our business, principally due to the peak consumer demand and related increased volume of our customers' GMV during the year-end holiday season. As a result, we have historically had higher revenue in our fourth quarter than other quarters in a given year due to increased GMV processed through our platform, resulting in higher variable subscription fees. Along with the seasonally higher revenue we have experienced in the fourth quarter, we have also experienced higher gross margins in the fourth quarter. Our cost to run our platform infrastructure is generally fixed. Therefore, when applied against our generally fixed costs, the higher revenue in the fourth quarter has resulted in higher overall gross margins for us.

Inflation

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. We continue to monitor the impact of inflation in order to minimize its effects through pricing strategies, productivity improvements and cost reductions. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

Critical Accounting Policies and Estimates

Our management's discussion and analysis of our financial condition and results of operations is based on our condensed consolidated financial statements, which have been prepared in accordance with U.S. GAAP. The preparation of these condensed consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reported period. In accordance with U.S. GAAP, we base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions, and to the extent that there are differences between our estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected. During the nine months ended September 30, 2014, there were no material changes to our critical accounting policies and use of estimates, which are disclosed in our audited consolidated financial statements for the year ended December 31, 2013 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 27, 2014.

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Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, No. 2014-09, Revenue from Contracts with Customers (Topic 606), or ASU 2014-09, which provides new guidance for revenue recognition. ASU 2014-09 provides that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 also requires improved disclosures to help users of financial statements better understand the nature, amount, timing, and uncertainty of revenue that is recognized. Entities have the option of using either a full retrospective or modified retrospective approach for the adoption of the standard. ASU 2014-09 will be effective for us beginning January 1, 2017 and early adoption is not permitted. We are currently evaluating the impact the adoption of ASU 2014-09 will have on our consolidated financial statements.

We have reviewed other new accounting pronouncements that were issued as of September 30, 2014 and do not believe that these pronouncements are applicable to us, or that they will have a material impact on our financial position or results of operations.

Results of Operations

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

The following table presents our results of operations for the three months ended September 30, 2014 and 2013:

	Three Months Ended September 30,											
	2014				2013				Period-to-Period Change			
	Amount		Percentage of Revenue		Amount		Percentage of Revenue		Amount		Percentage	
	(dollars in thousands)											
Revenue	$20,966		100.0	%	$16,620		100.0	%	$4,346		26.1	%
Cost of revenue	6,018		28.7		4,555		27.4		1,463		32.1	
Gross profit	14,948		71.3		12,065		72.6		2,883		23.9	
Operating expenses:												
Sales and marketing	13,865		66.1		9,316		56.1		4,549		48.8	
Research and development	4,263		20.3		2,991		18.0		1,272		42.5	
General and administrative	5,677		27.1		3,499		21.1		2,178		62.2	
Total operating expenses	23,805		113.5		15,806		95.2		7,999		50.6	
Loss from operations	(8,857	)	(42.2	)	(3,741	)	(22.6	)	(5,116	)	136.8	
Other (expense) income:												
Interest expense, net	(55	)	(0.3	)	(520	)	(3.1	)	465		(89.4	)
Other income, net	(86	)	(0.4	)	4		—		(90	)	*	
Total other (expense) income	(141	)	(0.7	)	(516	)	(3.1	)	375		(72.7	)
Loss before income taxes	(8,998	)	(42.9	)	(4,257	)	(25.7	)	(4,741	)	111.4	
Income tax expense	6		—		35		0.2		(29	)	(82.9	)
Net loss	$(9,004	)	(42.9	)%	$(4,292	)	(25.9	)%	$(4,712	)	109.8	

* = not meaningful

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Revenue

	Three Months Ended September 30,		Period-to-Period Change	
	2014	2013	Amount	Percentage
	(dollars in thousands)			
Revenue	$20,966	$16,620	$4,346	26.1 %

The increase in revenue for the three months ended September 30, 2014 was mainly driven by an increase in our core revenue, which is discussed below, and the expansion of our international operations. The growth in core revenue was partially offset by a $0.1 million, or 30.2%, decrease in our non-core revenue over the same period, as the products associated with our non-core, legacy acquisitions became a less significant part of our overall business focus.

Our revenue from international operations of $4.7 million, or 22.6% of total revenue, for the three months ended September 30, 2014 increased from $3.5 million, or 20.9% of total revenue, for the three months ended September 30, 2013. The increase in revenue from our international operations was primarily attributable to an increase in the number of international customers. During the three months ended September 30, 2014, we continued our expansion in the Asia-Pacific and Latin America regions.

Core Revenue

	Three Months Ended September 30,		Period-to-Period Change	
	2014	2013	Amount	Percentage
	(dollars in thousands)			
Core revenue	$20,686	$16,219	$4,467	27.5 %
Percentage of total revenue	98.7 %	97.6 %		
Non-core revenue	$280	$401	$(121)	(30.2)%
Percentage of total revenue	1.3 %	2.4 %		
Total revenue	$20,966	$16,620	$4,346	26.1 %

The growth in core revenue was primarily attributable to a 21.6% increase in the number of core customers using our platform at September 30, 2014 as compared to September 30, 2013. The increase in core customers accounted for 82.1% of the increase in core revenue during the three months ended September 30, 2014.

In addition, we experienced a 4.0% increase in the average revenue per core customer during the three months ended September 30, 2014 as compared to the three months ended September 30, 2013. The increase in the average revenue per core customer during the three months ended September 30, 2014 accounted for 17.9% of the increase in core revenue during the period. The increase in the average revenue per core customer was primarily attributable to an overall increase in transaction volume and, to a lesser extent, to modest overall increases in the percentage fees assessed on the fixed and variable portions of GMV under our contractual arrangements with some of our customers during the year. Because we generally enter into annual contracts with our customers, we may renegotiate either or both of the fixed and variable components of the pricing structure of a customer’s contract each year. In addition, the increase in average revenue per core customer was due in part to our established customers who have increased their revenue over time on our platform. In general, as customers mature they become more active by contributing a higher amount of GMV and/or subscribing to additional solutions on our platform.

Cost of Revenue

	Three Months Ended September 30,		Period-to-Period Change	
	2014	2013	Amount	Percentage
	(dollars in thousands)			
Cost of revenue	$6,018	$4,555	$1,463	32.1 %
Percentage of total revenue	28.7 %	27.4 %		

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The increase in cost of revenue was primarily attributable to a $0.9 million increase in salaries and personnel-related costs, as we increased the number of employees providing services to our expanding customer base and supporting our platform infrastructure from 129 at September 30, 2013 to 150 at September 30, 2014. During the three months ended September 30, 2014, we also experienced a $0.5 million increase in co-location facility costs and depreciation expense associated with equipment for our data centers.

Operating Expenses

Sales and marketing

	Three Months Ended September 30,				Period-to-Period Change		
	2014		2013		Amount	Percentage	
	(dollars in thousands)						
Sales and marketing	$13,865		$9,316		$4,549	48.8	%
Percentage of total revenue	66.1	%	56.1	%			

The increase in sales and marketing expense was primarily attributable to a $4.2 million increase in salaries and personnel-related costs, as we increased the number of sales and marketing and customer support personnel to continue driving revenue growth. The number of full-time sales and marketing employees increased from 259 at September 30, 2013 to 375 at September 30, 2014. In addition, we experienced a $0.3 million increase in our marketing and advertising expenses, promotional event programs and travel costs. The increase in sales and marketing expense as a percentage of revenue for the three months ended September 30, 2014 reflects our strategy of adding sales and marketing professionals and expanding our marketing activities in order to continue to grow our business.

Research and development

	Three Months Ended September 30,				Period-to-Period Change		
	2014		2013		Amount	Percentage	
	(dollars in thousands)						
Research and development	$4,263		$2,991		$1,272	42.5	%
Percentage of total revenue	20.3	%	18.0	%			

The increase in research and development expense was primarily attributable to a $1.3 million increase in salaries and personnel-related costs associated with an increase in research and development personnel. The number of full-time research and development employees increased from 80 at September 30, 2013 to 100 at September 30, 2014.

General and administrative

	Three Months Ended September 30,				Period-to-Period Change		
	2014		2013		Amount	Percentage	
	(dollars in thousands)						
General and administrative	$5,677		$3,499		$2,178	62.2	%
Percentage of total revenue	27.1	%	21.1	%			

The increase in general and administrative expense was primarily attributable to a $1.8 million increase in salaries and personnel-related costs associated with an increase in general and administrative personnel to support our growing business and obligations as a public company. The number of full-time general and administrative employees increased from 48 at September 30, 2013 to 63 at September 30, 2014. Bad debt expense increased by $0.2 million due to our revenue growth and an increase in the number of our customers. In addition, we experienced a $0.2 million increase in other general administrative costs necessary to support the overall growth in our business.

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Results of Operations

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

The following table presents our results of operations for the nine months ended September 30, 2014 and 2013:

	Nine Months Ended September 30,				Period-to-Period Change	
	2014		2013			
	Amount	Percentage of Revenue	Amount	Percentage of Revenue	Amount	Percentage
	(dollars in thousands)					
Revenue	$61,074	100.0 %	$47,518	100.0 %	$13,556	28.5 %
Cost of revenue	18,169	29.7	12,971	27.3	5,198	40.1
Gross profit	42,905	70.3	34,547	72.7	8,358	24.2
Operating expenses:						
Sales and marketing	42,131	69.0	26,398	55.6	15,733	59.6
Research and development	12,572	20.6	8,882	18.7	3,690	41.5
General and administrative	15,850	26.0	8,641	18.2	7,209	83.4
Total operating expenses	70,553	115.6	43,921	92.5	26,632	60.6
Loss from operations	(27,648)	(45.3)	(9,374)	(19.8)	(18,274)	194.9
Other (expense) income:						
Interest expense, net	(157)	(0.3)	(2,606)	(5.5)	2,449	(94.0)
Other income, net	(86)	(0.1)	17	—	(103)	*
Total other (expense) income	(243)	(0.4)	(2,589)	(5.5)	2,346	(90.6)
Loss before income taxes	(27,891)	(45.7)	(11,963)	(25.3)	(15,928)	133.1
Income tax expense	87	0.1	56	0.1	31	55.4
Net loss	$(27,978)	(45.8)%	$(12,019)	(25.4)%	$(15,959)	132.8

* = not meaningful

Revenue

	Nine Months Ended September 30,		Period-to-Period Change	
	2014	2013	Amount	Percentage
	(dollars in thousands)			
Revenue	$61,074	$47,518	$13,556	28.5 %

The increase in revenue for the nine months ended September 30, 2014 was mainly driven by an increase in our core revenue, which is discussed below, and the expansion of our international operations. The growth in core revenue was partially offset by a $0.4 million, or 29.3%, decrease in our non-core revenue over the same period, as the products associated with our non-core, legacy acquisitions became a less significant part of our overall business focus.

Our revenue from international operations of $13.9 million, or 22.7% of total revenue, for the nine months ended September 30, 2014 increased from $10.0 million, or 21.1% of total revenue, for the nine months ended September 30, 2013. The increase in revenue from our international operations was primarily attributable to an increase in the number of international customers. During the nine months ended September 30, 2014, we continued our expansion in the Asia-Pacific and Latin America regions.

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Core Revenue

	Nine Months Ended September 30,		Period-to-Period Change	
	2014	2013	Amount	Percentage
	(dollars in thousands)			
Core revenue	$60,101	$46,142	$13,959	30.3 %
Percentage of total revenue	98.4 %	97.1 %		
Non-core revenue	$973	$1,376	$(403)	(29.3)%
Percentage of total revenue	1.6 %	2.9 %		
Total revenue	$61,074	$47,518	$13,556	28.5 %

The growth in core revenue was primarily attributable to a 21.6% increase in the number of core customers using our platform at September 30, 2014 as compared to September 30, 2013. The increase in core customers accounted for 83.7% of the increase in core revenue during the nine months ended September 30, 2014.
In addition, we experienced a 3.9% increase in the average revenue per core customer during the nine months ended September 30, 2014 as compared to the nine months ended September 30, 2013. The increase in the average revenue per core customer during the nine months ended September 30, 2014 accounted for 16.3% of the increase in core revenue during the period.

Cost of Revenue

	Nine Months Ended September 30,		Period-to-Period Change	
	2014	2013	Amount	Percentage
	(dollars in thousands)			
Cost of revenue	$18,169	$12,971	$5,198	40.1 %
Percentage of total revenue	29.7 %	27.3 %		

The increase in cost of revenue was primarily attributable to a $3.3 million increase in salaries and personnel-related costs associated with an increase in the number of employees providing services to our expanding customer base and supporting our platform infrastructure. In addition, we experienced a $1.1 million increase in co-location facility costs and depreciation expense associated with equipment for our data centers. During the nine months ended September 30, 2014, we also incurred a $0.6 million charge for translation costs associated with a short-term initiative designed to expand our customers' presence in certain European countries. Lastly, we experienced a $0.2 million increase in credit card vendor transaction fees.

Operating Expenses

Sales and marketing

	Nine Months Ended September 30,		Period-to-Period Change	
	2014	2013	Amount	Percentage
	(dollars in thousands)			
Sales and marketing	$42,131	$26,398	$15,733	59.6 %
Percentage of total revenue	69.0 %	55.6 %		

The increase in sales and marketing expense was primarily attributable to a $12.8 million increase in salaries and personnel-related costs, as we increased the number of sales and marketing and customer support personnel to continue driving revenue growth. In addition, we experienced a $2.3 million increase in our marketing and advertising expenses, promotional event programs and travel costs. We also experienced a $0.4 million increase in recruiting and placement costs associated with hiring sales and marketing professionals. The increase in sales and marketing expense as a percentage of revenue for the nine months ended September 30, 2014 reflects our strategy of adding sales and marketing professionals and expanding our marketing activities in order to continue to grow our business.

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Research and development