SAFETY INSURANCE GROUP INC
Form 10-Q
November 04, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

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: 000-50070

SAFETY INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	13-4181699
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

20 Custom House Street, Boston, Massachusetts 02110

(Address of principal executive offices including zip code)

(617) 951-0600

(Registrant's telephone number, including area code)

Not Applicable

(Former name or former address, 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 large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	Accelerated filer
Non-accelerated filer	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 November 1, 2016 there were 15,150,619 shares of common stock with a par value of $0.01 per share outstanding.

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SAFETY INSURANCE GROUP, INC.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands, except share data)

	September 30, 2016 (Unaudited)	December 31, 2015
Assets		
Investments:		
Securities available for sale:		
Fixed maturities, at fair value (amortized cost: $1,109,950 and $1,063,971)	$ 1,152,283	$ 1,081,637
Equity securities, at fair value (cost: $89,247 and $102,541)	100,621	110,204
Other invested assets	21,622	17,602
Total investments	1,274,526	1,209,443
Cash and cash equivalents	52,277	47,494
Accounts receivable, net of allowance for doubtful accounts	199,655	178,567
Receivable for securities sold	647	260
Accrued investment income	9,602	8,922
Taxes recoverable	—	15,497
Receivable from reinsurers related to paid loss and loss adjustment expenses	34,614	40,972
Receivable from reinsurers related to unpaid loss and loss adjustment expenses	80,632	68,261
Ceded unearned premiums	26,600	23,222
Deferred policy acquisition costs	75,099	68,937
Deferred income taxes	—	4,430
Equity and deposits in pools	28,132	23,558
Other assets	13,789	14,306
Total assets	$ 1,795,573	$ 1,703,869
Liabilities		
Loss and loss adjustment expense reserves	$ 552,242	$ 553,977
Unearned premium reserves	439,732	401,961
Accounts payable and accrued liabilities	54,382	53,722
Payable for securities purchased	6,342	8,607
Payable to reinsurers	30,393	11,547
Deferred income taxes	6,079	—
Taxes payable	421	—
Other liabilities	18,679	29,556
Total liabilities	1,108,270	1,059,370

Commitments and contingencies (Note 7)

Shareholders’ equity

Common stock: $0.01 par value; 30,000,000 shares authorized; 17,430,189 and 17,373,643 shares issued	174	174
Additional paid-in capital	183,397	179,896
Accumulated other comprehensive income, net of taxes	34,910	16,464
Retained earnings	552,657	531,800
Treasury stock, at cost: 2,279,570 shares	(83,835)	(83,835)
Total shareholders' equity	687,303	644,499
Total liabilities and shareholders' equity	$ 1,795,573	$ 1,703,869

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net earned premiums	$ 190,712	$ 186,582	$ 563,759	$ 551,593
Net investment income	8,967	9,950	28,235	30,824
Earnings from partnership investments	802	859	3,089	1,436
Net realized gains (losses) on investments	4,891	(310)	4,928	(72)
Net impairment losses on investments (a)	—	(434)	(429)	(434)
Finance and other service income	4,713	4,623	13,282	13,564
Total revenue	210,085	201,270	612,864	596,911
Losses and loss adjustment expenses	124,961	128,931	366,084	484,281
Underwriting, operating and related expenses	58,406	53,624	171,876	157,919
Interest expense	22	22	67	67
Total expenses	183,389	182,577	538,027	642,267
Income (loss) before income taxes	26,696	18,693	74,837	(45,356)
Income tax expense (credit)	8,099	6,712	22,205	(21,213)
Net income (loss)	$ 18,597	$ 11,981	$ 52,632	$ (24,143)
Earnings (loss) per weighted average common share:				
Basic	$ 1.24	$ 0.80	$ 3.50	$ (1.62)
Diluted	$ 1.23	$ 0.80	$ 3.48	$ (1.62)
Cash dividends paid per common share	$ 0.70	$ 0.70	$ 2.10	$ 2.10
Number of shares used in computing earnings (loss) per share:				
Basic	14,960,516	14,880,796	14,941,732	14,861,533
Diluted	15,076,635	14,907,672	15,018,124	14,861,533

(a) No portion of the other-than-temporary impairments recognized in the period indicated were included in comprehensive income

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)

(Dollars in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income (loss)	$ 18,597	$ 11,981	$ 52,632	$ (24,143)
Other comprehensive income, net of tax:				
Unrealized holding gains or (losses) during the period, net of income tax expense (benefit) of $723, ($2,489), $11,657 and ($6,105)	1,343	(4,622)	21,649	(11,337)
Reclassification adjustment for losses or gains included in net income, net of income tax (expense) benefit of ($1,712), $109, ($1,725) and $25	(3,179)	202	(3,203)	47
Unrealized (losses) or gains on securities available for sale	(1,836)	(4,420)	18,446	(11,290)
Comprehensive income (loss)	$ 16,761	$ 7,561	$ 71,078	$ (35,433)

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders' Equity

(Unaudited)

(Dollars in thousands)

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income, Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2014	$ 173	$ 175,583	$ 28,715	$ 587,647	$ (83,835)	$ 708,283
Net loss, January 1 to September 30, 2015				(24,143)		(24,143)
Unrealized losses on securities available for sale, net of deferred federal income taxes			(11,290)			(11,290)
Restricted share awards issued	1	246				247
Recognition of employee share-based compensation, net of deferred federal income taxes		2,691				2,691
Exercise of options, net of federal income taxes		196				196
Dividends paid and accrued				(31,542)		(31,542)
Balance at September 30, 2015	$ 174	$ 178,716	$ 17,425	$ 531,962	$ (83,835)	$ 644,442

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income, Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders' Equity

Balance at December 31, 2015	$ 174	$ 179,896	$ 16,464	$ 531,800	$ (83,835)	$ 644,499
Net income, January 1 to September 30, 2016				52,632		52,632
Unrealized gains on securities available for sale, net of deferred federal income taxes			18,446			18,446
Restricted share awards issued		280				280
Recognition of employee share-based compensation, net of deferred federal income taxes		2,970				2,970
Exercise of options, net of federal income taxes		251				251
Dividends paid and accrued				(31,775)		(31,775)
Balance at September 30, 2016	$ 174	$ 183,397	$ 34,910	$ 552,657	$ (83,835)	$ 687,303

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

	Nine Months Ended September 30, 2016	2015
Cash flows from operating activities:		
Net income (loss)	$ 52,632	$ (24,143)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Depreciation and amortization, net	10,974	8,829
Provision (credit) for deferred income taxes	577	(497)
Net realized (gains) losses on investments	(4,928)	72
Net impairment losses on investments	429	434
Earnings from partnership investments	(3,089)	(1,436)
Changes in assets and liabilities:		
Accounts receivable	(21,088)	(18,236)
Accrued investment income	(680)	901
Receivable from reinsurers	(6,013)	(48,658)
Ceded unearned premiums	(3,378)	(2,576)
Deferred policy acquisition costs	(6,162)	(5,647)
Taxes recoverable	15,497	(23,929)
Other assets	(3,998)	(5,527)
Loss and loss adjustment expense reserves	(1,735)	71,317
Unearned premium reserves	37,771	34,648
Accounts payable and accrued liabilities	1,033	(23,110)
Payable to reinsurers	18,846	18,627
Other liabilities	(10,877)	8,149
Net cash provided by (used for) operating activities	75,811	(10,782)
Cash flows from investing activities:		
Fixed maturities purchased	(210,063)	(157,820)
Equity securities purchased	(18,370)	(23,725)
Other invested assets purchased	(3,525)	(3,434)
Proceeds from sales and paydowns of fixed maturities	77,514	109,346
Proceeds from maturities, redemptions, and calls of fixed maturities	77,995	97,403
Proceed from sales of equity securities	37,486	23,032
Proceeds from other invested assets redeemed	2,656	1,195
Fixed assets purchased	(3,245)	(3,140)
Net cash (used for) provided by investing activities	(39,552)	42,857

Cash flows from financing activities:		
Proceeds from stock options exercised	257	193
Excess tax (expense) benefit from stock options exercised	(6)	2
Dividends paid to shareholders	(31,727)	(31,482)
Net cash used for financing activities	(31,476)	(31,287)
Net increase in cash and cash equivalents	4,783	788
Cash and cash equivalents at beginning of year	47,494	42,455
Cash and cash equivalents at end of period	$ 52,277	$ 43,243

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

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

1. Basis of Presentation

The consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

The consolidated financial statements include Safety Insurance Group, Inc. and its subsidiaries (the "Company"). The subsidiaries consist of Safety Insurance Company, Safety Indemnity Insurance Company, Safety Property and Casualty Insurance Company, Safety Asset Management Corporation ("SAMC"), and Safety Management Corporation, which is SAMC's holding company. All intercompany transactions have been eliminated.

The financial information for the quarter and nine months ended September 30, 2016 and 2015 is unaudited; however, in the opinion of the Company, the information includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial condition, results of operations, and cash flows for the periods. The financial information as of December 31, 2015 is derived from the audited financial statements included in the Company's 2015 annual report on Form 10-K filed with the SEC on February 26, 2016.

These unaudited interim consolidated financial statements may not be indicative of financial results for the full year and should be read in conjunction with the audited financial statements included in the Company's annual report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on February 26, 2016.

The Company is a leading provider of property and casualty insurance focused primarily on the Massachusetts market. The Company's principal product line is automobile insurance. The Company operates through its insurance company subsidiaries, Safety Insurance Company, Safety Indemnity Insurance Company, and Safety Property and Casualty Insurance Company (together referred to as the "Insurance Subsidiaries").

The Insurance Subsidiaries began writing private passenger automobile and homeowners insurance in New Hampshire during 2008, personal umbrella insurance in New Hampshire during 2009, and commercial automobile insurance in New Hampshire during 2011. The Insurance Subsidiaries began writing all of these lines of business in Maine during 2016.

2. Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update ("ASU") No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 reduces diversity in practice in how certain transactions are classified in the statement of cash flows. The amendments in ASU 2016-15 provide guidance on specific cash flow issues including debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, and distributions received from equity method investees. ASU 2016-15 is effective for annual and interim periods beginning after December 15, 2017. The impact of the adoption of ASU 2016-15 to the Company’s financial position and results of operations is currently being evaluated.

In June 2016, the FASB issued Accounting Standards Update (“ASU”) 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Statements, which amends the guidance for the impairment of financial instruments and is expected to result in more timely recognition of impairment losses. The update introduces an impairment model referred to as the current expected credit loss (CECL) model. The impairment

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

model is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses. The ASU is also intended to reduce the complexity of the current guidance by decreasing the number of credit impairment models that entities use to account for debt instruments. For public business entities that are SEC filers, the amendments in ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Entities may adopt the amendments in this update earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The impact of the adoption of ASU 2016-13 to the Company's financial position and results of operations is currently being evaluated.

In March 2016, the FASB issued Accounting Standards Update ("ASU") 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This ASC update requires all excess tax benefits and tax deficiencies to be recognized as income tax expense or benefit in the income statement, and be treated as discreet items in the reporting period in which they occur. Additionally, excess tax benefits will be classified with other income tax cash flows as an operating activity and cash paid by an employer when directly withholding shares for tax withholding purposes will be classified as a financing activity. Awards that are used to settle employee tax liabilities will be allowed to qualify for equity classification for withholdings up to the maximum statutory tax rates in applicable jurisdictions. Regarding forfeitures, a company can make an entity-wide accounting policy election to either continue estimating the number of awards that are expected to vest or account for forfeitures when they occur. The updated guidance is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods. Early adoption is permitted. The impact of the adoption of ASU 2016-01 to the Company's financial position and results of operations is currently being evaluated.

In February 2016, the FASB issued ASU No. 2016-02, Leases (ASU 2016-02"). ASU 2016-02 establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The impact of the adoption of ASU 2016-02 to the Company's financial position and results of operations is currently being evaluated.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). The amendments in this ASC update address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU

2016-01: (1) requires equity investments (except those accounted for under the equity method or those that result in the consolidation of the investee) to be measured at fair value with changes in the fair value recognized in net income; (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) requires the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and (4) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the notes to the financial statements. These amendments are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The impact of the adoption of ASU 2016-01 to the Company's financial position and results of operations is currently being evaluated.

In May 2015, the FASB issued ASU 2015-09, Disclosures about Short-Duration Contracts ("ASU 2015-09"). ASU 2015-09 requires companies that issue short duration contracts to disclose additional information, including: (i) incurred and paid claims development tables; (ii) frequency and severity of claims; and (iii) information about material changes in judgments made in calculating the liability for unpaid claim adjustment expenses, including reasons for the change and the effects on the financial statements. ASU 2015-09 is effective for annual periods beginning after December

15, 2015, and interim periods within annual periods beginning after December 15, 2016. The amendments in ASU 2015-09 should be applied retrospectively by providing comparative disclosures for each period presented, except for those requirements that apply only to the current period. As the requirements of this literature are disclosure only, the application of this guidance will not impact our financial condition, results of operations or cash flows.

In May 2015, the FASB issued ASU 2015-07, Fair Value Measurement Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent) ("ASU 2015-07"). ASU 2015-07 removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The reporting entity should continue to disclose information on investments for which fair value is measured at net asset value (or its equivalent) as a practical expedient to help users understand the nature and risks of the investments and whether the investments, if sold, are probable of being sold at amounts different from net asset value. ASU 2015-07 is effective for fiscal years beginning after December 31, 2015. The Company adopted the updated accounting guidance retrospectively. The Company adjusted its previously reported financial information included herein to reflect the change in accounting guidance for assets measured using the net asset value. The impact of adopting the new accounting standard resulted in excluding a real estate investment trust of $19,653 and $19,097 from the fair value level disclosures as of September 30, 2016 and December 31, 2015.

In April 2015, the FASB issued ASU No. 2015-03, Imputation of Interest ("ASU 2015-03"). ASU 2015-03 simplifies the presentation of debt issuance costs as the amendments in this update require that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of debt liability, consistent with debt discounts or premiums. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this update. ASU 2015-03 is effective for annual and interim reporting periods beginning after December 15, 2015. The standard requires a retrospective approach where the balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. The standard also requires compliance with applicable disclosures for a change in an accounting principle. The Company's adoption of ASU 2015-03 had no impact on the Company's financial position, results of operations or cash flows.

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosures of Uncertainties about an Entity's Ability as a Going Concern" ("ASU 2014-15"). ASU 2014-15 provides guidance on determining when and how to disclose going concern uncertainties in the financial statements, and requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued. ASU 2014-15 is effective for annual periods ending after December 15, 2016 and interim periods thereafter. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have any impact on its financial position, results of operations, or cash flows.

In June 2014, the FASB issued ASU No. 2014-12, "Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period" ("ASU 2014-12”), which revises the accounting treatment for stock compensation tied to performance targets. ASU 2014-12 is effective for calendar years beginning after December 15, 2015. The impact of adoption was not material to the Company’s financial position, results of operations or cash flows.

In May 2014, the FASB issued as final, ASU 2014-09, “Revenue from Contracts with Customers (Topic 606)” which supersedes virtually all existing revenue recognition guidance under GAAP. The update's core principle is 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. The update is effective for interim and annual reporting periods in fiscal years beginning after December 15, 2017 and allows early adoption. ASU 2014-09 allows for the use of either the retrospective or modified retrospective approach of adoption. The Company does not expect the adoption of ASU 2014-09 to have a material impact on its financial position, results of operations, or cash flows.

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(Dollars in thousands except per share and share data)

3. Earnings (loss) per Weighted Average Common Share

Basic earnings (loss) per weighted average common share ("EPS") are calculated by dividing net income (loss) by the weighted average number of basic common shares outstanding during the period. Diluted earnings (loss) per share amounts are based on the weighted average number of common shares including non-vested performance stock grants and the net effect of potentially dilutive common stock options.

The following table sets forth the computation of basic and diluted EPS for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2016	2015	2016	2015	
Earnings attributable to common shareholders - basic and diluted:					
Net income (loss) from continuing operations	$ 18,597	$ 11,981	$ 52,632	$ (24,143)	
Allocation of income for participating shares	(119)	(90)	(363)	—	
Net income (loss) from continuing operations attributed to common shareholders	$ 18,478	$ 11,891	$ 52,269	$ (24,143)	
Earnings per share denominator - basis and diluted					
Total weighted average common shares outstanding, including participating shares	15,056,646	14,993,162	15,045,375	14,982,697	
Less: weighted average participating shares	(96,130)	(112,366)	(103,643)	(121,164)	
Basic earnings per share denominator	14,960,516	14,880,796	14,941,732	14,861,533	
Common equivalent shares- stock options	—	1,292	179	—	(1)
Common equivalent shares- non-vested performance stock grants	116,119	25,584	76,213	—	(2)
Diluted earnings per share denominator	15,076,635	14,907,672	15,018,124	14,861,533	
Basic earnings (loss) per share	$ 1.24	$ 0.80	$ 3.50	$ (1.62)	
Diluted earnings (loss) per share	$ 1.23	$ 0.80	$ 3.48	$ (1.62)	

Undistributed earnings (loss) attributable to common shareholders - basic and diluted:				
Net income (loss) from continuing operations attributable to common shareholders -Basic	$ 1.24	$ 0.80	$ 3.50	$ (1.62)
Dividends declared	(0.70)	(0.70)	(2.10)	(2.10)
Undistributed earnings (loss)	$ 0.54	$ 0.10	$ 1.40	$ (3.72)
Net income (loss) from continuing operations attributable to common shareholders -Diluted	$ 1.23	$ 0.80	$ 3.48	$ (1.62)
Dividends declared	(0.70)	(0.70)	(2.10)	(2.10)
Undistributed earnings (loss)	$ 0.53	$ 0.10	$ 1.38	$ (3.72)

(1) Excludes 1,735 of common equivalent shares related to stock options because their inclusion would be anti dilutive due to the net loss of the Company.
(2) Excludes 55,912 of common equivalent shares related to non-vested performance stock grants because their inclusion would be anti dilutive due to the net loss of the Company.

Diluted EPS excludes stock options with exercise prices and exercise tax benefits greater than the average market price of the Company's common stock during the period because their inclusion would be anti-dilutive. There were no anti-dilutive shares related to non vested performance stock grants for the three months ended September 30, 2016. There were 36 anti-dilutive shares related to non vested performance stock grants for the nine months ended September 30, 2016, respectively.

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(Dollars in thousands except per share and share data)

4. Share-Based Compensation

Management Omnibus Incentive Plan

Long-term incentive compensation is provided under the Company's 2002 Management Omnibus Incentive Plan ("the Incentive Plan") which provides for a variety of share-based compensation awards, including nonqualified stock options, incentive stock options, stock appreciation rights and restricted stock ("RS") awards.

The maximum number of shares of common stock with respect to which awards may be granted is 2,500,000. The Incentive Plan was amended in March of 2013 to remove "share recycling" plan provisions. Hence, shares of stock covered by an award under the Incentive Plan that are forfeited are no longer available for issuance in connection with 2013 and future grants of awards. At September 30, 2016, there were 279,142 shares available for future grant. The Board of Directors and the Compensation Committee intend to issue more awards under the Incentive Plan in the future.

Accounting and Reporting for Stock-Based Awards

Accounting Standards Codification ("ASC") 718, Compensation —Stock Compensation requires the Company to measure and recognize the cost of employee services received in exchange for an award of equity instruments. Under the provisions of ASC 718, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period (generally the vesting period of the equity grant).

The following table summarizes stock option activity under the Incentive Plan for the nine months ended September 30, 2016.

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	6,200	$ 42.85		
Exercised	(6,000)	$ 42.85		
Forfeitures	(200)	$ 42.85		
Outstanding at end of period	—	$ —	none	$ —
Exercisable at end of period	—	$ —	none	$ —

As of September 30, 2016, all stock option awards have expired and all compensation expense related to stock option awards has been recognized. The total intrinsic value of options exercised during the nine months ended September 30, 2016 and 2015 was $85 and $95, respectively. Cash received from stock options exercised was $257 and $193 for the nine months ended September 30, 2016 and 2015, respectively.

Restricted Stock

Service-based restricted stock awarded in the form of unvested shares is recorded at the market value of the Company's common stock on the grant date and amortized ratably as compensation expense over the requisite service period. Service-based restricted stock awards generally vest over a three-year period and vest 30% on the first and second anniversaries of the grant date and 40% on the third anniversary of the grant date, except for non-executive employees' restricted stock awards which vest ratably over a five-year service period and independent directors' stock awards which vest immediately. Our independent directors are subject to stock ownership guidelines, which require them to have a value four times their annual cash retainer.

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Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

In addition to service-based awards, the Company grants performance-based restricted shares to certain employees. These performance shares cliff vest after a three-year performance period provided certain performance measures are attained. A portion of these awards, which contain a market condition, vest according to the level of total shareholder return achieved by the Company compared to its property-casualty insurance peers over a three-year period. The remainder, which contain a performance condition, vest according to the level of Company's combined ratio results compared to a target based on its property-casualty insurance peers.

Actual payouts can range from 0% to 200% of target shares awarded depending upon the level of achievement of the respective market and performance conditions during a three calendar-year performance period. Compensation expense for share awards with a performance condition is based on the probable number of awards expected to vest using the performance level most likely to be achieved at the end of the performance period.

Performance-based awards with market conditions are accounted for and measured differently from awards that have a performance or service condition. The effect of a market condition is reflected in the award's fair value on the grant date. That fair value is recognized as compensation cost over the requisite service period regardless of whether the market-based performance objective has been satisfied.

All of the Company's restricted stock awards are issued as incentive compensation and are equity classified.

The following table summarizes restricted stock activity under the Incentive Plan during the nine months ended September 30, 2016, assuming a target payout for the 2016 performance-based shares.

	Shares Under Restriction	Weighted Average Fair Value	Performance-based Shares Under Restriction	Weighted Average Fair Value
Outstanding at beginning of year	112,024	$ 54.44	99,101	$ 55.55

Granted	46,556	56.09	44,626	61.07
Vested and unrestricted	(56,279)	53.43	(15,289)	47.42
Forfeited	(6,808)	50.02	(33,828)	52.07
Outstanding at end of period	95,493	$ 55.86	94,610	$ 57.60

As of September 30, 2016, there was $7,465 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 2.4 years. The total fair value of the shares that were vested and unrestricted during the nine months ended September 30, 2016 and 2015 was $3,732 and $2,897, respectively. For the nine months ended September 30, 2016 and 2015, the Company recorded compensation expense related to restricted stock of $2,048 and $1,710, net of income tax benefits of $1,103 and $921, respectively.

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5. Investments

The gross unrealized gains and losses on investments in fixed maturity securities, including redeemable preferred stocks that have characteristics of fixed maturities, and equity securities, including interests in mutual funds, and other invested assets were as follows for the periods indicated.

	As of September 30, 2016				
			Gross Unrealized Losses (3)		
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	$ 1,805	$ 5	$ (1)	$ —	$ 1,809
Obligations of states and political subdivisions	380,147	25,026	(301)	—	404,872
Residential mortgage-backed securities (1)	249,186	7,154	(156)	—	256,184
Commercial mortgage-backed securities	31,526	1,184	—	—	32,710
Other asset-backed securities	53,848	359	—	—	54,207
Corporate and other securities	393,438	11,630	(2,567)	—	402,501
Subtotal, fixed maturity securities	1,109,950	45,358	(3,025)	—	1,152,283
Equity securities (2)	89,247	13,621	(2,247)	—	100,621
Other invested assets (5)	21,622	—	—	—	21,622
Totals	$ 1,220,819	$ 58,979	$ (5,272)	$ —	$ 1,274,526

	As of December 31, 2015				
			Gross Unrealized Losses (3)		
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	$ 1,805	$ —	$ (4)	$ —	$ 1,801

Obligations of states and political subdivisions	377,188	21,160	(426)	—	397,922
Residential mortgage-backed securities (1)	237,896	5,188	(1,628)	—	241,456
Commercial mortgage-backed securities	28,851	30	(218)	—	28,663
Other asset-backed securities	24,037	39	(145)	—	23,931
Corporate and other securities	394,194	4,191	(10,521)	—	387,864
Subtotal, fixed maturity securities	1,063,971	30,608	(12,942)	—	1,081,637
Equity securities (2)	102,541	13,498	(5,835)	—	110,204
Other invested assets (5)	17,602	—	—	—	17,602
Totals	$ 1,184,114	$ 44,106	$ (18,777)	$ —	$ 1,209,443

(1) Residential mortgage-backed securities consists primarily of obligations of U.S. Government agencies including collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank (FHLB).

(2) Equity securities included interests in mutual funds held to fund the Company’s executive deferred compensation plan.

(3) Our investment portfolio included 204 and 514 securities in an unrealized loss position at September 30, 2016 and December 31, 2015, respectively.

(4) Amounts in this column represent other-than-temporary impairment (“OTTI”) recognized in accumulated other comprehensive income.

(5) Other invested assets are accounted for under the equity method which approximated fair value.

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The amortized cost and the estimated fair value of fixed maturity securities, by maturity, are shown below for the period indicated. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	As of September 30, 2016	
	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 37,219	$ 37,560
Due after one year through five years	395,168	411,320
Due after five years through ten years	308,632	324,502
Due after ten years through twenty years	30,786	31,878
Due after twenty years	3,585	3,922
Asset-backed securities	334,560	343,101
Totals	$ 1,109,950	$ 1,152,283

The gross realized losses and gains on sales of investments were as follows for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Gross realized gains				
Fixed maturity securities	$ 429	$ 81	$ 653	$ 346
Equity securities	5,031	1,022	6,142	2,465
Gross realized losses				
Fixed maturity securities	—	(1,302)	(991)	(2,520)
Equity securities	(569)	(111)	(876)	(363)
Net realized gains (losses) on investments	$ 4,891	$ (310)	$ 4,928	$ (72)

In the normal course of business, the Company enters into transactions involving various types of financial instruments, including investments in fixed maturities and equity securities. Investment transactions have credit exposure to the extent that a counter party may default on an obligation to the Company. Credit risk is a consequence of carrying, trading and investing in securities. To manage credit risk, the Company focuses on higher quality fixed income securities, reviews the credit strength of all companies in which it invests, limits its exposure in any one investment and monitors the portfolio quality, taking into account credit ratings assigned by recognized statistical rating organizations.

The following tables as of September 30, 2016 and December 31, 2015 present the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities aggregated by investment category. The tables also present the length of time that they have been in a continuous unrealized loss position.

	As of September 30, 2016					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Treasury securities	$ 1,001	$ 1	$ —	$ —	$ 1,001	$ 1
gations of states and political ivisions	26,437	301	—	—	26,437	301
dential mortgage-backed securities	23,640	111	4,204	45	27,844	156
mercial mortgage-backed securities	—	—	—	—	—	—
r asset-backed securities	—	—	—	—	—	—
porate and other securities	37,332	1,907	11,747	660	49,079	2,567
otal, fixed maturity securities	88,410	2,320	15,951	705	104,361	3,025
ty securities	6,381	265	15,052	1,982	21,433	2,247
l temporarily impaired securities	$ 94,791	$	**Being**	**After the**		

ne and Address of Beneficial Owner	**Offering (1)**	**%**	**Offered**	**Offering**	**%**
ned Executive Officers and Directors:					
d Friend (6)	1,838,649	9.9%		1,838,649	7
y Flowers (7)	1,548,316	8.3%		1,548,316	6
rew Keenan (8)	127,032	*		127,032	
mi Kumaresan (9)	157,662	*		157,662	
ert Rubin (10)	112,672	*		112,672	
Hromadko (4)	1,054,482	5.7%		1,054,482	4
les Kane		*			
l Krasnow (11)	207,771	1.1%		207,771	
iam G. Nelson	1,275,491	6.8%		1,275,491	5
in Vazirani (2)	5,893,935	31.6%		5,893,935	24
cutive Officers and Directors as a up (15 persons) (2), (4), (6), (7), (8), and (11)	12,143,555	64.6%		12,143,555	50
er Selling Stockholders:					
co Ancona	34,239	*	23,819	10,420	
hen Andress	37,668	*	34,245	3,423	
Besen	13,785	*	3,500	10,285	

es E. Bryant	17,121	*	17,121	
p M. Byrne	17,439	*	7,439	10,000
monAngels Co-Investment Fund II, (12)	200,475	1.07%	193,626	6,849
ur L. Goldstein	27,996	*	26,286	1,710
ard Karash	25,590	*	11,000	14,590
s P. Kellogg	43,545	*	8,400	35,145
es Kendall	37,668	*	20,000	17,668
er-Williams Family Trust (13)	31,356	*	3,000	28,356
hen R. Levy	26,130	*	24,420	1,710
es A. Manzi, Jr.	17,994	*	8,655	9,339
hael Perlmutter	46,590	*	17,121	29,469
Birch Nominee Trust No. 1 dtd /02 (14)	29,238	*	21,315	7,923
ard B. Roberts Trust 2003 (15)	23,025	*	21,315	1,710
cy H. Roberts Trust 2003 (16)	23,025	*	21,315	1,710
es Rosen	47,607	*	47,607	
riel Schmergel	21,315	*	21,315	
ptown Limited (17)	76,014	*	50,000	26,014
Shulsinger	11,697	*	2,500	9,197
slink Capital Partners I, L.P. (18)	527,604	2.83%	105,521	422,083
erline Capital LLC (19)	128,958	*	122,109	6,849
en F. Woit	76,308	*	71,898	4,410

* Represents beneficial ownership of less than one percent (1%) of our outstanding common stock.

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(1) Shares shown in the table above include shares held in the beneficial owner s name or jointly with others, or in the name of a bank, nominee or trustee for the beneficial owner s account.

(2) Consists of 5,744,570 shares held by Menlo Ventures X, L.P., 48,830 shares held by Menlo Entrepreneurs Fund X, L.P., and 100,535 shares held by MMEF X, L.P. MV Management X, L.L.C. is the general partner of each of the Menlo Funds, and the managing members of the general partner are H. DuBose Montgomery, John W. Jarve, Douglas C. Carlisle, Sonja H. Perkins, Mark A. Siegel, Pravin A. Vazirani, and Shawn T. Carolan. These individuals may be deemed to have shared voting and investment power over the shares held by the Menlo Funds. The address for Menlo Ventures is 3000 Sand Hill Road, Building 4, Suite 100, Menlo Park, CA 94025. Entities affiliated with Menlo Ventures have expressed an interest in purchasing up to 800,000 shares of our common stock being offered in this offering for investment purposes. Such purchases, if any, would be made at the public offering price. If any shares of common stock are purchased by Menlo Ventures, the number of shares beneficially owned and the percentage of common stock beneficially owned after the offering will differ from that set forth in the table above. If entities affiliated with Menlo Ventures purchased the entire 800,000 shares in which they have expressed an interest, the percentage of common stock beneficially owned after the offering by Menlo Ventures would be 27.9%.

(3) Performance Direct Investments II, L.P. is managed by Performance Direct Investors II GP, LLC, which is managed by Performance Equity Management, LLC, a non-member manager which is in turn managed by a committee of managing directors currently consisting of Charles Froland, John S. Clark, Jeffrey Barman, Marcia Haydel, S. Lawrence Rusoff, Jeffrey A. Reals and Frank Brenninkmeyer. These individuals may be deemed to have shared voting and investment power over the shares held by Performance Direct Investments II, L.P. The address for Performance Direct is c/o Performance Equity Management, LLC, 2 Pickwick Plaza, Suite 310, Greenwich, CT 06830.

(4) Consists of 425,769 shares held by Crosslink Ventures V, L.P., 52,443 shares held by Offshore Crosslink Ventures V Unit Trust, 16,077 shares held by Crosslink Bayview V, L.L.C., and 494,289 shares held by Crosslink Crossover Fund V, L.P. It also includes 65,904 shares held by Octave Fund. Crosslink Ventures V Holdings, L.L.C. is the general partner of Crosslink Ventures V, L.P. and Crossover Fund V Management, L.L.C. is the general partner of Crosslink Crossover Fund V, L.P. Gary Hromadko, one of our directors, is a managing member of a limited liability company that is the general partner of Octave Fund and may be deemed to have sole voting and investment power over the shares held by Octave Fund. The address for Crosslink Capital is Two Embarcadero Center, Suite 2200, San Francisco, CA 94111. Entities affiliated with Crosslink Capital have expressed an interest in purchasing up to 1,200,000 shares of our common stock being offered in this offering for investment purposes. Such purchases, if any, would be made at the public offering price. If any shares of common stock are purchased by Crosslink Capital, the number of shares beneficially owned and the percentage of common stock beneficially owned after the offering will differ from that set forth in the table above. If entities affiliated with Crosslink Capital purchased the entire 1,200,000 shares in which they have expressed an interest, the percentage of common stock beneficially owned after the offering by Crosslink Capital would be 9.4%.

(5) Consists of 702,030 shares held by J.P. Morgan Chase Bank, National Association, as trustee for First Plaza Group Trust FBO pool PMI-127 (beneficially owned by General Motors Hourly-Rate Employees Pension Plan), 143,820 shares held by J.P. Morgan Chase Bank, National Association, as trustee for First Plaza Group Trust FBO pool PMI-128 (beneficially owned by Delphi Hourly-Rate Employees Pension Plan), 123,882 shares held by J.P. Morgan Chase Bank, National Association, as trustee for First Plaza Group Trust FBO pool PMI-129 (beneficially owned by General Motors Retirement Program for Salaried Employees), and 31,914 shares held by J.P. Morgan Chase Bank, National Association, as trustee for First Plaza Group Trust FBO pool PMI-130 (beneficially owned by Delphi Retirement Program for Salaried Employees). General Motors Investment

Management Corporation, in its capacity as named fiduciary for investment purposes for the foregoing defined benefit plans (and their successors) that invest through the First Plaza Group Trust, considers the approval of certain private equity investments and their disposition by means of the Private Equity Investment Approval Committee of General Motors Investment Management Corporation. The Private Equity Investment Approval Committee currently consists of the following members: Walter Borst, Edgar Sullivan, John Stevens, and Michael Connors. As members of the Private Equity Investment Approval Committee, these individuals may be deemed to have shared voting and investment power over the shares held by First Plaza Group Trust. Pursuant to a Subadvisory Agreement, Performance Equity Management, LLC has been delegated non-discretionary management of

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the assets of First Plaza Group Trust invested in such shares. The address for First Plaza Group is c/o Performance Equity Management, LLC, 2 Pickwick Plaza, Suite 310, Greenwich, CT 06830.

(6) Includes 101,849 shares held by the David Friend 2009 Qualified Annuity Trust II, 106,806 shares held by the David Friend 2009 Qualified Annuity Trust III, 500,000 shares held by the David Friend 2010 Qualified Annuity Trust I, 100,000 shares held by the David Friend 2011 Qualified Annuity Trust I, 3,000 shares held by Jasper Friend, 3,000 shares held by Zachery Friend, 3,000 shares held by Zoe Friend, 3,000 shares held by Lilian Friend, 101,849 shares held by the Margaret F.A. Shepherd 2009 Qualified Annuity Trust, 106,806 shares held by the Margaret F.A. Shepherd 2009 Qualified Annuity Trust II, and 24,000 shares held by the Friend-Shepherd Family 2009 Irrevocable Trust. Also includes 30,681 shares subject to options held by Mr. Friend that are exercisable within 60 days of June 30, 2011.

(7) Includes 127,426 shares held by the Jeffry Flowers 2009 Grantor Retained Annuity Trust No. 1, 138,526 shares held by the Jeffry Flowers 2009 Grantor Retained Annuity Trust No. 2, 127,426 shares held by the Laurie Flowers 2009 Grantor Retained Annuity Trust No. 1, 138,526 shares held by the Laurie Flowers 2009 Grantor Retained Annuity Trust No. 2, 50,000 shares held by the Laurie Flowers 2010 Grantor Retained Annuity Trust, and 50,000 shares held by the Jeffry Flowers 2010 Grantor Retained Annuity Trust. Also includes 52,391 shares subject to options held by Mr. Flowers that are exercisable within 60 days of June 30, 2011.

(8) Includes 22,969 shares subject to options that are exercisable within 60 days of June 30, 2011.

(9) Includes 21,309 shares held by Jessica McIsaac and 1,375 shares subject to options held by Ms. McIsaac that are exercisable within 60 days of June 30, 2011. Also includes 46,710 shares subject to options held by Mr. Kumaresan that are exercisable within 60 days of June 30, 2011.

(10) Includes 93,292 shares subject to options that are exercisable within 60 days of June 30, 2011. Mr. Rubin resigned as our vice president of engineering in April 2011, but continues as our employee.

(11) Includes 5,000 shares held by the Rachel L. Krasnow Trust, 5,000 shares held by the Charles S. Krasnow Trust and 5,000 shares held by the Eric J. Krasnow Trust.

(12) CommonAngels Co-Investment Fund II, LLC is managed by an investment committee consisting of Chris Sheehan, James Geshwiler, Maia Heymann, Peter Bleyleben, Jonathan Green, Mike Dornbrook, Jack Derby, and Andy Macey. These individuals may be deemed to have shared voting and investment power over the shares held by CommonAngels Co-Investment Fund II, LLC.

(13) Michael Williams and Jeanne Lauer-Williams serve as Trustees of The Lauer-Williams Family Trust. These individuals may be deemed to have shared voting and investment power over the shares held by the Lauer-Williams Family Trust.

(14) Paul D. Birch serves as Trustee of the P.D. Birch Nominee Trust No. 1 dtd 9/10/02. Mr. Birch may be deemed to have sole voting and investment power over the shares held by the P.D. Birch Nominee Trust No. 1 dtd 9/10/02.

(15) Edward B. Roberts and Nancy H. Roberts serve as Trustees of the Edward B. Roberts Trust 2003. These individuals may be deemed to have shared voting and investment power over the shares held by the Edward B. Roberts Trust 2003.

(16)

Edward B. Roberts and Nancy H. Roberts serve as Trustees of the Nancy H. Roberts Trust 2003. These individuals may be deemed to have shared voting and investment power over the shares held by the Nancy H. Roberts Trust 2003.

(17) Sharptown Limited is managed by a board of directors consisting of Simon Paul Alan Brewer, Wendy Joy Burnett, Charles Malet de Carteret, Christopher John Bunt, and David Smaller. These individuals may be deemed to have shared voting and investment power over the shares held by Sharptown Limited.

(18) Translink Capital I, L.P. is managed by Translink Management I, LLC as its General Partner. Jay Eum is managing member of Translink Management I, LLC. Mr. Eum may be deemed to have sole voting and investment power over the shares held by Translink Capital I, L.P.

(19) Alexander M. Levine is managing member of Waterline Capital LLC. Mr. Levine may be deemed to have sole voting and investment power over the shares held by Waterline Capital LLC.

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DESCRIPTION OF CAPITAL STOCK

General

Upon the completion of this offering, our amended and restated certificate of incorporation will authorize us to issue up to 45,000,000 shares of common stock, $0.01 par value per share, and 6,000,000 shares of preferred stock, $0.01 par value per share. The following information reflects the filing of our amended and restated certificate of incorporation and the conversion of all outstanding shares of our preferred stock into shares of common stock immediately prior to the completion of this offering.

As of June 30, 2011, there were outstanding:

18,633,632 shares of common stock held by approximately 135 stockholders;

2,037,410 shares of common stock issuable upon exercise of outstanding stock options at a weighted average exercise price of $3.39 per share; and

11,316 shares of common stock issuable upon exercise of outstanding stock warrants at an exercise price of $2.32 per share.

The following description of our capital stock and provisions of our amended and restated certificate of incorporation and amended and restated bylaws are summaries and are qualified by reference to the amended and restated certificate of incorporation and the amended and restated bylaws that will be in effect upon completion of this offering. Copies of these documents have been filed with the SEC as exhibits to our registration statement, of which this prospectus forms a part. The descriptions of the common stock and preferred stock reflect changes to our capital structure that will occur upon the closing of this offering.

Common Stock

Dividend rights

Subject to preferences that may be applicable to any then outstanding preferred stock, holders of our common stock are entitled to receive such dividends, if any, as may be declared from time-to-time by our board of directors out of legally available funds.

Voting rights

Each holder of our common stock is entitled to one vote for each share on all matters submitted to a vote of the stockholders, including the election of directors. Our stockholders do not have cumulative voting rights in the election of directors. Accordingly, holders of a majority of the voting shares are able to elect all of the directors.

Liquidation

In the event of our liquidation, dissolution, or winding up, holders of our common stock will be entitled to the net assets legally available for distribution to stockholders after the payment of all of our debts and other liabilities and the satisfaction of any liquidation preference granted to the holders of any then outstanding shares of preferred stock.

Rights and preferences

Holders of our common stock have no preemptive, conversion, subscription or other rights, and there are no redemption or sinking fund provisions applicable to our common stock. The rights, preferences, and

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privileges of the holders of our common stock are subject to and may be adversely affected by, the rights of the holders of shares of any series of our preferred stock that we may designate in the future.

Preferred Stock

Upon the completion of this offering, our board of directors will have the authority, without further action by our stockholders, to issue up to 6,000,000 shares of preferred stock in one or more series and to fix the rights, preferences, privileges, and restrictions thereof. These rights, preferences, and privileges could include dividend rights, conversion rights, voting rights, terms of redemption, liquidation preferences, sinking fund terms, and the number of shares constituting any series or the designation of such series, any or all of which may be greater than the rights of our common stock. The issuance of our preferred stock could adversely affect the voting power of holders of our common stock and the likelihood that such holders will receive dividend payments and payments upon liquidation. In addition, the issuance of preferred stock could have the effect of delaying, deferring, or preventing a change of control of our company or other corporate action. Upon completion of this offering, no shares of preferred stock will be outstanding, and we have no present plan to issue any shares of preferred stock.

Registration Rights

We have granted the registration rights described below pursuant to an investors rights agreement with the holders of shares of our convertible preferred stock which will be converted into shares of common stock upon the completion of this offering.

Demand registration rights

After the completion of this offering, the holders of 12,599,946 shares of our common stock and 11,316 shares of common stock issuable upon the exercise of outstanding warrants will be entitled to certain demand registration rights. At any time beginning on the earlier of September 14, 2012 or six months after the consummation of this offering, the holders of at least 35% of these shares can, on not more than two occasions, request that we register all or a portion of their shares. Such request for registration must cover at least that number of shares with an anticipated aggregate offering price, net of underwriting discounts and commissions, exceeding $10 million. Additionally, we will not be required to effect a demand registration during the period beginning 60 days prior to the filing and 180 days following the effectiveness of a registration statement relating to a public offering of our securities (subject to extension in certain circumstances).

Piggyback registration rights

After the completion of this offering, in the event that we propose to register any of our securities under the Securities Act, either for our own account or for the account of other security holders, the holders of 12,599,946 shares of our common stock and 11,316 shares of common stock issuable upon the exercise of outstanding warrants will be entitled to certain piggyback registration rights allowing the holder to include their shares in such registration, subject to certain marketing and other limitations. As a result, whenever we propose to file a registration statement under the Securities Act, other than with respect to a registration related to employee benefit plans, debt securities or corporate reorganizations, the holders of these shares are entitled to notice of the registration and have the right, subject to limitations that the underwriters may impose on the number of shares included in the registration, to include their shares in the registration.

Form S-3 registration rights

After the completion of this offering, the holders of 12,599,946 shares of our common stock and 11,316 shares of common stock issuable upon the exercise of outstanding warrants will be entitled to certain Form S-3 registration rights. The holders of at least 10% of these shares can make a written request that we

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register their shares on Form S-3 if we are eligible to file a registration statement on Form S-3 and if the aggregate price to the public of the shares offered is at least $2.5 million. These stockholders may make an unlimited number of requests for registration on Form S-3. However, we will not be required to effect a registration on Form S-3 if we have effected one such registration in a given 12-month period.

We will pay the registration expenses of the holders of the shares registered pursuant to the demand, piggyback, and Form S-3 registrations described above. In an underwritten offering, the managing underwriter, if any, has the right, subject to specified conditions, to limit the number of shares such holders may include. Additionally, we will not be required to effect Form S-3 registrations during the period beginning 60 days prior to the filing and 180 days following the effectiveness of a registration statement relating to a public offering of our securities (subject to extension in certain circumstances).

The demand, piggyback, and Form S-3 registration rights described above will expire, with respect to any particular stockholder, after our initial public offering, when that stockholder can sell all of its shares under Rule 144 of the Securities Act during any three-month period. In any event, all such registration rights will expire upon the earlier of five years after the consummation of this offering or the consummation of certain events, including the sale of all of our assets, a change of control of our company, or a liquidation, dissolution, or winding up of our company.

Pursuant to the investors rights agreement, each stockholder that has registration rights has agreed that to the extent requested by us and the underwriters, such stockholder will not sell or otherwise dispose of any securities for a period of up to 180 days (subject to extension in certain circumstances). Certain stockholders have also entered into lock-up agreements with the underwriters in connection with this offering. See Underwriting.

Anti-Takeover Provisions

Certificate of Incorporation and Bylaws to be in effect upon the completion of this offering

Our amended and restated certificate of incorporation to be in effect upon the completion of this offering will provide for our board of directors to be divided into three classes with staggered three-year terms. Only one class of directors will be elected at each annual meeting of our stockholders, with the other classes continuing for the remainder of their respective three-year terms. Because our stockholders do not have cumulative voting rights, our stockholders holding a majority of the shares of common stock outstanding will be able to elect all of our directors. Our amended and restated certificate of incorporation and amended and restated bylaws to be effective upon the completion of this offering will provide that all stockholder actions must be effected at a duly called meeting of stockholders and not by a consent in writing, and that only our board of directors, chairperson of the board, chief executive officer, or president may call a special meeting of stockholders.

Our amended and restated certificate of incorporation and amended and restated bylaws will require a 75% stockholder vote for the rescission, alteration, amendment, or repeal of the bylaws by stockholders, and will provide that stockholders may only remove a director for cause with a 75% stockholder vote. Our amended and restated certificate of incorporation and amended and restated bylaws will also provide that vacancies occurring on our board of directors for any reason and newly created directorships resulting from an increase in the authorized number of directors may be filled only by vote of a majority of the remaining members of our board of directors. Our amended and restated bylaws will establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our board of directors. The combination of the classification of our board of directors, the lack of cumulative voting or the ability of stockholders to take action by written consent, the 75% stockholder voting requirements, the limitations on removing directors without cause, the ability of the board to fill vacancies, and the advance notice provisions will make it more difficult for our existing stockholders to replace our board of directors as well as for another party to obtain control of us by replacing our board of directors. Since our board of directors has the power to retain and discharge our

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officers, these provisions could also make it more difficult for existing stockholders or another party to effect a change in management. In addition, the authorization of undesignated preferred stock makes it possible for our board of directors to issue preferred stock with voting or other rights or preferences that could impede the success of any attempt to change our control.

These provisions may have the effect of deterring hostile takeovers or delaying changes in our control or management. These provisions are intended to enhance the likelihood of continued stability in the composition of our board of directors and its policies and to discourage certain types of transactions that may involve an actual or threatened acquisition of us. These provisions are designed to reduce our vulnerability to an unsolicited acquisition proposal. The provisions also are intended to discourage certain tactics that may be used in proxy fights. However, such provisions could have the effect of discouraging others from making tender offers for our shares and, as a consequence, they also may inhibit fluctuations in the market price of our stock that could result from actual or rumored takeover attempts. Such provisions may also have the effect of preventing changes in our management.

Section 203 of the Delaware General Corporation Law

We are subject to Section 203 of the Delaware General Corporation Law, which prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years after the date that such stockholder became an interested stockholder, with the following exceptions:

- before such date, the board of directors of the corporation approved either the business combination or the transaction that resulted in the stockholder becoming an interested stockholder;

- upon completion of the transaction that resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction began, excluding for purposes of determining the voting stock outstanding (but not the outstanding voting stock owned by the interested stockholder) those shares owned (i) by persons who are directors and also officers and (ii) employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer; or

- on or after such date, the business combination is approved by the board of directors and authorized at an annual or special meeting of the stockholders, and not by written consent, by the affirmative vote of at least two-thirds of the outstanding voting stock that is not owned by the interested stockholder.

In general, Section 203 defines business combination to include the following:

- any merger or consolidation involving the corporation and the interested stockholder;

- any sale, transfer, pledge, or other disposition of 10% or more of the assets of the corporation involving the interested stockholder;

- subject to certain exceptions, any transaction that results in the issuance or transfer by the corporation of any stock of the corporation to the interested stockholder;

- any transaction involving the corporation that has the effect of increasing the proportionate share of the stock or any class or series of the corporation beneficially owned by the interested stockholder; or

the receipt by the interested stockholder of the benefit of any loss, advances, guarantees, pledges, or other financial benefits by or through the corporation.

In general, Section 203 defines an interested stockholder as an entity or person who, together with the person s affiliates and associates, beneficially owns, or within three years prior to the time of determination of interested stockholder status did own, 15% or more of the outstanding voting stock of the corporation.

Acceleration of options upon change of control

Generally, under our 2005 Stock Incentive Plan and 2011 Plan, in the event of certain mergers, a reorganization or consolidation of our company with or into another corporation, or the sale of all or substantially all of our assets or all of our capital stock wherein the successor corporation does not assume outstanding options or issue equivalent options, our board of directors may accelerate vesting of options outstanding under such plans.

Choice of Forum

Our amended and restated certificate of incorporation in effect as of the closing of this offering will provide that the Court of Chancery of the State of Delaware will be the exclusive forum for any derivative action or proceeding brought on our behalf; any action asserting a breach of fiduciary duty; any action asserting a claim against us arising pursuant to the Delaware General Corporation Law, our amended and restated certificate of incorporation, or our amended and restated bylaws; or any action asserting a claim against us that is governed by the internal affairs doctrine.

Limitations of Liability and Indemnification

See Executive Compensation Limitation on Liability and Indemnification Matters.

The Nasdaq Global Market Listing

Our common stock has been approved for listing on the Nasdaq Global Market under the symbol CARB.

Transfer Agent and Registrar

Upon completion of this offering, the transfer agent and registrar for our common stock will be American Stock Transfer & Trust Company, LLC.

SHARES ELIGIBLE FOR FUTURE SALE

Prior to this offering, there has been no public market for our common stock. Future sales of our common stock in the public market, or the availability of such shares for sale in the public market, could adversely affect market prices prevailing from time-to-time. As described below, only a limited number of shares will be available for sale shortly after this offering due to contractual and legal restrictions on resale. Nevertheless, sales of our common stock in the public market after such restrictions lapse, or the perception that those sales may occur, could adversely affect the prevailing market price at such time and our ability to raise equity capital in the future.

Based on the number of shares outstanding as of June 30, 2011, upon the completion of this offering, shares of common stock will be outstanding, assuming no exercise of the underwriters overallotment option and no exercise of outstanding options or warrants. Of the outstanding shares, all of the shares sold in this offering will be freely tradable, except that any shares held by our affiliates, as that term is defined in Rule 144 under the Securities Act, may only be sold in compliance with the limitations described below. In addition, if members of our board of directors, or our executive officers, employees, or business associates purchase shares in this offering through the directed share program described under Underwriting Reserved Shares, the shares purchased by them in this offering will be further subject to lock-up agreements, as described below.

The remaining 17,750,105 shares of common stock outstanding after this offering will be restricted as a result of securities laws or lock-up agreements as described below. See Underwriting No Sales of Similar Securities . Following the expiration of the lock-up period, all shares will be eligible for resale in compliance with Rule 144 or Rule 701 to the extent such shares have been released from any repurchase option that we may hold. Restricted securities as defined under Rule 144 were issued and sold by us in reliance on exemptions from the registration requirements of the Securities Act. These shares may be sold in the public market only if registered or pursuant to an exemption from registration, such as Rule 144 or Rule 701 under the Securities Act.

Rule 144

In general, a person who has beneficially owned restricted shares of our common stock for at least six months would be entitled to sell their securities provided that (i) such person is not deemed to have been one of our affiliates at the time of, or at any time during the 90 days preceding, a sale and (ii) we are subject to the Exchange Act periodic reporting requirements for at least 90 days before the sale. Persons who have beneficially owned restricted shares of our common stock for at least six months but who are our affiliates at the time of, or any time during the 90 days preceding a sale, would be subject to additional restrictions, by which such person would be entitled to sell within any three-month period only a number of securities that does not exceed the greater of either of the following:

- 1% of the number of shares of our common stock then outstanding, which will equal approximately 240,001 shares immediately after this offering assuming no exercise of the underwriters overallotment option, based on the number of shares of common stock outstanding as of June 30, 2011; or

- the average weekly trading volume of our common stock on the Nasdaq Global Market during the four calendar weeks preceding the filing of a notice on Form 144 with respect to the sale;

provided, in each case, that we are subject to the Exchange Act periodic reporting requirements for at least 90 days before the sale. Such sales both by affiliates and by non-affiliates must also comply with the manner of sale, current public information, and notice provisions of Rule 144.

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Rule 701

Rule 701 under the Securities Act, as in effect on the date of this prospectus, permits resales of shares in reliance upon Rule 144 but without compliance with certain restrictions of Rule 144, including the holding period requirement. Most of our employees, executive officers, or directors who purchased shares under a written compensatory plan or contract may be entitled to rely on the resale provisions of Rule 701, but all holders of Rule 701 shares are required to wait until 90 days after the date of this prospectus before selling their shares. However, substantially all Rule 701 shares are subject to lock-up agreements as described below and under Underwriting included elsewhere in this prospectus and will become eligible for sale upon the expiration of the restrictions set forth in those agreements.

Lock-Up Agreements

All of our directors and officers and substantially all of our stockholders have signed lock-up agreements under which they have agreed not to sell, transfer, or dispose of, directly or indirectly, any shares of our common stock or any securities into or exercisable or exchangeable for shares of our common stock without the prior written consent of Merrill Lynch, Pierce, Fenner & Smith Incorporated and J.P. Morgan Securities LLC for a period of 180 days, subject to a possible extension under certain circumstances, after the date of this prospectus. The holders of approximately 97.1% of our outstanding shares of common stock have executed lock-up agreements. See Underwriting No Sales of Similar Securities . These agreements are described below under Underwriting.

Registration Rights

On the date beginning 180 days after the date of this prospectus, the holders of 12,599,946 shares of our common stock, and 11,316 shares of common stock issuable upon the exercise of outstanding warrants, or their transferees, will be entitled to certain rights with respect to the registration of those shares under the Securities Act. For a description of these registration rights, see Description of Capital Stock Registration Rights. After these shares are registered, they will be freely tradable without restriction under the Securities Act.

Stock Options

As soon as practicable after the completion of this offering, we intend to file a Form S-8 registration statement under the Securities Act to register shares of our common stock subject to options or other awards outstanding or reserved for issuance under our 2005 Stock Incentive Plan and our 2011 Plan. This registration statement will become effective immediately upon filing, and shares covered by this registration statement will thereupon be eligible for sale in the public markets, subject to vesting restrictions, the lock-up agreements described above, and Rule 144 limitations applicable to affiliates. For a more complete discussion of our stock plans, see Executive Compensation Employee Benefit and Stock Plans.

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MATERIAL U.S. FEDERAL INCOME TAX CONSEQUENCES TO NON-U.S. HOLDERS OF OUR COMMON STOCK

The following is a summary of the material U.S. federal income and estate tax consequences to non-U.S. holders (as defined below) of the ownership and disposition of our common stock issued pursuant to this offering. This discussion is not a complete analysis of all the potential U.S. federal income and estate tax consequences relating thereto, nor does it address any gift tax consequences or any tax consequences arising under any state, local, or foreign tax laws, or any other U.S. federal tax laws. This discussion is based on the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder, judicial decisions, and published rulings and administrative pronouncements of the Internal Revenue Service, or IRS, all as in effect as of the date of this offering. These authorities may change, possibly retroactively, resulting in U.S. federal income tax consequences different from those discussed below. No ruling has been or will be sought from the IRS with respect to the matters discussed below, and there can be no assurance that the IRS will not take a contrary position regarding the tax consequences of the ownership or disposition of our common stock, or that any such contrary position would not be sustained by a court.

This discussion is limited to non-U.S. holders who purchase our common stock issued pursuant to this offering and who hold our common stock as a capital asset within the meaning of Section 1221 of the Internal Revenue Code (generally, property held for investment). This discussion does not address all of the U.S. federal income and estate tax consequences that may be relevant to a particular holder in light of such holder s particular circumstances. This discussion also does not consider any specific facts or circumstances that may be relevant to holders subject to special rules under the U.S. federal income tax laws, including, without limitation, U.S. expatriates, partnerships or other pass-through entities, controlled foreign corporations, passive foreign investment companies, corporations that accumulate earnings to avoid U.S. federal income tax, financial institutions, insurance companies, brokers, dealers or traders in securities, commodities or currencies, tax-exempt organizations, tax-qualified retirement plans, persons who hold or receive our common stock pursuant to the exercise of any employee stock option or otherwise as compensation, persons subject to the alternative minimum tax, persons that own, or have owned, actually or constructively, more than 5% of our common stock, and persons holding our common stock as part of a hedging or conversion transaction or straddle, or a constructive sale, or other risk reduction strategy.

THIS DISCUSSION IS PROVIDED FOR GENERAL INFORMATION ONLY AND DOES NOT CONSTITUTE LEGAL ADVICE TO ANY PROSPECTIVE INVESTOR. PROSPECTIVE INVESTORS SHOULD CONSULT THEIR OWN TAX ADVISORS REGARDING THE PARTICULAR U.S. FEDERAL INCOME TAX CONSEQUENCES TO THEM OF OWNING AND DISPOSING OF OUR COMMON STOCK, AS WELL AS ANY TAX CONSEQUENCES ARISING UNDER ANY STATE, LOCAL, OR FOREIGN TAX LAWS AND ANY OTHER U.S. FEDERAL TAX LAWS. ADDITIONALLY, THIS DISCUSSION CANNOT BE USED BY ANY INVESTOR FOR THE PURPOSE OF AVOIDING TAX PENALTIES THAT MAY BE IMPOSED ON SUCH HOLDER.

Definition of Non-U.S. Holder

For purposes of this discussion, a non-U.S. holder is any beneficial owner of our common stock that is not a U.S. person or a partnership (or other entity treated as a partnership) for U.S. federal income tax purposes. A U.S. person is any of the following:

- an individual citizen or resident of the U.S.;

a corporation (or other entity treated as a corporation for U.S. federal income tax purposes) created or organized under the laws of the U.S., any state thereof or the District of Columbia;

an estate the income of which is subject to U.S. federal income tax regardless of its source; or a trust (1) whose administration is subject to the primary supervision of a U.S. court and which has one or more U.S. persons who have the authority to control all substantial decisions of the trust, or (2) that has a valid election in effect under applicable Treasury Regulations to be treated as a U.S. person.

If a partnership (or any other entity treated as a partnership for U.S. federal income tax purposes) holds our common stock, the U.S. federal income tax treatment of a partner of that partnership will generally depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership holding our common stock, you should consult your tax advisors.

Distributions on Our Common Stock

If we make distributions on our common stock (other than certain pro rata distributions of our common stock), such distributions will constitute dividends for U.S. federal income tax purposes to the extent paid from our current or accumulated earnings and profits, as determined under U.S. federal income tax principles. Amounts not treated as dividends for U.S. federal income tax purposes will first be applied against and reduce a holder s tax basis in the common stock, but not below zero. Any excess will be treated as gain realized on the sale or other disposition of the common stock and will be treated as described under Gain on Disposition of Our Common Stock below.

As discussed under Dividend Policy above, we do not currently expect to pay dividends. In the event that we do pay dividends, dividends paid to a non-U.S. holder of our common stock generally will be subject to U.S. federal withholding tax at a rate of 30% of the gross amount of the dividends, or such lower rate specified by an applicable income tax treaty. To receive the benefit of a reduced treaty rate, a non-U.S. holder must furnish to us or our paying agent a valid IRS Form W-8BEN (or applicable successor form) certifying such holder s qualification for the reduced rate. This certification must be provided to us or our paying agent prior to the payment of dividends and must be updated periodically. If the non-U.S. holder holds the stock through a financial institution or other agent acting on the non-U.S. holder s behalf, the non-U.S. holder will be required to provide appropriate documentation to the agent, which then will be required to provide certification to us or our paying agent, either directly or through other intermediaries. Non-U.S. holders that do not timely provide us or our paying agent with the required certification, but that qualify for a reduced treaty rate, may obtain a refund of any excess amounts withheld by timely filing an appropriate claim for refund with the IRS.

If a non-U.S. holder holds our common stock in connection with the conduct of a trade or business in the U.S., and dividends paid on the common stock are effectively connected with such holder s U.S. trade or business, the non-U.S. holder will be exempt from U.S. federal withholding tax. To claim the exemption, the non-U.S. holder must generally furnish to us or our paying agent a properly executed IRS Form W-8ECI (or applicable successor form).

Any dividends paid on our common stock that are effectively connected with a non-U.S. holder s U.S. trade or business (and if required by an applicable income tax treaty, attributable to a fixed base or permanent establishment maintained by the non-U.S. holder in the U.S.) generally will be subject to U.S. federal income tax on a net income basis at the regular graduated U.S. federal income tax rates in much the same manner as if such holder were a resident of the U.S. A non-U.S. holder that is a foreign corporation also may be subject to an additional branch profits tax equal to 30% (or such lower rate specified by an applicable income tax treaty) of its effectively connected earnings and profits for the taxable year, as adjusted for certain items. Non-U.S. holders should consult any applicable income tax treaties that may provide for different rules.

A non-U.S. holder who claims the benefit of an applicable income tax treaty with respect to a distribution generally will be required to satisfy applicable certification and other requirements prior to the

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distribution date. Non-U.S. holders should consult their tax advisors regarding their entitlement to benefits under a relevant income tax treaty.

Gain on Disposition of Our Common Stock

Subject to the discussion below regarding backup withholding, a non-U.S. holder generally will not be subject to U.S. federal income tax on any gain realized upon the sale or other disposition of our common stock, unless:

- the gain is effectively connected with the non-U.S. holder s conduct of a trade or business in the U.S., and if required by an applicable income tax treaty, attributable to a fixed base or permanent establishment maintained by the non-U.S. holder in the U.S.;

- the non-U.S. holder is a nonresident alien individual present in the U.S. for 183 days or more during the taxable year of the disposition, and certain other requirements are met; or

- our common stock constitutes a U.S. real property interest by reason of our status as a U.S. real property holding corporation, or USRPHC, for U.S. federal income tax purposes at any time within the shorter of the five-year period preceding the disposition or the non-U.S. holder s holding period for our common stock and our common stock has ceased to be regularly traded on an established securities market prior to the beginning of the calendar year in which the sale or other disposition occurs. The determination of whether we are a USRPHC depends on the fair market value of our U.S. real property interests relative to the fair market value of our other trade or business assets and our foreign real property interests. We believe that we are not currently, and do not anticipate becoming, a USRPHC for U.S. federal income tax purposes.

Gain described in the first bullet point above will be subject to U.S. federal income tax on a net income basis at the regular graduated U.S. federal income tax rates in the same manner as if such holder were a resident of the U.S. A non-U.S. holder that is a foreign corporation also may be subject to an additional branch profits tax equal to 30% (or such lower rate specified by an applicable income tax treaty) of its effectively connected earnings and profits for the taxable year, as adjusted for certain items. Non-U.S. holders should consult any applicable income tax treaties that may provide for different rules.

Gain described in the second bullet point above will be subject to U.S. federal income tax at a flat 30% rate (or such lower rate specified by an applicable income tax treaty), but may be offset by U.S. source capital losses (even though the individual is not considered a resident of the U.S.), provided that the non-U.S. holder has timely filed a U.S. federal income tax return with respect to such losses.

While we believe that we are not currently and do not anticipate becoming a USRPHC for U.S. federal income tax purposes, if we should at some point become a USRPHC, gain described in the third bullet point above will be subject to U.S. federal income tax under regular graduated U.S. federal income tax rates with respect to the gain recognized.

Information Reporting and Backup Withholding

We must report annually to the IRS and to each non-U.S. holder the amount of distributions on our common stock paid to such holder and the amount of any tax withheld with respect to those distributions. These information reporting requirements apply even if no withholding was required because the distributions were effectively connected with the holder s conduct of a U.S. trade or business, or withholding was reduced or eliminated by an applicable income tax treaty. This information also may be made available under a specific treaty or agreement with the tax authorities in the country in which the non-U.S. holder resides or is established. Backup withholding, currently at a

28% rate, however, generally will not apply to distributions to

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a non-U.S. holder of our common stock provided the non-U.S. holder furnishes to us or our paying agent the required certification as to its non-U.S. status, such as by providing a valid IRS Form W-8BEN or IRS Form W-8ECI, or certain other requirements are met.

Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules may be allowed as a refund or a credit against a non-U.S. holder s U.S. federal income tax liability, provided the required information is timely furnished to the IRS.

U.S. Federal Estate Tax

Our common stock beneficially owned by an individual who is not a citizen or resident of the U.S. (as defined for U.S. federal estate tax purposes) at the time of death will generally be includable in the decedent s gross estate for U.S. federal estate tax purposes, unless an applicable treaty provides otherwise.

Recent Legislation Relating to Foreign Entities

Recently enacted legislation will impose withholding taxes on certain types of payments made to foreign financial institutions (as defined under these rules) and certain other non-U.S. entities. Under this legislation, the failure to comply with additional certification, information reporting, and other specified requirements could result in withholding tax being imposed on payments of dividends and sales proceeds to foreign banks, custodial agents, intermediaries, and certain non-U.S. holders. The legislation imposes a 30% withholding tax on dividends on, or gross proceeds from the sale or other disposition of, our common stock paid to a foreign financial institution or to a foreign non-financial entity, unless (i) the foreign financial institution undertakes certain diligence and reporting obligations (including substantial information regarding U.S. account holders of such institution) or (ii) the foreign non-financial entity either certifies it does not have any substantial U.S. owners or furnishes identifying information regarding each substantial U.S. owner. If the payee is a foreign financial institution, it must enter into an agreement with the U.S. Treasury requiring, among other things, that it undertake to identify accounts held by certain U.S. persons or U.S.-owned foreign entities, annually report certain information about such accounts, and withhold 30% on payments to account holders whose actions prevent it from complying with these reporting and other requirements. Under certain circumstances, a non-U.S. holder might be eligible for refunds or credits of such taxes. The legislation applies to payments made after December 31, 2012. Prospective investors should consult their tax advisors regarding the possible implications of this legislation on their investment in our common stock.

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UNDERWRITING

Merrill Lynch, Pierce, Fenner & Smith Incorporated and J.P. Morgan Securities LLC are acting as representatives of each of the underwriters named below. Subject to the terms and conditions set forth in an underwriting agreement among us, the selling stockholders, and the underwriters, we and the selling stockholders have agreed to sell to the underwriters, and each of the underwriters has agreed, severally and not jointly, to purchase from us and the selling stockholders, the number of shares of common stock set forth opposite its name below.

Underwriter	Number of Shares
Merrill Lynch, Pierce, Fenner & Smith Incorporated	2,187,500
J.P. Morgan Securities LLC	2,187,500
William Blair & Company, L.L.C.	468,750
Canaccord Genuity Inc.	468,750
Oppenheimer & Co. Inc.	468,750
Pacific Crest Securities Inc.	468,750
Total	6,250,000

Subject to the terms and conditions set forth in the underwriting agreement, the underwriters have agreed, severally and not jointly, to purchase all of the shares sold under the underwriting agreement if any of these shares are purchased. If an underwriter defaults, the underwriting agreement provides that the purchase commitments of the nondefaulting underwriters may be increased or the underwriting agreement may be terminated.

We and the selling stockholders have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act, or to contribute to payments the underwriters may be required to make in respect of those liabilities.

The underwriters are offering the shares, subject to prior sale, when, as, and if issued to and accepted by them, subject to approval of legal matters by their counsel, including the validity of the shares, and other conditions contained in the underwriting agreement, such as the receipt by the underwriters of officers certificates and legal opinions. The underwriters reserve the right to withdraw, cancel, or modify offers to the public and to reject orders in whole or in part.

Entities affiliated with Menlo Ventures and entities affiliated with Crosslink Capital have expressed an interest in purchasing up to 800,000 and 1,200,000 shares, respectively, of our common stock being offered in this offering for investment purposes. As of June 30, 2011, Menlo Ventures and Crosslink Capital beneficially owned 31.6% and 5.7%, respectively, of our common shares prior to this offering. In addition, a member of our board of directors is a managing member of MV Management X, L.L.C., an affiliate of Menlo Ventures, and a member of our board of directors is an affiliate of Crosslink Capital. Such purchases, if any, would be made at the public offering price, and outside the reserved share program described below under Reserved Shares.

Commissions and Discounts

The representatives have advised us and the selling stockholders that the underwriters propose initially to offer the shares to the public at the public offering price set forth on the cover page of this prospectus and to dealers at that price less a concession not in excess of $0.42 per share. Any such dealers may resell shares to certain other brokers or dealers at a discount of up to $0.10 per share from the initial

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public offering price. After the initial offering, the public offering price, concession, or any other term of this offering may be changed.

The following table shows the public offering price, underwriting discount and proceeds before expenses to us and the selling stockholders. The information assumes either no exercise or full exercise by the underwriters of their overallotment option.

	Per Share	No Exercise	Full Exercise
Public offering price	$ 10.00	$ 62,500,000.00	$ 71,875,000.00
Underwriting discounts to be paid by:			
Us	$ 0.70	$ 3,756,531.10	$ 4,412,781.10
The selling stockholders	$ 0.70	$ 618,468.90	$ 618,468.90
Proceeds, before expenses, to us	$ 9.30	$ 49,908,198.90	$ 58,626,948.90
Proceeds, before expenses, to the selling stockholders	$ 9.30	$ 8,216,801.10	$ 8,216,801.10

The expenses of this offering, not including the underwriting discounts, are estimated at $2,700,000 and are payable by us.

Overallotment Option

We have granted an option to the underwriters, exercisable for 30 days after the date of this prospectus, to purchase up to 937,500 additional shares at the public offering price, less the underwriting discount. The underwriters may exercise this option solely to cover any overallotments. If the underwriters exercise this option, each will be obligated, subject to conditions contained in the underwriting agreement, to purchase a number of additional shares proportionate to that underwriter s initial amount reflected in the above table.

Reserved Shares

At our request, the underwriters have reserved for sale, at the initial public offering price, 310,010 shares offered by this prospectus for sale to some of our directors, officers, and existing holders of our preferred stock. If these persons purchase reserved shares, this will reduce the number of shares available for sale to the general public. Any reserved shares that are not so purchased will be offered by the underwriters to the general public on the same terms as the other shares offered by this prospectus.

No Sales of Similar Securities

We, the selling stockholders, our executive officers and directors, and certain of our other existing security holders have agreed not to sell or transfer any common stock or securities convertible into, exchangeable for, exercisable for, or repayable with common stock, for 180 days after the date of this prospectus without first obtaining the written consent of Merrill Lynch, Pierce, Fenner & Smith Incorporated and J.P. Morgan Securities LLC. Specifically, we and these other persons have agreed, with certain limited exceptions, not to directly or indirectly

offer, pledge, sell, or contract to sell any common stock;

sell any option or contract to purchase any common stock;

purchase any option or contract to sell any common stock;

grant any option, right, or warrant for the sale of any common stock;

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lend or otherwise dispose of or transfer any common stock;

request or demand that we file a registration statement related to the common stock; or

enter into any swap or other agreement that transfers, in whole or in part, the economic consequence of ownership of any common stock whether any such swap or transaction is to be settled by delivery of shares or other securities, in cash, or otherwise.

This lock-up provision applies to common stock and to securities convertible into or exchangeable or exercisable for or repayable with common stock. It also applies to common stock owned now or acquired later by the person executing the agreement or for which the person executing the agreement later acquires the power of disposition, subject to certain exceptions. For example, the restrictions in the lock-up agreements will not apply to up to 3,000,000 shares purchased in the offering by certain existing stockholders who are otherwise subject to such lockup restrictions. However, certain of these stockholders may be deemed to be our affiliates and subject to Section 16 of the Exchange Act and other securities laws, which may limit their ability or interest in selling or otherwise transferring such shares following the offering. In the event that either (x) during the last 17 days of the lock-up period referred to above, we issue an earnings release or material news or a material event relating to us occurs or (y) prior to the expiration of the lock-up period, we announce that we will release earnings results or become aware that material news or a material event will occur during the 16-day period beginning on the last day of the lock-up period, the restrictions described above shall continue to apply until the expiration of the 18-day period beginning on the issuance of the earnings release or the occurrence of the material news or material event.

Nasdaq Global Market Listing

Our common stock has been approved for listing on the Nasdaq Global Market, subject to notice of issuance, under the symbol CARB.

Before this offering, there has been no public market for our common stock. The initial public offering price has been determined through negotiations among us, the selling stockholders, and the representatives. In addition to prevailing market conditions, the factors considered in determining the initial public offering price were:

the valuation multiples of publicly traded companies that the representatives believe to be comparable to us;

our financial information;

the history of, and the prospects for, our company and the industry in which we compete;

an assessment of our management, its past and present operations, and the prospects for, and timing of, our future revenue;

the present state of our development; and

the above factors in relation to market values and various valuation measures of other companies engaged in activities similar to ours.

An active trading market for the shares may not develop. It is also possible that after this offering the shares will not trade in the public market at or above the initial public offering price.

The underwriters do not expect to sell more than 5% of the shares in the aggregate to accounts over which they exercise discretionary authority.

Price Stabilization, Short Positions, and Penalty Bids

Until the distribution of the shares is completed, SEC rules may limit underwriters and selling group members from bidding for and purchasing our common stock. However, the representatives may engage in transactions that stabilize the price of the common stock, such as bids or purchases to peg, fix, or maintain that price.

In connection with this offering, the underwriters may purchase and sell our common stock in the open market. These transactions may include short sales, purchases on the open market to cover positions created by short sales and stabilizing transactions. Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in this offering.   Covered   short sales are sales made in an amount not greater than the underwriters overallotment option described above. The underwriters may close out any covered short position by either exercising their overallotment option or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the overallotment option.   Naked   short sales are sales in excess of the overallotment option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of our common stock in the open market after pricing that could adversely affect investors who purchase in this offering. Stabilizing transactions consist of various bids for or purchases of shares of common stock made by the underwriters in the open market prior to the completion of this offering.

The underwriters may also impose a penalty bid. This occurs when a particular underwriter repays to the underwriters a portion of the underwriting discount received by it because the representatives have repurchased shares sold by or for the account of such underwriter in stabilizing or short covering transactions.

Similar to other purchase transactions, the underwriters   purchases to cover the syndicate short sales may have the effect of raising or maintaining the market price of our common stock or preventing or retarding a decline in the market price of our common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market. The underwriters may conduct these transactions on the Nasdaq Global Market, in the over-the-counter market, or otherwise.

Neither we nor any of the underwriters make any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of our common stock. In addition, neither we nor any of the underwriters make any representation that the representatives will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

Electronic Offer, Sale, and Distribution of Shares

In connection with this offering, certain of the underwriters or securities dealers may distribute prospectuses by electronic means, such as email. In addition, certain of the underwriters or securities dealers may facilitate internet distribution for this offering to certain of their internet subscription customers. Certain of the underwriters or securities dealers may allocate a limited number of shares for sale to their online brokerage customers. An electronic prospectus is available on the internet websites maintained by certain of the underwrites or securities dealers. Other than the prospectus in electronic format, none of the information on the respective websites of the underwriters or securities dealers is part of this prospectus.

Other Relationships

Some of the underwriters and their affiliates have engaged in, and may in the future engage in, investment banking and other commercial dealings in the ordinary course of business with us or our affiliates. They have received, or may in the future receive, customary fees and commissions for these transactions.

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In addition, in the ordinary course of their business activities, the underwriters and their affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers. Such investments and securities activities may involve securities and/or instruments of ours or our affiliates. The underwriters and their affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or financial instruments and may hold, or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

Notice To Prospective Investors In The European Economic Area

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State) an offer to the public of any shares which are the subject of this offering contemplated by this Prospectus (the Shares) may not be made in that Relevant Member State, except that an offer to the public in that Relevant Member State of any Shares may be made at any time under the following exemptions under the Prospectus Directive, if they have been implemented in that Relevant Member State:

A. to any legal entity which is a qualified investor as defined in the Prospectus Directive;

B. to fewer than 100 or, if the Relevant Member State has implemented the relevant provision of the 2010 PD Amending Directive, 150, natural or legal persons (other than qualified investors as defined in the Prospectus Directive), as permitted under the Prospectus Directive, subject to obtaining the prior consent of the representative for any such offer; or

C. in any other circumstances falling within Article 3(2) of the Prospectus Directive, provided that no such offer of Shares shall result in a requirement for the publication by the Company or any representative of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression an offer to the public in relation to any Shares in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and any Shares to be offered so as to enable an investor to decide to purchase any Shares, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State, the expression Prospectus Directive means Directive 2003/71/EC (and amendments thereto, including the 2010 PD Amending Directive, to the extent implemented in the Relevant Member State), and includes any relevant implementing measure in the Relevant Member State, and the expression 2010 PD Amending Directive means Directive 2010/73/EU.

Notice to Prospective Investors in the United Kingdom

Each representative has represented and agreed that:

A. it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the Financial Services and Markets Act (2000), or FSMA) received by it in connection with the issue or sale of the Shares in circumstances in which Section 21(1) of the FSMA does not apply to the Company; and

B. it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Shares in, from or otherwise involving the United Kingdom.

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Notice to Prospective Investors in Switzerland

The Shares may not be publicly offered in Switzerland and will not be listed on the SIX Swiss Exchange (SIX) or on any other stock exchange or regulated trading facility in Switzerland. This document has been prepared without regard to the disclosure standards for issuance prospectuses under art. 652a or art. 1156 of the Swiss Code of Obligations or the disclosure standards for listing prospectuses under art. 27 ff. of the SIX Listing Rules or the listing rules of any other stock exchange or regulated trading facility in Switzerland. Neither this document nor any other offering or marketing material relating to the Shares or this offering may be publicly distributed or otherwise made publicly available in Switzerland.

Neither this document nor any other offering or marketing material relating to this offering, the Company, or the Shares have been or will be filed with or approved by any Swiss regulatory authority. In particular, this document will not be filed with, and the offer of Shares will not be supervised by, the Swiss Financial Market Supervisory Authority FINMA, and the offer of Shares has not been and will not be authorized under the Swiss Federal Act on Collective Investment Schemes (CISA). The investor protection afforded to acquirers of interests in collective investment schemes under the CISA does not extend to acquirers of Shares.

Notice to Prospective Investors in the Dubai International Financial Centre

This prospectus relates to an Exempt Offer in accordance with the Offered Securities Rules of the Dubai Financial Services Authority (DFSA). This prospectus is intended for distribution only to persons of a type specified in the Offered Securities Rules of the DFSA. It must not be delivered to, or relied on by, any other person. The DFSA has no responsibility for reviewing or verifying any documents in connection with Exempt Offers. The DFSA has not approved this prospectus nor taken steps to verify the information set forth herein and has no responsibility for the prospectus. The securities to which this prospectus relates may be illiquid and/or subject to restrictions on their resale. Prospective purchasers of the securities offered should conduct their own due diligence on the securities. If you do not understand the contents of this prospectus you should consult an authorized financial advisor.

LEGAL MATTERS

Certain legal matters with respect to the legality of the issuance of the shares of common stock offered by us and the selling stockholders by this prospectus will be passed upon for us and the selling stockholders by Foley & Lardner LLP, Boston, Massachusetts. Lawyers in Foley & Lardner LLP own an aggregate of 202,251 shares of our common stock as of June 30, 2011. The underwriters are being represented by Davis Polk & Wardwell LLP, Menlo Park, California, in connection with this offering.

EXPERTS

The consolidated financial statements of Carbonite, Inc. at December 31, 2009 and 2010, and for each of the three years in the period ended December 31, 2010, appearing in this prospectus and registration statement have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their report thereon appearing elsewhere herein, and are included in reliance upon such report given on the authority of such firm as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We have filed with the SEC a registration statement on Form S-1 under the Securities Act with respect to this offering of our common stock. This prospectus, which constitutes a part of the registration statement, does not contain all of the information set forth in the registration statement, some items of which are contained in exhibits to the registration statement as permitted by the rules and regulations of the SEC. For further information with respect to us and our common stock, we refer you to the registration statement, including the exhibits and the financial statements and notes filed as a part of the registration statement. Statements contained in this prospectus concerning the contents of any contract or any other document are not necessarily complete. If a contract or document has been filed as an exhibit to the registration statement, please see the copy of the contract or document that has been filed. Each statement in this prospectus relating to a contract or document filed as an exhibit is qualified in all respects by the filed exhibit. The exhibits to the registration statement should be referenced for the complete contents of these contracts and documents. You may obtain copies of this information by mail from the Public Reference Section of the SEC, 100 F Street, N.E., Room 1580, Washington, D.C. 20549, at prescribed rates. You may obtain information on the operation of the public reference rooms by calling the SEC at 1-800-SEC-0330. The SEC also maintains an internet website that contains reports, proxy statements, and other information about issuers, like us, that file electronically with the SEC. The address of that website is www.sec.gov.

As a result of this offering, we will become subject to the information and reporting requirements of the Exchange Act and, in accordance with this law, will file periodic reports, proxy statements, and other information with the SEC. These periodic reports, proxy statements, and other information will be available for inspection and copying at the SEC s public reference facilities (located at the address set forth above) and the website of the SEC referred to above. We also maintain a website at www.carbonite.com. Upon completion of this offering, you may access our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act with the SEC free of charge at our website as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC. The information contained in, or that can be accessed through, our website is not part of this prospectus.

Through and including September 4, 2011 (the 25th day after the date of this prospectus), U.S. federal securities laws may require all dealers that effect transactions in our common stock, whether or not participating in this offering, to deliver a prospectus. This is in addition to the dealers obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

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CARBONITE, INC.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of
Carbonite, Inc.

We have audited the accompanying consolidated balance sheets of Carbonite, Inc. (the Company) as of December 31, 2009 and 2010, and the related statements of operations, redeemable and convertible preferred stock, stockholders deficit, and other comprehensive loss and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Carbonite, Inc. at December 31, 2009 and 2010, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Boston, Massachusetts
March 31, 2011

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Carbonite, Inc.

Consolidated Balance Sheets

	December 31, 2009	December 31, 2010	June 30, 2011 Actual (unaudited)	June 30, 2011 Pro Forma (unaudited)
	(in thousands, except share and per share amounts)			
ASSETS				
Current assets:				
Cash	$ 28,276	$ 13,855	$ 16,243	$ 16,243
Short-term investments	6,739	10,000		
Accounts receivable (net of reserves of $33, $17, and $19 at December 31, 2009, 2010, and June 30, 2011, respectively)	601	644	749	749
Prepaid expenses and other current assets	516	551	1,320	1,320
Total current assets	36,132	25,050	18,312	18,312
Property and equipment, net	10,228	15,818	19,505	19,505
Other assets	73	73	77	77
Long-term assets			1,772	1,772
Acquired intangible assets, net			1,190	1,190
Goodwill			1,514	1,514
Total assets	$ 46,433	$ 40,941	$ 42,370	$ 42,370
LIABILITIES, REDEEMABLE AND CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS DEFICIT				
Current liabilities:				
Accounts payable	$ 2,485	$ 4,868	$ 2,577	$ 2,577
Accrued expenses	3,411	3,947	5,764	5,764
Current portion of deferred revenue	17,641	28,616	35,419	35,419
Total current liabilities	23,537	37,431	43,760	43,760
Deferred revenue, net of current portion	5,503	10,106	13,893	13,893
Deferred rent, net of current portion	91	215	282	282
Warrant liability	18	82	101	
Commitments and contingencies (*Note 10*)				
Redeemable and convertible preferred stock:				
Redeemable convertible preferred stock; Series A-2, $0.01 par value; 506,646 shares authorized and 502,874 shares issued and outstanding at December 31, 2009 and 2010 and June 30, 2011 (actual), at redemption value; no shares authorized or issued and outstanding, pro forma.	4,194	4,404	4,509	
	63,576	64,326	64,326	

Convertible preferred stock; $0.01 par value; 4,062,540 shares authorized and 3,969,649 and 3,991,617 shares issued and outstanding at December 31, 2009 and 2010 and June 30, 2011 (actual), respectively (liquidation value of $69,310, $73,931, and $75,850 at December 31, 2009, and 2010, and June 30, 2011 (actual), respectively); no shares authorized or issued and outstanding, pro forma.				
Stockholders deficit:				
Common stock, $0.01 par value; 21,539,370 shares authorized; 4,266,078, 4,526,603 and 5,150,159 shares issued and outstanding at December 31, 2009, and 2010, and June 30, 2011 (actual), respectively, and 18,633,632 shares at June 30, 2011 (pro forma)	43	45	51	186
Additional paid-in capital	1,303	2,134	3,363	71,155
Accumulated deficit	(51,832)	(77,805)	(87,899)	(86,890)
Treasury stock, at cost (2,009 shares at June 30, 2011)			(22)	(22)
Accumulated other comprehensive income		3	6	6
Total stockholders deficit	(50,486)	(75,623)	(84,501)	(15,565)
Total liabilities, redeemable and convertible preferred stock, and stockholders deficit	$ 46,433	$ 40,941	$ 42,370	$ 42,370

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

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Carbonite, Inc.

Consolidated Statements of Operations

	Years Ended December 31,			Six Months Ended June 30,	
	2008	2009	2010	2010	2011
				(unaudited)	(unaudited)
	(in thousands, except share and per share amounts)				
Revenue	$ 8,202	$ 19,114	$ 38,563	$ 16,685	$ 27,242
Cost of revenue	4,273	8,954	16,284	7,449	10,311
Gross profit	3,929	10,160	22,279	9,236	16,931
Operating expenses:					
Research and development	4,663	6,210	10,868	4,973	7,710
General and administrative	2,389	2,485	4,209	2,033	2,878
Sales and marketing	14,729	21,067	33,098	16,464	16,358
Total operating expenses	21,781	29,762	48,175	23,470	26,946
Loss from operations	(17,852)	(19,602)	(25,896)	(14,234)	(10,015)
Interest income	413	391	207	133	58
Interest expense			(64)	(13)	(27)
Other income (expenses), net		(14)	(10)	1	(5)
Net loss	(17,439)	(19,225)	(25,763)	(14,113)	(9,989)
Accretion of redeemable convertible preferred stock	(210)	(210)	(210)	(105)	(105)
Net loss attributable to common stockholders	$ (17,649)	$ (19,435)	$ (25,973)	$ (14,218)	$ (10,094)
Net loss attributable to common stockholders per share basic and diluted	$ (4.61)	$ (4.78)	$ (5.90)	$ (3.26)	(2.02)
Weighted-average number of common shares used in computing net loss per share basic and diluted	3,828,073	4,065,230	4,399,137	4,367,982	5,009,565
Pro forma net loss attributable to common stockholders per share basic and diluted (unaudited)			$ (1.44)		$ (0.54)
Pro forma weighted-average number of common shares used			17,882,610		18,493,038

in computing net loss per
share basic and diluted
(unaudited)

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

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Carbonite, Inc.

Consolidated Statements of Redeemable and Convertible Preferred Stock, Stockholders Deficit, and Other Comprehensive Loss

Series A-2 Redeemable Convertible Preferred Stock		Convertible Preferred Stock		Common Stock		Additional			Accumulated Other	T
Number of Shares	Amount	Number of Shares	Amount	Number of Shares	Amount	Paid-in Capital	Accumulated Deficit	Treasury Stock	Comprehensive Loss	Stock De
				(in thousands, except share amounts)						
502,874	$ 3,774	2,243,248	$ 23,209	3,771,672	$ 38	$ 387	$ (14,748)	$	$	$ (1
				104,046	1	20				
		1,162,579	21,194							
				102,486	1	51				
	210						(210)			
						203				
							(17,439)			(1
502,874	3,984	3,405,827	44,403	3,978,204	40	661	(32,397)			(3
				55,500	1	70				
		563,822	19,173							
				232,374	2	182				
	210						(210)			

						390				
							(19,225)			(
502,874	4,194	3,969,649	63,576	4,266,078	43	1,303	(51,832)			(
		21,968	750							
				260,525	2	289				
	210						(210)			
						542				
							(25,763)		3	(
502,874	4,404	3,991,617	64,326	4,526,603	45	2,134	(77,805)		3	(
				625,565	6	719				
	105						(105)			
						510				
				(2,009)				(22)		

									3	
							(9,989)			
502,874	4,509	3,991,617	64,326	5,150,159	51	3,363	(87,899)	(22)	6	(8
(502,874)	(4,509)	(3,991,617)	(64,326)	13,483,473	135	67,691	1,009			6
						101				
	$		$	18,633,632	$ 186	$ 71,155	$ (86,890)	$ (22)	$ 6	$ (1

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

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Carbonite, Inc.

Consolidated Statements of Cash Flows

	Years Ended December 31,			Six Months Ended June 30,	
	2008	2009	2010	2010 (unaudited)	2011 (unaudited)
			(in thousands)		
Operating activities					
Net loss	$ (17,439)	$ (19,225)	$ (25,763)	$ (14,113)	$ (9,989)
Adjustments to reconcile net loss to net cash used in operating activities:					
Depreciation and amortization	1,481	2,977	5,060	2,240	3,538
Share-based compensation expense	203	390	542	272	552
Warrant remeasurement			64	13	19
Changes in assets and liabilities, net of acquisition:					
Accounts receivable	(120)	(352)	(43)	(749)	(104)
Prepaid expenses and other current assets	21	129	(35)	(223)	(757)
Other assets	(19)	(5)			(1,412)
Accounts payable	1,183	354	2,383	1,173	(2,575)
Accrued expenses	1,119	952	530	76	1,478
Deferred rent		91	131	38	67
Deferred revenue	5,866	13,743	15,579	7,550	10,004
Net cash provided by (used in) operating activities	(7,705)	(946)	(1,552)	(3,723)	821
Investing activities					
Purchases of property and equipment	(4,704)	(7,099)	(10,652)	(4,376)	(7,190)
Proceeds from short-term investments	4,025	22,732	6,808	1,947	10,000
Purchases of short-term investments	(25,114)	(8,382)	(10,069)	(5,067)	
Payment for acquisition, net of cash acquired					(1,949)
Net cash provided by (used in) investing activities	(25,793)	7,251	(13,913)	(7,496)	861
Financing activities					
Proceeds from issuance of preferred stock, net of issuance costs	21,194	19,173	750	750	
Proceeds from exercise of stock options	52	184	291	155	725
Proceeds from exercise of warrants	21				
Proceeds from issuance of common stock		71			
Repurchase of common stock					(22)
Net cash provided by financing activities	21,267	19,428	1,041	905	703

Effect of currency exchange rate changes on cash			3		3
Net increase (decrease) in cash	(12,231)	25,733	(14,421)	(10,314)	2,388
Cash, beginning of period	14,774	2,543	28,276	28,276	13,855
Cash, end of period	$ 2,543	$ 28,276	$ 13,855	$ 17,962	$ 16,243
Non cash investing and financing activities					
Accretion of redeemable convertible preferred stock	$ 210	$ 210	$ 210	$ 105	$ 105

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

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Carbonite, Inc.

Notes to Consolidated Financial Statements
(Information as of June 30, 2011 and for the six months ended June 30, 2010 and 2011 is unaudited)

1. Nature of Business

Carbonite, Inc. (the Company) was incorporated in the state of Delaware on February 10, 2005, and focuses on the development and marketing of personal computer backup software that enables users to backup, access, and restore data files online.

The Company is subject to a number of risks similar to those of other companies at its stage of development, including competition from established companies, the need for development of commercially viable services, and the need to obtain adequate financing necessary to fund future growth.

The Company has generated an accumulated deficit as of June 30, 2011, of approximately $87.9 million since inception. At June 30, 2011, the Company believes that its cash totaling approximately $16.2 million are sufficient to fund operations through at least the next 12 months.

The Company has evaluated subsequent events after the balance sheet date of June 30, 2011 through August 10, 2011.

2. Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States.

Use of Estimates in the Preparation of Financial Statements

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Although the Company regularly assesses these estimates, actual results could differ materially from these estimates. Changes in estimates are recorded in the period in which they become known. The Company bases its estimates on historical experience and various other assumptions that it believes to be reasonable under the circumstances. Actual results may differ from management s estimates if past experience or other assumptions do not turn out to be substantially accurate, even if such assumptions are reasonable when made.

Unaudited Pro Forma Information

The unaudited pro forma balance sheet as of June 30, 2011 reflects the conversion of all outstanding shares of redeemable and convertible preferred stock to common stock, and the conversion of a warrant for redeemable and convertible preferred stock to a warrant for common stock, to occur upon the closing of the Company s proposed public offering. Unaudited pro forma net loss per share is computed using the weighted average number of common shares outstanding after giving pro forma effect of the conversion of all redeemable and convertible preferred stock during the year ended December 31, 2010 and the six months ended June 30, 2011 into shares of the Company s common stock as if such conversion had occurred at the date of original issuance. Upon conversion of the redeemable and convertible preferred stock into shares of the

Carbonite, Inc.

Notes to Consolidated Financial Statements (Continued)

Company s common stock, the holders of the redeemable and convertible preferred stock are not entitled to receive undeclared dividends. Accordingly, the impact of the accretion of unpaid and undeclared dividends has not been reflected in the pro forma weighted average shares used to compute pro forma net loss per share.

Unaudited Interim Financial Statements

The accompanying unaudited June 30, 2011 consolidated balance sheet, the consolidated statements of operations and cash flows for the six months ended June 30, 2010 and 2011, and the consolidated statements of redeemable and convertible preferred stock, stockholders deficit, and other comprehensive loss for the six months ended June 30, 2011 and the related interim information contained within the notes to the consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial information. Accordingly, they do not include all of the information and the notes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, the unaudited interim consolidated financial statements reflect all adjustments, consisting of normal and recurring adjustments, necessary for the fair presentation of the Company s financial position at June 30, 2011 and results of its operations and its cash flows for the six months ended June 30, 2010 and 2011. The results for the six months ended June 30, 2011 are not necessarily indicative of future results.

Translation of Foreign Currencies

The financial statements of the Company s foreign subsidiary in China are translated into U.S. dollars. The functional currency of the Company s foreign subsidiary is its local currency. The Company translates the assets and liabilities of its foreign subsidiary at the exchange rates in effect at year-end. Revenues and expenses are translated using average exchange rates in effect during the year. Gains and losses from foreign currency translation are recorded to accumulated other comprehensive income (loss) included in stockholders deficit. Gains and losses arising from transactions denominated in foreign currencies are primarily related to intercompany accounts that have been determined to be temporary in nature. During the year ended December 31, 2010 and the six months ended June 30, 2011, the Company had foreign currency transaction losses of approximately $5,927 and $3,604 included in other expenses, respectively.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk primarily consist of cash, short-term investments, and accounts receivable. The Company maintains its cash and cash equivalent and short-term investment balances with high-quality financial institutions and, consequently, the Company believes that such funds are subject to minimal credit risk. Management believes that the Company is not exposed to significant credit risk due to the financial position of the depository institutions in which those financial instruments are held.

The Company sells its services primarily to individual and commercial customers. Payment for the majority of the Company s sales occurs via credit card. Due to these factors, no additional credit risk beyond amounts provided for collection losses is believed by management to be probable in the Company s accounts receivable. As of December 31, 2008, 2009, 2010 and June 30, 2011 and for the years and the six month period then ended, respectively, there were no customers that represented 10% or more of accounts receivable or revenue.

Carbonite, Inc.

Notes to Consolidated Financial Statements (Continued)

Revenue Recognition

The Company derives revenue from online backup subscription services. These services are standalone independent service solutions, which are generally contracted for a one- to three-year term. Subscription arrangements include access to use the Company s software via the internet. The Company recognizes revenue in accordance with the Financial Accounting Standards Codification (ASC) 605-10, *Overall Revenue Recognition.* Subscription revenue is recognized ratably on a daily basis upon activation over the subscription period, when persuasive evidence of an arrangement with a customer exists, the subscription period has been activated, the price is fixed or determinable, and collection is reasonably assured. Deferred revenues represent payments received from customers for subscription services prior to recognizing the revenue related to those payments.

Cash, Cash Equivalents, and Short-Term Investments

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be the equivalent of cash for the purpose of balance sheet and statement of cash flows presentation. The Company s short-term investments consist of bank certificates of deposit with maturities greater than three months but less than one year.

The Company reviews its investments for other-than-temporary impairment whenever evidence indicates that an investment s carrying amount is not recoverable within a reasonable period of time. There were no other-than-temporary impairments during the years ended December 31, 2008, 2009, 2010 and the six months ended June 30, 2011.

Property and Equipment

Property and equipment are stated at cost. Expenditures for repairs and maintenance are charged to expense as incurred. Upon retirement or sale, the cost of the assets disposed of and the related accumulated depreciation are eliminated from the accounts and any resulting gain or loss is reflected in the consolidated statement of operations. Depreciation and amortization is provided using the straight-line method over the estimated useful lives of the assets, which are as follows:

Asset Classification	**Estimated Useful Life**
Computer equipment	2 4 years
Software	3 years
Furniture and fixtures	5 years
Leasehold improvements	Shorter of useful life or remaining life of lease

Impairment of Long-Lived Assets

The Company reviews property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the recoverability of these assets is considered to be impaired, the impairment to be recognized equals the amount by which the carrying value of the assets exceeds its estimated fair value. The Company has not identified any impairment of its long-lived assets as of December 31, 2008, 2009, 2010 or June 30, 2011.

Carbonite, Inc.

Notes to Consolidated Financial Statements (Continued)

Goodwill and Acquired Intangible Assets

The Company records goodwill when consideration paid in a business acquisition exceeds the fair value of the net tangible assets and the identified intangible assets acquired. Goodwill is not amortized, but rather is tested for impairment annually or more frequently if facts and circumstances warrant a review. The Company performs its annual assessment for impairment of goodwill on November 30 and has determined that there is a single reporting unit for the purpose of conducting this annual goodwill impairment assessment. For purposes of assessing potential impairment, the Company annually estimates the fair value of the reporting unit (based on the Company s market capitalization) and compares this amount to the carrying value of the reporting unit (as reflected by the Company s total stockholders equity). If the Company determines that the carrying value of the reporting unit exceeds its fair value, an impairment charge would be recorded.

Intangible assets acquired in a business combination are recorded under the acquisition method of accounting at their estimated fair values at the date of acquisition. As the pattern of consumption of the economic benefits of the intangible assets cannot be reliably determined, the Company amortizes acquired intangible assets over their estimated useful lives on a straight-line basis.

In June 2011, the Company acquired substantially all of the assets of Phanfare, Inc., for $1.9 million, net of cash acquired, and the assumption of certain liabilities. Phanfare s service enables users to create, maintain, and share online photo and video albums. The Company will continue to employ Phanfare s five employees at its current location in Princeton, New Jersey.

The acquisition of Phanfare has been accounted for as a purchase of a business and, accordingly, the total purchase price has been allocated to the tangible and identifiable intangible assets acquired and the net liabilities assumed based on their respective fair values on the acquisition date. As a result of the acquisition of Phanfare, the Company recorded goodwill in the amount of $1.5 million and identifiable intangible assets of $1.2 million, which was comprised of $880 thousand related to developed technology, $180 thousand related to customer relationship and $150 related to non-compete agreements. The overall weighted-average life of the identified intangible assets acquired in the purchase of Phanfare was 4.7 years. These identified intangible assets will be amortized on a straight-line basis over their estimated useful lives.

The results of operation for the Company s acquisitions were not material for the periods presented.

Research and Development Costs

Research and development costs are expensed as incurred.

The Company follows the guidance of ASC 350-40, *Internal Use Software* and ASC 350-50, *Website Development Costs*, in accounting for its software and website development costs. The costs incurred in the preliminary stages of development are expensed as incurred. Once an application has reached the development stage, internal and external costs, if direct and incremental, are capitalized until the application is substantially complete and ready for its intended use. The Company has determined that technological feasibility is established at the time that a scalable working model of the application is complete. Because the Company believes its current process for developing applications is essentially completed concurrent with the establishment of technological feasibility, no costs have been capitalized to date. These costs are included in the accompanying statements of operations as research and development expense.

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Carbonite, Inc.

Notes to Consolidated Financial Statements (Continued)

Advertising Expenses

The Company expenses advertising costs as incurred. During the years ended December 31, 2008, 2009, and 2010, the Company incurred approximately $7.6 million, $10.8 million, and $23.6 million of advertising expense, respectively, which is included in sales and marketing expense in the accompanying statements of operations.

Accounts Receivable

Accounts receivable are recorded at the invoiced amount. The allowance for doubtful accounts is the Company s best estimate of the amount of probable credit losses in the Company s existing accounts receivable. The Company specifically analyzes historical bad debts, the aging of the accounts receivable, creditworthiness, and current economic trends, to evaluate the allowance for doubtful accounts. Past due balances are reviewed individually for collectability. Account balances are charged off against the allowance after all means of collection have been exhausted, and the potential for recovery is considered remote.

Accounts receivable allowance activity consisted of the following for the years ended December 31, 2008, 2009, and 2010 and the six month period ended June 30, 2011 (in thousands):

	Beginning Balance	Additions/ (Adjustments)	Write-Offs	Ending Balance
June 30, 2011 *(Unaudited)*	$ 17	$ 2	$ 0	$ 19
2010	$ 33	$ (16)	$	$ 17
2009	$ 87	$ 6	$ (60)	$ 33
2008	$ 1	$ 86	$	$ 87

Income Taxes

The Company provides for income taxes under the liability method. Deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates in effect when the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance to reflect the uncertainty associated with their ultimate realization.

The Company accounts for uncertain tax positions recognized in the consolidated financial statements by prescribing a more-likely-than-not threshold for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

Comprehensive Income (Loss)

All components of comprehensive income (loss) are required to be disclosed in the consolidated financial statements. Comprehensive income (loss) is defined as the change in equity of a business enterprise during a period from transactions, and other events and circumstances from nonowner sources. Accumulated other comprehensive income consists entirely of foreign currency translation adjustments for all periods.

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Carbonite, Inc.

Notes to Consolidated Financial Statements (Continued)

Net Loss per Share

The Company calculates basic and diluted net loss per common share by dividing the net loss adjusted for the dividend on the redeemable convertible preferred stock by the weighted average number of common shares outstanding during the period. The Company has excluded (a) all unvested restricted shares that are subject to repurchase and (b) the Company s other potentially dilutive shares, which include redeemable and convertible preferred stock, warrant for redeemable convertible preferred stock, and outstanding common stock options, from the weighted average number of common shares outstanding as their inclusion in the computation for all periods would be anti-dilutive due to net losses. The Company s redeemable and convertible preferred stock are participating securities as defined by ASC 260-10, *Earnings Per Share*, but are excluded from the earnings per share calculation as they do not have an obligation to share in the Company s net losses.

The following potentially dilutive common shares have been excluded from the computation of diluted weighted-average shares outstanding as of December 31, 2008, 2009, 2010 and June 30, 2010 and 2011, as they would be anti-dilutive:

	Years Ended December 31,		Six Months Ended June 30,
	2008	2009	