

Proto Labs Inc
Form 10-Q
April 30, 2019

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2019

or

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

For the transition period from _____ to _____

Commission File Number: 001-35435

Proto Labs, Inc.

(Exact name of registrant as specified in its charter)

Minnesota

(State or other jurisdiction of incorporation or organization)

41-1939628

(I.R.S. Employer Identification No.)

5540 Pioneer Creek Drive

Maple Plain, Minnesota

(Address of principal executive offices)

55359

(Zip Code)

(763) 479-3680

(Registrant's telephone number, including area code)

Not Applicable

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

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer
Smaller reporting company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 26,848,544 shares of Common Stock, par value \$0.001 per share, were outstanding at April 25, 2019.

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Proto Labs, Inc.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Proto Labs, Inc.****Consolidated Balance Sheets****(In thousands, except share and per share amounts)**

| | March 31, 2019 (Unaudited) | December 31, 2018 |
|---|---|----------------------------------|
| Assets | | |
| Current assets | | |
| Cash and cash equivalents | \$ 85,350 | \$ 85,046 |
| Short-term marketable securities | 35,045 | 46,750 |
| Accounts receivable, net of allowance for doubtful accounts of \$939 and \$919 as of March 31, 2019 and December 31, 2018, respectively | 61,535 | 59,155 |
| Inventory | 9,356 | 10,087 |
| Prepaid expenses and other current assets | 8,613 | 8,567 |
| Income taxes receivable | 2,852 | 5,757 |
| Total current assets | 202,751 | 215,362 |
| Property and equipment, net | 234,211 | 228,001 |
| Goodwill | 128,752 | 128,752 |
| Other intangible assets, net | 18,979 | 19,850 |
| Long-term marketable securities | 18,262 | 23,579 |
| Operating lease assets | 11,965 | - |
| Other long-term assets | 3,676 | 3,441 |
| Total assets | \$ 618,596 | \$ 618,985 |
| Liabilities and shareholders' equity | | |
| Current liabilities | | |
| Accounts payable | \$ 16,672 | \$ 17,411 |
| Accrued compensation | 10,129 | 18,130 |
| Accrued liabilities and other | 11,027 | 16,702 |
| Current operating lease liabilities | 3,021 | - |
| Income taxes payable | 594 | 491 |
| Total current liabilities | 41,443 | 52,734 |
| Long-term operating lease liabilities | 9,107 | - |
| Long-term deferred tax liabilities | 20,549 | 20,162 |
| Other long-term liabilities | 4,702 | 4,592 |

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| | | |
|--|------------|------------|
| Total liabilities | 75,801 | 77,488 |
| Shareholders' equity | | |
| Preferred stock, \$0.001 par value, authorized 10,000,000 shares; issued and outstanding 0 shares as of each of March 31, 2019 and December 31, 2018 | - | - |
| Common stock, \$0.001 par value, authorized 150,000,000 shares; issued and outstanding 26,846,981 and 26,984,747 shares as of March 31, 2019 and December 31, 2018, respectively | 27 | 27 |
| Additional paid-in capital | 259,611 | 258,502 |
| Retained earnings | 291,173 | 291,460 |
| Accumulated other comprehensive loss | (8,016) | (8,492) |
| Total shareholders' equity | 542,795 | 541,497 |
| Total liabilities and shareholders' equity | \$ 618,596 | \$ 618,985 |

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

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Proto Labs, Inc.
Consolidated
Statements of
Comprehensive
Income
(In thousands,
except share
and per share
amounts)
(Unaudited)

| | Three Months Ended | |
|--|---------------------------|-------------|
| | March 31, | |
| | 2019 | 2018 |
| Statements of Operations: | | |
| Revenue | \$113,452 | \$107,745 |
| Cost of revenue | 54,592 | 49,837 |
| Gross profit | 58,860 | 57,908 |
| Operating expenses | | |
| Marketing and sales | 18,577 | 16,572 |
| Research and development | 8,013 | 6,665 |
| General and administrative | 12,822 | 12,943 |
| Total operating expenses | 39,412 | 36,180 |
| Income from operations | 19,448 | 21,728 |
| Other income, net | 213 | 178 |
| Income before income taxes | 19,661 | 21,906 |
| Provision for income taxes | 4,150 | 3,855 |
| Net income | \$15,511 | \$18,051 |
| Net income per share: | | |
| Basic | \$0.58 | \$0.67 |
| Diluted | \$0.57 | \$0.66 |
| Shares used to compute net income per share: | | |
| Basic | 26,963,366 | 26,879,388 |
| Diluted | 27,177,039 | 27,197,099 |
| Comprehensive Income (net of tax) | | |
| Comprehensive income | \$15,987 | \$20,444 |

The
accompanying

notes are an
integral part of
these
consolidated
financial
statements.

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**Proto Labs,
Inc.
Consolidated
Statements of
Shareholders'
Equity
(In thousands,
except share
amounts)**

| | Common Stock | | Additional Paid-In | | Retained Earnings | | Accumulated Other Comprehensive Loss | | Total |
|---|---------------------|---------------|-------------------------------|------------|------------------------------|---|---|--|--------------|
| | Shares | Amount | Capital | | | | | | |
| Balance at January 1, 2019 | 26,984,747 | \$ 27 | \$ 258,502 | \$ 291,460 | \$ (8,492 |) | \$ 541,497 | | |
| Common shares issued on exercise of options and other, net of shares withheld for tax obligations | 19,950 | - | (420) | - | - | | (420) | | |
| Stock-based compensation expense | - | - | 3,040 | - | - | | 3,040 | | |
| Repurchases of common stock | (157,716) | - | (1,511) | (15,798) | - | | (17,309) | | |
| Net income | - | - | - | 15,511 | - | | 15,511 | | |
| <i>Other comprehensive income</i> | | | | | | | | | |
| Foreign currency translation adjustment | - | - | - | - | 476 | | 476 | | |
| Comprehensive income | | | | | | | 15,987 | | |
| Balance at March 31, 2019 | 26,846,981 | \$ 27 | \$ 259,611 | \$ 291,173 | \$ (8,016 |) | \$ 542,795 | | |

| | Common Stock | | Additional Paid-In | | Retained Earnings | | Accumulated Other Comprehensive Loss | | Total |
|---|---------------------|---------------|-------------------------------|------------|------------------------------|---|---|--|--------------|
| | Shares | Amount | Capital | | | | | | |
| Balance at January 1, 2018 | 26,828,651 | \$ 27 | \$ 241,725 | \$ 224,697 | \$ (5,234 |) | \$ 461,215 | | |
| Common shares issued on exercise of options and other, net of shares withheld for tax obligations | 102,895 | - | 2,250 | - | - | | 2,250 | | |
| Stock-based compensation expense | - | - | 2,307 | - | - | | 2,307 | | |
| Repurchases of common stock | - | - | - | - | - | | - | | |
| Revenue recognition transition adjustment | - | - | - | 1,460 | - | | 1,460 | | |
| Net income | - | - | - | 18,051 | - | | 18,051 | | |
| <i>Other comprehensive income</i> | | | | | | | | | |
| Foreign currency translation adjustment | - | - | - | - | 2,393 | | 2,393 | | |
| Comprehensive income | | | | | | | 20,444 | | |
| Balance at March 31, 2018 | 26,931,546 | \$ 27 | \$ 246,282 | \$ 244,208 | \$ (2,841 |) | \$ 487,676 | | |

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

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Proto Labs, Inc.
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

| | Three Months Ended March 31, 2019 2018 | |
|---|--|------------------|
| Operating activities | | |
| Net income | \$ 15,511 | \$ 18,051 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 7,439 | 6,259 |
| Stock-based compensation expense | 3,040 | 2,307 |
| Deferred taxes | 379 | 612 |
| Amortization of held-to-maturity securities | 16 | 163 |
| Other | 236 | 106 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (2,386) | (4,013) |
| Inventories | 739 | 807 |
| Prepaid expenses and other | (211) | (1,707) |
| Income taxes | 3,006 | 2,387 |
| Accounts payable | (805) | 2,291 |
| Accrued liabilities and other | (8,962) | (1,118) |
| Net cash provided by operating activities | 18,002 | 26,145 |
| Investing activities | | |
| Purchases of property, equipment and other capital assets | (12,735) | (25,513) |
| Cash used for acquisitions, net of cash acquired | - | (90) |
| Purchases of other assets and investments | (4,000) | - |
| Purchases of marketable securities | - | (3,389) |
| Proceeds from maturities of marketable securities | 17,006 | 13,551 |
| Net cash provided by (used in) investing activities | 271 | (15,441) |
| Financing activities | | |
| Payments on debt | - | (5,000) |
| Proceeds from exercises of stock options | 174 | 2,880 |
| Purchases of shares withheld for tax obligations | (594) | (628) |
| Repurchases of common stock | (17,309) | - |
| Net cash used in financing activities | (17,729) | (2,748) |
| Effect of exchange rate changes on cash and cash equivalents | (240) | 432 |
| Net increase in cash and cash equivalents | 304 | 8,388 |
| Cash and cash equivalents, beginning of period | 85,046 | 36,707 |
| Cash and cash equivalents, end of period | \$ 85,350 | \$ 45,095 |

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

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Note 1 – Basis of Presentation

The unaudited interim Consolidated Financial Statements of Proto Labs, Inc. (Protolabs, the Company, we, us or our) have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, the accompanying financial statements reflect all adjustments necessary for a fair presentation of the Company's statements of financial position, results of operations and cash flows for the periods presented. Except as otherwise disclosed herein, these adjustments consist of normal, recurring items. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole.

The preparation of the financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures at the date of the financial statements and during the reporting period. Actual results could materially differ from these estimates. For further information, refer to the audited Consolidated Financial Statements and Notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2018 as filed with the Securities and Exchange Commission (SEC) on February 22, 2019.

The accompanying Consolidated Balance Sheet as of December 31, 2018 was derived from the audited Consolidated Financial Statements but does not include all disclosures required by U.S. GAAP for a full set of financial statements. This Form 10-Q should be read in conjunction with the Company's Consolidated Financial Statements and Notes included in the Annual Report on Form 10-K filed on February 22, 2019 as referenced above.

Note 2 – Recent Accounting Pronouncements

Recently Adopted Accounting Pronouncements

During the first quarter of 2019, the Company adopted the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2016-02, *Leases* (ASC 842), which introduces the balance sheet recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous guidance. The Company has adopted the new lease standard using the new transition option issued under the amendments in ASU 2018-11, *Leases*, which allowed the Company to continue to apply the legacy guidance in Accounting Standards Codification (ASC) 840, *Leases*, in the comparative periods presented in the year of adoption. The Company elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allowed the Company to carry forward the historical lease classification. The Company made an accounting policy

election to keep leases with an initial term of 12 months or less off of the balance sheet. The Company will recognize those lease payments in the Consolidated Statements of Comprehensive Income on a straight-line basis over the lease term. The impact of the adoption was an increase to the Company's operating lease assets and liabilities on January 1, 2019 of \$13.1 million.

Table of Contents**Recently Issued Accounting Pronouncements**

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other*, which is intended to simplify the subsequent measurement of goodwill. This guidance will be effective for impairment tests in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years with early adoption permitted. The Company does not expect the impact to be material.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses*, which is intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments held by a reporting entity at each reporting date. This guidance will be effective for fiscal years beginning after December 15, 2020 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of future adoption of this guidance on its consolidated financial statements, but does not expect the impact to be material.

Note 3 – Net Income per Common Share

Basic net income per share is computed based on the weighted-average number of common shares outstanding. Diluted net income per share is computed based on the weighted-average number of common shares outstanding, increased by the number of additional shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of shares the Company could have repurchased from the proceeds from issuance of the potentially dilutive shares. Potentially dilutive shares of common stock include stock options, restricted stock units and restricted stock awards granted under stock-based compensation plans and shares committed to be purchased under the employee stock purchase plan. Performance stock units are excluded from the calculation of dilutive potential common shares until the performance conditions have been satisfied.

The table below sets forth the computation of basic and diluted net income per share:

| | Three Months Ended March 31, | |
|--|---|-------------|
| (in thousands, except share and per share amounts) | 2019 | 2018 |
| Net income | \$15,511 | \$18,051 |

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| | | |
|--|------------|------------|
| Basic - weighted-average shares outstanding: | 26,963,366 | 26,879,388 |
| Effect of dilutive securities: | | |
| Employee stock options and other | 213,673 | 317,711 |
| Diluted - weighted-average shares outstanding: | 27,177,039 | 27,197,099 |
| Net income per share: | | |
| Basic | \$0.58 | \$0.67 |
| Diluted | \$0.57 | \$0.66 |

Table of Contents**Note 4 – Goodwill and Other Intangible Assets**

There were no changes in the carrying amount of Goodwill during the three months ended March 31, 2019.

Intangible Assets other than goodwill at March 31, 2019 and December 31, 2018 were as follows:

| (in thousands) | March 31, 2019 | | | December 31, 2018 | | | Useful Life (in years) | Weighted Average Useful Life Remaining (in years) |
|---|----------------|-----------------------------|----------|-------------------|-----------------------------|----------|---------------------------------|---|
| | Gross | Accumulated Amortization | Net | Gross | Accumulated Amortization | Net | | |
| Intangible Assets with finite lives: | | | | | | | | |
| Marketing assets | \$930 | \$ (457) | \$473 | \$930 | \$ (434) | \$496 | 10.0 | 5.1 |
| Non-compete agreement | 270 | (210) | 60 | 270 | (206) | 64 | 2.0 - 5.0 | 3.8 |
| Trade secrets | 250 | (246) | 4 | 250 | (233) | 17 | 5.0 | 0.1 |
| Trade names | 1,080 | (675) | 405 | 1,080 | (540) | 540 | 2.0 | 0.8 |
| Software technology | 12,229 | (1,309) | 10,920 | 12,229 | (997) | 11,232 | 10.0 | 8.8 |
| Customer relationships | 10,070 | (2,953) | 7,117 | 10,070 | (2,569) | 7,501 | 6.0 - 9.0 | 4.6 |
| Total intangible assets | \$24,829 | \$ (5,850) | \$18,979 | \$24,829 | \$ (4,979) | \$19,850 | | |

Amortization expense for intangible assets was \$0.9 million and \$0.8 million for the three months ended March 31, 2019 and 2018, respectively.

Estimated aggregated amortization expense based on the current carrying value of the amortizable intangible assets is as follows:

(in thousands)

| | Estimated Amortization Expense |
|--------------------------------------|---|
| Remaining 2019 | \$ 2,580 |
| 2020 | 2,895 |
| 2021 | 2,895 |
| 2022 | 2,895 |
| 2023 | 2,691 |
| Thereafter | 5,023 |
| Total estimated amortization expense | \$ 18,979 |

Table of Contents**Note 5 – Fair Value Measurements**

ASC 820, *Fair Value Measurement* (ASC 820), defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy that requires classification based on observable and unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1—Quoted prices in active markets for identical assets or liabilities.

Level 2—Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company's cash consists of bank deposits. The Company's cash equivalents measured at fair value consist of money market mutual funds. The Company determines the fair value of these investments using Level 1 inputs.

The following table summarizes financial assets as of March 31, 2019 and December 31, 2018 measured at fair value on a recurring basis:

| (in thousands) | March 31, 2019 | | | December 31, 2018 | | |
|---------------------------|----------------|---------|---------|-------------------|---------|---------|
| | Level 1 | Level 2 | Level 3 | Level 1 | Level 2 | Level 3 |
| Financial Assets: | | | | | | |
| Cash and cash equivalents | | | | | | |
| Money market mutual fund | \$9,155 | \$ - | \$ - | \$8,943 | \$ - | \$ - |
| Total | \$9,155 | \$ - | \$ - | \$8,943 | \$ - | \$ - |

Note 6 – Marketable Securities

The Company invests in short-term and long-term agency, municipal, corporate and other debt securities. The securities are categorized as held-to-maturity and are recorded at amortized cost. Categorization as held-to-maturity is based on the Company's ability and intent to hold these securities to maturity. The following table summarizes information regarding the Company's short-term and long-term marketable securities as of March 31, 2019 and December 31, 2018:

| (in thousands) | March 31, 2019 | | | |
|---------------------------------------|-----------------------|-----------------------------|------------------------------|-----------------------|
| | Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| U.S. municipal securities | \$10,825 | \$ 7 | \$ (6 |) \$10,826 |
| Corporate debt securities | 24,513 | 52 | (27 |) 24,538 |
| U.S. government agency securities | 14,505 | - | (40 |) 14,465 |
| Certificates of deposit/time deposits | 3,464 | 10 | (10 |) 3,464 |
| Total marketable securities | \$53,307 | \$ 69 | \$ (83 |) \$53,293 |

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| (in thousands) | December 31, 2018 | | | |
|---------------------------------------|--------------------------|-------------------|-------------------|-------------------|
| | Cost | Unrealized | Unrealized | Fair Value |
| | | Gains | Losses | |
| U.S. municipal securities | \$17,509 | \$ 1 | \$ (33) |) \$17,477 |
| Corporate debt securities | 31,769 | - | (96) |) 31,673 |
| U.S. government agency securities | 16,843 | - | (88) |) 16,755 |
| Certificates of deposit/time deposits | 4,208 | - | (25) |) 4,183 |
| Total marketable securities | \$70,329 | \$ 1 | \$ (242) |) \$70,088 |

Fair values for the corporate debt securities are primarily determined based on quoted market prices (Level 1). Fair values for the U.S. municipal securities, U.S. government agency securities and certificates of deposit are primarily determined using dealer quotes or quoted market prices for similar securities (Level 2).

The Company tests for other-than-temporary losses on a quarterly basis and has considered the unrealized losses indicated above to be temporary in nature. In reaching this conclusion, the Company considered the credit quality of the issuers of the debt securities as well as the Company's intent to hold the investments to maturity and recover the full principal.

Classification of marketable securities as current or non-current is based upon the security's maturity date as of the date of these financial statements.

The March 31, 2019 balance of held-to-maturity debt securities by contractual maturity is shown in the following table at amortized cost. Actual maturities may differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

| (in thousands) | March 31, 2019 |
|---------------------------------------|-----------------------|
| Due in one year or less | \$35,045 |
| Due after one year through five years | 18,262 |
| Total marketable securities | \$53,307 |

Note 7 – Inventory

Inventory consists primarily of raw materials, which are recorded at the lower of cost or market using the average-cost method, which approximates first-in, first-out (FIFO) cost. The Company periodically reviews its inventory for slow-moving, damaged and discontinued items and provides allowances to reduce such items identified to their recoverable amounts.

The Company's inventory consisted of the following as of the dates indicated:

| | March 31, 2019 | December 31, 2018 |
|-----------------------------|-------------------------------|----------------------------------|
| (in thousands) | | |
| Raw materials | \$9,132 | \$ 9,560 |
| Work in process | 412 | 792 |
| Total inventory | 9,544 | 10,352 |
| Allowance for obsolescence | (188) | (265) |
| Inventory, net of allowance | \$9,356 | \$ 10,087 |

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Note 8 – Leases

The Company's significant accounting policies are disclosed in Note 2 to the Consolidated Financial Statements included in its Annual Report on Form 10-K for the year ended December 31, 2018. Significant changes to the Company's accounting policies as a result of adopting ASC 842 are discussed below.

The Company accounts for leases in accordance with ASC 842. The Company adopted the standard as of January 1, 2019, using the alternative transition method provided under ASC 842, which allowed the Company to initially apply the new lease standard at the adoption date (the "effective date method"). Under the effective date method, comparative periods are presented in accordance with ASC 840 and do not include any retrospective adjustments to reflect the adoption of ASC 842. The Company elected the package of practical expedients permitted under the transition guidance within the new standard. The Company did not elect the hindsight practical expedient. The Company recorded a net increase of \$13.1 million to its operating lease assets and liabilities on January 1, 2019. The adoption did not result in a cumulative-effect adjustment to the opening balance of retained earnings. The adoption of ASC 842 did not have a material impact on the Company's consolidated statements of comprehensive income, shareholders' equity or cash flows as of the adoption date.

The Company has operating leases for office space, manufacturing facilities and certain company vehicles and equipment. The leases have remaining lease terms of one year to 10 years. Leases with an initial term of 12 months or less are not recorded on the balance sheet; we recognize lease expense for these leases on a straight-line basis over the lease term. For purposes of calculating operating lease liabilities, lease terms may be deemed to include options to extend or terminate the lease when it is reasonably certain that the Company will exercise that option. As of March 31, 2019, the operating lease liability does not include any options to extend or terminate leases. The Company currently has no finance leases.

The Company determines if an arrangement is a lease at inception. Operating leases are included in operating lease assets, current operating lease liabilities and long-term operating lease liabilities in the Consolidated Balance Sheets and are recognized based on the present value of lease payments over the lease term at commencement date. The majority of the Company's leases do not provide an implicit rate of return, therefore, the Company uses its incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. Lease agreements that contain non-lease components, with the exception of certain real estate leases, are accounted for as a single lease component.

Supplemental balance sheet information related to leases was as follows:

| (in thousands) | March 31, 2019 |
|---------------------------------------|-------------------------------|
| Operating lease assets | \$11,965 |
| Current operating lease liabilities | \$3,021 |
| Long-term operating lease liabilities | 9,107 |
| Total operating lease liabilities | \$12,128 |

Lease expense is recognized on a straight line basis over the lease term, with variable payments recognized in the period those payments are incurred. The components of lease expense for the periods reported were as follows:

| (in thousands) | Three Months Ended March 31, 2019 |
|----------------------|--|
| Operating lease cost | \$ 1,070 |
| Variable lease cost | 239 |
| Total lease cost | \$ 1,309 |

Maturities of operating lease liabilities as of March 31, 2019 (in accordance with ASC 842) were as follows:

| (in thousands) | Operating Leases |
|--|-----------------------------|
| <u>Year Ending December 31,</u> | |
| 2019 (excluding three months ended March 31, 2019) | \$ 2,706 |
| 2020 | 2,627 |
| 2021 | 2,307 |
| 2022 | 2,256 |
| 2023 | 1,028 |
| After 2023 | 2,098 |
| Total future minimum lease payments | 13,022 |
| Less interest | (894) |
| Present value of lease liabilities | \$ 12,128 |

As of March 31, 2019, we have no operating leases that have not yet commenced.

Weighted average remaining lease term and discount rate was as follows:

| | March 31, 2019 |
|---|-------------------------------|
| Weighted Average Remaining Lease Term (Years) | 5.38 |
| Weighted Average Discount Rate | 2.6 % |

Supplemental cash flow information related to leases was as follows:

(in thousands)

**Three
Months
Ended
March
31, 2019**

Cash paid for amounts included in the measurement of operating lease liabilities:

| | |
|---|----------|
| Operating cash flows for operating leases | \$ 1,197 |
| Lease assets obtained in exchange for new operating lease liabilities | 13,049 |

Note 9 – Stock-Based Compensation

Under the Company's 2012 Long-Term Incentive Plan, as amended (the 2012 Plan), the Company has the ability to grant stock options, stock appreciation rights (SARs), restricted stock, restricted stock units, other stock-based awards and cash incentive awards. Awards under the 2012 Plan have a maximum term of ten years from the date of grant. The compensation committee may provide that the vesting or payment of any award will be subject to the attainment of specified performance measures in addition to the satisfaction of any continued service requirements and the compensation committee will determine whether such measures have been achieved. The per-share exercise price of stock options and SARs granted under the 2012 Plan generally may not be less than the fair market value of a share of our common stock on the date of the grant.

Employee Stock Purchase Plan

The Company's 2012 Employee Stock Purchase Plan (ESPP) allows eligible employees to purchase a variable number of shares of the Company's common stock each offering period at a discount through payroll deductions of up to 15 percent of their eligible compensation, subject to plan limitations. The ESPP provides for six-month offering periods with a single purchase period ending May 15 and November 15, respectively. At the end of each offering period, employees are able to purchase shares at 85 percent of the lower of the fair market value of the Company's common stock on the first trading day of the offering period or on the last trading day of the offering period.

Stock-Based Compensation Expense

Stock-based compensation expense was \$3.0 million and \$2.3 million for the three months ended March 31, 2019 and 2018, respectively.

Stock Options

The following table summarizes stock option activity during the three months ended March 31, 2019:

| | Stock Options | Weighted- Average Exercise Price |
|--|--------------------------|---|
| Options outstanding at December 31, 2018 | 252,616 | \$ 64.71 |
| Granted | 30,046 | 104.99 |
| Exercised | (3,010) | 57.85 |
| Forfeited | (680) | 96.20 |
| Options outstanding at March 31, 2019 | 278,972 | \$ 69.04 |
| Exercisable at March 31, 2019 | 157,602 | \$ 56.70 |

The outstanding options generally have a term of ten years. For employees, options granted become exercisable ratably over the vesting period, which is generally a period from four to five years, beginning on the first anniversary of the grant date, subject to the employee's continuing service to the Company. For directors, options generally

become exercisable in full on the first anniversary of the grant date.

The weighted-average grant date fair value of options that were granted during the three months ended March 31, 2019 was \$47.76.

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The following table provides the assumptions used in the Black-Scholes pricing model valuation of options during the three months ended March 31, 2019 and 2018:

| | Three Months Ended March 31, | |
|-------------------------|---|-------------|
| | 2019 | 2018 |
| Risk-free interest rate | 2.58 % | 2.52 % |
| Expected life (years) | 6.25 | 6.25 |
| Expected volatility | 42.74% | 42.22% |
| Expected dividend yield | 0 % | 0 % |

As of March 31, 2019, there was \$4.3 million of unrecognized compensation expense related to unvested stock options, which is expected to be recognized over a weighted-average period of 3.0 years.

Restricted Stock

Restricted stock awards are share-settled awards and restrictions lapse ratably over the vesting period, which is generally a period from four to five years, beginning on the first anniversary of the grant date, subject to the employee's continuing service to the Company. For directors, restrictions generally lapse in full on the first anniversary of the grant date.

The following table summarizes restricted stock activity during the three months ended March 31, 2019:

| | Restricted Stock | Weighted- Average Grant Date Fair Value Per Share |
|---------------------------------------|-----------------------------|--|
| Restricted stock at December 31, 2018 | 323,921 | \$ 79.85 |
| Granted | 27,476 | 105.03 |
| Restrictions lapsed | (22,420) | 71.40 |

| | | | |
|------------------------------------|---------|---|----------|
| Forfeited | (3,692 |) | 108.51 |
| Restricted stock at March 31, 2019 | 325,285 | | \$ 82.35 |

As of March 31, 2019, there was \$21.3 million of unrecognized compensation expense related to non-vested restricted stock, which is expected to be recognized over a weighted-average period of 3.0 years.

Performance Stock

Performance stock units (PSUs) are expressed in terms of a target number of PSUs, with anywhere between 0 percent and 150 percent of that target number capable of being earned and vesting at the end of a three-year performance period depending on the Company's performance in the final year of the performance period and the award recipient's continued employment.

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The following table summarizes performance stock activity during the three months ended March 31, 2019:

| | Performance Stock | Weighted- Average Grant Date Fair Value Per Share |
|--|------------------------------|--|
| Performance stock at December 31, 2018 | 52,140 | \$ 76.54 |
| Granted | 21,434 | 104.99 |
| Restrictions lapsed | - | - |
| Performance change | - | - |
| Forfeited | - | - |
| Performance stock at March 31, 2019 | 73,574 | \$ 84.83 |

As of March 31, 2019, there was \$4.0 million of unrecognized compensation expense related to non-vested performance stock, which is expected to be recognized over a weighted-average period of 2.3 years.

Employee Stock Purchase Plan

The following table presents the assumptions used to estimate the fair value of the ESPP during the three months ended March 31, 2019 and 2018:

| | Three Months Ended March 31, | |
|-------------------------|---|-------------|
| | 2019 | 2018 |
| Risk-free interest rate | 2.33 % | 1.48 % |
| Expected life (months) | 6.00 | 6.00 |
| Expected volatility | 37.36 % | 24.49 % |
| Expected dividend yield | 0 % | 0 % |

Note 10 – Accumulated Other Comprehensive Loss

Other comprehensive income (loss) is comprised entirely of foreign currency translation adjustments. The following table presents the changes in accumulated other comprehensive income (loss) balances during the three months ended March 31, 2019 and 2018:

| (in thousands) | Three Months Ended March 31, | |
|--|---|-------------|
| | 2019 | 2018 |
| Foreign currency translation adjustments | | |
| Balance at beginning of period | \$(8,492) | \$(5,234) |
| Other comprehensive income before reclassifications | 476 | 2,393 |
| Amounts reclassified from accumulated other comprehensive income | - | - |
| Net current-period other comprehensive income | 476 | 2,393 |
| Balance at end of period | \$(8,016) | \$(2,841) |

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Note 11 – Income Taxes

The Company is subject to income tax in multiple jurisdictions and the use of estimates is required to determine the provision for income taxes. For the three months ended March 31, 2019 and 2018, the Company recorded an income tax provision of \$4.2 million and \$3.9 million, respectively. The income tax provision is based on the estimated annual effective tax rate for the year applied to pre-tax income. The effective income tax rate for the three months ended March 31, 2019 was 21.1 percent compared to 17.6 percent in the same period of the prior year. The effective tax rate increased by 3.5 percent for the three months ended March 31, 2019 when compared to the same period in 2018 primarily due to a decrease for tax benefits from the vesting of restricted stock and exercise of stock options.

The effective income tax rate for the three months ended March 31, 2019 differs from the U.S. federal statutory rate of 21.0 percent due primarily to the mix of income earned in domestic and foreign tax jurisdictions and deductions for which the Company qualifies.

The Company had reserves against unrecognized tax benefits totaling \$4.3 million and \$4.1 million as of March 31, 2019 and December 31, 2018, respectively, all of which, if recognized, would affect the Company's effective tax rate. The Company recognizes interest and penalties related to income tax matters in income tax expense, and reports the liability in current or long-term income taxes payable as appropriate.

Note 12 – Segment Reporting

The Company's reportable segments are based on the internal reporting used by the Company's Chief Executive Officer, who is the chief operating decision maker (CODM), to assess operating performance and make decisions about the allocation of resources. The Corporate Unallocated and Japan category includes non-reportable segments, as well as research and development and general and administrative costs that the Company does not allocate directly to its operating segments.

Intercompany transactions primarily relate to intercontinental activity and have been eliminated and are excluded from the reported amounts. The difference between income from operations and pre-tax income relates to foreign currency-related gains and losses and interest income on cash balances and investments, which are not allocated to business segments.

Beginning in 2019, the Company's CODM made a decision to view certain research and development costs by geographic region. As a result, costs previously included in the Corporate Unallocated and Japan category have been included in the respective geographic regions. All periods presented have been restated to reflect this change.

Revenue and income from operations by reportable segment for the three months ended March 31, 2019 and 2018 were as follows:

| | Three Months Ended March 31, | |
|-----------------|---|-------------|
| (in thousands) | 2019 | 2018 |
| Revenue: | | |
| United States | \$87,811 | \$84,167 |
| Europe | 21,254 | 19,945 |
| Japan | 4,387 | 3,633 |
| Total revenue | \$113,452 | \$107,745 |

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| (in thousands) | Three Months Ended March 31, | |
|---------------------------------|---|-------------|
| | 2019 | 2018 |
| Income from Operations: | | |
| United States | \$26,310 | \$28,843 |
| Europe | 4,221 | 3,361 |
| Corporate Unallocated and Japan | (11,083) | (10,476) |
| Total Income from Operations | \$19,448 | \$21,728 |

Total long-lived assets at March 31, 2019 and December 31, 2018 were as follows:

| (in thousands) | March | December |
|---------------------------------|---------------------|---------------------|
| | 31, 2019 | 31, 2018 |
| Total long-lived assets: | | |
| United States | \$191,296 | \$185,979 |
| Europe | 35,465 | 34,577 |
| Japan | 7,450 | 7,445 |
| Total Assets | \$234,211 | \$228,001 |

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2018.

Forward-Looking Statements

Statements contained in this report regarding matters that are not historical or current facts are “forward-looking statements” within the meaning of The Private Securities Litigation Reform Act of 1995. In some cases, you can identify forward-looking statements by the following words: “may,” “will,” “could,” “would,” “should,” “expect,” “intend,” “p,” “anticipate,” “believe,” “estimate,” “predict,” “project,” “potential,” “continue,” “ongoing” or the negative of these terms or other comparable terminology, although not all forward-looking statements contain these words. These statements involve known and unknown risks, uncertainties and other factors that may cause our results to be materially different than those expressed or implied in such statements. Certain of these risk factors and others are described in Item 1A. “Risk Factors” of our most recent Annual Report on Form 10-K as filed with the SEC. Other unknown or unpredictable factors also could have material adverse effects on our future results. We cannot guarantee future results, levels of activity, performance or achievements. Accordingly, you should not place undue reliance on these forward-looking statements. Finally, we expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

Overview

We are the world’s largest and fastest digital manufacturer of custom prototypes and on-demand production parts. We manufacture prototypes and low-volume production parts for companies worldwide, who are under increasing pressure to bring their finished products to market faster than their competition. We utilize injection molding, computer numerical control (CNC) machining, 3D printing and sheet metal fabrication to manufacture custom parts for our customers. Our proprietary technology eliminates most of the time-consuming and expensive skilled labor conventionally required to quote and manufacture parts. Our customers conduct nearly all of their business with us over the Internet. We target our products to the millions of product developers and engineers who use three-dimensional computer-aided design (3D CAD) software to design products across a diverse range of end-markets.

Our primary manufacturing product lines currently include Injection Molding, CNC Machining, 3D Printing and Sheet Metal. We continually seek to expand the range of sizes and geometric complexity of the parts we can make

with these processes, to extend the variety of materials we are able to support and to identify additional manufacturing processes to which we can apply our technology in order to better serve the evolving preferences and needs of product developers and engineers.

Injection Molding

Our Injection Molding product line uses our 3D CAD-to-CNC machining technology for the automated design and manufacture of molds, which are then used to produce custom plastic and liquid silicone rubber injection-molded parts and over-molded and insert-molded injection-molded parts on commercially available equipment. Our Injection Molding product line works best for on-demand production, bridge tooling, pilot runs and functional prototyping. Our affordable aluminum molds and quick turnaround times help reduce design risk and limit overall production costs for product developers and engineers. Prototype quantities typically range from 25 to 100 parts. Because we retain possession of the molds, customers who need short-run production often come back to Protolabs' Injection Molding product line for additional quantities. They do so to support pilot production for product testing, while their tooling for high-volume production is being prepared, because they need on-demand manufacturing due to disruptions in their manufacturing process, because their product requires limited annual quantity or because they need end-of-life production support. In 2017, we launched an on-demand manufacturing injection molding product offering. This product offering utilizes our existing processes, but is designed to fulfill the needs of customers with on-going production needs, typically in annual volumes of less than 10,000 parts.

CNC Machining

Our CNC Machining product line uses commercially available CNC machines to offer milling and turning. CNC milling is a manufacturing process that cuts plastic and metal blocks into one or more custom parts based on the 3D CAD model uploaded by the product developer or engineer. CNC turning with live tooling combines both lathe and mill capabilities to machine parts with cylindrical features from metal rod stock. Our efficiencies derive from the automation of the programming of these machines and a proprietary fixturing process.

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Quick-turn CNC machining works best for prototyping, form and fit testing, jigs and fixtures and functional components for end-use applications. The CNC Machining product line is well suited to produce small quantities, typically in the range of one to 1,000 parts.

3D Printing

Our 3D Printing product line includes stereolithography, selective laser sintering, direct metal laser sintering, Multi Jet Fusion and PolyJet processes, which offer customers a wide-variety of high-quality, precision rapid prototyping and low-volume production. These processes create parts with a high level of accuracy, detail, strength and durability. Industrial 3D Printing is best suited for functional prototypes, complex designs and end-use applications produced in small quantities, typically in the range of one to 50 parts.

Sheet Metal

Our Sheet Metal product line includes quick-turn and e-commerce-enabled custom sheet metal parts, which provides customers with prototype and low-volume production parts. The rapid prototype sheet metal process is most often used when form, fit and function are all a priority. Our manufacturing process uses customer 3D CAD models uploaded by the product developer or engineer to fabricate quick-turn prototype sheet metal or short-run production parts. The Sheet Metal product line is well suited to produce quantities in the range of one to 500 parts.

Key Financial Measures and Trends

Revenue

Our operations are comprised of three geographic operating segments in the United States, Europe and Japan. Revenue is derived from our Injection Molding, CNC Machining, 3D Printing and Sheet Metal product lines. Injection Molding revenue consists of sales of custom injection molds and injection-molded parts. CNC Machining revenue consists of sales of CNC-machined custom parts. 3D Printing revenue consists of sales of 3D-printed parts. Sheet Metal revenue consists of sales of fabricated sheet metal custom parts. Our historical and current efforts to increase revenue have been directed at expanding the breadth of our product offerings, gaining new customers and selling to our existing customer base by increasing marketing and selling activities, including:

expanding the breadth and scope of each of our product lines by adding more sizes and materials to our offerings;
the introduction of our 3D Printing product line through our acquisition of FineLine in 2014
expanding 3D Printing to Europe through our acquisition of Alphaform in October 2015
the introduction of our Sheet Metal product line through our acquisition of RAPID in 2017 and
continuously improving the usability of our product lines such as our web-centric applications.

During the three months ended March 31, 2019, we served 20,573 unique product developers and engineers who purchased our products through our web-based customer interface, an increase of 9.3% over the same period in 2018.

Cost of Revenue, Gross Profit and Gross Margin

Cost of revenue consists primarily of raw materials, equipment depreciation, employee compensation, benefits, stock-based compensation, facilities costs and overhead allocations associated with the manufacturing process for molds and custom parts. We expect cost of revenue to increase in absolute dollars, but remain relatively constant as a percentage of total revenue.

We define gross profit as our revenue less our cost of revenue, and we define gross margin as gross profit expressed as a percentage of revenue. Our gross profit and gross margin are affected by many factors, including our mix of revenue by product line and geography, pricing, sales volume and manufacturing costs, the costs associated with increasing production capacity, and foreign exchange rates.

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Operating Expenses

Operating expenses consist of marketing and sales, research and development and general and administrative expenses. Personnel-related costs are the most significant component in each of these categories.

Our recent growth in operating expenses is mainly due to higher headcounts to support our growth and expansion, and we expect that trend to continue. Our business strategy is to continue to be a leading online and technology-enabled manufacturer of quick-turn, on-demand injection-molded, CNC-machined, CNC-turned, 3D-printed and sheet metal custom parts for prototyping and low-volume production. In order to achieve our goals, we anticipate continued substantial investments in technology and personnel, resulting in increased operating expenses.

Marketing and sales. Marketing and sales expense consists primarily of employee compensation, benefits, commissions, stock-based compensation, marketing programs such as electronic, print and pay-per-click advertising, trade shows and other related overhead. We expect sales and marketing expense to increase in the future as we increase the number of marketing and sales professionals and marketing programs targeted to increase our customer base and grow revenue.

Research and development. Research and development expense consists primarily of personnel and outside service costs related to the development of new processes and product lines, enhancement of existing product lines, development of software for internal use, maintenance of internally developed software, quality assurance and testing. Costs for internal use software are evaluated by project and capitalized where appropriate under ASC 350-40, *Intangibles — Goodwill and Other, Internal-Use Software*. We expect research and development expense to increase in the future as we seek to enhance and expand our product line offerings and supporting business systems.

General and administrative. General and administrative expense consists primarily of employee compensation, benefits, stock-based compensation, professional service fees related to accounting, tax and legal and other related overhead. We expect general and administrative expense to increase in the future as we continue to grow and expand as a global organization.

Other Income, net

Other income, net primarily consists of foreign currency-related gains and losses and interest income on cash balances and investments. Our foreign currency-related gains and losses will vary depending upon movements in underlying exchange rates. Our interest income will vary each reporting period depending on our average cash balances during

the period, composition of our marketable security portfolio and the current level of interest rates.

Provision for Income Taxes

Provision for income taxes is comprised of federal, state, local and foreign taxes based on pre-tax income. We expect income taxes to increase as our taxable income increases.

Table of Contents**Results of Operations**

The following table summarizes our results of operations and the related changes for the periods indicated. The results below are not necessarily indicative of the results for future periods.

| (dollars in thousands) | Three Months Ended March 31, | | | | Change | |
|----------------------------|-------------------------------------|--------|-------------|--------|---------------|----------|
| | 2019 | | 2018 | | \$ | % |
| Revenue | \$113,452 | 100.0 | \$107,745 | 100.0% | \$5,707 | 5.3 |
| Cost of revenue | 54,592 | 48.1 | 49,837 | 46.3 | 4,755 | 9.5 |
| Gross profit | 58,860 | 51.9 | 57,908 | 53.7 | 952 | 1.6 |
| Operating expenses: | | | | | | |
| Marketing and sales | 18,577 | 16.4 | 16,572 | 15.4 | 2,005 | 12.1 |
| Research and development | 8,013 | 7.1 | 6,665 | 6.2 | 1,348 | 20.2 |
| General and administrative | 12,822 | 11.3 | 12,943 | 12.0 | (121) | (0.9) |
| Total operating expenses | 39,412 | 34.8 | 36,180 | 33.6 | 3,232 | 8.9 |
| Income from operations | 19,448 | 17.1 | 21,728 | 20.2 | (2,280) | (10.5) |
| Other income, net | 213 | 0.2 | 178 | 0.2 | 35 | 19.7 |
| Income before income taxes | 19,661 | 17.3 | 21,906 | 20.4 | (2,245) | (10.2) |
| Provision for income taxes | 4,150 | 3.6 | 3,855 | 3.6 | 295 | 7.7 |
| Net income | \$15,511 | 13.7 % | \$18,051 | 16.8 % | \$(2,540) | (14.1)% |

Stock-based compensation expense included in the statements of operations data above for the three months ended March 31, 2019 and 2018 was as follows:

| (dollars in thousands) | Three Months Ended March 31, | |
|--|-------------------------------------|-------------|
| | 2019 | 2018 |
| Stock options and restricted stock | \$2,779 | \$2,153 |
| Employee stock purchase plan | 261 | 154 |
| Total stock-based compensation expense | \$3,040 | \$2,307 |
| Cost of revenue | \$421 | \$287 |
| Operating expenses: | | |
| Marketing and sales | 549 | 377 |
| Research and development | 423 | 314 |

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| | | |
|--|---------|---------|
| General and administrative | 1,647 | 1,329 |
| Total stock-based compensation expense | \$3,040 | \$2,307 |

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Table of Contents*Comparison of Three Months Ended March 31, 2019 and 2018**Revenue*

Revenue by reportable segment and the related changes for the three months ended March 31, 2019 and 2018 were as follows:

| | Three Months Ended March 31, | | 2018 | | Change | |
|------------------------|-------------------------------------|----------------|-------------|----------------|---------------|----------|
| | 2019 | % of | \$ | % of | \$ | % |
| (dollars in thousands) | \$ | Total | \$ | Total | \$ | % |
| | | Revenue | | Revenue | | |
| Revenue | | | | | | |
| United States | \$87,811 | 77.4 | % \$84,167 | 78.1 | % \$3,644 | 4.3 % |
| Europe | 21,254 | 18.7 | 19,945 | 18.5 | 1,309 | 6.6 |
| Japan | 4,387 | 3.9 | 3,633 | 3.4 | 754 | 20.8 |
| Total revenue | \$113,452 | 100.0 | % \$107,745 | 100.0 | % \$5,707 | 5.3 % |

Our revenue increased \$5.7 million, or 5.3%, for the three months ended March 31, 2019 compared to the same period in 2018. By reportable segment, revenue in the United States increased \$3.6 million, or 4.3%, for the three months ended March 31, 2019 compared to the same period in 2018. Revenue in Europe increased \$1.3 million, or 6.6%, and revenue in Japan increased \$0.8 million, or 20.8%, in each case for the three months ended March 31, 2019 compared to the same period in 2018.

Our revenue growth during the three months ended March 31, 2019 was the result of an increase in the volume of the product developers and engineers we served. During the three months ended March 31, 2019, we served 20,573 unique product developers and engineers, an increase of 9.3% over the same period in 2018.

Our revenue increases were primarily driven by increases in sales personnel and marketing activities. Our sales personnel focus on gaining new customer accounts and expanding the depth and breadth of existing customer accounts. Our marketing personnel focus on marketing activities that result in the greatest number of customer leads to support sales activity. International revenue was negatively impacted by \$1.7 million during the three months ended March 31, 2019 compared to the same period in 2018 as a result of foreign currency movements, primarily the weakening of the British Pound and Euro relative to the United States Dollar.

Revenue by product line and the related changes for the three months ended March 31, 2019 and 2018 were as follows:

| | Three Months Ended March 31, | | 2018 | | Change | |
|---------------------------|-------------------------------------|----------------|-------------|----------------|---------------|----------|
| | 2019 | % of | \$ | % of | \$ | % |
| (dollars in thousands) \$ | | Total | | Total | | |
| | | Revenue | | Revenue | | |
| Revenue | | | | | | |
| Injection Molding | \$55,311 | 48.8 | % \$51,343 | 47.7 | % \$3,968 | 7.7 % |
| CNC Machining | 37,872 | 33.4 | 36,731 | 34.1 | 1,141 | 3.1 |
| 3D Printing | 14,480 | 12.8 | 12,325 | 11.4 | 2,155 | 17.5 |
| Sheet Metal | 5,025 | 4.4 | 6,241 | 5.8 | (1,216) | (19.5) |
| Other Revenue | 764 | 0.6 | 1,105 | 1.0 | (341) | (30.9) |
| Total revenue | \$113,452 | 100.0 | % \$107,745 | 100.0 | % \$5,707 | 5.3 % |

By product line, our revenue growth was driven by a 7.7% increase in Injection Molding revenue, a 3.1% increase in CNC Machining revenue, a 17.5% increase in 3D Printing revenue, which was partially offset by a 19.5% decrease in Sheet Metal and a 30.9% decrease in Other Revenue, in each case for the three months ended March 31, 2019 compared to the same period in 2018.

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Cost of Revenue, Gross Profit and Gross Margin

Cost of Revenue. Cost of revenue increased \$4.8 million, or 9.5%, for the three months ended March 31, 2019 compared to the same period in 2018, which was faster than the rate of revenue increase of 5.3% for the three months ended March 31, 2019 compared to the same period in 2018. The increase in cost of revenue resulted from the growth of the business, and was due to raw material and production cost increases of \$0.3 million, an increase in direct labor headcount resulting in personnel and related cost increases of \$3.1 million and equipment and facility-related cost increases of \$1.4 million to support increased sales volumes.

Gross Profit and Gross Margin. Gross profit increased from \$57.9 million in the three months ended March 31, 2018 to \$58.9 million in the three months ended March 31, 2019 primarily due to an increase in revenue. Gross margin decreased from 53.7% in the three months ended March 31, 2018 to 51.9% in the three months ended March 31, 2019 due to the timing and mix of revenue, with the RAPID acquisition and CNC facility relocation in the United States being the primary drivers of the reduction in gross margin.

Operating Expenses, Other Income, net and Provision for Income Taxes

Marketing and Sales. Marketing and sales expenses increased \$2.0 million, or 12.1%, during the three months ended March 31, 2019 compared to the same period in 2018 due primarily to an increase in headcount resulting in personnel and related cost increases of \$1.5 million as well as marketing program cost increases of \$0.5 million.

Research and Development. Our research and development expenses increased \$1.3 million, or 20.2%, during the three months ended March 31, 2019 compared to the same period in 2018 due to an increase in headcount resulting in personnel and related cost increases of \$1.2 million, as well as an increase in operating costs of \$0.2 million, which were partially offset by a decrease in professional services costs of \$0.1 million.

General and Administrative. Our general and administrative expenses decreased \$0.1 million, or 0.9%, during the three months ended March 31, 2019 compared to the same period in 2018 due to personnel and related cost decreases of \$0.4 million, decreases in professional services costs of \$0.3 million and a decrease in amortization cost of \$0.2 million, which were partially offset by stock based compensation cost increases of \$0.3 million and administrative cost increases of \$0.5 million.

Other Income, net. We recognized other income, net of \$0.2 million for the three months ended March 31, 2019, which was consistent with other income, net of \$0.2 million for the three months ended March 31, 2018. Other

income, net for the three months ended March 31, 2019 primarily consisted of \$0.6 million in interest income on investments, which was partially offset by a \$0.4 million loss on foreign currency. Other income, net for the three months ended March 31, 2018 primarily consisted of \$0.3 million in interest income on investments, which was partially offset by a \$0.1 million loss on foreign currency.

Provision for Income Taxes. Our effective tax rate of 21.1% for the three months ended March 31, 2019 increased 3.5% compared to 17.6% for the same period in 2018. The increase in the effective tax rate is primarily due to a decrease for tax benefits from the vesting of restricted stock and exercise of stock options. Our income tax provision increased by \$0.3 million to \$4.2 million for the three months ended March 31, 2019 compared to our income tax provision of \$3.9 million for the three months ended March 31, 2018.

Table of Contents*Liquidity and Capital Resources**Cash Flows*

The following table summarizes our cash flows during the three months ended March 31, 2019 and 2018:

| (dollars in thousands) | Three Months Ended March 31, | |
|---|---|-------------|
| | 2019 | 2018 |
| Net cash provided by operating activities | \$18,002 | \$26,145 |
| Net cash provided by (used in) investing activities | 271 | (15,441) |
| Net cash used in financing activities | (17,729) | (2,748) |
| Effect of exchange rates on cash and cash equivalents | (240) | 432 |
| Net increase in cash and cash equivalents | \$304 | \$8,388 |

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Sources of Liquidity

Historically, we have primarily financed our operations and capital expenditures through cash flow from operations. We had cash and cash equivalents of \$85.4 million as of March 31, 2019, an increase of \$0.3 million from December 31, 2018. The increase in our cash was primarily due to cash generated through operations and proceeds from maturities of marketable securities, which were partially offset by investing activity and repurchases of common stock.

Cash Flows from Operating Activities

Cash flows from operating activities were \$18.0 million during the three months ended March 31, 2019 and primarily consisted of net income of \$15.5 million, adjusted for certain non-cash items, including depreciation and amortization of \$7.4 million, stock-based compensation expense of \$3.0 million and deferred taxes of \$0.4 million, which were partially offset by changes in operating assets and liabilities and other items totaling \$8.3 million. Cash flows from operating activities decreased \$8.1 million during the three months ended March 31, 2019 compared to the same period in 2018, primarily due to decreases in net income of \$2.5 million and changes in operating assets and liabilities of \$7.3 million driven by timing of cash receipts and payments, including annual incentive payments, a decrease in deferred taxes of \$0.2 million and a decrease in amortization of held-to-maturity securities of \$0.1 million, which were partially offset by increases in depreciation and amortization of \$1.2 million driven by an increase in capital investments, an increase in stock-based compensation expense of \$0.7 million, and an increase in other adjustments of \$0.1 million primarily due to changes in foreign currency.

Cash flows from operating activities were \$26.1 million during the three months ended March 31, 2018 and primarily consisted of net income of \$18.1 million, adjusted for certain non-cash items, including depreciation and amortization of \$6.3 million, stock-based compensation expense of \$2.3 million, deferred taxes of \$0.6 million and amortization of held-to-maturity securities of \$0.2 million.

Cash Flows from Investing Activities

Cash provided by investing activities was \$0.3 million during the three months ended March 31, 2019, consisting of \$17.0 million in proceeds from maturities of marketable securities, which were partially offset by \$12.7 million for the purchases of property, equipment and other capital assets and \$4.0 million for purchases of other assets and investments.

Cash used in investing activities was \$15.4 million during the three months ended March 31, 2018, consisting of \$25.5 million for the purchases of property, equipment and other capital assets and \$3.4 million for the purchases of marketable securities, and \$0.1 million in cash used for acquisitions, which were partially offset by \$13.6 million in proceeds from maturities of marketable securities.

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Cash Flows from Financing Activities

Cash used in financing activities was \$17.7 million during the three months ended March 31, 2019, consisting of \$17.3 million in repurchases of common stock and \$0.6 million in purchases of shares withheld for tax obligations, which were partially offset by \$0.2 million in proceeds from the exercise of stock options.

Cash used in financing activities was \$2.7 million during the three months ended March 31, 2018, consisting of \$5.0 million in payments on debt and \$0.6 million in purchases of shares withheld for tax obligations, which was partially offset by \$2.9 million in proceeds from the exercise of stock options.

Off-Balance Sheet Arrangements

Since our inception, we have not engaged in any off-balance sheet arrangements, including the use of structured finance, special purpose entities or variable interest entities.

Critical Accounting Policies and Use of Estimates

We have adopted various accounting policies to prepare the Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). Our significant accounting policies are disclosed in Note 2 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2018. See Note 8 to the Consolidated Financial Statements appearing in Part I, Item 1 in this Quarterly Report on Form 10-Q for significant changes to the Company's accounting policies as a result of adopting ASC 842.

Recent Accounting Pronouncements

For information on recent accounting pronouncements, see Note 2 to the Consolidated Financial Statements appearing in Part I, Item 1 in this Quarterly Report on Form 10-Q.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

Foreign Currency Risk

As a result of our foreign operations, we have revenue, expenses, assets and liabilities that are denominated in foreign currencies. We generate revenue and incur production costs and operating expenses in British Pounds, Euros and Japanese Yen.

Our operating results and cash flows are adversely impacted when the United States Dollar appreciates relative to foreign currencies. Additionally, our operating results and cash flows are adversely impacted when the British Pound appreciates relative to the Euro. As we expand internationally, our results of operations and cash flows will become increasingly subject to changes in foreign currency exchange rates.

We have not used forward contracts or currency borrowings to hedge our exposure to foreign currency risk. Foreign currency risk can be assessed by estimating the change in results of operations or financial position resulting from a hypothetical 10% adverse change in foreign exchange rates. We believe such a change would generally not have a material impact on our financial position, but could have a material impact on our results of operations. We recognized foreign currency losses of \$0.4 million and \$0.1 million during the three months ended March 31, 2019 and 2018, respectively.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (Exchange Act)) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this quarterly report, our disclosure controls and procedures are effective and provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported accurately and within the time frames specified in the SEC's rules and forms and accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are subject to various legal proceedings and claims that arise in the ordinary course of our business activities. Although the results of litigation and claims cannot be predicted with certainty, as of the date of these financial statements, we do not believe we are party to any litigation the outcome of which, if determined adversely to us, would individually or in the aggregate be reasonably expected to have a material adverse effect on our business.

Item 1A. Risk Factors

Part I, Item 1A. “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2018 includes a discussion of our risk factors. The information presented below updates, and should be read in conjunction with, the risk factors and information disclosed in our Form 10-K. Except as presented below, there have been no material changes from the risk factors described in our Form 10-K.

Political and economic uncertainty arising from the outcome of the United Kingdom’s referendum on its membership in the European Union could adversely affect our business and results of operations.

On June 23, 2016, the United Kingdom (UK) held a referendum in which voters approved a withdrawal from the European Union (EU), commonly referred to as “Brexit.” The timing of the UK’s exit from the EU remains uncertain; the EU has extended the deadline for the UK to exit the EU until October 31, 2019. The terms of the withdrawal are subject to ongoing negotiation that has created significant uncertainty about the future relationship between the UK and the EU. It is possible that the level of economic activity in this region will be adversely impacted and that there will be increased regulatory and legal complexities, including those relating to tax, trade, security and employees. In addition, Brexit could lead to economic uncertainty, including significant volatility in global stock markets and currency exchange rates, which may adversely impact our business. To mitigate the potential impact of Brexit on the import and export of goods to and from the UK, the Company is establishing business processes with shipping entities, including obtaining Authorized Economic Operator certification. In addition, the Company is increasing inventory in the UK and EU in an effort to maintain inventory required to meet customer demand in the event of disruption in shipments. Although the specific terms and the timeframe of the negotiations are unknown, it is possible that these changes could adversely affect our business and results of operations.

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

On February 9, 2017, we announced that our board of directors had authorized the repurchase of shares of our common stock from time to time on the open market or in privately negotiated purchases, at an aggregate purchase price of up to \$50 million. The timing and amount of any share repurchases will be determined by our management based on market conditions and other factors. The term of the program runs through December 31, 2021.

The common stock repurchase does not obligate us to repurchase any dollar amount or number of shares. During the three months ended March 31, 2019, we repurchased 157,716 shares of our common stock at a total purchase price of \$17.3 million under this program. Common stock repurchase activity through March 31, 2019 was as follows:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (in thousands) (1) |
|--|---|---|---|--|
| January 1, 2019 through January 31, 2019 | 10,000 | \$ 104.98 | 10,000 | \$ 32,316 |
| February 1, 2019 through February 28, 2019 | 90,100 | \$ 111.14 | 90,100 | \$ 22,302 |
| March 1, 2019 through March 31, 2019 | 57,616 | \$ 108.31 | 57,616 | \$ 16,062 |
| | 157,716 | \$ 109.72 | 157,716 | \$ 16,062 |

(1) Effective February 9, 2017 the Board of Directors authorized the repurchase of shares of the Company's common stock from time to time on the open market or in privately negotiated purchases, at an aggregate purchase price of up to \$50 million. The term of the program runs through December 31, 2021.

Item 3. Defaults Upon Senior Securities

No matters to disclose.

Item 4. Mine Safety Disclosures

No matters to disclose.

Item 5. Other Information

No matters to disclose.

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Item 6. Exhibits

The following documents are filed as part of this report:

| Exhibit Number | Description of Exhibit |
|-----------------------|---|
| 3.1 ⁽¹⁾ | <u>Third Amended and Restated Articles of Incorporation of Proto Labs, Inc.</u> |
| 3.2 ⁽²⁾ | <u>Articles of Amendment to Third Amended and Restated Articles of Incorporation of Proto Labs, Inc. dated May 20, 2015</u> |
| 3.3 ⁽³⁾ | <u>Second Amended and Restated By-Laws of Proto Labs, Inc., as amended through November 8, 2016</u> |
| 31.1 | <u>Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act</u> |
| 31.2 | <u>Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act</u> |
| 32.1 | <u>Certification of the Chief Executive Officer and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act</u> |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

Previously filed as Exhibit 3.2 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012, and incorporated by reference herein.

⁽¹⁾ Previously filed as Exhibit 3.1 to the Company's

Form 8-K
(File No.
001-35435),
filed with the
Commission
on May 21,
2015, and
incorporated
by reference
herein.
Previously
filed as
Exhibit 3.2 to
the
Company's
Form 8-K
(File No.
(3)001-35435),
filed with the
Commission
on November
8, 2016 and
incorporated
by reference
herein.

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SIGNATURE

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

Proto Labs, Inc.

Date: April 30, 2019 /s/ Victoria M. Holt
Victoria M. Holt
President and Chief Executive Officer

(Principal Executive Officer)

Date: April 30, 2019 /s/ John A.
Way
John A. Way
Chief
Financial
Officer

(Principal
Financial
Officer)