obligations under the Agreement. The loans are secured by a first priority security interest in substantially all assets of the Company.

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

The following discussion of our results of operations and financial condition should be read together with our unaudited consolidated financial statements for the three months ended October 31, 2016 and 2015, including the notes thereto, which appear elsewhere in this quarterly report on Form 10-Q. All amounts are in thousands, except per share data. This discussion, including, without limitation, the section titled "Summary of Operating Results", contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). All statements other than statements of historical facts are statements that could be deemed to be forward-looking statements. These statements are based on current expectations, estimates, forecasts, and projections about the markets in which we operate and the beliefs and assumptions of our management. Words such as "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," "endeavors," "strives," "may," variations of such words, and similar expressions are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties, and assumptions that are difficult to predict, estimate, or verify, including those identified in Part I, Item 1A of our annual report on Form 10-K for the year ended July 31, 2015, and elsewhere herein. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. We undertake no obligation to revise or update any forward-looking statements for any reason.

### Overview

ARI Network Services, Inc. offers an award-winning suite of Lead Generation and eCommerce Websites, eCatalog Solutions, Business Management Systems and Digital Marketing Services that help dealers, equipment manufacturers and distributors in select vertical markets Sell More Stuff!™ – online and in-store. Our innovative products are powered by a proprietary library of enriched electronic product content including OEM parts, aftermarket parts, garments and accessories (PG&A) and whole goods from more than 1,800 manufacturers. Business is complicated, but we believe our customers' technology tools don't have to be. We remove the complexity of selling and servicing new and used whole goods inventory and PG&A. More than 23,500 equipment dealers, distributors and manufacturers worldwide leverage our solutions to Sell More Stuff!™

We go to market under the "ARI Network Services, Inc." brand name in the powersports, outdoor power equipment (OPE), marine, home medical equipment (HME), recreational vehicles (RV) and appliance industries. We service customers in the automotive tire and wheel aftermarket (ATW) under the "TCS Technologies, an ARI Company" brand name; and we service the automotive aftermarket parts and service (AAPS) market under the "DCi, an ARI Company" brand name.

### Our Solutions

Our primary solutions include: (i) *Lead Generation and eCommerce Websites,* giving dealers and wholesalers an online presence optimized for today's digital path to purchase and serving as a platform to drive in-bound lead generation and eCommerce sales; (ii) *eCatalogs*, offering access to our proprietary library of enriched electronic product content via a suite of SaaS and DaaS solutions to enable the sale of whole goods inventory and PG&A; (iii) *Business Management Software* designed to streamline every aspect of a dealer's operation, drive profitability and allow them to provide better customer service; and (iv) *Digital Marketing Services* designed to generate leads and drive traffic both to the dealer's website and brick-and-mortar location.

Our solutions also improve our dealers' overall customer satisfaction through a highly efficient and accurate data lookup experience at the parts counter and a quicker response time to online inquiries, both of which serve to significantly improve a customer's overall experience with the dealer.

Our solutions are sold through our internal sales force and are composed primarily of recurring licenses and subscriptions and, in the case of business management software, perpetual licenses and maintenance contracts. Customers typically sign annual, auto-renewing contracts. Today, more than 90% of our revenues are recurring.

*Lead Generation and eCommerce Websites*

Our online solutions are tailored to each of the vertical markets we serve and are tightly integrated with our proprietary library of enriched electronic product content for major unit inventory and PG&A. Our website platform development teams continually innovate our platforms to keep up with the ever-evolving demands of our customers, online shoppers and search engines to ensure we can provide dealers with websites that perform well in search and convert online visits into leads, eCommerce sales and in-store visits. We offer a full menu of website add-ons, including a mobile inventory management application, third-party inventory integrations and business management integrations. Our lead generation tools are designed to efficiently manage and nurture leads through email campaigns, automated responses, sales team reminders and other lead generating activities, increasing conversion rates and ultimately revenues for our customers.

Lead Generation and eCommerce Websites are sold through our internal sales teams, which are aligned by vertical market. The sales process typically includes a live demo of the site and may include a free trial period (we refer to these as “test drives”). We typically charge monthly recurring subscription fees, and may charge a one-time set up fee to develop a new dealer website, as well as variable transaction fees. Our website solutions are typically sold under one-year, renewable contracts with monthly payment terms. We host and maintain more than 7,500 websites for dealers across all of our vertical markets.

*eCatalog Platform Solutions*

Our eCatalog solutions offer access to our proprietary library of enriched electronic product content via a suite of SaaS and DaaS solutions including dealer-facing manufacturer parts lookup portals and parts counter solutions; consumer-facing online parts lookup; and DaaS subscription access to our content library all designed to enable the sale of whole goods inventory and PG&A. Our eCatalog solutions are sold through our dedicated internal sales team. Fees charged for the use of our eCatalog products include a recurring license fee, subscription fees for subscribed catalogs and, in some cases, page view fees.

*Business Management Software*

Our business management software solutions are designed to streamline every aspect of a dealer’s operations to allow them to provide improved customer service. These products are sold through our dedicated internal sales team, and fees charged include perpetual one-time license or installation fees, maintenance and support fees, as well as hosting fees for our SaaS version. These solutions are currently only offered in the ATW aftermarket under the “TCS Technologies, an ARI Company” brand name.

*Digital Marketing Services*

ARI complements our suite of data-driven SaaS and DaaS solutions with digital marketing services that deliver the engaging experiences that today’s consumers expect, as well as meet the demands of leading search engines like Google. ARI’s Digital Marketing Services include search engine optimization, email marketing, search engine marketing (PPC), online reputation management and online directory management to help dealers drive more online leads, eCommerce sales and in-store traffic. Digital marketing services are sold through our dedicated internal sales team.

*Other Solutions*

We also offer a suite of complementary solutions, which include software, website customization, professional services and hosting services.

**Our Growth Strategy**

ARI’s goal is to become the leading provider of SaaS and DaaS solutions and complementary services that help our customers efficiently and effectively sell more major units, replacement parts, accessories and service – in other words, Sell More Stuff!™ Our continued goal is to grow revenues at a double-digit rate and to grow earnings through scalability. We intend to accomplish this goal by delivering our solutions to dealers, distributors, manufacturers, service providers and consumers in selected vertical markets where the finished goods are complex equipment requiring service and which are primarily sold and serviced through an independent dealer channel which typically carries multiple brands. We believe this strategy will drive increased value to our shareholders, employees and customers.

We also believe that the execution of the following strategic pillars will enable us to achieve the growth and profitability needed to drive long-term sustainable value for our shareholders:

- Drive organic growth through expanded service offerings to grow both our subscriber customer base and our average revenue per dealer;
- Differentiate our content;
- Enter new markets;
- Expand geographically;
- Nurture and retain existing customers through world-class customer service and value-added product feature updates;
- Lead the market with open integration to related platforms; and
- Successfully execute acquisitions that align with our core strategy.

These strategic foundations are primarily centered on enhancing the value proposition to our customers, which will lead to additional revenues through pricing actions, product and feature upsells, reduced customer churn rates, and expansion by leveraging our core competencies in new complementary markets. Each of these strategic pillars is a long-term foundation for the Company's growth; within each we have established near-term goals, as discussed below.

*Drive organic growth through expanded service offerings to grow both our subscriber customer base and our average revenue per dealer.*

As a subscription-based, recurring revenue (RR) business, the most important drivers of future growth are nurturing and defending our customer base; developing and selling additional products to our existing customer base; and acquiring new customers. We define RR as revenue from products and services which are subscription-based and renewable, including software access fees, data content fees, maintenance fees, support fees and hosting fees. We define churn as the percentage of RR that does not renew. RR increased 7.4%, or $789,000 to 93.7% of total revenue for the quarter ended October 31, 2016, compared to the same period last year. To experience further growth in RR, we will continue to develop and deploy innovative new solutions. We have resources assigned to each of our core products that continue to research and develop new value-added features and functionality for our existing products. The introduction of new solutions, upgrades to existing products, and new feature sets are all designed to grow our subscriber base of dealers and our average revenue per dealer (ARPD), an important measure for a subscription-based business. We have recently developed a number of new features, upgrades and products, including the following:

*Lead Generation and eCommerce Website Platforms*

- ARI Responsive Website Platform Development – we continued development and launched our next generation Responsive Design website platform, completing the first phase including advanced design capabilities, lead generation capabilities, and scalable website production tooling, among other market leading capabilities.

*eCatalog Platforms*

- Data Manager RT™ Development – We completed development and released to market our next generation of Data Manager™, our OEM parts product information management software. This next-generation platform provides OEMs with reduced publishing costs and time to market through real-time publishing, ensuring end users have access to the most accurate and rich part and service content across ARI's software ecosystem.
- PartStream™ Development – We developed and released a comprehensive upgrade to PartStream™, our leading Business-to-Consumer OEM parts shopping application, that now makes the application fully Responsive – providing customers a beautiful and intuitive parts shopping experience across all devices.

*Digital Marketing Services*

- Extended Digital Marketing Services Packages Available – We developed and launched extended Digital Advertising and Email Marketing packages, providing our customers with additional curated service packages that meet the demands of their unique business.

These product enhancements are designed to automate and enhance the marketing, sales and servicing activities for our customers in order to help them sell and service more parts, garments, accessories and whole goods.

*Differentiate our content.*

We believe we have the largest library of replacement part, major unit, and PG&A content in the vertical markets we serve. However, simply offering the largest content library in the markets we serve is not sufficient to drive the long-term revenue growth we desire. We strive to deliver more value to our customers through the enrichment of our content and during fiscal 2017 have made the following enhancements:

- PG&A Content Addition and Expansion – We've secured and authored product content for two market-leading distributor catalogs in our Marine and Home Medical Equipment markets, exponentially increasing the total number or e-commerce products available to sell in those markets.

*Enter new markets.*

ARI currently maintains a significant share in our core vertical markets of OPE, powersports, marine, RV and appliances. Accordingly, we anticipate low single-digit growth in these markets. ARI maintains a lower share in our growth vertical markets of HME, ATW and AAPS. Accordingly, we anticipate double-digit growth in these markets. As we continue to increase our share in our current markets, leveraging our technology in new and underserved markets will be important to maintaining high single digit to low double digit organic growth rates. ARI currently has more than 3,000 dealer websites in the ATW market. We estimate that the total addressable market includes approximately 18,000 dealers. Further, the broader AAPS market, which we entered via our acquisition of DCi, comprises nearly 80,000 independent service providers, more than all of our other markets combined. We intend to continue to invest heavily in this growth market, including seeking opportunities to leverage our products and services in the broader AAPS. We are one of the first website providers to service the HME market. We estimate that this market comprises nearly 25,000 service providers and believe the market to be in the early stages of eCommerce adoption.

On November 1, 2016, we acquired Auction123, Inc. ("Auction123"), which will accelerate ARI's growth in our existing vertical markets, as well as introduce ARI into the automotive dealer market. Auction123 has been a leader in online marketing solutions, inventory management and website development solutions for dealers in selected vertical markets. Their award-winning web-based software offers tight and seamless integration between the dealer management system (DMS), the dealer's website, eBay Motors, Craigslist, Facebook and other third-party classified websites.

*Expand geographically.*

Although we maintain relationships with dealers throughout the world, we have low penetration into international markets. Growing our international business will require us to secure and publish electronic content from manufacturers outside the U.S. and make changes to our existing product suite that will allow us to rapidly deploy these products in a scalable and efficient manner without the need to have "boots on the ground" in those countries. During fiscal 2015 and 2016, we added 15 new catalog content offerings in the international outdoor power equipment market. In September 2016, we hired a general manager in the Netherlands intended to expand our European presence.

*Nurture and retain existing customers through world-class customer service and value-added product feature updates.*

In order to achieve sustained double-digit organic growth, we not only need to execute the growth strategies described above, we must also retain our existing customers. In a SaaS business, the cost to retain an existing customer is much less than the cost to acquire a new customer. Accordingly, customer churn is an important metric we track and manage. We experienced improvements in our churn rates the past several years as a result of strategic actions taken by the Company, all of which are designed to enhance the "stickiness" of our product within our customers' operations. Our customer churn improved from 15.8% during the twelve months ended October 31, 2015 to 14.5% during the same period this year. We will continue to leverage our relationships with existing customers and closely monitor and manage the level of customer churn.

*Lead the market with open integration to related platforms.*

One of our strategic advantages is our focus on integrating our solutions with dealer business management systems (DMS) in order to pass key information, including customer and transactional data, between our solutions and the DMS, saving our customers valuable time and eliminating redundant data entry. We currently have integration capabilities with over 90 DMS (we refer to these relationships as "Compass Partners"), and we continue to seek other strategic alliances that can be integrated with our product and service offerings.

*Successfully execute acquisitions that align with our core strategy.*

Since 1995, we have had a formal corporate development program aimed at identifying, evaluating and closing acquisitions that align with our strategy. We focus on vertically-oriented markets with a large base of independent, multi-line dealers that sell and service complex equipment. Our strategy is to acquire companies that allow us to do one or more of the following: (i) expand our market share in existing verticals; (ii) expand into new markets that fit our desired profile; (iii) provide us with complementary products which can be cross-sold to our existing customer base; (iv) provide opportunities to cross-sell our existing products; and (v) can be integrated into our operations, thereby creating cost-saving synergies.

From the program's inception through November 1, 2016, we have closed 17 acquisitions. A summary of some of our most recent acquisitions is as follows:

| **Acquisition** | **Date** | **Strategy** |
|---|---|---|
| Auction123, LLC* | November 2016 | ▪ Expand our position in the automotive industry |
| Direct Communications Inc. | July 2015 | ▪ A leading provider of electronic catalog and content in the AAPS industry |
| TASCO Corporation (and affiliated Signal Extraprise Corporation) | April 2015 | ▪ Extend business management software platform in the ATW market |
| Tire Company Solutions, LLC | September 2014 | ▪ Consolidate website position and add new business management software in the ATW market |
| DUO Web Solutions | November 2013 | ▪ A leading provider of social media and online digital marketing services in the powersports industry |
| 50 Below Sales & Marketing, Inc. | November 2012 | ▪ A market leader in the powersports industry |
| (Retail Division) | | ▪ Entrance into ATW and DME industries |
| | | ▪ New award-winning website platform |
| Ready2Ride, Inc. | August 2012 | ▪ First of its kind aftermarket fitment data for the powersports industry |

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** Acquisition completed November 1, 2016 (see Note 8, Subsequent Events).*

**Summary of Operating Results**

Total revenue increased 4.6%, or $535,000, to $12,272,000 for the three months ended October 31, 2016 from $11,737,000 for the same period last year. Recurring revenue increased 7.4% to $11,498,000 during the three months ended October 31, 2016, compared to $10,709,000 during the same period last year. Recurring revenue constituted 93.7% of our total revenue for the three months ended October 31, 2016 compared to 91.2% for the same period last year. The growth in year-over-year revenue was entirely organic, primarily in the lead generation and eCommerce solutions and the digital marketing solutions.

Operating income decreased 5.0%, or $40,000, from $808,000 for the three months ended October 31, 2015 to $768,000 for the same period this year. Net operating expenses increased 4.0% or $355,000 during the three month period ended October 31, 2016, compared to the same period last year, primarily due to legal and accounting fees related to the Auction123 acquisition and operating expenses for the India operation, which began in the second quarter of fiscal 2016. Net income was $356,000, or $0.02 per share, for the three months ended October 31, 2016, compared to $389,000, or $0.02 per share, for the same period last year.

Cash provided by operations increased slightly from $1,735,000 for the three months ended October 31, 2015 to $1,764,000 for the same period this year.

**Revenue**

The following table summarizes our product revenue and RR and non-recurring revenue (in thousands):

| | Three months ended October 31 | | | | |
|---|---|---|---|---|---|
| | **2016** | **% of Total** | **2015** | **% of Total** | **% Change** |
| Lead Generation and eCommerce Websites | $ 6,268 | 51.1 % | $ 5,868 | 50.0 % | 6.8 % |
| eCatalog Services | 4,430 | 36.1 % | 4,515 | 38.5 % | (1.9)% |
| Business Management Software | 675 | 5.5 % | 809 | 6.9 % | (16.6)% |
| Digital Marketing Solutions | 708 | 5.8 % | 356 | 3.0 % | 98.9 % |
| Other Revenue | 191 | 1.5 % | 189 | 1.6 % | 1.1 % |
| Total revenue | $ 12,272 | 100.0 % | $ 11,737 | 100.0 % | 4.6 % |
| | | | | | |
| Recurring revenue | 11,498 | 93.7 % | 10,709 | 91.2 % | 7.4 % |
| Non-recurring revenue | 774 | 6.3 % | 1,028 | 8.8 % | (24.7)% |
| Total revenue | $ 12,272 | 100.0 % | $ 11,737 | 100.0 % | 4.6 % |

Total revenue increased 4.6% to $12,272,000 and RR increased 7.4% to $11,498,000 for the three months ended October 31, 2016, compared to the same period last year. RR represented 93.7% of total revenue for the first three months of fiscal 2017, versus 91.2% for the same period in fiscal 2016. We continue to focus on maintaining recurring revenue of over 90%.

*Lead Generation and eCommerce Website Revenue*

Our lead generation and eCommerce website solutions generate revenue from one-time setup and customization fees to develop new dealer websites, which is recognized ratably over the term of the contract, monthly recurring subscription fees and variable transaction fees. Our lead generation and eCommerce website solutions are typically sold as one year, renewable contracts with monthly payment terms. We estimate that we currently host and maintain more than 7,000 websites for dealers in all of our vertical markets. Lead generation and eCommerce website solutions have become ARI's largest source of revenue and accounted for 51.1% of total revenue during the three months ended October 31, 2016. Lead generation and eCommerce revenue increased 6.8% from $5,868,000 for the three months ended October 31, 2015, to $6,268,000 for the same period this year as a result of organic growth. We anticipate that our web platforms will continue to be one of the Company's largest sources of revenue growth.

*eCatalog Revenue*

Our eCatalog solutions generate revenue from renewable subscription fees for our software, data content, software maintenance and support fees and software customization fees. eCatalog is our second largest source of revenue, representing 36.1% of total revenue during the three months ended October 31, 2016. eCatalog revenue decreased 1.9% from $4,515,000 during the three months ended October 31, 2015 to $4,430,000 for the same period this year, primarily due to a decrease in non-recurring professional services revenue. The catalog content provided in our eCatalog solutions helps to drive sales growth in our website and lead management solutions, as well as continuing to drive organic growth in other areas of the business. Management expects eCatalog RR to increase at a low organic growth rate as the Company already has strong market share with this product.

*Business Management Software Revenue*

Business management software revenue is generated from perpetual one-time license and installation fees for the software, along with recurring maintenance, support and hosting fees for our SaaS version. Revenue from business management software represented 5.5% of total revenue for the three months ended October 31, 2016. Business management software revenue decreased 16.6% from $809,000 for the three months ended October 31, 2015 to $675,000 for the same period this year. The decrease in business management software revenue was primarily due to a decline in non-recurring perpetual license and professional service fees. Management expects fluctuations in non-recurring business management software revenue due to the timing of sales and professional service contracts.

*Digital Marketing Revenue*

Revenues from our Digital Marketing Solutions are generated from set-up fees and subscription fees for our lead generation tools through search engine optimization, social media marketing and website enhancements. We derived 5.8% of our revenues from Digital Marketing Services for the three months ended October 31, 2016. Digital marketing revenue increased 98.9%, from $356,000 during the three months ended October 31, 2015 to $708,000 during the same period this year, primarily due to organic growth in RR. Management expects digital marketing revenue to continue to see high double digit growth in fiscal 2017 as this service offering is a relatively new offering and is complementary to our other products, allowing us to expand within our current markets and current customers.

*Other Revenue*

We also offer a suite of complementary solutions, which include software, professional services and hosting services. Other revenue, which is primarily non-recurring in nature, represented approximately 1.5% of total revenue for the three months ended October 31, 2016, and was relatively consistent with the same quarter last year. Revenue from non-recurring professional services will fluctuate from period to period based on the timing of custom projects, which the Company has intentionally de-emphasized these projects as it focuses more on RR.

*Recurring Revenue*

RR is one of the most important growth drivers of our business and represented 93.7% of total revenue for the three months ended October 31, 2016. Increasing the percentage of our revenues that are recurring, while at the same time reducing the rate of customer churn, enhances our ability to generate profitable growth. Our subscription-based SaaS and DaaS products generate higher margins than our non-recurring products and services, and the incremental cost of selling these products to new dealers (we refer to these as new "logos") is relatively low. Reducing the rate of our customer churn, which is the percentage of RR that does not renew, helps drive organic growth as it allows for a greater percentage of our new logos to be incremental to the top line (versus making up for lost logos) and also increases the base upon which we can apply price increases and sell additional products and features.

We generate RR from each of our primary product categories from monthly license, subscription, maintenance and support fees. RR increased 7.4% from $10,709,000 during the three months ended October 31, 2015, to $11,498,000 during the same period this year, primarily due to organic growth in our Lead Generation and eCommerce Website and Digital Marketing solutions. We expect Lead Generation and eCommerce Website RR to continue to be our largest contributor to RR growth in fiscal 2017.

*Non-recurring Revenue*

Non-recurring revenue is generated from one-time perpetual license fees from our business management offerings, certain offerings within the Company's digital marketing services, professional services related to software customization and data conversion, usage fees charged on our RR products, set-up fees and other complementary products and services. Total non-recurring revenue decreased 24.7% from $1,028,000 during the three months ended October 31, 2015, to $774,000 during the same period this year, primarily due to decreased professional services and perpetual license revenue. Our goal is to maintain non-recurring revenue of less than 10% of total revenue, as the margins on this revenue tends to be lower than our RR products. Furthermore, non-recurring revenue must be resold each year.

**Cost of Revenue and Gross Margin**

We classify as cost of revenue those costs directly attributable to the provision of services. These costs include (i) software amortization, which represents the periodic amortization of costs for internally developed or purchased software sold to customers; (ii) direct labor for the provision of catalog production, product implementations and professional services revenue; and (iii) other direct costs, which represent amounts paid to third-party vendors for data royalties, as well as data conversion and replication fees directly attributable to the services we provide our customers.

The table below breaks out cost of revenue into each of these three categories (in thousands):

| | Three months ended October 31 | | | | |
|---|---|---|---|---|---|
| | 2016 | % of Revenue | 2015 | % of Revenue | % Change |
| Net revenues | $ 12,272 | | $ 11,737 | | 4.6 % |
| Cost of revenues: | | | | | |
| Amortization of capitalized software costs | 522 | 4.3 % | 496 | 4.2 % | 5.2 % |
| Direct labor | 785 | 6.4 % | 642 | 5.5 % | 22.3 % |
| Other direct costs | 982 | 8.0 % | 931 | 7.9 % | 5.5 % |
| Total cost of revenues | 2,289 | 18.7 % | 2,069 | 17.6 % | 10.6 % |
| Gross profit | $ 9,983 | 81.3 % | $ 9,668 | 82.4 % | 3.3 % |

Gross profit was $9,983,000 or 81.3% of revenue for the three months ended October 31, 2016, compared to $9,668,000 or 82.4% of revenue for the same period last year. Amortization of capitalized software costs as a percentage of revenue increased slightly from 4.2% for the three months ended October 31, 2015, to 4.3% for the same period this year. Direct labor costs as a percentage of revenue increased 22.3% for the three months ended October 31, 2016, compared to the same period last year primarily due to: (i) an increase in our digital marketing revenue, which has higher direct costs than our other products; (ii) an increase in website implementations; and (iii) the migration of customer websites in an effort to consolidate our customers to the product most suited to their industry and consolidate our website platforms. Other direct costs as a percentage of revenue increased slightly from 7.9% for the three months ended October 31, 2015, to 8.0% for the same period this year, primarily due to increased third party costs associated with our digital marketing offerings. The Company expects fluctuations in gross margin from quarter to quarter and year over year based on the mix of products sold.

**Operating Expenses**

We categorize net operating expenses as follows:

- Sales and marketing expenses consist primarily of personnel and related costs, including commissions for our sales and marketing employees and the cost of marketing programs and trade show attendance.
- Customer operations and support expenses are composed of our computer hosting operations, software maintenance agreements for our core network and personnel and related costs for operations and support employees.

- Software development and technical support expenses are composed primarily of personnel and related costs; we capitalize certain of these costs in accordance with GAAP, which is discussed below, while the remaining costs are primarily related to technical support and research and development.
- General and administrative expenses primarily consist of personnel and related costs for executive, finance, human resources and administrative personnel, legal and other professional fees and other corporate expenses and overhead.
- Depreciation and amortization expenses consist of depreciation on fixed assets, which are composed of leasehold improvements and information technology assets, and the amortization of acquisition-related intangible assets. Costs associated with the amortization of software products are a component of cost of revenue.
- We allocate certain shared costs among the various net operating expense classifications. Allocated costs include facilities, insurance, internal software and telecommunications. These costs are generally allocated based on headcount, unless circumstances dictate otherwise. All public company costs, including legal and accounting fees, investor relations costs, board fees and directors and officers liability insurance, remain in general and administrative.

The following table summarizes our operating expenses by expense category (in thousands):

| | Three months ended October 31 | | | | |
|---|---|---|---|---|---|
| | 2016 | % of Revenue | 2015 | % of Revenue | % Change |
| Sales and marketing | $ 2,687 | 21.9 % | $ 2,765 | 23.6 % | (2.8) % |
| Customer operations and support | 2,755 | 22.4 % | 2,446 | 20.8 % | 12.6 % |
| Software development and technical support | 1,256 | 10.3 % | 1,255 | 10.7 % | 0.1 % |
| General and administrative | 1,942 | 15.8 % | 1,785 | 15.2 % | 8.8 % |
| Depreciation and amortization (1) | 575 | 4.7 % | 609 | 5.2 % | (5.6) % |
| Net operating expenses | $ 9,215 | 75.1 % | $ 8,860 | 75.5 % | 4.0 % |

(1) Exclusive of amortization of software products of $522 and $496 for the three months ended October 31, 2016 and 2015, respectively, which are included in cost of revenue.

Net operating expenses increased 4.0%, or $355,000, for the three months ended October 31, 2016, compared to the same period last year. The increase in net operating expenses was primarily due to operating costs to support our growth in revenue, operating costs for the new India operation and acquisition costs for the Auction123 acquisition, which was completed November 1, 2016. Net operating expenses as a percentage of revenue decreased from 75.5% for the three months ended October 31, 2015, to 75.1% for the same period this year. Management expects net operating expenses to continue to decline as a percentage of total revenue to the extent the Company continues to leverage growth in its core RR products, as incremental costs related to these products decrease for every dollar of new revenue.

*Sales and Marketing*

Sales and marketing expense decreased 2.8%, or $78,000, during the three months ended October 31, 2016, compared to the same period last year. Sales and marketing expense as a percentage of revenue decreased from 23.6% of revenue for the three months ended October 31, 2015 to 21.9% for the same period in fiscal 2017. This decrease is due to the growth in our RR base, which requires much less resources to renew. Management expects sales and marketing expense as a percentage of revenue to be flat or down as RR continues to grow.

*Customer Operations and Support*

Customer operations and support expense increased 12.6%, or $309,000, during the three months ended October 31, 2016, compared to the same period last year, primarily due to the expenses associated with the India operation. Customer operations and support expense as a percentage of revenue increased from 20.8% of revenue for the three months ended October 31, 2015 to 22.4% during the same period this year. The customer operations and support functions of an acquired business typically take longer to fully integrate due to merging software platforms, help desks and customer hosting systems in order to operate more efficiently. Management expects customer operations and support expenses to decline as a percentage of revenue over time, to the extent we continue to integrate these areas into our operations and we supplement labor capacity in our India office, while RR continues to grow.

*Software Development and Technical Support*

Our software development and technical support staff have three essential responsibilities for which the accounting treatment varies depending upon the work performed: (i) costs associated with internal software development efforts (after technological feasibility is established) are capitalized as software product costs and amortized over the estimated useful lives of the product; (ii) costs for professional services performed for customers related to software customization projects are classified as cost of revenue; and (iii) all other activities, including research and development, are considered operating expenses and included within the software development and technical support operating expense category.

Software development and technical support costs were relatively the same for the three months ended October 31, 2016 and 2015. During the first quarter of fiscal 2017, we capitalized $451,000 of software development labor, overhead and interest expense, versus
$258,000 during the first quarter of fiscal 2016. The increase was a result of two significant product initiatives that escalated in the second quarter of fiscal 2016 as well as the commencement of development work from resources in our India office. In addition to internal capitalized software costs, we had outsourced development costs of $159,000 during the first fiscal 2017 and $115,000 during the first quarter of fiscal 2016. We devoted much of these resources to a major upgrade of our website and e-Catalog publishing products during both fiscal 2016 and 2017.

We expect fluctuations in the percentage of software development and technical support costs classified as operating expenses from period-to-period, based on the mix of research and prototype work versus capitalized software development and professional services activities.

*General and Administrative*

General and administrative expense increased 8.8%, or $157,000, during the three months ended October 31, 2016, compared to the same period last year, primarily due to legal fees and accounting fees related to the Auction123 acquisition. General and administrative expense as a percentage of revenue increased from 15.2% of revenue for the first quarter of fiscal 2016 to 15.8% for the same period in fiscal 2017. Management expects general and administrative expense as a percentage of revenue to decrease over time as we continue to scale the business, although additional acquisitions or other transactions could result in elevated general and administrative expense in future periods.

**Other Income and Expense**

The table below summarizes the components of other income and expenses (in thousands):

| | Three months ended October 31 | | |
|---|---|---|---|
| | 2016 | 2015 | % Change |
| Interest expense | $ (108) | $ (112) | (3.6)% |
| Other, net | 1 | (8) | (112.5)% |
| Total other income (expense) | $ (107) | $ (120) | (10.8)% |

Interest expense is composed of both interest paid on the Company’s debt financing arrangements and amortization of non-cash interest charges related to deferred finance costs and imputed interest on contingent liabilities. Interest and other expense decreased 10.8%, or $13,000, during the three months ended October 31, 2016, compared to the same period last year, primarily due to payments on our debt obligations and contingent liabilities.

**Income Taxes**

The Company has net deferred tax assets of $4,015,000 as of October 31, 2016, primarily consisting of net operating loss carryforwards (“NOLs”) and book to tax temporary differences. Income tax expense is provided for at the applicable statutory tax rate applied to current U.S. income before taxes, plus or minus any adjustments to the deferred tax assets and to the estimated valuation allowance against deferred tax assets. Income tax expense, if any, does not represent a significant current cash obligation, as we continue to have NOLs to offset substantially all of the taxable income.

We had income tax expense of $305,000 during the three months ended October 31, 2016, compared to $299,000 during the same period last year. We paid income taxes of $123,000 and $13,000 during the three months ended October 31, 2016 and 2015, respectively, primarily related to statutory alternative minimum taxes. Income tax expense may vary from period to period as we continue to evaluate the valuation allowance against net deferred tax assets.

We also have NOLs related to tax losses incurred by our India and Netherlands operations. We have determined that, consistent with prior periods, it is not likely that the net operating losses will be utilized and therefore, a full valuation allowance is recorded, resulting in $0 net deferred tax assets related to our international operations at October 31, 2016 and 2015.

**Adjusted EBITDA**

EBITDA is calculated as net income adjusted to exclude interest, amortization, depreciation and income tax expense. Adjusted EBITDA further eliminates non-cash, stock-based compensation expense. Management believes Adjusted EBITDA is helpful in understanding period-over-period operating results separate and apart from non-operating expenses and expenses pertaining to prior period investing activities, particularly given the Company's significant investments in capitalized software and its continuing efforts in completing acquisitions, which typically result in significant non-cash depreciation and amortization expense in subsequent periods. However, Adjusted EBITDA has significant limitations as an analytical tool and should only be used cautiously in addition to, and never as a substitute for, operating income, cash flows or other measures of financial performance prepared in accordance with generally accepted accounting principles and may not necessarily be comparable to similarly titled measures of other companies.

The table below presents the reconciliation of net income to EBITDA and Adjusted EBITDA (in thousands):

| | Three months ended October 31 | |
|---|---|---|
| | 2016 | 2015 |
| Net income | $ 356 | $ 389 |
| Interest expense | 108 | 112 |
| Amortization included in cost of sales | 522 | 496 |
| Depreciation and amortization | 575 | 609 |
| Income tax expense | 305 | 299 |
| EBITDA | $ 1,866 | $ 1,905 |
| Stock-based compensation expense | 149 | 115 |
| Adjusted EBITDA | $ 2,015 | $ 2,020 |
| | | |
| Revenue | $ 12,272 | $ 11,737 |
| Adjusted EBITDA as a % of revenue | 16.4 % | 17.2 % |

Adjusted EBITDA decreased 0.2%, from $2,020,000 during the first quarter of fiscal 2016, to $2,015,000 during the first quarter of fiscal 2017. Adjusted EBITDA as a percentage of revenue decreased from 17.2% during the three months ended October 31, 2015, to 16.4% during the same period this year. Management expects Adjusted EBITDA to increase in fiscal 2017, compared to the prior year, to the extent earnings increase as a result of RR growth.

**Liquidity and Capital Resources**

The following table sets forth certain cash flow information derived from our unaudited financial statements (in thousands):

| | Three months ended October 31 | | |
|---|---|---|---|
| | **2016** | **2015** | **Change** |
| Net cash provided by operating activities | $ 1,766 | $ 1,735 | $ 31 |
| Net cash used in investing activities | (782) | (665) | (117) |
| Net cash provided by (used in) financing activities | (481) | (173) | (308) |
| Effect of foreign currency exchange rate changes on cash | (4) | (2) | (2) |
| Net change in cash | $ 499 | $ 895 | $ (396) |
| Cash at end of period | $ 5,617 | $ 3,179 | $ 2,438 |

We generated $499,000 of net cash during the three months ended October 31, 2016, compared to $895,000 during the same period last year. We generated net cash from operating activities of $1,766,000 during the three months ended October 31, 2016, compared to $1,735,000 during the same period last year.

Cash used in investing activities increased $117,000 for the three months ended October 31, 2016, compared to the same period last year, primarily due to the increase in capitalized software costs related to the upgrades of our website platform and e-Catalog publishing product, partially offset by lower acquired technology equipment expenditures. We paid cash of $121,000 for contingent liabilities related to our acquisitions, capitalized $610,000 of software development costs, and acquired technology equipment of $51,000 during the three months ended October 31, 2016. We paid cash of $125,000 for contingent liabilities, capitalized $373,000 of software development costs, and acquired technology equipment of $167,000 during the three months ended October 31, 2015. We will continue to invest cash in the business to further our growth strategies previously discussed.

Net cash used in financing activities was $481,000 during the three months ended October 31, 2016, primarily to pay down the SVB note, the TCS Notes, the DCi Note and our capital lease obligations. Net cash used in financing activities was $173,000 during the three months ended October 31, 2015, primarily to pay down the SVB note and capital lease obligations.

Management believes that current cash balances and its ability to generate cash from operations are sufficient to fund our needs over the next twelve months, although additional financing may be necessary if the Company were to complete a material acquisition or to make a large investment in its business.

**Debt**

The Company has a Loan and Security Agreement (the "Agreement") with Silicon Valley Bank ("SVB"), pursuant to which SVB extended to the Company credit facilities consisting of a $3,000,000 revolving credit facility with a maturity date of November 30, 2016 and a $6,050,000 term loan with a maturity date of September 30, 2019. In addition to this, the Company has issued several promissory notes in connection with its acquisitions. See Note 3 to the consolidated financial statements for further details. The following table summarizes the minimum principal payments due on the SVB Term Note, the TCS Notes and the DCi Note as of October 31, 2016 (in thousands):

| Fiscal year ending July 31: | SVB Term Note | TCS Notes | DCi Notes | Total Notes Payable |
|---|---|---|---|---|
| 2017 | $ 681 | $ 728 | $ 467 | $ 1,876 |
| 2018 | 1,134 | 1,014 | 645 | 2,793 |
| 2019 | 1,210 | 261 | 671 | 2,142 |
| 2020 | 1,815 | — | — | 1,815 |
| | $ 4,840 | $ 2,003 | $ 1,783 | $ 8,626 |

In connection with the November 1, 2016 acquisition of Auction123123, the Company entered into the Second Loan Modification Agreement with SVB, which includes credit facilities consisting of $3,000,000 revolving credit facility with a maturity date of September 30, 2018 and a $13,000,000 term loan with a maturity date of November 1, 2021. This term loan is an amendment to the existing $6,050,000 term loan with a maturity date of September 30, 2019 (see Note 8, Subsequent Events).

**Off-Balance Sheet Arrangements**

The Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

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

Not Applicable.

## Item 4. *Controls and Procedures*

The Company has established disclosure controls and procedures to ensure that material information relating to it, including its consolidated subsidiaries, is made known on a timely basis to the officers who certify our financial reports and to other members of senior management and the Board of Directors.

The Company's management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, the Company's disclosure controls and procedures are effective (1) in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act and (2) to ensure that information required to be disclosed in the reports it files or submits under the Exchange Act is accumulated and communicated to its management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

There have not been any changes in our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) that occurred during the quarter ended October 31, 2016 that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.