31st, August 31st, November 30th and February 28th thereafter until May 28, 2016, at which time all accrued interest and outstanding principal will be due and payable in full. The Note may be prepaid in part or in full at any time without premium or penalty. The Note contains negative covenants relating to, among other things, the Company's incurrence of future indebtedness and liens and the making of dividends and distributions upon shares of the Company's capital stock, as well as customary events of default. As partial consideration for the Note, the Company issued 440,000 shares of the Company's common stock to the Holder.

The Note is subordinated in right of payment to all of the Company's existing indebtedness to Fifth Third and, subject to certain conditions, to all future indebtedness incurred to the Company's senior lenders, including to Fifth Third pursuant to the Credit Facilities. The Note is secured under a subordinated security agreement between the Holder and the Company by a security interest in substantially all of the Company's assets, subordinate to the security interests of Fifth Third and, subject to certain conditions, to all future senior debt incurred by the Company.

In connection with the acquisition and the related transactions, the Company entered into a second amendment to the Credit Facilities, effective as of November 28, 2012. Under amendment, Fifth Third consented to the acquisition of the 50 Below assets and the related transactions and provided waivers of certain provisions of the Credit Facilities, subject to certain terms and conditions. Such terms and conditions include, among others, amendments to the fixed charge coverage ratio (1.00x for the four fiscal quarter period ending January 31, 2013) and senior leverage (maximum senior funded debt to EBITDA) ratio (1.75x for the fiscal quarter ending January 31, 2013) financial covenants and the addition of a maximum total funded debt to EBITDA ratio financial covenant (2.50x for the four fiscal quarter period ending January 31, 2013); amendment of the revolving loan and term loan maturity dates from July 27, 2014 to December 15, 2013; and other customary terms and conditions.

We have evaluated and determined that the acquired business as described above constitutes a business that is "significant" as defined in the applicable SEC regulations. Because the initial accounting for the business combination is not complete, purchase price allocation, audited financial statements and pro forma financial information will be provided at a later date.

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, 2012 and 2011, 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 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 our annual report on Form 10-K for the year ended July 31, 2012, under "Item 1A. Risk Factors," 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 of Business

ARI Network Services, Inc. ("ARI" or the "Company") is a leader in creating, marketing, and supporting solutions that enhance revenue and reduce costs for our customers. Our innovative, technology-enabled solutions connect the community of consumers, dealers, distributors, and manufacturers to help them efficiently service and sell more whole goods, parts, garments, and accessories ("PG&A") in selected vertical markets worldwide that include power sports, outdoor power equipment, marine, and appliances. We estimate that more than 22,000 equipment dealers, 140 manufacturers, and 195 distributors worldwide leverage our technology to drive revenue, gain efficiencies and increase customer satisfaction.

Our Solutions

Today, we generate revenue from three primary categories of technology-enabled solutions: (i) electronic catalogs for publishing, viewing and interacting with PG&A information from Original Equipment Manufacturers ("OEMs"), aftermarket manufacturers and distributors; (ii) websites with eCommerce capabilities designed to leverage leads for sales of whole goods and sales of PG&A through the sites and provide information to consumers in dealers' local areas; and (iii) lead generation and management products and services designed to help dealers generate sales of whole goods and PG&A through efficient marketing of their products.

Electronic Catalogs

Our electronic catalog solutions, which encompass our PartSmart®, PartSmart Web™, PartStream™ and other various catalog products, leverage our industry-leading content database to allow distributors and dealers to view and interact with this information to efficiently support the sales and service of equipment. We believe that our catalog solution is the fastest and most efficient in the market, as it allows multi-line dealers to quickly access data for any of the brands serviced from within the software, allowing the dealer's parts and service operations to more quickly service and sell to its customers. We derived approximately 58% of our revenues from our electronic catalog services in the first quarter of fiscal 2013.

Website Solutions

Our eCommerce enabled website solutions, which are tailored to the vertical markets we serve, provide consumers with information about the dealership and its product lines and allow consumers to purchase OEM or aftermarket PG&A through the dealers' website 24 hours a day, 7 days a week. Our website solutions include WebSiteSmart Pro®, eXceleratePro™, eXceleratePro™ 2, and LeadStorm™. We also offer a mobile solution that allows some dealers' websites to be fully functional on smart mobile phones. Website services accounted for approximately 26% of revenues in the first quarter of fiscal 2013.

Lead Management Product

Our award-winning SaaS solution, Footsteps™, is designed to efficiently manage and nurture generated leads, increasing conversion rates and ultimately revenues. Footsteps™ connects equipment manufacturers with their dealer channel through lead consolidation and distribution, and allows the dealers to handle leads more efficiently and professionally through marketing automation and business management system integration. The product provides a complete database of customers and prospects, and manages the dealer to customer relationship from generating email campaigns and automated responses, to providing sales teams with a daily follow-up calendar and reminder notices. We derived approximately 4% of our revenues from Footsteps™ in the first quarter of fiscal 2013.

Lead Generation Service

Our web-based lead generation service, SearchEngineSmart™, generates increased traffic to dealers' stores and websites through optimization of the dealers' paid search engine marketing campaigns, which include optimization for results in our dealers' local areas. We derived approximately 5% of our revenues from lead generation services in the first quarter of fiscal 2013.

Other Services

We also offer a suite of complementary solutions, which include software and website customization services, website hosting, and document transfer and communication services. On a combined basis, these other services accounted for approximately 7% of revenue in the first quarter of fiscal 2013.

Further information regarding our service offerings can be accessed at the Company's website at www.arinet.com, or in our Annual Report on Form 10-K for the year ended July 31, 2012. Please note that we are not including the information contained on or available through our website as a part of, or incorporating such information by reference into, this quarterly report on Form 10-Q.

Our Strategy

ARI's goal is to drive increased value to our shareholders through sustained double digit revenue and earnings growth. We believe that execution of the following fundamental strategic pillars will enable us to continue to provide our customers with the innovative solutions and value-added services they have come to expect, which will ultimately drive the long-term growth and profitability our shareholders expect.

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

In fiscal 2012, we deployed a brand new, state-of-the-art call center to support our inside sales, customer service, technical support, and renewal teams. The call center was designed to drive increased efficiencies and activity levels within these groups, and includes the display of continuous, real time sales and support metrics throughout the call center. We will continue to leverage our relationships with existing customers and closely monitor and manage the level of customer churn. In fiscal 2012, our rate of customer churn improved by 19% over fiscal 2011 and we have seen an additional improvement of 21.2% in the first quarter of fiscal 2013, compared to the same period last year.

Drive organic growth through innovative new service offerings, differentiated content and geographic expansion

As a subscription-based, recurring revenue business, the most important drivers of future growth are adding new customers, increasing the level of our recurring revenue ("RR") and reducing the rate of customer churn. We define RR as products and services which are SaaS or DaaS-based and renewable, including license fees, maintenance fees, catalog subscription fees and hosting fees. In the first quarter of fiscal 2013 our RR increased 8.9% overall, and RR on our three core recurring products – catalog, website, and lead management – increased 9.5%. This increase was the result not only of the improvement in customer churn rates discussed above, but was also driven by progress we made with respect to our organic growth strategy, which includes the following critical objectives:

- *Develop and deploy innovative new solutions*. We have resources assigned to each of our core products who continue to research and develop new value-added features and functionality in our existing products. The introduction of new solutions, upgrades to existing products, and new feature sets are all designed to grow our average revenue per dealer ("ARPD"), an important measure for a subscription-based business, and the increase in our customer base serves to quickly compound the benefits of an increased ARPD.

- *Expand geographically*. Currently, only a small percentage of our revenues are generated from international operations. Our OEM customers have stated objectives to drive growth internationally, with a focus on the "BRIC" countries of Brazil, Russia, India, and China. We must continue to support our OEM customers with products and content for these markets. During the first quarter of fiscal 2013, we expanded our content offerings in the international outdoor power market. We began to upgrade our product roadmaps to allow us to rapidly deploy our products in these markets in a scalable and efficient manner.

- *Differentiate our content.* We believe that we have the largest library of whole goods and PG&A content data 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 growth we expect. We strive to deliver more value to our customers through enrichment of our content. Content enrichment can take several forms, including the incorporation of user reviews and feedback into our existing content, further enhancing content provided to us by our OEM customers, and creating new forms of content that further our customers' ability to efficiently service and sell more whole goods and PG&A.

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 the systems, saving our customers valuable time and eliminating redundant data entry. We currently have integration capabilities with over 90 DMS's (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

Historically, acquisitions have been a significant driver of ARI's growth. Since 2007, the Company has successfully closed six strategic acquisitions while reviewing, and ultimately deciding not to pursue, a multitude of others. Our 2009 acquisition of Channel Blade Technologies ("Channel Blade") and our 2008 acquisition of the electronic parts catalog and eCommerce assets of Info Access expanded not only our product offerings but the number of markets we serve. As a result of those acquisitions, ARI is the market leader in the marine, RV and appliance markets. Although we believe organic growth will be the primary driver of our business for the foreseeable future, we will continue to evaluate acquisitions that are in alignment with our core strategy.

On August 17, 2012 we successfully acquired substantially all of the assets of Ready2Ride, Inc. (“Ready2Ride”), the first-to-market and leading provider of aftermarket fitment data to the powersports industry. The acquisition of Ready2Ride is directly aligned with our strategy to further differentiate our content.

On November 28, 2012, the Company purchased the assets of the Retail Services Division of Fifty Below Sales & Marketing, Inc. (“50 Below”), a leading provider of eCommerce websites in the powersports, automotive tire and wheel aftermarket, medical equipment and pool and spa industries. We expect that the acquired business will add over 3,000 new dealers to our customer base and accelerate our entry into new, high-growth markets, including the automotive aftermarket, specifically automotive tire and wheel dealers.

Sales, Marketing and Support Teams

We organize our sales and marketing programs into three distinct sales channels and two geographic regions: North America and Europe.

Sales Channels

We go to market utilizing sales teams determined through a combination of customer, product, and geographic market. Our field sales personnel focus on building relationships with manufacturers and distributors, while our inside, telephone-based sales team focuses on selling to dealers. The dealer sales team located in the US is further divided by product (catalog sales versus other products and services) and we also have an international sales team in The Netherlands. We are also in the process of enhancing our core products to allow for online customer self-service sales capabilities.

Marketing

Our marketing strategy is designed to drive knowledge of our value proposition into the markets we serve. We use a variety of marketing programs to target and build relationships with our prospective and current customers and partners. Our primary marketing activities include:

- participation in dealer meetings, trade shows and industry events to create awareness, build our lead database and develop relationships;
- search engine marketing and online and print direct marketing to generate awareness and action;
- ongoing website development to educate prospects and provide product information, testimonials, live demonstrations and marketing collateral;
- email and phone campaigns used to capture leads;
- use of customer testimonials; and
- sales tool kits and field marketing training to enable our sales organization to more effectively develop leads and close transactions.

Customer Service and Support

Customer support is a critical part of our strategy as it is essential to retaining our existing customer base and reducing the level of customer churn. We maintain customer support operations in each of the Company’s four locations. Our support representatives are available via telephone or email. We also maintain a customer satisfaction and renewal team that focuses on proactively reaching out to customers to ensure that our customers are satisfied and are receiving the most value possible from their spend with ARI.

Our Competitive Strengths

Market Leader in Core Verticals

We believe that we are one of the leaders in each of our core vertical markets and also believe we are the market leader in the outdoor power, marine, and appliance markets. Our direct relationships with approximately 19,000 dealers, 140 manufacturers, and 195 distributors allow us to cost-effectively leverage our published catalog content into a large and diversified customer base and to launch new product enhancements and technology-enabled solutions to this customer base.

Breadth and Depth of Published Content

The breadth and depth of our catalog content, as well as our ability to enhance and efficiently publish manufacturers’ PG&A data as it becomes available, provides ARI with a critical competitive advantage. Our electronic catalog content enables multi-line dealers to easily access catalog content for multiple manufacturers using a single software platform. This advantage, which saves our customers significant time, provides "stickiness" to our catalog customer base that allows us to efficiently and cost effectively nurture our existing customers while devoting resources to develop new products and services, enabling us to grow our overall customer base.

Recurring Revenue Model

Approximately 84% of our revenue is subscription-based and recurring revenue. The majority of our customers are on contracts of twelve months or longer, and these contracts typically auto-renew for additional twelve month terms. This provides us with advanced visibility into our future revenues and opportunities to sell additional services to our customers. Our recurring revenue model also emphasizes the importance of maintaining a low rate of customer churn, one of the key drivers of any recurring revenue, subscription-based business.

Our recurring revenue model, when combined with low rates of customer churn, significantly reduces the cost to maintain and nurture our customer base. This in turn frees up resources to enhance our existing products and work toward new revenue generating product innovations. Additionally, a substantial portion of our electronic catalog business is focused on our customers' service and repair operations. This allows our revenues to remain strong even in a down economy, as consumers tend to repair, rather than buy new equipment during a challenging economy.

Suite of Products Covers Entire Sales and Service Cycle

Our suite of dealer products and services and eCommerce capabilities enhance our customers' front office operations by covering the entire sales cycle, from lead generation and lead management to sales of PG&A to the consumer, both in-store and online, and our electronic catalog products allow dealers to efficiently service and repair equipment.

We believe that our competitive advantages will enable us to compete effectively and sustainably in our core markets, although given the current pace of technological change, it is possible that unidentified competitors could emerge, existing competitors could merge and/or obtain additional capital, thereby making them more formidable, or new technologies could come on-stream and potentially threaten our position.

Our Markets and the Challenges We Face

Competition for our products and services varies by product and by vertical market. We believe that no single competitor today competes with us on every product and service in each of our industry verticals. In electronic catalogs, we compete primarily with Snap-on Business Solutions, which designs and delivers electronic parts catalogs, accessory sales tools, and manufacturer network development services, primarily to the automotive, power sports, outdoor power, construction, agriculture and mining markets. In addition, there is a variety of smaller companies focused on one or two specific industries.

In lead management, websites and eCommerce, our primary competitor is PowerSports Network, owned by Dominion Enterprises. Competition for our website development services also comes from in-house information technology groups that may prefer to build their own web-based proprietary systems, rather than use our proven industry solutions. There are also large, general market eCommerce companies, such as IBM, which offer products and services that could address some of our customers' needs. These general eCommerce companies do not typically compete with us directly, but they could decide to do so in the future. We believe we maintain a competitive advantage in our core vertical markets given the breadth and integration of our published content into our catalog, lead management and website products.

Several of the markets we serve, including power sports, marine, and RV, are closely aligned with the state of the economy, given the "luxury" nature of the products in those verticals. In fiscal 2010 we experienced an increase in customer churn in these markets due to manufacturer bankruptcies, dealer closures, and extreme cost reduction measures by our dealers. Our customer churn rates improved in these markets in over the past two years as the effects of the economy began to lessen in those markets. It is also important to note that the impacts of a difficult economic environment are somewhat softened by the consumers' willingness in a down economy to repair existing equipment rather than purchase new equipment, which serves to amplify the importance of our published parts content provided to customers via our catalog parts lookup products and our website products.

Summary of Operating Results

The revenue growth momentum achieved in fiscal 2012 continued into the first quarter of fiscal 2013, as total revenues in the quarter grew 9.8% over the same period last year. This growth is a direct result of the continued execution of ARI's growth strategy. One component of this strategy is to execute synergistic acquisitions. We recently executed two acquisitions directly tied to this strategy, as previously discussed. Although we believe these acquisitions will immediately increase our revenues and will significantly enhance our operating income and EBITDA in fiscal 2014, non-recurring costs associated with these acquisitions will continue into our third fiscal quarter and will impact our operating results for the full 2012 fiscal year.

- Total revenue increased 9.8% or $532,000 for the three month period ended October 31, 2012, compared to the same period last year. Recurring revenue increased 8.9% or $402,000 for the three months ended October 31, 2012, compared to the same period last year. We achieved organic revenue growth of approximately 7.4% for the quarter, compared to last year, excluding revenues from the Ready2Ride acquisition, which were included in catalog revenue.

- Operating income decreased $193,000 for the three months ended October 31, 2012, compared to the same period last year. This decline is largely due to acquisition-related costs of approximately $250,000 for legal fees and travel expenses, partially offset by a sales tax credit of $89,000 included in general and administrative expense, as well as integration costs related to the Ready2Ride acquisition.

- Net income decreased $159,000 for the quarter, compared to the same period last year, due to the decrease in operating income and the tax effect of the decrease in earnings.

- Cash flows from operations decreased 39.0% or $326,000 for the quarter ended October 31, 2012, compared to the same period last year. We utilized the cash generated from operations as well as additional financing to invest in two acquisitions, product development and our technology infrastructure.

We expect continued improvements in revenue for the remainder of fiscal 2013, relative to fiscal 2012, as we execute our strategies aimed at double digit revenue growth, but anticipate a year over year decline in earnings as we integrate the acquisitions and make investments in our infrastructure to support more rapid revenue growth.

Revenue

The following table summarizes our recurring and non-recurring revenue by major product category:

	Three months ended October 31		Percent
	2012	2011	Change
Catalog			
Recurring revenue	$ 3,321	$ 3,092	7.4 %
Non-recurring revenue	137	222	(38.3) %
Total catalog revenue	3,458	3,314	4.3 %
Percent of revenue recurring	*96.0 %*	*93.3 %*	
Website			
Recurring revenue	1,259	1,081	16.5 %
Non-recurring revenue	264	242	9.1 %
Total website revenue	1,523	1,323	15.1 %
Percent of revenue recurring	*82.7 %*	*817 %*	
Lead management			
Recurring revenue	212	205	3.4 %
Non-recurring revenue	45	51	(11.8) %
Total lead management revenue	257	256	0.4 %
Percent of revenue recurring	*82.5 %*	*80.1 %*	
Lead generation			
Recurring revenue	-	-	- %
Non-recurring revenue	307	192	59.9 %
Total lead generation revenue	307	192	59.9 %
Percent of revenue recurring	*- %*	*- %*	
Other			
Recurring revenue	147	159	(7.5) %
Non-recurring revenue	250	166	50.6 %
Total catalog revenue	397	325	22.2 %
Percent of revenue recurring	*37.0 %*	*48.9 %*	
Total			
Recurring revenue	4,939	4,537	8.9 %
Non-recurring revenue	1,003	873	14.9 %
Total revenue	$ 5,942	$ 5,410	9.8 %
Percent of revenue recurring	*83.1 %*	*83.9 %*	

Total revenue increased 9.8% or $532,000 for the three months ended October 31, 2012, compared to the same period last year. Recurring revenue increased 8.9% or $402,000 for the three months ended October 31, 2012, compared to the same period last year. This increase in revenue is attributed to new sales, recurring revenue from the Ready2Ride acquisition and continued decline in the Company's rate of customer churn, which has collectively led to continued growth in its recurring revenue. Given that a substantial portion of the Company's revenue is subscription-based, monthly recurring revenue ("MRR") is one of the performance indicators the Company closely monitors, as it is the key driver of future revenue growth.

Catalog

Catalog revenue is generated from catalog subscriptions, software license fees, license renewal fees, software maintenance and support fees and professional services related to data conversion. Revenue from the acquired Ready2Ride business is included in Catalog revenue. Catalog, which continues to be the Company's largest source of revenue, increased 4.3% or $144,000 for the three months ended October 31, 2012, compared to the same period last year, primarily due to revenue from the Ready2Ride customers. We expect to see year over year growth in catalog revenue for the remainder of fiscal 2013.

Website

Website revenue is generated from one-time set-up fees and recurring subscription fees on our website products, as well as transaction fees from customers' online sales generated via the websites. Website revenue increased 15.1% or $200,000 for the three month period ended October 31, 2012, compared to the same period last year. Recurring website revenue grew 16.5% for the three months ended October 31, 2012, compared to the same period last year due to an increase in the number of new websites. Non-recurring website revenue increased 9.1% for the three months ended October 31, 2012, compared to the same period last year. As the Company continues to focus on MRR growth, including the anticipated addition of revenue from the 50 Below acquisition, it expects total website revenue to continue to show double digit growth for the remainder of fiscal 2013, over the previous year, and for these products to be a long-term source of growth for the Company.

Lead Management

Lead management revenue is generated from one time set-up fees and recurring subscription fees for the use of the Company's Footsteps™ products. Revenue from lead management products for the three months ended October 31, 2012 was $257,000, consistent with revenue for the same period last year. The majority of lead management revenue is recurring in nature and increased 3.4% for the three months ended October 31, 2012, compared to the same period last year. The Company deployed early new editions of its Lead Management product, Footsteps Channel Connect™, which offers the product's base functionality at a low price with the option to upgrade to additional functionality, to a select number of customers. Our product development staff is incorporating the customer feedback into new releases of the product, which is expected to drive growth in fiscal 2013.

Lead Generation

Lead generation revenue is realized from the sale of the Company's SearchEngineSmart™ ("SES") service and is non-recurring. Revenue from the Company's lead generation services increased 59.9% or $115,000 for the three month period ended October 31, 2012, compared to the same period last year due to revenue from several new larger customers. Revenue from the Company's lead generation services does not directly contribute to MRR growth, but contributes to MRR growth in the lead management and website services.

Other Revenue

Other revenue primarily consists of professional services related to software customization, website hosting fees, and revenue generated from other products that are ancillary to our three core offerings. Other revenue increased 22.2% or $72,000 for the three months ended October 31, 2012, compared to the same period last year, primarily due to a large professional services contract with a major customer. Management anticipates that other revenue will fluctuate based on the timing of professional fees related to software customization.

Cost of Revenue

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 directly attributable to the services we provide our customers.

The table below breaks out cost of revenue into each of these three categories:

	Three months ended October 31			
	2012	Percent of Revenue	2011	Percent of Revenue
Net revenues	$ 5,942		$ 5,410	
Cost of revenues:				
Amortization of capitalized software costs	396	6.7 %	335	6.2 %
Direct labor	448	7.5 %	384	7.1 %
Other direct costs	564	9.5 %	417	7.7 %
Total cost of revenues	1,408	23.7 %	1,136	21.0 %
Gross profit	$ 4,534	76.3 %	$ 4,274	79.0 %

Gross profit was $4,534,000 or 76.3% of revenue for the three months ended October 31, 2012, compared to $4,274,000 or 79.0% of revenue for the same period last year. This decline in gross profit margin was primarily attributed to: (i) an increase in SES and professional services revenues, which have a much lower margin than our other core products; and (ii) an increase in website and lead management software amortization. The Company expects fluctuations in gross margin from quarter to quarter and year over year based on the mix of products sold, but expects its gross margins to improve over time as we focus our sales efforts on the higher margin, recurring revenue products.

Gross Margins

The following table summarizes our gross profit and gross margin percentage by major product category:

	Three months ended October 31		Percent
	2012	2011	Change
Catalog			
Revenue	$ 3,458	$ 3,314	4.3 %
Cost of revenue	477	489	(2.5) %
Gross profit	2,981	2,825	5.5 %
Gross margin percentage	*86.2 %*	*85.2 %*	
Website			
Revenue	1,523	1,323	15.1 %
Cost of revenue	262	332	(21.1) %
Gross profit	1,261	991	27.2 %
Gross margin percentage	*82.8 %*	*74.9 %*	
Lead management			
Revenue	257	256	0.4 %
Cost of revenue	167	111	50.5 %
Gross profit	90	145	(37.9) %
Gross margin percentage	*35.0 %*	*56.6 %*	
Lead generation			
Revenue	307	192	59.9 %
Cost of revenue	271	140	93.6 %
Gross profit	36	52	(30.8) %
Gross margin percentage	*11.7 %*	*27.1 %*	
Other			
Revenue	397	325	22.2 %
Cost of revenue	231	64	260.9 %
Gross profit	166	261	(36.4) %
Gross margin percentage	*41.8 %*	*80.3 %*	
Total			
Revenue	5,942	5,410	9.8 %
Cost of revenue	1,408	1,136	23.9 %
Gross profit	$ 4,534	$ 4,274	6.1 %
Gross margin percentage	*76.3 %*	*79.0 %*	

Catalog

Catalog gross profit margin increased from 85.2% for the three months ended October 31, 2011 to 86.2% for the three months ended October 31, 2012. The increase in margin is due to the cost savings realized for catalog replication and shipping as a result of our new internet updating capabilities used by more than 90% of our catalog customers. The Company expects catalog margins to gradually improve over time as the growth in recurring revenue has little incremental cost.

Website

Website gross profit margin increased from 74.9% for the three months ended October 31, 2011 to 82.8% for the same period this year. The improvement in website gross margin is primarily due to an increase in recurring revenue with relatively little incremental cost. The Company expects to see continued improvements in gross margin as we focus on increasing recurring revenue and streamlining operations.

Lead Management

Lead management gross profit margin decreased from 56.6% for the three months ended October 31, 2011 to 35.0% for the same period this year. The decline in gross profit margin is primarily due to an increase in software amortization of our newly enhanced lead management products.

Lead Generation

Lead generation gross profit margin decreased from 27.1% for the three months ended October 31, 2011 to 11.7% for the same period this year primarily due to several larger contracts with volume discounts. The Company expects fluctuations in lead generation gross margin from quarter to quarter.

Other Revenue

Gross profit margin on other revenue declined for the three months ended October 31, 2012, compared to the same period last year primarily due to the increase in professional services revenue, which has a lower margin than our other products. The Company expects fluctuations in gross margin on other revenue, depending on the mix of products and services sold.

Operating Expenses

The following table summarizes our unaudited operating expenses by expense category:

	Three months ended October 31				
	2012	Percent of Revenue	2011	Percent of Revenue	Percent Change
Sales and marketing	$ 1,046	17.6 %	$ 1,033	19.1 %	1.3 %
Customer operations and support (1)	1,008	17.0 %	846	15.6 %	19.1 %
Software development and technical support (2)	577	9.7 %	388	7.2 %	48.7 %
General and administrative (3)	1,320	22.2 %	1,108	20.5 %	19.1 %
Depreciation and amortization (4)	280	4.7 %	403	7.4 %	(30.5) %
Net operating expenses	$ 4,231	71.2 %	$ 3,778	69.8 %	12.0 %

(1) Net of capitalized software development costs of $8 and $26 in fiscal 2012 and 2011, respectively.
(2) Net of capitalized software development costs of $359 and $440 in fiscal 2012 and 2011, respectively.
(3) Net of capitalized software development costs of $25 in fiscal 2011.
(4) Exclusive of amortization of software products of $396 and $335 in fiscal 2012 and 2011, respectively, which are included in cost of revenue.

Net operating expenses increased 12.0% or $453,000 for the three month period ended October 31, 2012, compared to the same period last year. The increase was largely due to legal fees related to the Company's latest acquisitions and the operating expenses of the newly acquired Ready2Ride business.

Sales and Marketing Expenses

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. Marketing programs consist of lead generation and direct marketing, advertising, events and meeting costs, public relations, brand building and product management activities. Sales and marketing expenses increased 1.3% or $13,000 for the three months ended October 31, 2012, compared to the same period last year as a result of the addition of sales and marketing personnel related to the Ready2Ride acquisition. Sales and marketing expenses, as a percentage of revenue, decreased from 19.1% for the first quarter of fiscal 2012 to 17.6% for the same period this year. We anticipate that sales and marketing will continue to be one of our largest expenses, as we intend to continue to invest in sales and marketing to grow our customer base and expand relationships with our existing customers during the remainder of fiscal 2012. However, management expects sales and marketing costs to decline as a percentage of revenue in future years.

Customer Operations and Support

Customer operations and support expenses are composed of our customer hosting operations, software maintenance agreements for our core network, and personnel and related costs for operations and support employees. Customer operations and support costs increased 19.1% or $162,000 for the three months ended October 31, 2012, compared to the same period last year, due to the expansion of our operations and support team, including those supporting our Ready2Ride customers. Management expects customer operations and support to continue to be higher than the previous year for the remainder of fiscal 2013, but to decline as a percentage of revenue in future years.

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 are typically capitalized as software product costs and amortized over the estimated useful lives of the product; (ii) professional services performed for customers related to software customization projects are classified as cost of revenue; and (iii) all other activities are considered operating expenses and included within the software development and technical support operating expense category.

The table below summarizes our internal software development and technical support spending:

	Three months ended October 31		Percent
	2012	2011	Change
Total software development and technical support costs	$ 1,417	$ 1,263	12.2 %
Less: amount capitalized as software development	(392)	(491)	(20.2) %
Less: direct labor classified as cost of revenues	(448)	(384)	16.7 %
Net software development and technical support costs classified as operating expenses	$ 577	$ 388	48.7 %

The Company increased total software development and technical support costs by 12.2% or $154,000 for the three months ended October 31, 2012, compared to the same period last year, which is consistent with the strategy to release new products, create enhancements to existing products, offer expanded data content and deliver superior services and technical support to our customers.

During the first quarter of fiscal 2013, the Company capitalized $392,000 of software development labor and overhead, versus $491,000 for the same period last year. The Company deployed several new editions of its lead management product FootSteps™, which enable customers to add feature upgrades and grow with the product over time during fiscal 2012. The Company is working on several new enhancements expected to be released in the upcoming quarters, which it anticipates will increase future revenue for the Company.

Management expects total spending for software development and technical support to increase for the remainder of fiscal 2013 as we integrate our newly acquired technology with the look and feel of the Company's other product offerings and continue to focus on our core strategy of product enhancement and innovation. The Company expects fluctuations in the amount of software development and technical support costs classified as operating expenses from period to period, as the mix of research and prototype work versus capitalized software development and professional services activities will change, even if total software development and technical support departmental costs were to remain relatively constant.

General and Administrative

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. General and administrative costs increased 19.1% or $212,000, for the three month period ended October 31, 2012, compared to the same period last year. This increase was primarily due to legal fees and travel of approximately $250,000 related to the Ready2Ride and 50 Below acquisitions, offset in part by a credit of $89,000 for the reduction a sales tax provision related to a sales tax audit which has been resolved. As a percentage of revenue, general and administrative expenses increased from 20.5% for the three months ended October 31, 2011 to 22.2% for the same period this year. Management expects general and administrative expenses to increase as a result of the acquisitions but to decrease as a percentage of revenue compared to the previous year in the latter half of fiscal 2013.

Depreciation and Amortization

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 assets are a component of cost of revenue. Depreciation and amortization expense decreased 30.5% or $123,000 for the three months ended October 31, 2012, compared to the same period last year as intangible assets related to an earlier acquisition have become fully amortized and older technology related to our infrastructure is getting replaced by newer cloud-based technology which is classified in general and administrative expense. Management expects depreciation and amortization expense to increase over the previous year for the remainder of fiscal 2013 as a result of amortization of acquisition related intangible assets and our new cloud-based infrastructure.

Interest Expense

Interest expense increased slightly from $62,000 for the three months ended October 31, 2011 to $68,000 for the same period this year. Management expects interest expense to increase for the remainder of fiscal 2013, compared to the previous year, as a result of additional debt to finance the Company's acquisitions.

Other Income (Expense)

Other income (expense) consists of foreign currency exchange rate gains and losses, interest income and other gains or losses. Other income decreased from $6,000 for the three months ended October 31, 2011 to $4,000 for the same period this year.

Income Taxes

The Company has net deferred tax assets of $5,024,000, primarily consisting of net operating loss carryforwards and book to tax timing 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. This does not represent a current cash obligation, as we continue to have net operating loss carryforwards to offset taxable income.

The Company recorded income tax expense of $126,000 during the three months ended October 31, 2012, compared to $168,000 for the same period last year. The decrease in income tax expense was due to the decline in income before tax. Income tax expense may vary from period to period as the Company continues to evaluate the valuation allowance against net deferred tax assets on a semi-annual basis.

Liquidity and Capital Resources

The following table sets forth, for the periods indicated, certain cash flow information derived from the Company's financial statements:

	Three months ended October 31		Percent
	2012	2011	Change
Net cash provided by operating activities	$ 509	$ 835	(39.0) %
Net cash used in investing activities	(2,526)	(538)	(369.5) %
Net cash provided by (used in) financing activities	932	(438)	312.8 %
Effect of foreign currency exchange rate changes on cash	(4)	5	(180.0) %
Net change in cash	$ (1,089)	$ (136)	(700.7) %
Cash at end of period	$ 261	$ 1,350	(80.7) %

Net cash provided by operating activities decreased 39.0% or $326,000 over the same period, primarily due to the decline in earnings, which was driven by acquisition-related costs.

Cash used in investing activities increased $1,988,000 in the first quarter of fiscal 2013, compared to the same period last year. The Company invested more than $920,000 in the Ready2Ride acquisition in August 2012 and an additional $900,000 deposit on the 50 Below acquisition, which closed in November 2012. ARI also invested $381,000 in equipment and technology for our new cloud-based infrastructure and $396,000 on enhancements to our software products. We will continue to invest cash in the business for the development of new products and upgrades to existing products.

The Company had net cash provided by financing activities of $932,000 for the three months ended October 31, 2012 compared to net cash used in financing activities of $438,000 for the same period last year. The Company borrowed an additional $1,000,000 of debt from Fifth Third to partially fund its acquisitions.

In connection with the Company's acquisition of the 50 Below assets, the Company issued a Secured Non-Negotiable Subordinated Promissory Note dated as of November 28, 2012 (the "Note") issued to Michael D. Sifen, Inc. (the "Holder"), an affiliate of an existing shareholder of the Company, in aggregate principal amount of $3.5 million. Interest accrues on the outstanding unpaid principal under the Note from and after November 7, 2012 until November 28, 2013 at a rate of 10.0% per annum, and at a rate of 14.0% per annum thereafter. Accrued interest only will be payable quarterly commencing on February 28, 2013 and continuing on each May 31st, August 31st, November 30th and February 28th thereafter until May 28, 2016, at which time all accrued interest and outstanding principal will be due and payable in full. The Note may be prepaid in part or in full at any time without premium or penalty. The Note contains negative covenants relating to, among other things, the Company's incurrence of future indebtedness and liens and the making of dividends and distributions upon shares of the Company's capital stock, as well as customary events of default.

The Company also entered into the Second Amendment to Loan and Security Agreement with Fifth Third Bank, effective as of November 28, 2012. Under amendment, Fifth Third consented to the acquisition of the 50 Below assets and the related transactions and provided waivers of certain provisions of the Credit Facilities, subject to certain terms and conditions. Such terms and conditions include, among others, amendments to the fixed charge coverage ratio (1.00x for the four fiscal quarter period ending January 31, 2013) and senior leverage (maximum senior funded debt to EBITDA) ratio (1.75x for the fiscal quarter ending January 31, 2013) financial covenants and the addition of a maximum total funded debt to EBITDA ratio financial covenant (2.50x for the four fiscal quarter period ending January 31, 2013); amendment of the revolving loan and term loan maturity dates from July 27, 2014 to December 15, 2013; and other customary terms and conditions.

The Company was in compliance with the financial covenants contained in the Fifth Third credit facilities during the quarter ended October 31, 2012, and expects to remain in compliance with the amended financial covenants in the foreseeable future.

Management believes that current cash balances and its ability to generate cash from operations, as well as the existing availability under our line of credit with Fifth Third, are sufficient to fund our needs over the next twelve months.

Off-Balance Sheet Arrangements

The Company has no significant 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.