

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended October 31, 2015

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-19608

**ARI Network Services, Inc.**

(Exact name of registrant as specified in its charter)

WISCONSIN

39-1388360

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification No.)

10850 West Park Place, Suite 1200, Milwaukee, Wisconsin 53224

(Address of principal executive offices)

(414) 973-4300

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (S232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

As of December 4, 2015, there were 17,173,273 shares of the registrant's common stock outstanding.

**ARI Network Services, Inc.**

FORM 10-Q  
FOR THE THREE MONTHS ENDED OCTOBER 31, 2015  
INDEX

	<u>Page</u>
<b>PART I</b>	<b>FINANCIAL INFORMATION</b>
Item 1	<a href="#">Consolidated Financial Statements</a> 3
Item 2	<a href="#">Management’s Discussion and Analysis of Financial Condition and Results of Operations</a> 20
Item 3	<a href="#">Quantitative and Qualitative Disclosures about Market Risk</a> 32
Item 4	<a href="#">Controls and Procedures</a> 32
<b>PART II</b>	<b>OTHER INFORMATION</b>
Item 1	<a href="#">Legal Proceedings</a> 33
Item 1A	<a href="#">Risk Factors</a> 33
Item 2	<a href="#">Unregistered Sales of Equity Securities and Use of Proceeds</a> 33
Item 3	<a href="#">Defaults upon Senior Securities</a> 33
Item 4	<a href="#">Mine Safety Disclosures</a> 33
Item 5	<a href="#">Other Information</a> 33
Item 6	<a href="#">Exhibits</a> 33
	<a href="#">Signatures</a> 34

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**ARI Network Services, Inc.**  
**Consolidated Balance Sheets**  
*(Dollars in Thousands, Except per Share Data)*

	<i>(Unaudited)</i> October 31 2015	<i>(Audited)</i> July 31 2015
<b>ASSETS</b>		
Cash and cash equivalents	\$ 3,179	\$ 2,284
Trade receivables, less allowance for doubtful accounts of \$335 and \$372 at October 31, 2015 and July 31, 2015, respectively	2,147	2,046
Work in process	136	165
Prepaid expenses and other	736	820
Deferred income taxes	3,305	3,092
<i>Total current assets</i>	<u>9,503</u>	<u>8,407</u>
Equipment and leasehold improvements:		
Computer equipment and software for internal use	2,936	2,800
Leasehold improvements	629	629
Furniture and equipment	3,012	2,981
<i>Total equipment and leasehold improvements</i>	<u>6,577</u>	<u>6,410</u>
Less accumulated depreciation and amortization	(4,202)	(3,989)
<i>Net equipment and leasehold improvements</i>	<u>2,375</u>	<u>2,421</u>
Capitalized software product costs:		
Amounts capitalized for software product costs	25,836	25,463
Less accumulated amortization	(20,833)	(20,337)
<i>Net capitalized software product costs</i>	<u>5,003</u>	<u>5,126</u>
Deferred income taxes	1,892	2,398
Other intangible assets	9,719	10,116
Goodwill	21,066	21,168
<i>Total non-current assets</i>	<u>40,055</u>	<u>41,229</u>
Total assets	<u>\$ 49,558</u>	<u>\$ 49,636</u>

*See accompanying notes*

**ARI Network Services, Inc.**  
**Consolidated Balance Sheets**  
*(Dollars in Thousands, Except per Share Data)*

	<i>(Unaudited)</i> October 31 2015	<i>(Audited)</i> July 31 2015
<b>LIABILITIES</b>		
Current portion of long-term debt	\$ 1,693	\$ 1,338
Current portion of contingent liabilities	639	754
Accounts payable	785	708
Deferred revenue	6,674	7,327
Accrued payroll and related liabilities	2,207	1,752
Accrued sales, use and income taxes	167	140
Other accrued liabilities	696	748
Current portion of capital lease obligations	121	174
<i>Total current liabilities</i>	<u>12,982</u>	<u>12,941</u>
Long-term debt	8,510	9,079
Long-term portion of contingent liabilities	245	362
Capital lease obligations	94	106
Other long-term liabilities	199	199
<i>Total non-current liabilities</i>	<u>9,048</u>	<u>9,746</u>
Total liabilities	22,030	22,687
<b>SHAREHOLDERS' EQUITY</b>		
Cumulative preferred stock, par value \$.001 per share, 1,000,000 shares authorized; 0 shares issued and outstanding at October 31, 2015 and July 31, 2015, respectively	—	—
Junior preferred stock, par value \$.001 per share, 100,000 shares authorized; 0 shares issued and outstanding at October 31, 2015 and July 31, 2015, respectively	—	—
Common stock, par value \$.001 per share, 25,000,000 shares authorized; 17,169,523 and 17,097,426 shares issued and outstanding at October 31, 2015 and July 31, 2015, respectively	17	17
Additional paid-in capital	114,892	114,700
Accumulated deficit	(87,404)	(87,793)
Other accumulated comprehensive income	23	25
Total shareholders' equity	<u>27,528</u>	<u>26,949</u>
Total liabilities and shareholders' equity	<u>\$ 49,558</u>	<u>\$ 49,636</u>

*See accompanying notes*

**ARI Network Services, Inc.**  
**Consolidated Statements of Operations**  
*(Dollars in Thousands, Except per Share Data)*  
*(Unaudited)*

	<b>Three months ended October 31</b>	
	<b>2015</b>	<b>2014</b>
Net revenue	\$ 11,737	\$ 9,112
Cost of revenue	2,069	1,749
Gross profit	9,668	7,363
Operating expenses:		
Sales and marketing	2,765	2,542
Customer operations and support	2,446	1,690
Software development and technical support (net of capitalized software product costs)	1,255	872
General and administrative	1,785	1,604
Depreciation and amortization (exclusive of amortization of software product costs included in cost of revenue)	609	372
Net operating expenses	8,860	7,080
Operating income	808	283
Other income (expense):		
Interest expense	(112)	(89)
Loss on change in fair value of contingent liabilities	(8)	—
Other, net	—	(1)
Total other income (expense)	(120)	(90)
Income before provision for income tax	688	193
Income tax expense	(299)	(89)
Net income	<u>\$ 389</u>	<u>\$ 104</u>
Weighted average common shares outstanding:		
Basic	17,152	13,693
Diluted	17,604	14,014
Net income per common share:		
Basic	<u>\$ 0.02</u>	<u>\$ 0.01</u>
Diluted	<u>\$ 0.02</u>	<u>\$ 0.01</u>

*See accompanying notes*

**Consolidated Statements of Comprehensive Income (Loss)**  
*(Dollars in Thousands)*  
*(Unaudited)*

	<b>Three months ended October 31</b>	
	<b>2015</b>	<b>2014</b>
Net income	\$ 389	\$ 104
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustments	(2)	9
Total other comprehensive income (loss)	(2)	9
Comprehensive income	<u>\$ 387</u>	<u>\$ 113</u>

*See accompanying notes*

**ARI Network Services, Inc.**  
**Consolidated Statements of Cash Flows**  
(Dollars in Thousands)  
(Unaudited)

	Three months ended October 31	
	2015	2014
<i>Operating activities:</i>		
Net income	\$ 389	\$ 104
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of software products	496	549
Net non-cash interest expense	5	17
Depreciation and other amortization	610	371
Gain on change in fair value of earn-out payable	8	-
Provision for bad debt allowance	25	51
Deferred income taxes	293	69
Stock based compensation	90	68
Stock based director fees	25	35
Net change in assets and liabilities:		
Trade receivables	(102)	(224)
Work in process	29	(22)
Prepaid expenses and other	86	185
Other long-term assets	-	(39)
Accounts payable	71	226
Deferred revenue	(700)	(130)
Accrued payroll and related liabilities	435	230
Accrued sales, use and income taxes	27	-
Other accrued liabilities	(52)	144
<i>Net cash provided by operating activities</i>	<u>\$ 1,735</u>	<u>\$ 1,634</u>
<i>Investing activities:</i>		
Purchase of equipment, software and leasehold improvements	(167)	(21)
Cash paid for contingent liabilities related to acquisitions	(125)	(249)
Cash paid for net assets related to acquisitions	-	(4,200)
Software development costs capitalized	(373)	(341)
<i>Net cash used in investing activities</i>	<u>\$ (665)</u>	<u>\$ (4,811)</u>
<i>Financing activities:</i>		
Borrowings under line of credit, net	\$ -	\$ 1,000
Payments on long-term debt	(151)	(168)
Borrowings under long-term debt	-	2,168
Payments of capital lease obligations	(65)	(55)
Proceeds from exercise of common stock options	43	16
<i>Net cash provided by (used in) financing activities</i>	<u>\$ (173)</u>	<u>\$ 2,961</u>
Effect of foreign currency exchange rate changes on cash	(2)	5
Net change in cash and cash equivalents	895	(211)
Cash and cash equivalents at beginning of period	2,284	1,808
Cash and cash equivalents at end of period	<u>\$ 3,179</u>	<u>\$ 1,597</u>
<i>Cash paid for interest</i>	<u>\$ 113</u>	<u>\$ 74</u>
<i>Cash paid for income taxes</i>	<u>\$ 64</u>	<u>\$ 20</u>
<i>Non-cash investing and financing activities</i>		
Issuance of common stock in connection with acquisitions	\$ -	\$ 1,980
Debt issued in connection with acquisition	-	3,000
Capital leases acquired in connection with acquisitions	-	109
Current assets acquired in connection with acquisitions	32	634
Accrued liabilities assumed in connection with acquisitions	53	-
Issuance of common stock related to payment of contingent liabilities	60	42
Cashless exercise of common stock warrants	46	-
Issuance of common stock related to payment of director compensation	-	31
Issuance of common stock related to payment of employee compensation	-	97
Contingent liabilities incurred in connection with acquisition	(62)	761

See accompanying notes

**ARI Network Services, Inc.**  
**Notes to Consolidated Financial Statements**

**1. Description of the Business and Significant Accounting Policies**

*Description of the Business*

ARI Network Services, Inc. (“ARI” or “the Company”) creates software-as-a-service (“SaaS”), data-as-a-service (“DaaS”) and other solutions that help equipment manufacturers, distributors and dealers in selected vertical markets to Sell More Stuff!™ – online and in-store. We remove the complexity of selling and servicing new and used whole goods inventory and PG&A for customers in the automotive tire and wheel aftermarket (“ATW”), automotive aftermarket parts and service (“AAPS”), powersports, outdoor power equipment (“OPE”), marine, home medical equipment (“HME”), recreational vehicles (“RV”) and appliance industries. Our innovative products are powered by a proprietary library of enriched original equipment and aftermarket content from over 1,800 manufacturers. More than 23,500 equipment dealers, distributors and manufacturers worldwide leverage our web and eCatalog platforms to Sell More Stuff!™

We were incorporated in Wisconsin in 1981. Our principal executive office and headquarters is located in Milwaukee, Wisconsin. The office address is 10850 West Park Place, Suite 1200, Milwaukee, WI 53224, and our telephone number at that location is (414) 973-4300. Our principal website address is [www.arinet.com](http://www.arinet.com). ARI also maintains operations in Cypress, California; Floyds Knobs, Indiana; Des Moines, Iowa; Duluth, Minnesota; Wexford, Pennsylvania; Cookeville, Tennessee; Salt Lake City, Utah; and Leiden, The Netherlands.

*Basis of Presentation*

These consolidated financial statements include the consolidated financial statements of ARI and its wholly-owned subsidiary, ARI Europe B.V. and have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”). We eliminated all significant intercompany balances and transactions in consolidation. All adjustments that, in the opinion of management, are necessary for a fair presentation for the periods presented have been reflected as required by Regulation S-X, Rule 10-01.

*Fiscal Year*

Our fiscal year ends on July 31. References to fiscal 2016, for example, refer to the fiscal year ended July 31, 2016, and references to fiscal 2015 refer to the fiscal year ended July 31, 2015.

*Revenue Recognition*

Revenues from subscription fees for use of our software, access to our catalog content, and software maintenance and support fees are all recognized ratably over the contractual term of the arrangement. The Company has customer contracts with multiple services or elements, which may be delivered at different times. The Company accounts for delivered elements in accordance with the selling price when arrangements include multiple product components or other elements and vendor-specific objective evidence exists for the value of all undelivered elements. Revenue on undelivered elements is recognized when the elements are delivered. ARI considers all arrangements with payment terms extending beyond 12 months not to be fixed or determinable and evaluates other arrangements with payment terms longer than normal to determine whether the arrangement is fixed or determinable. If the fee is not fixed or determinable, revenue is recognized as payments become due from the customer. Arrangements that include acceptance terms beyond the standard terms are not recognized until acceptance has occurred. If collectability is not considered probable, revenue is recognized when the fee is collected.

For software license arrangements that do not require significant modification or customization of the underlying software, the Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collectability is probable.

Revenues for professional services to customize complex features and functionality in a product's base software code or develop complex interfaces within a customer's environment are recognized as the services are performed if they are determined to have standalone value to the customer or if all of following conditions are met i) the customer has a contractual right to take possession of the software; ii) the customer will not incur significant penalty if it exercises this right; and iii) it is feasible for the customer to either run the software on its own hardware or contract with another unrelated party to host the software. When the current estimates of total contract revenue for professional services and the total related costs indicate a loss, a provision for the entire loss on the contract is made in the period the amount is determined. Professional service revenues for set-up and integration of hosted websites, or other services considered essential to the functionality of other elements of the arrangement, are amortized over the term of the contract.

Revenue for variable transaction fees, primarily for use of the shopping cart feature of our websites, is recognized as it is earned.

Amounts received for shipping and handling fees are reflected in revenue. Costs incurred for shipping and handling are reported in cost of revenue.

Amounts invoiced to customers prior to recognition as revenue, as discussed above, are reflected in the accompanying balance sheets as deferred revenue.

No single customer accounted for 10% or more of ARI's revenue during the three months ended October 31, 2015 or 2014.

#### *Trade Receivables, Credit Policy and Allowance for Doubtful Accounts*

Trade receivables are uncollateralized customer obligations due on normal trade terms, most of which require payment within thirty (30) days from the invoice date. Payments of trade receivables are allocated to the specific invoices identified on the customer's remittance advice or, if unspecified, are applied to the earliest unpaid invoices.

The carrying amount of trade receivables is reduced by an allowance that reflects management's best estimate of the amounts that will not be collected. Management individually reviews receivable balances that exceed ninety (90) days from the invoice date and, based on an assessment of current creditworthiness and estimates the portion of the balance that will not be collected. The allowance for potential doubtful accounts is reflected as an offset to trade receivables in the accompanying balance sheets.

#### *Capitalized and Purchased Software Product Costs*

Certain software development and acquisition costs are capitalized when incurred. Capitalization of these costs begins upon the establishment of technological feasibility. The establishment of technological feasibility and the on-going assessment of recoverability of software costs require considerable judgment by management with respect to certain external factors, including, but not limited to, the determination of technological feasibility, anticipated future gross revenue, estimated economic life and changes in software and hardware technologies.

The annual amortization of software products is computed using the straight-line method over the estimated economic life of the product, which currently ranges from two to nine years. Amortization starts when the product is available for general release to customers. The Company capitalizes software enhancements on an on-going basis and all other software development and support expenditures are charged to expense in the period incurred.

#### *Deferred Loan Fees and Debt Discounts*

Fees associated with securing debt are capitalized and shown as contra-debt, reducing the carrying amount of long term debt on the consolidated balance sheet. Deferred loan fees and debt discounts are amortized to interest expense over the life of the debt using the effective interest method.



## Deferred Income Taxes

The tax effect of the temporary differences between the book and tax bases of assets and liabilities and the estimated tax benefit from tax net operating losses is reported as deferred tax assets and liabilities in the consolidated balance sheets. An assessment of the likelihood that net deferred tax assets will be realized from future taxable income is performed at each reporting date or when events or changes in circumstances indicate that there may be a change in the valuation allowance. Because the ultimate realizability of deferred tax assets is highly subject to the outcome of future events, the amount established as a valuation allowance is considered to be a significant estimate that is subject to change in the near term. To the extent a valuation allowance is established or there is a change in the allowance during a period, the change is reflected with a corresponding increase or decrease in income tax expense in the consolidated statements of operations.

## Legal Provisions

ARI is periodically involved in legal proceedings arising from contracts, patents or other matters in the normal course of business. We reserve for any material estimated losses if the outcome is probable and reasonably estimable, in accordance with GAAP. We had no provisions for legal proceedings during the three months ended October 31, 2015 or 2014.

## Recently Adopted Accounting Standards

On August 1, 2015, the Company retrospectively adopted Accounting Standards Update (“ASU”) 2015-03 related to the presentation of debt issuance costs. Debt issuance costs of \$29,000, previously recorded to prepaid expenses and other, and \$84,000, previously recorded to other long-term assets as of July 31, 2015, are now presented as a direct deduction from the carrying amount of long-term debt on the balance sheet as of October 31, 2015.

## 2. Basic and Diluted Net Income per Common Share

Basic net income per common share is computed by dividing net income by the basic weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period and reflects the potential dilution that could occur if all of ARI’s outstanding stock options and warrants that are in the money were exercised (calculated using the treasury stock method).

The following table is a reconciliation of basic and diluted net income per common share (in thousands, except per share data):

	<b>Three months ended October 31</b>	
	<b>2015</b>	<b>2014</b>
Net income	<u>\$ 389</u>	<u>\$ 104</u>
Weighted-average common shares outstanding	17,152	13,693
Effect of dilutive stock options and warrants	452	321
Diluted weighted-average common shares outstanding	<u>17,604</u>	<u>14,014</u>
Net income per share		
Basic	<u>\$ 0.02</u>	<u>\$ 0.01</u>
Diluted	<u>\$ 0.02</u>	<u>\$ 0.01</u>
Options and warrants that could potentially dilute net income per share in the future that are not included in the computation of diluted net income per share, as their impact is anti-dilutive	<u>-</u>	<u>226</u>

### 3. Debt

#### *Silicon Valley Bank*

On April 26, 2013, the Company entered into 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 April 26, 2015 and a \$4,500,000 term loan with a maturity date of April 26, 2018.

On September 30, 2014, in connection with the Company's acquisition of Tire Company Solutions, LLC ("TCS"), the Company entered into the First Loan Modification Agreement (the "Modification Agreement") with SVB, which contained substantial amendments to the terms of the Agreement.

The Modification Agreement includes credit facilities consisting of a \$3,000,000 revolving credit facility with a maturity date of September 30, 2016 and a \$6,050,000 term loan with a maturity date of September 30, 2019. This term loan is an amendment to the existing \$4,500,000 term loan with an original maturity date of April 26, 2018.

The term loan and any loans made under the SVB revolving credit facility accrue interest at a per annum rate equal to the Prime rate plus the Applicable Margin for Prime Rate Loans set forth in the chart below determined based on the Total Leverage Ratio, as defined in the Modification Agreement. The Company had \$0 outstanding on the revolving credit facility and the effective interest rate was 3.75% at October 31, 2015.

<b>Total Leverage Ratio</b>	<b>Applicable Margin for Prime Rate Loans</b>	
$\geq 2.50$ to 1.0:	1.50	%
$> 1.75$ to 1.00 but $< 2.50$ to 1.00:	1.00	%
$\leq 1.75$ to 1.00:	0.50	%

Principal in respect of any loans made under the revolving facility is required to be paid in its entirety on or before September 30, 2016. Principal in respect of the term loan is required to be paid in quarterly installments on the first day of each fiscal quarter of the Company as follows: \$151,250 commenced on November 1, 2014 through August 1, 2016; \$226,875 commencing on November 1, 2016 through August 1, 2017; and \$302,500 commencing on November 1, 2017 through August 1, 2019. All remaining principal in respect of the term loan is due and payable on September 30, 2019. The Company is permitted to prepay all of, but not less than all of, the outstanding principal amount of the term loan upon notice to SVB and, in certain circumstances, the payment of a prepayment penalty of up to \$61,000. Following July 31, 2015, the Modification Agreement requires the Company to make additional payments in the amount of 25% of excess cash flow, as defined in the agreement, until the Company's Total Leverage Ratio is less than 2.00 to 1.00.

The Modification Agreement contains covenants that restrict, among other things and subject to certain conditions, the ability of the Company to permit a change of control, incur debt, create liens on its assets, make certain investments, enter into merger or acquisition transactions and make distributions to its shareholders. Financial covenants include the maintenance of a minimum Total Leverage Ratio equal to or less than 3.00 to 1.00 and the maintenance of a Fixed Charge Coverage Ratio (as defined in the Modification Agreement) equal to or greater than 1.25 to 1.00. The Total Leverage Ratio was 1.34 and the Fixed Charge Ratio was 4.37 for the twelve months ended October 31, 2015. The Modification Agreement also contains customary events of default that, if triggered, could result in an acceleration of the Company's obligations under the Modification Agreement. The loans are secured by a first priority security interest in substantially all assets of the Company.

#### *TCS Promissory Notes*

In connection with the acquisition of TCS, on September 30, 2014, the Company issued two promissory notes (the "Notes") in the aggregate principal amount of \$3,000,000 to the former owners of TCS. In February 2015, the principal amount of the Notes was reduced by \$66,575 as a result of post-closing adjustments to the valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement. The Notes initially accrue interest on the outstanding unpaid principal balance at a rate per annum equal to 5.0%; however, if any amount payable under a Note is not paid when due, such overdue amount will bear interest at the default rate of 7.5% from the date of such non-payment until such amount is paid in full. Accrued interest on the Notes will be due and payable quarterly commencing on December 29, 2014 and continuing on each 90th calendar day thereafter, until September 30, 2018, at which time all accrued interest and outstanding principal balance will be due and payable in full. The first four payments due and payable under the Notes will be interest only payments, and payments of principal and interest shall not commence until the payment due on December 29, 2015. The payments are subject to acceleration upon certain Events of Default, as defined in the Notes.

### DCi Promissory Note

In connection with the acquisition of Direct Communications Inc. (“DCi”), on July 13, 2015, the Company issued a promissory note (the “DCi Note”) in the aggregate principal amount of \$2,000,000 to the former owners of DCi. In October 2015, the principal amount of the DCi Notes was reduced by \$61,038 as a result of post-closing adjustments to the estimated valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement. The DCi Note initially accrues interest on the outstanding unpaid principal balance at a rate per annum equal to 4.0%. Accrued interest on the DCi Note is due and payable quarterly commencing on October 13, 2015 and continuing on each 90th calendar day thereafter, until July 13, 2019, at which time all accrued interest and outstanding principal balance will be due and payable in full. The first four payments due and payable under the DCi Note are interest only payments, and payments of principal and interest shall not commence until the payment due on October 13, 2016. The payments are subject to acceleration upon certain Events of Default, as defined in the DCi Note.

The following table sets forth certain information related to the Company’s long-term debt as of October 31, 2015 and July 31, 2015 (in thousands):

	October 31 2015	July 31 2015
Notes payable principal	\$ 10,317	\$ 10,529
Less debt issuance costs	(114)	(112)
Less current maturities	(1,693)	(1,338)
Notes payable - non-current	<u>\$ 8,510</u>	<u>\$ 9,079</u>

Minimum principal payments due on the SVB Term Note and the TCS Notes are as follows for the fiscal years ending (in thousands):

	SVB Term Note	TCS Notes	DCi Notes	Total Notes Payable
2016	\$ 454	\$ 693	\$ —	\$ 1,147
2017	832	965	643	2,440
2018	1,134	1,014	669	2,817
2019	1,210	261	627	2,098
2020	1,815	—	—	1,815
	<u>\$ 5,445</u>	<u>\$ 2,933</u>	<u>\$ 1,939</u>	<u>\$ 10,317</u>

## 4. Business Combinations

### DCi Acquisition

On July 13, 2015, the Company acquired substantially all of the assets of DCi, a leading provider of differentiated product content and electronic catalog software serving manufacturers, distributors, jobbers and independent retailers in the AAPS. Consideration for the acquisition included: (1) a cash payment equal to \$3,750,000; (2) 159,795 shares of the Company’s common stock; and (3) the issuance of a promissory note in principal amount of \$2,000,000 to DCi. The principal amount of the Notes was reduced by \$61,038 as a result of post-closing adjustments to the estimated valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement.

The Company expects the DCi acquisition to accelerate its growth in the AAPS and provide a platform to further expand the reach of ARI’s data-driven eCommerce websites and automotive point-of-sale software. The combined customer benefits and operational efficiencies are expected to result in a stronger organization that can create more value for our customers, shareholders and employees.

The following tables show the preliminary allocation of the preliminary DCi purchase price (in thousands):

	<b>Preliminary Purchase Price</b>
Cash	\$ 3,750
Financed by note payable	1,939
Issuance of common stock	500
Purchase price	<u>\$ 6,189</u>

  

	<b>Preliminary Purchase Allocation</b>
Trade receivables	\$ 425
Prepaid expense and other	30
Assumed liabilities	(255)
Furniture and equipment	512
Software product costs	607
Intangible assets	2,126
Goodwill	2,744
Purchase price allocation	<u>\$ 6,189</u>

Intangible assets include the fair value of tradenames, customer relationships, and non-competition agreements. Estimated goodwill represents the additional benefits provided to the Company by the acquisition of DCi operational synergies. The Company acquired approximately \$2,900,000 of tax deductible goodwill related to the DCi acquisition. The final purchase price, as well as the purchase price allocation, is subject to the completion of the final valuation of the net assets acquired and the calculation of the working capital adjustment as set forth in the asset purchase agreement. The final valuation is expected to be completed as soon as is practicable but no later than July 13, 2016 and could have a material impact on the preliminary purchase price allocation disclosed above.

#### *TASCO Acquisition*

On April 27, 2015, the Company acquired substantially all of the assets of TASCO Corporation and its affiliated company Signal Extraprise Corporation (collectively "TASCO"), a leading provider of business management software designed exclusively for the automotive tire and wheel aftermarket industry. Consideration for the acquisition included: (1) a cash payment at the closing of the transaction equal to \$1,750,000, which was funded through a borrowing on the Company's revolving credit facility; (2) 242,424 shares of the Company's common stock; and (3) a \$200,000 holdback payable on April 27, 2016. In October 2015, the holdback amount was reduced by \$61,922 as a result of post-closing adjustments to the valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement. The Company determined that the TASCO assets acquired did not constitute a business that is "significant" as defined in the applicable SEC regulations.

The following tables show the preliminary allocation of the purchase price (in thousands):

	<b>Preliminary Purchase Price</b>
Cash	1,750
Issuance of common stock	800
Contingent holdback	138
Purchase price	<u>2,688</u>

  

	<b>Preliminary Purchase Allocation</b>
Trade receivables	120
Assumed liabilities	(227)
Software product costs	291
Intangible assets	1,387
Goodwill	1,117
Purchase price allocation	<u>2,688</u>

The final purchase price, as well as the purchase price allocation, is subject to the completion of the final valuation of the net assets acquired and the calculation of the holdback payment, which is subject to set-off and a working capital adjustment as set forth in the asset purchase agreement. The final valuation is expected to be completed as soon as is practicable but no later than April 27, 2016 and could have a material impact on the preliminary purchase price allocation disclosed above.

#### *TCS Acquisition*

On September 30, 2014, the Company acquired substantially all of the assets of TCS, a leading provider of software, websites and digital marketing services designed exclusively for dealers, wholesalers, retreaders and manufacturers within the automotive tire and wheel industries. Consideration for the acquisition included (1) a cash payment equal to \$4,200,000; (2) 618,744 shares of the Company's common stock; (3) the issuance of two promissory notes in aggregate principal amount of \$2,933,000 (as adjusted) to the former owners of TCS; and (4) a contingent earn-out purchase price contingent upon the attainment of specific revenue goals over the first three years following the acquisition.

The TCS acquisition increased the Company's portfolio of ATW dealer websites by more than 30%. The acquisition is expected to accelerate ARI's opportunity to drive organic growth through the cross-selling of new products. It also provides solutions for the entire ATW supply chain, including wholesalers, retreaders and manufacturers. The TCS business offers a business management solution for ATW dealers as well as for auto repair shops. The combined customer benefits and operational efficiencies are expected to result in a stronger organization that can create more value for our customers, shareholders and employees.

The acquisition was funded from cash on hand, an increase in our SVB Term Loan, funds available on our revolving credit facility seller financing and the Company's common stock. The following tables show the allocation of the purchase price (in thousands):

	<b>Purchase Price</b>
Cash	\$ 4,200
Financed by note payable	2,933
Issuance of common stock	1,980
Contingent earn-out	711
Purchase price	<u>\$ 9,824</u>

	<b>Purchase Allocation</b>
Trade receivables	\$ 606
Prepaid expense and other	33
Assumed liabilities	(668)
Furniture and equipment	117
Software product costs	820
Intangible assets	4,080
Goodwill	4,836
Purchase price allocation	<u>\$ 9,824</u>

Intangible assets include the fair value of tradenames, customer relationships, and non-competition agreements. Estimated goodwill represents the additional benefits provided to the Company by the acquisition of TCS operational synergies. The Company cannot determine revenue and expenses specifically related to the TCS operation since the date of acquisition, as we have begun integration of the businesses. The Company acquired approximately \$5,200,000 of tax deductible goodwill related to the TCS acquisition.

#### *Pro Forma Information*

The following unaudited pro forma combined financial information presents the Company's results as if the Company had acquired TCS and DCI on August 1, 2014. The unaudited pro forma information has been prepared with the following considerations:

- i. The unaudited pro forma condensed consolidated financial information has been prepared using the acquisition method of accounting under existing GAAP. The Company is the acquirer for accounting purposes.
- ii. The pro forma combined financial information does not reflect any operating cost synergy savings that the combined company may achieve as a result of the acquisition, the costs necessary to achieve these operating synergy savings or additional charges necessary as a result of the acquisition.

The unaudited pro forma financial information presented is for information purposes only and does not purport to represent what the Company's, TCS's or DCi's financial position or results of operations would have been had the acquisition in fact occurred on such date or at the beginning of the period indicated, nor does it project the Company's and TCS's financial position or results of operation for any future date or period.

	Three months ended October 31	
	2015	2014
Revenue	\$ 11,737	\$ 10,972
Net income	\$ 389	\$ 203
Net income per common share:		
Basic	\$ 0.02	\$ 0.01
Diluted	\$ 0.02	\$ 0.01

Pro forma adjustments to net income include amortization costs related to the acquired intangible assets, acquisition-related professional fees, interest expense on the debt incurred to acquire the assets of TCS and DCi, and the tax effect of the historical TCS and DCi results of operations and the pro forma adjustments at an estimated tax rate of 40% as follows:

	Three months ended October 31	
	2015	2014
Amortization of intangible assets	-	126
Acquisition-related professional fees	-	(210)
Interest expense	-	65
Income tax benefit (expense)	-	66

The Company reduced goodwill by approximately \$100,000 during the quarter ended October 31, 2015, as a result of adjustments to the preliminary purchase price allocation of the TCS, TASC0 and DCi acquisitions. The Company cannot determine revenue and expenses specifically related to its acquisitions since the date of acquisition, as we begin integrating these operations into our business upon closing of the acquisitions.

## 5. Contingent Liabilities

Consideration for the April 2015 TASC0 acquisition includes a \$138,078 (as adjusted) holdback payable on April 27, 2016, contingent on the final working capital balance of TASC0 as of the transaction close date.

Consideration for the September 2014 TCS acquisition includes a contingent earn-out purchase price payable in three potential payments and contingent upon the attainment of specific revenue goals. The earn-out does not have an upper range, however, the payout at 100% per the asset purchase agreement is \$933,000 and the estimated fair value is \$711,000 at July 31, 2015.

Consideration for the 2012 Ready2Ride acquisition included a contingent hold-back purchase price of up to \$250,000 and contingent earn-out payments as follows: (i) the first earn-out payment, composed of \$125,000 was paid in October 2013 and 10,000 shares of common stock issued in November 2013; (ii) the second earn-out payment, composed of \$125,000 and 15,000 shares of common stock, was paid in September 2014; and (iii) the third earn-out payment, composed of \$125,000 and 15,000 shares of common stock, was paid in August 2015.

The following table shows changes in the holdback and earn-out payable related to the Ready2Ride, TCS and TASC0 acquisitions (in thousands):

	Three months ended October 31	
	2015	2014
Beginning balance	\$ 1,116	\$ 448
Additions	-	761
Adjustments	(62)	-
Payments	(186)	(292)
Imputed interest recognized	8	9
Loss on change in fair value of earn-out	8	-
Ending balance	\$ 884	\$ 926
Less current portion	\$ (639)	\$ (165)
Ending balance, long-term	\$ 245	\$ 761

The following table shows the remaining estimated payments of contingent liabilities related to the TCS and TASCO acquisitions at October 31, 2015, (in thousands):

	2016	\$	514
	2017		268
	2018		114
	2019		22
	Total estimated payments		918
	Less imputed interest		(34)
	Present value of contingent liabilities	\$	<u>884</u>

## 6. Other Intangible Assets

Amortizable intangible assets include customer relationships and other intangibles including trade names and non-compete agreements. Amortizable intangible assets are composed of the following at October 31, 2015 and 2014 (in thousands):

	Three months ended October 31, 2014			Wtd. avg. remaining life
	Cost Basis	Accumulated Amortization	Net Value	
<b>Customer relationships</b>				
Beginning balance	\$ 7,174	\$ (3,584)	\$ 3,590	
Activity	2,270	(199)	2,071	
Ending balance	<u>\$ 9,444</u>	<u>\$ (3,783)</u>	<u>\$ 5,661</u>	9.00
<b>Other intangibles</b>				
Beginning balance	\$ 383	\$ (361)	\$ 22	
Activity	1,390	(16)	1,374	
Ending balance	<u>\$ 1,773</u>	<u>\$ (377)</u>	<u>\$ 1,396</u>	4.86
<b>Total intangibles</b>				
Beginning balance	\$ 7,557	\$ (3,945)	\$ 3,612	
Activity	3,660	(215)	3,445	
Ending balance	<u>\$ 11,217</u>	<u>\$ (4,160)</u>	<u>\$ 7,057</u>	8.20
	Three months ended October 31, 2015			Wtd. avg. remaining life
	Cost Basis	Accumulated Amortization	Net Value	
<b>Customer relationships</b>				
Beginning balance	\$ 11,947	\$ (4,418)	\$ 7,529	
Activity	—	(285)	(285)	
Ending balance	<u>\$ 11,947</u>	<u>\$ (4,703)</u>	<u>\$ 7,244</u>	11.84
<b>Other intangibles</b>				
Beginning balance	\$ 3,203	\$ (616)	\$ 2,587	
Activity	—	(112)	(112)	
Ending balance	<u>\$ 3,203</u>	<u>\$ (728)</u>	<u>\$ 2,475</u>	3.09
<b>Total intangibles</b>				
Beginning balance	\$ 15,150	\$ (5,034)	\$ 10,116	
Activity	—	(397)	(397)	
Ending balance	<u>\$ 15,150</u>	<u>\$ (5,431)</u>	<u>\$ 9,719</u>	11.13

## 7. Stock-based Compensation Plans

The Company uses the Black-Scholes model to value stock options granted. Volatility is calculated as managements' estimate of future volatility over the expected term of the option based on historical volatility of the Company's stock. The expected life of options granted represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the contractual term of the options is based on the United States Treasury yields in effect at the time of grant.

Stock options granted to employees under the Company's stock option plan typically vest 25% on the first anniversary of the grant and 25% on the one year anniversary of each of the three following years. Stock options granted to non-employee directors under the Company's stock option plan typically vest 50% on the first anniversary of the grant and 50% on the next one year anniversary. The Company recognizes stock option expense over the vesting period for each vesting tranche.

As recognizing stock-based compensation expense is based on awards ultimately expected to vest, the amount of recognized expense has been reduced for estimated forfeitures based on the Company's historical experience. Total stock option compensation expense recognized by the Company was approximately \$24,000 and \$29,000 during the three month periods ended October 31, 2015 and 2014, respectively. There was approximately \$112,000 and \$276,000 of total unrecognized compensation costs related to non-vested options granted under the Company's stock option plans as of October 31, 2015 and 2014, respectively. Total unrecognized compensation cost will be adjusted for any future changes in estimated and actual forfeitures. There were no capitalized stock-based compensation costs during the periods presented.

The following table shows the weighted average assumptions used to estimate the fair value of options granted:

	<b>Three months ended October 31</b>	
	<b>2015</b>	<b>2014</b>
Expected life (years)	n/a	5.1
Risk-free interest rate	n/a	1.7%
Expected volatility	n/a	65.2%
Expected forfeiture rate	9.4%	8.4%
Expected dividend yield	n/a	-
Weighted-average estimated fair value of options granted during the year	n/a	\$ 1.78
Cash received from the exercise of stock options	\$ 44,000	\$ 24,500

### *2000 Stock Option Plan*

The Company's 2000 Stock Option Plan (the "2000 Plan") had 1,950,000 shares of common stock authorized for issuance. Each incentive stock option that was granted under the 2000 Plan is exercisable for a period of not more than ten years from the date of grant (five years in the case of a participant who is a 10% shareholder of the Company, unless the stock options are nonqualified), or such shorter period as determined by the Compensation Committee, and shall lapse upon the expiration of said period, or earlier upon termination of the participant's employment with the Company. The 2000 Plan expired on December 13, 2010, at which time it was terminated except for outstanding options. While options previously granted under the 2000 Plan will continue to be effective through the remainder of their terms or until exercised, no new options may be granted under the 2000 Plan.



Changes in option shares under the 2000 Plan during the three months ended October 31, 2015 were as follows:

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Intrinsic Value
Outstanding at 7/31/15	472,250	\$ 1.52	2.52	\$ 783,174
Granted	-	n/a	n/a	n/a
Exercised	(20,000)	0.65	n/a	n/a
Forfeited	-	n/a	n/a	n/a
Outstanding at 10/31/15	452,250	\$ 1.56	2.36	\$ 963,184
Exercisable at 10/31/15	452,250	\$ 1.56	2.36	\$ 963,184

The range of exercise prices for options outstanding under the 2000 Plan was \$0.49 to \$2.275 at October 31, 2015.

#### 2010 Equity Incentive Plan

The Board of Directors adopted the ARI Network Services, Inc. 2010 Equity Incentive Plan (as amended, the "2010 Plan") on November 9, 2010. The plan was approved by the Company's shareholders in December 2010, and amendments to the 2010 Plan were approved by the Company's shareholders in January 2014. The 2010 Plan is the successor to the Company's 2000 Plan. There are 1,850,000 shares of Company common stock authorized for issuance under the 2010 Plan. Potential awards under the 2010 Plan include incentive stock options and non-statutory stock options, shares of restricted stock or restricted stock units, stock appreciation rights ("SARs), and shares of common stock. Up to 1,525,000 of the shares authorized for issuance under the 2010 Plan may be used for common stock, restricted stock or restricted stock unit awards.

The exercise price for options and SARs under the 2010 Plan cannot be less than 100% of the fair market value of the Company's common stock on the date of grant, and the exercise prices for options and SARs cannot be repriced without shareholder approval, except to reflect changes to the capital structure of the Company as described in the 2010 Plan. The maximum term of options and SARs under the 2010 Plan is 10 years. The 2010 Plan does not have liberal share counting provisions (such as provisions that would permit shares withheld for payment of taxes or the exercise price of stock options to be re-granted under the plan).

Changes in option shares under the 2010 Plan during the three months ended October 31, 2015 were as follows:

	Number of Options	Wtd. Avg. Exercise Price	Wtd. Avg. Remaining Contractual Period (Years)	Aggregate Intrinsic Value
Outstanding at 7/31/15	434,751	\$ 2.34	7.47	\$ 387,964
Granted	-	n/a	n/a	n/a
Exercised	(25,000)	1.23	n/a	n/a
Forfeited	(2,500)	1.00	n/a	n/a
Outstanding at 10/31/15	407,251	\$ 2.42	7.54	\$ 518,887
Exercisable at 10/31/15	257,003	\$ 2.07	7.09	\$ 415,897

The range of exercise prices for options outstanding under the 2010 Plan was \$0.59 to \$3.61 at October 31, 2015.

Changes in the 2010 Plan's non-vested option shares included in the outstanding shares above during the nine months ended October 31, 2015 were as follows:

	Number of Options	Wtd. Avg. Exercise Price
Non-vested at 7/31/15	161,498	\$ 2.99
Granted	-	n/a
Vested	(8,750)	3.22
Forfeited	(2,500)	1.00
Non-vested at 10/31/15	150,248	\$ 3.00

The weighted average remaining vesting period was 2.05 years at October 31, 2015.

### Employee Stock Purchase Plan

The Company's 2000 Employee Stock Purchase Plan, as amended, ("ESPP") has 575,000 shares of common stock reserved for issuance, of which 263,974 and 224,955 of the shares have been issued as of October 31, 2015 and 2014, respectively. All employees with at least nine months of service are eligible to participate. Shares may be purchased at the end of a specified period at the lower of 85% of the market value at the beginning or end of the specified period through accumulation of payroll deductions, not to exceed 5,000 shares per employee per year. The Company expensed \$20,000 and \$0 related to the ESPP discount during the three months ended October 31, 2015 and 2014, respectively.

### Restricted Stock

Up to 1,525,000 of the shares authorized for issuance under the 2010 Plan may be granted in the form of shares of common stock, restricted stock or restricted stock units. The Company grants restricted stock to its directors as an annual retainer, its officers under the LTEB and from time to time to directors, officers or employees as incentive compensation or as discretionary compensation in place of cash.

The Compensation Committee adopted the Long-Term Executive Bonus Plan ("LTEB") for eligible executive officers of the Company effective beginning in fiscal 2013. In March 2015, the Compensation Committee issued 550,000 shares of restricted stock under the LTEB, which will vest according to the following schedule:

- 30% when the volume weighted average price of the Company's common stock for the previous 30 trading day period (the "30-day VWAP") equals or exceeds trades at or above \$6.00
- 20% when the 30-day VWAP equals or exceeds \$7.00
- 20% when the 30-day VWAP equals or exceeds \$8.00
- 30% when the 30-day VWAP equals or exceeds \$9.00

Under the plan described above, a target price must be reached within a four-year period starting on the date of grant for any restricted stock to vest. All unvested restricted stock will be forfeited when the four-year period expires. The initial value of the common stock granted under the LTEB was approximately \$350,000, valued using a Monte Carlo Simulation with a 46% volatility rate and a 1.34% risk free interest rate, and is expensed over the vesting period. The remaining balance of unrecognized compensation expense related to the fiscal 2015 LTEB is \$282,000.

The Company recognized compensation expense of \$73,000 and \$74,000 during the three months ended October 31, 2015 and 2014, respectively related to restricted stock expensed over the vesting period. The remaining balance of unrecognized compensation expense related to restricted stock was \$462,000 at October 31, 2015.

Changes in unvested restricted shares of common stock under the 2010 Plan during the three months ended October 31, 2015 and 2014 were as follows:

	Three months ended October 31	
	2015	2014
Beginning balance unvested restricted stock	671,211	93,704
Granted	-	29,819
Vested	(10,995)	(28,610)
Forfeited	(939)	-
Ending balance unvested restricted stock	659,277	94,913

## 8. Income Taxes

The unaudited provision for income taxes for the three months ended October 31, 2015 and 2014 is composed of the following (in thousands):

	<u>Three months ended October 31</u>	
	<u>2015</u>	<u>2014</u>
Current:		
Federal	\$ —	\$ (2)
State	(6)	(18)
Change in valuation allowance	—	—
Deferred, net	(293)	(69)
Income tax expense	<u>\$ (299)</u>	<u>\$ (89)</u>

The provision for income taxes is based on taxes payable under currently enacted tax laws and an analysis of temporary differences between the book and tax bases of the Company's assets and liabilities, including various accruals, allowances, depreciation and amortization, and does not represent current taxes due. The tax effect of these temporary differences and the estimated benefit from tax net operating losses are reported as deferred tax assets and liabilities in the consolidated balance sheet. We have unused net operating loss carry forwards ("NOLs") for federal income tax purposes, and as a result, we generally only pay alternative minimum taxes at the federal level.

The Company also has NOLs related to tax losses incurred by its Netherlands operation. Under tax laws in the Netherlands, NOLs are able to be carried forward for a period of nine years. The Company has determined that, consistent with prior periods, it is not likely that the net operating losses will be utilized by the Company. This conclusion was primarily based on the negative evidence of a history of losses and expired NOLs related to this entity. In the opinion of the management of the Company, there is not enough positive evidence to overcome this negative evidence. Therefore, a full valuation allowance is recorded, resulting in \$0 net deferred tax assets related to the Netherlands operation at October 31, 2015 and 2014.

As of October 31, 2015, the Company had accumulated NOLs for federal, state and international tax purposes of approximately \$4,401,000, \$12,144,000 and \$2,081,000, respectively.

We perform an evaluation of uncertain tax positions as a component of income tax expense on an annual basis. We determined that ARI did not have any significant risk related to income tax expense and therefore no amounts were reserved for uncertain tax positions as of October 31, 2015 and 2014. We will accrue and recognize interest and penalties related to uncertain tax positions as a component of income tax expense if it becomes necessary. Fiscal years subsequent to 2011 remain open and subject to examination by state tax jurisdictions and the United States federal tax authorities.

## **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, 2015 and 2014, 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 entitled "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 data-driven software tools and marketing services to help dealers, equipment manufacturers and distributors in selected vertical markets Sell More Stuff!™ – online and in-store. Our innovative products are powered by a proprietary data repository of enriched original equipment and aftermarket electronic content of 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 for customers in the automotive tire and wheel aftermarket ("ATW"), automotive aftermarket parts and service ("AAPS"), powersports, outdoor power equipment ("OPE"), marine, home medical equipment ("HME"), recreational vehicles ("RV") and appliance industries. More than 23,500 equipment dealers, distributors and manufacturers worldwide leverage our web and eCatalog platforms to Sell More Stuff!™

### **Our Solutions**

We offer software as a service ("SaaS") and data as a service ("DaaS") solutions to help our customers Sell More Stuff!™ both online and in-store. Our primary solutions include: (i) *Lead Generation and eCommerce Websites*, which provide a web presence for dealers and wholesalers, and serve as a platform for driving leads and eCommerce sales; (ii) *eCatalogs*, which drive sales of inventory and PG&A at the dealer's parts counter, their online website and other sources through parts lookup of our proprietary data repository; (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 solutions* designed to generate leads and drive traffic both to the dealer's website and brick-and-mortar location.

Our solutions also improve our customers' 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 SaaS and DaaS 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, approximately 90% of our revenues are recurring.

### *Lead Generation and eCommerce Websites*

Our Lead Generation and eCommerce-enabled website solutions provide consumers with information about a dealership and its product lines through our extensive library of electronic catalog content and allow consumers to obtain information on whole goods and purchase PG&A via the dealer's website 24 hours a day, 7 days a week. Our website solutions are tailored to each of the vertical markets we serve and are tightly integrated with our electronic library of inventory and PG&A content. 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 generated leads through email campaigns, automated responses, sales team reminders, and other lead generating activities, increasing conversion rates and ultimately revenues for our customers.

Websites are sold through our inside sales teams, which are aligned by vertical market. The sales process will typically include a live demo of the site and may even include a free trial period (we refer to these as "test drives"). In addition to monthly recurring subscription fees, we may also charge a nominal, 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 estimate that as of October 31, 2015, we host and maintain more than 7,000 websites for dealers across all of our vertical markets.

### *eCatalog Platform Solutions*

Our eCatalog solutions leverage our industry-leading library of electronic whole goods, aftermarket PG&A and OEM Parts content to allow manufacturers, distributors, dealers and consumers to view and interact with this information to efficiently support the sales and service of equipment either in-store or online. We offer a variety of both DaaS and SaaS eCatalog products tailored to the specific industries we serve.

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 a new offering, as a result of our acquisitions of Tire Company Solutions, LLC (TCS) in September 2014 and TASCO Corporation (TASCO) in April 2015, and are currently only offered in the ATW and AAPS aftermarkets.

### *Digital Marketing Services*

ARI complements our suite of data-driven software tools with digital marketing services that deliver the engaging experiences that today's consumers demand. ARI's digital marketing services include search engine optimization, email marketing, social media management, search engine marketing ("PPC"), online reputation management and online directory management to help dealers drive more online leads, eCommerce sales and in-store traffic.

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

We also believe 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. 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 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 and support fees and hosting fees. We define churn as the percentage of RR that does not renew. RR increased 31.4%, or \$2,559,000 to 91.2% of total revenue for the first three months of fiscal 2016, compared to the same period last year. To improve on these results, 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 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. We have recently released a number of new features, upgrades and products, including the following:

#### *Web Platforms*

- Online Inventory Purchasing - we released a new feature that allows consumers to purchase in-stock major units online, enabling consumers to pay and request in-store pickup or shipping of items such as motorcycles, chainsaws, lawn mowers and other major units.
- New Payment Integration - we released an additional automated credit card processor option to enhance our offering for dealers. ChargeltPro is also an exclusive partner with Ideal Systems, a leading dealer management system that ARI has integrations with in the OPE market. The integrated solution helps fully automate the process of processing e-commerce orders and collecting payment via ARI’s websites.
- Optimized Lead Forms – we released an improved version of our key unit request lead form, which is the most frequently completed lead form across all of our websites. The optimized version significantly simplifies the process and information required for consumers to submit a quote request. This update reduces form abandonment and increases lead conversion rates across the platform in each industry.
- Local SEO Enhancements – we significantly enhanced all major unit shopping areas of the website to boost the Search Engine ranking of our customers for those items, helping to increase traffic and sales. The enhancements specifically helped strengthen the organic search position of our dealers for brand and unit searches in their geographic region.
- Consumer Inventory Availability Notifications – we released a major unit inventory feature that allows consumers to enter details on the major unit products they're interested in purchasing and receive automated email notifications when matching units become available. Dealers are provided reporting on active customer search requests, which can help dealers target inventory acquisitions that match customer demand.
- Enhanced Inventory Search Options – we released new search refinements options so now dealers have more control over the inventory/brochure menus on their search results pages, enabling dealers to tailor the shopping experience to their unique market’s needs. This enhancement helps provide consumers with the most relevant search refinement options matched to their intent.
- Expansion To New Markets – We have tailored the Endeavor website platform to address the unique needs of the Recreational Vehicle market. Supporting the release of Endeavor in this market, we have completed integration and partnership with Sys2K™, a leading provider of dealer management software for RV dealers and manufacturers. Through this partnership, ARI and Sys2K are jointly marketing the integrated solution to current Sys2K customers as well as dealers in the broader market.
- Exclusive CDK Integration Expansion – we worked closely with CDK to develop an improved unit inventory integration on top of their core specification. This new integration provides ARI with exclusive access to more comprehensive parts and unit information that enable more frequent synchronization of data and quicker turnaround times for updating inventory on dealers’ websites.

### *eCatalog Platforms*

- New Business System Integration - we completed a new business system integration with PartSmart®, our in-store OEM parts lookup solution. This provides pricing, inventory and picklist integration with AGN, the business management system of choice for Harley-Davidson dealers in India.
- Data Manager® Development – we performed significant development on the next generation of Data Manager®, our OEM parts product information management software. This next generation platform is being designed to reduce OEM publishing costs and time to market through real-time publishing, ensuring end users have access to the most accurate and rich part and service information across ARI’s software ecosystem.

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 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. Our content acquisition and enhancement activities to date for this Fiscal Year included:
  - New Market Product Information - We completed the addition of RV Major Unit information and floorplans encompassing over 45 manufacturers, supporting the entry of the Endeavor website platform into the RV market.
  - International Catalog Expansion - We’ve further expanded our robust library of international parts catalogs, now encompassing more than 55 manufacturers.
  - PG&A Content Expansion - We authored, enriched and added over 32,000 new parts to our PG&A product content collection. This serves to strengthen our strategy of providing dealers and consumers with timely access to new products, as well as an expansive variety of accessory options.
  - The inclusion of Automotive Aftermarket Performance and Accessory content with the DCi acquisition adds over a million parts into the ARI service offering.
- *Enter new markets.* ARI currently maintains a significant share in our core vertical markets of OPE, powersports, marine 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 substantial organic growth rates. Including the acquisition of TCS, ARI currently has more than 3,000 dealer websites in the ATW market. We estimate that the total market approximates 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 an early stage with respect to eCommerce adoption. We recently invested in dedicated resources designed to expedite our growth in this market.
- *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 OEMs outside the U.S. and make changes to our existing products 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 2014 and 2015, we added 15 new catalog content offerings in the international outdoor power equipment market.

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

In order to achieve sustained double-digit 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. On a trailing twelve month basis, churn was 15.8% for the period ending October 31, 2015, compared to 12.9% for the same period last year. The increase was due to the termination of a bulk license arrangement with an OEM, price increases for some legacy customers who had heavily discounted pricing, and the growth in website revenue which tends to have a higher churn rate. 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’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*

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 have one or more of the following attributes: (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.

Since the program’s inception, we have closed 16 acquisitions. A summary of some of our most recent acquisitions is as follows:

<b>Acquisition</b>	<b>Date</b>	<b>Strategy</b>
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. (Retail Division)	November 2012	▪ A market leader in the powersports industry ▪ 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



## Acquisitions

On July 13, 2015, the Company acquired substantially all of the assets of Direct Communications Inc. (DCi), a leading provider of differentiated product content and electronic catalog software serving manufacturers, distributors, jobbers and independent retailers in AAPS. Consideration for the acquisition included: (1) a cash payment equal to \$3,750,000; (2) 159,795 shares of the Company's common stock; and (3) the issuance of a promissory note in principal amount of \$2,000,000 to DCi. The principal amount of the Notes was reduced by \$61,038 as a result of post-closing adjustments to the valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement.

On April 27, 2015, the Company acquired substantially all of the assets of TASC0, a leading provider of business management software designed exclusively for the automotive ATW aftermarket industry. Consideration for the acquisition included: (1) a cash payment at the closing of the transaction equal to \$1,750,000; (2) 242,424 shares of the Company's common stock; and (3) a \$200,000 holdback payable on April 27, 2016. The holdback amount was reduced by \$61,922 as a result of post-closing adjustments to the estimated valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement.

On September 30, 2014, the Company acquired substantially all of the assets of TCS, a leading provider of software, websites and marketing services designed exclusively for the automotive ATW vertical. Consideration for the acquisition included: (1) a cash payment equal to \$4,200,000; (2) 618,744 shares of the Company's common stock; (3) the issuance of two promissory notes initially in aggregate principal amount of \$3,000,000 to the former owners of TCS. The principal amount of the notes was reduced by \$67,000 to \$2,933,000 as a result of post-closing adjustments to the valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement; and (4) a contingent earn-out purchase price payable in three potential payments and contingent upon the attainment of specific revenue goals. The earn-out does not have an upper range, however, the payout at 100% per the asset purchase agreement is \$933,000 and the estimated fair value is \$711,000.

The Company's strategy is to integrate the sales teams from acquisitions as quickly as possible in order to realize cross selling synergies. As a result, we do not track revenues and costs specific to the individual acquired businesses.

## Summary of Operating Results

Total revenue increased 28.8%, or \$2,625,000, for the three months ended October 31, 2015 to \$11,737,000, compared to \$9,112,000 for the same period last year. Recurring revenue constituted 91.2% of our total revenue for the three months ended October 31, 2015 compared to 89.4% for the same period last year. Recurring revenue increased 31.4% to \$10,709,000 during the three months ended October 31, 2015, compared to 8,150,000 during the same period last year. The growth in year over year total revenue was attributable to incremental revenue from the TCS business acquired in September 2014, the TASC0 business acquired in April 2015 and the DCi business acquired in July 2015, as well as organic growth in revenue from ARI's historical products, most notably the lead generation and website offerings.

Operating income increased 185.5%, or \$525,000, from \$283,000 for the three months ended October 31, 2014 to \$808,000 for the same period this year. The increase is a result of less transaction expenses in the period when compared to last year and increased operational efficiencies, primarily in sales and marketing and general and administrative expenses. Net operating expenses increased 25.1%, from \$8,860,000, during the three month period ended October 31, 2015, compared to \$7,080,000 during the same period last year, primarily due to the additional costs of the acquired company's operations.

Net income was \$389,000, or \$0.02 per share, for the three months ended October 31, 2015, compared to \$104,000, or \$0.01 per share, for the same period last year.

Cash provided by operations was \$1,735,000 for the three months ended October 31, 2015 compared to \$1,634,000 for the same period last year, primarily as a result of revenue growth and operational efficiencies.

## Revenue

The following table summarizes our product revenue and RR and non-recurring revenue for the three months ended October 31 (in thousands):

	Three months ended October 31				
	2015	% of Total	2014	Total	% Change
Lead Generation and eCommerce Websites	\$ 5,868	50.0 %	\$ 4,816	52.9 %	21.8 %
eCatalog Services	4,515	38.5 %	3,476	38.1 %	29.9 %
Business Management Software	809	6.9 %	122	1.3 %	100.0 %
Digital Marketing Services	356	3.0 %	231	2.5 %	54.1 %
Other Revenue	189	1.6 %	467	5.1 %	(59.5)%
Total revenue	<u>\$ 11,737</u>	<u>100.0 %</u>	<u>\$ 9,112</u>	<u>100.0 %</u>	<u>28.8 %</u>
Recurring revenue	10,709	91.2	8,150	89.4	31.4 %
Non-recurring revenue	1,028	8.8	962	10.6	6.9 %
Total revenue	<u>\$ 11,737</u>	<u>100.0 %</u>	<u>\$ 9,112</u>	<u>100.0 %</u>	<u>28.8 %</u>

Total revenue increased 28.8%, or \$2,625,000, for the three months ended October 31, 2015 to \$11,737,000, compared to \$9,112,000 for the same period last year. RR increased 31.4%, or \$2,559,000, to \$10,709,000 for the three months ended October 31, 2015, compared to \$8,150,000 for the same period last year. RR represented 91.2% of total revenues in the first three months of fiscal 2016 versus 89.4% in the first three months of fiscal 2015. The increase in RR as a percentage of total revenue for the three months ended October 31, 2015, was related to the incorporation of the DCi operations this period and a higher portion of non-recurring professional services revenue in the period ending October 31, 2014. We continue to focus on achieving recurring revenue of 90% or greater.

### *Lead Generation and eCommerce Website Revenue*

Our lead generation and eCommerce website solutions generate revenue from one-time set-up 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 50.0% of total revenue during the three months ended October 31, 2015. Lead generation and eCommerce revenue increased 21.8% to \$5,868,000 for the three months ended October 31, 2015, compared to the same period last year. The growth in Website revenue was the result of both organic growth and our acquisition of TCS in September 2014. We anticipate that our web platforms will continue to be the Company's largest source of growth, with much of this growth coming in the ATW market.

### *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 38.5% of total revenue during the three months ended October 31, 2015. eCatalog revenue increased 29.9% or \$1,039,000 during the three months ended October 31, 2015 to \$4,515,000, compared to \$3,476,000 during the same period last year, primarily due to our acquisition of DCi in July of 2015. 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.

### *Business Management Software*

Business management software revenue is generated from perpetual one-time license and installation fees for our new business management software, along with recurring maintenance and support fees, as well as hosting fees for our SaaS version. These products were acquired as part of the TASC0 and TCS acquisitions. Business management software revenue was \$809,000 and represented 6.9% of total revenue during fiscal 2015. The increase in revenue of \$687,000, when compared to the same period in the prior year, was a result of the acquisitions of TCS in September 2014 and TASC0 in April 2015.

### *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. Total digital marketing revenue increased 54.1% to \$356,000 during the three months ended October 31, 2015, compared to the same period last year. We expect digital marketing revenue to continue to increase over the prior year as we continue to grow this business.

### *Other Revenue*

We also offer a suite of complementary solutions, which include software and website customization services, perpetually licensed software and hosting services. Other revenue, which is primarily non-recurring in nature, decreased 59.5% to \$189,000 during the three months ended October 31, 2015, compared to the same period last year. The decrease in other revenue is principally due to a large one time service contract with one of our major manufacturers resulting in revenue during the three months ended October 31, 2014.

### *Recurring Revenue*

RR is one of the most important growth drivers of our business. 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 31.4%, or \$2,559,000, for the three months ended October 31, 2015, compared to the same period last year. The growth in RR was primarily attributable to both the addition of RR from our acquisitions of TCS, TASC0 and DCi and organic growth. We expect RR to continue to grow in as compared to the comparable periods throughout fiscal 2016.

### *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 revenues were \$1,028,000 for the three months ended October 31, 2015, versus \$962,000 for the same period last year, an increase of 6.9%, primarily due to an increase in non-recurring revenues related to perpetual license revenue for our business management offerings and other non-recurring revenue related to our acquired businesses. These increases are partially offset by a large one time service contract with one of our major manufacturers which resulted in non-recurring revenue during the three months ended October 31, 2014.

Our goal is to maintain non-recurring revenues of less than 10% of total revenues, as the margins on these revenues tend to be lower than our RR products. Furthermore, these revenues 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 for the three months ended October 31 (in thousands):

	Three months ended October 31				
	2015	% of Revenue	2014	% of Revenue	% Change
Net revenues	\$ 11,737		\$ 9,112		28.8 %
Cost of revenues:					
Amortization of capitalized software costs	496	4.2 %	549	6.0 %	(9.7) %
Direct labor	642	5.5 %	476	5.2 %	34.9 %
Other direct costs	931	7.9 %	724	7.9 %	28.6 %
Total cost of revenues	2,069	17.6 %	1,749	19.2 %	18.3 %
Gross profit	<u>\$ 9,668</u>	<u>82.4 %</u>	<u>\$ 7,363</u>	<u>80.8 %</u>	<u>31.3 %</u>

Gross profit was \$9,668,000 or 82.4% of revenue for the three months ended October 31, 2015, compared to \$7,363,000 or 80.8% of revenue for the same period last year. Amortization of capitalized software costs as a percentage of revenue decreased for the three months ended October 31, 2015, compared to the same period last year, primarily due to revenue increasing at a faster rate than software amortization costs. Direct labor costs as a percentage of revenue increased 0.3 percentage points for the three months ended October 31, 2015, compared to the same period last year primarily due to an increase in our digital marketing revenue and website implementations. Other direct costs as a percentage of revenue remained consistent for the three months ended October 31, 2015, compared to the same period last year. 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; and
- 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					
		% of		% of		%
	2015	Revenue	2014	Revenue	Change	
Sales and marketing	\$ 2,765	23.6 %	\$ 2,542	27.9 %	8.8 %	
Customer operations and support	2,446	20.8 %	1,690	18.5 %	44.7 %	
Software development and technical support	1,255	10.7 %	872	9.6 %	43.9 %	
General and administrative	1,785	15.2 %	1,604	17.6 %	11.3 %	
Depreciation and amortization <sup>(1)</sup>	609	5.2 %	372	4.1 %	63.7 %	
Net operating expenses	<u>\$ 8,860</u>	<u>75.5 %</u>	<u>\$ 7,080</u>	<u>77.7 %</u>	<u>25.1 %</u>	

(1) Exclusive of amortization of software products of \$496 and \$549 for the three months ended October 31, 2015 and 2014, respectively, which are included in cost of revenue.

Net operating expenses increased 25.1% or \$1,780,000 for the three months ended October 31, 2015, compared to the same period last year. The Company acquired the net assets of TCS in September 2014, TASC0 in April 2015 and DCi in July 2015. The increase in net operating expenses was primarily due to the operating costs of these acquisitions during the first quarter of fiscal 2016. Net operating expenses as a percentage of revenue decreased from 77.7% in the first quarter of fiscal 2015 to 75.5% in the first quarter of fiscal 2016. Management expects net operating expenses to continue to decline as a percentage of total revenue, as the Company continues to integrate the TCS, TASC0 and DCi operations and, to the extent the Company can 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 increased 8.8%, or \$223,000, during the three months ended October 31, 2015, compared to the same period last year. The increase was primarily a result of the expenses associated with the TCS and DCi operations. Sales and marketing expense as a percentage of revenue decreased from 27.9% of revenue for the three months ended October 31, 2014 to 23.6% for the same period in fiscal 2016. 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 fluctuate quarter to quarter, based upon the timing of the Company's marketing events and trade show schedule and its decision to add additional sales and marketing resources to drive organic revenue growth.

#### *Customer Operations and Support*

Customer operations and support expense increased 44.7%, or \$756,000, during the three months ended October 31, 2015, compared to the same period last year. The increase was primarily a result of the expense associated with the TCS, TASC0 and DCi operations. Customer operations and support expense as a percentage of revenue increased from 18.5% of revenue for the three months ended October 31, 2014 to 20.8% during the first three months of fiscal 2016. 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 continue to increase during fiscal 2016, compared to the prior year, due to the additional costs associated with the acquisitions, but to decline as a percentage of revenue over time, as we continue to integrate these areas into our operations, 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 increased 43.9%, or \$383,000, during the three months ended October 31, 2015 versus the same period last year. The increase was primarily a result of the additional development staff associated with the TCS software.

During the three months ended October 31, 2015, we capitalized \$258,000 of software development labor and overhead, versus \$260,000 during the same period last year. In addition to internal capitalized software costs, we had outsourced capitalized development costs of \$115,000 during the three months ended October 31, 2015 and \$77,000 during the same period last year. During the three months ended October 31, 2015, we devoted resources to several new enhancements of our website products.

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 11.3%, or \$181,000, during the three months ended October 31, 2015, compared to the same period last year. The quarter to date increase was primarily a result of the additional headcount from the TCS and DCi acquisitions. General and administrative expense as a percentage of revenue decreased from 17.6% of revenue for the three months ended October 31, 2014 to 15.2% for the same period in fiscal 2016. 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 for the three months ended October 31 (in thousands):

	Three months ended October 31		
	2015	2014	% Change
Interest expense	\$ (112)	\$ (89)	25.8 %
Loss on change in fair value of contingent liabilities	(8)	—	100.0 %
Other, net	—	(1)	(100.0)%
Total other income (expense)	<u>\$ (120)</u>	<u>\$ (90)</u>	<u>33.3 %</u>

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 expense increased 25.8% or \$23,000 during the three months ended October 31, 2015, compared to the same period last year. The increase in interest expense is primarily a result of additional debt to partially fund the TCS and DCi acquisitions.

#### **Income Taxes**

The Company has net deferred tax assets of \$5,197,000 as of October 31, 2015, 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 \$299,000 during the three months ended October 31, 2015, compared to \$89,000 during the same period last year. We paid income taxes of \$64,000 and \$20,000 during the three months ended October 31, 2015 and 2014, 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 Netherlands operation. 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 the Netherlands operation at October 31, 2015 and 2014.

## Adjusted EBITDA

EBITDA is calculated as net income adjusted to exclude interest expense, 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	
	2015	2014
Net income (loss)	\$ 389	\$ 104
Interest	112	89
Amortization included in cost of sales	496	549
Depreciation and amortization	609	372
Income taxes	299	89
EBITDA	\$ 1,905	\$ 1,203
Stock-based compensation expense	115	103
Adjusted EBITDA	\$ 2,020	\$ 1,306
Revenue	\$ 11,737	\$ 9,112
Adjusted EBITDA as a % of revenue	17.2 %	14.3 %

Adjusted EBITDA increased 54.7%, from \$1,306,000 during the first quarter of fiscal 2015 to \$2,020,000 during the first quarter of fiscal 2016. Adjusted EBITDA as a percentage of revenue increased from 14.3% during the three months ended October 31, 2014 to 17.2% during the same period this year. The increase was primarily due to the improvement in operating income. Management expects adjusted EBITDA as a percentage of revenue to increase during fiscal 2016, to the extent earnings continue to increase as a result of RR growth and as the Company recognizes a full year of earnings related to its recent acquisitions.

## 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		
	2015	2014	Change
Net cash provided by operating activities	\$ 1,735	\$ 1,634	\$ 101
Net cash used in investing activities	(665)	(4,811)	4,146
Net cash provided by financing activities	(173)	2,961	(3,134)
Effect of foreign currency exchange rate changes on cash	(2)	5	(7)
Net change in cash	\$ 895	\$ (211)	\$ 1,106
Cash at end of period	\$ 3,179	\$ 1,597	\$ 1,582

We generated \$895,000 of net cash during the three months ended October 31, 2015, compared to the utilization of \$211,000 during the same period last year. We generated net cash provided by operating activities of \$1,735,000 during the three months ended October 31, 2015 compared to \$1,634,000 during the same period last year. This increase in cash generated from operations was primarily due to increased pre-tax profitability.

Cash used in investing activities decreased \$4,146,000 for the three months ended October 31, 2015, compared to the same period last year. We paid cash of \$125,000 for a contingent liability from a previous acquisition, capitalized \$373,000 of software development costs, and acquired technology equipment of \$167,000 during the three months ended October 31, 2015. We paid cash of \$4,200,000 as consideration for the TCS acquisition, paid \$249,000 for a contingent liability from a previous acquisition, capitalized \$341,000 of software development costs, and acquired technology equipment of \$21,000, during the three months ended October 31, 2014. We will continue to invest cash in the business to further our growth strategies previously discussed.

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. Net cash provided from financing activities was \$2,961,000 during the three months ended October 31, 2014, as the Company increased its senior debt, as described below, by \$3,000,000 to partially fund the TCS acquisition in September 2014.

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 September 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 Company's outstanding debt obligations as of October 31, 2015 (in thousands):

	SVB Term Note	TCS Notes	DCi Notes	Total Notes Payable
2016	\$ 454	\$ 693	\$ —	\$ 1,147
2017	832	965	643	2,440
2018	1,134	1,014	669	2,817
2019	1,210	261	627	2,098
2020	1,815	—	—	1,815
	<u>\$ 5,445</u>	<u>\$ 2,933</u>	<u>\$ 1,939</u>	<u>\$ 10,317</u>

## 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, 2015 that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.



## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

From time to time, the Company may be involved in litigation relating to claims arising out of its operations in the usual course of business. No material legal proceedings to which the Company is a party exist at October 31, 2015.

### **Item 1A. Risk Factors**

The Company's risks and uncertainties are described in Part I, Item 1A of the Company's annual report on Form 10-K for the fiscal year ended July 31, 2015. There have been no significant changes to the risks described in our Form 10-K.

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

None.

### **Item 3. Defaults upon Senior Securities**

None.

### **Item 4. Mine Safety Disclosures**

Not applicable.

### **Item 5. Other Information**

Not applicable.

### **Item 6. Exhibits**

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.

32.1 Section 1350 Certification of Chief Executive Officer.

32.2 Section 1350 Certification of Chief Financial Officer.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on this 15<sup>th</sup> day of December, 2015.

ARI NETWORK SERVICES, INC.  
*(Registrant)*

By: /s/ Roy W. Olivier  
Roy W. Olivier  
President and Chief Executive Officer

By: /s/ William A. Nurthen  
William A. Nurthen  
Vice President of Finance and Chief Financial Officer