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 and six months ended January 31, 2016 and 2015, including the notes thereto, which appear elsewhere in this quarterly report on Form 10-Q. All amounts are in thousands, except per share data. This discussion, including, without limitation, the section 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 setup 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 January 31, 2016, 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 Solutions

ARI complements our suite of data-driven software tools with digital marketing solutions that deliver the engaging experiences that today's consumers demand. ARI's digital marketing solutions 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 17.0%, or $1,567,000 to 91.6% of total revenue for the quarter ended January 31, 2016, compared to the same period last year and 23.8% or $4,127,000 to 91.4% of total revenue for the six months ended January 31, 2016, compared to the same period last year. To experience further growth in RR, we will continue to:

- *Develop and deploy innovative new solutions*. We have resources assigned to each of our core products that continue to research and develop new value-added features and functionality for our existing products. The introduction of new solutions, upgrades to existing products, and new feature sets are all designed to grow our 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

  - Dealer Management System Software Integrations – we completed development to integrate our web platform with three leading management software systems vendors operating in the powersports, marine, RV, and outdoor power markets.
  - Manufacturer Branded Platform Program – we developed tooling that enabled us to rapidly launch over 4,000 websites with consistent branding and OEM marketing control in support of our partnership with Toro, a leading outdoor power equipment manufacturer.
  - Supplier Drop Shipment Program – we developed and released an integration with a leading Home Medical product supplier, enabling automated drop-ship fulfillment of eCommerce orders. This is our second drop-ship program in the Home Medical market.
  - Search Engine and Conversion Optimization – we performed various enhancements to help increase traffic to our customers’ websites and increase conversion rates within the website, yielding up to 50% improvement in both of these areas as a result.
  - Responsive Website Platform – we began development on a next generation architecture for our dealership websites, which is natively based on Responsive Design and includes dramatic performance and scalability capabilities.

eCatalog Platforms

- Data Manager® Development – we continued development and market testing of 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.

Digital Marketing Services

- New Digital Marketing Services Packages – we recently developed and launched a new set of innovative Digital Marketing Services packages, offering a curated blend of services targeted for unique customer segments that increase business traffic and drive sales opportunities. The new solutions recently earned a prestigious powersports industry award.

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.
- *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.

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 15.5% for the period ending January 31, 2016, compared to 14.5% 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. The Company recently signed an exclusive reseller agreement with CDK Global Recreation, the provider of Lightspeed, a renowned DMS in the powersports industry. They will integrate ARI's AccessorySmart® into their DMS, which will automatically offer our product to their customers. 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:

Acquisition	Date	Strategy
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 solutions 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 DCi Note was reduced by approximately $64,000 as a result of post-closing adjustments to the valuation of the net assets acquired, pursuant to the terms of the asset purchase agreement.

On April 27, 2015, the Company acquired substantially all of the assets of TASCO, 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 approximately $62,000 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 $2,933,000 (as adjusted) to the former owners of TCS; 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 fair value was estimated at $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 15.9%, or $1,613,000, for the three months ended January 31, 2016 to $11,752,000, compared to $10,139,000 for the same period last year. Year-to-date revenue increased 22.0% or $4,238,000 to $23,489,000, compared to $19,251,000 for the same period last year. Recurring revenue increased 17.0% to $10,769,000 during the three months ended January 31, 2016 and 23.8% to $21,479,000 during the six months ended January 31, 2016, compared to $9,202,000 and $17,352,000, respectively, during the same periods last year. Recurring revenue constituted 91.4% of our total revenue for the six months ended January 31, 2016 compared to 90.1% for 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 TASCO 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, primarily in the lead generation and eCommerce solutions. Growth was also driven by organic growth in the acquired TCS business primarily in the business management software segment.

Operating income increased 30.3%, or $203,000, from $670,000 for the three months ended January 31, 2015 to $873,000 for the same period this year and increased 76.4% or $728,000 from $953,000 for the six months ended January 31, 2015 to $1,681,000 for the same period this year. Net operating expenses increased 15.9% or $1,208,000 during the three month period ended January 31, 2016, compared to the same period last year, primarily due to the additional costs of the DCi and TASCO operations. Net operating expenses increased 20.3% or $2,988,000 during the six months ended January 31, 2016, compared to the same period last year, primarily due to the additional costs of the DCi and TASCO operations and six months of TCS operations in fiscal 2016, compared to four months last year.

Net income was $448,000, or $0.03 per share, for the three months ended January 31, 2016, compared to $260,000, or $0.02 per share, for the same period last year. Net income for the six months ended January 31, 2016 was $837,000, or $0.05 per share, compared to a net income of $365,000, or $0.03 per share, for the same period last year.

Cash provided by operations increased 7.9% to $2,951,000 for the six months ended January 31, 2016 compared to $2,734,000 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 (in thousands):

	Three months ended January 31					Six months ended January 31				
	2016	% of Total	2015	% of Total	% Change	2016	% of Total	2015	% of Total	% Change
Lead Generation and eCommerce Websites	$ 5,876	50.0 %	$ 5,723	56.4 %	2.7 %	$ 11,744	50.0 %	$ 10,539	54.7 %	11.4 %
eCatalog Services	4,446	37.8 %	3,448	34.0 %	28.9 %	8,961	38.1 %	6,924	36.0 %	29.4 %
Business Management Software	866	7.4 %	411	4.1 %	110.7 %	1,675	7.1 %	533	2.8 %	214.3 %
Digital Marketing Solutions	382	3.3 %	340	3.4 %	12.4 %	737	3.1 %	571	3.0 %	29.1 %
Other Revenue	182	1.5 %	217	2.1 %	(16.1)%	372	1.6 %	684	3.6 %	(45.6)%
Total revenue	$ 11,752	100.0 %	$ 10,139	100.0 %	15.9 %	$ 23,489	100.0 %	$ 19,251	100.0 %	22.0 %
Recurring revenue	10,769	91.6	9,202	90.8	17.0 %	21,479	91.4	17,352	90.1	23.8 %
Non-recurring revenue	983	8.4	937	9.2	4.9 %	2,010	8.6	1,899	9.9	5.8 %
Total revenue	$ 11,752	100.0 %	$ 10,139	100.0 %	15.9 %	$ 23,489	100.0 %	$ 19,251	100.0 %	22.0 %

Total revenue increased 15.9% to $11,752,000 and 22.0% to $23,489,000, for the three and six months ended January 31, 2016, respectively, compared to the same periods last year. RR increased 17.0% to $10,769,000 and 23.8% to $21,479,000 for the three and six months ended January 31, 2016, respectively, compared to the same periods last year. RR represented 91.4% of total revenue for the first six months of fiscal 2016, versus 90.1% for the same period in fiscal 2015. 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 setup and customization fees to develop new dealer websites, which is recognized ratably over the term of the contract, monthly recurring subscription fees and variable transaction fees. Our lead generation and eCommerce website solutions are typically sold as one year, renewable contracts with monthly payment terms. We estimate that we currently host and maintain more than 7,000 websites for dealers in all of our vertical markets. Lead generation and eCommerce website solutions have become ARI's largest source of revenue and accounted for 50.0% of total revenue during the six months ended January 31, 2016. Lead generation and eCommerce revenue increased 2.7% to $5,876,000 for the three months ended January 31, 2016, compared to the same period last year as a result of organic growth. Lead generation and eCommerce revenue increased 11.4% to $11,744,000 for the six months ended January 31, 2016, compared to the same period last year as a result of both organic growth and our acquisition of TCS in September 2014. We anticipate that our web platforms will continue to be one of the Company's largest source of revenue growth.

eCatalog Revenue

Our eCatalog solutions generate revenue from renewable subscription fees for our software, data content, software maintenance and support fees and software customization fees. eCatalog is our second largest source of revenue, representing 38.1% of total revenue during the six months ended January 31, 2016. eCatalog revenue increased 28.9% to $4,446,000 during the three months ended January 31, 2016 and 29.4% to $8,961,000 during the six months ended January 31, 2016, compared to the same periods last year, primarily due to our acquisition of DCi in July 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, support fees and hosting fees. These products were acquired as part of the TASCO and TCS acquisitions. Business management software revenue more than doubled from $411,000 for the three months ended January 31, 2015 to $866,000 for the same period this year. Business management software revenue increased from $533,000 for the six months ended January 31, 2015 to $1,675,000 for the same period this year. Revenue from business management software represented 7.1% of total revenue during fiscal 2016. The increase in business management software revenue is primarily a result of revenue from the newly acquired TASCO product in April 2015, as well as organic growth in the business management software segment acquired through TCS.

Digital Marketing Revenue

Revenues from our digital marketing solutions are generated from set-up fees and subscription fees for our search engine optimization, social media marketing and website enhancement tools. Total digital marketing revenue increased 12.4% to $382,000 and 29.1% to $737,000 during the three and six months ended January 31, 2016, compared to the same periods 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 16.1% to $182,000 and 45.6% to $372,000 during the three and six months ended January 31, 2016, compared to the same periods last year. The decrease in other revenue is principally due to a large one-time professional service contract with one of our major manufacturers resulting in revenue during fiscal 2015.

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 17.0%, or $1,567,000 and 23.8% or $4,127,000 for the three and six months ended January 31, 2016, compared to the same periods last year. The growth in RR was primarily attributable to both the addition of RR from our acquisitions of TCS, TASCO and DCi and organic growth. We expect RR to continue to grow over the prior year 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 solutions, professional services related to software customization and data conversion, usage fees charged on our RR products, set-up fees and other complementary products and services. Total non-recurring revenue was $983,000 and $2,010,000 for the three and six months ended January 31, 2016, versus $937,000 and $1,899,000 for the same periods last year. The increase in non-recurring revenue is 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 fiscal 2015.

Our goal is to maintain non-recurring revenue of less than 10% of total revenue, as the margin on this revenue tends to be lower than our RR products. Furthermore, non-recurring revenue must be resold each year.

Cost of Revenue and Gross Margin

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

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

	Three months ended January 31					Six months ended January 31				
	2016	% of Revenue	2015	% of Revenue	% Change	2016	% of Revenue	2015	% of Revenue	% Change
Net revenues	$ 11,752		$ 10,139		15.9 %	$ 23,489		$ 19,251		22.0 %
Cost of revenues:										
Amortization of capitalized software	544	4.6 %	553	5.5 %	(1.6) %	1,040	4.4 %	1,102	5.7 %	(5.6) %
Direct labor	626	5.3 %	523	5.2 %	19.7 %	1,268	5.4 %	999	5.2 %	26.9 %
Other direct costs	894	7.6 %	786	7.8 %	13.7 %	1,825	7.8 %	1,510	7.8 %	20.9 %
Total cost of revenues	2,064	17.6 %	1,862	18.4 %	10.8 %	4,133	17.6 %	3,611	18.8 %	14.5 %
Gross profit	$ 9,688	82.4 %	$ 8,277	81.6 %	17.0 %	$ 19,356	82.4 %	$ 15,640	81.2 %	23.8 %

Gross profit was $9,688,000 or 82.4% of revenue for the three months ended January 31, 2016, compared to $8,277,000 or 81.6% of revenue for the same period last year. Amortization of capitalized software costs as a percentage of revenue decreased for the three and six months ended January 31, 2016, compared to the same periods last year, primarily due to revenue increasing at a faster rate than software amortization costs. Direct labor costs as a percentage of revenue increased for the three and six months ended January 31, 2016, compared to the same periods 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 six months ended January 31, 2016, 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 January 31					Six months ended January 31				
	2016	% of Revenue	2015	% of Revenue	% Change	2016	% of Revenue	2015	% of Revenue	% Change
Sales and marketing	$ 2,748	23.4 %	$ 2,668	26.3 %	3.0 %	$ 5,513	23.5 %	$ 5,210	27.1 %	5.8 %
Customer operations and support	2,428	20.7 %	1,871	18.5 %	29.8 %	4,874	20.8 %	3,561	18.5 %	36.9 %
Software development and technical	1,319	11.2 %	1,072	10.6 %	23.0 %	2,574	11.0 %	1,944	10.1 %	32.4 %
General and administrative	1,730	14.7 %	1,588	15.7 %	8.9 %	3,515	15.0 %	3,192	16.6 %	10.1 %
Depreciation and amortization (1)	590	5.0 %	408	4.0 %	44.6 %	1,199	5.1 %	780	4.1 %	53.7 %
Net operating expenses	$ 8,815	75.0 %	$ 7,607	75.0 %	15.9 %	$ 17,675	75.2 %	$ 14,687	76.3 %	20.3 %

(1) Exclusive of amortization of software products of $544, $553, $1,040 and $1,102 for the three and six months ended January 31, 2016 and 2015, respectively, which are included in cost of revenue.

Net operating expenses increased 15.9% or $1,208,000 and 20.3% or $2,988,000 for the three and six months ended January 31, 2016, compared to the same period last year. The Company acquired the net assets of TCS in September 2014, TASCO 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 half of fiscal 2016, while there were no operating costs for TASCO and DCi, and only four months of TCS operations during the first half of fiscal 2015. Net operating expenses as a percentage of revenue decreased from 76.3% for the first half of fiscal 2015 to 75.2% for the first half of fiscal 2016. Management expects net operating expenses to continue to decline as a percentage of total revenue to the extent the Company continues to make progress in its integration of the TCS, TASCO 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 3.0%, or $80,000 and 5.8% or $303,000 during the three and six months ended January 31, 2016, compared to the same periods 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 27.1% of revenue for the six months ended January 31, 2015 to 23.5% 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 29.8% or $557,000 and 36.9%, or $1,313,000, during the three and six months ended January 31, 2016, compared to the same periods last year. The increase was primarily a result of the expense associated with the TCS, TASCO and DCi operations. Customer operations and support expense as a percentage of revenue increased from 18.5% of revenue for the six months ended January 31, 2015 to 20.8% during the first six 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 life 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 23.0%, or $247,000, during the three months ended January 31, 2016 versus the same period last year and 32.4%, or $630,000, during the six months ended January 31, 2016 versus the same period last year. The increase was primarily a result of the additional development staff associated with the TCS software and the Company's continued focus on reducing churn.

During the three and six months ended January 31, 2016, we capitalized $300,000 and $558,000 of software development labor, overhead and interest expense, versus $256,000 and $516,000 during the same periods last year. In addition to internal capitalized software costs, we had outsourced capitalized development costs of $154,000 and $269,000 during the three and six months ended January 31, 2016 and $123,000 and $202,000 during the same periods last year. During the three months ended January 31, 2016, we devoted resources to several new enhancements of our website and eCatalog 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 8.9%, or $142,000 and 10.1%, or $323,000, during the three and six months ended January 31, 2016, compared to the same periods last year. The 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 16.6% of revenue for the six months ended January 31, 2015 to 15.0% 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 (in thousands):

	Three months ended January 31			Six months ended January 31		
	2016	2015	% Change	2016	2015	% Change
Interest expense	$ (120)	$ (140)	(14.3)%	$ (232)	$ (229)	1.3 %
Other, net	—	4	(100.0)%	(8)	3	(366.7)%
Total other income (expense)	$ (120)	$ (136)	(11.8)%	$ (240)	$ (226)	6.2 %

Interest expense is composed of both interest paid on the Company's debt financing arrangements and amortization of non-cash interest charges related to deferred finance costs and imputed interest on contingent liabilities. Interest and other expense decreased 11.8% or $16,000 during the three months ended January 31, 2016, compared to the same period last year, as the Company paid down a portion of its debt obligations and contingent liabilities. Interest and other expense increased 6.2% or $14,000 during the six months ended January 31, 2016, compared to the same period last year, primarily as a result of additional debt obligations and contingent liabilities to partially fund the TCS and DCi acquisitions.

Income Taxes

The Company has net deferred tax assets of $4,898,000 as of January 31, 2016, primarily consisting of net operating loss carryforwards ("NOLs") and book to tax temporary differences. Income tax expense is provided for at the applicable statutory tax rate applied to current U.S. income before taxes, plus or minus any adjustments to the deferred tax assets and to the estimated valuation allowance against deferred tax assets. Income tax expense, if any, does not represent a significant current cash obligation, as we continue to have NOLs to offset substantially all of the taxable income.

We had income tax expense of $305,000 and $604,000 during the three and six months ended January 31, 2016, compared to $274,000 and $363,000 during the same periods last year. We paid income taxes of $43,000 and $55,000 during the six months ended January 31, 2016 and 2015, respectively, primarily related to statutory alternative minimum taxes. Income tax expense may vary from period to period as we continue to evaluate the valuation allowance against net deferred tax assets.

We also have NOLs related to tax losses incurred by our 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 January 31, 2016 and 2015.

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 January 31		Six months ended January 31		Twelve months ended January 31	
	2016	2015	2016	2015	2016	2015
Net income (loss)	$ 448	$ 260	$ 837	$ 364	$ 1,544	$ 698
Interest	120	140	232	229	468	367
Amortization included in cost of sales	544	553	1,040	1,102	1,961	2,192
Depreciation and amortization	590	408	1,199	780	2,175	1,442
Loss on FMV of Warrant Derivatives	-	-	-	-	-	(4)
Loss on impairment of long-lived assets	-	-	-	-	-	35
Income taxes	305	274	604	363	1,052	746
EBITDA	$ 2,007	$ 1,635	$ 3,912	$ 2,838	$ 7,200	$ 5,476
Stock-based compensation expense	88	107	203	210	439	609
Adjusted EBITDA	$ 2,095	$ 1,742	$ 4,115	$ 3,048	$ 7,639	$ 6,085
Revenue	$ 11,752	$ 10,139	$ 23,489	$ 19,251	$ 44,681	$ 35,975
Adjusted EBITDA as a % of revenue	17.8 %	17.2 %	17.5 %	15.8 %	17.1 %	16.9 %

Adjusted EBITDA increased 20.3%, from $1,742,000 during the second quarter of fiscal 2015 to $2,095,000 during the second quarter of fiscal 2016. Adjusted EBITDA increased 35.0%, from $3,048,000 during the first half of fiscal 2015 to $4,115,000 during the first half of fiscal 2016. Adjusted EBITDA as a percentage of revenue increased from 15.8% during the six months ended January 31, 2015 to 17.5% 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, versus fiscal 2015, 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):

	Six months ended January 31		
	2016	**2015**	**Change**
Net cash provided by operating activities	$ 2,951	$ 2,734	$ 217
Net cash used in investing activities	(1,473)	(5,389)	3,916
Net cash provided by (used in) financing activities	(595)	2,556	(3,151)
Effect of foreign currency exchange rate changes on cash	(1)	(21)	20
Net change in cash	$ 882	$ (120)	$ 1,002
Cash at end of period	$ 3,166	$ 1,688	$ 1,478

We generated $882,000 of net cash during the six months ended January 31, 2016, compared to the utilization of $120,000 during the same period last year. We generated net cash provided by operating activities of $2,951,000 during the six months ended January 31, 2016 compared to $2,734,000 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 $3,916,000 for the six months ended January 31, 2016, compared to the same period last year. We paid cash of $322,000 for contingent liabilities related to our acquisitions, capitalized $827,000 of software development costs, and acquired technology equipment of $324,000 during the six months ended January 31, 2016. We paid cash of $4,200,000 as consideration for the TCS acquisition, paid $250,000 for contingent liabilities, capitalized $718,000 of software development costs, acquired technology equipment of $279,000, and received $58,000 from an earn-out receivable during the six months ended January 31, 2015. We will continue to invest cash in the business to further our growth strategies previously discussed.

Net cash used in financing activities was $595,000 during the six months ended January 31, 2016, primarily to pay down the SVB note, the TCS notes and our capital lease obligations. Net cash provided from financing activities was $2,556,000 during the six months ended January 31, 2015, 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 January 31, 2016 (in thousands):

	SVB Term Note	TCS Notes	DCi Notes	Total Notes Payable
2016	$ 303	$ 465	$ —	$ 767
2017	832	965	620	2,417
2018	1,134	1,014	645	2,793
2019	1,210	261	671	2,143
2020	1,815	—	—	1,815
	$ 5,294	$ 2,705	$ 1,936	$ 9,935

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.