

Edgar Filing: STRATASYS INC - Form 10-Q

STRATASYS INC  
Form 10-Q  
November 09, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011  
OR

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

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

Commission File Number: 1-13400

STRATASYS, INC.

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

36-3658792  
(I.R.S. Employer  
Identification No.)

7665 Commerce Way, Eden Prairie, Minnesota  
(Address of principal executive offices)

55344  
(Zip Code)

(952) 937-3000

(Registrant's telephone number, including area code)

Not Applicable

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

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

Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 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-accelerate 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)

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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 November 1, 2011 the Registrant had 21,200,220 shares of common stock, \$.01 par value, issued and outstanding.

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Stratasys, Inc.

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STRATASYS, INC. AND SUBSIDIARIES  
CONSOLIDATED FINANCIAL STATEMENTS

PART I - FINANCIAL INFORMATION  
Item 1. Financial Statements.

Consolidated Balance Sheets

|                                                                                                                                                                      | September 30,<br>2011<br>(unaudited) | December 31,<br>2010  |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------|-----------------------|
| <b>ASSETS</b>                                                                                                                                                        |                                      |                       |
| <b>Current assets</b>                                                                                                                                                |                                      |                       |
| Cash and cash equivalents                                                                                                                                            | \$ 15,231,778                        | \$ 27,554,411         |
| Short-term investments - held to maturity                                                                                                                            | 3,047,213                            | 8,797,878             |
| Accounts receivable, less allowance for doubtful<br>accounts of \$1,154,709 at September 30, 2011<br>and \$1,094,588 at December 31, 2010                            | 23,766,474                           | 20,051,451            |
| Inventories                                                                                                                                                          | 21,983,920                           | 17,880,714            |
| Net investment in sales-type leases, less allowance<br>for doubtful accounts of \$245,332 at September 30,<br>2011 and \$189,338 at December 31, 2010                | 2,911,027                            | 3,096,911             |
| Prepaid expenses and other current assets                                                                                                                            | 4,660,515                            | 3,384,394             |
| Deferred income taxes                                                                                                                                                | 3,826,000                            | 3,447,000             |
| <b>Total current assets</b>                                                                                                                                          | <b>75,426,927</b>                    | <b>84,212,759</b>     |
| Property and equipment, net                                                                                                                                          | 37,828,246                           | 29,872,945            |
| <b>Other assets</b>                                                                                                                                                  |                                      |                       |
| Goodwill                                                                                                                                                             | 25,055,948                           | 867,700               |
| Other intangible assets, net                                                                                                                                         | 25,930,787                           | 5,538,014             |
| Net investment in sales-type leases                                                                                                                                  | 4,274,110                            | 3,067,446             |
| Long-term investments - available for sale                                                                                                                           | -                                    | 1,185,250             |
| Long-term investments - held to maturity                                                                                                                             | 42,652,402                           | 52,504,650            |
| Other non-current assets                                                                                                                                             | 172,490                              | 1,210,867             |
| <b>Total other assets</b>                                                                                                                                            | <b>98,085,737</b>                    | <b>64,373,927</b>     |
| <b>Total assets</b>                                                                                                                                                  | <b>\$ 211,340,910</b>                | <b>\$ 178,459,631</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                          |                                      |                       |
| <b>Current liabilities</b>                                                                                                                                           |                                      |                       |
| Accounts payable and other current liabilities                                                                                                                       | \$ 15,499,810                        | \$ 14,408,628         |
| Unearned revenues                                                                                                                                                    | 12,266,829                           | 11,561,521            |
| <b>Total current liabilities</b>                                                                                                                                     | <b>27,766,639</b>                    | <b>25,970,149</b>     |
| <b>Non-current liabilities</b>                                                                                                                                       |                                      |                       |
| Deferred tax liabilities                                                                                                                                             | 7,519,500                            | 207,000               |
| <b>Total liabilities</b>                                                                                                                                             | <b>35,286,139</b>                    | <b>26,177,149</b>     |
| <b>Commitments and contingencies</b>                                                                                                                                 |                                      |                       |
| <b>Stockholders' equity</b>                                                                                                                                          |                                      |                       |
| Common stock, \$.01 par value, authorized 30,000,000 shares;<br>26,857,801 and 26,509,518 shares issued at September 30,<br>2011 and December 31, 2010, respectively | 268,578                              | 265,095               |

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|                                                                                         |                |                |
|-----------------------------------------------------------------------------------------|----------------|----------------|
| Additional paid-in capital                                                              | 116,544,175    | 107,781,990    |
| Retained earnings                                                                       | 98,225,797     | 83,385,484     |
| Accumulated other comprehensive income (loss)                                           | 20,646         | (145,662)      |
| Treasury stock at cost, 5,687,631 shares at September 30,<br>2011 and December 31, 2010 | (39,004,425)   | (39,004,425)   |
| Total stockholders' equity                                                              | 176,054,771    | 152,282,482    |
| Total liabilities and stockholders' equity                                              | \$ 211,340,910 | \$ 178,459,631 |

See accompanying notes to consolidated financial statements.

**STRATASYS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED FINANCIAL STATEMENTS**

## Consolidated Statements of Operations and Comprehensive Income (Unaudited)

|                                                   | Three Months Ended September 30, |                     | Nine Months Ended September 30, |                     |
|---------------------------------------------------|----------------------------------|---------------------|---------------------------------|---------------------|
|                                                   | 2011                             | 2010                | 2011                            | 2010                |
| <b>Net sales</b>                                  |                                  |                     |                                 |                     |
| Products                                          | \$ 32,255,554                    | \$ 23,966,937       | \$ 90,521,228                   | \$ 69,526,507       |
| Services                                          | 7,440,470                        | 6,291,609           | 21,048,816                      | 18,785,660          |
| Fair value of warrant related to OEM agreement    | -                                | -                   | -                               | (4,987,806)         |
|                                                   | 39,696,024                       | 30,258,546          | 111,570,044                     | 83,324,361          |
| <b>Cost of sales</b>                              |                                  |                     |                                 |                     |
| Products                                          | 14,868,919                       | 12,695,679          | 42,647,905                      | 35,805,842          |
| Services                                          | 3,273,159                        | 2,853,879           | 9,382,333                       | 8,627,451           |
|                                                   | 18,142,078                       | 15,549,558          | 52,030,238                      | 44,433,293          |
| <b>Gross profit</b>                               | <b>21,553,946</b>                | <b>14,708,988</b>   | <b>59,539,806</b>               | <b>38,891,068</b>   |
| <b>Operating expenses</b>                         |                                  |                     |                                 |                     |
| Research and development                          | 3,613,668                        | 2,242,263           | 10,687,578                      | 7,191,594           |
| Selling, general and administrative               | 10,083,451                       | 8,403,902           | 28,738,326                      | 24,385,683          |
|                                                   | 13,697,119                       | 10,646,165          | 39,425,904                      | 31,577,277          |
| <b>Operating income</b>                           | <b>7,856,827</b>                 | <b>4,062,823</b>    | <b>20,113,902</b>               | <b>7,313,791</b>    |
| <b>Other income (expense)</b>                     |                                  |                     |                                 |                     |
| Interest income, net                              | 276,089                          | 217,651             | 698,469                         | 596,541             |
| Foreign currency transaction gains (losses), net  | (217,857)                        | 227,623             | (429,840)                       | (570,184)           |
| Other                                             | 755,030                          | 48,078              | 2,264,307                       | 42,093              |
|                                                   | 813,262                          | 493,352             | 2,532,936                       | 68,450              |
| <b>Income before income taxes</b>                 | <b>8,670,089</b>                 | <b>4,556,175</b>    | <b>22,646,838</b>               | <b>7,382,241</b>    |
| <b>Income taxes</b>                               | <b>2,812,920</b>                 | <b>1,380,625</b>    | <b>7,806,524</b>                | <b>2,317,635</b>    |
| <b>Net income</b>                                 | <b>\$ 5,857,169</b>              | <b>\$ 3,175,550</b> | <b>\$ 14,840,314</b>            | <b>\$ 5,064,606</b> |
| <b>Net income per common share</b>                |                                  |                     |                                 |                     |
| Basic                                             | \$ 0.28                          | \$ 0.15             | \$ 0.70                         | \$ 0.25             |
| Diluted                                           | 0.27                             | 0.15                | 0.68                            | 0.24                |
| <b>Weighted average common shares outstanding</b> |                                  |                     |                                 |                     |
| Basic                                             | 21,165,401                       | 20,586,695          | 21,107,474                      | 20,519,189          |
| Diluted                                           | 21,542,674                       | 21,000,804          | 21,669,848                      | 21,035,559          |
| <b>Comprehensive Income</b>                       |                                  |                     |                                 |                     |
| Net income                                        | \$ 5,857,169                     | \$ 3,175,550        | \$ 14,840,314                   | \$ 5,064,606        |
| Other comprehensive income (loss):                |                                  |                     |                                 |                     |

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|                                         |              |              |               |              |
|-----------------------------------------|--------------|--------------|---------------|--------------|
| Foreign currency translation adjustment | 57,382       | 221,975      | 166,308       | (75,408)     |
| Comprehensive income                    | \$ 5,914,551 | \$ 3,397,525 | \$ 15,006,622 | \$ 4,989,198 |

See accompanying notes to consolidated financial statements.

**STRATASYS, INC. AND SUBSIDIARIES**  
**CONSOLIDATED FINANCIAL STATEMENTS**

Consolidated Statements of Cash Flows (Unaudited)

|                                                                                                                                       | Nine Months Ended September 30, |                     |
|---------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|---------------------|
|                                                                                                                                       | 2011                            | 2010                |
| <b>Cash flows from operating activities</b>                                                                                           |                                 |                     |
| Net income                                                                                                                            | \$ 14,840,314                   | \$ 5,064,606        |
| Adjustments to reconcile net income to net cash provided by operating activities:                                                     |                                 |                     |
| Deferred income taxes                                                                                                                 | (210,410)                       | -                   |
| Depreciation                                                                                                                          | 4,288,846                       | 4,847,219           |
| Amortization                                                                                                                          | 3,241,141                       | 1,948,406           |
| Stock-based compensation                                                                                                              | 1,088,025                       | 931,632             |
| Excess tax benefit from stock options                                                                                                 | (2,562,753)                     | -                   |
| Fair value of warrant related to OEM agreement                                                                                        | -                               | 4,987,806           |
| Gain on disposal of property and equipment                                                                                            | (155,608)                       | -                   |
| Gain on sale of investment                                                                                                            | (1,830,595)                     | -                   |
| <br>Increase (decrease) in cash attributable to changes in operating and liabilities, net of acquired assets and liabilities assumed: |                                 |                     |
| Accounts receivable, net                                                                                                              | (3,275,739)                     | (476,588)           |
| Inventories                                                                                                                           | (4,875,117)                     | (5,597,357)         |
| Net investment in sales-type leases                                                                                                   | (1,020,780)                     | 937,976             |
| Prepaid expenses                                                                                                                      | 36,001                          | (196,627)           |
| Other assets                                                                                                                          | 234,087                         | 848,405             |
| Accounts payable and other current liabilities                                                                                        | 2,612,251                       | 1,140,693           |
| Unearned revenues                                                                                                                     | 551,278                         | 205,517             |
| <b>Net cash provided by operating activities</b>                                                                                      | <b>12,960,941</b>               | <b>14,641,688</b>   |
| <br><b>Cash flows from investing activities</b>                                                                                       |                                 |                     |
| Proceeds from the maturity of investments                                                                                             | 19,727,063                      | 19,731,121          |
| Proceeds from the sale of investments                                                                                                 | 15,748,196                      | -                   |
| Purchase of investments                                                                                                               | (16,905,667)                    | (58,443,732)        |
| Proceeds from sale of property and equipment                                                                                          | 100                             | -                   |
| Acquisition of property and equipment                                                                                                 | (9,595,479)                     | (2,270,462)         |
| Acquisition of intangible and other assets                                                                                            | (3,537,482)                     | (998,389)           |
| Acquisition of Solidscape, Inc., net of cash acquired                                                                                 | (38,559,085)                    | -                   |
| <b>Net cash used in investing activities</b>                                                                                          | <b>(33,122,354)</b>             | <b>(41,981,462)</b> |
| <br><b>Cash flows from financing activities</b>                                                                                       |                                 |                     |
| Proceeds from exercise of stock options and warrants                                                                                  | 5,114,890                       | 3,958,400           |
| Cash paid for vested stock option repurchases                                                                                         | -                               | (2,136,605)         |
| Excess tax benefit from stock options                                                                                                 | 2,562,753                       | -                   |
| <b>Net cash provided by financing activities</b>                                                                                      | <b>7,677,643</b>                | <b>1,821,795</b>    |
| <br>Effect of exchange rate changes on cash                                                                                           | 161,137                         | (66,019)            |
| <br><b>Net decrease in cash and cash equivalents</b>                                                                                  | <b>(12,322,633)</b>             | <b>(25,583,998)</b> |

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|                                                |            |            |
|------------------------------------------------|------------|------------|
| Cash and cash equivalents, beginning of period | 27,554,411 | 48,315,926 |
|------------------------------------------------|------------|------------|

|                                          |               |               |
|------------------------------------------|---------------|---------------|
| Cash and cash equivalents, end of period | \$ 15,231,778 | \$ 22,731,928 |
|------------------------------------------|---------------|---------------|

## Supplemental disclosures of cash flow information:

|                     |              |              |
|---------------------|--------------|--------------|
| Cash paid for taxes | \$ 3,869,502 | \$ 3,195,953 |
|---------------------|--------------|--------------|

|                                       |        |         |
|---------------------------------------|--------|---------|
| Transfer of fixed assets to inventory | 95,372 | 275,375 |
|---------------------------------------|--------|---------|

|                                       |           |           |
|---------------------------------------|-----------|-----------|
| Transfer of inventory to fixed assets | 2,445,253 | 1,761,405 |
|---------------------------------------|-----------|-----------|

|                               |            |   |
|-------------------------------|------------|---|
| Fair value of assets acquired | 47,818,196 | - |
|-------------------------------|------------|---|

|                          |             |   |
|--------------------------|-------------|---|
| Less liabilities assumed | (8,718,622) | - |
|--------------------------|-------------|---|

|                     |            |   |
|---------------------|------------|---|
| Net acquired assets | 39,099,574 | - |
|---------------------|------------|---|

|                    |           |   |
|--------------------|-----------|---|
| Less cash acquired | (540,489) | - |
|--------------------|-----------|---|

|                                                       |               |      |
|-------------------------------------------------------|---------------|------|
| Acquisition of Solidscape, Inc., net of cash acquired | \$ 38,559,085 | \$ - |
|-------------------------------------------------------|---------------|------|

See accompanying notes to consolidated financial statements.

STRATASYS, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation and Consolidation

The consolidated interim financial statements include the accounts of Stratasys, Inc. and its wholly-owned subsidiaries (collectively, the “Company”). All intercompany accounts and transactions have been eliminated in consolidation. The consolidated interim financial information herein is unaudited; however, such information reflects all adjustments (consisting of normal, recurring adjustments), which are, in the opinion of management, necessary for a fair statement of results for the interim period. The results of operations for the three and nine months ended September 30, 2011 are not necessarily indicative of the results to be expected for the full year. Certain financial information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted. The reader is referred to the audited consolidated financial statements and notes thereto for the year ended December 31, 2010, filed as part of the Company’s Annual Report on Form 10-K for such year.

On May 3, 2011, Stratasys, Inc. acquired Solidscape, Inc., a Delaware corporation (“Solidscape”). Accordingly, all of the assets acquired and liabilities assumed were recorded at their respective fair values and our consolidated results of operations include Solidscape’s operating results from May 3, 2011 through September 30, 2011.

Note 2. Recently Issued Accounting Pronouncements

In October 2009, the FASB issued Accounting Standards Update (“ASU”) No. 2009-13 Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force, that provides amendments to the criteria for separating consideration in multiple-deliverable arrangements. As a result of these amendments, multiple-deliverable revenue arrangements will be separated in more circumstances than under previous U.S. GAAP. The ASU does this by establishing a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence (“VSOE”) if available, third-party evidence if VSOE is not available, or estimated selling price if neither VSOE nor third-party evidence is available. A vendor will be required to determine its best estimate of selling price in a manner that is consistent with that used to determine the price to sell the deliverable on a stand-alone basis. This ASU also eliminates the residual method of allocation and will require that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method, which allocates any discount in the overall arrangement proportionally to each deliverable based on its relative selling price. This standard became effective for the Company in January 2011 and did not have a material impact on the Company’s consolidated results of operations or financial position.

The Company may, at times, enter into multiple-deliverable arrangements with customers. Typically, this occurs when customers purchase a system and also purchase one or more years of annual maintenance contracts that begin after the initial warranty period expires.

In accordance with ASC 605, Revenue Recognition, when two or more product offerings with varying delivery dates are contained in a single arrangement, revenue is allocated between the items based on their relative selling price, provided that each item meets the criteria for treatment as a separate unit of accounting. An item is considered a separate unit of accounting if it has value to the customer on a stand-alone basis and there is objective and reliable evidence of the selling price of the items. The Company determines the selling price by reference to the prices it charges when the items are sold separately. If the Company does not sell the item separately, the selling price is determined by reference to comparable third-party evidence. If neither of these methods provides an appropriate basis for determining a selling price, then one is estimated based on the price at which the Company would sell the item if it was sold regularly on a standalone basis.

In December 2010, the FASB issued ASU No. 2010-29, Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations. This ASU specifies that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments in this ASU also expand the supplemental pro forma disclosures under Topic 805 to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The amended guidance was effective prospectively for business combinations for which the acquisition date was on or after the beginning of the first annual reporting period beginning on or after December 15, 2010 and was applied to the acquisition of Solidscape, Inc. as described in Note 3 – Business Combinations.

## STRATASYS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In October 2009, the FASB issued ASU 2009-14, Certain Revenue Arrangements That Include Software Elements — a consensus of the FASB Emerging Issues Task Force. This ASU removes tangible products containing software components and nonsoftware components that function together to deliver the tangible product's essential functionality from the scope of the software revenue guidance in Subtopic 985-605 of the Codification. Additionally, ASU 2009-14 provides guidance on how a vendor should allocate arrangement consideration to deliverables in an arrangement that includes both tangible products and software that is not essential to the product's functionality. This standard became effective for the Company in January 2011 and did not have a material impact on the Company's consolidated results of operations or financial position.

In May 2011, the FASB issued ASU No. 2011-04, Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This update provides clarification on existing fair value measurement requirements, amends existing guidance primarily related to fair value measurements for financial instruments, and requires enhanced disclosures on fair value measurements. The additional disclosures are specific to Level 3 fair value measurements and transfers between Level 1 and Level 2 of the fair value hierarchy. This ASU is effective on a prospective basis for annual and interim reporting periods beginning on or after December 15, 2011. The Company does not expect that adoption of this standard will have a material impact on its results of operations or financial position.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income. This ASU (1) eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity; (2) requires the consecutive presentation of the statement of net income and other comprehensive income; and (3) requires an entity to present reclassification adjustments on the face of the financial statements from other comprehensive income to net income. The guidance does not change the items reported in other comprehensive income or when an item of other comprehensive income is reclassified to net income. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and is to be applied retrospectively. The Company has chosen early adoption as allowed by the ASU. Since this standard impacts disclosure requirements only, the adoption of this standard did not have an impact on the Company's consolidated results of operations or financial condition.

#### Note 3. Business Combinations

On May 3, 2011, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Solidscape, Inc., a Delaware corporation ("Solidscape"); Granite Acquisition Corporation, a Delaware corporation and the Company's wholly-owned subsidiary ("Merger Sub"); and the Controlling Stockholders identified in the Merger Agreement, pursuant to which the Company acquired all the outstanding shares of capital stock of Solidscape in a cash-for-stock transaction where all the outstanding shares of capital stock and all in-the-money options to purchase shares of common stock of Solidscape were exchanged for an aggregate purchase price of \$39.4 million, plus certain purchase price adjustments. Under the terms of the Merger Agreement, Merger Sub merged with and into Solidscape, with Solidscape surviving as the Company's wholly-owned subsidiary (the "Merger"). The Merger Agreement was unanimously approved by the Company's board of directors.

In the second quarter of 2011, the Company incurred acquisition-related costs of approximately \$615,000, which are recorded as selling, general and administrative expenses in the Consolidated Statements of Operations.

The acquisition has been accounted for under the acquisition method of accounting in accordance with ASC Topic 805, Business Combinations. Under the acquisition method of accounting, the total estimated purchase price is allocated to the net tangible and intangible assets of Solidscape acquired in connection with the acquisition, based on their estimated fair values. The purchase price allocation was estimated based on information that was available as of September 30, 2011 and may be adjusted for final income taxes. The allocation of the purchase price to assets acquired and liabilities assumed is as follows:

## STRATASYS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

|                                      | Allocation of<br>Purchase Price |
|--------------------------------------|---------------------------------|
| Cash and cash equivalents            | \$ 540,489                      |
| Accounts receivable                  | 439,284                         |
| Inventories                          | 1,577,970                       |
| Other current assets                 | 771,441                         |
| Deferred income taxes                | 383,000                         |
| Property and equipment, net          | 364,443                         |
| Goodwill                             | 24,241,569                      |
| Intangible assets                    | 19,500,000                      |
| Accounts payable & other liabilities | (1,041,681)                     |
| Unearned revenue                     | (154,031)                       |
| Deferred tax liabilities             | (7,522,910)                     |
| Total purchase price                 | \$ 39,099,574                   |

The allocation of the purchase price to the net assets acquired and liabilities assumed resulted in the recognition of the following intangible assets:

|                         | Amount        | Weighted Average<br>Life - Years |
|-------------------------|---------------|----------------------------------|
| Developed technology    | \$ 11,750,000 | 6.7                              |
| Customer base           | 5,100,000     | 15                               |
| Trademarks              | 1,150,000     | 15                               |
| In-process R&D          | 1,150,000     | Indefinite                       |
| Non-compete agreement   | 350,000       | 3                                |
| Total intangible assets | \$ 19,500,000 |                                  |

The fair value of the identified intangible assets was estimated using an income approach. Under the income approach, an intangible asset's fair value is equal to the present value of future economic benefits to be derived from ownership of the asset. Indications of value are developed by discounting future net cash flows to their present value at market-based rates of return. The goodwill recognized as a result of the Solidscape acquisition is primarily attributable to the value of the workforce, corporate synergies, as well as unidentifiable intangible assets. None of the goodwill recognized is expected to be deductible for income tax purposes. The useful life of the intangible assets for amortization purposes was determined with the help of outside consultants considering the period of expected cash flows used to measure the fair value of the intangible assets adjusted as appropriate for the entity-specific factors including legal, regulatory, contractual, competitive economic or other factors that may limit the useful life of intangible assets.

The actual Solidscape net sales and net income (loss) included in the Company's Consolidated Statements of Operations for the three and nine months ended September 30, 2011 and the supplemental unaudited pro forma net sales and net income of the combined entity had the acquisition been completed on the first day of the earliest period presented are as follows:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

| (Unaudited)                                            | Net Sales     | Net Income<br>(Loss) | Net Income (Loss)<br>Per Common Share<br>- Diluted |
|--------------------------------------------------------|---------------|----------------------|----------------------------------------------------|
| Actual for the three months ended September 30, 2011   | \$ 2,942,053  | \$ 121,021           | \$ 0.01                                            |
| Actual for the nine months ended September 30, 2011    | 5,037,601     | (127,682)            | (0.01)                                             |
| Supplemental pro forma combined results of operations: |               |                      |                                                    |
| Three months ended September 30, 2011                  | 39,696,024    | 5,857,170            | 0.27                                               |
| Three months ended September 30, 2010                  | 33,416,286    | 3,426,719            | 0.16                                               |
| Nine months ended September 30, 2011                   | 116,055,771   | 15,975,762           | 0.74                                               |
| Nine months ended September 30, 2010                   | \$ 93,196,198 | \$ 5,155,417         | \$ 0.25                                            |

Adjustments to the supplemental pro forma combined results of operations are as follows:

| (Unaudited)                                                                                 | Periods Ended September 30, |            |              |              |
|---------------------------------------------------------------------------------------------|-----------------------------|------------|--------------|--------------|
|                                                                                             | Three Months                |            | Nine Months  |              |
|                                                                                             | 2011                        | 2010       | 2011         | 2010         |
| Non-recurring expense related to fair market value adjustment to acquisition-date inventory | \$ -                        | \$ -       | \$ 561,094   | \$ -         |
| Net impact of the change in amortization of intangibles                                     | -                           | 78,488     | 104,650      | 235,461      |
| Add interest on loans and preferred stock no longer incurred post-merger                    | -                           | 374,522    | 384,860      | 1,163,071    |
| Add management fees no longer incurred post-merger                                          | -                           | 52,174     | 71,450       | 156,872      |
| Remove expenses related to business combination (deal fees, bonus & option payments)        | -                           | -          | 3,127,980    | -            |
| Adjust taxes to the blended rate after business combination                                 | -                           | 61,696     | (2,235,415)  | (450,443)    |
|                                                                                             | \$ -                        | \$ 566,880 | \$ 2,014,619 | \$ 1,104,962 |

These unaudited pro forma condensed consolidated financial results have been prepared for illustrative purposes only and do not purport to be indicative of the results of operations that actually would have resulted had the acquisition occurred on the first day of the earliest period presented, or of future results of the consolidated entities. The unaudited pro forma condensed consolidated financial information does not reflect any operating efficiencies and cost savings that may be realized from the integration of the acquisition.

Note 4. Fair Value of Warrant Related to OEM Agreement

During the first quarter of 2010, the Company signed a Master OEM Agreement (the "OEM Agreement") with Hewlett-Packard Company ("HP") to develop and manufacture an HP-branded 3D printer. In connection with the OEM Agreement, the Company issued a warrant to HP during the first quarter of 2010 to purchase 500,000 shares of common stock at an exercise price of \$17.78 per share. The exercise price was determined by the 20 day average market closing price of the Company's common stock immediately prior to the issuance of the warrant. The warrant vested immediately and has a seven-year term. The fair value of the warrant was properly classified as a reduction of revenue on the Consolidated Statement of Operations for the period ended March 31, 2010. The warrant has not been exercised.

The Company used the Black-Scholes option-pricing model to determine the fair value of the warrant granted to HP. The following assumptions were applied in determining the value:

## STRATASYS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

|                                        |           |
|----------------------------------------|-----------|
| Risk-free interest rate                | 3.1%      |
| Expected term                          | 4.5 years |
| Expected price volatility              | 47%       |
| Dividend yield                         | -         |
| Weighted average grant date fair value | \$ 9.98   |

The Company's computation of expected volatility is based on a combination of historical and market-based implied volatility from traded options on the Company's stock. The expected term was calculated in accordance with ASC 718. The interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield curve in effect at the time of grant.

## Note 5. Investments

Classification of investments as current or non-current is dependent upon management's intended holding period, the investment's maturity date and liquidity considerations based on market conditions. These investments are then evaluated and classified as available-for-sale or held-to-maturity in accordance with the provisions of ASC 320, Investments - Debt and Equity Securities. This evaluation takes into consideration the Company's past history of holding investments until maturity, projected cash flow estimates, future capital requirements, the existence of credit deterioration of the issuer and the Company's overall investment strategy as established by management and approved by the Company's Board of Directors.

If management has the positive intent and ability to hold its debt securities until maturity, they are classified as "held-to-maturity" and accounted for using the amortized-cost method. All other securities are classified as "available-for-sale" and accounted for at fair value with the unrealized gain or loss, net of tax, reported in other comprehensive income. While the Company does not generally hold any investments for trading purposes, the Company did liquidate certain investments during the three months ended June 30, 2011 to fund the acquisition of Solidscape. The Company believes that the liquidation of these investments was an isolated event that is unusual and nonrecurring in nature and was not reasonably anticipated. The net carrying value of liquidated investments was \$14.0 million and the sale resulted in a gain of approximately \$64,000. The Company does not currently hold any investments for trading purposes and had no unrecognized gains or losses related to held-to-maturity investments at September 30, 2011 or December 31, 2010, as the fair value of those investments approximated cost.

The Company invests in certificates of deposit, corporate bonds, tax-free government bonds, and auction rate securities ("ARS"), all of which are insured. The following is a summary of amounts recorded on the Consolidated Balance Sheet for marketable securities (current and non-current) at September 30, 2011 and December 31, 2010.

|                                                       | September, 30<br>2011<br>(unaudited) | December 31,<br>2010 |
|-------------------------------------------------------|--------------------------------------|----------------------|
| Bonds                                                 | \$ 3,047,213                         | \$ 6,837,521         |
| Other securities                                      | -                                    | 357                  |
| Certificates of deposit                               | -                                    | 1,960,000            |
| Short-term investments - held to maturity             | 3,047,213                            | 8,797,878            |
| Auction rate securities                               | -                                    | 1,185,250            |
| Long-term investments - available for sale securities | -                                    | 1,185,250            |
| Auction rate securities                               | 2,200,000                            | 2,200,000            |
| Bonds                                                 | 40,452,402                           | 50,304,650           |
| Long-term investments - held to maturity              | 42,652,402                           | 52,504,650           |
| Total investments                                     | \$ 45,699,615                        | \$ 62,487,778        |



## STRATASYS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Short-term and long-term investments consist of corporate bonds, tax-free government bonds, and ARS. At September 30, 2011, the Company's investments included:

- approximately \$43.5 million in bonds maturing between February 2012 and September 2016, all of which have ratings between AAA and BAA1 at September 30, 2011; and
- approximately \$2.2 million of a tax-free ARS, which re-prices approximately every 35 days. The ARS had a rating of A1 at September 30, 2011.

During the three months ended September 30, 2011, the Company sold its investment in a tax-free ARS issued by Jefferson County, Alabama. During the economic downturn in 2008, with the assistance of outside consultants, the Company determined that the ARS had incurred both a temporary and other-than-temporary impairment to its fair value. Due to negotiations between Jefferson County and bondholders, the market for these bonds improved and in the quarter ended September 30, 2011 the Company was able to sell its investment for \$1.8 resulting in the Company recognizing a gain of \$626,000. The following table summarizes the activity of this investment from December 31, 2008 to September 30, 2011.

|                                                                               |              |
|-------------------------------------------------------------------------------|--------------|
| Net carrying value at December 31, 2008                                       | \$ 1,109,250 |
| Temporary impairment transferred to other-than-temporary impairment           | 40,500       |
| Other-than-temporary impairment - recognized in other income                  | (94,000)     |
| Net carrying value at December 31, 2009                                       | 1,055,750    |
| Principal payment received                                                    | (25,000)     |
| Adjustment to temporary impairment - recognized in other comprehensive income | 154,500      |
| Net carrying value at December 31, 2010                                       | 1,185,250    |
| Principal payment received                                                    | (25,000)     |
| Reduction in carrying value due to sale of ARS                                | (1,786,438)  |
| Gain on sale of ARS - recognized in other income                              | 626,188      |
| Net carrying value at September 30, 2011                                      | \$ -         |

## Note 6. Inventories

Inventories consisted of the following at September 30, 2011 and December 31, 2010, respectively:

|                 | 2011          | 2010          |
|-----------------|---------------|---------------|
| Finished goods  | \$ 8,842,416  | \$ 7,045,840  |
| Raw materials   | 13,141,504    | 10,834,874    |
| Total Inventory | \$ 21,983,920 | \$ 17,880,714 |

## Note 7. Material Commitments

The Company estimates that as of September 30, 2011 and December 31, 2010, it had approximately \$23.8 million and \$22.5 million, respectively, of purchase commitments for inventory from vendors. In addition to purchase commitments for inventory, the Company also has future commitments for leased facilities of approximately \$1.3 million. The Company intends to finance its purchase commitments from existing cash and investments or from cash flows from operations.

## Note 8. Earnings per Common Share

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The Company complies with ASC 260, Earnings Per Share, which requires dual presentation of basic and diluted income per common share for all periods presented. Basic net income per share excludes dilution and is computed by dividing net income by the weighted average number of shares outstanding for the periods that have net income.

## STRATASYS, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then share in the income of the Company. The difference between the number of common shares used to compute basic net income per share and diluted net income per share relates to additional common shares that would be issued upon the assumed exercise of stock options and warrants, net of the common shares that would hypothetically be repurchased using the proceeds received from the original exercise.

The additional common shares amounted to 377,273 and 414,109 for the three months ended September 30, 2011 and 2010, respectively, and 562,374 and 516,370 for the nine months ended September 30, 2011 and 2010, respectively. There were 5,000 options excluded from the dilution calculation for the three months ended September 30, 2011 and no options were excluded from the dilution calculation for the nine months ended September 30, 2011, since their inclusion would not have had a dilutive effect. A total of 16,600 and 14,600 options were excluded from the dilution calculation for the three and nine months ended September 30, 2010, respectively, for the same reason.

The following table provides information relative to stock options that were exercised in the respective periods:

|                                                                            | Periods Ended September 30, |              |                |              |
|----------------------------------------------------------------------------|-----------------------------|--------------|----------------|--------------|
|                                                                            | Three Months                |              | Nine Months    |              |
|                                                                            | 2011                        | 2010         | 2011           | 2010         |
| Proceeds from exercise of stock options                                    | \$ 109,180                  | \$ 1,364,813 | \$ 5,114,889   | \$ 3,958,400 |
| Number of options exercised                                                | 9,000                       | 100,750      | 348,283        | 292,750      |
| Weighted average exercise price                                            | \$ 12.13                    | \$ 13.55     | \$ 14.69       | \$ 13.52     |
| Tax benefit recognized in stockholders' equity from stock option exercises | \$ (31,824)                 | \$ (4,928)   | \$ (2,562,753) | \$ (501,069) |

## Note 9. Stock-Based Compensation

The Company accounts for stock-based compensation under the guidance of ASC 718, Compensation-Stock Compensation. ASC 718 establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services and transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. The stock-based compensation expense, the associated estimated deferred income tax benefit on nonqualified stock options and the current income tax benefit resulting from disqualifying dispositions of incentive stock options were as follows for the respective periods:

|                                  | Periods Ended September 30, |            |              |            |
|----------------------------------|-----------------------------|------------|--------------|------------|
|                                  | Three Months                |            | Nine Months  |            |
|                                  | 2011                        | 2010       | 2011         | 2010       |
| Stock-based compensation expense | \$ 440,829                  | \$ 310,544 | \$ 1,088,025 | \$ 931,632 |
| Income tax benefit               | (95,585)                    | (48,288)   | (383,481)    | (257,408)  |
|                                  | \$ 345,244                  | \$ 262,256 | \$ 704,544   | \$ 674,224 |

There were 325,000 options granted in the nine months ended September 30, 2011 and 300,000 options granted in the nine months ended September 30, 2010.

## Note 10. Income Taxes

The Company uses a two-step approach to recognizing and measuring uncertain tax positions (tax contingencies) in accordance with ASC 740, Income Taxes. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The Company reevaluates these tax positions quarterly and makes adjustments as required. The Company had unrecognized tax benefits of \$1.4 million at

September 30, 2011 and December 31, 2010.

## STRATASYS, INC. AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Note 11. Fair Value Measurements

Fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. A hierarchy has been established for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available.

Observable inputs are inputs market participants would use in valuing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the factors market participants would use in valuing the asset or liability developed based upon the best information available under the circumstances. The hierarchy is broken down into three levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

During the quarter ended September 30, 2011, the Company had no significant measurements of assets or liabilities at fair value on a recurring or nonrecurring basis subsequent to their initial recognition.

#### Note 12. Foreign Currency Hedge

The Company invoices sales to certain European distributors in Euros and such receivable balances are subject to fluctuations in the exchange rates of that currency in relation to the United States dollar. The Company's strategy is to hedge most of its Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that its earnings will be adversely affected by changes in currency exchange rates. The Company does not use derivative financial instruments for speculative or trading purposes. The Company enters into 30-day foreign currency forward contracts on the last day of each month and therefore the notional value of the contract equals the fair value at the end of each reporting period. As such, there is no related asset or liability or unrealized gain or loss recorded on the Balance Sheet as of the end of the period. All realized gains and losses related to hedging activities are recorded in current period earnings under the Consolidated Statements of Operations and Comprehensive Income caption "Foreign currency transaction gains (losses), net".

The Company hedged between €4.2 million and €4.8 million for the three months ended September 30, 2011 and between €4.0 million and €5.6 million for the nine months ended September 30, 2011 of accounts receivable that were denominated in Euros. The foreign currency forward contracts resulted in a currency translation gain of approximately \$417,000 for the three months ended September 30, 2011 and a loss of approximately \$438,000 for the three months ended September 30, 2010. Foreign currency forward contracts resulted in a currency translation loss of approximately \$159,000 for the nine months ended September 30, 2011 and a gain of approximately \$252,000 for the nine months ended September 30, 2010. The resulting gain or loss from foreign currency forward contracts only partially offset the total foreign currency transactions gains or losses that the Company recorded.

The Company will continue to monitor exposure to currency fluctuations. Instruments that may be used to hedge future risks may include foreign currency forward, swap, and option contracts. These instruments may be used to selectively manage risks, but there can be no assurance that the Company will be fully protected against material foreign currency fluctuations.

STRATASYS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 13. Accounting for Collaborative Arrangements

In 2008, the Company fulfilled its responsibilities under a three-year, \$3.6 million agreement with a Fortune 500 global manufacturing company to jointly advance its proprietary FDM (Fused Deposition Modeling) technology for rapid manufacturing applications. This agreement entitled the Company to receive reimbursement payments as it achieved specific milestones stated in the agreement. This effort was focused around the Company's high-performance systems and resulted in the commercial release of the Fortus 900mc. Because receipt of these payments represented reimbursements of costs actually incurred under this joint development project, all payments received were recorded as offsets to the research and development expenditures and are therefore not recognized as revenue.

Due to the success of this initial arrangement, the Company is continuing this relationship under similar terms and objectives. During the three months ended September 30, 2011 and 2010, approximately \$170,000 and \$352,000, respectively, of research and development expenses were offset by payments that were received from that company. During the nine months ended September 30, 2011 and 2010, approximately \$509,000 and \$889,000, respectively, of research and development expenses were offset by payments that were received from that company.

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

### Overview

#### Description of Business

We develop, manufacture, and market a family of 3D printing, rapid prototyping ("RP") and direct digital manufacturing ("DDM") systems, which enable engineers and designers to create physical models, prototypes, tooling, jigs, fixtures, and end use parts out of production grade thermoplastic directly from a computer aided design ("CAD") workstation. Our systems and related consumable products are distributed mainly through a world-wide network of value added resellers that sell and service our products to end users. We also operate a service business that uses our systems to print parts from a customer's CAD file, typically in situations where these customers have not yet purchased a system or do not have enough capacity on their existing systems.

In May 2011, we acquired Solidscape, Inc. for \$39.1 million in cash plus certain purchase price adjustments. Solidscape is a manufacturer of high precision 3D printers and is a proven leader in investment casting applications that require ultra-fine feature detail. This addition provides us with access to markets currently not served by Stratasys, including the under-penetrated jewelry, dental and precision industrial casting markets. We believe that this acquisition will provide the potential to expand our technology platform into new applications and will create synergies, particularly in manufacturing, our respective sales channels, and research and development.

#### Summary of Financial Results

For the quarter ended September 30, 2011, we recorded net income of \$5.9 million, or \$0.27 per diluted share, as compared to net income of \$3.2 million, or \$0.15 per diluted share, for the quarter ended September 30, 2010. Results for the third quarter of 2011 include three months of operations of Solidscape, which was acquired on May 3, 2011.

Our revenues in the third quarter of 2011 increased to \$39.7 million as compared to revenues of \$30.3 million that were reported in the third quarter of 2010. Gross profit of \$21.6 million in the second quarter of 2011 increased as compared to \$14.7 million reported in the prior year

Our balance sheet continues to be strong. As of September 30, 2011, our cash and investments balance was approximately \$60.9 million, down from \$90.0 million at December 31, 2010. The decrease in cash and investments as of September 30, 2011 reflects approximately \$39.1 million paid for the acquisition of Solidscape, which closed in May. We generated approximately \$5.9 million of cash from operations during the quarter, primarily driven by our net income adjusted for non-cash charges for depreciation, amortization and stock-based compensation. We also have no debt and believe that we have adequate liquidity to fund our growth strategy throughout the remainder of 2011 and into 2012.

#### Our Market Strategy and Description of Current Conditions

It is our belief that we are successfully implementing our overall marketing strategy in the 3D printing, RP and DDM markets through the expansion of our distribution channel and the introduction of new products.

**Distribution Channel** We recently completed the initial term of a Master Original Equipment Manufacturer Agreement (the "OEM Agreement") with Hewlett-Packard Company ("HP"), and are now in an extension term, which currently expires September 30, 2012. Under the OEM Agreement, we are manufacturing a line of FDM ("Fused Deposition Modeling") 3D printers and related accessories and consumables exclusively for HP for resale under the HP DesignJet brand in eight European countries. We believe this distribution channel continues to be a valuable approach to increase sales and enhance awareness of 3D printing.

**3D Printers** We are the unit leaders in the 3D printing market and have followed a strategy of moving down the price elasticity curve, evidenced by our introduction of the uPrint and uPrint Plus systems. We believe our strategy of offering low-priced 3D printing systems combined with high reliability, ease of use and increased functionality will allow for an increase of 3D printers in the market and continue to make our 3D printers an attractive alternative to our competitors' products.

We also believe our lower-priced systems and the expansion of our distribution channel with HP will increase awareness of our technology and products. Lower-priced systems will reduce our margins as a percentage of revenue from the levels we have previously achieved, but we intend to compensate for these lower margins by expanding the market and unit volume for our 3D printers (and related proprietary consumables), thereby substantially increasing the number of 3D printers sold and our overall revenues and profits. Although we believe that there is a large market for our 3D printers, there can be no assurance that we will be able to increase our revenues sufficiently to maintain or increase our profitability.

To improve our product offerings, we also introduced support-material enhancements concurrently with the launch of the uPrint Plus. The first, Smart Supports, is a software feature that can reduce support material usage by up to 40%. The second is a new soluble support material called SR-30, which can dissolve 69% faster than the previous soluble support material.

**RP and DDM Markets** Our strategy in the high-performance market is to expand our installed base of RP and DDM systems by helping customers build stable, strong, accurate and durable parts for functional testing and end-use. We plan to build on our leadership position in this area by offering additional system capabilities and improved material properties. We also have growing opportunities in DDM applications. DDM involves the manufacture of parts fabricated directly from our systems that are subsequently incorporated into the user's end product or production process. DDM is particularly attractive in applications that require short-run or low-volume parts that require rapid turn-around and for which tooling would not be cost effective due to small volumes.

In February 2011, we obtained ISO 9001:2008 certification by maintaining a highly developed quality management system and continually improving its effectiveness in accordance with the ISO requirements. We believe that ISO certification is a key requirement in expanding our products' applicability to the RP and DDM markets that we are focusing on such as aerospace, defense, medical, and automotive. We will use this certification to demonstrate our ability to consistently provide products that meet customer and applicable regulatory requirements and enhance customer satisfaction through its effective application.

We continued to collaborate with a Fortune 500 global manufacturing company to advance our proprietary FDM technology for direct digital manufacturing applications and expect to maintain this collaboration throughout the remainder of 2011 and into 2012 for the seventh consecutive year.

**Recurring Revenues** As our installation base of systems has increased, we expect an increasing amount of revenue from the sales of consumables, maintenance contracts, and other services. We have experienced an increase in consumable sales throughout 2010 and into 2011.

**RedEye Paid Parts Service** Our RedEye paid parts service makes and sells physical models, tooling and prototype parts for RP and DDM applications based on our customers' CAD files. We believe that a significant portion of RedEye sales have come from current system users that have had short-term capacity constraints on their own FDM systems. We believe that another part of sales has come from the rising demand for our technology in DDM applications, because of the production-grade thermoplastics used. To take advantage of the growth we see in our DDM customer base, we are adding staff to our existing sales force that will focus exclusively on large strategic accounts.

#### Developments in Our Business During the Period

Our third quarter results reflected an increase in sales driven mainly by Fortus 3D production systems and consumables. Fortus system sales in the third quarter of 2011 increased by 102% as compared to the third quarter of 2010. The sales increase in higher-priced Fortus systems was primarily driven by the introduction of the Fortus 250mc Production System in July 2011 and increased demand for direct digital manufacturing applications, which include aircraft repair and maintenance. Consumable sales increased by 26% as compared to the third quarter of 2010 due to an increase in system usage by our installed base and the acquisition of Solidscape. Our overall gross margin improved to 54.3% from 48.6% in the third quarter of 2010. Both the increased Fortus systems and consumable sales, combined with decreased lower margin sales to HP, contributed to the higher gross margin in the current quarter.

In July 2011, we introduced the Fortus 250mc Production System. The Fortus 250mc combines the ease-of-use and affordability of Dimension 3D Printers with the control of Insight Software, used to drive the Fortus line of production systems. With Insight, users will have added control of build speed, part accuracy, and feature detail. The Fortus 250mc uses Stratasys SR-30 soluble support material, which has a faster dissolve time than other soluble support materials.

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During the quarter ended June 30, 2011, we signed a modification of our OEM Agreement with HP both expanding the territories and extending the term. The OEM Agreement now includes three additional European countries in addition to France, Germany, Italy, Spain and the United Kingdom and extends the expiration date to September 30, 2012.

In May 2011, we acquired Solidscape as described under “Description of Business” above. Solidscape leadership and management will stay with the company, which will operate from its base in New Hampshire as a wholly owned subsidiary of Stratasys.

Given our strong cash position and absence of debt, we believe that we have adequate liquidity to fund our growth strategy for the remainder of 2011 and into 2012. We may make investments in strategic acquisitions, fixed assets, process improvements, information technology (“IT”), and human resource development activities that will be required for future growth. Our expense levels are based in part on our expectations of future sales and we will make adjustments as we consider appropriate. While we have adjusted, and will continue to adjust, our expense levels based on both actual and anticipated sales, fluctuations in sales in a particular period could adversely impact our operating results.

### Cautionary Note Concerning Factors that May Affect Future Results

Our current and future growth is largely dependent upon our ability to penetrate new markets and develop and market new rapid prototyping and manufacturing systems, materials, applications, and services that meet the needs of our current and prospective customers. Our expense levels are based in part on our expectations of future revenues. While we have adjusted, and will continue to adjust, our expense levels based on both actual and anticipated revenues, fluctuations in revenues in a particular period could adversely impact our operating results. Our ability to continue to implement our strategy in 2011 is subject to numerous uncertainties and risks, many of which are described in this Management’s Discussion and Analysis of Financial Condition and Results of Operations, in the section below captioned “Forward Looking Statements and Factors That May Affect Future Results of Operations,” and in Item 1A, “Risk Factors,” of our Annual Report on Form 10-K for 2010 and our Quarterly Reports on Form 10-Q and Current Reports on Form 8-K filed and to be filed in 2011. We cannot ensure that our efforts will be successful.

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## Results of Operations (unaudited)

The following table sets forth certain consolidated statements of operations data as a percentage of net sales for the periods indicated. All items are included in or derived from our consolidated interim statements of operations.

Three- and Nine-Month Periods Ended September 30,

|                                      | Three Months |        | Nine Months |        |
|--------------------------------------|--------------|--------|-------------|--------|
|                                      | 2011         | 2010   | 2011        | 2010   |
| Net sales                            | 100.0%       | 100.0% | 100.0%      | 100.0% |
| Cost of sales                        | 45.7%        | 51.4%  | 46.6%       | 53.3%  |
| Gross profit                         | 54.3%        | 48.6%  | 53.4%       | 46.7%  |
| Research and development             | 9.1%         | 7.4%   | 9.6%        | 8.6%   |
| Selling, general, and administrative | 25.4%        | 27.8%  | 25.8%       | 29.3%  |
| Operating income                     | 19.8%        | 13.4%  | 18.0%       | 8.8%   |
| Other income (expense)               | 1.9%         | 1.6%   | 2.3%        | 0.1%   |
| Income before income taxes           | 21.8%        | 15.1%  | 20.3%       | 8.9%   |
| Income tax expense                   | 7.1%         | 4.6%   | 7.0%        | 2.8%   |
| Net income                           | 14.8%        | 10.5%  | 13.0%       | 6.1%   |

## Net Sales

Our net sales of \$39.7 million in the third quarter of 2011 increased by 31.2% as compared to net sales of \$30.3 million in the third quarter of 2010. Net sales of \$111.6 million in the first nine months of 2011 increased by 26.3% as compared to net sales of \$88.3 million in the same prior-year period. The following is a breakdown of our revenues by products and services:

Three- and Nine-Month Periods Ended September 30,

| (In Thousands)        | Three Months |           | Period-over-<br>period<br>change | Nine Months |           | Period-over-<br>period<br>change |
|-----------------------|--------------|-----------|----------------------------------|-------------|-----------|----------------------------------|
|                       | 2011         | 2010      |                                  | 2011        | 2010      |                                  |
| Products              | \$ 32,256    | \$ 23,967 | 34.6%                            | \$ 90,521   | \$ 69,526 | 30.2%                            |
| Services              | 7,440        | 6,292     | 18.2%                            | 21,049      | 18,786    | 12.0%                            |
| Fair value of warrant | -            | -         | -                                | -           | (4,988)   | -                                |
|                       | \$ 39,696    | \$ 30,259 | 31.2%                            | \$ 111,570  | \$ 83,324 | 33.9%                            |

Sales derived from products increased \$8.3 million, or 34.6%, in the quarter ended September 30, 2011, as compared with the quarter ended September 30, 2010. System revenue grew by 37.0% as a result of increased sales of our higher priced Fortus 3D production systems and the addition of Solidscape in May 2011. We shipped 600 units in the third quarter of 2011 as compared with 631 units shipped in the third quarter of 2010. The decrease in total units shipped as compared to the prior year is primarily due to the promotional introduction of the uPrint Plus in the first quarter of 2010 and shift in system mix towards our higher priced Fortus 3D production systems, partially offset by the acquisition of Solidscape in May 2011. Consumable revenue increased 26.1%, primarily driven by acceleration in customer usage, our growing installation base of systems, the acquisition of Solidscape in May 2011 and a price increase of approximately 3.8% that was effective on April 1, 2011.

For the nine months ended September 30, 2011, sales derived from products increased \$21.0 million, or 30.2%, as compared with the nine months ended September 30, 2010. System revenue grew by 30.1% as a result of increased sales of our higher priced Fortus 3D production systems and the addition of Solidscape in May 2011. We shipped 1,902 units in the first three quarters of 2011 as compared with 1,923 units shipped in same prior-year period. The decrease in total units shipped as compared to the prior year is primarily due to a lack of channel development and marketing for our uPrint systems, a shift in system mix towards our Fortus 3D production systems and the promotional introduction of the uPrint Plus in the first quarter of 2010, partially offset by the acquisition of Solidscape in May 2011. Consumable revenue increased 28.9%, primarily driven by acceleration in customer usage and our growing installed base of systems.



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Sales from our service offerings increased by approximately \$1.1 million, or 18.2%, in the quarter ended September 30, 2011 and \$2.3 million, or 12.0%, in the nine months ended September 30, 2011 as compared to the same prior-year periods. Maintenance revenue increased by 14.9% and 12.6% for the three and nine months ended September 30, 2011, respectively, as compared with the same prior-year periods. These increases reflect our growing installation base of systems and the reduced impact of an extension in system warranty periods implemented in 2009. Sales from our RedEye paid parts service increased by 19.2% and 9.1% for the three and nine months ended September 30, 2011, respectively, primarily resulting from increased new customer business and an increase in average sales price.

During the first quarter of 2010, we signed an OEM Agreement with HP to develop and manufacture a line of HP-branded 3D printers. In connection with the OEM Agreement, we issued a warrant to HP during the first quarter of 2010 to purchase 500,000 shares of common stock at an exercise price of \$17.78 per share. The exercise price was determined by the 20 day average market closing price of our common stock immediately prior to the issuance of the warrant. The warrant vested immediately and has a seven-year term. The warrant has not been exercised. The grant date fair value of the warrant was classified as a reduction of revenue on the Consolidated Statement of Operations for the nine months ended September 30, 2010.

Revenues in the Americas region, which includes North and South America, accounted for approximately 56.3% and 55.6% of total revenue for the quarters ended September 30, 2011 and 2010, respectively. Revenues in the Americas region accounted for approximately 54.6% and 55.8% of total revenue for the nine months ended September 30, 2011 and 2010, respectively.

Revenues outside the Americas region accounted for approximately 43.7% and 44.4% of total revenues for the quarters ended September 30, 2011 and 2010, respectively. Revenues outside the Americas region accounted for approximately 45.4% and 44.2% of total revenues for the nine months ended September 30, 2011 and 2010, respectively.

### Gross Profit

Three- and Nine-Month Periods Ended September 30,

| (In Thousands)        | Three Months |           | Period-over-Nine Months |           | Period-over- |               |
|-----------------------|--------------|-----------|-------------------------|-----------|--------------|---------------|
|                       | 2011         | 2010      | period change           | 2011      | 2010         | period change |
| Products              | \$ 17,387    | \$ 11,271 | 54.3%                   | \$ 47,873 | \$ 33,721    | 42.0%         |
| Services              | 4,167        | 3,438     | 21.2%                   | 11,667    | 10,158       | 14.9%         |
| Fair value of warrant | -            | -         | -                       | -         | (4,988)      | -             |
| Total                 | \$ 21,554    | \$ 14,709 | 46.5%                   | \$ 59,540 | \$ 38,891    | 53.1%         |

  

| Gross Profit as a Percentage of Related Sales |       |       |       |       |
|-----------------------------------------------|-------|-------|-------|-------|
| Products                                      | 53.9% | 47.0% | 52.9% | 48.5% |
| Services                                      | 56.0% | 54.6% | 55.4% | 54.1% |
| Total                                         | 54.3% | 48.6% | 53.4% | 46.7% |

Gross profit increased by \$6.8 million, or 46.5%, to \$21.6 million in the quarter ended September 30, 2011 as compared with \$14.7 million in the same prior-year period. The increase is primarily attributable to increased sales of our higher-margin Fortus 3D production systems and consumables, combined with decreased lower-margin sales to HP. Gross profit for the nine months ended September 30, 2011 increased by \$20.6 million, or 53.1%, to \$59.5 million as compared with \$38.9 million in the same prior-year period. The increase for the nine-month period was primarily attributable to a \$5.0 million charge to revenue in the first quarter of 2010 related to the warrant issued to HP in connection with an OEM Agreement as well as higher sales volume.

Product gross profit increased by 54.3% and 42.0% for the three and nine months ended September 30, 2011, respectively, as compared to the same prior-year periods. This increase is primarily due to increased volume to cover fixed overhead and a product mix that favored our higher priced Fortus systems, which included the introduction of our new Fortus 250mc 3D production system. The increase in gross profit as a percentage of related sales was primarily due to increased growth in our higher-margin Fortus systems and consumables as well as decreased sales of lower-margin systems to HP.



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Gross profit from services increased by 21.2% and 14.9% for the three and nine months ended September 30, 2011, respectively, as compared to the same prior-year periods due to increased growth in system maintenance and RedEye paid parts service sales. Higher sales have a positive impact on gross profit as a large portion of costs associated with our service businesses are fixed.

### Operating Expenses

Operating expenses and operating expense as a percentage of sales, as well as the percentage changes in operating expenses were as follows:

Three- and Nine-Month Periods Ended September 30,

| (In Thousands)                    | Three Months |           | Period-over-Nine Months<br>period<br>change | Period-over-Nine Months |           | Period-over-<br>period<br>change |
|-----------------------------------|--------------|-----------|---------------------------------------------|-------------------------|-----------|----------------------------------|
|                                   | 2011         | 2010      |                                             | 2011                    | 2010      |                                  |
| Research & development            | \$ 3,614     | \$ 2,242  | 61.2%                                       | \$ 10,688               | \$ 7,191  | 48.6%                            |
| Selling, general & administrative | 10,083       | 8,404     | 20.0%                                       | 28,738                  | 24,386    | 17.8%                            |
|                                   | \$ 13,697    | \$ 10,646 | 28.7%                                       | \$ 39,426               | \$ 31,577 | 24.9%                            |
| Percentage of sales               | 34.5%        | 35.2%     |                                             | 35.3%                   | 37.9%     |                                  |

Research and development expense increased by 61.2% and 48.6% for the three and nine months ended September 30, 2011 as compared to the same prior-year periods. The overall increase was driven primarily by new product initiatives within 3D printing and 3D production systems, including Solidscape, as well as a decrease in research and development expense reimbursements received in connection with our collaborative agreement further discussed below. Capitalized research and development expenditures for the quarter ended September 30, 2011 relating to internally developed software was approximately \$273,000 as compared to \$287,000 for the same prior-year period. Capitalized software for the nine months ended September 30, 2011 was approximately \$897,000 as compared to \$915,000 for the same prior-year period.

In 2008, we fulfilled our responsibilities under a three-year, \$3.6 million agreement with a Fortune 500 global manufacturing company to jointly advance our proprietary FDM technology for rapid manufacturing applications. This agreement entitled us to receive reimbursement payments as we achieved specific milestones stated in the agreement. This effort was focused around our high-performance systems and resulted in the commercial release of the Fortus 900mc. Because receipt of these payments represented reimbursements of costs actually incurred under this joint development project, all payments received were recorded as offsets to the research and development expenditures and are therefore not recognized as revenue.

Due to the success of this initial arrangement, we are continuing this relationship under similar terms and objectives. During the three months ended September 30, 2011 and September 30, 2010, approximately \$170,000 and \$352,000, respectively, of research and development expenses were offset by payments that we received from that company. During the nine months ended September 30, 2011 and 2010, approximately \$509,000 and \$889,000 of research and development expenses were offset.

Selling, general and administrative expenses increased by 20.0% and 17.8% for the three and nine months ended September 30, 2011 as compared to the same prior-year periods. The increase is primarily due to expenses related to the acquisition of Solidscape and increased employee-related expenses.

### Operating Income

Operating income and operating income as a percentage of sales, as well as the percentage changes in operating income, were as follows:

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Three- and Nine-Month Periods Ended September 30,

| (In Thousands)      | Three Months |          | Period-over-<br>period<br>change | Nine Months |          | Period-over-<br>period<br>change |
|---------------------|--------------|----------|----------------------------------|-------------|----------|----------------------------------|
|                     | 2011         | 2010     |                                  | 2011        | 2010     |                                  |
| Operating income    | \$ 7,857     | \$ 4,063 | 93.4%                            | \$ 20,114   | \$ 7,314 | 175.0%                           |
| Percentage of sales | 19.8%        | 13.4%    |                                  | 18.0%       | 8.8%     |                                  |

Operating income increased by \$3.8 million, or 93.4%, to \$7.9 million in the quarter ended September 30, 2011 as compared with \$4.1 million in the same prior-year period. The overall increase in operating income was primarily attributable to increased product sales led by our higher-margin Fortus systems and consumables. Operating income for the nine months ended September 30, 2011 was \$20.1 million as compared to \$7.3 million in the same prior-year period. This increase was primarily attributable to increased product sales led by our higher-margin Fortus systems and consumables as well as a \$5.0 million charge to revenue in the first quarter of 2010 related to the warrant issued to HP in connection with an OEM Agreement.

## Other Income

Other income as a percentage of sales and changes in other income were as follows:

Three- and Nine-Month Periods Ended September 30,

| (In Thousands)               | Three Months |        | Period-over-<br>period<br>change | Nine Months |        | Period-over-<br>period<br>change |
|------------------------------|--------------|--------|----------------------------------|-------------|--------|----------------------------------|
|                              | 2011         | 2010   |                                  | 2011        | 2010   |                                  |
| Interest income              | \$ 276       | \$ 217 | 27.2%                            | \$ 698      | \$ 596 | 17.1%                            |
| Foreign currency transaction |              |        |                                  |             |        |                                  |
| gains (losses)               | (218)        | 228    | 195.6%                           | (430)       | (570)  | 24.6%                            |
| Other                        | 755          | 48     | n/a                              | 2,265       | 42     | n/a                              |
|                              | \$ 813       | \$ 493 | n/a                              | \$ 2,533    | \$ 68  | n/a                              |
| Percentage of sales          | 2.0%         | 1.6%   |                                  | 2.3%        | 0.1%   |                                  |

Interest income increased by 27.2% and 17.1% for the three and nine months ended September 30, 2011 and 2010, respectively, compared to the same prior-year periods. The increase is primarily due to a higher effective interest rate of our investment portfolio.

Our strategy is to hedge most of our Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that our earnings will be adversely affected by changes in currency exchange rates. In addition to our Euro-denominated accounts receivable, we also have Euro-denominated assets related to our foreign subsidiaries that are also subject to fluctuations in exchange rates. We do not use derivative financial instruments for speculative or trading purposes. We will continue to monitor exposure to currency fluctuations. Instruments to hedge risks may include foreign currency forward, swap, and option contracts. These instruments will be used to selectively manage risks, but there can be no assurance that we will be fully protected against material foreign currency fluctuations.

Other income increased by \$707,000 for the three months ended September 30, 2011 as compared to the prior-year period due to the gain on the sale of the Jefferson County, Alabama auction rate security that had been impaired in prior years. Other income increased by \$2.2 million for the nine months ended September 30, 2011 as compared to the prior-year period due to a gain on the sale of an equity investment that we maintained in an independent online parts quoting service company in the first quarter of 2011 and the sale of the Jefferson County, Alabama ARS.

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## Income Tax Expense

Income taxes and income taxes as a percentage of net income before income taxes, as well as the percentage changes, were as follows:

Three- and Nine-Month Periods Ended September 30,

| (In Thousands)     | Three Months |          | Period-over-<br>period<br>change | Nine Months |          | Period-over-<br>period<br>change |
|--------------------|--------------|----------|----------------------------------|-------------|----------|----------------------------------|
|                    | 2011         | 2010     |                                  | 2011        | 2010     |                                  |
| Income tax expense | \$ 2,813     | \$ 1,381 | 103.7%                           | \$ 7,807    | \$ 2,318 | 236.8%                           |
| Effective tax rate | 32.4%        | 30.3%    |                                  | 34.5%       | 31.4%    |                                  |

The effective tax rate of 32.4% for the quarter ended September 30, 2011 was higher as compared to the 30.3% effective rate for the same prior-year period. The increase is primarily due to a reduction in contingency reserves in 2010 pertaining to positions taken on our 2006 tax return for which the statute of limitations expired. The effective tax rate of 34.5% for the nine months ended September 30, 2011 was higher as compared to the 31.4% effective rate for the same prior-year period due to a favorable tax liability adjustment in 2010 resulting from the disqualifying dispositions of incentive stock options and the reduction in contingency reserves in the third quarter of 2010 as noted above.

## Net Income

Net income and net income as a percentage of sales, as well as the percentage changes in net income, were as follows:

Three- and Nine-Month Periods Ended September 30,

| (In Thousands)      | Three Months |          | Period-over-<br>period<br>change | Nine Months |          | Period-over-<br>period<br>change |
|---------------------|--------------|----------|----------------------------------|-------------|----------|----------------------------------|
|                     | 2011         | 2010     |                                  | 2011        | 2010     |                                  |
| Net income          | \$ 5,857     | \$ 3,176 | 84.4%                            | \$ 14,840   | \$ 5,065 | 193.0 %                          |
| Percentage of sales | 14.8%        | 10.5%    |                                  | 13.3%       | 6.1%     |                                  |

Net income in the current period increased during the three and nine months ended September 30, 2011 as compared to the same prior year periods primarily due to increased product sales, a favorable product mix and a \$3.2 million, net of tax, warrant charge in the first quarter of 2010 in connection with an OEM Agreement.

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### Liquidity and Capital Resources (unaudited)

A summary of our consolidated interim statements of cash flows for the nine months ended September 30, 2011 and 2010 are as follows:

(In Thousands)

|                                                | 2011      | 2010      |
|------------------------------------------------|-----------|-----------|
| Net income                                     | \$ 14,840 | \$ 5,065  |
| Deferred income taxes                          | (210)     | -         |
| Depreciation and amortization                  | 7,530     | 6,796     |
| Stock-based compensation                       | 1,088     | 932       |
| Excess tax benefit from stock options          | (2,563)   | -         |
| Fair value of warrant related to OEM agreement | -         | 4,988     |
| Gain on disposal of property and equipment     | (156)     | -         |
| Gain on sale of investment                     | (1,831)   | -         |
| Changes in operating assets and liabilities    | (5,737)   | (3,139)   |
| Net cash provided by operating activities      | 12,961    | 14,642    |
| Net cash used in investing activities          | (33,122)  | (41,981)  |
| Net cash provided by financing activities      | 7,678     | 1,822     |
| Effect of exchange rate changes on cash        | 161       | (67)      |
| Net decrease in cash and cash equivalents      | (12,322)  | (25,584)  |
| Cash and cash equivalents, beginning of period | 27,554    | 48,316    |
| Cash and cash equivalents, end of period       | \$ 15,232 | \$ 22,732 |

Our cash and cash equivalents balance decreased by \$12.3 million to \$15.2 million at September 30, 2011, from \$27.6 million at December 31, 2010. The decrease is primarily due to approximately \$39.1 million in cash used for the acquisition of Solidscape during the second quarter of 2011.

In the nine months ended September 30, 2011, net cash provided by our operating activities was \$13.0 million compared to cash provided by operations of \$14.6 million during the comparable 2010 period. Our accounts receivable balance increased to \$23.8 million at September 30, 2011 from \$20.1 million as of December 31, 2010. This increase was principally due to sales growth in the first nine months of 2011 and the acquisition of Solidscape. At September 30, 2011, our inventory balance increased to \$22.0 million as compared to \$17.9 million at December 31, 2010. This increase was principally due to strong order flow and anticipated sales growth for both systems and consumables and the acquisition of Solidscape.

Our investing activities used net cash of \$33.1 million in first nine months of 2011 as compared to \$42.0 million in same prior-year period. In May 2011, we acquired Solidscape, Inc. for \$39.1 million in cash plus certain purchase price adjustments. We received net cash of approximately \$18.6 million in connection with the purchase, maturity and sale of investments during the first nine months of 2011 as compared to \$38.7 million net cash used for the purchase and maturity of investments during the same prior-year period. We used cash of approximately \$9.6 million for fixed asset additions in the first nine months of 2011 as compared to \$2.3 million in the same prior-year period. Net cash used for payments for intangible assets and other investments, including patents and capitalized software was \$3.5 million during the first nine months of 2011 as compared to \$1.0 million for the same prior-year period. Much of the capital expenditures in 2011 have been for equipment required by the ongoing needs of our business, including manufacturing facilities and fixtures for new products and consumable manufacturing.

In the nine months ended September 30, 2011, net cash provided by financing activities of \$7.7 million resulted from the proceeds from the exercise of stock options and adjustment to income taxes payable for excess tax benefits from the exercise of stock options.

For the remainder of 2011, we expect to use our cash flows from operations and/or our cash and investments as follows:

- for improvements to our facilities;

- for the continuation of our leasing program;

- for working capital purposes;
- for information systems and infrastructure enhancements;
- for new product and materials development;
- for sustaining engineering;
- for acquisition of equipment, including production equipment, tooling, and computers;
- for increased selling and marketing activities, especially as they relate to the continued market and channel development;
- for new product and materials development; and
- for acquisitions and/or strategic alliances.

Our total current assets amounted to approximately \$75.4 million at September 30, 2011, most of which consisted of cash and cash equivalents, investments, accounts receivable and inventories. Total current liabilities amounted to approximately \$27.8 million and we have no debt. We believe that we have adequate resources to fund our foreseeable future growth.

#### Inflation

We believe that inflation has not had a material effect on our operations or on our financial condition during the three most recent fiscal years and during the current quarter.

#### Foreign Currency Transactions

We invoice sales to certain European distributors in Euros, and reported results are therefore subject to fluctuations in the exchange rates of that currency in relation to the United States dollar. Our strategy is to hedge most of our Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that our earnings will be adversely affected by changes in currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes. We enter into 30-day foreign currency forward contracts on the last day of each month and therefore the notional value of the contract equals the fair value. As such, there is no related asset or liability or unrealized gains or losses recorded on the Balance Sheet as of the end of the period. All realized gains and losses related to hedging activities are recorded in current period earnings under the Statement of Operations caption "Foreign currency transactions gains (losses), net."

We hedged between €4.2 million and €4.8 million for the three months ended September 30, 2011 and between €4.0 million and €5.6 million for the nine months ended September 30, 2011 of accounts receivable that were denominated in Euros. The foreign currency forward contracts resulted in a currency translation gain of approximately \$417,000 for the three months ended September 30, 2011 and a loss of approximately \$438,000 for the three months ended September 30, 2010. Foreign currency forward contracts resulted in a currency translation loss of approximately \$159,000 for the nine months ended September 30, 2011 and a gain of approximately \$252,000 for the nine months ended September 30, 2010. The resulting gain or loss from foreign currency forward contracts only partially offset the total foreign currency transactions gains or losses that we recorded.

We will continue to monitor exposure to currency fluctuations. Instruments to hedge risks may include foreign currency forward, swap, and option contracts. These instruments will be used to selectively manage risks, but there can be no assurance that we will be fully protected against material foreign currency fluctuations.

#### Critical Accounting Policies

We have prepared our consolidated interim financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America. This has required us to make estimates, judgments, and assumptions that affected the amounts we

reported.

We have identified several critical accounting policies that required us to make assumptions about matters that were uncertain at the time of our estimates. Had we used different estimates and assumptions, the amounts we recorded could have been significantly different. Additionally, if we had used different assumptions or if different conditions existed, our financial condition or results of operations could have been materially different. Certain critical accounting policies that were affected by the estimates, assumptions, and judgments used in the preparation of our consolidated interim financial statements are described in our Annual Report on Form 10-K for 2010 and in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2011. Additional critical accounting policies are set forth below.

## Intangible Assets

Intangible assets are capitalized and amortized over their estimated useful or economic lives using the straight-line method in conformity with ASC 350, Intangibles – Goodwill and Other, as follows:

|                                        | Years      |
|----------------------------------------|------------|
| Capitalized software development costs | 3          |
| Trademarks                             | 5-15       |
| Patents                                | 10         |
| RP technology                          | 6-11       |
| Solidscape customer base               | 15         |
| Solidscape non-compete agreement       | 3          |
| In-process research and development    | Indefinite |

The costs of software development, including significant product enhancements, incurred subsequent to establishing technological feasibility have been capitalized in accordance with ASC 985-20, Costs of Software to be Sold, Leased or Marketed. Costs incurred prior to establishment of technological feasibility are charged to research and development expense.

We evaluate the recoverability of identifiable intangible assets whenever events or changes in circumstances indicate that an intangible asset's carrying amount may not be recoverable. Such circumstances could include, but are not limited to (1) a significant decrease in the market value of an asset, (2) a significant adverse change in the extent or manner in which an asset is used, or (3) an accumulation of costs significantly in excess of the amount originally expected for the acquisition of an asset. We measure the carrying amount of the asset against the estimated undiscounted future cash flows associated with it. Should the sum of the expected future net cash flows be less than the carrying value of the asset being evaluated, an impairment loss would be recognized. The impairment loss would be calculated as the amount by which the carrying value of the asset exceeds its fair value. The fair value is measured based on quoted market prices, if available. If quoted market prices are not available, the estimate of fair value is based on various valuation techniques, including the discounted value of estimated future cash flows.

We evaluate the carrying value of goodwill during the fourth quarter of each year and between annual evaluations if events occur or circumstances change that would more likely than not reduce the fair value of the reporting unit below its carrying amount. Such circumstances could include, but are not limited to (1) a significant adverse change in legal factors or in business climate, (2) unanticipated competition, or (3) an adverse action or assessment by a regulator. When evaluating whether goodwill is impaired, we compare the fair value of the reporting unit to which the goodwill is assigned to the reporting unit's carrying amount, including goodwill. The fair value of the reporting unit is estimated using the income, or discounted cash flows, approach. If the carrying amount of a reporting unit exceeds its fair value, then the amount of the impairment loss must be measured. The impairment loss would be calculated by comparing the implied fair value of reporting unit goodwill to its carrying amount. If the carrying value of the reporting unit exceeds its fair value, an additional calculation is done to determine if the goodwill has been impaired. In making that determination, the implied fair value of the reporting unit is allocated to all of the other assets and liabilities including items that may not be recorded on the balance sheet but which have some fair value. An impairment loss would be recognized if the remaining implied fair value after allocation to all other assets and liabilities exceeds the carrying value of the goodwill.

The evaluation of intangible asset and goodwill impairment requires us to make assumptions about future cash flows over the life of the asset being evaluated that include, among others, growth in revenues, margins realized, level of operating expenses and cost of capital. These assumptions require significant judgment and actual results may differ from assumed and estimated amounts.

## Forward-looking Statements and Factors That May Affect Future Results of Operations

All statements herein that are not historical facts or that include such words as “expects”, “anticipates”, “projects”, “estimates”, “vision”, “planning”, “could”, “potential”, “plan”, “believes”, “desires”, “intends” or similar words constitute forward-looking statements that we deem to be covered by and to qualify for the safe harbor protection covered by the Private Securities Litigation Reform Act of 1995 (the “1995 Act”). Investors and prospective investors in our Company should understand that several factors govern whether any forward-looking statement herein will be or can be achieved. Any one of these factors could cause actual results to differ materially from those projected herein.

These forward-looking statements include the expected increases in net sales of RP, DDM, and 3D printing systems, services and consumables, and our ability to maintain our gross margins on these sales. The forwardlooking statements include projected revenue and income in future quarters; the size of the 3D printing market; our objectives for the marketing and sale of our uPrint and Dimension 3D printers and our Fortus 3D Production Systems, particularly for use in direct digital manufacturing (DDM); the demand for our proprietary consumables; the expansion of our RedEye paid parts service; and our beliefs with respect to the growth in the demand for our products and the impact of our OEM Agreement on sales of our products. They include our plans and objectives to introduce new products, to control expenses, to improve the quality and reliability of our systems, to respond to new or existing competitive products, and to improve profitability. The forward-looking statements included herein are based on current expectations that involve a number of risks and uncertainties, some of which are described in Item 1A, "Risk Factors" in our Annual Report on Form 10-K for 2010 and in our current report on Form 8-K dated May 3, 2011 and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011. These forward-looking statements are based on assumptions, among others, that we will be able to:

- continue to introduce new high-performance and 3D printing systems and materials acceptable to the market, and to continue to improve our existing technology and software in our current product offerings;
- successfully develop the 3D printing market with our Dimension BST, Dimension SST, Dimension Elite, and uPrint systems, and that the market will accept these systems;
- successfully develop the DDM market with our Fortus 250mc, 360mc, 400mc and 900mc, and that the market will accept these systems;
- maintain our revenues and gross margins on our present products;
- successfully operate and grow Solidscape;
- control our operating expenses;
- expand our manufacturing capabilities to meet the expected demand generated by our uPrint, Dimension BST, Dimension SST and Dimension Elite systems, our consumable products and our RedEye paid parts service and sales under our OEM Agreement with HP;
- successfully commercialize new materials and gain market acceptance for these new materials;
- recruit, retain, and develop employees for both Stratasys and Solidscape with the necessary skills to produce, create, commercialize, market, and sell our products; and
- successfully integrate the operations of Solidscape with the operations of Stratasys.

Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, geo-political, competitive, market and technological conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of those assumptions could prove inaccurate, and therefore there is and can be no assurance that the results contemplated in any such forward-looking statement will be realized. The impact of actual experience and business developments may cause us to alter our marketing plans, our capital expenditure budgets, or our engineering, selling, manufacturing or other budgets, which may in turn affect our results of operations or the success of our new product development and introduction. We may not be able to alter our plans or budgets in a timely manner, resulting in reduced profitability or losses.

Due to the factors noted above and elsewhere in this Management's Discussion and Analysis of Financial Condition and Results of Operations, our future earnings and stock price may be subject to significant volatility, particularly on a quarterly basis. Additionally, we may not learn of revenue or earnings shortfalls until late in a fiscal quarter, since we frequently receive a significant number of orders very late in a quarter. This could result in an immediate and adverse effect on the trading price of our common stock. Past financial performance should not be considered a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Interest Rate Risk

Our cash and cash equivalent investments are exclusively in short-term money market and sweep instruments with maturities of less than 90 days and are subject to limited interest rate risk. A 10% change in interest rates would not have a material effect on our financial condition or results of operations. Our short- and long-term investments are invested in auction rate securities and corporate and municipal bonds that bear interest at rates of 0.4% to 6.4%. An immediate 10% change in interest rates would have no material effect on our financial condition or results of operations.

Foreign Currency Exchange Rate Risk

We have not historically hedged sales from or expenses incurred by our European operations that have a functional currency in Euros. Therefore, a hypothetical 10% change in the exchange rates between the U.S. dollar and the Euro could increase or decrease our income before taxes by less than \$0.4 million for the continued maintenance of our European facility.

We hedged between €4.2 million and €4.8 million for the three months ended September 30, 2011 and between €4.0 million and €5.6 million for the nine months ended September 30, 2011 of accounts receivable that were denominated in Euros. The foreign currency forward contracts resulted in a currency translation gain of approximately \$417,000 for the three months ended September 30, 2011 and a loss of approximately \$438,000 for the three months ended September 30, 2010. Foreign currency forward contracts resulted in a currency translation loss of approximately \$159,000 for the nine months ended September 30, 2011 and a gain of approximately \$252,000 for the nine months ended September 30, 2010. The resulting gain or loss from foreign currency forward contracts only partially offset the total foreign currency transactions gains or losses that we recorded.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report (the "Evaluation Date"). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective. Disclosure controls and procedures require that the information relating to us required to be disclosed in our Securities and Exchange Commission ("SEC") reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

An evaluation was also performed under the supervision and with the participation of management, including the CEO and CFO, of any change in our internal controls over financial reporting that occurred during the last fiscal quarter and that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting. That evaluation did not identify any changes in our internal control over financial reporting during our most recently completed fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934).

PART II OTHER INFORMATION

ITEM 1A. RISK FACTORS

You are encouraged to review the discussion of Forward Looking Statements and Factors That May Affect Future Results of Operations appearing in this report at Part I, “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, “Item 1A. Risk Factors” in our 2010 Form 10-K, the factors in our Current Report on Form 8-K dated May 3, 2011 (the “May 3 Form 8-K”), and the factors in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2011 (the “First Quarter Form 10-Q”), which could materially affect our business, financial condition or operating results. The risks described in our 2010 Form 10-K, in the May 3 Form 8-K and in the First Quarter Form 10-Q are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition or operating results.

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### Item 6. Exhibits

#### (a) Exhibits.

|         |                                                                                                               |
|---------|---------------------------------------------------------------------------------------------------------------|
| 31.1    | Certification of the Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a).                    |
| 31.2    | Certification of the Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a).                    |
| 32.1    | Certification of the Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350. |
| 32.2    | Certification of the Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350. |
| 101.INS | XBRL Instance Document*                                                                                       |
| 101.SCH | XBRL Taxonomy Extension Schema Document*                                                                      |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document*                                                        |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document*                                                         |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document*                                                              |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document*                                                       |

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\* The XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability of that section and shall not be incorporated by reference into any filing or other document pursuant to the Securities Act of 1933, as amended, except as shall be expressly set forth by specific reference in such filing or document.

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.

Date: November 9, 2011

Stratasys, Inc.

By: /s/ ROBERT F. GALLAGHER  
Robert F. Gallagher  
Chief Financial Officer