

Rocket Fuel Inc.
Form 10-Q
November 13, 2013
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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, 2013

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 001-36071

Rocket Fuel Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

30-0472319
(IRS Employer
Identification No.)

350 Marine Parkway
Marina Park Center
Redwood City, CA 94065

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code:

(650) 595-1300

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-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

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Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (a Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding as of October 31, 2013
Common Stock	32,821,242

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Quarterly Report on Form 10-Q

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Rocket Fuel Inc.****Condensed Consolidated Balance Sheet****(in thousands, except par values, share and per share data)****(unaudited)**

	September 30, 2013	December 31, 2012
Assets		
Current Assets:		
Cash and cash equivalents	\$ 125,282	\$ 14,896
Accounts receivable, net	67,984	47,333
Deferred tax assets	334	334
Prepaid expenses and other current assets	2,159	1,215
Total current assets	195,759	63,778
Property, equipment and software, net	20,941	10,939
Other assets	1,165	472
Total assets	\$ 217,865	\$ 75,189
Liabilities and Stockholders Equity		
Current Liabilities:		
Accounts payable	\$ 34,088	\$ 17,482
Accrued and other current liabilities	15,707	6,186
Deferred revenue	451	187
Current portion of line of credit	11,853	
Current portion of long-term debt	4,375	1,988
Total current liabilities	66,474	25,843
Line of credit - Less current portion		1,853
Long-term debt - Less current portion	10,625	3,125
Deferred rent - Less current portion	482	430
Deferred tax liabilities	334	334
Convertible preferred stock warrant liability		2,741
Total liabilities	77,915	34,326
Commitments and contingencies (Note 11)		
Stockholders Equity (Note 8)		
Convertible preferred stock, Series A, \$0.001 par value - 10,884,902 authorized as of December 31, 2012; 0 and 10,618,372 issued and outstanding as of September 30, 2013 and December 30, 2012, respectively		9,788
Convertible preferred stock, Series B, \$0.001 par value - 4,811,855 authorized as of December 31, 2012; 0 and 4,811,855 issued and outstanding as of September 30, 2013 and December 31, 2012, respectively		9,935

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Convertible preferred stock, Series C, \$0.001 par value - 1,116,030 authorized as of December 31, 2012; 0 and 1,116,030 issued and outstanding as of September 30, 2013 and December 31, 2012, respectively				6,501
Convertible preferred stock, Series C-1, \$0.001 par value - 2,975,228 authorized as of December 31, 2012; 0 and 2,932,675 issued and outstanding as of September 30, 2013 and December 31, 2012, respectively				34,393
Common stock, \$0.001 par value - 1,000,000,000 and 35,850,100 authorized as of September 30, 2013 and December 31, 2012, respectively; 32,807,784 and 8,680,041 issued and outstanding as of September 30, 2013 and December 31, 2012, respectively		33		8
Additional paid-in capital		182,332		3,865
Accumulated other comprehensive loss		(101)		(84)
Accumulated deficit		(42,314)		(23,543)
Total stockholders' equity		139,950		40,863
Total liabilities and stockholders' equity	\$	217,865	\$	75,189

See Notes to Condensed Consolidated Financial Statements

Table of Contents**Rocket Fuel Inc.****Condensed Consolidated Statements of Operations****(in thousands)****(unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenue	\$ 62,458	\$ 26,902	\$ 155,039	\$ 66,494
Cost of revenue	31,877	14,955	81,529	36,988
Gross Profit	30,581	11,947	73,510	29,506
Operating expenses:				
Research and development	4,464	1,066	10,587	2,604
Sales and marketing	21,644	10,351	56,293	25,893
General and administrative	8,719	1,675	19,671	4,245
Total operating expenses	34,827	13,092	86,551	32,742
Loss from operations	(4,246)	(1,145)	(13,041)	(3,236)
Other expense, net:				
Interest expense	(251)	(63)	(604)	(233)
Other income (expense) - net	155	65	(213)	157
Change in fair value of convertible preferred stock warrant liability	(2,385)	(831)	(4,740)	(1,093)
Other expense, net	(2,481)	(829)	(5,557)	(1,169)
Loss before income taxes	(6,727)	(1,974)	(18,598)	(4,405)
Provision for income taxes	(133)	(28)	(173)	(67)
Net loss	\$ (6,860)	\$ (2,002)	\$ (18,771)	\$ (4,472)
Basic and diluted net loss per share attributable to common stockholders	\$ (0.61)	\$ (0.25)	\$ (2.01)	\$ (0.56)
Basic and diluted weighted-average shares used to compute net loss per share attributable to common stockholders	11,315	8,067	9,346	7,971

See Notes to Condensed Consolidated Financial Statements

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Rocket Fuel Inc.

Condensed Consolidated Statements of Comprehensive Loss

(in thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net loss	\$ (6,860)	\$ (2,002)	\$ (18,771)	\$ (4,472)
Other comprehensive loss:				
Foreign currency translation adjustments	24	(38)	(17)	(36)
Comprehensive loss	\$ (6,836)	\$ (2,040)	\$ (18,788)	\$ (4,508)

See Notes to Condensed Consolidated Financial Statements

Table of Contents**Rocket Fuel Inc.****Statement of Changes in Stockholders' Equity**

(in thousands, except share data)

(unaudited)

	Convertible Preferred Stock		Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Stockholders' Equity					
	Shares	Amount	Shares	Amount									
Balance - December 31, 2012	19,478,932	60,617	8,680,041	8	3,865	(84)	(23,543)	40,863					
Issuance of common stock upon exercises of employee stock options, net of repurchases			382,281	1	437			438					
Conversion of convertible preferred stock to common stock	(19,478,932)	(60,617)	19,478,932	19	60,598								
Conversion of convertible preferred stock warrants to common stock			266,530	1	7,579			7,580					
Issuance of common stock from initial public offering, net of issuance costs			4,000,000	4	103,140			103,144					
Stock-based compensation					6,713			6,713					
Foreign currency translation adjustment						(17)		(17)					
Net loss							(18,771)	(18,771)					
Balance - September 30, 2013		\$	32,807,784	\$	33	\$	182,332	\$	(101)	\$	(42,314)	\$	139,950

See Notes to Condensed Consolidated Financial Statements

Table of Contents**Rocket Fuel Inc.****Condensed Consolidated Statements of Cash Flows****(in thousands)****(unaudited)**

	Nine Months Ended September 30,	
	2013	2012
OPERATING ACTIVITIES:		
Net loss	\$ (18,771)	\$ (4,472)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	4,583	2,461
Provision for doubtful accounts	521	63
Stock-based compensation	6,277	507
Issuance of restricted stock for services provided		20
Amortization of debt discount	1	6
Loss on disposal of property, equipment and software	(26)	
Change in fair value of preferred stock warrant liability	4,740	1,093
Changes in operating assets and liabilities:		
Accounts receivable	(21,236)	(15,586)
Prepaid expenses and other current assets	(941)	(679)
Other assets	(700)	(251)
Accounts payable	12,532	3,951
Accrued and other liabilities	5,496	2,235
Deferred rent	100	315
Deferred revenue	264	18
Net cash used in operating activities	(7,160)	(10,319)
INVESTING ACTIVITIES:		
Purchases of property, equipment and software	(5,564)	(2,513)
Capitalized internal use software development costs	(4,486)	(3,294)
Net cash used in investing activities	(10,050)	(5,807)
FINANCING ACTIVITIES:		
Proceeds from issuance of common stock in initial public offering, net of underwriting discounts and commission	107,880	
Payments of costs related to initial public offering	(1,534)	
Proceeds from the issuance of convertible preferred stock		34,500
Proceeds from the exercise of common stock warrants	97	
Issuance costs related to convertible preferred stock		(105)
Proceeds from exercise of vested common stock options	208	46
Proceeds from early exercise of unvested common stock options	1,058	378
Repurchases of common stock options early exercised	(11)	(3)
Borrowings from line of credit	10,000	4,000
Repayment of line of credit		(6,000)
Proceeds from issuance of long-term debt	10,000	3,000
Repayment of long-term debt	(114)	(311)
Net cash provided by financing activities	127,584	35,505
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	12	(51)

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CHANGE IN CASH AND CASH EQUIVALENTS		110,386		19,328
CASH AND CASH EQUIVALENTS-Beginning of period		14,896		5,071
CASH AND CASH EQUIVALENTS-End of period	\$	125,282	\$	24,399
SUPPLEMENTAL DISCLOSURES OF OTHER CASH FLOW INFORMATION:				
Cash paid for income taxes	\$	348	\$	
Cash paid for interest	\$	543	\$	233
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:				
Purchases of property and equipment recorded in accounts payable and accruals	\$	4,952	\$	232
Deferred offering costs recorded in accrued liabilities	\$	3,194	\$	
Vesting of early exercised options	\$	229	\$	91
Stock-based compensation capitalized in internally developed software costs	\$	437	\$	
Conversion of convertible preferred stock to common stock	\$	60,617	\$	
Conversion of preferred stock warrants to common stock	\$	7,481	\$	

See Notes to Condensed Consolidated Financial Statements

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Rocket Fuel Inc.

Notes to Condensed Consolidated Financial Statements

(unaudited)

1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Rocket Fuel Inc. (the "Company") was incorporated as a Delaware corporation on March 25, 2008. The Company is a provider of an artificial-intelligence digital advertising solution. The Company is headquartered in Redwood City, California, and has offices throughout the United States. The Company established a wholly-owned subsidiary in the United Kingdom in 2011, with branches in various countries through Europe, and a wholly-owned subsidiary in Germany in 2013.

In September 2013, the Company completed the initial public offering of its common stock (the "IPO") whereby 4,000,000 shares of common stock were sold by the Company and 600,000 shares of common stock were sold by selling stockholders. The public offering price of the shares sold in the offering was \$29.00 per share. The Company did not receive any proceeds from the sale of shares by the selling stockholders. The total gross proceeds from the offering to the Company were \$116.0 million. After deducting underwriters' discounts and commissions, the aggregate net proceeds received by the Company totaled approximately \$107.9 million.

Basis of Presentation The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("GAAP") and applicable rules and regulations of the Securities and Exchange Commission ("SEC") regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Therefore, these condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes presented in the Company's prospectus filed with the SEC on September 20, 2013 pursuant to Rule 424(b) under the Securities Act of 1933.

The condensed consolidated balance sheet as of December 31, 2012 included herein was derived from the audited financial statements as of that date, but does not include all notes and other disclosures required by GAAP.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all normal recurring adjustments necessary to present fairly the financial position, results of operations, and cash flows for the interim periods, but are not necessarily indicative of the results of operations to be anticipated for the full year 2013 or any future period.

Principles of Consolidation The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, which are engaged in marketing and selling advertising campaigns. All intercompany transactions and balances have been eliminated in consolidation.

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Use of Estimates The preparation of unaudited condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the unaudited condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Such estimates include, but are not limited to, provisions for doubtful accounts, the amount of software development costs which should be capitalized, future taxable income, the useful lives of long-lived assets and the assumptions used for purposes of determining stock-based compensation. Actual results could differ from those estimates.

Foreign Currency Translation Each of the Company's foreign subsidiaries records its assets, liabilities and results of operations in its local currency, which is its functional currency. The Company translates these subsidiary consolidated financial statements into U.S. dollars each reporting period for purposes of consolidation.

Assets and liabilities of the Company's foreign subsidiaries are translated at the period-end currency exchange rates, certain equity accounts are translated at historical exchange rates while revenue, expenses, gains and losses are translated at the average currency exchange rates in effect for the period. The effects of these translation adjustments are reported in a separate component of stockholders' equity titled accumulated other comprehensive loss.

Fair Value of Financial Instruments The Company's financial instruments consist principally of cash equivalents, accounts receivable, accounts payable, accrued liabilities, term debt and line of credit. The fair value of the Company's cash equivalents is determined based on quoted prices in active markets for identical assets for its money market funds. The recorded values of the Company's accounts receivable, accounts payable, accrued liabilities approximate their current fair values due to the relatively short-term nature of these accounts. The Company believes that the fair value of the term debt and line of credit approximates its recorded amount at September 30, 2013 as the interest rate on the term debt and line of credit is variable and is based on market interest rates after consideration of default and credit risk.

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Cash and Cash Equivalents Cash consists of cash maintained in checking and savings accounts. All highly liquid investments purchased with an original maturity date of three months or less at the date of purchase are considered to be cash equivalents. Cash equivalents consist of money market funds.

Concentration of Credit Risk Financial instruments, which potentially subject the Company to significant concentrations of credit risk, consist primarily of cash and accounts receivable. A significant portion of the Company's cash is held at one major financial institution, which management assesses to be of high credit quality. The Company has not experienced any losses in such accounts.

The Company mitigates its credit risk with respect to accounts receivable by performing credit evaluations and monitoring its customers' accounts receivable balances. As of September 30, 2013, no customer accounted for 10% or more of accounts receivable. As of December 31, 2012, one customer accounted for 10% of accounts receivable.

During the three and nine months ended September 30, 2013 and 2012, no single customer represented more than 10% of revenue.

Provision for Doubtful Accounts The Company records a provision for doubtful accounts based on historical experience and a detailed assessment of the collectability of its accounts receivable. In estimating the allowance for doubtful accounts, management considers, among other factors, the aging of the accounts receivable, historical write-offs and the credit-worthiness of each customer. If circumstances change, such as higher-than-expected defaults or an unexpected material adverse change in a major customer's ability to meet its financial obligations, the Company's estimate of the recoverability of the amounts due could be reduced by a material amount.

The following table presents the changes in the allowance for doubtful accounts (in thousands):

	Nine Months Ended September 30, 2013		Year Ended December 31, 2012	
Allowance for doubtful accounts:				
Balance, beginning of period	\$	468	\$	203
Bad debt expense		521		285
Recoveries (write-offs), net		19		(20)
Balance, end of the period	\$	1,008	\$	468

Property and Equipment Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization is computed using the straight-line method over the estimated useful lives of the related assets. Maintenance and repairs are charged to expense as incurred, and improvements and betterments are capitalized. When assets are retired or otherwise disposed of, the cost and accumulated depreciation and amortization are removed from the balance sheet and any resulting gain or loss is reflected in operations in the period realized.

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Property and equipment are initially recorded at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Depreciation and amortization periods for the Company's property and equipment are as follows:

Asset Classification	Estimated Useful Life
Computer hardware and purchased software	2-3 years
Capitalized internal use software costs	2-3 years
Office equipment, furniture and fixtures	5 years
Leasehold improvements	Shorter of the lease term or estimated useful life

Internal Use Software Development Costs The Company incurs costs to develop software for internal use. The Company expenses all costs that relate to the planning and post implementation phases of development as research and development expense. The Company capitalizes costs when preliminary efforts are successfully completed, management has authorized and committed project funding, and it is probable that the project will be completed and will be used as intended. Costs incurred for enhancements that are expected to result in additional material functionality are capitalized. The Company capitalized \$4.9 million and \$3.3 million in internal-use software costs during the nine months ended September 30, 2013 and 2012, respectively, which are included in property, equipment and software, net on the consolidated balance sheets.

Amortization commences when the website or software for internal use is ready for its intended use and the amortization period is the estimated useful life of the related asset, which is generally two to three years. Amortization expense totaled \$0.9 million and

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\$0.6 million for the three months ended September 30, 2013 and 2012, respectively, and \$2.5 million and \$1.6 million for the nine months ended September 30, 2013 and 2012, respectively.

Impairment of Long-lived Assets The Company periodically reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset is impaired or its estimated useful life is no longer appropriate. If indicators of impairment exist and the undiscounted projected cash flows associated with such asset is less than the carrying amount of the asset, an impairment loss is recorded to write the asset down to its estimated fair value. Fair value is estimated based on discounted future cash flows. No impairment charges were recorded during the three and nine months ended September 30, 2013 and 2012.

Revenue Recognition We generate revenue by delivering digital advertisements to Internet users through various channels, including display, mobile, social and video.

The Company recognizes revenue when all four of the following criteria are met:

- Persuasive evidence of an arrangement exists;
- Delivery has occurred or a service has been provided;
- Customer fees are fixed or determinable; and
- Collection is reasonably assured.

Revenue arrangements are evidenced by a fully executed insertion order (IO). Generally, IOs state the number and type of advertising impressions to be delivered, the agreed upon rate and a fixed period of time for delivery.

The Company determines collectability by performing ongoing credit evaluations and monitoring its customers' accounts receivable balances. For new customers and their agents, which may be advertising agencies or other third parties, the Company performs a credit check with an independent credit agency and may check credit references to determine creditworthiness. The Company only recognizes revenue when collection is reasonably assured.

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In the normal course of business, the Company frequently contracts with advertising agencies on behalf of their advertiser clients. The determination of whether revenue should be reported on a gross or net basis is based on an assessment of whether the Company is acting as the principal or an agent in the transaction. In determining whether the Company acts as the principal or an agent, the Company follows the accounting guidance for principal-agent considerations. While none of the factors identified in this guidance is individually considered presumptive or determinative, because the Company is the primary obligor and is responsible for (i) fulfilling the advertisement delivery, (ii) establishing the selling prices for delivery of the advertisements, and (iii) performing all billing and collection activities including retaining credit risk, the Company acts as the principal in these arrangements and therefore reports revenue earned and costs incurred on a gross basis.

On occasion, the Company has offered customer incentive programs which provide rebates after achieving a specified level of advertising spending. The Company records reductions to revenue for estimated commitments related to these customer incentive programs. For transactions involving incentives, the Company recognizes revenue net of the estimated amount to be paid by rebate, provided that the rebate amount can be reasonably and reliably estimated and the other conditions for revenue recognition have been met. The Company's policy requires that, if rebates cannot be reliably estimated, revenue is not recognized until reliable estimates can be made or the program lapses.

Multiple-Element Arrangements The Company enters into arrangements to sell advertising that includes different media placements or ad services that are delivered at the same time, or within close proximity of one another. Beginning on January 1, 2011, the Company adopted authoritative guidance on multiple element arrangements, using the prospective method for all arrangements entered into or materially modified from the date of adoption. Under this new guidance, the Company allocates arrangement consideration in multiple-deliverable revenue arrangements at the inception of an arrangement to all deliverables or those packages in which all components of the package are delivered at the same time, based on the relative selling price method in accordance with the selling price hierarchy, which includes: (1) vendor-specific objective evidence (VSOE), if available; (2) third-party evidence (TPE), if VSOE is not available; and (3) best estimate of selling price (BESP), if neither VSOE nor TPE is available.

VSOE The Company determines VSOE based on its historical pricing and discounting practices for the specific product or service when sold separately. In determining VSOE, the Company requires that a substantial majority of the stand-alone selling prices for these services fall within a reasonably narrow pricing range. The Company has not been able to establish VSOE for any of its advertising offerings.

TPE When VSOE cannot be established for deliverables in multiple element arrangements, the Company applies judgment with respect to whether it can establish a selling price based on TPE. TPE is determined based on competitor prices for similar deliverables when sold separately. Generally, the Company's go-to-market strategy differs from that of its peers, and its offerings contain a significant level of differentiation such that the comparable pricing of services cannot be obtained. Furthermore, the

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Company is unable to reliably determine the selling prices of similar competitor services on a stand-alone basis. As a result, the Company has not been able to establish selling price based on TPE.

BESP When it is unable to establish selling price using VSOE or TPE, the Company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the service were sold on a stand-alone basis. BESP is generally used to allocate the selling price to deliverables in the Company's multiple element arrangements. The Company determines BESP for deliverables by considering multiple factors, including, but not limited to, prices it charges for similar offerings, market conditions, competitive landscape and pricing practices. In particular, the Company reviews multiple data points to determine BESP, including price lists used by the Company's sales team in pricing negotiations, historical average and median pricing achieved in prior contractual customer arrangements and input from the Company's sales operation department regarding what it believes the deliverables could be sold for on a stand-alone basis. BESP is determined at an advertising unit level that is consistent with the Company's underlying market strategy and stratified based on specific consideration of geography, industry and size, as deemed necessary.

The Company limits the amount of allocable arrangement consideration to amounts that are fixed or determinable and that are not contingent on future performance or future deliverables. The Company regularly reviews BESP. Changes in assumptions or judgments or changes to the elements in the arrangement could cause a material increase or decrease in the amount of revenue that the Company reports in a particular period.

The Company recognizes the relative fair value of advertising services as they are delivered, assuming all other revenue recognition criteria are met. Deferred revenue is comprised of contractual billings in excess of recognized revenue and payments received in advance of revenue recognition, and is typically recognized within twelve months.

Cost of Revenue Cost of revenue consists primarily of media cost for advertising impressions purchased from real-time advertising exchanges and other third parties. Cost of revenue also includes third-party data center costs and the salaries and related costs of the Company's operations group. This group sets up, initiates and monitors the Company's advertising campaigns. In addition, depreciation of the data center equipment, rental payments to third-party vendors for data centers and amortization of capitalized internal use software are included in cost of revenue.

Research and Development Research and development expenses include costs associated with the maintenance and ongoing development of the Company's technology, including compensation and employee benefits and allocated costs, such as facility-related expenses, insurance, supplies and other fixed costs, associated with the Company's engineering and research and development departments, as well as costs for contracted services and supplies. The Company reviews costs incurred in the application development stage and assesses such costs for capitalization.

Sales and Marketing Sales and marketing expenses consist primarily of compensation (including commissions) and employee benefits of sales and marketing personnel and related support teams, allocated costs, such as facility-related expenses, insurance, supplies and other fixed costs, certain advertising costs, travel, trade shows and marketing materials. The Company incurred advertising costs of \$1.6 million and \$0.1 million for the three months ended September 30, 2013 and 2012, respectively, and \$3.3 million and \$0.1 million for the nine months ended September 30, 2013 and 2012, respectively.

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General and Administrative General and administrative expenses include facilities costs, executive and administrative compensation and employee benefits, depreciation, professional services fees, insurance costs, bad debt and other allocated costs, such as facility-related expenses, supplies and other fixed costs.

Stock-Based Compensation The Company measures compensation expense for all stock-based payment awards, including stock options and restricted stock units granted to employees, based on the estimated fair values on the date of the grant. The fair value of each stock-based payment award granted is estimated using the Black-Scholes option pricing model. Stock-based compensation is recognized on a straight-line basis over the requisite service period, net of estimated forfeitures. The forfeiture rate is based on an analysis of the Company's actual historical forfeitures.

The Company accounts for stock options issued to nonemployees based on the fair value of the awards determined using the Black-Scholes option pricing model. The fair value of stock options granted to nonemployees is re-measured as the stock options vest, and the resulting change in fair value, if any, is recognized in the Company's consolidated statement of operations during the period the related services are rendered, generally between one and four years.

Preferred Stock Warrant Liability Freestanding warrants related to shares that are redeemable or contingently redeemable are classified as a liability on the Company's consolidated balance sheet as of December 31, 2012. The fully vested convertible preferred stock warrants are subject to re-measurement at each balance sheet date, and any change in fair value is recognized as a component of other expense, net. As completion of the Company's initial public offering constituted a liquidation event, the convertible preferred stock warrants were converted into common stock or warrants to purchase common stock, and the liability was reclassified to additional paid-in capital as of September 30, 2013.

Income Taxes The Company accounts for income taxes using an asset and liability approach. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Operating loss and tax credit carryforwards are measured by applying currently enacted tax laws. Valuation allowances are provided when necessary to reduce net deferred tax assets to an amount that is more likely than not to be realized. Due to uncertainty as to the realization of benefits from deferred tax assets, including net operating loss carryforwards, research and development and other tax credits, the Company has provided a full valuation allowance reserved against such assets as of September 30, 2013 and December 31, 2012.

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The Company recognizes the tax effects of an uncertain tax position only if it is more likely than not to be sustained based solely on its technical merits as of the reporting date, and then, only in an amount more likely than not to be sustained upon review by the tax authorities. The Company considers many factors when evaluating and estimating its tax positions and tax benefits, which may require periodic adjustments and which may not accurately anticipate actual outcomes.

Deferred Offering Costs Deferred offering costs consisted primarily of direct incremental costs related to the Company's IPO of its common stock. Approximately \$0.1 million of deferred offering costs are included in other assets on the Company's consolidated balance sheets as of December 31, 2012. Upon the completion of the IPO, these amounts were offset against the proceeds of the IPO.

Comprehensive Loss In June 2011, the Financial Accounting Standards Board (FASB) issued an accounting standards update that requires an entity to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This guidance eliminates the option to present the components of other comprehensive income as part of the statement of equity. The Company retrospectively adopted these new standards in the first quarter of 2012 and has presented a separate consolidated statement of comprehensive loss for the three and nine months ended September 30, 2013 and 2012.

Recently Issued Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2013-11, *Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* (ASU 2013-11). The guidance requires an entity to present its unrecognized tax benefits net of its deferred tax assets when settlement in this manner is available under the tax law, which would be based on facts and circumstances as of the balance sheet reporting date and would not consider future events. Gross presentation in the notes to the financial statements will still be required. ASU 2013-11 will apply on a prospective basis to all unrecognized tax benefits that exist at the effective date. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of ASU 2013-11 is not expected to have a material impact on our consolidated condensed financial statements.

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2. FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received on sale of an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants at the measurement date. The FASB has established a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3).

The three levels of the fair value hierarchy under the guidance for fair value measurement are described below:

- Level 1** Inputs are unadjusted quoted prices in active markets for identical assets or liabilities. Pricing inputs are based upon quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. The valuations are based on quoted prices of the underlying security that are readily and regularly available in an active market, and accordingly, a significant degree of judgment is not required. As of September 30, 2013 and December 31, 2012, the Company used Level 1 assumptions for its money market funds.
- Level 2** Pricing inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. As of September 30, 2013 and December 31, 2012, the Company did not have any Level 2 financial assets or liabilities.
- Level 3** Pricing inputs are generally unobservable for the assets or liabilities and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are therefore determined using model-based techniques that include option pricing models, discounted cash flow models, and similar techniques. As of September 30, 2013, the Company did not have any Level 3 financial assets or liabilities. As of December 31, 2012, the Company used Level 3 assumptions for its convertible preferred stock warrant liability.

The carrying amounts of cash equivalents, accounts receivable, prepaid expenses, accounts payable and accrued liabilities approximate fair value due to the short-term nature of these items. Based on the borrowing rates currently available to the Company or debt with similar terms, the carrying value of the line of credit and term-debt approximate fair value (using Level 2 inputs).

Level 3 includes convertible preferred stock warrant liability, the value of which is determined based on an option-pricing model that takes into account the expected term as well as multiple inputs, such as the Company's stock price, risk-free interest rates and expected volatility.

The following table sets forth the Company's financial instruments that were measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012, by level within the fair value hierarchy. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires management to make judgments and consider factors specific to the asset or liability. The Company's fair value hierarchy for its financial assets and financial liabilities that are carried at fair value are as follows (in thousands):

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September 30, 2013	Fair Value	Level 1	Level 2	Level 3
Money market funds (included in cash and cash equivalents)	\$ 2,900	\$ 2,900	\$	\$

December 31, 2012	Fair Value	Level 1	Level 2	Level 3
Money market funds (included in cash and cash equivalents)	\$ 2,900	\$ 2,900	\$	\$
Convertible preferred stock warrant liability	\$ (2,741)	\$	\$	\$ (2,741)

Convertible Preferred Stock Warrant Liability Warrants to purchase the Company's convertible preferred stock are classified as liabilities in the consolidated balance sheet as of December 31, 2012. The warrants are subject to remeasurement at each balance sheet date, and any change in fair value is recognized as a component of other income (expense) in the consolidated statements of operations.

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A reconciliation of the convertible preferred stock warrants measured and recorded at fair value on a recurring basis, using significant unobservable inputs (Level 3) is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Balance at beginning of period	\$ 5,096	\$ 695	\$ 2,741	\$ 433
Changes in fair value of warrants	2,385	831	4,740	1,093
Conversion of warrants to common stock	(7,481)		(7,481)	
Balance at end of period	\$	\$ 1,526	\$	\$ 1,526

3. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of September 30, 2013 and December 31, 2012 consisted of the following (in thousands):

	September 30, 2013	December 31, 2012
Cash and cash equivalents		
Cash	\$ 122,382	\$ 11,996
Money market funds	2,900	2,900
Total cash and cash equivalents	\$ 125,282	\$ 14,896

4. PROPERTY, EQUIPMENT AND SOFTWARE

Property, equipment and software as of September 30, 2013 and December 31, 2012 consisted of the following (in thousands):

	September 30, 2013	December 31, 2012
Capitalized internal use software costs	\$ 15,364	\$ 10,441
Computer hardware and software	12,970	4,281
Furniture and fixtures	1,624	816
Leasehold improvements	807	656
Construction in progress	1,115	1,126
Total	31,880	17,320
Accumulated depreciation and amortization	(10,939)	(6,381)
Net property, equipment and software	\$ 20,941	\$ 10,939

Total depreciation and amortization expense, excluding amortization of internal use software costs, was \$0.8 million and \$0.4 million for the three months ended September 30, 2013 and 2012, respectively, and \$2.1 million and \$0.9 million for the nine months ended September 30,

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2013 and 2012, respectively. Amortization expense of internal use software costs was \$0.9 million and \$0.6 million for the three months ended September 30, 2013 and 2012, respectively, and \$2.5 million and \$1.6 million for the nine months ended September 30, 2013 and 2012, respectively. The Company held no capital leases as of September 30, 2013 and December 31, 2012.

5. ACCRUED AND OTHER CURRENT LIABILITIES

Accrued and other current liabilities as of September 30, 2013 and December 31, 2012 consisted of the following (in thousands):

	September 30, 2013	December 31, 2012
Payroll and related expenses	\$ 7,765	\$ 3,357
Accrued vacation	1,791	991
Professional services	1,932	268
Accrued credit cards	751	122
Early exercise of unvested stock options	1,269	451
Other accrued expenses	2,199	997
Total	\$ 15,707	\$ 6,186

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6. OTHER INCOME (EXPENSE), NET

Other income (expense), net for the three and nine months ended September 30, 2013 and 2012 consisted of the following (in thousands):

**Three Months Ended
September 30,**

Nine Months Ended