

SolarWinds, Inc.
Form 10-K/A
March 28, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K/A

Amendment No. 1

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

For the fiscal year ended: December 31, 2013

Commission file number: 001-34358

SOLARWINDS, INC.

(Exact name of registrant as specified in its charter)

Delaware

73-1559348

(State or other jurisdiction of incorporation or
organization)

(I.R.S. Employer Identification Number)

3711 S. MoPac Expressway

78746

Austin, Texas

(address of principal executive offices)

(zip code)

Registrant's telephone number, including area code: (512) 682-9300

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange on Which Registered

Common Stock, \$0.001 par value

New York Stock Exchange

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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.

Large accelerated filer Accelerated filer Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Based on the closing price of the registrant's common stock on the last business day of the registrant's most recently completed second fiscal quarter, which was June 28, 2013, the aggregate market value of its shares held by non-affiliates on that date was approximately \$2,532,978,272.

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On February 12, 2014, 75,133,750 shares of common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Annual Report on Form 10-K incorporates certain information by reference from the definitive proxy statement for the registrant's 2014 Annual Meeting of Stockholders to be filed within 120 days of the registrant's fiscal year ended December 31, 2013 (the "Proxy Statement"). Except with respect to information specifically incorporated by reference in this Form 10-K, the Proxy Statement is not deemed to be filed as part of this Form 10-K.

EXPLANATORY NOTE

SolarWinds, Inc. (the “Company”) is filing this Amendment No. 1 on Form 10-K/A (“Form 10 K/A”) to its Annual Report on Form 10-K for the fiscal year ended December 31, 2013 as filed with the Securities and Exchange Commission (the “SEC”) on February 14, 2014 (the “Original Filing”) solely to correct an administrative error in the content of Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

The error appears in the second paragraph under the heading “Revenue—License, Maintenance and Other Revenue” on page 36 of the Original Filing. The first sentence of that paragraph states, “New license sales in our commercial business increased 53.6% in 2013 as compared to 2012.” The correct statement is as follows: “New license sales in our commercial business increased 10.5% in 2013 as compared to 2012.”

Except as described above, no other changes have been made to the Original Filing. This Form 10 K/A does not amend, modify or update the financial statements or any other items or disclosures set forth in the Original Filing. The XBRL exhibits are not included in this Amendment No. 1 as there were no revisions made to the financial data in the Original Filing. The Original Filing sets forth disclosures that are unaffected by the amendment. Accordingly, this Form 10 K/A should be read in conjunction with the Original Filing and all filings made with the SEC subsequent to the date of the Original Filing.

Parts of this Form 10-K/A contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and the Private Securities Litigation Reform Act of 1995. Forward-looking statements include any statement that does not directly relate to any historical or current fact. Such statements may be signified by terms such as “anticipates,” “believes,” “seeks,” “estimates,” “expects,” “intends,” “plans,” “predicts,” “projects,” “should,” “will,” “would,” “could” or similar expressions and the negatives of those terms. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially and adversely different from any future results, performance or achievements expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under the heading “Risk Factors” under Part I, Item 1A of the Original Filing. Given these risks and uncertainties, you should not place undue reliance on these forward-looking statements. Also, forward-looking statements represent our management’s beliefs and assumptions only as of the date of the original filing of the Form 10-K. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially and adversely from those anticipated in these forward-looking statements, even if new information becomes available in the future.

PART II

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the "Selected Consolidated Financial Data" and our consolidated financial statements and related notes included elsewhere in this report. In addition to historical consolidated financial information, the following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially and adversely from those anticipated in the forward-looking statements. See the sections entitled "Safe Harbor Cautionary Statement" and "Risk Factors" above for a discussion of the uncertainties, risks and assumptions associated with these statements.

Overview

We design, develop, market, sell and support powerful yet easy-to-use enterprise-class IT infrastructure management software to IT professionals in organizations of all sizes. Our product offerings range from individual software tools to more comprehensive software products that solve problems encountered every day by IT professionals and help to enable efficient and effective management of their network, systems and application infrastructure. Our products are ready-to-use, featuring intuitive and easily customized user interfaces and built-in workflows. Our products can be downloaded directly from our websites and installed and configured by our end-users in a matter of hours. Our customers include small- and mid-size businesses, large enterprises, managed service providers, and local, state and federal government entities that have purchased our products.

Acquisitions

We have made multiple acquisitions of businesses as part of our growth strategy, including the following acquisitions during 2013:

In May 2013, we acquired N-able Technologies International, Inc., or N-able, for \$127.7 million. The acquisition of N-able increased our product offerings and we believe will allow us to leverage the large opportunity associated with the adoption of cloud and SaaS-based services among small and medium-sized businesses, or SMBs, by enhancing our remote monitoring and management, or RMM, offerings and adding managed service provider, or MSP, service automation to the broad range of management challenges that we address for the IT industry.

In October 2013, we acquired Confio Corporation, or Confio, a database performance management company, for approximately \$103.0 million. By acquiring Confio, we added database performance management solutions to our product portfolio.

We account for our acquisitions using the acquisition method of accounting. Accordingly, the financial results for our acquisitions are included in our consolidated financial results since the applicable acquisition dates. For further information regarding these acquisitions, see Note 2, Acquisitions in the Notes to Consolidated Financial Statements in Item 8 of Part II of this Annual Report on Form 10-K.

Key Financial Highlights

Key financial highlights for 2013 include the following:

- Total revenue was \$335.4 million for 2013 compared to \$269.0 million for 2012, or an increase of 24.7%;
- Combined maintenance and subscription revenue for 2013 was \$199.5 million compared to \$145.0 million for 2012, representing 37.6% year-over-year growth in recurring revenue;
- Net income was \$89.8 million for 2013 compared to \$81.3 million for 2012, or an increase of 10.4%;
- Net income was \$1.17 per share on a fully diluted basis for 2013 compared to \$1.07 per share on a fully diluted basis for 2012, or an increase of 9.3%, and
- Cash flow from operating activities was \$163.3 million for 2013 compared to \$143.4 million for 2012, or an increase of 13.9%.

In 2013, we invested across our business and, in particular, in areas that we believe are an important foundation for our long term growth such as:

• We released key new versions of our products, which continued to improve the usability and add features our customers rely on daily. We also released additional free tools, which reflects our continued commitment to the IT

community and our customers;

We focused on finding new ways to communicate and sell to our customer base. Our customer base continues to grow and evolve with our business and we have to find new ways to deliver value to these customers;

We continued to expand our international research and development locations allowing us to respond to user demand and support new product releases and enhancements for our acquired and internally developed technologies. In addition, we are focused on the integration of the core products in our portfolio in order to deliver a suite of products with a seamless user experience; and

We invested in brand awareness in emerging markets, such as security and systems management, and critical geographies like Germany, UK, Australia and Brazil. This investment was designed to place us front and center as companies search for information and solutions for their IT management challenges.

We are committed to our business model and have continued to focus on ways to leverage and refine our model. We are pursuing a number of strategies that we believe will enable us to continue to grow. We have made progress towards our goals in recent periods but there are still many areas where we believe that we can continue to grow and improve. We expect to grow our business by investing in the following initiatives:

Expanding our web presence, brand awareness and improving our communication with prospects and our current customer base both domestically and internationally;

Accelerating the rate at which we are selling additional products into our install base;

Improving the competitive positioning of our products by investing in new product features and infrastructure;

Increasing our presence in several key geographic markets including Asia-Pacific, Latin America, Europe, Middle East and Africa by expanding our product portfolio, localizing marketing material, and establishing new relationships with distributors and resellers;

Acquiring and internally developing products that will expand our presence in our current markets or new markets; and

Expanding our international operations company-wide at lower cost locations to drive our competitive advantage. We expect to continue to generate solid growth while delivering strong operating income and to increase our cash flows from operating activities with our disciplined approach to investing in our business combined with our large market opportunity.

Key Business Metrics

We review a number of key business metrics to help us monitor the performance of our business model and to identify trends affecting our business. The measures that we believe are the primary indicators of our quarterly and annual performance are as follows:

Revenue Growth

Revenue growth includes the total revenue growth in our license, maintenance and subscription revenue, which are critical to our long-term success. We have employed a differentiated business model for marketing and selling high volumes of enterprise-class software, which is focused on revenue growth at high operating margins. We regularly review our total revenue growth to measure the success of our investments and strategic business decisions. We have built a financial and operational model that focuses on the long-term value of our customer relationships. After the initial new license or subscription purchase, our goal is to create opportunities for sales of additional products, license or subscription upgrades and renewal purchases from the customer. This is an important component of our financial model and future revenue growth. This model is based on the premise that we will be able to deliver ongoing value to our customers and maintain a long-term financial relationship with the users of our IT management products. Our recurring revenue, which includes maintenance and subscription revenue, is reflective of the relationship we have built with our customers. Our annual revenue growth percentages were 24.7%, 35.6% and 30.2% for the years ended December 31, 2013, 2012 and 2011, respectively. We expect our revenue growth to be approximately 22-25% for the fiscal year 2014.

Non-GAAP Operating Income and Non-GAAP Operating Margin

Our management uses non-GAAP operating income and non-GAAP operating margin as key measures of our performance. Because our non-GAAP operating income excludes certain items such as amortization of intangible assets, stock-based compensation and related employer-paid payroll taxes, certain acquisition related adjustments and

restructuring charges that may not be indicative of our core business, we believe that this measure provides us with additional useful information to

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measure and understand our performance, particularly with respect to changes in performance from period to period. We use non-GAAP operating income and non-GAAP operating margin in the preparation of our budgets and to measure and monitor our performance. Non-GAAP operating income and non-GAAP operating margin is not determined in accordance with GAAP and is not a substitute for, or superior to, financial measures determined in accordance with GAAP. We increased our investments in the business in the last half of 2013 and we expect our non-GAAP operating margin to be approximately 40-41% for fiscal year 2014.

For further discussion regarding non-GAAP financial measures including non-GAAP operating income, see “Non-GAAP Financial Measures” below.

Opportunities, Trends and Uncertainties

Businesses, governments and other organizations are increasingly relying on networks, systems, and applications to execute their operations, facilitate their internal and external communications and transact business with their customers and partners. The size of these networks, the number of applications and servers, and the complexity of physical and virtual server environments are increasing as organizations place more reliance on them. In addition, business initiatives to capture, store, and analyze an increasing amount of organizational data are creating new IT management challenges. Furthermore, the adoption of cloud computing technologies, which is shifting a growing number of critical workloads off premises, is also creating new IT management complexities and placing increasing importance on the performance of IT assets as compute resources become more distributed. The development and evolution of cloud computing technologies is also allowing a growing number of small and medium-sized organizations to rely upon third parties, known as managed service providers, for their IT management needs. These managed service providers need powerful, yet easy-to-use and affordable solutions in order to address a wide range of IT management issues for the thousands of small and medium-sized organizations they serve.

In order to address these challenges, we offer a cohesive portfolio of powerful, yet easy-to-use and affordably priced IT management products spanning networks, systems, and application management. This includes software that we have either developed or acquired that allows IT professionals to manage the performance, health, and configurations of network devices, firewalls, applications, physical and virtual servers, storage devices, as well as software for log and security information management. It also includes software that provides IT professionals with mobile and remote access to their IT infrastructure and software to help them track and resolve IT issues along with their IT assets. Lastly, our portfolio includes a set of cloud-based remote monitoring and management products that allow managed service providers to remotely access and address a broad range of IT issues faced by their customers in order to ensure the performance and security of their networks, desktops, servers, and other proprietary systems. We believe that IT-related trends and the limitations of existing offerings present a significant market opportunity for our products and we have begun to increase our investment as a percentage of revenue to take advantage of this market opportunity. We expect our revenue to continue to grow as we capitalize on these and other market opportunities through acquisitions and development. However, our ability to meet our target will depend on a number of factors and assumptions, many of which are outside of our control. Further, any revenue growth and operating synergies of our acquired products and businesses depends on our ability to successfully integrate those products and businesses and may be lower than expected if we are unable to do so in the future.

In 2013, we recognized 26.5% of our revenue from sales by our international subsidiaries, which includes all subsidiaries outside of North America. We believe there is a substantial opportunity for additional sales of our software in Europe, Middle East and Africa, or EMEA, region, the Asian-Pacific region, and the Latin American region. We intend to increase our sales, marketing and support operations in these regions. However, we believe there is significant uncertainty regarding the economic conditions in certain of these geographic regions, particularly in parts of Europe. While we believe that any difficult economic conditions may adversely affect the sales of our products, this could also offer us an opportunity to market and sell our products to mid-size businesses and enterprise customers at compelling prices compared to the prices of some competing products.

We expect the U.S. federal government to continue to be a significant market opportunity, as we believe the ease of deployment, power and scalability of our products gives us a competitive advantage to sell to various agencies and departments of the U.S. federal government. The U.S. federal government new license sales, including both direct sales and sales through distributors and resellers, were 9.4% of our total new license sales in 2013 as compared to

10.7% and 12.8% of our total new license sales in 2012 and 2011, respectively. We have experienced and continue to expect inconsistency in the buying pattern of the U.S. federal government for larger transactions with our products. We believe that many of our larger transactions, both new licenses and maintenance renewals, with the U.S. federal government are dependent on specific projects that may not be continued at the same scale in the future due to budgetary cuts or other reasons, and the reduction or cancellation of specific projects such as these could result in our sales to the U.S. federal government growing less rapidly than expected or even decreasing. In addition, our sales, both new licenses and maintenance renewals, to the U.S. federal government are largely dependent on systems integrators, distributors and resellers whose purchases from us have been difficult to predict.

Key Components of Our Results of Operations

Sources of Revenue

Our revenue is primarily comprised of license, maintenance and subscription revenue.

License, Maintenance and Other Revenue. We primarily license our software under perpetual licenses, which ordinarily include one year of maintenance as part of the initial purchase price of the product. License revenue reflects the revenue recognized from sales of new perpetual licenses and upgrades of license size to our software. We have experienced annual growth in license revenue. Customers can renew, and generally have renewed, their maintenance agreements at our standard list maintenance renewal pricing for their software products. Current customers with maintenance agreements are entitled to receive unspecified upgrades or enhancements when and if they become available. Maintenance revenue is an important source of our future revenue. We have experienced strong and consistent annual and quarterly growth in maintenance and other revenue. Because our maintenance base continues to grow each year due to new license sales, high customer retention and acquisitions, we expect maintenance revenue to continue to increase in absolute dollars in future periods.

Subscription Revenue. We primarily derive subscription revenue from fees received from customers for time-based license arrangements and software-as-a-service, or SaaS, offerings which were introduced during the second quarter of 2013 as a result of our acquisition of N-able. We currently sell our subscription products separately from our perpetual offerings.

Cost of Revenue

Cost of revenue primarily consists of personnel costs related to providing technical support services, amortization of acquired developed product technologies and royalty and hosting fees. Personnel costs include salaries, bonuses and stock-based compensation and related employer-paid payroll taxes for technical support personnel, as well as an allocation of our facilities, information technology, employee benefit and other overhead costs. We allocate stock-based compensation expense and related employer-paid payroll taxes to personnel costs based on the expense category in which the option or restricted stock unit holder works. We allocate overhead, such as rent, computer and other technology costs, and employee benefit costs to personnel costs in each expense category based on worldwide headcount in that category.

The amortization of developed product technologies can vary significantly each period based on the size and timing of our acquisitions. We expect our cost of revenue to increase in absolute dollars and to fluctuate as a percentage of revenue as we acquire additional companies or technologies and as we increase our headcount to support new customers and product offerings.

Operating Expenses

We classify our operating expenses into four categories: sales and marketing, research and development, general and administrative and accrued earnout gain.

Our operating expenses primarily consist of personnel costs, contract research and development costs, marketing program costs and legal, accounting, consulting and other professional service fees. Personnel costs for each category of operating expenses primarily include employee compensation costs and facility overhead costs. We include restructuring charges related to severance and relocation in the employee's respective department.

Our operating expenses increased in absolute dollars and as a percentage of revenue in 2013 compared to 2012 and 2011, as we have continued to build infrastructure and add employees through acquisitions and organic growth across all departments in order to accelerate and support our growth. The number of full-time employees as of December 31, 2013 was 1,312, as compared to 865 as of December 31, 2012 and 628 as of December 31, 2011. We added 188 full-time employees with the N-able acquisition in May 2013 and 70 full-time employees with the acquisition of Confio in October 2013, which increased our operating expenses in the second half of 2013. We expect these acquisitions will continue to increase our operating expenses in future periods as we invest in these businesses.

We expect our operating expenses to continue to increase in absolute dollars as we make long-term investments in our business both domestically and internationally. As we acquire additional companies or technologies and integrate the businesses, our operating expenses in future periods may increase in absolute dollars and fluctuate as a percentage of revenue as a result of such acquisitions. In addition, we intend to continue to grant equity awards to our current

executives and employees and those who join us in the future through acquisitions or otherwise, which will result in additional stock-based compensation expense.

Sales and Marketing. Sales and marketing expenses primarily consist of personnel costs for our sales, marketing and business development employees and executives, commissions earned by our sales personnel, the cost of marketing programs

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such as paid search, trade shows, search engine optimization and management, website maintenance and design and the cost of business development programs. We will continue to hire sales personnel in the United States and in our international sales offices to drive new license sales growth. We also expect to continue to invest in our websites, online user community site, brand awareness initiatives and marketing programs to drive customer downloads and support our new product launches.

Research and Development. Research and development expenses primarily consist of personnel costs for our product development employees and executives and, to a lesser extent, contractor fees. We have devoted our development efforts primarily to expanding our product line and increasing the functionality and enhancing the ease-of-use of our software products. We have significantly increased our research and development employee headcount with the acquisition of N-able and the continued expansion of our research and development centers in the Czech Republic and India. We expect to continue to invest in our research and development activities by hiring engineers in our international locations, which will allow us to continue our research and development growth strategy internationally.

General and Administrative. General and administrative expenses primarily consist of personnel costs for our executive, finance, legal, human resources and administrative personnel and amortization of acquired intangible assets. Legal, accounting and other professional service fees, restructuring charges related to the closing of certain offices along with general corporate expenses are also recorded in general and administrative expenses. We expect to incur higher administrative costs in future periods as our business continues to grow both organically and through acquisitions.

Accrued Earnout Gain. Accrued earnout gain represents the change in the fair value of the contingent consideration liability recorded in connection with our acquisitions due to subsequent adjustments in the probability assumptions. We review the probability of achieving the earnout objectives each quarter to determine if the probability assumptions need to be adjusted and the contingent consideration revalued.

Other Income (Expense)

Other income (expense) primarily consists of interest income, interest expense, transactional foreign exchange gains (losses), foreign exchange contracts gains (losses) and grant income. We periodically receive government grant income related to grants in our Czech Republic and Ireland entities for the creation of job positions and related training costs. The amount and timing of the grant payments is determined by the Czech and Irish governments. Interest income represents interest received on our cash, cash equivalents and short-term and long-term investments, including any amortization or accretion of the premium and discount. Interest expense is associated with outstanding borrowings under our Credit Agreement dated October 2013. Foreign exchange gains (losses) primarily relate to expenses and billing transactions denominated in currencies other than the functional currency of the associated subsidiary. Foreign exchange contracts gains (losses) relate to the settlement of foreign currency forward contracts utilized to hedge foreign currency exposures that are not formally designated as hedges.

Income Tax Expense

Income tax expense primarily consists of corporate income taxes related to profits resulting from the sale of our software offerings by our four entities that sell our software, two in the United States, one in Canada and one in Ireland. The rate of taxation on income earned by our U.S. entities is higher than the rate of taxation on income earned by our Canadian and Irish entities. If our international income, as a percentage of total income, increases as we expect, then our effective income tax rate should correspondingly decline. However, our effective tax rate may be affected by many other factors, such as changes in tax laws, regulations or rates, new interpretations of existing laws or regulations, the impact of accounting for stock-based compensation, the impact of accounting for business combinations, the impact of accounting for uncertain tax positions, changes in our international structure, shifts in the amount of taxable income earned in the United States, as compared with other regions in the world, and changes in overall levels of income before tax.

Our results of operations reflect an income tax benefit from the tax credit incentives under the U.S. research and experimentation tax credit, or R&E tax credit, for the years ended December 31, 2011 and 2013. Our results of operations for the year ended December 31, 2012 do not reflect an income tax benefit related to the R&E tax credits as the R&E tax credit expired on December 31, 2011. However, the R&E tax credit was extended by the signing of the American Taxpayer Relief Act of 2012, or the Act, on January 2, 2013. The Act retroactively reinstated and extended

the R&E tax credit from January 1, 2012 through December 31, 2013. Since the Act was enacted during 2013, the income tax benefit related to the 2012 R&E tax credit was reflected in our results of operations for the year ended December 31, 2013. Additionally, the 2013 R&E tax credit is also reflected in our results of operations for the year ended December 31, 2013.

The tax credit expired on December 31, 2013, and may not be renewed, or if renewed, it may be renewed on terms significantly less favorable than current tax incentives or on terms resulting in our disqualification from the benefits of the R&E tax credit. The elimination or significant reduction in the R&E tax credit would increase our effective tax rate and could adversely affect our results of operations in the future.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in conformity with United States of America generally accepted accounting principles, or GAAP, and require our management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many instances, we could reasonably use different accounting estimates, and in some instances, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are differences between our estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected, perhaps materially.

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application, while in other cases, management's judgment is required in selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. We believe that these accounting policies requiring significant management judgment and estimates are critical to understanding our historical and future performance, as these policies relate to the more significant areas of our financial results. These critical accounting policies are:

- Valuation of goodwill, intangibles, long-lived assets and contingent consideration, including accrued earnouts;
- Revenue recognition;
- Stock-based compensation;
- Income taxes; and
- Loss contingencies.

Acquisitions, Goodwill and Identifiable Intangible Assets. When we acquire businesses, we allocate the purchase price to the fair value of the assets acquired and liabilities assumed, including identifiable intangible assets. Any residual purchase price is recorded as goodwill. We must also estimate the fair value of any contingent consideration. The operating results of acquisitions are included in our consolidated financial statements from the effective date of the acquisition.

The fair value of identifiable intangible assets is based on significant judgments made by management. We typically engage third party valuation appraisal firms to assist us in determining the fair values and useful lives of the assets acquired. Such valuations and useful life determinations require us to make significant estimates and assumptions. These estimates and assumptions are based on historical experience and information obtained from management, and also include, but are not limited to, future expected cash flows earned from the intangible asset and discount rates applied in determining the present value of those cash flows. Unanticipated events and circumstances may occur that could affect the accuracy or validity of such assumptions, estimates or actual results.

The acquired developed product technologies recorded for each acquisition were feasible at the date of acquisition as they were being actively marketed and sold by the acquired company at the acquisition date. In addition to the acquired developed product technologies, we also record intangible assets for the acquired company's customer relationships, customer backlog, trademarks, in process research and development and non-competition covenants. An impairment of goodwill or indefinite-lived intangible assets is recognized when the carrying amount of the assets exceeds their fair value. The process of evaluating the potential impairment is highly subjective and requires the application of significant judgment. For purposes of the annual impairment test, we assess qualitative factors to determine if it is more likely than not that goodwill and indefinite-lived assets might be impaired and whether it is necessary to perform the quantitative impairment test which considers our market capitalization compared with the carrying amount of our net assets on the date of the test, since we have only one reporting unit. If an event occurs that would cause us to revise our estimates and assumptions used in analyzing the value of our goodwill and other intangible assets with indefinite lives, the revision could result in a non-cash impairment charge that could have a material impact on our financial results. As of December 31, 2013 and 2012, we performed our annual review of goodwill and indefinite-lived intangible assets and concluded that no impairment existed for our reporting unit during any of the periods presented. No impairment charges have been required to date.

We evaluate long-lived assets, including identifiable intangible assets and other assets, for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Events or changes in circumstances that could result in an impairment review include, but are not limited to, significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of the acquired assets or the strategy for our overall business, and significant negative industry or economic trends. If an event occurs that would cause us to revise our estimates and assumptions used in analyzing the value of our property and equipment or our finite-lived intangibles and other

assets, that revision could result in a non-cash impairment charge that could have a material impact on our financial results. As of December 31, 2013 and 2012, there were no indicators that our long-lived assets were impaired.

Contingent Consideration. Our acquisitions may include contingent consideration payments based on future sales or product milestones of an acquired entity. We estimate the fair value of contingent consideration liabilities based on certain milestones of the acquired companies and estimated probabilities of achievement and discount the liabilities to present value using our pre-tax cost of debt. We believe our estimates and assumptions are reasonable; however, there is significant judgment involved. Changes in the fair value of contingent consideration liabilities may result from changes in discount periods, changes in the timing and amount of sales and/or other specific milestone estimates and changes in probability assumptions with respect to the likelihood of achieving the various earnout criteria. At each reporting date, the contingent consideration liability is revalued to estimated fair value and changes in fair value subsequent to the acquisitions are reflected in net income in the consolidated statements of income and could cause a material impact to, and volatility in, our operating results.

Revenue Recognition

We derive substantially all of our revenue from the licensing of our software products, the sale of annual maintenance agreements for these products and our subscription products and services. In accordance with current guidance, we recognize revenue for software, maintenance and subscriptions when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectability is reasonably assured. Our return policy generally does not allow our customers to return software products.

We generally use a purchase order, an authorized credit card, an electronic or manually signed license agreement, or the receipt of a cash payment as evidence of an arrangement. We consider delivery to have occurred and recognize revenue when risk of loss transfers to the customer, reseller or distributor or the customer has access to their subscription which is generally upon electronic transfer of the license key or password that provides immediate availability of the product to the purchaser. We account for sales incentives to customers, resellers or distributors as a reduction of revenue at the time we recognize the revenue from the related product sale. We report revenue net of any sales tax collected.

We sell our software products through our direct sales force and through our distributors and other resellers. Our distributors and resellers do not carry inventory of our software and we generally require them to specify the end-user of the software at the time of the order. If the distributor or reseller does not provide end-user information, then we will generally not fulfill the order. Our distributors and resellers have no rights of return or exchange for software that they purchase from us and payment for these purchases is due to us without regard to whether the distributors or resellers collect payment from their customers. Sales through resellers and distributors are typically evidenced by a reseller or distributor agreement, together with purchase orders or authorized credit cards on a transaction-by-transaction basis.

License Revenue. Under software revenue recognition guidance, we use the residual method to recognize revenue when a license agreement includes one or more elements to be delivered and vendor-specific objective evidence, or VSOE, of fair value for all undelivered elements exists. Because our software is generally sold with maintenance, we calculate the amount of revenue allocated to the software license by determining the fair value of the maintenance and subtracting it from the total invoice or contract amount. We establish VSOE of the fair value of maintenance services by the standard published list pricing for our maintenance renewals since we generally charge list prices for our maintenance renewals. If evidence of the fair value of one or more undelivered elements does not exist, all revenue is generally deferred and recognized when delivery of those elements occurs or when fair value can be established.

When the undelivered element for which we do not have VSOE of fair value is support, revenue for the entire arrangement is recognized ratably over the support period. If in the future we were unable to establish VSOE of fair value of the maintenance or other services the timing of our revenue recognition could be impacted significantly.

Maintenance and Other Revenue. We derive maintenance revenue from fees for software maintenance services. We typically include one year of maintenance as part of the initial purchase price of each perpetual software offering and then sell renewals of this maintenance agreement. We generally bill maintenance renewal agreements annually in advance for services to be performed over a 12-month period. Customers have the option to purchase maintenance renewals for periods other than 12 months. We generally recognize maintenance revenue ratably on a daily basis over

the contract period. Customers with maintenance agreements are entitled to receive unspecified upgrades or enhancements to new versions of their software products on a when-and-if-available basis. Other revenue is not currently significant nor do we expect it to be significant in future periods.

Subscription Revenue. We primarily derive subscription revenue from fees received from customers for time-based license arrangements and software-as-a-service, or SaaS offerings. We generally invoice subscription agreements monthly in advance over the subscription period. Subscription revenue is recognized ratably over the subscription term when all revenue recognition criteria have been met. We introduced these offerings in the second quarter of 2013 as a result of the acquisition of N-able.

Stock-Based Compensation

We have granted and expect to continue to grant our employees and directors stock-based incentive awards. These awards are in the form of stock options, restricted stock and restricted stock units. We measure stock-based compensation expense for all share-based awards granted based on the estimated fair value of those awards on the date of grant. The fair values of stock option awards are estimated using a Black-Scholes valuation model. The fair value of restricted stock and restricted stock unit awards is determined using the fair market value of our common stock based on the quoted market price on the date of grant, or intrinsic value.

We use various assumptions in estimating the fair value of options at the date of grant using the Black-Scholes option model including expected dividend yield, volatility, risk-free rate of return and expected life. We have not paid and do not anticipate paying cash dividends on our common stock; therefore, we assume the expected dividend yield to be zero. We estimate the expected volatility using a weighted average of the historical volatility of our common stock and historical volatility of comparable public companies from a representative industry peer group. We based the risk-free rate of return on the average U.S. treasury yield curve for five- and seven-year terms. As allowed under current guidance, we have elected to apply the “simplified method” in developing our estimate of expected life for “plain vanilla” stock options by using the midpoint between the vesting date and contractual termination date since we do not have sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term due to the limited period of time our common stock has been publicly traded. For all dates, we granted employees options at exercise prices equal to the fair value of the underlying common stock on the date of grant, which is the closing price of our common stock as reported by the NYSE.

We plan to grant restricted stock units as the primary form of equity awards to our employees in 2014. We will continue to grant restricted stock units and stock options to our executives and board of directors in 2014.

Income Taxes

We use the liability method of accounting for income taxes as set forth in the authoritative guidance for accounting for income taxes. Under this method, we recognize deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the respective carrying amounts and tax basis of our assets and liabilities.

The guidance on accounting for uncertainty in income taxes prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. At December 31, 2013 and 2012, we had \$15.1 million and \$8.8 million of gross unrecognized tax benefits, respectively, all of which, if recognized, would affect our effective tax rate.

We accrue interest and penalties related to unrecognized tax benefits as a component of income tax expense. At December 31, 2013 and 2012, we had accrued interest and penalties related to unrecognized tax benefits of approximately \$0.6 million and \$0.2 million, respectively.

In calculating our effective tax rate, we make judgments regarding certain tax positions, including the timing and amount of deductions and allocations of income among various tax jurisdictions.

The guidance requires us to identify, evaluate and measure all uncertain tax positions taken or to be taken on tax returns and to record liabilities for the amount of these positions that may not be sustained, or may only partially be sustained, upon examination by the relevant taxing authorities. Although we believe that our estimates and judgments are reasonable, actual results may differ from these estimates. Some or all of these judgments are subject to review by the taxing authorities.

We establish valuation allowances when necessary to reduce deferred tax assets to the amounts expected to be realized. On a quarterly basis, we evaluate the need for, and the adequacy of, valuation allowances based on the expected realization of our deferred tax assets. The factors used to assess the likelihood of realization include our latest forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets.

We intend to invest our non-U.S. earnings permanently in foreign operations, and for this reason, we do not record federal income taxes on the undistributed earnings of our foreign subsidiaries.

Comparison of the Years Ended December 31, 2013 and 2012

	Year Ended December 31,		2012	% of		Change
	2013	% of Revenue		% of Revenue		
	(in thousands)		(in thousands)			(in thousands)
Revenue:						
License	\$ 135,839	40.5	% \$ 123,984	46.1	%	\$ 11,855
Maintenance and other	191,491	57.1	144,980	53.9		46,511
Subscription	8,055	2.4	—	—		8,055
Total revenue	335,385	100.0	268,964	100.0		66,421
Cost of revenue	27,916	8.3	18,400	6.8		9,516
Gross profit	307,469	91.7	250,564	93.2		56,905
Operating expenses:						
Sales and marketing	99,289	29.6	73,046	27.2		26,243
Research and development	37,514	11.2	28,769	10.7		8,745
General and administrative	49,044	14.6	35,649	13.3		13,395
Accrued earnout gain	(125)	—	(570)	(0.2)		445
Total operating expenses	185,722	55.4	136,894	50.9		48,828
Operating income	121,747	36.3	113,670	42.3		8,077
Other income (expense):						
Interest income	396	0.1	430	0.2		(34)
Interest expense	(215)	(0.1)	—	—		(215)
Other income (expense), net	(425)	(0.1)	419	0.2		(844)
Total other income	(244)	(0.1)	849	0.3		(1,093)
Income before income taxes	121,503	36.2	114,519	42.6		6,984
Income tax expense	31,725	9.5	33,176	12.3		(1,451)
Net income	\$ 89,778	26.8	% \$ 81,343	30.2	%	\$ 8,435

Revenue

Revenue increased \$66.4 million, or 24.7%, in the year ended December 31, 2013 compared to the year ended December 31, 2012. Total revenue by product group was \$222.5 million and \$198.5 million for network management, \$97.1 million and \$70.4 million for systems and application management and \$15.8 million and \$0 for our MSP products for the years ended December 31, 2013 and 2012, respectively.

Revenue from our international subsidiaries was 26.5% and 24.5% of total revenue in 2013 and 2012, respectively.

Other than the United States, no single country accounted for 10% or more of our total revenues during these periods. We expect international sales as a percentage of our total sales in 2014 to remain consistent as compared to 2013. We plan to continue expanding our sales efforts outside of the U.S.

License, Maintenance and Other Revenue

License revenue increased \$11.9 million due to continued growth in new license sales of our systems and application management products such as Solarwinds Server & Application Monitor, Web Help Desk and Solarwinds Database Performance Analyzer which was added through the acquisition of Confio. These increases were offset by decreases in other system management products such as DameWare and Storage Manager and other decreases in network management products. We had two transactions in 2012 that resulted in license revenue greater than \$0.5 million, whereas we had three transactions that resulted in license revenue greater than \$0.5 million in 2013.

New license sales in our commercial business increased 10.5% in 2013 as compared to 2012. Our commercial product transaction growth was 30.4% in 2013 as compared to 2012 as a result of our growth in new license sales of our systems management products, particularly Web Help Desk and Serv-U. As the number of product transactions fluctuates with changes in the business or product mixes, this also affects our average transaction size for new license sales. As of December 31, 2013,

the commercial average transaction size for new license sales, was approximately \$7,900 as compared to approximately \$8,900 as of December 31, 2012, a decrease of 11.6%. The decrease in our average transaction size was primarily due to the high volume of transactions of our Web Help Desk and Serv-U products in the last year combined with their lower average transaction size than our other products.

In the fourth quarter of 2013, we changed the methodology for calculating our average transaction size and product transaction volume growth metrics. We now calculate these metrics using commercial transactions only and excluding any transactions that consist solely of our network management and systems and application management transactional products sold on a stand-alone basis or our MSP products. In addition, we no longer calculate these metrics using a trailing 12-month average. We have recalculated these metrics as disclosed in the revenue comparison for the years ended December 31, 2012 and 2011 based on the new methodology.

Maintenance and other revenue increased \$46.5 million due to a growing maintenance renewal customer base and an increase in new license sales, which drives new maintenance revenue. We have maintained high customer retention and in addition, our renewal base has continued to increase each quarter as we have begun to renew and recognize the maintenance revenue associated with our acquired products.

Subscription Revenue

Subscription revenue of \$8.1 million is from the sale of products introduced as a result of our acquisition of N-able technologies in the second quarter of 2013. N-Central, N-able's flagship product for MSP's, had a strong performance as we transitioned N-able into a subscription model and invested in their business.

Cost of Revenue

Cost of revenue increased \$9.5 million, or 51.7%, in 2013 compared to 2012. Cost of license revenue increased by \$3.4 million in 2013 compared to 2012, primarily due to the amortization of acquired product technologies associated with our acquisitions that were completed in 2012 and 2013. Cost of maintenance revenue also increased \$1.4 million, primarily due to increased headcount to support new customers, additional product offerings from acquisitions and internal product development. Cost of subscription revenue consists of personnel costs, amortization of acquired developed product technologies and other direct costs, including royalty fees and hosting fees, related to our subscription products and services which were introduced during the second quarter of 2013.

Operating Expenses

Sales and Marketing. Sales and marketing expenses increased \$26.2 million, or 35.9%, in 2013 compared to 2012. We continue to invest in the sales and marketing efforts that drive our revenue growth. In addition, we have increased employee headcount in our sales, marketing and maintenance renewal teams as a result of organic growth and through acquisitions. As a result of these expansion efforts, our sales and marketing personnel costs, which include stock-based compensation expense, increased by \$18.0 million and marketing program costs increased \$6.3 million. Our sales expense as a percentage of revenue remained consistent in 2013 as compared to 2012.

Research and Development. Research and development expenses increased \$8.7 million, or 30.4%, in 2013 compared to 2012. This increase was primarily related to the increase in research and development headcount related to the acquisition of N-able in the second quarter of 2013. In addition, in order to support the ongoing development of acquired and new products, we continued to increase the size of our Czech Republic and India research and development centers during 2012 and 2013. Due to this growth, our personnel costs, which include stock-based compensation expense, increased by \$6.1 million and contract services increased \$2.6 million in 2013 as compared to 2012.

General and Administrative. General and administrative expenses increased \$13.4 million, or 37.6%, in 2013 compared to 2012. This increase was primarily due to a \$6.3 million increase in personnel costs, which include stock-based compensation expense, an increase of \$1.9 million in amortization expense related to certain acquired intangible assets, and a \$1.7 million increase in professional fees. In addition, restructuring charges, which primarily consist of accelerated depreciation on leasehold improvements and lease abandonment charges related to the closing of certain offices, increased \$1.8 million.

Accrued Earnout Gain. We recorded a \$0.1 million accrued earnout gain in 2013 as compared to a \$0.6 million accrued earnout gain in 2012 due to the changes in probability of achieving certain sales milestones related to our acquisition related contingent considerations during the periods.

Other Income (Expense)

Other income (expense) decreased by \$1.1 million primarily due to increases in net losses on foreign currency transactions and interest expense for the year ended December 31, 2013 as compared to 2012. In 2013, we borrowed \$40.0

12

million at an interest rate of approximately 1.4% under a revolving loan under the Credit Agreement that was used to finance a portion of the consideration paid upon the acquisition of Confio.

Income Tax Expense

Our income tax expense decreased by \$1.5 million in 2013 as compared to 2012. This decrease resulted from the availability of the U.S. R&E tax credit offset by an increase in our income before income taxes of \$7.0 million when comparing the same periods. Our results of operations for the year ended December 31, 2012 do not reflect an income tax benefit related to the R&E tax credits as the R&E tax credit expired on December 31, 2011. However, the R&E tax credit was extended by the signing of the American Taxpayer Relief Act of 2012, or the Act, on January 2, 2013. The Act retroactively reinstated and extended the R&E tax credit from January 1, 2012 through December 31, 2013. Since the Act was enacted during 2013, the income tax benefit related to the 2012 R&E tax credit was included in our results of operations for the year ended December 31, 2013.

Our effective tax rate decreased from 29.0% in 2012 to 26.1% in 2013, which was primarily attributable to the availability of the U.S. R&E tax credit which resulted in the entire 2012 R&E tax credit being recognized in 2013 as well as an increase in international earnings, which are generally taxed at lower tax rates.

Comparison of the Years Ended December 31, 2012 and 2011

	Year Ended December 31,				
	2012	% of	2011	% of	Change
	(in thousands)	Revenue	(in thousands)	Revenue	(in thousands)
Revenue:					
License	\$ 123,984	46.1	% \$ 92,254	46.5	% \$ 31,730
Maintenance and other	144,980	53.9	106,104	53.5	38,876
Total revenue	268,964	100.0	198,358	100.0	70,606
Cost of revenue	18,400	6.8	11,989	6.0	6,411
Gross profit	250,564	93.2	186,369	94.0	64,195
Operating expenses:					
Sales and marketing	73,046	27.2	53,850	27.1	19,196
Research and development	28,769	10.7	21,332	10.8	7,437
General and administrative	35,649	13.3	28,076	14.2	7,573
Accrued earnout gain	(570)	(0.2)	(664)	(0.3)	94
Total operating expenses	136,894	50.9	102,594	51.7	34,300
Operating income	113,670	42.3	83,775	42.2	29,895
Other income (expense):					
Interest income	430	0.2	308	0.2	122
Other income, net	419	0.2			