

**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, 2016

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: 001-35435

Proto Labs, Inc.

(Exact name of registrant as specified in its charter)

Minnesota

(State or other jurisdiction of incorporation or organization)

41-1939628

(I.R.S. Employer Identification No.)

5540 Pioneer Creek Drive

Maple Plain, Minnesota

(Address of principal executive offices)

55359

(Zip Code)

(763) 479-3680

(Registrant's telephone number, including area code)

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer

Accelerated filer

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 (as defined in 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: 26,432,035 shares of Common Stock, par value \$0.001 per share, were outstanding at October 25, 2016.

Proto Labs, Inc.
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Proto Labs, Inc.
Consolidated Balance Sheets
(In thousands, except share and per share amounts)

	September 30, 2016 (Unaudited)	December 31, 2015
Assets		
Current assets		
Cash and cash equivalents	\$ 68,218	\$ 47,653
Short-term marketable securities	39,028	33,201
Accounts receivable, net of allowance for doubtful accounts of \$333 and \$330 as of September 30, 2016 and December 31, 2015, respectively	37,261	36,125
Inventory	9,930	9,771
Prepaid expenses and other current assets	5,392	5,224
Income taxes receivable	-	6,028
Total current assets	159,829	138,002
Property and equipment, net	142,722	125,475
Goodwill	28,916	28,916
Other intangible assets, net	2,817	3,337
Long-term marketable securities	68,387	64,789
Other long-term assets	1,374	517
Total assets	<u>\$ 404,045</u>	<u>\$ 361,036</u>
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable	\$ 10,703	\$ 13,643
Accrued compensation	10,330	9,993
Accrued liabilities and other	3,612	2,626
Income taxes payable	541	-
Total current liabilities	25,186	26,262
Long-term deferred tax liabilities	4,247	4,240
Other long-term liabilities	3,795	2,889
Total liabilities	33,228	33,391
Shareholders' equity		
Preferred stock, \$0.001 par value, authorized 10,000,000 shares; issued and outstanding 0 shares as of each of September 30, 2016 and December 31, 2015	-	-
Common stock, \$0.001 par value, authorized 150,000,000 shares; issued and outstanding 26,432,035 and 26,200,718 shares as of September 30, 2016 and December 31, 2015, respectively	26	26
Additional paid-in capital	210,226	198,835
Retained earnings	167,331	133,996
Accumulated other comprehensive loss	(6,766)	(5,212)
Total shareholders' equity	370,817	327,645
Total liabilities and shareholders' equity	<u>\$ 404,045</u>	<u>\$ 361,036</u>

The accompanying notes are an integral part of these consolidated financial statements.

Proto Labs, Inc.
Consolidated Statements of Comprehensive Income
(In thousands, except share and per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Statements of Operations:				
Revenue	\$ 78,173	\$ 67,842	\$ 225,702	\$ 190,347
Cost of revenue	33,448	27,517	99,077	77,218
Gross profit	44,725	40,325	126,625	113,129
Operating expenses				
Marketing and sales	11,787	10,027	34,182	28,383
Research and development	5,976	4,760	17,110	13,471
General and administrative	10,020	8,134	28,397	20,683
Total operating expenses	27,783	22,921	79,689	62,537
Income from operations	16,942	17,404	46,936	50,592
Other income, net	625	593	2,342	100
Income before income taxes	17,567	17,997	49,278	50,692
Provision for income taxes	5,585	5,615	15,943	16,171
Net income	\$ 11,982	\$ 12,382	\$ 33,335	\$ 34,521
Net income per share:				
Basic	\$ 0.45	\$ 0.47	\$ 1.27	\$ 1.33
Diluted	\$ 0.45	\$ 0.47	\$ 1.26	\$ 1.31
Shares used to compute net income per share:				
Basic	26,416,041	26,083,405	26,334,738	25,952,451
Diluted	26,609,878	26,381,313	26,539,078	26,290,758
Comprehensive Income (net of tax)				
Comprehensive income	\$ 11,828	\$ 11,416	\$ 31,781	\$ 33,754

The accompanying notes are an integral part of these consolidated financial statements.

Proto Labs, Inc.
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2016	2015
Operating activities		
Net income	\$ 33,335	\$ 34,521
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,831	10,422
Stock-based compensation expense	5,260	4,515
Deferred taxes	495	(310)
Excess tax benefit from stock-based compensation	(1,965)	(5,212)
Loss on impairment of assets	455	-
Amortization of held-to-maturity securities	881	936
Other	(1,381)	-
Changes in operating assets and liabilities:		
Accounts receivable	(1,626)	(8,827)
Inventories	(203)	(1,117)
Prepaid expenses and other	(1,107)	(2,596)
Income taxes	8,114	(546)
Accounts payable	(2,043)	3,744
Accrued liabilities and other	3,131	5,754
Net cash provided by operating activities	<u>56,177</u>	<u>41,284</u>
Investing activities		
Purchases of property and equipment	(30,981)	(27,259)
Purchases of marketable securities	(56,213)	(42,674)
Proceeds from maturities of marketable securities	45,907	40,899
Net cash used in investing activities	<u>(41,287)</u>	<u>(29,034)</u>
Financing activities		
Payments on debt	-	(107)
Acquisition-related contingent consideration	(400)	(1,400)
Proceeds from exercises of stock options and other	4,168	5,165
Excess tax benefit from stock-based compensation	1,965	5,212
Net cash provided by financing activities	<u>5,733</u>	<u>8,870</u>
Effect of exchange rate changes on cash and cash equivalents	(58)	(318)
Net increase in cash and cash equivalents	<u>20,565</u>	<u>20,802</u>
Cash and cash equivalents, beginning of period	<u>47,653</u>	<u>43,329</u>
Cash and cash equivalents, end of period	<u>\$ 68,218</u>	<u>\$ 64,131</u>

The accompanying notes are an integral part of these consolidated financial statements.

Note 1 – Basis of Presentation

The unaudited interim Consolidated Financial Statements of Proto Labs, Inc. (Proto Labs, the Company, we, us or our) have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, the accompanying financial statements reflect all adjustments necessary for a fair presentation of the Company's statements of financial position, results of operations and cash flows for the periods presented. Except as otherwise disclosed herein, these adjustments consist of normal, recurring items. Operating results for interim periods are not necessarily indicative of results that may be expected for the fiscal year as a whole.

The preparation of the financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures at the date of the financial statements and during the reporting period. Actual results could materially differ from these estimates. For further information, refer to the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 as filed with the Securities and Exchange Commission (SEC) on February 26, 2016.

The accompanying Consolidated Balance Sheet as of December 31, 2015 was derived from the audited Consolidated Financial Statements but does not include all disclosures required by U.S. GAAP for a full set of financial statements. This Form 10-Q should be read in conjunction with the Company's Consolidated Financial Statements and Notes included in the Annual Report on Form 10-K filed on February 26, 2016 as referenced above.

Note 2 – Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers. This ASU is a comprehensive new revenue recognition model that requires a company to recognize revenue from the transfer of goods or services to customers in an amount that reflects the consideration that the entity expects to receive in exchange for those goods or services. The Company is required to adopt the new pronouncement using one of two retrospective application methods.

On July 9, 2015, the FASB voted to approve a deferral of the effective date of ASU 2014-09 by one year to December 15, 2017 for annual reporting periods beginning after that date. The Company is evaluating the application method and the impact of this new standard on its financial statements, but does not expect the impact to be material.

In February 2016, the FASB issued ASU 2016-02, Leases, which introduces the balance sheet recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous guidance. The guidance will be effective for annual reporting periods beginning after December 15, 2018 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of the future adoption of this standard on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Employee Share-Based Payment Accounting, which is intended to simplify several aspects of the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures, statutory tax withholding requirements, and classification in the statement of cash flows. This guidance will be effective for annual reporting periods beginning after December 15, 2016 and interim periods within those fiscal years with early adoption permitted. The Company is currently evaluating the impact this new guidance will have on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows, which is intended to reduce diversity in how companies present and classify certain cash receipts and cash payments in the statement of cash flows. This guidance will be effective for annual reporting periods beginning after December 15, 2017 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of the future adoption of this guidance on its consolidated financial statements, but does not expect the impact to be material.

Note 3 – Net Income per Common Share

Basic net income per share is computed based on the weighted-average number of common shares outstanding. Diluted net income per share is computed based on the weighted-average number of common shares outstanding, increased by the number of additional shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of shares the Company could have repurchased from the proceeds from issuance of the potentially dilutive shares. Potentially dilutive shares of common stock include stock options, restricted stock units and restricted stock awards granted under stock-based compensation plans and shares committed to be purchased under the employee stock purchase plan.

The table below sets forth the computation of basic and diluted net income per share:

(in thousands, except share and per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	\$ 11,982	\$ 12,382	\$ 33,335	\$ 34,521
Basic - weighted-average shares outstanding:	26,416,041	26,083,405	26,334,738	25,952,451
Effect of dilutive securities:				
Employee stock options and other	193,837	297,908	204,340	338,307
Diluted - weighted-average shares outstanding:	26,609,878	26,381,313	26,539,078	26,290,758
Net income per share:				
Basic	\$ 0.45	\$ 0.47	\$ 1.27	\$ 1.33
Diluted	\$ 0.45	\$ 0.47	\$ 1.26	\$ 1.31

Note 4 – Goodwill and Other Intangible Assets

There were no changes in the carrying amount of Goodwill during the nine months ended September 30, 2016.

Intangible assets other than Goodwill at September 30, 2016 and December 31, 2015 were as follows:

(in thousands)	September 30, 2016			December 31, 2015			Useful Life (in years)	Weighted Average Useful Life Remaining (in years)
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net		
Intangible Assets with finite lives:								
Marketing assets	\$ 930	\$ (225)	\$ 705	\$ 930	\$ (155)	\$ 775	10.0	7.6
Non-compete agreement	190	(190)	-	190	(158)	32	2.0	-
Trade secrets	250	(121)	129	250	(83)	167	5.0	2.6
Internally developed software	680	(548)	132	680	(378)	302	3.0	0.6
Customer relationships	2,530	(679)	1,851	2,530	(469)	2,061	9.0	6.6
Total intangible assets	\$ 4,580	\$ (1,763)	\$ 2,817	\$ 4,580	\$ (1,243)	\$ 3,337		

Amortization expense for intangible assets was \$0.2 million for each of the three months ended September 30, 2016 and 2015. Amortization expense for intangible assets for the nine months ended September 30, 2016 and 2015 was \$0.5 million and \$0.6 million, respectively.

Estimated aggregated amortization expense based on the current carrying value of the amortizable intangible assets is as follows:

(in thousands)	Estimated Amortization Expense
Remaining 2016	\$ 162
2017	500
2018	424
2019	391
2020	374
Thereafter	966
Total estimated amortization expense	\$ 2,817

Note 5 – Fair Value Measurements

ASC 820, *Fair Value Measurement* (ASC 820), defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy that requires classification based on observable and unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1—Quoted prices in active markets for identical assets or liabilities.

Level 2—Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company's cash consists of bank deposits. The Company's cash equivalents measured at fair value consist of money market mutual funds. The Company determines the fair value of these investments using Level 1 inputs.

The following table summarizes financial assets as of September 30, 2016 and December 31, 2015 measured at fair value on a recurring basis:

(in thousands)	September 30, 2016			December 31, 2015		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Financial Assets:						
Cash and cash equivalents						
Money market mutual fund	\$ 5,538	\$ -	\$ -	\$ 11,896	\$ -	\$ -
Total	\$ 5,538	\$ -	\$ -	\$ 11,896	\$ -	\$ -

Note 6 – Marketable Securities

The Company invests in short-term and long-term agency, municipal, corporate and other debt securities. The securities are categorized as held-to-maturity and are recorded at amortized cost. Categorization as held-to-maturity is based on the Company's ability and intent to hold these securities to maturity. Information regarding the Company's short-term and long-term marketable securities as of September 30, 2016 and December 31, 2015 is as follows:

(in thousands)	September 30, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. municipal securities	\$ 42,718	\$ 7	\$ (76)	\$ 42,649
Corporate debt securities	32,745	18	(33)	32,730
U.S. government agency securities	24,770	4	(25)	24,749
Certificates of deposit/time deposits	7,182	32	-	7,214
Total marketable securities	\$ 107,415	\$ 61	\$ (134)	\$ 107,342

(in thousands)	December 31, 2015			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
U.S. municipal securities	\$ 35,667	\$ 8	\$ (56)	\$ 35,619
Corporate debt securities	28,133	-	(114)	28,019
U.S. government agency securities	26,784	2	(99)	26,687
Certificates of deposit/time deposits	5,909	2	(11)	5,900
Commercial paper	1,497	-	(2)	1,495
Total marketable securities	\$ 97,990	\$ 12	\$ (282)	\$ 97,720

Fair values for the corporate debt securities are primarily determined based on quoted market prices (Level 1). Fair values for the U.S. municipal securities, U.S. government agency securities and certificates of deposit are primarily determined using dealer quotes or quoted market prices for similar securities (Level 2).

The Company tests for other-than-temporary losses on a quarterly basis and has considered the unrealized losses indicated above, which are the result of changes in interest rates, to be temporary in nature. In reaching this conclusion, the Company considered the credit quality of the issuers of the debt securities as well as the Company's intent to hold the investments to maturity and recover the full principal.

Classification of marketable securities as current or non-current is based upon the security's maturity date as of the date of these financial statements.

The September 30, 2016 balance of held-to-maturity debt securities by contractual maturity is shown in the following table at amortized cost. Actual maturities may differ from contractual maturities because the issuers of the securities may have the right to prepay obligations without prepayment penalties.

(in thousands)	September 30, 2016
Due in one year or less	\$ 39,028
Due after one year through five years	68,387
Total marketable securities	\$ 107,415

Note 7 – Inventory

Inventory consists primarily of raw materials, which are recorded at the lower of cost or market using the average-cost method, which approximates first-in, first-out (FIFO) cost. The Company periodically reviews its inventory for slow-moving, damaged and discontinued items and provides allowances to reduce such items identified to their recoverable amounts.

The Company's inventory consisted of the following as of the dates indicated:

(in thousands)	September 30, 2016	December 31, 2015
Raw materials	\$ 9,226	\$ 8,589
Work in process	1,105	1,529
Total inventory	10,331	10,118
Allowance for obsolescence	(401)	(347)
Inventory, net of allowance	\$ 9,930	\$ 9,771

Note 8 – Stock-Based Compensation

Under the Company's 2012 Long-Term Incentive Plan, as amended (2012 Plan), the Company has the ability to grant stock options, stock appreciation rights (SARs), restricted stock, stock units, other stock-based awards and cash incentive awards. Awards under the 2012 Plan have a maximum term of ten years from the date of grant. The compensation committee may provide that the vesting or payment of any award will be subject to the attainment of specified performance measures in addition to the satisfaction of any continued service requirements and the compensation committee will determine whether such measures have been achieved. The per-share exercise price of stock options and SARs granted under the 2012 Plan generally may not be less than the fair market value of a share of our common stock on the date of the grant.

Employee Stock Purchase Plan

The Company's 2012 Employee Stock Purchase Plan (ESPP) allows eligible employees to purchase a variable number of shares of the Company's common stock each offering period at a discount through payroll deductions of up to 15 percent of their eligible compensation, subject to plan limitations. The ESPP provides for six-month offering periods with a single purchase period ending May 15 and November 15, respectively. At the end of each offering period, employees are able to purchase shares at 85 percent of the lower of the fair market value of the Company's common stock on the first trading day of the offering period or on the last trading day of the offering period.

Stock-Based Compensation Expense

Stock-based compensation expense was \$1.7 million and \$1.6 million for the three months ended September 30, 2016 and 2015, respectively, and \$5.3 million and \$4.5 million for the nine months ended September 30, 2016 and 2015, respectively.

Stock Options

The following table summarizes stock option activity during the nine months ended September 30, 2016:

	Stock Options	Weighted-Average Exercise Price
Options outstanding at December 31, 2015	766,042	\$ 36.52
Granted	113,645	58.12
Exercised	(173,781)	18.42
Forfeited	(69,965)	61.37
Options outstanding at September 30, 2016	<u>635,941</u>	\$ 42.59
Exercisable at September 30, 2016	<u>368,052</u>	\$ 31.13

The outstanding options generally have a term of ten years. For employees, options granted become exercisable ratably over the vesting period, which is generally a five-year period beginning on the first anniversary of the grant date, subject to the employee's continuing service to the Company. For directors, options generally become exercisable in full on the first anniversary of the grant date.

The weighted-average grant date fair value of options that were granted during the nine months ended September 30, 2016 was \$26.62.

The following table provides the assumptions used in the Black-Scholes pricing model valuation of options during the nine months ended September 30, 2016 and 2015, respectively:

	Nine Months Ended September 30,	
	2016	2015
Risk-free interest rate	1.53 - 1.68%	1.69 - 1.77%
Expected life (years)	6.50	5.50 - 6.50
Expected volatility	44.38 - 45.93%	46.80 - 47.23%
Expected dividend yield	0%	0%

As of September 30, 2016, there was \$6.2 million of unrecognized compensation expense related to unvested stock options, which is expected to be recognized over a weighted-average period of 3.2 years.

Restricted Stock

Restricted stock awards are share-settled awards and restrictions lapse ratably over the vesting period, which is generally a five-year period, beginning on the first anniversary of the grant date, subject to the employee's continuing service to the Company. For directors, restrictions generally lapse in full on the first anniversary of the grant date.

The following table summarizes restricted stock activity during the nine months ended September 30, 2016:

	Restricted Stock	Weighted- Average Grant Date Fair Value Per Share
Restricted stock at December 31, 2015	124,393	\$ 68.97
Granted	159,705	59.43
Restrictions lapsed	(40,779)	67.85
Forfeited	(19,645)	63.99
Restricted stock at September 30, 2016	<u>223,674</u>	<u>\$ 62.80</u>

As of September 30, 2016, there was \$12.3 million of unrecognized compensation expense related to non-vested restricted stock, which is expected to be recognized over a weighted-average period of 3.9 years.

Employee Stock Purchase Plan

The following table presents the assumptions used to estimate the fair value of the ESPP during the nine months ended September 30, 2016 and 2015, respectively:

	Nine Months Ended September 30,					
	2016			2015		
Risk-free interest rate	0.39	-	0.56%	0.08	-	0.10%
Expected life (months)	6.00			6.00		
Expected volatility	29.41	-	49.13%	33.68	-	37.64%
Expected dividend yield	0%			0%		

Note 9 – Accumulated Other Comprehensive Income (Loss)

Other comprehensive income (loss) is comprised entirely of foreign currency translation adjustments. The following table presents the changes in accumulated other comprehensive income (loss) balances during the three and nine months ended September 30, 2016 and 2015, respectively:

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Foreign currency translation adjustments				
Balance at beginning of period	\$ (6,612)	\$ (2,730)	\$ (5,212)	\$ (2,929)
Other comprehensive loss before reclassifications	(154)	(966)	(1,554)	(767)
Amounts reclassified from accumulated other comprehensive income (loss)	-	-	-	-
Net current-period other comprehensive loss	(154)	(966)	(1,554)	(767)
Balance at end of period	<u>\$ (6,766)</u>	<u>\$ (3,696)</u>	<u>\$ (6,766)</u>	<u>\$ (3,696)</u>

Note 10 – Income Taxes

The Company is subject to income tax in multiple jurisdictions and the use of estimates is required to determine the provision for income taxes. For each of the three months ended September 30, 2016 and 2015, the Company recorded an income tax provision of \$5.6 million. For the nine months ended September 30, 2016 and 2015, the Company recorded an income tax provision of \$15.9 million and \$16.2 million, respectively. The income tax provision is based on the estimated annual effective tax rate for the year applied to pre-tax income. The effective income tax rate for the three months ended September 30, 2016 was 31.8 percent compared to 31.2 percent in the same period of the prior year. The effective income tax rate for the nine months ended September 30, 2016 was 32.4 percent compared to 31.9 percent in the same period of the prior year.

The effective income tax rate for the three and nine months ended September 30, 2016 differs from the U.S. federal statutory rate of 35.0 percent due primarily to the mix of income earned in domestic and foreign tax jurisdictions and deductions for which the Company qualifies.

The Company had reserves against unrecognized tax benefits totaling \$3.8 million and \$2.8 million at September 30, 2016 and December 31, 2015, respectively, all of which, if recognized, would affect the Company's effective tax rate. The Company recognizes interest and penalties related to income tax matters in income tax expense, and reports the liability in current or long-term income taxes payable as appropriate.

Note 11 – Revenue and Geographic Information

The Company's revenue is primarily derived from its Injection Molding (Protomold), CNC Machining (Firstcut) and 3D Printing (Fineline) product lines. Total revenue by product line is as follows:

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue:				
Injection Molding (Protomold)	\$ 46,445	\$ 41,971	\$ 134,376	\$ 119,521
CNC Machining (Firstcut)	21,781	19,833	60,510	54,788
3D Printing (Fineline)	9,850	6,038	28,059	16,038
Other	97	-	2,757	-
Total revenue	<u>\$ 78,173</u>	<u>\$ 67,842</u>	<u>\$ 225,702</u>	<u>\$ 190,347</u>

Revenue to external customers based on the billing location of the end user customer and long-lived assets by geographic region are as follows:

(in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue:				
United States	\$ 55,677	\$ 50,214	\$ 158,095	\$ 144,357
International	22,496	17,628	67,607	45,990
Total revenue	<u>\$ 78,173</u>	<u>\$ 67,842</u>	<u>\$ 225,702</u>	<u>\$ 190,347</u>

(in thousands)	September 30, 2016	December 31, 2015
Long-lived assets:		
United States	\$ 109,230	\$ 98,633
International	33,492	26,842
Total long-lived assets	<u>\$ 142,722</u>	<u>\$ 125,475</u>

Item 2. 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 our unaudited consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2015.

Forward-Looking Statements

Statements contained in this report regarding matters that are not historical or current facts are “forward-looking statements” within the meaning of The Private Securities Litigation Reform Act of 1995. In some cases, you can identify forward-looking statements by the following words: “may,” “will,” “could,” “would,” “should,” “expect,” “intend,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “project,” “potential,” “continue,” “ongoing” or the negative of these terms or other comparable terminology, although not all forward-looking statements contain these words. These statements involve known and unknown risks, uncertainties and other factors that may cause our results to be materially different than those expressed or implied in such statements. Certain of these risk factors and others are described in Item 1A. “Risk Factors” of our most recent Annual Report on Form 10-K as filed with the SEC. Other unknown or unpredictable factors also could have material adverse effects on our future results. We cannot guarantee future results, levels of activity, performance or achievements. Accordingly, you should not place undue reliance on these forward-looking statements. Finally, we expressly disclaim any intent or obligation to update any forward-looking statements to reflect subsequent events or circumstances.

Overview

We are a leading online and technology-enabled manufacturer of quick-turn, on-demand injection-molded, CNC-machined and 3D printed custom parts for prototyping and low-volume production. We provide “Real Parts, Really Fast” to product developers and engineers worldwide, who are under increasing pressure to bring their finished products to market faster than their competition. We believe custom parts manufacturing has historically been an underserved market due to the inefficiencies inherent in the quotation, equipment set-up and non-recurring engineering processes required to produce custom parts. Our proprietary technology eliminates most of the time-consuming and expensive skilled labor conventionally required to quote and manufacture parts. Our customers conduct nearly all of their business with us over the Internet. We target our products to the millions of product developers and engineers who use three-dimensional computer-aided design (3D CAD) software to design products across a diverse range of end-markets.

Our primary manufacturing product lines currently include Injection Molding (Protomold), CNC Machining (Firstcut) and 3D Printing (Fineline). We continually seek to expand the range of size and geometric complexity of the parts we can make with these manufacturing processes, to extend the variety of materials we are able to support and to identify additional manufacturing processes to which we can apply our technology in order to better serve the evolving preferences and needs of product developers and engineers.

Injection Molding (Protomold)

Our Injection Molding (Protomold) product line uses our 3D CAD-to-CNC machining technology for the automated design and manufacture of thermoplastic, metal, or liquid silicone injection molds, which are then used to produce custom injection-molded parts on commercially available equipment. Our Injection Molding (Protomold) product line is used for prototype, on-demand and low-volume production. Prototype quantities typically range from 25 to 100 parts. Because we retain possession of the molds, customers who need low-volume production often come back to Proto Labs’ Injection Molding product line for additional quantities typically ranging up to 10,000 parts or more. They do so to support pilot production while their tooling for high-volume production is being prepared, because they need on-demand manufacturing due to disruptions in their manufacturing process, because their product will only be released in a limited quantity, or because they need end-of-life production support. These additional part orders typically occur on approximately half of the molds that we make, typically accounting for approximately half of our total Injection Molding (Protomold) revenue.

CNC Machining (Firstcut)

Our CNC Machining (Firstcut) product line uses commercially available CNC machines to cut plastic or metal blocks or bars into one or more custom parts based on the 3D CAD model uploaded by the product developer or engineer. Our efficiencies derive from the automation of the programming of these machines and a proprietary fixturing process. The CNC Machining (Firstcut) product line is well suited to produce small quantities, typically in the range of one to 200 parts.

3D Printing (Fineline)

Our 3D Printing (Fineline) includes stereolithography (SL), selective laser sintering (SLS) and direct metal laser sintering (DMLS) processes, which offers customers a wide-variety of high-quality, precision rapid prototyping and low volume production. These processes create parts with a high level of accuracy, detail, strength and durability. 3D Printing is well suited to produce small quantities, typically in the range of one to 50 parts.

Key Financial Measures and Trends

Revenue

The Company's operations are conducted in three geographic markets consisting of the United States, Europe and Japan, which we believe are three of the largest geographic markets where product developers and engineers are located. Revenue within each of our United States and Europe markets is derived from our Injection Molding (Protomold), CNC Machining (Firstcut) and 3D Printing (Fineline) product lines. Revenue within our Japan market is derived from our Injection Molding (Protomold) and CNC Machining (Firstcut) product lines. Our historical and current efforts to increase revenue have been directed at gaining new customers and selling to our existing customer base by:

- increasing marketing and selling activities;
- introducing our CNC Machining (Firstcut) product line in 2007;
- expanding internationally, including the opening of our Japanese plant in 2009;
- offering additional product lines such as 3D Printing (Fineline), through our acquisition of FineLine Prototyping, Inc. (FineLine) in April 2014 and expanded through our acquisition of certain assets, including shares of select subsidiaries, of Alphaform AG (Alphaform) in October 2015;
- improving the usability of our product lines such as our web-centric applications;
- expanding the breadth and scope of our products, for example, by adding more sizes and materials to our offerings such as liquid silicone rubber (LSR); and
- expanding the breadth of manufacturing capabilities, for example, by adding rapid overmolding technology to our Injection Molding (Protomold) product line.

Excluding product developers and engineers gained through the acquisition of Alphaform, we served 14,271 unique product developers and engineers during the three months ended September 30, 2016, an increase of 13.8% over the same period in 2015. We served 26,528 unique product developers and engineers during the nine months ended September 30, 2016, an increase of 17.2% over the same period in 2015.

Cost of Revenue, Gross Profit and Gross Margin

Cost of revenue consists primarily of raw materials, employee compensation, benefits, stock-based compensation, equipment depreciation, facilities costs and overhead allocations associated with the manufacturing process for molds and custom parts. We expect cost of revenue to increase in absolute dollars, but remain relatively constant as a percentage of total revenue.

We define gross profit as our revenue less our cost of revenue, and we define gross margin as gross profit expressed as a percentage of revenue. Our gross profit and gross margin are affected by many factors, including our pricing, sales volume and manufacturing costs, the costs associated with increasing production capacity, the mix between sales by product line, the mix between domestic and foreign revenue sources, and foreign exchange rates.

Operating Expenses

Operating expenses consist of marketing and sales, research and development and general and administrative expenses. Personnel-related costs are the most significant component of the marketing and sales, research and development and general and administrative expense categories.

Our recent growth in operating expenses is mainly due to higher headcounts to support our growth and expansion, and we expect that trend to continue. Our business strategy is to continue to be a leading online and technology-enabled manufacturer of quick-turn, on-demand injection-molded, CNC-machined, CNC-turned and 3D printed custom parts for prototyping and low-volume production. In order to achieve our goals, we anticipate continued substantial investments in technology and personnel, resulting in increased operating expenses.

Marketing and sales. Marketing and sales expense consists primarily of employee compensation, benefits, commissions, stock-based compensation, marketing programs such as print and pay-per-click advertising, trade shows, direct mail and other related overhead. We expect sales and marketing expense to increase in the future as we increase the number of marketing and sales professionals and marketing programs targeted to increase our customer base.

Research and development. Research and development expense consists primarily of employee compensation, benefits, stock-based compensation, depreciation on equipment, outside services and other related overhead. All of our research and development costs have been expensed as incurred. We expect research and development expense to increase in the future as we seek to enhance and expand our product line offerings.

General and administrative. General and administrative expense consists primarily of employee compensation, benefits, stock-based compensation, professional service fees related to accounting, tax and legal and other related overhead. We expect general and administrative expense to increase in the future as we continue to grow and expand as a global organization.

Other Income (Expense), Net

Other income (expense), net primarily consists of foreign currency-related gains and losses and interest income on cash balances and investments. Our foreign currency-related gains and losses will vary depending upon movements in underlying exchange rates. Our interest income will vary each reporting period depending on our average cash balances during the period, composition of our marketable security portfolio and the current level of interest rates.

Provision for Income Taxes

Provision for income taxes is comprised of federal, state, local and foreign taxes based on pre-tax income. We expect income taxes to increase as our taxable income increases and we expect our effective tax rate to remain relatively constant.

Results of Operations

The following table summarizes our results of operations and the related changes for the periods indicated. The results below are not necessarily indicative of the results for future periods.

(dollars in thousands)	Three Months Ended September 30,				Change		Nine Months Ended September 30,				Change	
	2016		2015		\$	%	2016		2015		\$	%
Revenue	\$78,173	100.0%	\$67,842	100.0%	\$10,331	15.2	\$225,702	100.0%	\$190,347	100.0%	\$35,355	18.6
Cost of revenue	33,448	42.8	27,517	40.6	5,931	21.6	99,077	43.9	77,218	40.6	21,859	28.3
Gross profit	44,725	57.2	40,325	59.4	4,400	10.9	126,625	56.1	113,129	59.4	13,496	11.9
Operating expenses:												
Marketing and sales	11,787	15.1	10,027	14.7	1,760	17.6	34,182	15.1	28,383	14.9	5,799	20.4
Research and development	5,976	7.6	4,760	7.0	1,216	25.5	17,110	7.6	13,471	7.1	3,639	27.0
General and administrative	10,020	12.8	8,134	12.0	1,886	23.2	28,397	12.6	20,683	10.9	7,714	37.3
Total operating expenses	27,783	35.5	22,921	33.7	4,862	21.2	79,689	35.3	62,537	32.9	17,152	27.4
Income from operations	16,942	21.7	17,404	25.7	(462)	(2.7)	46,936	20.8	50,592	26.6	(3,656)	(7.2)
Other income (expense), net	625	0.8	593	0.9	32	5.4	2,342	1.0	100	0.1	2,242	*
Income before income taxes	17,567	22.5	17,997	26.6	(430)	(2.4)	49,278	21.8	50,692	26.7	(1,414)	(2.8)
Provision for income taxes	5,585	7.2	5,615	8.3	(30)	(0.5)	15,943	7.0	16,171	8.5	(228)	(1.4)
Net income	<u>\$11,982</u>	<u>15.3%</u>	<u>\$12,382</u>	<u>18.3%</u>	<u>\$ (400)</u>	<u>-3.2%</u>	<u>\$ 33,335</u>	<u>14.8%</u>	<u>\$ 34,521</u>	<u>18.1%</u>	<u>\$ (1,186)</u>	<u>-3.4%</u>

* Percentage change not meaningful

Stock-based compensation expense included in the statements of operations data above is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
(dollars in thousands)				
Stock options and restricted stock	\$ 1,553	\$ 1,483	\$ 4,820	\$ 4,138
Employee stock purchase plan	166	123	440	377
Total stock-based compensation expense	<u>\$ 1,719</u>	<u>\$ 1,606</u>	<u>\$ 5,260</u>	<u>\$ 4,515</u>
Cost of revenue	\$ 205	\$ 136	\$ 489	\$ 378
Operating expenses:				
Marketing and sales	250	288	741	796
Research and development	309	335	1,084	964
General and administrative	955	847	2,946	2,377
Total stock-based compensation expense	<u>\$ 1,719</u>	<u>\$ 1,606</u>	<u>\$ 5,260</u>	<u>\$ 4,515</u>

Comparison of Three Months Ended September 30, 2016 and 2015

Revenue

Revenue by product line and the related changes for the three months ended September 30, 2016 and 2015 were as follows:

(dollars in thousands)	Three Months Ended September 30,				Change	
	2016		2015		\$	%
	\$	% of Total Revenue	\$	% of Total Revenue		
Revenue						
Injection Molding (Protomold)	\$ 46,445	59.4%	\$ 41,971	61.9%	\$ 4,474	10.7%
CNC Machining (Firstcut)	21,781	27.9	19,833	29.2	1,948	9.8
3D Printing (Fineline)	9,850	12.6	6,038	8.9	3,812	63.1
Other	97	0.1	-	-	97	100.0
Total revenue	<u>\$ 78,173</u>	<u>100.0%</u>	<u>\$ 67,842</u>	<u>100.0%</u>	<u>\$ 10,331</u>	<u>15.2%</u>

Revenue by geographic region, based on the billing location of the end customer, for the three months ended September 30, 2016 and 2015 is summarized as follows:

(dollars in thousands)	Three Months Ended September 30,				Change	
	2016		2015		\$	%
	\$	% of Total Revenue	\$	% of Total Revenue		
Revenue						
United States	\$ 55,677	71.2%	\$ 50,214	74.0%	\$ 5,463	10.9%
International	22,496	28.8	17,628	26.0	4,868	27.6
Total revenue	<u>\$ 78,173</u>	<u>100.0%</u>	<u>\$ 67,842</u>	<u>100.0%</u>	<u>\$ 10,331</u>	<u>15.2%</u>

Our revenue increased \$10.3 million, or 15.2%, for the three months ended September 30, 2016 compared to the same period in 2015. By geographic region, this revenue growth was driven by a 10.9% increase in United States revenue and a 27.6% increase in international revenue, which included \$4.0 million in revenue from our acquisition of Alphaform in October 2015, in each case for the three months ended September 30, 2016 compared to the same period in 2015.

By product line, this revenue growth was driven by a 10.7% increase in Injection Molding (Protomold) revenue, a 9.8% increase in CNC Machining (Firstcut) revenue, and a 63.1% increase in 3D Printing (Fineline) revenue, in each case for the three months ended September 30, 2016 compared to the same period in 2015. Alphaform revenue by product line included \$1.9 million in Injection Molding (Protomold) revenue, \$2.0 million in 3D Printing (Fineline) revenue and \$0.1 million of Other revenue, in each case for the three months ended September 30, 2016.

Our revenue growth during the three months ended September 30, 2016 was the result of an increase in the volume of the product developers and engineers we served as well as revenue gained through our acquisition of Alphaform. During the three months ended September 30, 2016, excluding product developers and engineers gained through the acquisition of Alphaform, we served 14,271 unique product developers and engineers, an increase of 13.8% over the same period in 2015. Average revenue per product developer or engineer, excluding product developers and engineers gained through the acquisition of Alphaform, decreased 3.9% during the three months ended September 30, 2016 compared to the same period in 2015.

Our revenue increases were primarily driven by increases in sales personnel and marketing activities and revenue earned as a result of our acquisition of Alphaform in October 2015. Our sales personnel focus on gaining new customer accounts and expanding the depth and breadth into existing customer accounts. Our marketing personnel focus on marketing activities that have proven to result in the greatest number of customer prospects to support sales activity.

During the second quarter of 2016, we made the decision to discontinue offering two manufacturing processes within our Injection Molding (Protomold) product lines, including Metal Injection Molding (MIM) and Magnesium Thixomolding (Thixo), as well as exit our non-core resin resale business, which was acquired from Alphaform in October 2015. MIM, Thixo, and resin resale in aggregate represented approximately 1.4% of revenue during the three months ended September 30, 2016.

International revenue decreased by \$0.3 million for the three months ended September 30, 2016 compared to the same period in 2015 as a result of foreign currency movements, primarily the strengthening of the United States dollar relative to the British Pound. The effect of pricing changes on international revenue was negligible for the three months ended September 30, 2016 compared to the same period in 2015.

Cost of Revenue, Gross Profit and Gross Margin

Cost of Revenue. Cost of revenue increased \$5.9 million, or 21.6%, for the three months ended September 30, 2016 compared to the same period in 2015, which was faster than the rate of revenue increase of 15.2% for the three months ended September 30, 2016 compared to the same period in 2015. The increase in cost of revenue resulted from the growth of the business, including the Alphaform acquisition, and was due to raw material and production cost increases of \$1.4 million to support increased sales volumes, an increase in direct labor headcount resulting in personnel and related cost increases of \$2.9 million and equipment and facility-related cost increases of \$1.6 million, which included \$0.4 million of accelerated depreciation of leasehold assets resulting from our move to new facilities in the U.S. and Japan in the third quarter of 2016.

Gross Profit and Gross Margin. Gross profit increased from \$40.3 million, or 59.4% of revenues, in the three months ended September 30, 2015 to \$44.7 million, or 57.2% of revenue, in the three months ended September 30, 2016 primarily due to increases in revenue offset by the cost of revenue as discussed above. Gross margin decreased primarily as a result of lower margins from the acquired Alphaform business, as well as increases in investments of additional manufacturing capacity, the impact of fluctuations in foreign currency exchange rates and accelerated depreciation of leasehold assets.

Operating Expenses, Other Income (Expense), net and Provision for Income Taxes

Marketing and Sales. Marketing and sales expenses increased \$1.8 million, or 17.6%, during the three months ended September 30, 2016 compared to the same period in 2015 due primarily to an increase in headcount resulting in personnel and related cost increases of \$1.7 million as well as marketing program cost increases of \$0.1 million.

Research and Development. Our research and development expenses increased \$1.2 million, or 25.5%, during the three months ended September 30, 2016 compared to the same period in 2015 due to an increase in headcount resulting in personnel and related cost increases of \$0.9 million and operating cost increases of \$0.4 million, which were partially offset by a decrease in professional services cost of \$0.1 million.

General and Administrative. Our general and administrative expenses increased \$1.9 million, or 23.2%, during the three months ended September 30, 2016 compared to the same period in 2015 due to an increase in headcount resulting in personnel and related cost increases of \$0.8 million, stock-based compensation cost increases of \$0.1 million, professional services cost increases of \$0.1 million and administrative cost increases of \$0.9 million. The administrative costs in the three months ended September 30, 2016, include accelerated depreciation and facilities-related charges of \$0.4 million resulting from our move to new facilities in the U.S. and Japan in the third quarter of 2016.

Other Income (Expense), net. We recognized other income, net of \$0.6 million for each of the three months ended September 30, 2016 and 2015. Other income, net included \$0.4 million in foreign currency exchange gains for each of the three months ended September 30, 2016 and 2015.

Provision for Income Taxes. Our effective tax rate of 31.8% for the three months ended September 30, 2016 increased 0.6% compared to 31.2% for the same period in 2015. The increase in the effective tax rate is primarily due to changes in reserves for uncertain tax positions for which the company qualifies in the quarter ended September 30, 2016 compared to the quarter ended September 30, 2015. Our income tax provision of \$5.6 million for the three months ended September 30, 2016 did not materially change compared to our income tax provision for the three months ended September 30, 2015.

Comparison of Nine Months Ended September 30, 2016 and 2015

Revenue

Revenue by product line and the related changes for the nine months ended September 30, 2016 and 2015 were as follows:

(dollars in thousands)	Nine Months Ended September 30,				Change	
	2016		2015		\$	%
	\$	% of Total Revenue	\$	% of Total Revenue		
Revenue						
Injection Molding (Protomold)	\$ 134,376	59.5%	\$ 119,521	62.8%	\$ 14,855	12.4%
CNC Machining (Firstcut)	60,510	26.8	54,788	28.8	5,722	10.4
3D Printing (Fineline)	28,059	12.4	16,038	8.4	12,021	75.0
Other	2,757	1.3	-	-	2,757	100.0
Total revenue	\$ 225,702	100.0%	\$ 190,347	100.0%	\$ 35,355	18.6%

Revenue by geographic region, based on the billing location of the end customer, for the nine months ended September 30, 2016 and 2015 is summarized as follows:

(dollars in thousands)	Nine Months Ended September 30,				Change	
	2016		2015		\$	%
	\$	% of Total Revenue	\$	% of Total Revenue		
Revenue						
United States	\$ 158,095	70.0%	\$ 144,357	75.8%	\$ 13,738	9.5%
International	67,607	30.0	45,990	24.2	21,617	47.0
Total revenue	\$ 225,702	100.0%	\$ 190,347	100.0%	\$ 35,355	18.6%

Our revenue increased \$35.4 million, or 18.6%, for the nine months ended September 30, 2016 compared to the same period in 2015. By geographic region, this revenue growth was driven by a 9.5% increase in United States revenue and a 47.0% increase in international revenue, which included \$13.6 million in revenue from our acquisition of Alphaform in October 2015, in each case for the nine months ended September 30, 2016 compared to the same period in 2015.

By product line, this revenue growth was driven by a 12.4% increase in Injection Molding (Protomold) revenue, a 10.4% increase in CNC Machining (Firstcut) revenue, and a 75.0% increase in 3D Printing (Fineline) revenue, in each case for the nine months ended September 30, 2016 compared to the same period in 2015. Alphaform revenue by product line included \$4.3 million in Injection Molding (Protomold) revenue, \$6.6 million in 3D Printing (Fineline) revenue and \$2.7 million of Other revenue, in each case for the nine months ended September 30, 2016.

Our revenue growth during the nine months ended September 30, 2016 was the result of increased volume of the product developers and engineers we served as well as revenue gained through our acquisition of Alphaform. During the nine months ended September 30, 2016, excluding product developers and engineers gained through the acquisition of Alphaform, we served 26,528 unique product developers and engineers, an increase of 17.2% over the same period in 2015. Average revenue per product developer or engineer, excluding product developers and engineers gained through the acquisition of Alphaform, decreased 4.9% during the nine months ended September 30, 2016 compared to the same period in 2015.

Our revenue increases were primarily driven by increases in sales personnel and marketing activities and revenue earned as a result of our acquisition of Alphaform in October 2015. Our sales personnel focus on gaining new customer accounts and expanding the depth and breadth into existing customer accounts. Our marketing personnel focus on marketing activities that have proven to result in the greatest number of customer prospects to support sales activity.

During the second quarter of 2016, we made the decision to discontinue offering two manufacturing processes within our Injection Molding (Protomold) product lines, including MIM and Thixo, as well as exit our non-core resin resale business, which was acquired from Alphaform in October 2015. MIM, Thixo, and resin resale in aggregate represented approximately 1.9% of revenue during the nine months ended September 30, 2016.

International revenue decreased by \$0.6 million for the nine months ended September 30, 2016 compared to the same period in 2015 as a result of foreign currency movements, primarily the strengthening of the United States dollar relative to the British Pound. The effect of pricing changes on international revenue was negligible for the nine months ended September 30, 2016 compared to the same period in 2015.

Cost of Revenue, Gross Profit and Gross Margin

Cost of Revenue. Cost of revenue increased \$21.9 million, or 28.3%, for the nine months ended September 30, 2016 compared to the same period in 2015, which was faster than the rate of revenue increase of 18.6% for the nine months ended September 30, 2016 compared to the same period in 2015. The increase in cost of revenue resulted from the growth of the business including the Alphaform acquisition, and was due to raw material and production cost increases of \$6.9 million to support increased sales volumes, an increase in direct labor headcount resulting in personnel and related cost increases of \$10.8 million and equipment and facility-related cost increases of \$4.2 million, which included \$0.5 million of accelerated depreciation of leasehold assets resulting from our move to new facilities in the U.S. and Japan in the third quarter of 2016.

Gross Profit and Gross Margin. Gross profit increased from \$113.1 million, or 59.4% of revenues, in the nine months ended September 30, 2015 to \$126.6 million, or 56.1% of revenue, in the nine months ended September 30, 2016 primarily due to increases in revenue offset by the cost of revenue as discussed above. Gross margin decreased primarily as a result of lower margins from the acquired Alphaform business, as well as increases in investments of additional manufacturing capacity, accelerated depreciation of leasehold assets and the impact of fluctuations in foreign currency exchange rates.

Operating Expenses, Other Income (Expense), net and Provision for Income Taxes

Marketing and Sales. Marketing and sales expenses increased \$5.8 million, or 20.4%, during the nine months ended September 30, 2016 compared to the same period in 2015 due to an increase in headcount resulting in personnel and related cost increases of \$4.8 million and marketing program cost increases of \$1.0 million. The increase in marketing program costs is the result of our focus and concentration on funding those programs that have proven to be the most effective in growing our business.

Research and Development. Our research and development expenses increased \$3.6 million, or 27.0%, during the nine months ended September 30, 2016 compared to the same period in 2015 due to an increase in headcount resulting in personnel and related cost increases of \$2.9 million, operating cost increases of \$0.6 million and professional services cost increases of \$0.1 million.

General and Administrative. Our general and administrative expenses increased \$7.7 million, or 37.3%, during the nine months ended September 30, 2016 compared to the same period in 2015 due to an increase in headcount resulting in personnel and related cost increases of \$3.0 million, stock-based compensation cost increases of \$0.5 million, professional services cost increases of \$0.8 million and administrative cost increases of \$3.4 million. The administrative costs in the nine months ended September 30, 2016, include asset impairment charges of \$0.5 million as a result of our decision to discontinue MIM and Thixo manufacturing processes as noted above, and accelerated depreciation and facilities-related charges of \$0.6 million resulting from our move to new facilities in the U.S. and Japan in the third quarter of 2016.

Other Income (Expense), net. We recognized other income, net of \$2.3 million for the nine months ended September 30, 2016, an increase of \$2.2 million compared to other income, net \$0.1 million for the nine months ended September 30, 2015. Other income, net included \$1.6 million in foreign currency exchange gains for the nine months ended September 30, 2016 compared to \$0.4 million in foreign currency exchange losses in the same period of the prior year. The increase was primarily due to the amount of foreign-currency denominated cash balances abroad and movements in underlying exchange rates at the end of the period.

Provision for Income Taxes. Our effective tax rate of 32.4% for the nine months ended September 30, 2016 increased 0.5% compared to 31.9% for the same period in 2015. The increase in the effective tax rate is primarily due to changes in reserves for uncertain tax positions for which the company qualifies in the quarter ended September 30, 2016 compared to the quarter ended September 30, 2015. As a result of a decrease in income before income taxes, our income tax provision decreased by \$0.2 million to \$15.9 million for the nine months ended September 30, 2016 compared to our income tax provision of \$16.2 million for the nine months ended September 30, 2015.

Liquidity and Capital Resources

Cash Flows

The following table summarizes our cash flows during the nine months ended September 30, 2016 and 2015:

(dollars in thousands)	Nine Months Ended September 30,	
	2016	2015
Net cash provided by operating activities	\$ 56,177	\$ 41,284
Net cash used in investing activities	(41,287)	(29,034)
Net cash provided by financing activities	5,733	8,870
Effect of exchange rates on cash and cash equivalents	(58)	(318)
Net increase in cash and cash equivalents	<u>\$ 20,565</u>	<u>\$ 20,802</u>

Sources of Liquidity

Historically, we have primarily financed our operations and capital expenditures through cash flow from operations. We had cash and cash equivalents of \$68.2 million as of September 30, 2016, an increase of \$20.6 million from December 31, 2015. The increase in our cash was primarily due to cash generated through operations and, to a lesser extent, proceeds from exercises of stock options and purchases through our employee stock purchase plan, which were partially offset by investing activity.

Cash Flows from Operating Activities

Cash flows from operating activities were \$56.2 million during the nine months ended September 30, 2016 and primarily consisted of net income of \$33.3 million, adjusted for certain non-cash items, including depreciation and amortization of \$12.8 million, stock-based compensation expense of \$5.3 million, deferred taxes of \$0.5 million, loss on impairment of assets of \$0.5 million and amortization of held-to-maturity securities of \$0.9 million, which were partially offset by excess tax benefit from stock-based compensation expense of \$2.0 million and other adjustments of \$1.3 million. Cash flows from operating activities increased \$14.9 million during the nine months ended September 30, 2016 compared to the same period in 2015 primarily due to increases in depreciation and amortization of \$2.4 million driven by an increase in capital investments, stock-based compensation expense of \$0.8 million driven by an increase in equity activity, loss on impairment of assets of \$0.5 million driven by the decision to exit certain product lines, a decrease in excess tax benefits of \$3.2 million, an increase in deferred taxes of \$0.8 million and changes in operating assets and liabilities of \$9.8 million driven by general growth of the business. These increases were partially offset by a decrease in net income of \$1.2 million, as well as other adjustments of \$1.4 million primarily related to unrealized gains on the translation of foreign currency denominated cash.

Cash flows from operating activities of \$41.3 million during the nine months ended September 30, 2015 primarily consisted of net income of \$34.5 million, adjusted for certain non-cash items, including depreciation and amortization of \$10.4 million, stock-based compensation expense of \$4.5 million and amortization of held-to-maturity securities of \$0.9 million, which were partially offset by deferred taxes of \$0.3 million and excess tax benefit from stock-based compensation expense of \$5.2 million.

Cash Flows from Investing Activities

Cash used in investing activities was \$41.3 million during the nine months ended September 30, 2016, consisting of \$31.0 million for the purchases of property and equipment and \$56.2 million for the purchases of marketable securities, which were partially offset by \$45.9 million in proceeds from maturities of marketable securities.

Cash used in investing activities was \$29.0 million during the nine months ended September 30, 2015 consisting of \$27.2 million for the purchases of property and equipment and \$42.7 million for the purchases of marketable securities, which were partially offset by \$40.9 million in proceeds from maturities and call redemptions of marketable securities.

Cash Flows from Financing Activities

Cash provided by financing activities was \$5.7 million during the nine months ended September 30, 2016, consisting of proceeds from exercises of stock options of \$4.1 million and \$2.0 million in excess tax benefit on stock-based compensation, which were partially offset by \$0.4 million for acquisition-related contingent consideration payments.

Cash provided by financing activities was \$8.9 million during the nine months ended September 30, 2015, consisting of proceeds from exercises of stock options of \$5.2 million and \$5.2 million in excess tax benefit on stock-based compensation, which were partially offset by \$1.4 million for payments of acquisition-related contingent consideration and \$0.1 million for payments of debt.

Off-Balance Sheet Arrangements

Since our inception, we have not engaged in any off-balance sheet arrangements, including the use of structured finance, special purpose entities or variable interest entities.

Critical Accounting Policies and Use of Estimates

We have adopted various accounting policies to prepare the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). Our significant accounting policies are disclosed in Note 2 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2015. There were no material changes in our significant accounting policies during the nine months ended September 30, 2016.

Recent Accounting Pronouncements

For information on recent accounting pronouncements, see Note 2 to the consolidated financial statements appearing in Part I, Item 1 in this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Foreign Currency Risk

As a result of our foreign operations, we have revenue, expenses, assets and liabilities that are denominated in foreign currencies. We generate revenue and incur production costs and operating expenses in British Pounds, Euros and Japanese Yen.

Our operating results and cash flows are adversely impacted when the United States dollar appreciates relative to other foreign currencies. Additionally, our operating results and cash flows are adversely impacted when the British Pound appreciates relative to the Euro. As we expand internationally, our results of operations and cash flows will become increasingly subject to changes in foreign currency exchange rates.

We have not used forward contracts or currency borrowings to hedge our exposure to foreign currency risk. Foreign currency risk can be assessed by estimating the change in results of operations or financial position resulting from a hypothetical 10% adverse change in foreign exchange rates. We believe such a change would generally not have a material impact on our financial position, but could have a material impact on our results of operations. We recognized foreign currency gains of \$0.4 million and \$1.6 million in the three and nine months ended September 30, 2016, respectively. We recognized foreign currency gains of \$0.4 million and foreign currency losses of \$0.4 million in the three and nine months ended September 30, 2015, respectively.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (Exchange Act)) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this quarterly report, our disclosure controls and procedures are effective and provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported accurately and within the time frames specified in the SEC's rules and forms and accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are subject to various legal proceedings and claims that arise in the ordinary course of our business activities. Although the results of litigation and claims cannot be predicted with certainty, as of the date of these financial statements, we do not believe we are party to any litigation the outcome of which, if determined adversely to us, would individually or in the aggregate be reasonably expected to have a material adverse effect on our business.

Item 1A. Risk Factors

There have been no material changes from the risk factors we previously disclosed in Part I, Item 1A. "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2015, except as disclosed in Part II, Item 1A. "Risk Factors" in our Quarterly Report on Form 10-Q for the three months ended June 30, 2016. The information disclosed in such 10-Q updates, and should be read in conjunction with, the risk factors and information disclosed in our Form 10-K. Except as presented in such 10-Q, there have been no material changes from the risk factors described in our Form 10-K.

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

No matters to disclose.

Item 3. Defaults Upon Senior Securities

No matters to disclose.

Item 4. Mine Safety Disclosures

No matters to disclose.

Item 5. Other Information

No matters to disclose.

Item 6. Exhibits

The following documents are filed as part of this report:

Exhibit Number	Description of Exhibit
3.1 ⁽¹⁾	Third Amended and Restated Articles of Incorporation of Proto Labs, Inc.
3.2 ⁽²⁾	Amended and Restated By-Laws of Proto Labs, Inc.
3.3 ⁽³⁾	Articles of Amendment to Third Amended and Restated Articles of Incorporation of Proto Labs, Inc. dated May 20, 2015
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act
32.1	Certification of the Chief Executive Officer and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

- (1) Previously filed as Exhibit 3.2 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012, and incorporated by reference herein.
- (2) Previously filed as Exhibit 3.4 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012, and incorporated by reference herein.
- (3) Previously filed as Exhibit 3.1 to the Company's Form 8-K (File No. 001-35435), filed with the Commission on May 21, 2015, and incorporated by reference herein.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Proto Labs, Inc.

Date: November 2, 2016

/s/ Victoria M. Holt

Victoria M. Holt
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 2, 2016

/s/ John A. Way

John A. Way
Chief Financial Officer
(Principal Financial Officer)

**CERTIFICATION PURSUANT TO RULE 13a-14(a) OR 15d-14(a) OF
THE SECURITIES EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002**

I, Victoria M. Holt, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Proto Labs, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

- a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
- b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
- d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 2, 2016

By: /s/ Victoria M. Holt
Victoria M. Holt
President and Chief Executive Officer
(Principal Executive Officer)

**CERTIFICATION PURSUANT TO RULE 13a-14(a) OR 15d-14(a) OF
THE SECURITIES EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002**

I, John A. Way, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Proto Labs, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

- a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
- b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
- c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
- d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 2, 2016

By: /s/ John A. Way
John A. Way
Chief Financial Officer
(Principal Financial Officer)

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Victoria M. Holt, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Proto Labs, Inc. on Form 10-Q for the fiscal quarter ended September 30, 2016 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Proto Labs, Inc.

Date: November 2, 2016

By: /s/ Victoria M. Holt
Name: Victoria M. Holt
Title: President and Chief Executive Officer

I, John A. Way, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Proto Labs, Inc. on Form 10-Q for the fiscal quarter ended September 30, 2016 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Proto Labs, Inc.

Date: November 2, 2016

By: /s/ John A. Way
Name: John A. Way
Title: Chief Financial Officer