

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

FORM 10-K

(Mark One)

- ☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2018
- 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)

5540 Pioneer Creek Drive
Maple Plain, Minnesota
(Address of principal executive offices)

41-1939628
(I.R.S. Employer
Identification No.)

55359
(Zip Code)

(763) 479-3680
(Registrant's telephone number, including area code)

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

| <u>Title of Each Class</u> | <u>Name of Each Exchange on Which Registered</u> |
|---|--|
| Common Stock, Par Value \$0.001 Per Share | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: **None**

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 every Interactive Data File required to be submitted 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 such files). Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☐

Emerging growth company ☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

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

As of June 30, 2018 (the last business day of the Registrant’s most recently completed second fiscal quarter), the aggregate market value of voting stock held by non-affiliates of the Registrant was approximately \$3.2 billion.

As of February 15, 2019, there were 26,982,587 shares of the Registrant’s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant’s Proxy Statement for its 2019 Annual Meeting of Shareholders are incorporated by reference to Part III of this Annual Report on Form 10-K.

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Special Note Regarding Forward Looking Statements

Statements contained in this Annual Report on Form 10-K 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 which may cause our results to be materially different than those expressed or implied in such statements. In particular, some of the risks associated with our business include:

- the level of competition in our industry and our ability to compete;
- our ability to respond to changes in our industry;
- our ability to effectively grow our business and manage our growth;
- our ability to continue to sell to existing and new customers;
- our ability to meet product developers’ and engineers’ needs and expectations regarding quick turnaround time, price and specifications for quality;
- the adoption rate of e-commerce and 3D CAD software by product developers and engineers;
- our ability to process a large volume of designs and identify significant opportunities in our business;
- our ability to maintain and enhance our brand;
- our ability to successfully identify, complete and integrate acquisitions or other strategic transactions;
- the loss of key personnel or failure to attract and retain additional personnel;
- system interruptions at our operating facilities;
- possible unauthorized access to customers’ confidential information stored in our systems; and
- our ability to protect our intellectual property and not infringe on others’ intellectual property.

Certain of these factors and others are described in the discussion on risk factors that appear in Part I, Item 1A. “Risk Factors” of this Annual Report on Form 10-K and uncertainties are detailed in this and other reports and filings with the Securities and Exchange Commission (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.

PART I

Item 1. Business

Overview

Proto Labs, Inc. was incorporated in Minnesota in 1999. The terms “Proto Labs,” the “Company,” “we,” “us,” and “our” as used herein refer to the business and operations of Proto Labs, Inc. and its subsidiaries. We are the world’s largest and fastest digital manufacturer of custom prototypes and on-demand production parts. Our mission is to help companies accelerate product development, reduce risk, and optimize supply chains by providing quality prototyping and on-demand manufacturing services at unprecedented speeds. Our automated quoting and manufacturing systems allow us to produce commercial-grade plastic, metal, and liquid silicone rubber parts within days. We manufacture prototype and low volume production parts for companies worldwide, who are under increasing pressure to bring their finished products to market faster than their competition. We utilize injection molding, computer numerical control (CNC) machining, 3D printing and sheet metal fabrication to manufacture custom parts for our customers. 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. We have established our operations in the United States, Europe and Japan, which we believe are three of the largest geographic markets where these product developers and engineers are located. We believe our use of advanced technology enables us to offer significant advantages at competitive prices to many customers and is the primary reason we have become a leading supplier of custom parts.

We believe prototype and low volume 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 customers typically order short run custom parts for a variety of reasons, including:

- they need a prototype to confirm the form, fit and function of one or more components of a product under development;
- they need an initial supply of parts to support pilot production for testing of a product;
- they need an initial supply of parts to support production while their high-volume production mold is being prepared;
- they need to meet their customers' variable demand for custom parts in a competitive timeframe;
- their product will only be released in a limited quantity; or
- they need to support end-of-life production in a cost-effective manner.

In each of these instances, we believe our solution provides product developers, engineers, and supply chains with an exceptional combination of speed, quality, competitive pricing, ease of use and reliability that they typically cannot find among conventional custom parts manufacturers. Our technology enables us to ship parts as soon as the same day after receipt of a customer’s design submission.

Our primary manufacturing product lines currently include Injection Molding, CNC Machining, 3D Printing and Sheet Metal. We continually seek to expand the range of size and geometric complexity of the parts we can make with these 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.

We have experienced significant growth since our inception in 1999. We have grown our total revenue from \$209.6 million in 2014 to \$445.6 million in 2018. We have grown our net income from \$41.6 million in 2014 to \$76.6 million in 2018.

Our increases in revenue and income from operations can be attributed to expanding our customer base, broadening our parts envelope, and launching new manufacturing technologies. We were founded in 1999 with plastic injection molding, and have expanded our product lines over the years by the introduction of:

- CNC machining in 2007;
- liquid silicon rubber (LSR) and lathe manufacturing processes that expanded the breadth and scope of our injection molding and CNC machining product lines in 2014;
- 3D printing, including stereolithography (SL), selective laser sintering (SLS), and direct metal laser sintering (DMLS), through our acquisition of FineLine Prototyping, Inc. (FineLine) in 2014 and expanded through our acquisition of certain assets of Alphaform AG (Alphaform) in 2015;
- rapid overmolding technology in 2016 and insert molding technology in 2017, both of which expanded the breadth of our manufacturing capabilities in our Injection Molding product line;
- PolyJet and Multi Jet Fusion (MJF) in 2017, which expanded the processes with which we produce 3D printed parts;

- injection molding commercial offerings tailored to on-demand manufacturing customers in 2017;
- sheet metal fabrication capability through our acquisition of RAPID Manufacturing Group, LLC (RAPID) in 2017; and
- expanded CNC machining capabilities for larger and more complex parts through our acquisition of RAPID in 2017.

Industry Overview

Our Industry

We serve product developers and engineers worldwide who bring new ideas to market in the form of products containing one or more custom parts. Many of these product developers and engineers use 3D CAD software to create digital models representing their custom part designs that are then used to create physical parts for concept modeling, prototyping, functional testing, market evaluation or production. Custom prototype parts play a critical role in the product development process, as they provide product developers and engineers with the ability to test and confirm their intended performance requirements and explore design alternatives.

Early in the product development process, 3D printing processes such as SL and PolyJet can be used to quickly produce an approximate physical representation of a part, but these representations may not meet product developers' and engineers' requirements for material properties. As an alternative, injection molding, CNC machining, sheet metal, and 3D printing processes such as SLS, DMLS, and MJF can be used to produce low volumes of high-quality custom parts in either metal or plastic. For follow-on functional testing, market evaluation and production runs, parts are typically manufactured using injection molding, CNC machining and sheet metal fabrication.

Our Solution

We have developed proprietary software and advanced manufacturing processes that automate much of the skilled labor conventionally required in quoting, production engineering and manufacturing of custom parts. We believe our interactive web-based interface and highly automated processes address the desires of many product developers and engineers for a fast, efficient and cost-effective means to obtain custom parts, and are the primary reasons we have become a leading supplier of custom parts.

Key elements of our solution include:

Sophisticated Technology that Reduces Turnaround Time

Our digital model is centered on our web-based interface and proprietary software, which automate many of the manual and time-consuming processes typically required to obtain custom parts from conventional suppliers. Our platform automates many aspects of the entire process from design submission through manufacturability analysis and feedback, quotation, order submission, mold design, tool path generation, mold or part manufacture and digital inspection. To utilize our platform, a prospective customer uploads a 3D CAD file of their required part through our website. Often within minutes of design submission, our software analyzes the design, assesses the manufacturability of the design and our ability to make the part, and returns a firm price quotation with any recommendations for design modifications. Many of our customers find this analysis particularly helpful, as it diagnoses and prevents potential problems prior to manufacturing. We can also provide a flow analysis to identify design flaws that limit the ability to manufacture a quality part.

Our quoting system is highly interactive, enabling our prospective customers to change the material, finish, quantity or shipping schedule of orders, and to instantly receive an updated quotation. Once an order is received, our software automates much of the manual engineering and skilled labor that is normally required to manufacture parts. As a result, in many cases we are able to quote orders in minutes and ship parts as soon as the same day ordered.

Scale to Process Large Numbers of Unique Part Designs

Our proprietary, highly scalable quoting technology addresses the manual processes conventionally involved in submitting a design, analyzing its manufacturability, making design revision recommendations and generating price quotations. This enables us to quickly analyze high volumes of 3D CAD part design submissions and provide feedback to our prospective product developer and engineer customers. In 2018 alone, we generated quotations for over 1,100,000 design submissions. Our proprietary manufacturing automation technology is also highly scalable, enabling us to process large numbers of unique designs and, combined with our manufacturing processes, efficiently and effectively manufacture high volumes of parts to meet the needs of product developers and engineers.

Enhanced Customer Experience

Our web-based customer interface provides a straightforward means of submitting 3D CAD part designs. Our proprietary manufacturability analysis then quickly analyzes whether a part design falls within our manufacturing capabilities. In many cases, our software provides suggested design modifications to enhance manufacturability, which is presented to the product developer or engineer in an interactive quotation containing a color-coded 3D representation of the part. This allows product developers and engineers to quickly determine the manufacturability of their parts, understand the cost and when they can be shipped. Our interactive quotations provide instant visibility into the impact of changing an order's various parameters such as material, finish, quantity or shipping schedule. As a result, we provide product developers and engineers with an easy-to-use and consistent means to obtain custom parts.

Attractive Custom Pricing

Based on internal market research, we believe we generally have competitive pricing on custom orders. We believe this, combined with speed, is a direct result of our technology and the efficiency of our operations, both of which were designed specifically for lower volume runs of custom parts production. By limiting these costs, we can typically offer attractive pricing not normally possible in the low volume, high mix custom parts market, and as a result, we can typically offer product developers and engineers competitive prices on custom manufactured parts.

Our Product Lines

Our Injection Molding, CNC Machining, 3D Printing and Sheet Metal product lines offer many product developers and engineers the ability to quickly and efficiently outsource their quick-turn custom parts manufacturing. See Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" for the historical revenue generated by each of Injection Molding, CNC Machining, 3D Printing and Sheet Metal.

Injection Molding

Our Injection Molding product line uses our 3D CAD-to-CNC machining technology for the automated design and manufacture of molds, which are then used to produce custom plastic and liquid silicone rubber injection-molded parts and over-molded and insert-molded injection-molded parts on commercially available equipment. Our Injection Molding product line works best for on-demand production, bridge tooling, pilot runs and functional prototyping. Our affordable aluminum molds and quick turnaround times help reduce design risk and limit overall production costs for product developers and engineers. Prototype quantities typically range from 25 to 100 parts. Because we retain possession of the molds, customers who need short-run production often come back to Proto Labs' Injection Molding product line for additional quantities. They do so to support pilot production for product testing, 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 requires limited annual quantity or because they need end-of-life production support. In 2017, we launched an on-demand manufacturing injection molding service. This service utilizes our existing processes, but is designed to fulfill the needs of customers with on-going production needs, typically in annual volumes of less than 10,000 parts.

CNC Machining

Our CNC Machining product line uses commercially available CNC machines to offer milling and turning. CNC milling is a manufacturing process that cuts plastic and metal blocks into one or more custom parts based on the 3D CAD model uploaded by the product developer or engineer. CNC turning with live tooling combines both lathe and mill capabilities to machine parts with cylindrical features from metal rod stock. Our efficiencies derive from the automation of the programming of these machines and a proprietary fixturing process. Quick-turn CNC machining works best for prototyping, form and fit testing, jigs and fixtures and functional components for end-use applications. The CNC Machining product line is well suited to produce small quantities, typically in the range of one to 1,000 parts.

3D Printing

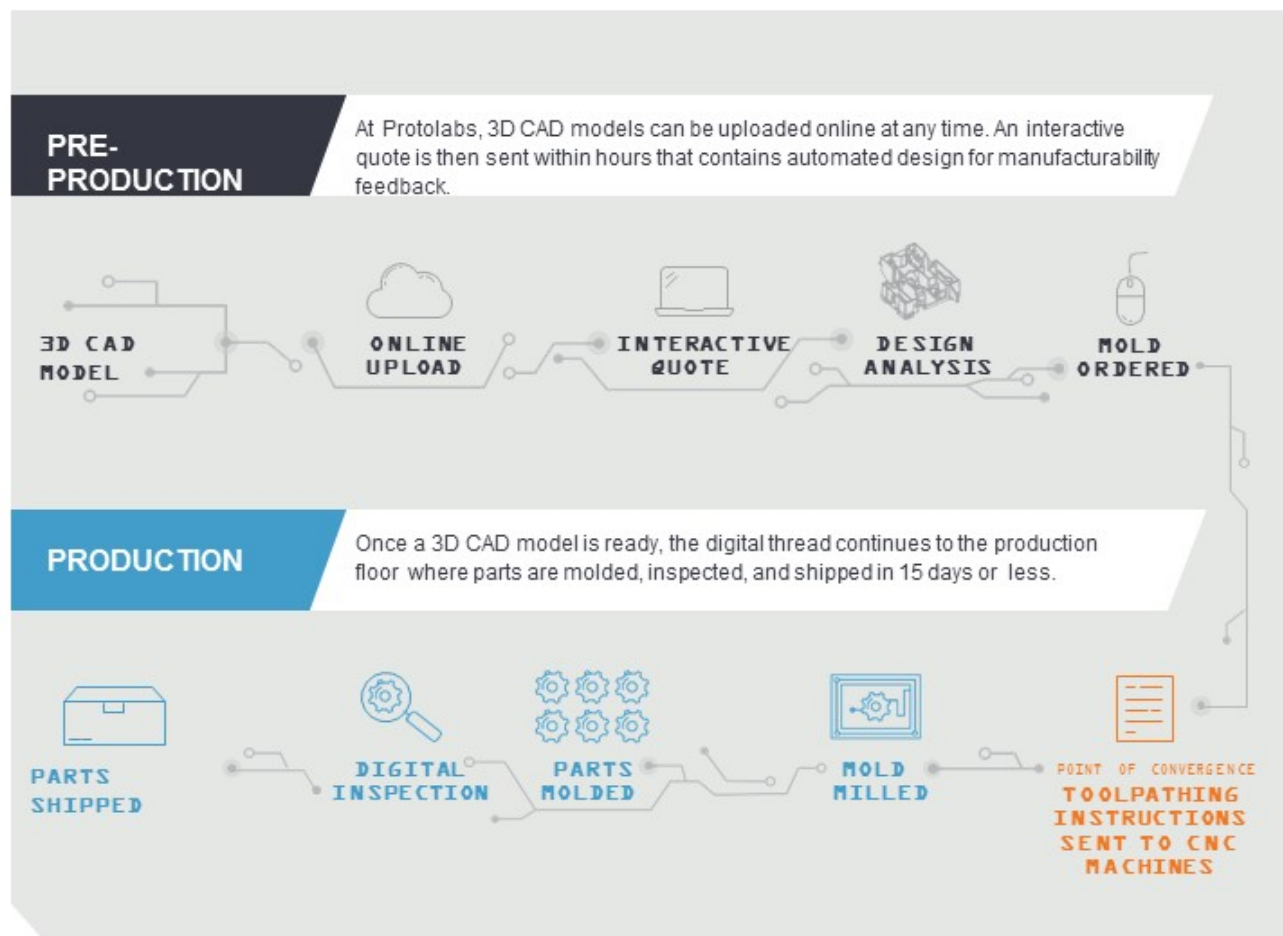
Our 3D Printing product line includes SL, SLS, DMLS, MJF and PolyJet processes, which offers customers a wide-variety of high-quality, precision rapid prototyping and low volume production. These processes create parts with a high level of accuracy, detail, strength and durability. Industrial 3D Printing is best suited for functional prototypes, complex designs and end-use applications. 3D Printing is well suited to produce small quantities, typically in the range of one to 50 parts.

Sheet Metal

Our Sheet Metal product line includes quick-turn and e-commerce-enabled custom sheet metal parts, providing customers with prototype and low-volume production parts. The rapid prototype sheet metal process is most often used when form, fit and function are all a priority. Our manufacturing process uses customer 3D CAD models uploaded by the product developer or engineer to fabricate quick turn prototype sheet metal or short run production parts. The Sheet Metal product line is well suited to produce quantities in the range of one to 500 parts.

Our Process

Digital Differentiation



The process for Injection Molding begins when the product developer or engineer uploads one or more 3D CAD models representing the desired part geometry through our website. Our proprietary software uses complex algorithms to analyze the 3D CAD geometry, analyze its manufacturability and support the creation of an interactive, web-based quotation containing pricing and manufacturability information. A link to the quotation is then e-mailed to the product developer or engineer, who can access the quotation, change a variety of order parameters and instantly see the effect on price before finalizing the order. Our proprietary software supports the creation of the mold design and the tool paths required to manufacture the mold components, which are then routed to our CNC machining centers for execution. Once the mold is assembled, it is placed in one of our injection molding presses to create the required parts. Parts are shipped in as little as one business day from design submission. We ship our parts via small parcel common carriers on standard terms and conditions. Our other services have similar processes, but differ mainly due to the nature of the manufacturing processes on which each service is based.

Our Growth Strategy

The principal elements of our growth strategy are to:

Expand the Customer Base

We plan to expand our customer base to serve more product developers and engineers within the companies that have already used our product lines. Individual product developers and engineers typically make or influence the choice of vendor when sourcing custom parts. We believe a significant opportunity exists for us to leverage highly satisfied product developers and engineers to encourage others within the same organization to utilize our product lines. We have historically gained a significant number of new customers through word-of-mouth referrals from other product developers and engineers, and combine these referrals with the efforts of our marketing and sales force to identify and market our product lines to the colleagues of our existing customers.

We also plan to use our marketing and sales capabilities to continue to pursue product developers and engineers within companies who have not yet used our products. Our presence in geographic regions that have high populations of 3D CAD users provides us with a broad universe of potential new customer companies on which to focus our marketing and sales efforts.

We believe there may be opportunities to grow by identifying and expanding into select additional geographic markets. We currently operate in the United States, Europe and Japan, where we believe a substantial portion of the world's product developers and engineers are located. We entered the European market in 2005 and launched operations in Japan in 2009. For 2018, revenue earned in these markets represents approximately 21.3% of our total revenue. While we currently do not have specific plans to expand into any particular geographic markets, we believe opportunities exist to serve the needs of product developers and engineers in select new geographic regions and we will continue to evaluate such opportunities if and when they arise.

We plan to further enhance the functionality and ease of use of our platform and expand the capabilities of our technology in order to further increase automation and meet the evolving needs of product developers and engineers worldwide. We believe product developers and engineers have come to expect advanced web-based tools and a fully integrated Internet platform from their vendors. We will continue to use the Internet to provide product developers and engineers with a standardized interface through which they can upload their 3D CAD models and obtain firm, interactive quotations quickly and efficiently.

Launch New Manufacturing Technology

We seek to identify additional manufacturing processes to which we can apply our digital technology and expertise to meet a greater range of product developers' and engineers' needs. Introducing new manufacturing processes can both attract new customers and provide us with a significant opportunity to cross-sell our existing product lines to our existing customer base. We regularly evaluate new manufacturing processes to offer product developers and engineers and introduce such new processes when we are confident that a sufficient market demand exists and that we can offer the same advantages our customers have come to expect from us.

We were founded with Injection Molding which represents 47.2% of our total revenue for the year ended December 31, 2018. Examples of new manufacturing services we have added include CNC Machining, 3D Printing and Sheet Metal. Our CNC Machining product line was first introduced in the United States and Europe in 2007, expanded to Japan in 2009, and further expanded in the United States through our acquisition of RAPID in November 2017. CNC Machining represents 34.5% of our total revenue for the year ended December 31, 2018. 3D printing technologies were introduced through our acquisition of FineLine in April 2014. We further expanded our 3D printing capabilities in October 2015 through our acquisition of Alphaform. Our 3D product line represents 12.0% of our total revenue for the year ended December 31, 2018. Our Sheet Metal product line was introduced through our acquisition of RAPID in November 2017 and represents 5.6% of total revenue for the year ended December 31, 2018.

We continue to expand our core product lines through product line extensions including liquid silicone rubber injection molding, lathe-turned parts, rapid overmolding, insert molding, PolyJet and MJF. We introduced liquid silicone rubber injection molding during 2014 and in 2015, we introduced lathe-turned products. In 2016, we expanded the breadth of our manufacturing capabilities by adding rapid overmolding technology. In 2017, we added insert molding to our Injection Molding product line and PolyJet and MJF to our 3D Printing product line. In addition, we launched on-demand manufacturing to address the needs of the low-volume, high-mix product segment. We also opened our first metrology lab in 2017 for enhanced inspection reporting on end-use production parts, including First Article Inspection Reports and digital inspection reports.

Broaden the Parts Envelope

We regularly analyze the universe of customer design submissions that we are currently unable to manufacture and focus a portion of our research and development efforts to expand the range of parts that we can produce. Since we first introduced our Injection Molding product line in 1999, we have steadily expanded the size and geometric complexity of the injection-molded parts we are able to manufacture, and we continue to extend the diversity of materials we are able to support. Similarly, since first introducing our CNC Machining product line in 2007, we have expanded the range of part sizes, design geometries and materials we can support. In 2017, we launched two new 3D Printing processes, which strengthened our capability to manufacture complex part geometries quickly and accurately. Through our acquisition of RAPID in November 2017, we added quick-turn and e-commerce-enabled Sheet Metal services to our portfolio and expanded our CNC Machining capabilities to support larger and more complex projects. As we continue to expand the range of our existing process capabilities, we believe we will meet the needs of a broader set of product developers and engineers and consequently convert a higher number of quotation requests into orders.

Marketing

Our global marketing effort generates prospects for our sales teams and seeks to strengthen our reputation as an industry leader in digital manufacturing services for custom prototyping and low-volume manufacturing. Since we are an agile, technology-based company, much of our marketing activities occur online. We use marketing automation software to enhance the productivity of our marketing and sales teams and continuously track the results of every campaign to ensure our return on investment.

We maintain top-of-mind brand awareness with product developers and engineers through regular publication of technical information including design guidelines and helpful tips, engineering white papers, educational webinars, quick videos, and a quarterly journal focused on important industry topics. We also provide complimentary physical design aids to designers and engineers — as well as teachers and students — that highlight technical aspects of injection molding to help create efficient, well-designed parts. We believe these educational materials are key aspects of our lead generation efforts.

Marketing represents the face of Proto Labs, so it is our goal to actively and intelligently engage designers and engineers across multiple mediums — whether print, online, social media or in person. By doing this, we gain new customers, drive sales and build brand equity.

Sales and Customer Service

We maintain an internal sales team trained in the basics of part design and the capabilities of our manufacturing product lines, as well as the key advantages of our processes over alternate methods of custom parts manufacturing. We organize our sales team into complementary roles: business development, account management and strategic account management, with the former focused on selling to new customer companies within targeted market segments and the latter two focused on expanding sales within existing customer companies.

We believe our sales staff is adept at researching customer companies and networking to find additional product developers and engineers who may have a need for our products. We also have a team of customer service engineers who can support highly technical engineering discussions with product developers and engineers as required during the sales process. Our revenue is generated from a diverse customer base, with no single customer company representing more than 2% of our total revenue in 2018.

Competition

The market for custom parts manufacturing is fragmented, highly competitive and subject to rapid and significant technological change. Our potential competitors include:

- *Captive in-house product manufacturing.* Many larger companies undertaking product development have established additive rapid prototyping (3D printing), CNC machining, injection molding or sheet metal capabilities internally to support prototyping or manufacturing requirements of their product developers and engineers.
- *Other custom parts manufacturers.* There are thousands of alternative manufacturing machine shops, injection molding suppliers, sheet metal fabricators, and 3D printing service bureaus and vendors worldwide. The size and scale of these businesses range from very small specialty shops to large, high-volume production manufacturers.

We believe that the key competitive factors in our industry include:

- Quality: dimensional accuracy, surface finish, material properties, color and cleanliness;
- Speed: turnaround time for quotations and parts;

- Reliability: greater than 97% on-time delivery;
- Service: overall customer experience, from web interface to post-sales support;
- Capability: range of part sizes and dimensional complexities supported, variety of manufacturing processes offered, materials supported and post-processing provided;
- Scale: ability to support thousands of part designs in parallel;
- Capacity: ability to manage peaks in demand with very short lead times and no minimum order quantities; and
- Price: mold and part pricing.

We believe that our digital end-to-end manufacturing capability positions us favorably and has enabled us to become a leader in our markets. We also believe that substantially all of our current direct competitors are relatively small in terms of size of operations, revenue, number of customers and volume of parts sold, and generally lack our technological capabilities. However, our industry is evolving rapidly and other companies, including potentially larger and more established companies with developed technological capabilities, may begin to focus on low volume, high mix custom parts manufacturing. These companies could more directly compete with us, along with our existing competitors, and could also launch new products and product lines that we do not offer that may quickly gain market acceptance. Any of the foregoing could adversely affect our ability to attract customers.

Intellectual Property

We regard our patents, trademarks, service marks, trade dress, trade secrets, copyrights, domain names and other intellectual property as valuable to our business and rely on patent, trademark and copyright law, trade secret protection and confidentiality and/or license agreements with our employees, customers, vendors and others to protect our proprietary rights. We register our patents, trademarks and service marks in the United States and other jurisdictions as we deem appropriate. As of December 31, 2018, we owned and had applications pending for patents relating to various aspects of our quoting and manufacturing processes as follows:

| Jurisdiction | Issued Patents | Applications Pending |
|----------------|----------------|----------------------|
| United States | 18 | 11 |
| United Kingdom | 2 | 0 |
| Germany | 0 | 2 |

Our patents have expiration dates ranging from 2022 to 2032. We also owned approximately 20 registered and 3 pending United States trademarks or service marks as of December 31, 2018, with corresponding registered protection in Europe and Japan for the most important of these marks such as PROTO LABS, PROTOMOLD, FIRSTCUT, PROTOQUOTE, FIRSTQUOTE, PROTOFLOW and FINELINE, corresponding approved protection in Canada for PROTO LABS, FIRSTCUT and FINELINE, and corresponding registered protection in Australia, Canada and Mexico for PROTOMOLD. There can be no assurance that the steps we take to protect our proprietary rights will be adequate or that third parties will not infringe or misappropriate such rights. We have been subject to claims and expect to be subject to legal proceedings and claims from time to time in the ordinary course of our business. In particular, we may face claims from third parties that we have infringed their patents, trademarks or other intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources. Any unauthorized disclosure or use of our intellectual property could make it more expensive to do business and harm our operating results.

Employees

As of December 31, 2018 we had 2,487 full-time employees. We also regularly use independent contractors and other temporary employees across the organization to augment our regular staff. We believe that our future success will depend in part on our continued ability to attract, hire and retain qualified personnel.

Available Information

Our principal executive offices are located at 5540 Pioneer Creek Drive, Maple Plain, Minnesota 55359 and our telephone number is (763) 479-3680. Our website address is www.protolabs.com. Information on our website does not constitute part of this Annual Report on Form 10-K or any other report we file or furnish with the SEC. We provide free access to various reports that we file with or furnish to the SEC through our website as soon as reasonably practicable after they have been filed or furnished. These reports include, but are not limited to, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to these reports. Our SEC reports can be accessed through the investor relations section of our website.

The SEC maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file information electronically with the SEC. The SEC's website is www.sec.gov.

Executive Officers of the Registrant

Set forth below are the names of our current executive officers, their ages, titles, the year first appointed as an executive officer, and employment for the past five years:

| | | |
|---------------------|----|---|
| Victoria M. Holt | 61 | President, Chief Executive Officer and Director |
| Robert Bodor | 46 | Vice President/General Manager – Americas |
| John A. Way | 46 | Chief Financial Officer and Executive Vice President of Development |
| Arthur R. Baker III | 51 | Chief Technology Officer |
| David M. Fein | 50 | Chief Revenue Officer |
| Bjoern Klaas | 49 | Vice President/General Manager and Managing Director – Europe, Middle East and Africa |

Executive officers of the Company are elected at the discretion of the board of directors with no fixed terms. There are no family relationships between or among any of the executive officers or directors of the Company.

Victoria M. Holt. Ms. Holt has been our President and Chief Executive Officer since February 2014. Prior to joining Proto Labs, Ms. Holt served as President and Chief Executive Officer of Spartech Corporation, a leading producer of plastic sheet, compounds and packaging products, from September 2010 until Spartech was purchased by PolyOne Corporation in March 2013. Ms. Holt also is a member of the Board of Directors of Waste Management, Inc.

Robert Bodor. Dr. Bodor has served as our Vice President/General Manager - Americas since January 2015. From July 2013 to January 2015, Dr. Bodor served as our Chief Technology Officer. From December 2012 to June 2013, Dr. Bodor served as our Director of Business Development. Prior to joining Proto Labs, from January 2011 to December 2012, Dr. Bodor held several roles at Honeywell, most recently leading SaaS business offerings for Honeywell's Life Safety Division.

John A. Way. Mr. Way has served as our Chief Financial Officer and Executive Vice President of Development since December 2014. From October 2013 to September 2014, Mr. Way served as Chief Financial Officer of Univita Health Inc., a privately held home healthcare service provider. From September 2012 to July 2013, Mr. Way served as Chief Financial Officer of Virtual Radiologic, a global telemedicine company. From October 2002 to November 2012, Mr. Way worked in senior financial positions at several divisions within UnitedHealth Group, including Chief Financial Officer of Optum Collaborative Care, SecureHorizons and OptumHealth.

Arthur R. Baker III. Dr. Baker has been our Chief Technology Officer since May 2016. Prior to joining Proto Labs, Dr. Baker served as Chief Technology Officer of PaR Systems, a robotics and specialty machine tool builder. From 2005 to 2014, Dr. Baker held multiple positions at MTS Systems, including General Manager of the Test Division, Chief Technology Officer, and Vice President of Engineering and Operations. MTS Systems was a leader in mechanical testing and simulation systems for automotive, aerospace, medical, civil-seismic and general research.

David M. Fein. Mr. Fein has been our Chief Revenue Officer since December 2016. Prior to joining Proto Labs, Mr. Fein spent 16 years at PMC-Sierra, Inc., a semiconductor and software solutions provider for big data storage, optical transport networks and wireless infrastructure markets. Most recently, Mr. Fein served as Executive Vice President, Worldwide Sales from December 2014 until PMC-Sierra, Inc. was acquired by Microsemi Corporation in January 2016. From November 2008 to November 2014, Mr. Fein served as Vice President, Sales for the Americas at PMC-Sierra.

Bjoern Klaas. Mr. Klaas has led our company's business in Europe, Middle East and Africa as the Vice President and Managing Director since December 2017. Prior to joining Proto Labs, Mr. Klaas held key positions with global polymer supplier PolyOne from 2012 to 2017, most recently as its Vice President and General Manager for its ColorMatrix Group headquartered in the United States. From 2008 to 2012, Mr. Klaas worked at Colorant-Chromatics, a global leader for high temperature polymer formulations, as the General Manager for the global business.

Item 1A. Risk Factors

The following are the significant factors that could materially adversely affect our business, financial condition, or operating results, as well as adversely affect the value of an investment in our common stock.

Risks Relating to Our Business

We face significant competition and expect to face increasing competition in many aspects of our business, which could cause our operating results to suffer.

The market for custom parts manufacturing is fragmented and highly competitive. We compete for customers with a wide variety of custom parts manufacturers and methods. Some of our current and potential competitors include captive in-house product lines, other custom parts manufacturers and alternative manufacturing vendors such as those utilizing 3D printing processes including stereolithography (SL), selective laser sintering (SLS), direct metal laser sintering (DMLS), PolyJet and Multi Jet Fusion (MJF). Moreover, some of our existing and potential competitors are researching, designing, developing and marketing other types of products and product lines. We also expect that future competition may arise from the development of allied or related techniques for custom parts manufacturing that are not encompassed by our patents, from the issuance of patents to other companies that may inhibit our ability to develop certain products and from improvements to existing technologies. Furthermore, our competitors may attempt to adopt and improve upon key aspects of our business model, such as development of technology that automates much of the manual labor conventionally required to quote and manufacture custom parts, implementation of interactive web-based and automated user interface and quoting systems and/or building scalable operating models specifically designed for efficient custom production. Third-party CAD software companies may develop software that mold-makers, injection molders and CNC machine shops could use to compete with our business model. Additive manufacturers may develop stronger, higher temperature resins or introduce other improvements that could more effectively compete with us on part quality. We may also, from time to time, establish alliances or relationships with other competitors or potential competitors. To the extent companies terminate such relationships and establish alliances and relationships with our competitors, our business could be harmed.

Existing and potential competitors may have substantially greater financial, technical, marketing and sales, manufacturing, distribution and other resources and name recognition than us, as well as experience and expertise in intellectual property rights and operating within certain international locations, any of which may enable them to compete effectively against us.

Though we plan to continue to expend resources to develop new technologies, processes and product lines, we cannot assure you that we will be able to maintain our current position or continue to compete successfully against current and future sources of competition. Our challenge in developing new products is finding product lines for which our automated quotation and manufacturing processes offer an attractive value proposition, and we may not be able to find any new product lines with potential economies of scale similar to our existing product lines. If we do not keep pace with technological change and introduce new technologies, processes and product lines, the demand for our products and product lines may decline and our operating results may suffer.

Our success depends on our ability to deliver products and product lines that meet the needs of product developers and engineers and to effectively respond to changes in our industry.

We derive almost all of our revenue from the manufacture and sale to product developers and engineers of quick-turn low volumes of custom parts for prototyping, support of internal manufacturing and limited quantity product release. Our business has been, and, we believe, will continue to be, affected by changes in product developer and engineering requirements and preferences, rapid technological change, new product and product line introductions and the emergence of new standards and practices, any of which could render our technology, products and product lines less attractive, uneconomical or obsolete. To the extent that our customers' need for quick-turn parts decreases significantly for any reason, it would likely have a material adverse effect on our business and operating results and harm our competitive position. In addition, CAD simulation and other technologies may reduce the demand for physical prototype parts. Therefore, we believe that to remain competitive, we must continually expend resources to enhance and improve our technology, product offerings and product lines.

In particular, we plan to increase our research and development efforts and to continue to focus a significant portion of those efforts to further develop our technology in areas such as our interactive user interface and manufacturing processes, potentially introduce new manufacturing processes within the research and development initiative we refer to as Protoworks, and broaden the range of parts that we are able to manufacture. We believe successful execution of this part of our business plan is critical for our ability to compete in our industry and grow our business, and there are no guarantees we will be able to do so in a timely fashion, or at all. Broadening the range of parts we offer is of particular importance since limitations in manufacturability are the primary reason we are not able to fulfill many quotation requests. There are no guarantees that the resources devoted to executing on this aspect of our business plan will improve our business and operating results or result in increased demand for our products and product lines. Failures in this area could adversely impact our operating results and harm our reputation and brand. Even if we are successful in executing in these areas, our industry is subject to rapid and significant technological change, and our competitors may develop new technologies, processes and product lines that are superior to ours. Our research and development costs were approximately \$28.7 million, \$23.6 million and \$22.4 million for the years ended December 31, 2018, 2017 and 2016, respectively, and there is no guarantee that these costs will enable us to maintain or grow our revenue profitability. Refer to Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this Annual Report on Form 10-K for additional discussion related to research and development costs.

Any failure to properly meet the needs of product developers and engineers or respond to changes in our industry on a cost-effective and timely basis, or at all, would likely have a material adverse effect on our business and operating results and harm our competitive position.

Our failure to meet our product developers’ and engineers’ expectations regarding quick turnaround time would adversely affect our business and results of operations.

We believe many product developers and engineers are facing increased pressure from global competitors to be first to market with their finished products, often resulting in a need for quick turnaround of custom parts. We believe our ability to quickly quote, manufacture and ship custom parts has been an important factor in our results to date. There are no guarantees we will be able to meet product developers’ and engineers’ increasing expectations regarding quick turnaround time, especially as we increase the scope of our operations. If we fail to meet our customers’ expectations regarding turnaround time in any given period, our business and results of operations will likely suffer.

Our failure to meet our product developers’ and engineers’ price expectations would adversely affect our business and results of operations.

Demand for our product lines is sensitive to price. We believe our competitive pricing has been an important factor in our results to date. Therefore, changes in our pricing strategies can have a significant impact on our business and ability to generate revenue. Many factors, including our production and personnel costs and our competitors’ pricing and marketing strategies, can significantly impact our pricing strategies. If we fail to meet our customers’ price expectations in any given period, demand for our products and product lines could be negatively impacted and our business and results of operations could suffer.

Our failure to meet our product developers’ and engineers’ quality specifications would adversely affect our business and results of operations.

We believe many product developers and engineers have a need for specific quality of quick-turn, on-demand custom parts. We believe our ability to create parts with the specifications of the product developers and engineers is an important factor in our results to date. If we fail to meet our customers’ specifications in any given period, demand for our products and product lines could be negatively impacted and our business and results of operations could suffer.

The strength of our brand is important to our business, and any failure to maintain and enhance our brand would hurt our ability to retain and expand our customer base as well as further penetrate existing customers.

Since our products and product lines are sold primarily through our websites, the success of our business depends upon our ability to attract new and repeat customers to our websites in order to increase business and grow our revenue. Customer awareness and the perceived value of our brand will depend largely on the success of our marketing efforts, as well as our ability to consistently provide quality custom parts within the required timeframes and positive customer experiences, which we may not do successfully. A primary component of our business strategy is the continued promotion and strengthening of our brand, and we have incurred and plan to continue to incur substantial expense related to advertising and other marketing efforts directed toward enhancing our brand. We have initiated marketing efforts through social media, but this method of marketing may not be successful and subjects us to a greater risk of inconsistent messaging and bad publicity. We may choose to increase our branding expense materially, but we cannot be sure that this investment will be profitable. If we are unable to successfully maintain and enhance our brand, this could have a negative impact on our business and ability to generate revenue.

Our business depends in part on our ability to process a large volume of new part designs from a diverse group of product developers and engineers and successfully identify significant opportunities for our business based on those submissions.

We believe the volume of new part designs we process and the size and diversity of our customer base give us valuable insight into the needs of our prospective customers. We utilize this industry knowledge to determine where we should focus our development resources. If the number of new part designs we process or the size and diversity of our customer base decrease, our ability to successfully identify significant opportunities for our business and meet the needs of product developers and engineers could be negatively impacted. In addition, even if we do continue to process a large number of new part designs and work with a significant and diverse customer base, there are no guarantees that any industry knowledge we extract from those interactions will be successfully utilized to help us identify significant business opportunities or better understand the needs of product developers and engineers.

The loss of one or more key members of our management team or personnel, or our failure to attract, integrate and retain additional personnel in the future, could harm our business and negatively affect our ability to successfully grow our business.

We are highly dependent upon the continued service and performance of the key members of our management team and other personnel. The loss of any of these individuals, each of whom is “at will” and may terminate his or her employment relationship with us at any time, could disrupt our operations and significantly delay or prevent the achievement of our business objectives. We believe that our future success will also depend in part on our continued ability to identify, hire, train and motivate qualified personnel. A possible shortage of qualified individuals in the regions where we operate might require us to pay increased compensation to attract and retain key employees, thereby increasing our costs. In addition, we face intense competition for qualified individuals from numerous companies, many of whom have substantially greater financial and other resources and name recognition than us. We may be unable to attract and retain suitably qualified individuals who are capable of meeting our growing operational, managerial and other requirements, or we may be required to pay increased compensation in order to do so. Our failure to attract, hire, integrate and retain qualified personnel could impair our ability to achieve our business objectives.

If we fail to grow our business as anticipated, our net sales, gross margin and operating margin will be adversely affected.

We are attempting to grow our business substantially. To this end, we have made and expect to continue to make significant investments in our business, including investments in our infrastructure, technology, and marketing and sales efforts. These investments include dedicated facilities expansion and increased staffing, both domestic and international. If our business does not generate the level of revenue required to support our investment, our net sales and profitability will be adversely affected.

If we are unable to manage our growth and expand our operations successfully, our reputation and brand may be damaged, and our business and results of operations may be harmed.

Over the past several years, we have experienced rapid growth. For example, we have grown from 1,077 full-time employees as of January 1, 2015 to 2,487 full-time employees as of December 31, 2018. We have expanded internationally, including establishing manufacturing operations in Europe in 2005 and Japan in 2009. In 2014, we expanded our product lines with 3D Printing through our acquisition of FineLine. In 2015, we expanded our manufacturing operations and our 3D Printing product lines in Europe through our acquisition of Alphaform. In 2017, we expanded our product lines to include Sheet Metal through our acquisition of RAPID. We expect this growth to continue and the number of countries and facilities from which we operate to increase in the future. Our ability to effectively manage our anticipated growth and expansion of our operations will require us to do, among other things, the following:

- enhance our operational, financial and management controls and infrastructure, human resource policies, and reporting systems and procedures, in particular as we continue to operate as a global organization;
- effectively scale our operations, including accurately predicting the need for floor space, equipment, and additional staffing;
- successfully identify, recruit, hire, train, maintain, motivate and integrate additional employees; and
- expand our international resources.

These enhancements and improvements will require significant capital expenditures and allocation of valuable management and employee resources. Furthermore, our growth, combined with the geographical dispersion of our operations, has placed, and will continue to place, a strain on our operational, financial and management infrastructure. Our future financial performance and our ability to execute on our business plan will depend, in part, on our ability to effectively manage any future growth and expansion. There are no guarantees we will be able to do so in an efficient or timely manner, or at all. Our failure to effectively manage growth and expansion could have a material adverse effect on our business, results of operations, financial condition, prospects, and reputation and brand, including impairing our ability to perform to our customers’ expectations.

We may not timely and effectively scale and adapt our existing technology, processes and infrastructure to meet the needs of our business.

A key element to our continued growth is the ability to quickly and efficiently quote an increasing number of product developer and engineer submissions across geographic regions and to manufacture the related parts. This will require us to timely and effectively scale and adapt our existing technology, processes and infrastructure to meet the needs of our business. With respect to our websites and quoting technology, it may become increasingly difficult to maintain and improve their performance, especially during periods of heavy usage and as our solutions become more complex and our user traffic increases across geographic regions. Similarly, our manufacturing automation technology may not enable us to process the large numbers of unique designs and efficiently manufacture the related parts in a timely fashion to meet the needs of product developers and engineers as our business continues to grow. Any failure in our ability to timely and effectively scale and adapt our existing technology, processes and infrastructure could negatively impact our ability to retain existing customers and attract new customers, damage our reputation and brand, result in lost revenue, and otherwise substantially harm our business and results of operations.

Numerous factors may cause us not to maintain the revenue growth that we have historically experienced.

Although our revenue has grown over the past five years from \$209.6 million for the year ended December 31, 2014 to \$445.6 million for the year ended December 31, 2018, we may not be able to maintain our historical rate of revenue growth. We believe that our continued revenue growth will depend on many factors, a number of which are out of our control, including among others, our ability to:

- retain and further penetrate existing customer companies, as well as attract new customer companies;
- consistently execute on custom part orders in a manner that satisfies product developers' and engineers' needs and provides them with a superior experience;
- develop new technologies or manufacturing processes and broaden the range of parts we offer;
- successfully execute on our international strategy and expand into new geographic markets;
- capitalize on product developer and engineer expectations for access to comprehensive, user-friendly e-commerce capabilities 24 hours per day, 7 days per week;
- increase the strength and awareness of our brand across geographic regions;
- respond to changes in product developer and engineer needs, technology and our industry;
- react to challenges from existing and new competitors; and
- respond to an economic recession which negatively impacts manufacturers' ability to innovate and bring new products to market.

We cannot assure you that we will be successful in addressing the factors above and continuing to grow our business and revenue.

Our operating results and financial condition may fluctuate on a quarterly and annual basis.

Our operating results and financial condition may fluctuate from quarter to quarter and year to year, and are likely to continue to vary due to a number of factors, some of which are outside of our control. In addition, our actual or projected operating results may fail to match our past performance. These events could in turn cause the market price of our common stock to fluctuate. If our operating results do not meet the expectations of securities analysts or investors, who may derive their expectations by extrapolating data from recent historical operating results, the market price of our common stock will likely decline.

Our operating results and financial condition may fluctuate due to a number of factors, including those listed below and those identified throughout this "Risk Factors" section:

- the development of new competitive systems or processes by others;
- the entry of new competitors into our market, whether by established companies or by new companies;

- changes in the size and complexity of our organization, including our international operations;
- levels of sales of our products and product lines to new and existing customers;
- the geographic distribution of our sales;
- changes in product developer and engineer preferences or needs;
- changes in the amount that we invest to develop, acquire or license new technologies and processes, which we anticipate will generally increase and may fluctuate in the future;
- delays between our expenditures to develop, acquire or license new technologies and processes, and the generation of sales related thereto;
- our ability to timely and effectively scale our business during periods of sequential quarterly or annual growth;
- limitations or delays in our ability to reduce our expenses during periods of declining sequential quarterly or annual revenue;
- changes in our pricing policies or those of our competitors, including our responses to price competition;
- changes in the amount we spend in our marketing and other efforts;
- unexpected increases in expenses as compared to our related accounting accruals or operating plan;
- the volatile global economy;
- general economic and industry conditions that affect customer demand and product development trends;
- interruptions to or other problems with our website and interactive user interface, information technology systems, manufacturing processes or other operations;
- changes in accounting rules and tax and other laws; and
- plant shutdowns due to a health pandemic or weather conditions.

Due to all of the foregoing factors and the other risks discussed in this “Risk Factors” section, you should not rely on quarter-to-quarter or year-to-year comparisons of our operating results as an indicator of future performance.

Interruptions to or other problems with our website and interactive user interface, information technology systems, manufacturing processes or other operations could damage our reputation and brand and substantially harm our business and results of operations.

The satisfactory performance, reliability, consistency, security and availability of our websites and interactive user interface, information technology systems, manufacturing processes and other operations are critical to our reputation and brand, and to our ability to effectively service product developers and engineers. Any interruptions or other problems that cause any of our websites, interactive user interface or information technology systems to malfunction or be unavailable, or negatively impact our manufacturing processes or other operations, may damage our reputation and brand, result in lost revenue, cause us to incur significant costs seeking to remedy the problem and otherwise substantially harm our business and results of operations.

A number of factors or events could cause such interruptions or problems, including among others: human and software errors, design faults, challenges associated with upgrades, changes or new facets of our business, power loss, telecommunication failures, fire, flood, extreme weather, political instability, acts of terrorism, war, break-ins and security breaches, contract disputes, labor strikes and other workforce-related issues, capacity constraints due to an unusually large number of product developers and engineers accessing our websites or ordering parts at the same time, and other similar events. These risks are augmented by the fact that our customers come to us largely for our quick-turn manufacturing capabilities and that accessibility and turnaround speed are often of critical importance to these product developers and engineers. We are dependent upon our facilities through which we satisfy all of our production demands and in which we house all of the computer hardware necessary to operate our websites and systems as well as managerial, customer service, sales, marketing and other similar functions, and we have not identified alternatives to these facilities or established fully redundant systems in multiple locations. However, we have back-up computing systems for each of our United States, European and Japanese operations. In addition, we are dependent in part on third parties for the implementation and maintenance of certain aspects of our communications and production systems, and therefore preventing, identifying and rectifying problems with these aspects of our systems is to a large extent outside of our control.

Moreover, the business interruption insurance that we carry may not be sufficient to compensate us for the potentially significant losses, including the potential harm to the future growth of our business that may result from interruptions in our product lines as a result of system failures.

We store confidential customer information in our systems that, if breached or otherwise subjected to unauthorized access, may harm our reputation or brand or expose us to liability.

Our system stores, processes and transmits our customers' confidential information, including the intellectual property in their part designs and other sensitive data. We rely on encryption, authentication and other technologies licensed from third parties, as well as administrative and physical safeguards, to secure such confidential information. Any compromise of our information security could damage our reputation and brand and expose us to a risk of loss, costly litigation and liability that would substantially harm our business and operating results. We may not have adequately assessed the internal and external risks posed to the security of our company's systems and information and may not have implemented adequate preventative safeguards or take adequate reactionary measures in the event of a security incident. In addition, most states have enacted laws requiring companies to notify individuals and often state authorities of data security breaches involving their personal data. These mandatory disclosures regarding a security breach often lead to widespread negative publicity, which may cause our existing and prospective customers to lose confidence in the effectiveness of our data security measures. Any security breach, whether successful or not, would harm our reputation and brand and could cause the loss of customers.

Aspects of our business are subject to privacy, data use and data security regulations, which may impact the way we use data to target customers.

Privacy and security laws and regulations may limit the use and disclosure of certain information and require us to adopt certain cybersecurity and data handling practices that may affect our ability to effectively market our services to current, past or prospective customers. In many jurisdictions consumers must be notified in the event of a data security breach, and such notification requirements continue to increase in scope and cost. The changing privacy laws in the United States, Europe and elsewhere—including the General Data Protection Regulation (GDPR) in the European Union, which became effective May 25, 2018, and the California Consumer Privacy Act of 2018, which was enacted on June 28, 2018 and will become effective on January 1, 2020—create new individual privacy rights and impose increased obligations, including disclosure obligations, on companies handling personal data. The impact of these continuously evolving laws and regulations could have a material adverse effect on the way we use data to digitally market and pursue our customers.

Global economic conditions may harm our ability to do business, increase our costs and negatively affect our stock price.

The prospects for economic growth in the United States and other countries remain uncertain and could worsen. Economic concerns and other issues such as reduced access to capital for businesses may cause product developers and engineers to further delay or reduce the product development projects that our business supports. Given the continued uncertainty concerning the global economy, we face risks that may arise from financial difficulties experienced by our suppliers, product developers and engineers and other related risks to our business.

Political and economic uncertainty arising from the outcome of the United Kingdom's referendum on its membership in the European Union could adversely affect our business and results of operations.

On June 23, 2016, the United Kingdom (UK) held a referendum in which voters approved a withdrawal from the European Union (EU), commonly referred to as “Brexit,” and in March 2017, notified the EU that it intended to exit as provided in Article 50 of the Treaty on European Union. The terms of the withdrawal are subject to ongoing negotiation that has created significant uncertainty about the future relationship between the UK and the EU. It is possible that the level of economic activity in this region will be adversely impacted and that there will be increased regulatory and legal complexities, including those relating to tax, trade, security and employees. In addition, Brexit could lead to economic uncertainty, including significant volatility in global stock markets and currency exchange rates, which may adversely impact our business. Although the specific terms and the timeframe of the negotiations are unknown, it is possible that these changes could adversely affect our business and results of operations.

We operate a global business that exposes us to additional risks.

We have established our operations in the United States, Europe and Japan and are seeking to further expand our international operations. As of December 31, 2018, we had sold products into approximately 60 countries. In addition to English, our website is available in British English, French, German, Italian, Japanese and Spanish. Our international revenue accounted for approximately 21%, 24% and 25% of our total revenue in the years ended December 31, 2018, 2017 and 2016, respectively. The future growth and profitability of our international business is subject to a variety of risks and uncertainties. Many of the following factors have adversely affected our international operations and sales to customers located outside of the United States and may again in the future:

- difficulties in staffing and managing foreign operations, particularly in new geographic locations;
- challenges in providing solutions across a significant distance, in different languages and among different cultures;
- rapid changes in government, economic and political policies and conditions, political or civil unrest or instability, terrorism or epidemics, and other similar outbreaks or events;
- economic uncertainty, including significant volatility in global stock markets and currency exchange rates, resulting from Brexit;
- fluctuations in foreign currency exchange rates;
- differences in product developer and engineer preferences and means of procuring parts;
- compliance with and changes in foreign laws and regulations, as well as U.S. laws affecting the activities of U.S. companies abroad, including those associated with export controls, tariffs and embargoes, other trade restrictions and antitrust and data privacy concerns;
- different, complex and changing laws governing intellectual property rights, sometimes affording companies lesser protection in certain areas;
- differing levels of use of the Internet or 3D CAD software;
- seasonal reductions in business activity in certain parts of the world, particularly during the summer months in Europe and holiday season;
- higher costs of doing business internationally;
- interruptions resulting from any events affecting raw material supply or manufacturing capabilities abroad;
- protectionist laws and business practices that favor local producers and service providers;
- taxation;
- energy costs;
- restrictions imposed by local labor practices and laws on our business and operations;
- workforce uncertainty in countries where labor unrest is more common than in the United States;
- transportation delays; and
- increased payment risk and higher levels of payment fraud.

Our business depends on product developers' and engineers' demand for our product lines, the general economic health of current and prospective customers, and companies' desire or ability to make investments in new products. A deterioration of global, regional or local political, economic or social conditions could affect potential customers in ways that reduce demand for our product lines, disrupt our manufacturing and sales plans and efforts or otherwise negatively impact our business. Acts of terrorism, wars, public health issues and increased energy costs could disrupt commerce in ways that could impair our ability to get products to our customers and increase our manufacturing and delivery costs. We have not undertaken hedging transactions to cover our foreign currency exposure, and changes in foreign currency exchange rates may negatively impact reported revenue and expenses. In addition, our sales are often made on unsecured credit terms, and a deterioration of political, economic or social conditions in a given country or region could reduce or eliminate our ability to collect accounts receivable in that country or region. In any of these events, our results of operations could be materially and adversely affected.

If a natural or man-made disaster strikes any of our manufacturing facilities, we will be unable to manufacture our products for a substantial amount of time and our sales will decline.

We manufacture all of our products in 12 manufacturing facilities, located in Maple Plain, Minnesota; Rosemount, Minnesota; Plymouth, Minnesota; Brooklyn Park, Minnesota; Cary, North Carolina; Nashua, New Hampshire (3 facilities); Telford, United Kingdom; Feldkirchen, Germany; Eschenlohe, Germany; and Zama, Kanagawa, Japan. These facilities and the manufacturing equipment we use would be costly to replace and could require substantial lead time to repair or replace. Our facilities may be harmed by natural or man-made disasters, including, without limitation, earthquakes, floods, tornadoes, fires, hurricanes, tsunamis and nuclear disasters.

In the event any of our facilities are affected by a disaster, we may:

- be unable to meet the shipping deadlines of our customers;
- experience disruptions in our ability to process submissions and generate quotations, manufacture and ship parts, provide marketing and sales support and customer service, and otherwise operate our business, any of which could negatively impact our business;
- be forced to rely on third-party manufacturers;
- need to expend significant capital and other resources to address any damage caused by the disaster; and
- lose customers and be unable to regain those customers.

Although we possess insurance for damage to our property and the disruption of our business from casualties, this insurance may not be sufficient to cover all of our potential losses and may not continue to be available to us on acceptable terms, or at all.

If our present single or limited source suppliers become unavailable or inadequate, our customer relationships, results of operations and financial condition may be adversely affected.

We acquire substantially all of the manufacturing equipment and certain of our materials that are critical to the ongoing operation and future growth of our business from just a few third parties. We do not have long-term supply contracts with any of our suppliers and operate on a purchase-order basis. While most manufacturing equipment and materials for our products are available from multiple suppliers, certain of those items are only available from single or limited sources. Should any of our present single or limited source suppliers for manufacturing equipment or materials become unavailable or inadequate, or impose terms unacceptable to us such as increased pricing terms, we could be required to spend a significant amount of time and expense to develop alternate sources of supply, and we may not be successful in doing so on terms acceptable to us, or at all. Natural disasters, such as hurricanes, may affect our supply of materials, particularly resins, from time to time, and we may purchase larger amounts of certain materials in anticipation of future shortages or increases in pricing. In addition, if we were unable to find a suitable supplier for a particular type of manufacturing equipment or material, we could be required to modify our existing business processes and offerings to accommodate the situation. As a result, the loss of a single or limited source supplier could adversely affect our relationship with our customers and our results of operations and financial condition.

We may not be able to adequately protect or enforce our intellectual property rights, which could impair our competitive position.

Our success and future revenue growth will depend, in part, on our ability to protect our intellectual property. We rely primarily on patents, licenses, trademarks and trade secrets, as well as non-disclosure agreements and other methods, to protect our proprietary technologies and processes globally. Despite our efforts to protect our proprietary technologies and processes, it is possible that competitors or other unauthorized third parties may obtain, copy, use or disclose our technologies and processes. We cannot assure you that any of our existing or future patents will not be challenged, invalidated or circumvented. As such, any rights granted under these patents may not provide us with meaningful protection. We may not be able to obtain foreign patents corresponding to our United States patents. Even if foreign patents are granted, effective enforcement in foreign countries may not be available. If our patents and other intellectual property do not adequately protect our technology, our competitors may be able to offer product lines similar to ours. Our competitors may also be able to develop similar technology independently or design around our patents. Any of the foregoing events would lead to increased competition and lower revenue or gross margin, which would adversely affect our net income.

We may be subject to infringement claims.

We may be subject to intellectual property infringement claims from individuals, vendors and other companies who have acquired or developed patents in the fields of injection molding, CNC machining, 3D printing, sheet metal or part production for purposes of developing competing products or for the sole purpose of asserting claims against us. Any claims that our products or processes infringe the intellectual property rights of others, regardless of the merit or resolution of such claims, could cause us to incur significant costs in responding to, defending and resolving such claims, and may prohibit or otherwise impair our ability to commercialize new or existing products. If we are unable to effectively defend our processes, our market share, sales and profitability could be adversely impacted.

Our failure to expand our intellectual property portfolio could adversely affect the growth of our business and results of operations.

Expansion of our intellectual property portfolio is one of the available methods of growing our revenue and our profits. This involves a complex and costly set of activities with uncertain outcomes. Our ability to obtain patents and other intellectual property can be adversely affected by insufficient inventiveness of our employees, by changes in intellectual property laws, treaties, and regulations, and by judicial and administrative interpretations of those laws, treaties and regulations. Our ability to expand our intellectual property portfolio could also be adversely affected by the lack of valuable intellectual property for sale or license at affordable prices. There is no assurance that we will be able to obtain valuable intellectual property in the jurisdictions where we and our competitors operate or that we will be able to use or license that intellectual property.

We may be subject to product liability claims, which could result in material expense, diversion of management time and attention and damage to our business and reputation and brand.

The prototype parts we manufacture and the parts we manufacture in low volumes may contain undetected defects or errors that are not discovered until after the products have been installed and used by customers. This could result in claims from customers or others, damage to our business and reputation and brand, or significant costs to correct the defect or error.

We attempt to include provisions in our agreements with customers that are designed to limit our exposure to potential liability for damages arising from defects or errors in our products. However, it is possible that these limitations may not be effective as a result of unfavorable judicial decisions or laws enacted in the future.

The sale and support of our products entails the risk of product liability claims. Any product liability claim brought against us, regardless of its merit, could result in material expense, diversion of management time and attention, damage to our business and reputation and brand, and cause us to fail to retain existing customers or to fail to attract new customers.

Government regulation of the Internet and e-commerce is evolving, and unfavorable changes or failure by us to comply with these regulations could substantially harm our business and results of operations.

We are subject to general business regulations and laws as well as regulations and laws specifically governing the Internet and e-commerce. Existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, restrictions on imports and exports, customs, tariffs, user privacy, data protection, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, the provision of online payment services, broadband residential Internet access and the characteristics and quality of products and product lines. It is not clear how existing laws governing issues such as property use and ownership, sales and other taxes, fraud, libel and personal privacy apply to the Internet and e-commerce, especially where these laws were adopted prior to the advent of the Internet and do not contemplate or address the unique issues raised by the Internet or e-commerce. Those laws that do reference the Internet are being interpreted by the courts and their applicability and reach are therefore uncertain. The costs of compliance with these regulations may increase in the future as a result of changes in the regulations or the interpretation of them. Further, any failures on our part to comply with these regulations may subject us to significant liabilities. Those current and future laws and regulations or unfavorable resolution of these issues may substantially harm our business and results of operations.

Changes in, or interpretation of, tax rules and regulations may impact our effective tax rate and future profitability.

We are a multinational company based in the United States and subject to tax in multiple tax jurisdictions, both domestic and abroad. Our future effective tax rates could be adversely affected by changes in statutory tax rates or interpretation of tax rules, including those set forth in the Tax Cuts and Jobs Act enacted in 2017, and regulations in jurisdictions in which we do business, changes in the amount of revenue or earnings in the countries with varying statutory tax rates, or by changes in the valuation of deferred tax assets and liabilities.

In addition, we are subject to audits and examinations of previously filed income tax returns by the Internal Revenue Service, or IRS, and other domestic and foreign tax authorities. We regularly assess the potential impact of such examinations to determine the adequacy of our provision for income taxes and have reserved for potential adjustments that may result from the current examinations. We believe such estimates to be reasonable; however, there is no assurance that the final determination of any examination will not have an adverse effect on our operating results and financial position.

We may require additional capital to support business growth, and this capital might not be available on acceptable terms, if at all.

We intend to continue to make investments to support our business growth and may require additional funds to respond to business challenges, including the need to complement our growth strategy, increase market share in our current markets or expand into other markets, or broaden our technology, intellectual property or product line capabilities. Accordingly, we may need to engage in equity or debt financings to secure additional funds. If we raise additional funds through future issuances of equity or convertible debt securities, our existing shareholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock. Any debt financing we secure in the future could involve restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions. We may not be able to obtain additional financing on terms favorable to us, if at all. If we are unable to obtain adequate financing or financing on terms satisfactory to us when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly impaired, and our business may be harmed.

Any acquisition, strategic relationship, joint venture or investment could disrupt our business and harm our operating results and financial condition.

Our business and our customer base have been built primarily through organic growth. However, from time to time, we may selectively pursue acquisitions, strategic relationships, joint ventures or investments that we believe may allow us to complement our growth strategy, increase market share in our current markets or expand into other markets, or broaden our technology, intellectual property or product line capabilities. For example, in April 2014, we acquired FineLine to enable us to offer our customers 3D printing manufacturing processes; in October 2015, we acquired Alphaform to enable us to expand our 3D printing capabilities in Europe, and in November 2017, we acquired RAPID to enable us to offer our customers Sheet Metal and expand our CNC Machining processes. We cannot forecast the number, timing or size of any future acquisitions or other similar strategic transactions, or the effect that any such transactions might have on our operating or financial results. We have limited experience engaging in these types of transactions. Such transactions may be complex, time consuming and expensive, and may present numerous challenges and risks including:

- an acquired company, asset or technology not furthering our business strategy as anticipated;
- difficulties entering and competing in new product or geographic markets and increased competition, including price competition;
- integration challenges;
- challenges in working with strategic partners and resolving any related disagreements or disputes;
- high valuation for a company, asset or technology, or changes in the economic or market conditions or assumptions underlying our decision to make an acquisition;
- significant problems or liabilities, including increased intellectual property and employment related litigation exposure, associated with acquired businesses, assets or technologies;
- acquisition of a significant amount of goodwill, which could result in future impairment charges that would reduce our earnings; and
- requirements to record substantial charges and amortization expense related to certain purchased intangible assets, deferred stock compensation and other items, as well as other charges or expenses.

Any one of these challenges or risks could impair our ability to realize any benefit from our acquisitions, strategic relationships, joint ventures or investments after we have expended resources on them, as well as divert our management's attention. Any failure to successfully address these challenges or risks could disrupt our business and harm our operating results and financial condition. Moreover, any such transaction may not be viewed favorably by investors or stakeholders.

In addition, from time to time we may enter into negotiations for acquisitions, relationships, joint ventures or investments that are not ultimately consummated. These negotiations could result in significant diversion of management time, as well as substantial out-of-pocket costs.

Our business involves the use of hazardous materials, and we and our suppliers must comply with environmental laws and regulations, which can be expensive and restrict how we do business.

Our business involves the controlled storage, use and disposal of hazardous materials. We and our suppliers are subject to federal, state and local as well as foreign laws and regulations governing the use, manufacture, storage, handling and disposal of these hazardous materials. Although we believe that the safety procedures utilized by us and our suppliers for handling and disposing of these materials comply with the standards prescribed by these laws and regulations, we cannot eliminate the risk of accidental contamination or injury from these materials. In the event of an accident, state, federal or foreign authorities may curtail the use of these materials and interrupt our business operations. We do not currently maintain hazardous materials insurance coverage. If we are subject to any liability as a result of activities involving hazardous materials, our business and financial condition may be adversely affected and our reputation and brand may be harmed.

If we are unable to meet regulatory quality standards applicable to our manufacturing and quality processes for the parts we manufacture, our business, financial condition or operating results could be harmed.

As a manufacturer of CNC-machined and injection-molded custom parts, we comply with certain regulatory standards, including International Organization for Standardization, or ISO, 9001:2015 for our manufacturing facilities in Minnesota. In North Carolina, we comply with the ISO 9001:2015 standard for our plastics manufacturing and the AS9100D standard for our metals manufacturing. In New Hampshire, we comply with the ISO 9001:2015 and the AS9100D standards for our CNC-machined and sheet metal. We are also able to meet regulatory standards ISO 9001:2008 at our manufacturing facilities in Feldkirchen, Germany and Eschenlohe, Germany. We also meet regulatory standard ISO 13485 at our manufacturing facility in Eschenlohe, Germany and regulatory standard ISO 14001 at our manufacturing facility in Feldkirchen, Germany. We are also able to meet regulatory standards ISO 9001, ISO 14001 and ISO 27001 in Japan. If any regulatory inspection reveals that we are not in compliance with applicable standards, regulators may take action against us, including issuing a warning letter, imposing fines on us, requiring a recall of the parts we manufactured or closing our manufacturing facilities. If any of these actions were to occur, it could harm our reputation as well as our business, financial condition and operating results. In addition, we may need to obtain additional certifications in the future and there are no guarantees we would be able to do so on a timely basis, if at all. Moreover, obtaining and maintaining required regulatory certifications can be costly and divert management's attention.

We are subject to payment-related risks.

We accept payments using a variety of methods, including credit card, customer invoicing, physical bank check and payment upon delivery. As we offer new payment options to our customers, we may be subject to additional regulations, compliance requirements and fraud risk. For certain payment methods, including credit and debit cards, we pay interchange and other fees, which may increase over time and raise our operating costs and lower profitability. We rely on third parties to provide payment processing services, including the processing of credit cards, debit cards or electronic checks, and it could disrupt our business if these companies become unwilling or unable to provide these services to us. We are also subject to payment card association operating rules, certification requirements and rules governing electronic funds transfers, which could change or be reinterpreted to make it difficult or impossible for us to comply. If we fail to comply with these rules or requirements, we may be subject to fines and higher transaction fees and lose our ability to accept credit and debit card payments from our customers, process electronic funds transfers, or facilitate other types of online payments, and our business and operating results could be adversely affected.

Risks Relating to Ownership of Our Common Stock

Our stock price has been and may continue to be volatile.

In the year ended December 31, 2018, our common stock traded as high as \$165.00 and as low as \$102.02. The market for our common stock may become less active, liquid or orderly, which could depress the trading price of our common stock. Some of the factors, many of which are outside of our control, that may cause the market price of our common stock to fluctuate include:

- fluctuations in our financial condition and operating results;
- our ability to retain and attract customers and increase net sales;
- pricing pressures due to competition or otherwise and changes in gross margins;
- changes in general economic and market conditions, economic uncertainty and changes in product development activity levels;
- announcements by us or our competitors of technological innovations or new product or product lines offerings or significant acquisitions;
- timing, effectiveness, and costs of expansion and upgrades of our offerings, systems and infrastructure;
- changes in key personnel;
- success in entry into new markets and expansion efforts;
- the public's response to press releases or other public announcements by us or third parties, including our filings with the Securities and Exchange Commission and announcements relating to litigation;
- the projections we may provide to the public, any changes in these projections or our failure to meet these projections;
- the issuance of new or updated research or reports by any securities or industry analysts who follow our common stock, changes in analysts' financial estimates or ratings, and failure of securities analysts to initiate or maintain coverage of our common stock;
- changes in the market valuations of similar companies;
- significant lawsuits, including patent or shareholder litigation;
- changes in laws or regulations applicable to us;
- changes in accounting principles;
- the sustainability of an active trading market for our common stock;
- future sales of our common stock by us or our shareholders, including sales by our officers, directors and significant shareholders;
- share price and volume fluctuations attributable to inconsistent trading levels of our shares; and
- other events or factors, including those resulting from war, acts of terrorism, natural disasters or responses to these events.

In addition, the stock markets have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many companies. In the past, shareholders have instituted securities class action litigation following periods of market volatility. If we were to become involved in securities litigation, we could incur substantial costs and our resources and the attention of management could be diverted from our business.

If securities or industry analysts publish inaccurate or unfavorable research or reports about our business, our stock price and trading volume could decline.

The trading market for our common stock depends, in part, on the research and reports that securities or industry analysts publish about us or our business. We do not have any control over these analysts. If one or more of the analysts who covers us downgrades our common stock, changes their opinion of our shares or publishes inaccurate or unfavorable research about our business, our stock price would likely decline. If one or more of these analysts ceases coverage of us or fails to publish reports on us regularly, demand for our common stock could decrease and we could lose visibility in the financial markets, which could cause our stock price and trading volume to decline.

Our failure to maintain proper and effective internal controls over financial reporting and otherwise comply with Section 404 of the Sarbanes-Oxley Act or prevent or detect misstatements in our financial statements in the future could harm our business and cause a decrease in our stock price.

Ensuring that we have internal financial and accounting controls and procedures adequate to produce accurate financial statements on a timely basis is a costly and time-consuming effort that needs to be re-evaluated frequently. The Sarbanes-Oxley Act requires, among other things, that we maintain effective internal control over financial reporting and disclosure controls and procedures. In particular, we are required to perform annual system and process evaluation and testing of our internal control over financial reporting to allow management and our independent registered public accounting firm to report on the effectiveness of our internal control over financial reporting, as required by Section 404 of the Sarbanes-Oxley Act. If we are not able to comply with the requirements of Section 404 in the future, or if we fail to prevent or detect misstatements in the financial statements we include in our reports filed with the SEC, our business could be harmed and the market price of our common stock could decline.

Anti-takeover provisions in our charter documents and Minnesota law might discourage or delay acquisition attempts for us that you might consider favorable.

Our Third Amended and Restated Articles of Incorporation, as amended, and Amended and Restated By-Laws contain provisions that may make the acquisition of our company more difficult without the approval of our board of directors. These provisions:

- permit our board of directors to issue up to 10,000,000 shares of preferred stock, with any rights, preferences and privileges as our board may designate, including the right to approve an acquisition or other change in our control;
- provide that the authorized number of directors may be changed by resolution of the board of directors;
- provide that all vacancies, including newly created directorships, may, except as otherwise required by law, be filled by the affirmative vote of a majority of directors then in office, even if less than a quorum;
- provide that shareholders seeking to present proposals before a meeting of shareholders or to nominate candidates for election as directors at a meeting of shareholders must provide notice in writing in a timely manner, and also specify requirements as to the form and content of a shareholder's notice; and
- do not provide for cumulative voting rights.

We are subject to the provisions of Section 302A.673 of the Minnesota Statutes, which regulates business combinations. Section 302A.673 generally prohibits any business combination by an issuing public corporation, or any of its subsidiaries, with an interested shareholder, which means any shareholder that purchases 10% or more of the corporation's voting shares within four years following the date the person became an interested shareholder, unless the business combination is approved by a committee composed solely of one or more disinterested members of the corporation's board of directors before the date the person became an interested shareholder.

These anti-takeover provisions could discourage, delay or prevent a transaction involving a change in control of our company, even if doing so would benefit our shareholders. These provisions could also discourage proxy contests and make it more difficult for you and other shareholders to elect directors of your choosing and to cause us to take other corporate actions you desire.

We do not expect to pay any cash dividends for the foreseeable future.

We have never declared or paid any cash dividends on our common stock, and we do not anticipate that we will pay any such cash dividends for the foreseeable future. We anticipate that we will retain all of our future earnings for use in the business and for general corporate purposes. Any determination to pay dividends in the future will be at the discretion of our board of directors and will depend upon results of operations, financial condition, contractual restrictions, restrictions imposed by applicable law and other factors our board of directors deems relevant.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We believe that our facilities are well maintained and of sufficient capacity to support our current operations. We have facilities in the following regions:

United States

Our corporate headquarters are located in Maple Plain, Minnesota in a facility we own encompassing approximately 95,000 square feet of office space. We also own a nearby facility encompassing approximately 35,000 square feet of manufacturing space. We own a facility in Rosemount, Minnesota that encompasses approximately 130,000 square feet of manufacturing and office space. We also own a facility in Plymouth, Minnesota that encompasses approximately 170,000 square feet of manufacturing and office space. We recently purchased a facility in Brooklyn Park, Minnesota that encompasses approximately 215,000 square feet of manufacturing and office space.

We own a facility in Cary, North Carolina that encompasses approximately 77,000 square feet of manufacturing and office space.

In November 2017, we purchased RAPID and assumed the leases of three facilities in Nashua, New Hampshire. The three facilities we lease total approximately 146,000 square feet of manufacturing and office space. The leases expire at various times from 2019 to 2022.

Europe

Our European operations are headquartered in Telford, United Kingdom in a facility we own encompassing approximately 126,000 square feet of office and manufacturing space.

We also lease office space in the United Kingdom; Mosbach, Germany; Le Bourget du Lac, France; Novara, Italy and Nacka, Sweden, for sales, customer service and technical support staff. The leases expire at various times from 2019 to 2025. In October 2015, we purchased Alphaform, headquartered in Feldkirchen (Munich), Germany. As a result of the acquisition, we lease manufacturing and office facilities encompassing approximately 60,000 square feet in Feldkirchen, Germany and approximately 22,000 square feet in Eschenlohe, Germany. The leases expire at various times from 2019 to 2028.

Japan

Our Japan operations are headquartered in Zama, Kanagawa, Japan (southwest of Tokyo). In 2016, we moved into a new leased facility encompassing approximately 96,000 square feet of office and manufacturing space. The lease expires in April 2023.

Item 3. 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 this Annual Report on Form 10-K, 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 4. Mine Safety Disclosures

Not applicable.

PART II**Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock has traded on the New York Stock Exchange (NYSE) under the symbol “PRLB” since February 24, 2012. Prior to that date, there was no public market for our common stock.

As of February 15, 2019, we had 10 holders of record of our common stock. The actual number of shareholders is greater than this number of record holders, and includes shareholders who are beneficial owners, but whose shares are held in street name by brokers and other nominees.

We have never declared or paid any cash dividends on our capital stock and we do not intend to pay cash dividends on our common stock for the foreseeable future. Any future determination related to our dividend policy will be made at the discretion of our board of directors and will depend on then-existing conditions, including our financial condition, operating results, contractual restrictions, capital requirements, business prospects and other factors our board of directors may deem relevant.

Outstanding Equity Awards

The following table summarizes, as of December 31, 2018, information about shares of our common stock that may be issued under equity compensation plans approved by shareholders and plans not approved by shareholders:

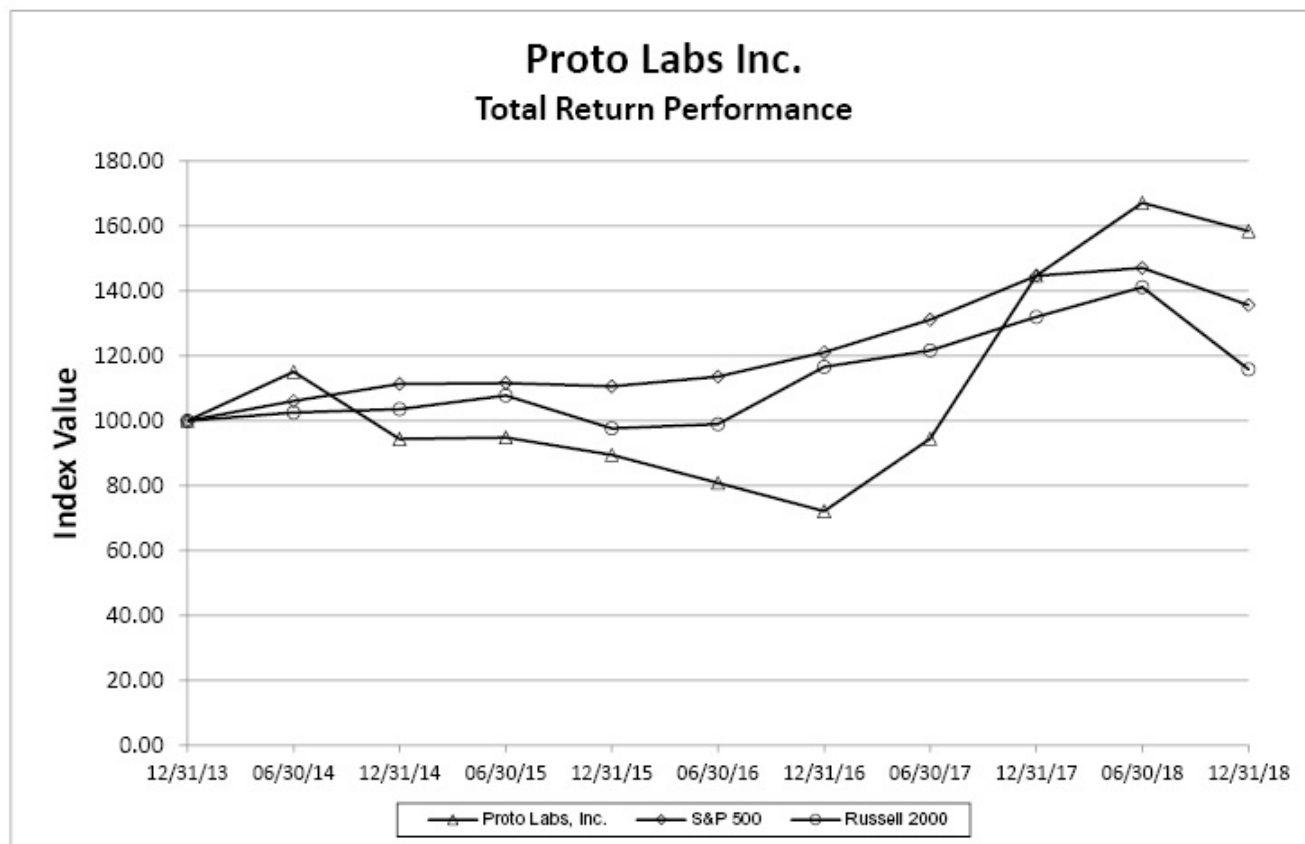
| Plan Category | Number of shares to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of shares remaining available for future issuance under equity compensation plans (excluding shares in first column) |
|---|--|--|--|
| Equity compensation plans approved by shareholders ⁽¹⁾ | 622,250 | \$64.71 | 6,354,388 ⁽²⁾ |
| Equity compensation plans not approved by shareholders | None | N/A | None |

⁽¹⁾ Includes the 2000 Stock Option Plan, the 2012 Long-Term Incentive Plan and our Employee Stock Purchase Plan.

⁽²⁾ Includes 1,210,445 shares remaining available for issuance as of December 31, 2018 under our Employee Stock Purchase Plan.

Performance Graph

The following graph shows a comparison from December 31, 2013 through December 31, 2018 of the cumulative total return for our common stock, the S&P 500 Index and the Russell 2000 Index. We have selected the Russell 2000 Index because the Russell 2000 Index measures the performance of the small market capitalization segment of U.S. equity instruments and we are a member company included in the Russell 2000 Index. Such returns are based on historical results and are not intended to suggest future performance. Data for the S&P 500 Index and the Russell 2000 Index assume reinvestment of dividends.



| Index | 12/31/13 | 06/30/14 | 12/31/14 | 06/30/15 | 12/31/15 | 06/30/16 | 12/31/16 | 06/30/17 | 12/31/17 | 06/30/18 | 12/31/18 |
|------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| Proto Labs, Inc. | 100.00 | 115.09 | 94.35 | 94.80 | 89.48 | 80.87 | 72.14 | 94.48 | 144.70 | 167.11 | 158.46 |
| S&P 500 | 100.00 | 106.05 | 111.39 | 111.62 | 110.58 | 113.55 | 121.13 | 131.11 | 144.65 | 147.07 | 135.63 |
| Russell 2000 | 100.00 | 102.52 | 103.53 | 107.76 | 97.62 | 98.99 | 116.63 | 121.63 | 131.96 | 141.20 | 115.89 |

Unregistered Sales of Equity Securities and Issuer Purchases of Equity Securities

On February 9, 2017, we announced that our board of directors had authorized the repurchase of shares of our common stock from time to time on the open market or in privately negotiated purchases, at an aggregate purchase price of up to \$50 million. The timing and amount of any share repurchases will be determined by our management based on market conditions and other factors. The term of the program runs through December 31, 2021.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (in thousands) (1) |
|--|-------------------------------------|---------------------------------|--|---|
| October 1, 2018 through October 31, 2018 | 7,500 | \$ 116.95 | 7,500 | \$ 44,715 |
| November 1, 2018 through November 30, 2018 | 54,098 | \$ 121.58 | 54,098 | \$ 38,138 |
| December 1, 2018 through December 31, 2018 | 43,000 | \$ 110.98 | 43,000 | \$ 33,366 |
| | <u>104,598</u> | \$ 116.89 | <u>104,598</u> | \$ 33,366 |

(1) Effective February 9, 2017 the Board of Directors authorized the repurchase of shares of the Company's common stock from time to time on the open market or in privately negotiated purchases, at an aggregate purchase price of up to \$50 million. The term of the program runs through December 31, 2021.

During the year ended December 31, 2018, we repurchased 104,598 shares at an average price of \$116.89 per share for an aggregate purchase price of \$12.2 million. We have \$33.4 million remaining under this authorization.

Item 6. Selected Financial Data

The following tables set forth selected consolidated financial data for the periods and at the dates indicated. The selected consolidated statements of comprehensive income data for the years ended December 31, 2018, 2017 and 2016 and selected consolidated balance sheets data as of December 31, 2018 and 2017 are derived from our audited consolidated financial statements included in Item 8. "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K. The selected consolidated statements of comprehensive income data for the years ended December 31, 2015 and 2014 and selected consolidated balance sheet data as of December 31, 2016, 2015 and 2014 are derived from our audited consolidated financial statements not included in this report.

The historical results presented below are not necessarily indicative of the results to be expected for any future period. You should read this selected consolidated financial data in conjunction with Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and the consolidated financial statements and related notes appearing in Item 8. “Financial Statements and Supplementary Data” of this Annual Report on Form 10-K.

| (in thousands, except share and per share amounts) | Year Ended December 31, | | | | |
|---|-------------------------|------------|------------|------------|------------|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| Consolidated Statements of Comprehensive Income Data | | | | | |
| Revenue | \$ 445,596 | \$ 344,490 | \$ 298,055 | \$ 264,106 | \$ 209,583 |
| Cost of revenue | 206,917 | 150,648 | 131,118 | 109,703 | 81,182 |
| Gross profit | 238,679 | 193,842 | 166,937 | 154,403 | 128,401 |
| Operating expenses: | | | | | |
| Marketing and sales | 68,533 | 56,856 | 46,131 | 39,188 | 29,144 |
| Research and development | 28,735 | 23,560 | 22,388 | 18,350 | 16,607 |
| General and administrative | 52,513 | 41,200 | 36,651 | 29,716 | 22,122 |
| Total operating expenses | 149,781 | 121,616 | 105,170 | 87,254 | 67,873 |
| Income from operations | 88,898 | 72,226 | 61,767 | 67,149 | 60,528 |
| Other income, net | 2,757 | 2,209 | 2,454 | 712 | 3 |
| Income before income taxes | 91,655 | 74,435 | 64,221 | 67,861 | 60,531 |
| Provision for income taxes | 15,067 | 22,657 | 21,514 | 21,347 | 18,896 |
| Net income | \$ 76,588 | \$ 51,778 | \$ 42,707 | \$ 46,514 | \$ 41,635 |
| Net income per share ⁽¹⁾ | | | | | |
| Basic | \$ 2.84 | \$ 1.94 | \$ 1.62 | \$ 1.79 | \$ 1.62 |
| Diluted | \$ 2.81 | \$ 1.93 | \$ 1.61 | \$ 1.77 | \$ 1.60 |
| Weighted average shares outstanding ⁽¹⁾ | | | | | |
| Basic | 26,982,614 | 26,647,610 | 26,365,173 | 26,005,858 | 25,692,699 |
| Diluted | 27,278,816 | 26,845,071 | 26,564,639 | 26,320,284 | 26,100,320 |
| Other comprehensive income (loss) (net of tax) | | | | | |
| Foreign currency translation adjustments | \$ (3,258) | \$ 5,519 | \$ (5,541) | \$ (2,283) | \$ (1,838) |
| Comprehensive income | \$ 73,330 | \$ 57,297 | \$ 37,166 | \$ 44,231 | \$ 39,797 |

- (1) See Note 3 of Notes to Consolidated Financial Statements for an explanation of the method used to calculate net income per basic and diluted share attributable to common shareholders and weighted average shares outstanding for the years ended December 31, 2018, 2017, and 2016, respectively.

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

| (in thousands) | Year Ended December 31, | | | | |
|--|-------------------------|----------|----------|----------|----------|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| Stock options and grants | \$ 10,113 | \$ 7,954 | \$ 6,177 | \$ 5,580 | \$ 4,386 |
| Employee stock purchase plan | 815 | 604 | 598 | 502 | 423 |
| Total stock-based compensation expense | \$ 10,928 | \$ 8,558 | \$ 6,775 | \$ 6,082 | \$ 4,809 |
| Cost of revenue | \$ 1,543 | \$ 970 | \$ 691 | \$ 513 | \$ 386 |
| Operating expenses: | | | | | |
| Marketing and sales | 1,942 | 1,429 | 977 | 1,074 | 927 |
| Research and development | 1,517 | 1,091 | 1,396 | 1,285 | 1,048 |
| General and administrative | 5,926 | 5,068 | 3,711 | 3,210 | 2,448 |
| Total stock-based compensation expense | \$ 10,928 | \$ 8,558 | \$ 6,775 | \$ 6,082 | \$ 4,809 |

| (in thousands) | Year Ended December 31, | | | | |
|---|-------------------------|------------|------------|------------|------------|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| Consolidated Balance Sheets Data | | | | | |
| Cash and cash equivalents | \$ 85,046 | \$ 36,707 | \$ 68,795 | \$ 47,653 | \$ 43,329 |
| Working capital | 162,628 | 121,249 | 134,357 | 111,740 | 89,102 |
| Total assets | 618,985 | 518,738 | 414,241 | 361,036 | 287,031 |
| Total liabilities | 77,488 | 57,523 | 34,408 | 33,391 | 21,492 |
| Total shareholders' equity | \$ 541,497 | \$ 461,215 | \$ 379,833 | \$ 327,645 | \$ 265,539 |

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 consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K. This discussion and analysis contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under “Risk Factors” and elsewhere in this Annual Report on Form 10-K.

Overview

We are an e-commerce driven digital manufacturer of quick-turn, on-demand injection-molded, CNC-machined, 3D-printed and sheet metal-fabricated custom parts for prototyping and short-run production. We provide custom parts 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 in low volumes, and our customers conduct nearly all of their business with us over the Internet. We target our product lines to the millions of product developers and engineers who use 3D CAD software to design products across a diverse range of end markets. Our primary manufacturing product lines currently include Injection Molding, CNC Machining, 3D Printing and Sheet Metal.

We have experienced significant growth since our inception. Since we first introduced our Injection Molding product line in 1999, we have steadily expanded the size and geometric complexity of the injection-molded parts we are able to manufacture, and we continue to extend the diversity of materials we are able to support. Similarly, since first introducing our CNC Machining product line in 2007, we have expanded the range of part sizes, design geometries and materials we can support. In 2014, we acquired FineLine Prototyping, Inc. (FineLine) to expand the number of process types we offer to include stereolithography (SL), selective laser sintering (SLS) and direct metal laser sintering (DMLS). In 2017, we acquired RAPID to expand the number of process types we offer to include sheet metal fabrication and expand our CNC machining capability. We also continually seek to enhance other aspects of our technology and manufacturing processes, including our interactive web-based and automated user interface and quoting system. We intend to continue to invest significantly to enhance our technology and manufacturing processes and expand the range of our existing capabilities with the aim of meeting the needs of a broader set of customers. As a result of the factors described above, many of our customers tend to return to Proto Labs to meet their ongoing needs, with approximately 91%, 89% and 86% of our revenue in 2018, 2017 and 2016, respectively, derived from existing customers.

We have established our operations in the United States, Europe and Japan, which we believe are three of the largest geographic markets where product developers and engineers are located. We entered the European market in 2005, launched operations in Japan in late 2009 and further expanded into Europe through our acquisition of Alphaform in 2015 and the United States through our acquisition of RAPID in November 2017. As of December 31, 2018, we had sold products into approximately 60 countries. Our revenue outside of the United States accounted for approximately 21%, 24% and 25% of our consolidated revenue in the years ended December 31, 2018, 2017 and 2016, respectively. We intend to continue to expand our international sales efforts and believe opportunities exist to serve the needs of product developers and engineers in select new geographic regions.

We have grown our total revenue from \$209.6 million in 2014 to \$445.6 million in 2018. During this period, our operating expenses increased from \$67.9 million in 2014 to \$149.8 million in 2018. We have grown our income from operations from \$60.5 million in 2014 to \$88.9 million in 2018. Our recent growth in revenue and income from operations has been accompanied by increased cost of revenues and operating expenses. We expect to increase investment in our operations to support anticipated future growth as discussed more fully below.

In addition, we believe that a number of trends affecting our industry have affected our results of operations and may continue to do so. For example, we believe that many of our target product developer and engineer customers are facing three mega trends, which are disrupting product growth models. We believe our customers are facing increased pressure to shorten product life-cycles, to embed products with internet of things technology, and to deliver products that are personalized and customized to unique customer specifications. We believe we continue to be well positioned to benefit from these trends, given our proprietary technology that enables us to automate and integrate the majority of activities involved in procuring custom parts. While our business may be positively affected by these trends, our results may also be favorably or unfavorably impacted by other trends that affect product developer and engineer orders for custom parts in low volumes, including, among others, changes in product developer and engineer preferences or needs, developments in our industry and among our competitors, and factors impacting new product development volume such as economic conditions. For a more complete discussion of the risks facing our business, see Part I, Item 1A. “Risk Factors” of this Annual Report on Form 10-K.

Key Financial Measures and Trends

Revenue

Our operations are comprised of three geographic operating segments in the United States, Europe and Japan. Revenue is derived from our Injection Molding, CNC Machining, 3D Printing and Sheet Metal product lines. Injection Molding revenue consists of sales of custom injection molds and injection-molded parts. CNC Machining revenue consists of sales of CNC-machined custom parts. 3D Printing revenue consists of sales of 3D-printed parts. Sheet Metal revenue consists of sales of fabricated sheet metal custom parts. Our revenue is generated from a diverse customer base, with no single customer company representing more than 2% of our total revenue in 2018. 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, including:

- the introduction of our 3D Printing product line through our acquisition of FineLine in 2014;
- expanding 3D printing to Europe through our acquisition of Alphaform in October 2015;
- the introduction of our Sheet Metal product line through our acquisition of RAPID in 2017;
- continuously improving the usability of our product lines such as our web-centric applications; and
- expanding the breadth and scope of our products by adding more sizes and materials to our offerings.

During 2018, we served 45,968 unique product developers and engineers who purchased our products through our web-based customer interface, an increase of 22.5% over the same period in 2017.

During 2017, we served 37,538 unique product developers and engineers who purchased our products through our web-based customer interface, an increase of 19.3% over the same period in 2016.

During 2016, we served 31,457 unique product developers and engineers who purchased our products through our web-based customer interface, an increase of 15.5% over the same period in 2015. The 2016 information does not include 3D Printing and Injection Molding customers resulting from the Alphaform acquisition who do not utilize our web-based interface.

Cost of Revenue, Gross Profit and Gross Margin

Cost of revenue consists primarily of raw materials, equipment depreciation, employee compensation, benefits, stock-based compensation, 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.

Our business model requires that we invest in our capacity well in advance of demand to ensure we can fulfill the expectations for quick delivery of our products to our customers. Therefore, during each of 2018, 2017 and 2016 we made significant investments in additional factory space, equipment, and infrastructure in the United States. We also made significant investments in infrastructure in Europe in 2017 and significant investments in additional factory space in Japan in 2016. We expect to continue to grow in future periods, which will result in the need for additional investments in factory space and equipment. We expect that these additional costs for factory and equipment expansion can be absorbed by revenue growth, and allow gross margins by product line to remain relatively consistent over time.

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 mix of revenue by product line, pricing, sales volume and manufacturing costs, the costs associated with increasing production capacity, 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 in each of these 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, 3D-printed and sheet metal 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 electronic, print and pay-per-click advertising, trade shows 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 and grow revenue.

Research and development. Research and development expense consists primarily of personnel and outside service costs related to the development of new processes and product lines, enhancement of existing product lines, software developed for internal use, maintenance of internally developed software, quality assurance and testing. Costs for internal use software are evaluated by project and capitalized where appropriate under Accounting Standards Codification (ASC) 350-40, *Intangibles — Goodwill and Other, Internal-Use Software*. We expect research and development expense to increase in the future as we seek to enhance and expand our product line offerings and supporting business systems.

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, Net

Other income, 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. On December 22, 2017, the Tax Cuts and Jobs Act was signed into law in the United States. As a result, many provisions will affect our tax rate in future years. Some provisions, such as the reduction to the U.S. corporate tax rate from 35% to 21%, beginning in 2018, will likely reduce our effective tax rate in future years. Other provisions taken in isolation, such as the elimination of the Domestic Production Activities Deduction, will likely result in an increase to our tax rate. Overall, we anticipate our effective tax rate will be lower in 2018 and beyond than in recent periods based on the current tax laws.

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) | Year Ended December 31, | | | | Change | | Year Ended December 31, | | | | Change | |
|----------------------------|----------------------------|--------|-----------|--------|-----------|--------|----------------------------|--------|-----------|--------|----------|--------|
| | 2018 | | 2017 | | \$ | % | 2017 | | 2016 | | \$ | % |
| Revenue | \$445,596 | 100.0% | \$344,490 | 100.0% | \$101,106 | 29.3 | \$344,490 | 100.0% | \$298,055 | 100.0% | \$46,435 | 15.6 |
| Cost of revenue | 206,917 | 46.4 | 150,648 | 43.7 | 56,269 | 37.4 | 150,648 | 43.7 | 131,118 | 44.0 | 19,530 | 14.9 |
| Gross profit | 238,679 | 53.6 | 193,842 | 56.3 | 44,837 | 23.1 | 193,842 | 56.3 | 166,937 | 56.0 | 26,905 | 16.1 |
| Operating expenses: | | | | | | | | | | | | |
| Marketing and sales | 68,533 | 15.4 | 56,856 | 16.5 | 11,677 | 20.5 | 56,856 | 16.5 | 46,131 | 15.5 | 10,725 | 23.2 |
| Research and development | 28,735 | 6.4 | 23,560 | 6.8 | 5,175 | 22.0 | 23,560 | 6.8 | 22,388 | 7.5 | 1,172 | 5.2 |
| General and administrative | 52,513 | 11.8 | 41,200 | 12.0 | 11,313 | 27.5 | 41,200 | 12.0 | 36,651 | 12.3 | 4,549 | 12.4 |
| Total operating expenses | 149,781 | 33.6 | 121,616 | 35.3 | 28,165 | 23.2 | 121,616 | 35.3 | 105,170 | 35.3 | 16,446 | 15.6 |
| Income from operations | 88,898 | 20.0 | 72,226 | 21.0 | 16,672 | 23.1 | 72,226 | 21.0 | 61,767 | 20.7 | 10,459 | 16.9 |
| Other income, net | 2,757 | 0.6 | 2,209 | 0.6 | 548 | 24.8 | 2,209 | 0.6 | 2,454 | 0.8 | (245) | (10.0) |
| Income before income taxes | 91,655 | 20.6 | 74,435 | 21.6 | 17,220 | 23.1 | 74,435 | 21.6 | 64,221 | 21.5 | 10,214 | 15.9 |
| Provision for income taxes | 15,067 | 3.4 | 22,657 | 6.6 | (7,590) | (33.5) | 22,657 | 6.6 | 21,514 | 7.2 | 1,143 | 5.3 |
| Net income | \$ 76,588 | 17.2% | \$ 51,778 | 15.0% | \$ 24,810 | 47.9% | \$ 51,778 | 15.0% | \$ 42,707 | 14.3% | \$ 9,071 | 21.2% |

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

| (dollars in thousands) | Year Ended December 31, | | |
|--|-------------------------|----------|----------|
| | 2018 | 2017 | 2016 |
| Stock options and grants | \$ 10,113 | \$ 7,954 | \$ 6,177 |
| Employee stock purchase plan | 815 | 604 | 598 |
| Total stock-based compensation expense | \$ 10,928 | \$ 8,558 | \$ 6,775 |
| Cost of revenue | \$ 1,543 | \$ 970 | \$ 691 |
| Operating expenses: | | | |
| Marketing and sales | 1,942 | 1,429 | 977 |
| Research and development | 1,517 | 1,091 | 1,396 |
| General and administrative | 5,926 | 5,068 | 3,711 |
| Total stock-based compensation expense | \$ 10,928 | \$ 8,558 | \$ 6,775 |

Comparison of Years Ended December 31, 2018 and 2017

Revenue

Revenue by reportable segment and the related changes for 2018 and 2017 is summarized as follows:

| (dollars in thousands) | Year Ended December 31, | | | | Change | |
|------------------------|-------------------------|--------------------|------------|--------------------|------------|-------|
| | 2018 | | 2017 | | | |
| | \$ | % of Total Revenue | \$ | % of Total Revenue | \$ | % |
| Revenue | | | | | | |
| United States | \$ 350,535 | 78.7% | \$ 263,086 | 76.4% | \$ 87,449 | 33.2% |
| Europe | 80,889 | 18.2 | 70,154 | 20.4 | 10,735 | 15.3 |
| Japan | 14,172 | 3.1 | 11,250 | 3.2 | 2,922 | 26.0 |
| Total revenue | \$ 445,596 | 100.0% | \$ 344,490 | 100.0% | \$ 101,106 | 29.3% |

Our revenue increased \$101.1 million, or 29.3%, for 2018 compared with 2017. By reportable segment, revenue in the United States increased \$87.4 million, or 33.2%, for 2018 compared with 2017. Revenue growth in the United States was partially attributable to the acquisition of RAPID in November 2017. Revenue in Europe increased \$10.7 million, or 15.3%, for 2018 compared with 2017. Revenue in Japan increased \$2.9 million, or 26.0%, for 2018 compared with 2017.

Our revenue growth in 2018 was primarily driven by an increased volume of the product developers and engineers we served. During 2018, we served 45,968 unique product developers and engineers, an increase of 22.5% over 2017. Average revenue per product developer or engineer increased 6% during 2018 as compared to 2017 due to changes in the mix of products purchased by our customers.

Our revenue increases were primarily driven by increases in sales personnel and marketing activities. Our sales personnel focus on gaining new customer accounts and expanding the depth and breadth of existing customer accounts. Our marketing personnel focus on marketing activities that have proven to generate the greatest number of customer leads to support sales activity. International revenue increased by \$3.5 million in 2018 compared to 2017 as a result of foreign currency movements, primarily the strengthening of the Euro relative to the United States dollar.

Revenue by product line and the related changes for 2018 and 2017 is summarized as follows:

| (dollars in thousands) | Year Ended December 31, | | | | Change | |
|------------------------|-------------------------|------------|------------|------------|------------|-------|
| | 2018 | | 2017 | | | |
| | | % of Total | | % of Total | | |
| | \$ | Revenue | \$ | Revenue | \$ | % |
| Revenue | | | | | | |
| Injection Molding | \$ 210,523 | 47.2% | \$ 194,432 | 56.4% | \$ 16,091 | 8.3% |
| CNC Machining | 153,521 | 34.5 | 103,739 | 30.1 | 49,782 | 48.0 |
| 3D Printing | 53,342 | 12.0 | 43,329 | 12.6 | 10,013 | 23.1 |
| Sheet Metal | 24,998 | 5.6 | 1,767 | 0.5 | 23,231 | * |
| Other Revenue | 3,212 | 0.7 | 1,223 | 0.4 | 1,989 | * |
| Total revenue | \$ 445,596 | 100.0% | \$ 344,490 | 100.0% | \$ 101,106 | 29.3% |

*Percentage change not meaningful

By product line, our revenue growth was driven by an 8.3% increase in Injection Molding revenue, a 48.0% increase in CNC Machining revenue and a 23.1% increase in 3D Printing revenue, as well as a \$23.2 million increase in Sheet Metal revenue and a \$2.0 million increase in Other Revenue, in each case for 2018 compared with 2017. Our November 2017 acquisition of RAPID added the Sheet Metal product line, expanded our CNC Machining product line and contributed to Other Revenue.

Cost of Revenue, Gross Profit and Gross Margin

Cost of Revenue. Cost of revenue increased \$56.3 million, or 37.4%, for 2018 compared to 2017, which was faster than the rate of revenue increase of 29.3% for 2018 compared to 2017. The increase in cost of revenue resulted from the growth of the business, including via the RAPID acquisition, and was due to raw material and production cost increases of \$16.6 million to support increased sales volumes, an increase in direct labor headcount resulting in personnel and related cost increases of \$30.8 million and equipment and facility-related cost increases of \$8.9 million.

Gross Profit and Gross Margin. Gross profit increased from \$193.8 million in 2017 to \$238.7 million in 2018 primarily due to an increase in revenue. Gross margin decreased from 56.3% of revenue in 2017 to 53.6% of revenue in 2018 primarily due to the timing and mix of revenue, with the RAPID acquisition and CNC facility relocation in the United States being the primary drivers of the reduction in gross margin.

Income from Operations

Income from operations increased \$16.7 million, or 23.1%, for 2018 compared with 2017. By reportable segment, income from operations for the United States, Europe and Corporate Unallocated and Japan increased 17.0%, 30.8% and 10.9%, respectively, as a percentage of revenue for 2018 compared with 2017.

Operating Expenses

Marketing and Sales. Marketing and sales expense increased \$11.7 million, or 20.5%, for 2018 compared to 2017 due to an increase in headcount resulting in personnel and related cost increases of \$10.0 million and marketing program cost increases of \$1.7 million. The increase in marketing program costs is the result of our focus on funding those programs that have proven to be the most effective in growing our business.

Research and Development. Our research and development expense increased \$5.2 million, or 22.0%, for 2018 compared to 2017 due to an increase in headcount resulting in personnel and related cost increases of \$4.9 million and professional services cost increases of \$0.6 million, which were partially offset by a decrease in operating cost of \$0.3 million.

General and Administrative. Our general and administrative expense increased \$11.3 million, or 27.5%, for 2018 compared to 2017 due to an increase in headcount resulting in personnel and related cost increases of \$2.4 million, stock- based compensation cost increases of \$0.9 million, administrative cost increases of \$5.3 million and amortization cost increases of \$2.7 million.

Other Income, Net and Provision for Income Taxes

Other Income, Net. We recognized other income, net of \$2.8 million in 2018, an increase of \$0.6 million compared to other income, net of \$2.2 million for 2017. Other income, net for 2018 primarily consisted of \$1.7 million in interest income on investments, a \$0.7 million gain on our sale of RAPID Wire & Cable, LLC and a \$0.4 million gain on foreign currency. Other income, net for 2017 primarily consisted of \$1.5 million in interest income on investments, a \$0.4 million favorable legal settlement and a \$0.3 million gain on foreign currency.

Provision for Income Taxes. Our income tax provision decreased by \$7.6 million for 2018 compared to 2017. The decrease in the provision is primarily due to the Tax Cuts and Jobs Act that went into effect in 2018 and benefits from the vesting of restricted stock and the exercise of stock options. Our effective tax rate of 16.4% for 2018 decreased 14.0% compared to 30.4% for the same period in 2017.

Comparison of Years Ended December 31, 2017 and 2016

Revenue

Revenue by reportable segment and the related changes for 2017 and 2016 is summarized as follows:

| (dollars in thousands) | Year Ended December 31, | | | | Change | |
|------------------------|-------------------------|------------|------------|------------|-----------|-------|
| | 2017 | | 2016 | | | |
| | | % of Total | | % of Total | | |
| | \$ | Revenue | \$ | Revenue | \$ | % |
| Revenue | | | | | | |
| United States | \$ 263,086 | 76.4% | \$ 223,930 | 75.1% | \$ 39,156 | 17.5% |
| Europe | 70,154 | 20.4 | 63,365 | 21.3 | 6,789 | 10.7 |
| Japan | 11,250 | 3.2 | 10,760 | 3.6 | 490 | 4.6 |
| Total revenue | \$ 344,490 | 100.0% | \$ 298,055 | 100.0% | \$ 46,435 | 15.6% |

Our revenue increased \$46.4 million, or 15.6%, for 2017 compared with 2016. By reportable segment, revenue in the United States increased \$39.2 million, or 17.5%, for 2017 compared with 2016. Revenue growth in the United States was partially attributable to the acquisition of RAPID in November 2017, which contributed \$3.6 million in revenue. Excluding RAPID, revenue in the United States increased \$35.6 million, or 15.9%, for 2017 compared with 2016.

Revenue in Europe increased \$6.8 million, or 10.7%, for 2017 compared with 2016. Revenue in Japan increased \$0.5 million, or 4.6%, for 2017 compared with 2016.

Our revenue growth in 2017 was the result of increased volume of the product developers and engineers we served. During 2017, we served 37,538 unique product developers and engineers, an increase of 19.3% over 2016. Average revenue per product developer or engineer remained relatively consistent during 2017 as compared to 2016.

Our revenue increases were primarily driven by increases in sales personnel and marketing activities. Our sales personnel focus on gaining new customer accounts and expanding the depth and breadth of existing customer accounts. Our marketing personnel focus on marketing activities that have proven to result in the greatest number of customer leads to support sales activity. The impact on international revenue in 2017 compared to 2016 as a result of foreign currency movements was not material.

Revenue by product line and the related changes for 2017 and 2016 is summarized as follows:

| (dollars in thousands) | Year Ended December 31, | | | | Change | |
|------------------------|-------------------------|------------|------------|------------|-----------|--------|
| | 2017 | | 2016 | | | |
| | | % of Total | | % of Total | | |
| | \$ | Revenue | \$ | Revenue | \$ | % |
| Revenue | | | | | | |
| Injection Molding | \$ 194,432 | 56.4% | \$ 175,974 | 59.0% | \$ 18,458 | 10.5% |
| CNC Machining | 103,739 | 30.1 | 81,407 | 27.3 | 22,332 | 27.4 |
| 3D Printing | 43,329 | 12.6 | 37,847 | 12.7 | 5,482 | 14.5 |
| Sheet Metal | 1,767 | 0.5 | - | - | 1,767 | 100.0 |
| Other Revenue | 1,223 | 0.4 | 2,827 | 1.0 | (1,604) | (56.7) |
| Total revenue | \$ 344,490 | 100.0% | \$ 298,055 | 100.0% | \$ 46,435 | 15.6% |

By product line, our revenue growth was driven by a 10.5% increase in Injection Molding revenue, a 27.4% increase in CNC Machining revenue and a 14.5% increase in 3D Printing revenue, in each case for 2017 compared with 2016, which was partially offset by a \$1.6 million decrease in Other Product revenue. As a result of our acquisition of RAPID in November 2017, we experienced a \$1.8 million increase in Sheet Metal revenue, a \$1.7 million increase in CNC Machining revenue and a \$0.2 million increase in Other Product revenue.

Cost of Revenue, Gross Profit and Gross Margin

Cost of Revenue. Cost of revenue increased \$19.5 million, or 14.9%, for 2017 compared to 2016, which was slower than the rate of revenue increase of 15.6% for 2017 compared to 2016 reflecting the realization of productivity improvements. The increase in cost of revenue resulted from the growth of the business, including via the RAPID acquisition, and was due to raw material and production cost increases of \$5.6 million to support increased sales volumes, an increase in direct labor headcount resulting in personnel and related cost increases of \$12.7 million and equipment and facility-related cost increases of \$1.2 million.

Gross Profit and Gross Margin. Gross profit increased from \$166.9 million in 2016 to \$193.8 million in 2017 primarily due to an increase in revenue growth. Gross margin increased from 56.0% of revenue in 2016 to 56.3% of revenue in 2017 primarily due to increases in revenue and realization of manufacturing productivity improvements.

Income from Operations

Income from operations increased \$10.5 million, or 16.9%, for 2017 compared with 2016. By reportable segment, income from operations for the United States and Europe increased 15.5% and 10.2%, respectively, as a percentage of revenue for 2017 compared with 2016. Income from operations for Corporate Unallocated and Japan decreased 11.6% as a percentage of revenue for 2017 compared with 2016.

Operating Expenses

Marketing and Sales. Marketing and sales expense increased \$10.7 million, or 23.2%, for 2017 compared to 2016 due to an increase in headcount resulting in personnel and related cost increases of \$10.3 million and marketing program cost increases of \$0.4 million. The increase in marketing program costs is the result of our focus on funding those programs that have proven to be the most effective in growing our business.

Research and Development. Our research and development expense increased \$1.2 million, or 5.2%, for 2017 compared to 2016 due to an increase in headcount resulting in personnel and related cost increases of \$0.9 million and other operating cost increases of \$0.3 million.

General and Administrative. Our general and administrative expense increased \$4.5 million, or 12.4%, for 2017 compared to 2016 due to an increase in headcount resulting in personnel and related cost increases of \$4.0 million, professional service cost increases of \$0.4 million primarily related to outside legal and accounting services, and stock-based compensation cost increases of \$1.3 million, partially offset by a decrease in facility and administrative costs of \$1.2 million resulting from \$0.8 million of non-recurring costs related to facility moves and vacating leases in 2016.

Other Income, Net and Provision for Income Taxes

Other Income, Net. We recognized other income, net of \$2.2 million in 2017, a decrease of \$0.3 million compared to other income, net of \$2.5 million for 2016. Other income, net decreased primarily due to a decrease of \$1.1 million in foreign currency exchange gains, which were partially offset by a \$0.4 million favorable legal settlement in the second quarter of 2017 and an increase of \$0.5 million in interest income on investments.

Provision for Income Taxes. Our income tax provision increased by \$1.1 million for 2017 compared to 2016. This was the result of a significant increase to taxable income along with a tax provision for the transition tax that was part of the Tax Cuts and Jobs Act. Partially offsetting these tax increases was a tax benefit recorded to reflect the decrease to the valuation of our deferred tax liabilities caused by the U.S. corporate income tax rate reduction. As a result of this decrease to the valuation of deferred tax liability, our effective tax rate decreased to 30.4% in 2017 from 33.4% in 2016.

Selected Quarterly Results of Operations Data

The following tables set forth selected unaudited quarterly results of operations data for 2018 and 2017. This unaudited quarterly information has been prepared on the same basis as our annual audited consolidated financial statements appearing elsewhere in this Annual Report on Form 10-K and includes all adjustments, consisting only of normal recurring adjustments, that we consider necessary to present fairly the financial information for the fiscal quarters presented. The quarterly data should be read in conjunction with our selected financial data and consolidated financial statements and the related notes appearing elsewhere in this Annual Report on Form 10-K. Operating results for any quarter are not necessarily indicative of results for a full-year period, and the historical results presented below are not necessarily indicative of the results to be expected in any future period.

| (in thousands, except share and per share amounts) | Three Months Ended | | | | | | | |
|---|--------------------|------------------|------------------|------------------|------------------|------------------|------------------|------------------|
| | Dec. 31, 2018 | Sep. 30, 2018 | Jun. 30, 2018 | Mar. 31, 2018 | Dec. 31, 2017 | Sep. 30, 2017 | Jun. 30, 2017 | Mar. 31, 2017 |
| | (unaudited) | | | | | | | |
| Consolidated Statements of Comprehensive Income Data: | | | | | | | | |
| Revenue | \$ 112,769 | \$ 115,430 | \$ 109,652 | \$ 107,745 | \$ 94,178 | \$ 88,105 | \$ 82,040 | \$ 80,167 |
| Cost of revenue | 53,614 | 53,027 | 50,439 | 49,837 | 41,290 | 38,793 | 35,671 | 34,894 |
| Gross profit | 59,155 | 62,403 | 59,213 | 57,908 | 52,888 | 49,312 | 46,369 | 45,273 |
| Operating expenses: | | | | | | | | |
| Marketing and sales | 17,586 | 16,818 | 17,557 | 16,572 | 15,393 | 13,846 | 14,630 | 12,987 |
| Research and development | 7,580 | 7,458 | 7,032 | 6,665 | 5,776 | 5,877 | 6,084 | 5,823 |
| General and administrative | 13,834 | 13,096 | 12,640 | 12,943 | 12,944 | 10,222 | 9,253 | 8,781 |
| Total operating expenses | 39,000 | 37,372 | 37,229 | 36,180 | 34,113 | 29,945 | 29,967 | 27,591 |
| Income from operations | 20,155 | 25,031 | 21,984 | 21,728 | 18,775 | 19,367 | 16,402 | 17,682 |
| Other income (expense), net | 1,381 | 390 | 808 | 178 | 430 | 291 | 1,173 | 315 |
| Income before income taxes | 21,536 | 25,421 | 22,792 | 21,906 | 19,205 | 19,658 | 17,575 | 17,997 |
| Provision for income taxes | 2,250 | 4,484 | 4,478 | 3,855 | 4,933 | 6,438 | 5,489 | 5,797 |
| Net income | \$ 19,286 | \$ 20,937 | \$ 18,314 | \$ 18,051 | \$ 14,272 | \$ 13,220 | \$ 12,086 | \$ 12,200 |
| Net income per share: | | | | | | | | |
| Basic | \$ 0.71 | \$ 0.77 | \$ 0.68 | \$ 0.67 | \$ 0.53 | \$ 0.50 | \$ 0.46 | \$ 0.46 |
| Diluted | \$ 0.71 | \$ 0.77 | \$ 0.67 | \$ 0.66 | \$ 0.53 | \$ 0.49 | \$ 0.45 | \$ 0.46 |
| Shares used to compute net income per share: | | | | | | | | |
| Basic | 27,040,207 | 27,038,585 | 26,972,990 | 26,879,388 | 26,705,909 | 26,617,349 | 26,541,978 | 26,466,731 |
| Diluted | 27,311,988 | 27,337,886 | 27,274,882 | 27,197,099 | 27,009,017 | 26,802,034 | 26,649,152 | 26,599,200 |

Liquidity and Capital Resources

Cash Flows

The following table summarizes our cash flows for the years ended December 31, 2018, 2017 and 2016:

| (dollars in thousands) | Year Ended December 31, | | |
|---|-------------------------|--------------------|------------------|
| | 2018 | 2017 | 2016 |
| Net cash provided by operating activities | \$ 122,929 | \$ 81,748 | \$ 77,499 |
| Net cash used in investing activities | (63,281) | (123,975) | (60,755) |
| Net cash (used in) provided by financing activities | (10,438) | 9,192 | 5,315 |
| Effect of exchange rates on cash and cash equivalents | (871) | 947 | (917) |
| Net increase in cash and cash equivalents | <u>\$ 48,339</u> | <u>\$ (32,088)</u> | <u>\$ 21,142</u> |

Sources of Liquidity

We finance our operations and capital expenditures through cash flow from operations. We had cash and cash equivalents of \$85.0 million as of December 31, 2018, an increase of \$48.3 million from December 31, 2017. The increase in our cash was due primarily to cash generated through operations. We had cash and cash equivalents of \$36.7 million as of December 31, 2017, a decrease of \$32.1 million from December 31, 2016. The decrease in our cash was due primarily to the acquisition of RAPID in November 2017. We had cash and cash equivalents of \$68.8 million as of December 31, 2016, an increase of \$21.1 million from December 31, 2015. The increase in our cash was due primarily to cash generated through operations.

As of December 31, 2018, the amount of cash and cash equivalents held by foreign subsidiaries was \$46.9 million. The Tax Cuts and Jobs Act imposes a transition tax on foreign earnings previously treated as permanently reinvested, resulting in an increase to our U.S. tax liability. However, our intent is to continue to permanently reinvest these funds outside the U.S. and our current plans do not demonstrate a need to repatriate them to fund our domestic operations. We believe that our existing cash and cash equivalents together with cash generated from operations will be sufficient to meet our working capital expenditure requirements for at least the next 12 months.

Cash Flows from Operating Activities

Cash flow from operating activities of \$122.9 million during 2018 primarily consisted of net income of \$76.6 million, adjusted for certain non-cash items, including depreciation and amortization of \$26.8 million, stock-based compensation expense of \$10.9 million and deferred taxes of \$11.9 million, which were partially offset by changes in operating assets and liabilities and other items totaling \$3.3 million. The cash flow from operating activities during 2018 compared to 2017 increased \$41.2 million due to increases in net income of \$24.8 million, increases in stock-based compensation expense of \$2.4 million driven by an increased level of equity grants to employees, increases in depreciation and amortization of \$8.3 million driven by an increase in capital investments and increases in deferred taxes of \$10.8 million. These increases were partially offset by changes in operating assets and liabilities and other items of \$5.1 million.

Cash flow from operating activities of \$81.8 million during 2017 primarily consisted of net income of \$51.8 million, adjusted for certain non-cash items, including depreciation and amortization of \$18.5 million, stock-based compensation expense of \$8.6 million and changes in operating assets and liabilities and other items totaling \$2.9 million. The cash flow from operating activities during 2017 compared to 2016 increased \$4.2 million due to increases in net income of \$9.0 million, increases in stock-based compensation expense of \$1.8 million driven by an increased level of equity grants to employees and increases in depreciation and amortization of \$1.0 million driven by an increase in capital investments. These increases were partially offset by decreases to deferred taxes of \$1.6 million, amortization of held-to-maturity securities of \$0.1 million and changes in operating assets and liabilities of \$5.9 million.

Cash flow from operating activities of \$77.5 million during 2016 primarily consisted of net income of \$42.7 million, adjusted for certain non-cash items, including depreciation and amortization of \$17.5 million, stock-based compensation expense of \$6.8 million, deferred taxes of \$2.8 million, loss on impairment of assets of \$0.5 million and amortization of held-to-maturity securities of \$1.2 million. The cash flow from operating activities during 2016 compared to 2015 increased \$13.4 million due to changes in operating assets and liabilities of \$14.0 million, increases in depreciation and amortization of \$3.4 million driven by an increase in capital investments, stock-based compensation expense of \$0.7 million driven by an increased level of equity grants to employees, loss on impairment of assets of \$0.5 million driven by the decision to exit certain product lines, and a \$0.3 million of gain from the Alphaform acquisition in 2015 that did not recur. These increases were partially offset by a decrease in net income of \$3.8 million, a decrease in deferred taxes of \$0.1 million, a decrease in amortization of held-to-maturity securities of \$0.1 million, as well as other adjustments of \$1.5 million primarily related to unrealized gains on the translation of foreign currency denominated cash.

Cash Flows from Investing Activities

Cash used in investing activities was \$63.3 million for the year ended December 31, 2018, consisting of \$87.1 million for the purchase of property, equipment and other capital assets primarily to expand our production capacity and \$41.4 million for the purchase of marketable securities, which were partially offset by \$65.1 million in proceeds from maturities of marketable securities and \$0.1 million in other investing activities.

Cash used in investing activities was \$123.9 million for the year ended December 31, 2017, consisting of \$110.5 million for the purchase of RAPID, \$32.6 million for the purchase of property, equipment and other capital assets primarily to expand our production capacity, \$20.0 million for the purchase of marketable securities and \$8.8 million for the purchases of other assets and investments, which were partially offset by \$48.0 million in proceeds from maturities and call redemption of marketable securities.

Cash used in investing activities was \$60.8 million for the year ended December 31, 2016, consisting of \$33.6 million for the purchase of property, equipment and other capital assets primarily to expand our production capacity, and \$89.3 million for the purchase of marketable securities, which were partially offset by \$62.1 million in proceeds from maturities and call redemption of marketable securities.

Cash Flows from Financing Activities

Cash used in financing activities was \$10.4 million for the year ended December 31, 2018, consisting of \$12.2 million in repurchases of common stock and payments on short-term debt obligations of \$5.0 million, partially offset by \$6.8 million in proceeds from exercises of stock options.

Cash provided by financing activities was \$9.2 million for the year ended December 31, 2017, consisting of \$5.0 million in short-term debt obligations and \$8.6 million in proceeds from the exercise of stock options, partially offset by \$4.4 million for repurchases of common stock.

Cash provided by financing activities was \$5.3 million for the year ended December 31, 2016, consisting of \$5.7 million in proceeds from exercises of stock options, partially offset by \$0.4 million for payments of acquisition-related contingent consideration.

Operating and Capital Expenditure Requirements

We believe, based on our current operating plan, that our cash balances and cash generated through operations and interest income will be sufficient to meet our anticipated cash requirements through at least the next 12 months. From time to time we may seek to sell equity or convertible debt securities or enter into credit facilities. The sale of equity and convertible debt securities may result in dilution to our shareholders. If we raise additional funds through the issuance of convertible debt securities or enter into credit facilities, these securities and debt holders could have rights senior to those of our common stock, and this debt could contain covenants that would restrict our operations. We may require additional capital beyond our currently forecasted amounts. Any such required additional capital may not be available on terms acceptable to us, or at all.

Our future capital requirements will depend on many factors, including the following:

- the revenue growth in Injection Molding, CNC Machining, 3D Printing and Sheet Metal product lines;
- costs of operations, including costs relating to expansion and growth;
- the emergence of competing or complementary technological developments;
- the costs of filing, prosecuting, defending and enforcing any patent claims and other intellectual product rights, or participating in litigation-related activities; and
- the acquisition of businesses, products and technologies, although we currently have no commitments or agreements relating to any of these types of transactions.

Our recent annual capital expenditures have varied between 10% and 20% of annual revenue. We believe future growth capital expenditures, excluding any expenditures for buildings and maintenance capital we might purchase for our operations, are likely to vary between approximately 8% and 12% of annual revenue.

Contractual Obligations

As of December 31, 2018, our contractual obligations and the effect such obligations are expected to have on our liquidity and cash flows in future periods were as follows:

| (in thousands) | Total | Payment Due by Period | | | |
|------------------|------------------|-----------------------|-----------------|-----------------|----------------------|
| | | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
| Operating leases | \$ 13,617 | \$ 3,411 | \$ 4,878 | \$ 3,186 | \$ 2,142 |
| Total | <u>\$ 13,617</u> | <u>\$ 3,411</u> | <u>\$ 4,878</u> | <u>\$ 3,186</u> | <u>\$ 2,142</u> |

The table above reflects only payment obligations that are fixed and determinable. Our commitments for operating leases relate to three of our United States manufacturing facilities; our European sales, customer service and technical support offices; manufacturing and office facilities located in Germany; and our Japan facility.

Financing Arrangements

The following table summarizes our financing arrangements as of December 31, 2018 and 2017:

| (in thousands) | December 31, | |
|--|--------------|-----------------|
| | 2018 | 2017 |
| Revolving Credit Facility, with interest rates from 2.50% to 2.59%, due at maturity in November 2019 | \$ - | \$ 5,000 |
| Total Financing Obligations | <u>\$ -</u> | <u>\$ 5,000</u> |

Inflation

We experience normal inflation and changing prices, primarily on our production materials and labor. We believe that inflation and changing prices have not had a material effect on our financial condition during the three most recent fiscal years.

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

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates, judgments and assumptions that affect the reported amount of assets, liabilities, revenue, expenses and related disclosures. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, goodwill, other intangible assets, stock-based compensation, and income taxes. We base our estimates of the carrying value of certain assets and liabilities on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many cases, we could reasonably have used different accounting policies and estimates. In some cases, changes in the accounting estimates are reasonably likely to occur from period to period. Management has discussed the development, selection and disclosure of these estimates with the audit committee of our board of directors. Our actual results may differ significantly from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments used in the preparation of our consolidated financial statements. See the Notes to Consolidated Financial Statements included in Item 8. "Financial Statements and Supplementary Data" in this Annual Report on Form 10-K for additional information about these critical accounting policies, as well as a description of our other accounting policies.

Revenue Recognition

On January 1, 2018, we adopted ASC 606, *Revenue from Contracts with Customers*, using the modified retrospective approach. We manufacture custom parts to specific customer orders that have no alternative use to us, and we believe there is a legally enforceable right to payment for performance completed to date on these manufactured parts. For manufactured parts that meet these two criteria, we will recognize revenue over time.

Prior to 2018, we recognized revenue in accordance with ASC 605, *Revenue Recognition*, which states that revenue is realized or realizable and earned when all of the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the price to the buyer is fixed or determinable, and (4) collectability is reasonably assured. Revenue was recognized upon transfer of title and risk of loss, which was generally upon the shipment of parts in our Injection Molding, CNC Machining, 3D Printing, Sheet Metal and Other product lines.

Goodwill

We recognize goodwill in accordance with ASC 350, *Intangibles—Goodwill and Other*. Goodwill is the excess of cost of an acquired entity over the amounts assigned to assets acquired and liabilities assumed in a business combination. Goodwill is not amortized. Goodwill is tested for impairment annually in the fourth quarter of each year, and is tested for impairment between annual tests if an event occurs or circumstances change that would indicate the carrying amount may be impaired. An impairment charge for goodwill is recognized only when the estimated fair value of a reporting unit, including goodwill, is less than its carrying amount. As of December 31, 2018 no impairment charges for goodwill have been recognized.

Other Intangible Assets

We recognize other intangible assets in accordance with ASC 350, *Intangibles—Goodwill and Other*. Other intangible assets include software technology, customer relationships and other intangible assets acquired from independent parties. Other intangible assets with a definite life are amortized over a period ranging from two to 10 years on a straight line basis, and are tested for impairment whenever events or circumstances indicate that the carrying amount of an asset (asset group) may not be recoverable. An impairment loss is recognized when the carrying amount of an asset exceeds the estimated undiscounted cash flows generated by the asset. As of December 31, 2018 no impairment charges for intangible assets have been recognized.

Stock-Based Compensation

We determine our stock-based compensation in accordance with ASC 718, *Compensation—Stock Compensation* (ASC 718), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and non-employee directors based on the grant date fair value of the award.

Determining the appropriate fair value model and calculating the fair value of stock option grants requires the input of subjective assumptions. We use the Black-Scholes option pricing model to value our stock option awards. Stock-based compensation expense is significant to our consolidated financial statements and is calculated using our best estimates, which involve inherent uncertainties and the application of management's judgment. Significant estimates include our expected term and stock price volatility. If different estimates and assumptions had been used, our common stock valuations could be significantly different and related stock-based compensation expense may be materially impacted.

The Black-Scholes option pricing model requires inputs such as the risk-free interest rate, expected term, expected volatility and expected dividend yield. We base the risk-free interest rate that we use in the Black-Scholes option pricing model on zero coupon U.S. Treasury instruments with maturities similar to the expected term of the award being valued. The expected term of stock options is estimated from the vesting period of the award and represents the weighted average period that our stock options are expected to be outstanding. We estimated the volatility of our stock price based on the historic volatility of our common stock. We have never paid and do not anticipate paying any cash dividends in the foreseeable future and, therefore, we use an expected dividend yield of zero in the option pricing model. We account for forfeitures as they occur.

The fair value of each new employee option awarded was estimated on the date of grant for the periods below using the Black-Scholes option pricing model with the following assumptions:

| | Year Ended December 31, | | |
|--|-------------------------|----------------|----------------|
| | 2018 | 2017 | 2016 |
| Risk-free interest rate | 2.52 - 3.07% | 2.24 - 2.36% | 1.53 - 2.68% |
| Expected life (years) | 6.25 | 6.50 | 6.50 |
| Expected volatility | 41.68 - 42.22% | 42.68 - 44.68% | 44.38 - 45.93% |
| Expected dividend yield | 0% | 0% | 0% |
| Weighted average grant date fair value | \$50.08 | \$32.26 | \$26.61 |

Our 2012 Employee Stock Purchase Plan (ESPP) allows eligible employees to purchase a variable number of shares of our common stock during each offering period at a discount through payroll deductions of up to 15% of their eligible compensation, subject to plan limitations. The ESPP provides for six-month offering periods with a single purchase period. At the end of each offering period, employees are able to purchase shares at 85% of the lower of the fair market value of our common stock on the first trading day of the offering period or on the last trading day of the offering period. We determine the fair value stock-based compensation related to our ESPP in accordance with ASC 718 using the component measurement approach and the Black-Scholes standard option pricing model.

The fair value of each offering period was estimated using the Black-Scholes option pricing model with the following assumptions:

| | Year ended December 31, | | |
|-------------------------|-------------------------|----------------|----------------|
| | 2018 | 2017 | 2016 |
| Risk-free interest rate | 2.06 - 2.33% | 0.97 - 1.48% | 0.56 - 0.59% |
| Expected life (months) | 6.00 | 6.00 | 6.00 |
| Expected volatility | 31.50 - 37.36% | 24.49 - 34.51% | 39.51 - 49.13% |
| Expected dividend yield | 0% | 0% | 0% |

There are significant differences among option valuation models, and this may result in a lack of comparability with other companies that use different models, methods and assumptions. If factors change and we employ different assumptions in the application of ASC 718 in future periods, or if we decide to use a different valuation model, such as a lattice model, the stock-based compensation expense that we record in the future under ASC 718 may differ significantly from what we have recorded using the Black-Scholes option pricing model and could materially affect our operating results.

We recognize stock-based compensation expense on a straight-line basis over the requisite service period. We recorded stock-based compensation expense relating to stock options, restricted stock awards, performance stock units and our ESPP of \$10.9 million, \$8.6 million and \$6.8 million during the years ended December 31, 2018, 2017 and 2016, respectively. As of December 31, 2018, we had \$3.3 million of unrecognized stock-based compensation costs related to unvested stock options that are expected to be recognized over a weighted average period of 2.8 years. We issued options to purchase 36,600, 60,100 and 117,480 shares of our common stock in 2018, 2017 and 2016, respectively. As of December 31, 2018, we had \$20.7 million of unrecognized stock-based compensation costs related to non-vested restricted stock, which is expected to be recognized over a weighted average period of 3.1 years. We issued restricted stock awards of 106,855, 210,744 and 161,555 shares of our common stock in 2018, 2017 and 2016, respectively. As of December 31, 2018, we had \$2.2 million of unrecognized stock-based compensation costs related to non-vested performance stock, which is expected to be recognized over a weighted average period of 1.8 years. We issued performance stock awards of 20,006 and 25,707 shares of our common stock in 2018 and 2017, respectively. We issued no performance stock awards in 2016.

In future periods, our stock-based compensation expense is expected to increase due to our existing unrecognized stock-based compensation and the issuance of additional stock-based awards to continue to attract and retain employees and non-employee directors.

Income Taxes

We account for income taxes in accordance with ASC 740, *Income Taxes* (ASC 740). Under this method, we determine tax assets and liabilities based upon the differences between the financial statement carrying amounts and the tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. The tax consequences of most events recognized in the current year's financial statements are included in determining income taxes currently payable. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities and equity, revenues, expenses, gains and losses, differences arise between the amount of taxable income and pretax financial income for a year and between the tax basis of assets or liabilities and their reported amounts in the financial statements. Because we assume that the reported amounts of assets and liabilities will be recovered and settled, respectively, a difference between the tax basis of an asset or liability and its reported amount in the balance sheet will result in a taxable or a deductible amount in some future years when the related liabilities are settled or the reported amounts of the assets are recovered, giving rise to a deferred tax asset or liability. We establish a valuation allowance for any portion of our deferred tax assets that we believe will not be recognized.

ASC 740 also clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements. Additionally, ASC 740 provides guidance on measurement, de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Including interest and penalties, we have established a liability for uncertain tax positions of \$4.6 million as of December 31, 2018.

The effective tax rate decreased by 14.0% for the year ended December 31, 2018 when compared to 2017 primarily due to the impact of tax reform. The Tax Cuts and Jobs Act (the "Act") was enacted on December 22, 2017. The Act reduced the U.S. federal corporate tax rate from 35% to 21%, requires companies to pay a transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creates new taxes on certain foreign sourced earnings. The reduction to the U.S. tax rate also results in revaluing deferred tax liabilities. At December 31, 2017, we had not completed our accounting for the tax effects of the enactment of the Act. However, we made a reasonable estimate on the effects of the transition tax and recognized a provisional amount of \$2.4 million which was included as a component of income tax expense from continuing operations. We were also required to revalue our deferred tax liabilities to reflect the new U.S. federal corporate income tax rate from the Act which resulted in the recognition of an estimated tax benefit of \$4.2 million in 2017. At December 31, 2018, we completed our accounting for the tax effects of the enactment of the Act. As a result, we recorded a tax benefit of \$0.7 million for the final accounting for the transition tax and a tax benefit of \$0.5 million resulting from the completion of the accounting related to the revaluation of our net deferred tax liabilities utilizing the new U.S. federal corporate income tax rate. The impact of the tax effects for the enactment of the Act was a tax benefit of \$3.0 million. The foreign tax effects of the transition tax was based on our total post-1986 earnings and profits that were previously deferred from U.S. income taxes. No additional income taxes have been provided for any remaining undistributed foreign earnings not subject to the transition tax or any additional outside basis difference inherent in these entities as these amounts continue to be indefinitely reinvested in foreign operations.

Recently adopted accounting pronouncements

During the first quarter of 2018, we adopted the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers* (ASC 606). 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. We adopted the new revenue standard using the modified retrospective approach. We manufacture custom parts to specific customer orders that have no alternative use to us, and we believe there is a legally enforceable right to payment for performance completed to date on these manufactured parts. For manufactured parts that meet these two criteria, we will recognize revenue over time. The transition adjustment recorded was an increase of \$1.5 million to our retained earnings balance as of January 1, 2018.

During the first quarter of 2018, we adopted ASU 2017-09, *Compensation – Stock Compensation*, which is intended to provide clarity and reduce diversity in practice as well as cost and complexity when applying the guidance to a change to the terms or conditions of a share-based payment award. The adoption of this guidance did not have a material impact on our consolidated financial statements.

Recently issued accounting pronouncements

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. We will adopt the lease standard on January 1, 2019 using the new transition option issued under the amendments in ASU 2018-11, *Leases*, which will allow us to continue to apply the legacy guidance in ASC 840, *Leases*, in the comparative periods presented in the year of adoption. We will elect the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allows us to carry forward the historical lease classification. We will make an accounting policy election to keep leases with an initial term of 12 months or less off of the balance sheet. We will recognize those lease payments in the Consolidated Statements of Comprehensive Income on a straight-line basis over the lease term. The impact of adoption is expected to be an increase to our operating lease assets and liabilities on January 1, 2019 of approximately \$14.0 million.

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other*, which is intended to simplify the subsequent measurement of goodwill. This guidance will be effective for impairment tests in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years with early adoption permitted. We do not expect the impact to be material.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses*, which is intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments held by a reporting entity at each reporting date. This guidance will be effective for fiscal years beginning after December 15, 2020 and interim periods within those fiscal years with early adoption permitted. We are evaluating the impact of future adoption of this guidance on our consolidated financial statements, but we do not expect the impact to be material.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Quantitative and Qualitative Disclosure of Market Risks

Our exposure to market risk is confined to our cash and cash equivalent balances and investments. The primary goals of our investment policy are preservation of capital, fulfillment of liquidity needs and fiduciary control of cash and cash equivalent balances. We also seek to maximize income from our investments without assuming significant risk. To achieve our goals, we maintain a portfolio of debt securities with various maturities ranging from one to three years. Due to the nature of our investment portfolio, we are subject to interest rate risks, which we mitigate by holding our investments to maturity. In future periods, we will continue to evaluate our investment policy in order to continue our overall goals.

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 Pound, Euro 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 \$0.3 million, \$0.4 million and \$1.4 million for the years ended December 31, 2018, 2017 and 2016, respectively.

Item 8. Financial Statements and Supplementary Data

Proto Labs, Inc.
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Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of Proto Labs, Inc.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Proto Labs, Inc. (the Company) as of December 31, 2018 and 2017, the related consolidated statements of comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes (collectively referred to as the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated February 22, 2019 expressed an unqualified opinion thereon.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Ernst & Young LLP

We have served as the Company's auditor since 2011.

Minneapolis, Minnesota
February 22, 2019

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of Proto Labs, Inc.

Opinion on Internal Control over Financial Reporting

We have audited Proto Labs, Inc.'s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). In our opinion, Proto Labs, Inc. (the Company) maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of Proto Labs, Inc. as of December 31, 2018 and 2017, the related consolidated statements of comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes and our report dated February 22, 2019 expressed an unqualified opinion thereon.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Ernst & Young LLP

Minneapolis, Minnesota
February 22, 2019

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

| | December 31, | |
|---|---------------------|-------------|
| | 2018 | 2017 |
| Assets | | |
| Current assets | | |
| Cash and cash equivalents | \$ 85,046 | \$ 36,707 |
| Short-term marketable securities | 46,750 | 57,424 |
| Accounts receivable, net of allowance for doubtful accounts of \$919 and \$757 as of December 31, 2018 and December 31, 2017, respectively | 59,155 | 51,503 |
| Inventory | 10,087 | 11,271 |
| Prepaid expenses and other current assets | 8,567 | 6,267 |
| Income taxes receivable | 5,757 | 1,832 |
| Total current assets | 215,362 | 165,004 |
| Property and equipment, net | 228,001 | 166,440 |
| Goodwill | 128,752 | 128,504 |
| Other intangible assets, net | 19,850 | 19,084 |
| Long-term marketable securities | 23,579 | 37,034 |
| Other long-term assets | 3,441 | 2,672 |
| Total assets | \$ 618,985 | \$ 518,738 |
| Liabilities and shareholders' equity | | |
| Current liabilities | | |
| Accounts payable | \$ 17,411 | \$ 15,876 |
| Accrued compensation | 18,130 | 12,100 |
| Accrued liabilities and other | 16,702 | 8,408 |
| Short-term debt obligations | - | 5,000 |
| Income taxes payable | 491 | 2,371 |
| Total current liabilities | 52,734 | 43,755 |
| Long-term income taxes payable | - | 2,181 |
| Long-term deferred tax liabilities | 20,162 | 6,966 |
| Other long-term liabilities | 4,592 | 4,621 |
| Total liabilities | 77,488 | 57,523 |
| Shareholders' equity | | |
| Preferred stock, \$0.001 par value, authorized 10,000,000 shares; issued and outstanding 0 shares as of December 31, 2018 and December 31, 2017, respectively | - | - |
| Common stock, \$0.001 par value, authorized 150,000,000 shares; issued and outstanding 26,984,747 and 26,828,651 shares as of December 31, 2018 and December 31, 2017, respectively | 27 | 27 |
| Additional paid-in capital | 258,502 | 241,725 |
| Retained earnings | 291,460 | 224,697 |
| Accumulated other comprehensive loss | (8,492) | (5,234) |
| Total shareholders' equity | 541,497 | 461,215 |
| Total liabilities and shareholders' equity | \$ 618,985 | \$ 518,738 |

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)

| | Year Ended December 31, | | |
|--|-------------------------|------------------|------------------|
| | 2018 | 2017 | 2016 |
| Statements of Operations: | | | |
| Revenue | \$ 445,596 | \$ 344,490 | \$ 298,055 |
| Cost of revenue | 206,917 | 150,648 | 131,118 |
| Gross profit | 238,679 | 193,842 | 166,937 |
| Operating expenses | | | |
| Marketing and sales | 68,533 | 56,856 | 46,131 |
| Research and development | 28,735 | 23,560 | 22,388 |
| General and administrative | 52,513 | 41,200 | 36,651 |
| Total operating expenses | 149,781 | 121,616 | 105,170 |
| Income from operations | 88,898 | 72,226 | 61,767 |
| Other income, net | 2,757 | 2,209 | 2,454 |
| Income before income taxes | 91,655 | 74,435 | 64,221 |
| Provision for income taxes | 15,067 | 22,657 | 21,514 |
| Net income | <u>\$ 76,588</u> | <u>\$ 51,778</u> | <u>\$ 42,707</u> |
| Net income per share: | | | |
| Basic | <u>\$ 2.84</u> | <u>\$ 1.94</u> | <u>\$ 1.62</u> |
| Diluted | <u>\$ 2.81</u> | <u>\$ 1.93</u> | <u>\$ 1.61</u> |
| Shares used to compute net income per share: | | | |
| Basic | 26,982,614 | 26,647,610 | 26,365,173 |
| Diluted | 27,278,816 | 26,845,071 | 26,564,639 |
| Other Comprehensive (Loss) Income, net of tax | | | |
| Foreign currency translation adjustments | \$ (3,258) | \$ 5,519 | \$ (5,541) |
| Comprehensive income | <u>\$ 73,330</u> | <u>\$ 57,297</u> | <u>\$ 37,166</u> |

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

Proto Labs, Inc.
Consolidated Statements of Shareholders' Equity
(In thousands, except share amounts)

| | Common Stock | | Additional | Retained | Accumulated | |
|---|-------------------|--------------|-------------------|-------------------|--------------------|-------------------|
| | Shares | Amount | Paid-In | Earnings | Other | Total |
| | | | Capital | | Comprehensive | |
| | | | | | Loss | |
| Balance at January 1, 2016 | 26,200,718 | 26 | 198,835 | 133,996 | (5,212) | 327,645 |
| Common shares issued on exercise of options and other | 304,150 | - | 5,715 | - | - | 5,715 |
| Excess tax benefit from stock option exercises | - | - | 2,532 | - | - | 2,532 |
| Stock-based compensation expense | - | - | 6,775 | - | - | 6,775 |
| Net income | - | - | - | 42,707 | - | 42,707 |
| <i>Other comprehensive income</i> | | | | | | |
| Foreign currency translation adjustment | - | - | - | - | (5,541) | (5,541) |
| Comprehensive income | | | | | | 37,166 |
| Balance at December 31, 2016 | <u>26,504,868</u> | <u>\$ 26</u> | <u>\$ 213,857</u> | <u>\$ 176,703</u> | <u>\$ (10,753)</u> | <u>\$ 379,833</u> |
| Common shares issued on exercise of options and other | 283,449 | 1 | 8,603 | - | - | 8,604 |
| Common shares issued for RAPID acquisition | 118,140 | 1 | 11,335 | - | - | 11,336 |
| Stock-based compensation expense | - | - | 8,558 | - | - | 8,558 |
| Repurchases of Common Stock | (77,806) | (1) | (628) | (3,784) | - | (4,413) |
| Net income | - | - | - | 51,778 | - | 51,778 |
| <i>Other comprehensive income</i> | | | | | | |
| Foreign currency translation adjustment | - | - | - | - | 5,519 | 5,519 |
| Comprehensive income | | | | | | 57,297 |
| Balance at December 31, 2017 | <u>26,828,651</u> | <u>\$ 27</u> | <u>\$ 241,725</u> | <u>\$ 224,697</u> | <u>\$ (5,234)</u> | <u>\$ 461,215</u> |
| Common shares issued on exercise of options and other | 260,694 | - | 6,791 | - | - | 6,791 |
| Stock-based compensation expense | - | - | 10,928 | - | - | 10,928 |
| Repurchases of Common Stock | (104,598) | - | (942) | (11,287) | - | (12,229) |
| Revenue recognition transition adjustment | - | - | - | 1,462 | - | 1,462 |
| Net income | - | - | - | 76,588 | - | 76,588 |
| <i>Other comprehensive income</i> | | | | | | |
| Foreign currency translation adjustment | - | - | - | - | (3,258) | (3,258) |
| Comprehensive income | | | | | | 73,330 |
| Balance at December 31, 2018 | <u>26,984,747</u> | <u>\$ 27</u> | <u>\$ 258,502</u> | <u>\$ 291,460</u> | <u>\$ (8,492)</u> | <u>\$ 541,497</u> |

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

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

| | Year Ended December 31, | | |
|---|-------------------------|------------------|------------------|
| | 2018 | 2017 | 2016 |
| Operating activities | | | |
| Net income | \$ 76,588 | \$ 51,778 | \$ 42,707 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 26,754 | 18,474 | 17,485 |
| Stock-based compensation expense | 10,928 | 8,558 | 6,775 |
| Deferred taxes | 11,936 | 1,174 | 2,780 |
| Loss on impairment of assets | - | 513 | 455 |
| Gain on sale of business | (671) | - | - |
| Amortization of held-to-maturity securities | 374 | 1,063 | 1,173 |
| Other | (619) | (153) | (1,541) |
| Changes in operating assets and liabilities, net of acquisitions: | | | |
| Accounts receivable | (6,098) | (9,933) | 900 |
| Inventories | (189) | (985) | 136 |
| Prepaid expenses and other | (2,098) | (691) | (1,312) |
| Income taxes | (6,652) | 1,646 | 8,207 |
| Accounts payable | 1,942 | 3,176 | (1,116) |
| Accrued liabilities and other | 10,734 | 7,128 | 850 |
| Net cash provided by operating activities | 122,929 | 81,748 | 77,499 |
| Investing activities | | | |
| Purchases of property, equipment and other capital assets | (87,104) | (32,635) | (33,616) |
| Cash used for acquisitions, net of cash acquired | (90) | (110,533) | - |
| Proceeds from sale of business | 284 | - | - |
| Purchases of other assets and investments | (126) | (8,742) | - |
| Purchases of marketable securities | (41,384) | (20,037) | (89,315) |
| Proceeds from maturities of marketable securities | 65,139 | 47,972 | 62,176 |
| Net cash used in investing activities | (63,281) | (123,975) | (60,755) |
| Financing activities | | | |
| Payments on debt | (5,000) | - | - |
| Proceeds from issuance of debt | - | 5,000 | - |
| Acquisition-related contingent consideration | - | - | (400) |
| Repurchases of common stock | (12,229) | (4,410) | - |
| Proceeds from exercises of stock options and other | 6,791 | 8,602 | 5,715 |
| Net cash (used in) provided by financing activities | (10,438) | 9,192 | 5,315 |
| Effect of exchange rate changes on cash and cash equivalents | (871) | 947 | (917) |
| Net increase (decrease) in cash and cash equivalents | 48,339 | (32,088) | 21,142 |
| Cash and cash equivalents, beginning of period | 36,707 | 68,795 | 47,653 |
| Cash and cash equivalents, end of period | \$ 85,046 | \$ 36,707 | \$ 68,795 |
| Supplemental cash flow disclosure | | | |
| Cash paid for interest | \$ 39 | \$ 19 | \$ 1 |
| Cash paid for taxes | \$ 9,966 | \$ 19,113 | \$ 9,802 |

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

Proto Labs, Inc.
Notes to Consolidated Financial Statements

Note 1 — Nature of Business

Organization and business

Proto Labs, Inc. and its subsidiaries (Proto Labs, the Company, we, us, or our) is an e-commerce driven digital manufacturer of quick-turn, on-demand injection-molded, computer numerical control (CNC) machined, 3D-printed and sheet metal-fabricated custom parts for prototyping and short-run production. The Company's customers are product developers and engineers throughout the world who require a faster and less expensive way to obtain low volumes of parts. The Company's proprietary technology eliminates most of the time-consuming and expensive skilled labor conventionally required to quote and manufacture parts in low volumes, and its customers conduct nearly all of their business with the Company over the Internet. The Company targets its product lines to the millions of product developers and engineers who use three-dimensional (3D) computer-aided design (CAD) software to design products across a diverse range of end-markets. The Company has established operations in the United States, Europe and Japan, which the Company believes are among the largest geographic markets where these product developers and engineers are located. The Company's primary manufacturing product lines currently include Injection Molding, CNC Machining, 3D Printing and Sheet Metal. Proto Labs, Inc. is located in Maple Plain, Minnesota. The Company's subsidiaries are:

| Name | Location |
|-------------------------------------|----------------|
| PL-US International LLC | United States |
| Rapid Manufacturing Group LLC | United States |
| Proto Labs Ltd. | United Kingdom |
| PL Euro Services Ltd. | United Kingdom |
| PL International Holdings, UK, Ltd. | United Kingdom |
| PL DE Holding GmbH | Germany |
| Proto Labs GmbH | Germany |
| Proto Labs Eschenlohe GmbH | Germany |
| Proto Labs, G.K. | Japan |

Note 2 — Summary of Significant Accounting Policies

Principles of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, as listed within "Organization and business" above. All intercompany accounts and transactions have been eliminated in consolidation.

Comprehensive income

Components of comprehensive income include net income and foreign currency translation adjustments. Comprehensive income is disclosed in the accompanying consolidated statements of comprehensive income and consolidated statements of shareholders' equity.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

Accounting estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and related disclosures at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and cash equivalents

Cash and cash equivalents include cash and other investments, including marketable securities, with maturities of three months or less at the date of purchase. The Company maintains its cash in bank deposit accounts, which, at times, may exceed federally insured limits. The Company has not experienced any losses on such accounts.

Marketable securities

Marketable securities include held-to-maturity debt securities recorded at amortized cost. Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designation as of each balance sheet date. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. Held-to-maturity securities are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts to maturity computed under the effective interest method. Such amortization is included in other income, net. Interest on securities classified as held to maturity is included in other income, net. The classification of marketable securities as current or non-current is dependent upon the security's maturity date. Securities with maturities of three months or less at the time of purchase are categorized as cash equivalents as described above. The Company reviews impairments associated with its marketable securities in accordance with the measurement guidance provided by ASC 320, *Investments – Debt and Equity Securities*, when determining the classification of impairment as “temporary” or “other-than-temporary.” The factors used to differentiate between temporary and other-than-temporary include assessment of the quality of the security, credit ratings actions and management's intent to hold the security to maturity as well as other factors.

Accounts receivable and allowance for doubtful accounts

Accounts receivable are reported at the invoiced amount less an allowance for doubtful accounts. As of each balance sheet date, the Company evaluates its accounts receivable and establishes an allowance for doubtful accounts based on a combination of specific customer circumstances and credit conditions taking into account the history of write-offs and collections. A receivable is considered past due if payment has not been received within the period agreed upon in the invoice. Accounts receivable are written off after all collection efforts have been exhausted. Recoveries of trade receivables previously written off are recorded when received.

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.

Property, equipment and leasehold improvements

Property, equipment and leasehold improvements are stated at cost. Major improvements that substantially extend an asset's useful life are capitalized. Repairs, maintenance and minor improvements are charged to operations as incurred. Depreciation, including amortization of leasehold improvements and assets recorded under capital leases, is calculated using the straight-line method over the estimated useful lives of the individual assets and ranges from 3 to 39 years. Manufacturing equipment is depreciated over 3 to 15 years, office furniture and equipment are depreciated over 3 to 7 years, computer hardware and software are depreciated over 3 to 5 years, building costs are depreciated over 39 years, leasehold improvements are depreciated over the estimated lives of the related assets or the life of the lease, whichever is shorter, and building and land improvements are depreciated over 10 to 39 years. Assets not in service are not depreciated until the asset is put into use.

The Company follows ASC 350-40, *Internal-Use Software*, in accounting for internally developed software. As of December 31, 2018 and 2017, respectively, \$16.6 million and \$4.9 million of software development costs were capitalized.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

Goodwill

The Company recognizes goodwill in accordance with ASC 350, *Intangibles—Goodwill and Other*. Goodwill is the excess of cost of an acquired entity over the amounts assigned to assets acquired and liabilities assumed in a business combination. Goodwill is not amortized. Goodwill is tested for impairment annually in the fourth quarter of each year, and is tested for impairment between annual tests if an event occurs or circumstances change that would indicate the carrying amount may be impaired. An impairment charge for goodwill is recognized only when the estimated fair value of a reporting unit, including goodwill, is less than its carrying amount.

Other Intangible Assets

Other intangible assets include software technology, customer relationships and other intangible assets acquired from other independent parties. Other intangible assets with a definite life are amortized over a period ranging from two to 10 years on a straight line basis, and are tested for impairment whenever events or circumstances indicate that the carrying amount of an asset (asset group) may not be recoverable. An impairment loss is recognized when the carrying amount of an asset exceeds the estimated undiscounted cash flows generated by the asset. The amount of the impairment loss recorded is calculated by the excess of the asset's carrying value over its fair value.

Accounting for long-lived assets

The Company periodically reviews the carrying amount of its property, equipment and leasehold improvements to determine if circumstances exist indicating an impairment or if depreciation periods should be modified. If facts or circumstances indicate that an impairment may exist, the Company will prepare a projection of the undiscounted future cash flows of the specific assets to determine if the assets are recoverable. If impairment exists based on these projections, an adjustment will be made to reduce the carrying amount of the specific assets to fair value.

Revenue recognition

On January 1, 2018, the Company adopted ASC 606, *Revenue from Contracts with Customers*, using the modified retrospective approach. The Company manufactures custom parts to specific customer orders that have no alternative use to the Company, and the Company believes there is a legally enforceable right to payment for performance completed to date on these manufactured parts. For manufactured parts that meet these two criteria, the Company will recognize revenue over time.

Prior to 2018, the Company recognized revenue when it was realized or realizable and earned when all of the following criteria were met: persuasive evidence of an arrangement existed, delivery had occurred or services had been rendered, the price to the buyer was fixed or determinable and collectability was reasonably assured. Revenue was recognized upon transfer of title and risk of loss, which was generally upon the shipment of parts in the Company's Injection Molding, CNC Machining, 3D Printing and Sheet Metal product lines. Freight billed to customers was included in revenues, and all freight expenses paid by the Company were included in cost of revenue.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

Income taxes

The Company accounts for income taxes in accordance with ASC 740, *Income Taxes* (ASC 740). Under this method, the Company determines tax assets and liabilities based upon the differences between the financial statement carrying amounts and the tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. The tax consequences of most events recognized in the financial statements are included in determining income taxes currently payable. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities and equity, revenues, expenses, gains and losses, differences arise between the amount of taxable income and pretax financial income for a year and between the tax basis of assets or liabilities and their reported amounts in the financial statements. Because the Company assumes that the reported amounts of assets and liabilities will be recovered and settled, respectively, a difference between the tax basis of an asset or liability and its reported amount in the balance sheet will result in a taxable or a deductible amount in some future years when the related liabilities are settled or the reported amounts of the assets are recovered, giving rise to a deferred tax asset or liability. The Company establishes a valuation allowance for any portion of its deferred tax assets that the Company believes may not be recognized.

ASC 740 also clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements by requiring that individual tax positions are recorded only when they meet a more-likely-than-not criterion. Additionally, ASC 740 provides guidance on measurement, de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Stock-based compensation

The Company accounts for stock-based compensation in accordance with ASC 718, *Compensation—Stock Compensation* (ASC 718). Under the fair value recognition provisions of ASC 718, the Company measures stock-based compensation cost at the grant date fair value and recognizes the compensation expense over the requisite service period, which is the vesting period, using a straight-line attribution method. The amount of stock-based compensation expense recognized during a period is based on the portion of the awards that are ultimately expected to vest. The Company accounts for forfeitures as they occur. Ultimately, the total expense recognized over the vesting period will only be for those awards that vest. The Company's awards are not eligible to vest early in the event of retirement, however, the awards vest early in the event of a change in control.

In determining the compensation cost of the options granted, the fair value of options granted has been estimated on the date of grant using the Black-Scholes option-pricing model.

Advertising costs

Advertising is expensed as incurred and was approximately \$11.8 million, \$10.7 million and \$10.5 million for the years ended December 31, 2018, 2017 and 2016, respectively.

Research and development

Research and development expenses consist primarily of personnel and outside service costs related to the creation of and enhancements to our customer-facing and internal operating software systems, development of new processes and product lines, enhancement of existing product lines, quality assurance and testing. Research and development costs were approximately \$28.7 million, \$23.6 million and \$22.4 million for the years ended December 31, 2018, 2017 and 2016, respectively.

Foreign currency translation/transactions

The Company translated the balance sheets of its foreign subsidiaries at period-end exchange rates and the income statement at the average exchange rates in effect throughout the period. The Company has recorded the translation adjustment as a separate component of consolidated shareholders' equity. Foreign currency transaction gains and losses are recognized in the consolidated statements of comprehensive income.

Business combinations

The Company accounts for business combinations in accordance with ASC 805, *Business Combinations* (ASC 805). On November 30, 2017, the Company acquired RAPID Manufacturing Group, LLC (RAPID) for \$121.9 million, consisting of \$110.6 million in cash and \$11.3 million in the Company's common stock.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

Recently adopted accounting pronouncements

During the first quarter of 2018, the Company adopted the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers* (ASC 606). 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 has adopted the new revenue standard using the modified retrospective approach. The Company manufactures custom parts to specific customer orders that have no alternative use to the Company, and the Company believes there is a legally enforceable right to payment for performance completed to date on these manufactured parts. For manufactured parts that meet these two criteria, the Company will recognize revenue over time. The transition adjustment recorded was an increase of \$1.5 million to the Company's retained earnings balance as of January 1, 2018.

During the first quarter of 2018, the Company adopted ASU 2017-09, *Compensation – Stock Compensation*, which is intended to provide clarity and reduce diversity in practice as well as cost and complexity when applying the guidance to a change to the terms or conditions of a share-based payment award. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

Recently issued accounting pronouncements

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 will adopt the lease standard on January 1, 2019 using the new transition option issued under the amendments in ASU 2018-11, *Leases*, which will allow the Company to continue to apply the legacy guidance in ASC 840, *Leases*, in the comparative periods presented in the year of adoption. The Company will elect the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allows the Company to carry forward the historical lease classification. The Company will make an accounting policy election to keep leases with an initial term of 12 months or less off of the balance sheet. The Company will recognize those lease payments in the Consolidated Statements of Comprehensive Income on a straight-line basis over the lease term. The impact of adoption is expected to be an increase to the Company's operating lease assets and liabilities on January 1, 2019 of approximately \$14.0 million.

In January 2017, the FASB issued ASU 2017-04, *Intangibles – Goodwill and Other*, which is intended to simplify the subsequent measurement of goodwill. This guidance will be effective for impairment tests in fiscal years beginning after December 15, 2019 and interim periods within those fiscal years with early adoption permitted. The Company does not expect the impact to be material.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses*, which is intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments held by a reporting entity at each reporting date. This guidance will be effective for fiscal years beginning after December 15, 2020 and interim periods within those fiscal years with early adoption permitted. The Company is evaluating the impact of future adoption of this guidance on its consolidated financial statements, but does not expect the impact to be material.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

Note 3 – Revenue

The Company provides quality, quick-turn prototyping and on-demand manufacturing services. As a result, the majority of revenue recognized in a reporting period is based on completed, invoiced contracts. The Company accounts for revenue in accordance with ASC 606, which the Company adopted on January 1, 2018, using the modified retrospective method. Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while prior period amounts are not adjusted and continue to be reported in accordance with the Company's historic accounting under ASC 605. The Company recorded a net increase of \$1.5 million to its retained earnings balance on January 1, 2018 due to the cumulative impact of adopting ASC 606. The impact of adopting ASC 606 was to increase revenue by \$0.3 million and increase cost of revenue by \$0.2 million for the year ended December 31, 2018, and to increase accounts receivable by \$2.9 million and decrease inventory by \$1.3 million as of December 31, 2018, which includes the transition adjustment of \$1.5 million noted above.

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of account in ASC 606. The majority of the Company's CNC machining, 3D printing, and sheet metal contracts have a single performance obligation. The majority of the Company's injection molding contracts have multiple performance obligations including one obligation to produce the mold and a second obligation to produce parts. For injection molding contracts with multiple performance obligations, we allocate revenue to each performance obligation based on its relative standalone selling price. We generally determine standalone selling price based on the price charged to customers.

The Company manufactures parts that have no alternative use to the Company since the parts are custom made to specific customer orders, and the Company believes there is a legally enforceable right to payment for performance completed to date on these manufactured parts. For manufactured parts that meet these two criteria, the Company will recognize revenue over time. Revenue is recognized over time using the input method based on time in production to measure progress toward satisfying performance obligations.

Revenue by geographic region for the years ended December 31, 2018, 2017 and 2016 was as follows:

| (in thousands) | Year Ended December 31, | | |
|-----------------|-------------------------|-------------------|-------------------|
| | 2018 | 2017 | 2016 |
| Revenue: | | | |
| United States | \$ 350,535 | \$ 263,086 | \$ 223,930 |
| Europe | 80,889 | 70,154 | 63,365 |
| Japan | 14,172 | 11,250 | 10,760 |
| Total revenue | <u>\$ 445,596</u> | <u>\$ 344,490</u> | <u>\$ 298,055</u> |

Revenue by product line for the years ended December 31, 2018, 2017 and 2016 was as follows:

| (in thousands) | Year Ended December 31, | | |
|-------------------|-------------------------|-------------------|-------------------|
| | 2018 | 2017 | 2016 |
| Revenue: | | | |
| Injection Molding | \$ 210,523 | \$ 194,432 | \$ 175,974 |
| CNC Machining | 153,521 | 103,739 | 81,407 |
| 3D Printing | 53,342 | 43,329 | 37,847 |
| Sheet Metal | 24,998 | 1,767 | - |
| Other Revenue | 3,212 | 1,223 | 2,827 |
| Total revenue | <u>\$ 445,596</u> | <u>\$ 344,490</u> | <u>\$ 298,055</u> |

The Company generally expenses sales commissions when incurred because the amortization period would have been one year or less. These costs are recorded within marketing and sales expenses. The value of unsatisfied performance obligations for contracts with an original expected length of one year or less is not material.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

Note 4 – 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 the 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 and other stock-based awards granted under stock-based compensation plans and shares committed to be purchased under the employee stock purchase plan.

The following table presents the calculation of net income per basic and diluted share attributable to common shareholders:

| (in thousands, except share and per share amounts) | Year Ended December 31, | | |
|---|-------------------------|-------------------|-------------------|
| | 2018 | 2017 | 2016 |
| Net Income | \$ 76,588 | \$ 51,778 | \$ 42,707 |
| Basic - weighted-average shares outstanding: | 26,982,614 | 26,647,610 | 26,365,173 |
| Effect of dilutive securities: | | | |
| Employee stock options and other | 296,202 | 197,461 | 199,466 |
| Diluted - weighted-average shares outstanding: | <u>27,278,816</u> | <u>26,845,071</u> | <u>26,564,639</u> |
| Net income per share attributable to common shareholders: | | | |
| Basic | <u>\$ 2.84</u> | <u>\$ 1.94</u> | <u>\$ 1.62</u> |
| Diluted | <u>\$ 2.81</u> | <u>\$ 1.93</u> | <u>\$ 1.61</u> |

Note 5 – Business Combinations

On November 30, 2017, the Company acquired RAPID for \$121.9 million, consisting of \$110.6 million in cash (net of cash acquired) and \$11.3 million in the Company's common stock. The operations of RAPID are integrated into the operations of the Company.

RAPID is a New Hampshire-based custom parts supplier specializing in quick-turn sheet metal fabrication and CNC machining. With the acquisition, the Company offers its customers another quick-turn manufacturing service while expanding its CNC machining capabilities.

The acquisition has been accounted for under the acquisition method of accounting in accordance with ASC 805. The fair value of the consideration paid exceeded the fair value of the assets acquired and liabilities assumed, which resulted in goodwill of \$99.8 million. The goodwill primarily relates to synergies resulting from the acquisition and is deductible for tax purposes over a 15-year period.

Proto Labs, Inc.
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The RAPID amortizable intangible assets were valued as of the acquisition date and were deemed to have a weighted-average useful life of 5.5 years. The customer relationships were valued at \$7.5 million based on the Multi-Period Excess Earnings Method and are amortized over 6.0 years. The trade names were valued at \$1.1 million based on the Relief-from-Royalty Method and are amortized over 2.0 years. The non-competition agreement was valued at \$0.1 million based on the Discounted Cash Flow method and will be amortized over 5 years. The allocation of the purchase price to assets acquired and liabilities assumed is as follows:

| | |
|----------------------------------|-------------------|
| (in thousands) | |
| Assets acquired: | |
| Current assets | \$ 6,720 |
| Goodwill | 99,836 |
| Other intangible assets | 8,700 |
| Other long-term assets | 8,855 |
| Total assets acquired | <u>124,111</u> |
| Liabilities assumed: | |
| Current liabilities | 2,067 |
| Other long-term liabilities | 85 |
| Total liabilities assumed | <u>2,152</u> |
| Net assets acquired | <u>\$ 121,959</u> |
| Cash paid | \$ 115,378 |
| Cash acquired | <u>(4,755)</u> |
| Net cash consideration | 110,623 |
| Equity portion of purchase price | <u>11,336</u> |
| Total purchase consideration | <u>\$ 121,959</u> |

The following unaudited pro forma information represents the Company's results of operations as if the fiscal 2017 acquisition of RAPID had occurred at the beginning of fiscal 2016. These performance results may not be indicative of the actual results that would have occurred under the ownership and management of the Company.

| (in thousands) | Year Ended December 31, | |
|----------------|-------------------------|------------|
| | 2017 | 2016 |
| | (unaudited) | |
| Revenue | \$ 386,677 | \$ 336,634 |
| Net income | 55,070 | 41,805 |

The unaudited pro forma net income for the year ended December 31, 2017 excludes transaction costs of approximately \$1.9 million and includes the increase in estimated depreciation expense of approximately \$0.9 million and the increase in estimated amortization expense of approximately \$3.0 million. The unaudited pro forma net income for the year ended December 31, 2016 includes the impact of new stock options and restricted stock units granted to employees of approximately \$0.2 million in connection with the acquisition, an increase in estimated depreciation expense of approximately \$0.6 million and the increase in estimated amortization expense of approximately \$3.1 million. The pro forma net income for the years ended December 31, 2017 and 2016 include the related tax effects of the adjustments. The pro forma information has been prepared for comparative purposes only and includes certain adjustments, as noted above. The adjustments are estimates and actual amounts may differ materially from these estimates. They do not reflect the effect of costs or synergies that would have been expected to result from the integration of the RAPID acquisition. The pro forma information does not purport to be indicative of the results of operations that actually would have resulted had the RAPID acquisition occurred on January 1, 2016. The Company's 2017 Consolidated Statements of Comprehensive Income include \$3.6 million of revenue and \$0.7 million of net loss related to RAPID. The net loss was primarily driven by \$1.1 million of bonus payments to RAPID employees as a result of the acquisition.

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Note 6 – Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill for the years ended December 31, 2018 and 2017 were as follows:

| (in thousands) | Dec. 31, 2016 | Goodwill acquired during 2017 | Dec. 31, 2017 | Goodwill acquired during 2018 | Dec. 31, 2018 |
|----------------|------------------|-------------------------------------|-------------------|-------------------------------------|-------------------|
| United States | \$ 24,047 | \$ 99,588 | \$ 123,635 | \$ 248 | \$ 123,883 |
| Europe | 4,239 | - | 4,239 | - | 4,239 |
| Japan | 630 | - | 630 | - | 630 |
| Total goodwill | <u>\$ 28,916</u> | <u>\$ 99,588</u> | <u>\$ 128,504</u> | <u>\$ 248</u> | <u>\$ 128,752</u> |

As described in Note 5 – Business Combinations, the Company acquired RAPID in November 2017. The fair value of the consideration paid exceeded the fair value of the assets acquired and liabilities assumed, which resulted in goodwill in the United States of \$99.6 million for the year ended December 31, 2017 and a related working capital adjustment of \$0.2 million for the year ended December 31, 2018.

Intangible assets other than goodwill for the years ended December 31, 2018 and 2017 were as follows:

| (in thousands) | Year Ended December 31, 2018 | | | Year Ended December 31, 2017 | | | 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 | \$ (434) | \$ 496 | \$ 930 | \$ (341) | \$ 589 | 10.0 | 5.3 |
| Non-compete agreement | 270 | (206) | 64 | 270 | (190) | 80 | 2.0 - 5.0 | 4.0 |
| Trade secrets | 250 | (233) | 17 | 250 | (183) | 67 | 5.0 | 0.3 |
| Trade names | 1,080 | (540) | 540 | 1,080 | - | 1,080 | 2.0 | 1.0 |
| Software technology | 12,229 | (997) | 11,232 | 8,229 | - | 8,229 | 10.0 | 9.0 |
| Customer relationships | 10,070 | (2,569) | 7,501 | 10,070 | (1,031) | 9,039 | 6.0 - 9.0 | 4.8 |
| Total intangible assets | <u>\$ 24,829</u> | <u>\$ (4,979)</u> | <u>\$ 19,850</u> | <u>\$ 20,829</u> | <u>\$ (1,745)</u> | <u>\$ 19,084</u> | | |

Amortization expense for intangible assets for the years ended December 31, 2018, 2017 and 2016 was \$3.2 million, \$0.5 million and \$0.7 million, respectively.

The Company acquired a software company in December 2017, which was accounted for as an asset acquisition and resulted in an \$8.2 million software technology intangible asset for the year ended December 31, 2017. The acquisition did not meet the definition of a business under ASC 805. The asset acquisition included an additional \$5.0 million in contingent consideration to be recognized and paid upon completion of certain milestones over a 24-month period. The completion of each milestone will result in additional value to the software technology intangible asset. We recognized \$4.0 million of the contingent consideration for the year ended December 31, 2018. We did not recognize any of the contingent consideration for the year ended December 31, 2017 as the contingency was not resolved.

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

| (in thousands) | Estimated Amortization Expense |
|--------------------------------------|--------------------------------------|
| 2019 | \$ 3,451 |
| 2020 | 2,895 |
| 2021 | 2,895 |
| 2022 | 2,895 |
| 2023 | 2,691 |
| Thereafter | 5,023 |
| Total estimated amortization expense | <u>\$ 19,850</u> |

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Note 7 – 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 which 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 equivalents measured at fair value as of December 31, 2018 and 2017, respectively, consist of money market mutual funds. The Company determines the fair value of these financial assets using Level 1 inputs.

The following tables summarize financial assets as of December 31, 2018 and 2017 measured at fair value on a recurring basis:

| (in thousands) | December 31, 2018 | | | December 31, 2017 | | |
|---------------------------|-------------------|-------------|-------------|-------------------|-------------|-------------|
| | Level 1 | Level 2 | Level 3 | Level 1 | Level 2 | Level 3 |
| Financial Assets: | | | | | | |
| Cash and cash equivalents | | | | | | |
| Money market mutual funds | \$ 8,943 | \$ - | \$ - | \$ 3,034 | \$ - | \$ - |
| Total | <u>\$ 8,943</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 3,034</u> | <u>\$ -</u> | <u>\$ -</u> |

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Note 8 – 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 December 31, 2018 and 2017 is as follows:

| (in thousands) | December 31, 2018 | | | |
|---------------------------------------|-------------------|---------------------|----------------------|------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| U.S. government agency securities | \$ 16,843 | \$ - | \$ (88) | \$ 16,755 |
| Corporate debt securities | 31,769 | - | (96) | 31,673 |
| U.S. municipal securities | 17,509 | 1 | (33) | 17,477 |
| Certificates of deposit/time deposits | 4,208 | - | (25) | 4,183 |
| Total marketable securities | <u>\$ 70,329</u> | <u>\$ 1</u> | <u>\$ (242)</u> | <u>\$ 70,088</u> |

| (in thousands) | December 31, 2017 | | | |
|---------------------------------------|-------------------|---------------------|----------------------|------------------|
| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
| U.S. government agency securities | \$ 32,320 | \$ - | \$ (199) | \$ 32,121 |
| Corporate debt securities | 29,806 | - | (128) | 29,678 |
| U.S. municipal securities | 28,364 | - | (104) | 28,260 |
| Certificates of deposit/time deposits | 3,968 | - | (32) | 3,936 |
| Total marketable securities | <u>\$ 94,458</u> | <u>\$ -</u> | <u>\$ (463)</u> | <u>\$ 93,995</u> |

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 to be temporary in nature. The investment policy adopted by the Company dictates that only investments in quality, highly rated debt securities are permitted. Those unrealized losses displayed above are the result of macroeconomic factors and are indicative of neither the quality of the underlying security nor the issuer's ability to pay its debt. The Company intends, and has the ability, 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.

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The December 31, 2018 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) | December 31, 2018 |
|---------------------------------------|------------------------------|
| Due in one year or less | \$ 46,750 |
| Due after one year through five years | 23,579 |
| Total marketable securities | <u>\$ 70,329</u> |

Note 9 – Property and Equipment

Property and equipment consists of the following:

| (in thousands) | December 31, | |
|---|---------------------|-------------------|
| | 2018 | 2017 |
| Land | \$ 10,566 | \$ 8,910 |
| Buildings and improvements | 72,819 | 49,921 |
| Machinery and equipment | 185,416 | 148,535 |
| Computer hardware and software | 22,323 | 17,634 |
| Leasehold improvements | 7,330 | 6,634 |
| Construction in progress | 25,279 | 8,988 |
| Total | <u>323,733</u> | <u>240,622</u> |
| Accumulated depreciation and amortization | (95,732) | (74,182) |
| Property and equipment, net | <u>\$ 228,001</u> | <u>\$ 166,440</u> |

Depreciation expense for the years ended December 31, 2018, 2017 and 2016 was \$23.5 million, \$18.0 million and \$16.8 million, respectively.

Note 10 – 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 consists of the following:

| (in thousands) | December 31, | |
|-----------------------------|---------------------|------------------|
| | 2018 | 2017 |
| Raw materials | \$ 9,560 | \$ 9,767 |
| Work in process | 792 | 1,998 |
| Total inventory | <u>10,352</u> | <u>11,765</u> |
| Allowance for obsolescence | (265) | (494) |
| Inventory, net of allowance | <u>\$ 10,087</u> | <u>\$ 11,271</u> |

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Note 11 – Financing Obligations

The Company's debt consists of the following:

| (in thousands) | December 31, | |
|--|--------------|----------|
| | 2018 | 2017 |
| Revolving Credit Facility, with interest rates from 2.50% to 2.59%, due at maturity in November 2019 | \$ - | \$ 5,000 |
| Total Financing Obligations | \$ - | \$ 5,000 |

The Company entered into a Credit Agreement (the "Credit Agreement") with Wells Fargo Bank, National Association, as lender on November 27, 2017. The Credit Agreement provides the Company with a committed \$30.0 million unsecured revolving credit facility (the "Facility"), which includes a \$5.0 million letter of credit sub-facility. The commitments under the Facility will expire on November 30, 2019, and any loans outstanding on such date will mature and be payable on such date. The Company's obligations under the Credit Agreement are guaranteed by the Company's domestic subsidiaries. Loans under the Facility bear interest at a rate per annum equal to, at the election of the Company, either (i) a fluctuating rate per annum equal to daily one month LIBOR plus 1%, or (ii) a fixed rate per annum equal to LIBOR for an interest period of one, two or six months (as designated by the Company) plus 1%. In addition, the Company will pay a commitment fee on the average daily unused amount of the Facility at a rate per annum equal to 0.15%.

Note 12 – Employee Benefit Plans

The Company maintains a 401(k) retirement plan that covers employees in the United States. Under the plan, a full-time or regular part-time (over 20 hours/week) employee becomes a participant after completing three months of employment. Employees may elect to contribute up to 50 percent of regular gross pay, subject to federal law limits on the dollar amount that participants may contribute to the plan, each calendar year. The Company matches part of the employee contributions and may make a discretionary contribution to the plan. Total employer contributions were approximately \$2.7 million, \$1.9 million and \$1.6 million for the years ended December 31, 2018, 2017 and 2016, respectively.

The Company also sponsors a defined contribution retirement plan that covers the employees in the United Kingdom. Total employer contributions were approximately \$0.3 million, \$0.3 million and \$0.2 million for the years ended December 31, 2018, 2017 and 2016, respectively.

Note 13 – Stock-Based Compensation

The Company has two equity incentive plans: the 2000 Stock Option Plan (2000 Plan) and the 2012 Long-Term Incentive Plan (2012 Plan). Upon the adoption of the 2012 Plan on February 21, 2012, all shares that were reserved but not issued under the 2000 Plan were assumed by the 2012 Plan. No additional awards will be issued under the 2000 Plan. Under the 2012 Plan, the Company has the ability to grant stock options, stock appreciation rights (SARs), restricted stock, performance 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 of the board of directors 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. Restricted stock is valued at fair market value on the date of grant.

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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 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, and 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. The Company determines the fair value stock-based compensation related to its ESPP in accordance with ASC 718 using the component measurement approach and the Black-Scholes standard option pricing model.

Employees purchased 33,562 and 41,307 shares of common stock under the ESPP at an average exercise price of \$85.61 and \$48.91 during 2018 and 2017, respectively. As of December 31, 2018, 1,210,445 shares remained available for future issuance under the ESPP.

The Company determines its stock-based compensation in accordance with ASC 718, which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and non-employee directors based on fair value.

Determining the appropriate fair value model and calculating the fair value of stock option grants requires the input of subjective assumptions. The Company uses the Black-Scholes option pricing model to value its stock option awards. Stock-based compensation expense is calculated using the Company's best estimates, which involve inherent uncertainties and the application of management's judgment. Significant estimates include its expected term and stock price volatility.

The expected term of stock options is estimated from the vesting period of the award and represents the weighted average period that the Company's stock options are expected to be outstanding. The Company estimates the volatility of its stock price based on the historic volatility of its common stock. The Company bases the risk-free interest rate that it uses in the Black-Scholes option pricing model on U.S. Treasury instruments with maturities similar to the expected term of the award being valued. The Company has never paid and does not anticipate paying, any cash dividends in the foreseeable future and, therefore, the Company uses an expected dividend yield of zero in the option pricing model. The Company accounts for forfeitures as they occur. The Company allocates stock-based compensation expense on a straight-line basis over the requisite service period.

The following table summarizes stock-based compensation expense for the years ended December 31, 2018, 2017 and 2016, respectively:

| (in thousands) | Year Ended December 31, | | |
|--|-------------------------|-----------------|-----------------|
| | 2018 | 2017 | 2016 |
| Stock options and other | \$ 10,113 | \$ 7,954 | \$ 6,177 |
| Employee stock purchase plan | 815 | 604 | 598 |
| Total stock-based compensation expense | <u>\$ 10,928</u> | <u>\$ 8,558</u> | <u>\$ 6,775</u> |
| Cost of revenue | \$ 1,543 | \$ 970 | \$ 691 |
| Operating expenses: | | | |
| Marketing and sales | 1,942 | 1,429 | 977 |
| Research and development | 1,517 | 1,091 | 1,396 |
| General and administrative | 5,926 | 5,068 | 3,711 |
| Total stock-based compensation expense | <u>\$ 10,928</u> | <u>\$ 8,558</u> | <u>\$ 6,775</u> |

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Stock Options

The following table provides the assumptions used in the Black-Scholes option pricing model for the years ended December 31, 2018, 2017 and 2016:

| | Year Ended December 31, | | |
|--|-------------------------|----------------|----------------|
| | 2018 | 2017 | 2016 |
| Risk-free interest rate | 2.52 - 3.07% | 2.24 - 2.36% | 1.53 - 2.68% |
| Expected life (years) | 6.25 | 6.50 | 6.50 |
| Expected volatility | 41.68 - 42.22% | 42.68 - 44.68% | 44.38 - 45.93% |
| Expected dividend yield | 0% | 0% | 0% |
| Weighted average grant date fair value | \$50.08 | \$32.26 | \$26.61 |

The following table summarizes stock option activity and the weighted average exercise price for the years ended December 31, 2018, 2017 and 2016:

| | Stock Options | Weighted-Average Exercise Price |
|--|---------------|---------------------------------|
| Options outstanding at January 1, 2016 | 766,042 | \$ 36.52 |
| Granted | 117,480 | 57.99 |
| Exercised | (226,164) | 16.65 |
| Cancelled | (87,719) | 61.41 |
| Options outstanding at December 31, 2016 | 569,639 | 45.00 |
| Granted | 60,100 | 69.06 |
| Exercised | (187,313) | 35.93 |
| Cancelled | (43,371) | 61.02 |
| Options outstanding at December 31, 2017 | 399,055 | 51.13 |
| Granted | 36,600 | 110.59 |
| Exercised | (155,765) | 38.92 |
| Cancelled | (27,274) | 74.35 |
| Options outstanding at December 31, 2018 | 252,616 | \$ 64.71 |
| Exercisable at December 31, 2018 | 125,925 | \$ 53.02 |

The outstanding options have a term of 10 years. For employees, options that have been granted become exercisable ratably over the vesting period, which is generally a four- or 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 total intrinsic value of options exercised during the years ended December 31, 2018, 2017 and 2016, was \$13.0 million, \$7.0 million and \$11.1 million, respectively. The aggregate intrinsic value represents the cumulative difference between the fair market value of the underlying common stock and the option exercise prices.

For options outstanding at December 31, 2018, the weighted-average remaining contractual term was 5.7 years and the aggregate intrinsic value was \$12.2 million. For options exercisable at December 31, 2018, the weighted-average remaining contractual term was 3.5 years and the aggregate intrinsic value was \$7.5 million. Refer to the table below for additional information.

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The following table summarizes information about stock options outstanding at December 31, 2018:

| Range of Exercise Prices | Options Outstanding, Vested and Expected to Vest | | | Options Exercisable | |
|-----------------------------|--|---|---|-----------------------|---|
| | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price (\$) | Number Exercisable | Weighted Average Exercise Price (\$) |
| \$3.67 to \$31.43 | 30,972 | 2.95 | 24.59 | 30,972 | 24.59 |
| \$31.44 to \$66.87 | 133,492 | 5.36 | 58.52 | 69,210 | 58.78 |
| \$66.88 to \$96.20 | 51,894 | 5.55 | 72.49 | 25,743 | 71.73 |
| \$96.21 to \$123.10 | 36,258 | 9.23 | 110.59 | 0 | 0.00 |

The fair value of share-based payment transactions is recognized in the consolidated statements of comprehensive income. As of December 31, 2018, there was \$3.3 million of total unrecognized compensation cost related to unvested stock options, which is expected to be recognized over a weighted average period of 2.8 years. The total fair value of options vested was \$1.5 million, \$2.8 million and \$3.6 million for the years ended December 31, 2018, 2017 and 2016, respectively.

Restricted Stock

The 2012 Plan provides for the award of restricted stock or restricted stock units. Restricted stock awards are share settled and restrictions lapse ratably over the vesting period, which is generally a four- or 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 for the years ended December 31, 2018, 2017 and 2016:

| | Restricted Stock Awards | Weighted- Average Grant Date Fair Value Per Share |
|---------------------------------------|----------------------------|---|
| Restricted stock at January 1, 2016 | 124,393 | \$ 68.97 |
| Granted | 161,555 | 59.37 |
| Restrictions lapsed | (41,415) | 67.78 |
| Forfeited | (29,428) | 63.23 |
| Restricted stock at December 31, 2016 | 215,105 | 62.78 |
| Granted | 210,744 | 63.70 |
| Restrictions lapsed | (60,102) | 63.60 |
| Forfeited | (30,916) | 61.99 |
| Restricted stock at December 31, 2017 | 334,831 | 63.29 |
| Granted | 106,855 | 115.41 |
| Restrictions lapsed | (86,191) | 63.64 |
| Forfeited | (31,574) | 68.67 |
| Restricted stock at December 31, 2018 | <u>323,921</u> | \$ 79.85 |

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As of December 31, 2018, there was \$20.7 million of unrecognized compensation expense related to non-vested restricted stock, which is expected to be recognized over a weighted-average period of 3.1 years.

Performance Stock

Performance Stock Units (PSUs) are expressed in terms of a target number of PSUs, with anywhere between 0 percent and 150 percent of that target number capable of being earned and vesting at the end of a three-year performance period depending on the Company's performance in the final year of the performance period and the award recipient's continued employment.

The following table summarizes performance stock activity for the years ended December 31, 2018, 2017 and 2016:

| | Performance Stock Awards | Weighted- Average Grant Date Fair Value Per Share |
|--|-----------------------------|---|
| Performance stock at January 1, 2016 | - | \$ - |
| Granted | - | - |
| Restrictions lapsed | - | - |
| Forfeited | - | - |
| Performance stock at December 31, 2016 | - | - |
| Granted | 25,707 | 58.35 |
| Restrictions lapsed | - | - |
| Forfeited | - | - |
| Performance stock at December 31, 2017 | 25,707 | 58.35 |
| Granted | 20,006 | 105.75 |
| Restrictions lapsed | - | - |
| Performance assumption change | 6,427 | 58.35 |
| Forfeited | - | - |
| Performance stock at December 31, 2018 | 52,140 | \$ 76.54 |

As of December 31, 2018, there was \$2.2 million of unrecognized compensation expense related to non-vested performance stock, which is expected to be recognized over a weighted-average period of 1.8 years.

Employee Stock Purchase Plan

The following table presents the assumptions used to estimate the fair value of the ESPP during the years ended December 31, 2018, 2017 and 2016:

| | Year ended December 31, | | |
|-------------------------|-------------------------|----------------|----------------|
| | 2018 | 2017 | 2016 |
| Risk-free interest rate | 2.06 - 2.33% | 0.97 - 1.48% | 0.56 - 0.59% |
| Expected life (months) | 6.00 | 6.00 | 6.00 |
| Expected volatility | 31.50 - 37.36% | 24.49 - 34.51% | 39.51 - 49.13% |
| Expected dividend yield | 0% | 0% | 0% |

Note 14 – Commitments

The Company leases property from third parties. The Company leases three of its U.S. facilities with terms expiring at various times from 2019 to 2022. The Company also leases office space in the United Kingdom, France, Germany, Sweden and Italy with terms expiring at various times from 2019 to 2025. The Company leases an office and manufacturing space in Japan, and the initial term expires in April 2023. The Company also leases manufacturing space in Germany with terms expiring at various times from 2019 to 2028.

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Future minimum commitments under non-cancelable leases at December 31, 2018, are as follows:

| (in thousands) | <u>Operating Leases</u> |
|-------------------------------------|-----------------------------|
| Years Ending December 31, | |
| 2019 | \$ 3,411 |
| 2020 | 2,612 |
| 2021 | 2,266 |
| 2022 | 2,211 |
| 2023 | 975 |
| After 2023 | 2,142 |
| Total future minimum lease payments | <u>\$ 13,617</u> |

Rental expense was approximately \$4.2 million, \$3.0 million and \$3.6 million for the years ended December 31, 2018, 2017 and 2016, respectively.

Note 15 – Accumulated Other Comprehensive Loss

Other comprehensive loss is comprised entirely of foreign currency translation adjustments. The following table presents the changes in accumulated other comprehensive loss balances for the years ending December 31, 2018, 2017 and 2016, respectively:

| (in thousands) | <u>Year Ended December 31,</u> | | |
|---|--------------------------------|-------------------|--------------------|
| | <u>2018</u> | <u>2017</u> | <u>2016</u> |
| Foreign currency translation adjustments | | | |
| Balance at beginning of period | \$ (5,234) | \$ (10,753) | \$ (5,212) |
| Other comprehensive (loss) income before reclassifications | (3,258) | 5,519 | (5,541) |
| Amounts reclassified from accumulated other comprehensive income (loss) | - | - | - |
| Net current-period other comprehensive (loss) income | <u>(3,258)</u> | <u>5,519</u> | <u>(5,541)</u> |
| Balance at end of period | <u>\$ (8,492)</u> | <u>\$ (5,234)</u> | <u>\$ (10,753)</u> |

Note 16 – 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 the years ended December 31, 2018, 2017 and 2016, the Company recorded an income tax provision of \$15.1 million, \$22.7 million and \$21.5 million, respectively. The effective income tax rate for the years ended December 31, 2018, 2017 and 2016 was 16.4 percent, 30.4 percent and 33.4 percent, respectively.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

The effective tax rate decreased by 14.0% for the year ended December 31, 2018 when compared to 2017 primarily due to the impact of the Tax Cuts and Jobs Act (the “Act”), which was enacted on December 22, 2017. The Act reduced the U.S. federal corporate tax rate from 35% to 21%, requires companies to pay a transition tax on earnings of certain foreign subsidiaries that were previously tax deferred and creates new taxes on certain foreign sourced earnings. The reduction to the U.S. tax rate results in revaluing deferred tax liabilities. At December 31, 2017, the Company had not completed its accounting for the tax effects of the enactment of the Act. However, the Company made a reasonable estimate on the effects of the transition tax and recognized a provisional amount of \$2.4 million which was included as a component of income tax expense from continuing operations. The Company was also required to revalue its deferred tax liabilities to reflect the new U.S. federal corporate income tax rate from the Act which resulted in the recognition of an estimated tax benefit of \$4.2 million in 2017. At December 31, 2018, the Company completed its accounting for the tax effects of the enactment of the Act. As a result, the Company recorded a tax benefit of \$0.7 million for the final accounting for the transition tax and a tax benefit of \$0.5 million resulting from the completion of the accounting related to the revaluation of its net deferred tax liabilities utilizing the new U.S. federal corporate income tax rate. The impact of the tax effects for the enactment of the Act was a tax benefit of \$3.0 million. The foreign tax effects of the transition tax was based on our total post-1986 earnings and profits that we previously deferred from U.S. income taxes. No additional income taxes have been provided for any remaining undistributed foreign earnings not subject to the transition tax or any additional outside basis difference inherent in these entities as these amounts continue to be indefinitely reinvested in foreign operations.

The provision for income taxes is based on income before income taxes reported for financial statement purposes. The components of income before income taxes are as follows:

| (in thousands) | Year Ended December 31, | | |
|----------------|-------------------------|------------------|------------------|
| | 2018 | 2017 | 2016 |
| Domestic | \$ 81,893 | \$ 69,929 | \$ 59,232 |
| Foreign | 9,762 | 4,506 | 4,989 |
| Total | <u>\$ 91,655</u> | <u>\$ 74,435</u> | <u>\$ 64,221</u> |

Significant components of the provision for income taxes for the following periods are as follows:

| (in thousands) | Year Ended December 31, | | |
|---------------------|-------------------------|------------------|------------------|
| | 2018 | 2017 | 2016 |
| Current: | | | |
| Federal | \$ (782) | \$ 17,808 | \$ 15,119 |
| State | 2,078 | 1,367 | 1,091 |
| Foreign | 1,810 | 2,215 | 2,439 |
| Deferred | | | |
| Federal | 11,325 | 865 | 2,758 |
| State | 538 | 193 | 75 |
| Foreign | (430) | (1,918) | (1,960) |
| Valuation Allowance | 528 | 2,127 | 1,992 |
| Total | <u>\$ 15,067</u> | <u>\$ 22,657</u> | <u>\$ 21,514</u> |

A reconciliation of the federal statutory income tax rate to the effective tax rate is as follows:

| | Year Ended December 31, | | |
|---|-------------------------|-------|-------|
| | 2018 | 2017 | 2016 |
| Federal tax statutory rate | 21.0% | 35.0% | 35.0% |
| State tax (net of federal benefit) | 2.0 | 1.7 | 0.6 |
| Share based compensation | (2.8) | (0.8) | - |
| Valuation allowance against deferred tax assets | 0.7 | 2.9 | 3.1 |
| Research and development credit | (2.5) | (2.2) | (2.2) |
| Foreign rate differential | (0.1) | (1.9) | (2.8) |
| Tax reserves | (0.1) | 0.9 | 1.4 |
| Domestic manufacturing deduction | - | (2.5) | (1.8) |
| Other | (0.5) | (0.2) | 0.1 |
| Transition tax | (0.8) | 3.2 | - |
| Revaluation of deferred tax liability | (0.5) | (5.7) | 0.0 |
| Total | 16.4% | 30.4% | 33.4% |

Significant components of deferred tax assets and liabilities are as follows:

| (in thousands) | December 31, | |
|---|--------------|------------|
| | 2018 | 2017 |
| Deferred tax assets: | | |
| Accrued expenses | \$ 931 | \$ 756 |
| Stock options, restricted stock and other | 2,908 | 2,309 |
| Intangible assets | 748 | 429 |
| Inventories | 154 | 220 |
| Other assets | 666 | 625 |
| Net operating loss | 6,605 | 6,374 |
| Less valuation allowance | (6,900) | (6,633) |
| Total deferred tax assets | 5,112 | 4,080 |
| Deferred tax liabilities: | | |
| Depreciation | (21,788) | (9,528) |
| Goodwill | (3,486) | (1,518) |
| Total deferred tax liabilities | (25,274) | (11,046) |
| Net deferred tax liability | \$ (20,162) | \$ (6,966) |

The Company has recorded no U.S. deferred taxes related to the undistributed earnings of its non-U.S. subsidiaries as of December 31, 2018. Such amounts are intended to be reinvested outside of the United States indefinitely. It is not practicable to estimate the amount of additional tax that might be payable on the foreign earnings. As of December 31, 2018, the Company had accumulated undistributed earnings in non-U.S. subsidiaries of \$6.8 million.

As of December 31, 2018, the Company had estimated net operating loss carry forwards of \$22.5 million for tax purposes. The net operating losses relate to operations in Japan and Germany. Japan losses can be carried forward for up to ten years but are limited to 50 percent of taxable income. Germany net operating losses may be carried forward without any time limitations but are limited to €1 million, plus 50 percent of taxable income exceeding €1 million. The remaining Japan net operating losses begin to expire at various dates between 2019 and 2026. The Company's Japan operations are taxed both by local authorities and in the U.S.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

The Company establishes valuation allowances for deferred tax assets when, after consideration of all positive and negative evidence, it is considered more-likely-than-not that a portion of the deferred tax assets will not be realized. The Company's valuation allowances of \$6.9 million and \$6.6 million at December 31, 2018 and 2017, respectively, reduce the carrying value of deferred tax assets associated with certain net operating loss carry forwards and other assets with insufficient positive evidence for recognition. The increase in the valuation allowance is primarily attributable to fluctuations in foreign currency and the net operating losses incurred in Germany in 2018.

The Company files a U.S. federal income tax return and income tax returns in various states and foreign jurisdictions. With a few exceptions, the Company is no longer subject to U.S. federal, state, or foreign income tax examinations by tax authorities for years before 2015.

The Company has liabilities related to unrecognized tax benefits totaling \$4.1 million and \$4.2 million at December 31, 2018 and 2017, respectively, that if recognized would result in a reduction of the Company's effective tax rate. The liabilities are classified as other long-term liabilities in the accompanying consolidated balance sheets. The Company does not anticipate that total unrecognized tax benefits will materially change in the next twelve months. 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. Interest and penalties were immaterial for each of the years ended December 31, 2018, 2017 and 2016.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| | December 31, | |
|---|---------------------|-----------------|
| | 2018 | 2017 |
| Balance at beginning of period | \$ 4,233 | \$ 3,796 |
| Additions for tax positions of current year | 593 | 831 |
| Additions for tax positions of prior years | 309 | 48 |
| Decrease related to expiration of statutes of limitations | (1,039) | (442) |
| Balance at period end | <u>\$ 4,096</u> | <u>\$ 4,233</u> |

Note 17 – Litigation

From time to time, the Company may be subject to various legal proceedings and claims that arise in the ordinary course of its business. Although the results of litigation and claims cannot be predicted with certainty, the Company does not believe it is a party to any litigation the outcome of which, if determined adversely, would individually or in the aggregate be reasonably expected to have a material adverse effect on its business.

Note 18 – Segment Reporting

The Company's reportable segments are based on the internal reporting used by the Company's CEO, who is the chief operating decision maker (CODM), to assess operating performance and make decisions about the allocation of resources. The Company's reportable segments are based upon geographic region, consisting of the United States and Europe. The Corporate Unallocated and Japan category includes non-reportable segments, as well as research and development and general and administrative costs that are global in nature and that the Company does not allocate directly to its operating segments.

Revenue in the United States is derived from Injection Molding, CNC Machining, 3D Printing and Sheet Metal product lines. Revenue in Europe is derived from Injection Molding, CNC Machining, and 3D Printing product lines. Revenue in Japan is derived from Injection Molding and CNC Machining product lines. Injection Molding revenue consists of sales of custom injection molds and injection-molded parts. CNC Machining revenue consists of sales of CNC-machined and lathe-turned customer parts. 3D Printing revenue consists of sales of 3D-printed parts. Sheet Metal revenue consists of sales of fabricated sheet metal parts.

Proto Labs, Inc.
Notes to Consolidated Financial Statements

The accounting policies of the reportable segments are the same as those described in Note 2 – Summary of Significant Accounting Policies. Intercompany transactions primarily relate to intercontinental activity and have been eliminated and are excluded from the reported amounts. The difference between income from operations and pre-tax income relates to foreign currency-related gains and losses and interest income on cash balances and investments, which are not allocated to business segments.

Revenue and income from operations by reportable segment are as follows:

| (in thousands) | Year Ended December 31, | | |
|-----------------|-------------------------|-------------------|-------------------|
| | 2018 | 2017 | 2016 |
| Revenue: | | | |
| United States | \$ 350,535 | \$ 263,086 | \$ 223,930 |
| Europe | 80,889 | 70,154 | 63,365 |
| Japan | 14,172 | 11,250 | 10,760 |
| Total revenue | <u>\$ 445,596</u> | <u>\$ 344,490</u> | <u>\$ 298,055</u> |

| (in thousands) | Year Ended December 31, | | |
|---------------------------------|-------------------------|------------------|------------------|
| | 2018 | 2017 | 2016 |
| Income from Operations: | | | |
| United States | \$ 120,641 | \$ 103,136 | \$ 89,308 |
| Europe | 16,804 | 12,846 | 11,657 |
| Corporate Unallocated and Japan | (48,547) | (43,756) | (39,198) |
| Total income from operations | <u>\$ 88,898</u> | <u>\$ 72,226</u> | <u>\$ 61,767</u> |

Total long-lived assets, expenditures for additions to long-lived assets and depreciation and amortization expense are as follows:

| (in thousands) | December 31, 2018 | December 31, 2017 | December 31, 2016 |
|---------------------------|----------------------|----------------------|----------------------|
| | | | |
| Long-lived assets: | | | |
| United States | \$ 185,979 | \$ 125,308 | \$ 108,650 |
| Europe | 34,577 | 33,691 | 23,199 |
| Japan | 7,445 | 7,441 | 7,625 |
| Total long-lived assets | <u>\$ 228,001</u> | <u>\$ 166,440</u> | <u>\$ 139,474</u> |

| (in thousands) | Year Ended December 31, | | |
|---|-------------------------|------------------|------------------|
| | 2018 | 2017 | 2016 |
| Expenditures for additions to long-lived assets: | | | |
| United States | \$ 78,762 | \$ 20,370 | \$ 21,190 |
| Europe | 7,576 | 11,704 | 5,954 |
| Japan | 766 | 561 | 6,472 |
| Total expenditures for additions to long-lived assets | <u>\$ 87,104</u> | <u>\$ 32,635</u> | <u>\$ 33,616</u> |

Proto Labs, Inc.
Notes to Consolidated Financial Statements

| (in thousands) | Year Ended December 31, | | |
|---------------------------------------|-------------------------|------------------|------------------|
| | 2018 | 2017 | 2016 |
| Depreciation and Amortization: | | | |
| United States | \$ 21,117 | \$ 13,267 | \$ 12,533 |
| Europe | 4,679 | 4,174 | 3,386 |
| Japan | 958 | 1,033 | 1,566 |
| Total depreciation and amortization | <u>\$ 26,754</u> | <u>\$ 18,474</u> | <u>\$ 17,485</u> |

Note 19 – Subsequent Events

None.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9A. 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 Annual Report on Form 10-K, our disclosure controls and procedures were effective and provided 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 timeframes 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.

Management's Annual Report on Internal Control Over Financial Reporting

The Company's management is responsible for establishing and maintaining an adequate system of internal control over financial reporting, as defined in the Exchange Act Rule 13a-15(f). Management conducted an assessment of the Company's internal control over financial reporting based on the framework established by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework* (2013 framework). Based on the assessment, management concluded that, as of December 31, 2018, the Company's internal control over financial reporting is effective. The Company's registered public accounting firm's attestation report on the Company's internal control over financial reporting is provided in Part II, Item 8 of this Annual Report on Form 10-K.

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.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item with respect to Item 401 relating to executive officers is contained in Item 1 of this Annual Report on Form 10-K under the heading “Executive Officers of the Registrant” and with respect to other information relating to our directors will be set forth in our 2019 Proxy Statement under the caption “Proposal 1 — Election of Directors,” which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, and is incorporated herein by reference.

The information required by this item under Item 405 of Regulation S-K is incorporated herein by reference to the section titled “Corporate Governance — Section 16(a) Beneficial Ownership Reporting Compliance” of our 2019 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K. The information required by this item under Items 407 (c)(3), (d)(4) and (d)(5) of Regulation S-K is incorporated herein by reference to the section titled “Corporate Governance” of our 2015 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

We have adopted a Code of Ethics and Business Conduct that applies to all of our directors, officers and employees, including our principal executive officer and principal financial officer. The Code of Ethics and Business Conduct is available on our website at www.protolabs.com under the Investors Relations section. We plan to post to our website at the address described above any future amendments or waivers of our Code of Ethics and Business Conduct.

Item 11. Executive Compensation

Information related to this item is incorporated herein by reference to the sections titled “Compensation Discussion and Analysis,” “Corporate Governance — Compensation Committee Interlocks and Insider Participation,” and “Compensation Committee Report” of our 2019 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

Item 12. Security Ownership of Certain Beneficial Owners and Management

Information related to security ownership required by this item is incorporated herein by reference to the section titled “Security Ownership of Certain Beneficial Owners and Management” of our 2019 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K. Information related to our equity compensation plans required by this item is incorporated herein by reference to the section titled “Compensation Discussion and Analysis – Information Regarding Equity-Based Compensation Plans” of our 2019 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Information required by this item is incorporated herein by reference to the sections titled “Corporate Governance — Certain Relationships and Related Party Transactions,” and “Corporate Governance — Director Independence” of our 2019 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

Item 14. Principal Accountant Fees and Services

Information required by this item is incorporated herein by reference to the section titled “Fees Paid to Independent Registered Public Accounting Firm” of our 2019 Proxy Statement, which will be filed no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this report:

1. Consolidated Financial Statements

See Index to Consolidated Financial Statement at Item 8 herein.

2. Financial Statement Schedules

Schedules not listed above have been omitted because the information required to be set forth therein is not applicable or is shown in the financial statement or notes herein.

3. Exhibits

See the Exhibit Index immediately following the signature page of this Annual Report on Form 10-K.

SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) 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: February 22, 2019

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

Date: February 22, 2019

/s/ John A. Way
John A. Way
Chief Financial Officer
(Principal Financial and Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

Date: February 22, 2019

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

Date: February 22, 2019

/s/ John A. Way
John A Way
Chief Financial Officer
(Principal Financial and Accounting Officer)

Chairman of the Board of Directors:
Sven A. Wehrwein*

Directors:
Archie C. Black*
Sujeet Chand*
Rainer Gawlick*
John B. Goodman*
Donald G. Krantz*

*Victoria M. Holt, by signing her name hereto, does hereby sign this document on behalf of each of the above named officers and directors of the registrant pursuant to powers of attorney duly executed by such persons and filed as an exhibit hereto.

Date: February 22, 2019

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

Table of Contents

| Exhibit Number | Description of Exhibit |
|-------------------------|---|
| 2.1 ⁽²⁹⁾ | <u>Membership Interest Purchase Agreement, dated November 16, 2017, by and among Proto Labs, Inc., Rapid Manufacturing Group, LLC and the members listed therein. (Certain schedules and exhibits have been omitted in accordance with Item 601(b)(2) of Regulation S-K. A copy of any omitted schedule and/or exhibit will be furnished to the Securities and Exchange Commission upon request.)</u> |
| 3.1 ⁽¹⁾ | <u>Third Amended and Restated Articles of Incorporation of Proto Labs, Inc.</u> |
| 3.2 ⁽²⁷⁾ | <u>Articles of Amendment to Third Amended and Restated Articles of Incorporation of Proto Labs, Inc. dated May 20, 2015</u> |
| 3.3 ⁽²⁾ | <u>Second Amended and Restated By-Laws of Proto Labs, Inc. as amended through November 8, 2016.</u> |
| 4.1 ⁽³⁾ | <u>Form of certificate representing common shares of Proto Labs, Inc.</u> |
| 10.1 ⁽⁴⁾ # | <u>2012 Long-Term Incentive Plan, as amended as of August 5, 2015</u> |
| 10.2 ⁽⁵⁾ # | <u>Form of Incentive Stock Option Agreement under 2012 Long-Term Incentive Plan</u> |
| 10.3 ⁽⁶⁾ # | <u>Form of Non-Statutory Stock Option Agreement (Directors) under 2012 Long-Term Incentive Plan</u> |
| 10.4 ⁽⁷⁾ # | <u>Form of Non-Statutory Stock Option Agreement (U.S. Employees) under 2012 Long-Term Incentive Plan</u> |
| 10.5 ⁽⁸⁾ # | <u>Form of Non-Statutory Stock Option Agreement (U.K. Employees) under 2012 Long-Term Incentive Plan</u> |
| 10.6 ⁽⁹⁾ # | <u>Employee Stock Purchase Plan</u> |
| 10.7 ⁽¹⁰⁾ | <u>Stock Subscription Warrant issued to John B. Tumelty</u> |
| 10.8 ⁽¹¹⁾ # | <u>2000 Stock Option Plan, as amended</u> |
| 10.9 ⁽¹²⁾ # | <u>Form of Incentive Stock Option Agreement under 2000 Stock Option Plan</u> |
| 10.10 ⁽¹³⁾ # | <u>Form of Non-Statutory Stock Option Agreement (Directors) under 2000 Stock Option Plan</u> |
| 10.11 ⁽¹⁴⁾ # | <u>Form of Non-Statutory Stock Option Agreement (U.S. Employees) under 2000 Stock Option Plan</u> |
| 10.12 ⁽¹⁵⁾ # | <u>Form of Non-Statutory Stock Option Agreement (U.S. Employees) under 2000 Stock Option Plan</u> |
| 10.13 ⁽¹⁶⁾ # | <u>Form of Non-Statutory Stock Option Agreement (U.K. Employees) under 2000 Stock Option Plan</u> |
| 10.14 ⁽¹⁷⁾ # | <u>Amended and Restated Credit Agreement, dated as of September 30, 2011, between Proto Labs, Inc. and Wells Fargo Bank, N.A.</u> |
| 10.15 ⁽¹⁸⁾ # | <u>Credit Agreement, dated November 27, 2017, by and among Proto Labs and Wells Fargo Bank, National Association</u> |
| 10.16 ⁽¹⁹⁾ # | <u>Form of U.S. Severance Agreement</u> |
| 10.17 ⁽²⁰⁾ # | <u>Form of UK Severance Agreement</u> |
| 10.18 ⁽²¹⁾ # | <u>Executive Employment Agreement, dated February 6, 2014, by and between Proto Labs, Inc. and Victoria M. Holt</u> |
| 10.19 ⁽²²⁾ # | <u>Form of Restricted Stock Agreement under 2012 Long-Term Incentive Plan for the initial grant to Victoria M. Holt</u> |
| 10.20 ⁽²³⁾ # | <u>Form of Restricted Stock Unit Agreement under 2012 Long-Term Incentive Plan (U.S. Employees)</u> |
| 10.21 ⁽²⁴⁾ # | <u>Form of Restricted Stock Unit Agreement under 2012 Long-Term Incentive Plan (U.K. Employees)</u> |
| 10.22 ⁽²⁵⁾ # | <u>Form of Restricted Stock Unit Agreement under 2012 Long-Term Incentive Plan (Directors)</u> |
| 10.23 ⁽²⁶⁾ # | <u>Severance Agreement, dated December 18, 2014, by and between Proto Labs, Inc. and John A. Way</u> |
| 10.24 ⁽²⁸⁾ # | <u>Form of Performance Stock Unit Agreement under 2012 Long-Term Incentive Plan</u> |
| 10.25 ⁽³⁰⁾ # | <u>Form of Deferred Stock Unit Agreement under 2012 Long-Term Incentive Plan</u> |
| 21.1 | <u>Subsidiaries of Proto Labs, Inc.</u> |
| 23.1 | <u>Consent of Ernst & Young LLP</u> |
| 24.1 | <u>Powers of Attorney</u> |
| 31.1 | <u>Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act</u> |
| 31.2 | <u>Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act</u> |
| 32.1* | <u>Certification of the Chief Executive Officer and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act</u> |
| 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) Incorporated by reference to 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.
- (2) Incorporated by reference to Exhibit 3.1 to the Company's Form 8-K, filed with the Commission on November 8, 2016.
- (3) Incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012.
- (4) Incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q, filed with the Commission on November 3, 2015.
- (5) Incorporated by reference to Exhibit 10.14 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012.
- (6) Incorporated by reference to Exhibit 10.15 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012.
- (7) Incorporated by reference to Exhibit 10.16 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012.
- (8) Incorporated by reference to Exhibit 10.17 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012.
- (9) Incorporated by reference to Exhibit 10.18 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on February 13, 2012.
- (10) Incorporated by reference to Exhibit 99.7 to the Company's Registration Statement on Form S-8 (File No. 333-179651), filed with the Commission on February 23, 2012.
- (11) Incorporated by reference to Exhibit 10.7 to the Company's Registration Statement on Form S-1 (File No. 333-175745), filed with the Commission on July 25, 2011.
- (12) Incorporated by reference to Exhibit 10.8 to the Company's Registration Statement on Form S-1 (File No. 333-175745), filed with the Commission on July 25, 2011.
- (13) Incorporated by reference to Exhibit 10.9 to the Company's Registration Statement on Form S-1 (File No. 333-175745), filed with the Commission on July 25, 2011.
- (14) Incorporated by reference to Exhibit 10.10 to the Company's Registration Statement on Form S-1 (File No. 333-175745), filed with the Commission on July 25, 2011.
- (15) Incorporated by reference to Exhibit 10.11 to the Company's Registration Statement on Form S-1 (File No. 333-175745), filed with the Commission on July 25, 2011.
- (16) Incorporated by reference to Exhibit 10.12 to the Company's Registration Statement on Form S-1 (File No. 333-175745), filed with the Commission on July 25, 2011.
- (17) Incorporated by reference to Exhibit 10.19 to the Company's Registration Statement on Form S-1/A (File No. 333-175745), filed with the Commission on October 26, 2011.
- (18) Incorporated by reference to Exhibit 10.1 to the Company's Form 8-K, filed with the Commission on December 1, 2017.
- (19) Incorporated by reference to Exhibit 99.1 to the Company's Form 8-K, filed with the Commission on March 1, 2013.
- (20) Incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q, filed with the Commission on May 8, 2013.
- (21) Incorporated by reference to Exhibit 10.1 to the Company's Form 8-K, filed with the Commission on February 6, 2014.
- (22) Incorporated by reference to Exhibit 10.2 to the Company's Form 8-K, filed with the Commission on February 6, 2014.
- (23) Incorporated by reference to Exhibit 10.1 to the Company's Form 8-K, filed with the Commission on February 12, 2014.
- (24) Incorporated by reference to Exhibit 10.2 to the Company's Form 8-K, filed with the Commission on February 12, 2014.
- (25) Incorporated by reference to Exhibit 99.6 to the Company's Registration Statement on Form S-8 (file No. 333-194272), filed with the Commission on March 3, 2014.
- (26) Incorporated by reference to Exhibit 10.1 to the Company's Form 8-K, filed with the Commission on December 19, 2014.
- (27) Incorporated by reference to Exhibit 3.1 to the Company's Form 8-K, filed with the Commission on May 21, 2015.
- (28) Incorporated by reference to Exhibit 10.1 to the Company's Form 8-K, filed with the Commission on February 17, 2017.
- (29) Incorporated by reference to Exhibit 2.1 to the Company's Form 8-K, filed with the Commission on November 21, 2017.
- (30) Incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q, filed with the Commission on August 1, 2018.

Indicates management contract or compensatory plan or arrangement.

* The certifications furnished in Exhibit 32.1 hereto are deemed to accompany this Annual Report on Form 10-K and will not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended. Such certifications will not be deemed to be incorporated by reference into any filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that the registrant specifically incorporates it by reference.

** Users of this data are advised that, pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability under these sections.

SUBSIDIARIES OF THE REGISTRANT

All of the Company’s subsidiaries listed below are wholly owned.

| <u>Name</u> | <u>Jurisdiction of Incorporation or Organization</u> |
|----------------------------------|--|
| PL-US International LLC | United States |
| Rapid Manufacturing Group LLC | United States |
| Proto Labs Ltd. | United Kingdom |
| PL Euro Services Ltd. | United Kingdom |
| PL International Holdings UK Ltd | United Kingdom |
| PL DE Holding GmbH | Germany |
| Proto Labs GmbH | Germany |
| Proto Labs Eschenlohe GmbH | Germany |
| Proto Labs G.K. | Japan |

Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in the Registration Statements (Form S-8 Nos. 333-179651, 333-194272 and 333-202486) pertaining to the 2012 Long-Term Incentive Plan, Employee Stock Purchase Plan, 2000 Stock Option Plan, and Stock Subscription Warrant of Proto Labs, Inc. of our reports dated February 22, 2019, with respect to the consolidated financial statements of Proto Labs, Inc., and the effectiveness of internal control over financial reporting of Proto labs, Inc., included in this Annual Report (Form 10-K) for the year ended December 31, 2018.

/s/ Ernst & Young LLP

Minneapolis, Minnesota
February 22, 2019

PROTO LABS, INC.
POWER OF ATTORNEY OF DIRECTOR AND/OR OFFICER

Each of the undersigned directors and/or officers of Proto Labs, Inc., a Minnesota corporation (the “Company”), does hereby make, constitute and appoint Victoria M. Holt and John A. Way, and each of them, either of whom may act without the joinder of the other, the undersigned’s true and lawful attorney-in-fact and agent, with full power of substitution, for the undersigned and in the undersigned’s name, place and stead, to sign on his or her behalf, individually and in the capacities stated below, the Annual Report on Form 10-K for the year ended December 31, 2018 under the Securities Exchange Act of 1934, as amended, with any amendment or amendments thereto, with all exhibits thereto and other supporting documents, with the U.S. Securities and Exchange Commission, granting unto said attorneys-in-fact, and each of them, full power and authority to do and perform any and all acts necessary or incidental to the performance and execution of the powers herein expressly granted.

IN WITNESS WHEREOF, each of the undersigned directors and/or officers of Proto Labs, Inc. has hereunto set his or her hand this 22nd day of February, 2019.

/s/ Sven Wehrwein
 Sven A. Wehrwein

Chairman

/s/ Victoria M. Holt
 Victoria M. Holt

President, Chief Executive Officer and Director

/s/ John A. Way
 John A. Way

Chief Financial Officer

/s/ Archie C. Black
 Archie C. Black

Director

/s/ Rainer Gawlick
 Rainer Gawlick

Director

/s/ John B. Goodman
 John B. Goodman

Director

/s/ Donald G. Krantz
 Donald G. Krantz

Director

/s/ Sujeet Chand
 Sujeet Chand

Director

**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 Annual Report on Form 10-K 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: February 22, 2019

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 Annual Report on Form 10-K 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: February 22, 2019

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 Annual Report of Proto Labs, Inc. on Form 10-K for the fiscal year ended December 31, 2018 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 Annual Report on Form 10-K fairly presents in all material respects the financial condition and results of operations of Proto Labs, Inc.

Date: February 22, 2019

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 Annual Report of Proto Labs, Inc. on Form 10-K for the fiscal year ended December 31, 2018 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 Annual Report on Form 10-K fairly presents in all material respects the financial condition and results of operations of Proto Labs, Inc.

Date: February 22, 2019

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