QUINSTREET, INC
Form 10-Q
February 15, 2013
**Table of Contents**

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

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

**For the quarterly period ended December 31, 2012**

**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 No. 001-34628**

# QuinStreet, Inc.

**(Exact Name of Registrant as Specified in Its Charter)**

| | |
|---|---|
| **Delaware** | **77-0512121** |
| **(State or Other Jurisdiction of Incorporation or Organization)** | **(I.R.S. Employer Identification No.)** |
| **950 Tower Lane, 6th Floor Foster City, California** | **94404** |
| **(Address of principal executive offices)** | **(Zip Code)** |

**650-578-7700**

**Registrant s telephone number, including area code**

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

| | | | |
|---|---|---|---|
| Large accelerated filer | ¨ | Accelerated filer | x |
| Non-accelerated filer | ¨ (Do not check if a smaller reporting company) | Smaller reporting company | ¨ |

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

Number of shares of common stock outstanding as of January 31, 2013: 42,795,215

Table of Contents

**QUINSTREET, INC.**

**INDEX**


| | |
|---|---|
| PART I. FINANCIAL INFORMATION | 3 |
| Item 1. Financial Statements | 3 |
| Condensed Consolidated Balance Sheets at December 31, 2012 and June 30, 2012 | 3 |
| Condensed Consolidated Statements of Operations for the Three and Six Months Ended December 31, 2012 and 2011 | 4 |
| Condensed Consolidated Statements of Comprehensive (Loss) Income for the Three and Six Months Ended December 31, 2012 and 2011 | 5 |
| Condensed Consolidated Statements of Cash Flows for the Six Months Ended December 31, 2012 and 2011 | 6 |
| Notes to Condensed Consolidated Financial Statements | 7 |
| Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations | 22 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 33 |
| Item 4. Controls and Procedures | 34 |
| PART II. OTHER INFORMATION | 36 |
| Item 1. Legal Proceedings | 36 |
| Item 1A. Risk Factors | 36 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 55 |
| Item 3. Defaults Upon Senior Securities | 55 |
| Item 4. Mine Safety Disclosures | 55 |
| Item 5. Other Information | 55 |
| Item 6. Exhibits | 56 |
| SIGNATURES | 57 |

Table of Contents

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**QUINSTREET, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(In thousands, except share and per share data)**

**(Unaudited)**

| | December 31, 2012 | June 30, 2012 |
|---|---|---|
| **Assets** | | |
| Current assets | | |
| Cash and cash equivalents | $ 68,323 | $ 68,531 |
| Marketable securities | 39,445 | 36,736 |
| Accounts receivable, net | 41,196 | 52,830 |
| Deferred tax assets | 7,662 | 7,665 |
| Prepaid expenses and other assets | 12,389 | 7,774 |
| Total current assets | 169,015 | 173,536 |
| Property and equipment, net | 8,012 | 8,755 |
| Goodwill | 150,432 | 243,049 |
| Other intangible assets, net | 61,726 | 72,444 |
| Deferred tax assets, noncurrent | 37,363 | 8,446 |
| Other assets, noncurrent | 824 | 930 |
| Total assets | $ 427,372 | $ 507,160 |
| **Liabilities and Stockholders Equity** | | |
| Current liabilities | | |
| Accounts payable | $ 18,506 | 22,870 |
| Accrued liabilities | 24,864 | 29,462 |
| Deferred revenue | 1,955 | 2,553 |
| Debt | 14,624 | 15,429 |
| Total current liabilities | 59,949 | 70,314 |
| Debt, noncurrent | 85,037 | 92,167 |
| Other liabilities, noncurrent | 6,822 | 6,322 |
| Total liabilities | 151,808 | 168,803 |
| Commitments and contingencies (See Note 8) | | |
| Stockholders equity | | |
| Common stock: $0.001 par value; 100,000,000 shares authorized; 42,788,671 and 43,350,831 shares issued, and 42,788,671 and 43,222,031 shares outstanding at December 31, 2012 and June 30, 2012, respectively | 43 | 43 |
| Additional paid-in capital | 220,345 | 220,552 |

| | | | |
|---|---|---|---|
| Treasury stock, at cost (0 and 128,800 shares at December 31, 2012 and June 30, 2012) | | | (1,178) |
| Accumulated other comprehensive loss | | (1,575) | (1,439) |
| Retained earnings | | 56,751 | 120,379 |
| Total stockholders equity | | 275,564 | 338,357 |
| Total liabilities and stockholders equity | $ | 427,372 | $ 507,160 |

See notes to condensed consolidated financial statements

3

Table of Contents

**QUINSTREET, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(In thousands, except per share data)**

**(Unaudited)**

| | Three Months Ended December 31, 2012 | Three Months Ended December 31, 2011 | Six Months Ended December 31, 2012 | Six Months Ended December 31, 2011 |
|---|---|---|---|---|
| Net revenue | $ 71,751 | $ 90,523 | $ 150,377 | $ 191,747 |
| Cost of revenue [1] | 61,712 | 68,396 | 126,902 | 144,144 |
| Gross profit | 10,039 | 22,127 | 23,475 | 47,603 |
| Operating expenses: [1] | | | | |
| Product development | 4,504 | 5,102 | 9,397 | 11,176 |
| Sales and marketing | 3,496 | 3,686 | 7,187 | 7,720 |
| General and administrative | 4,019 | 4,847 | 7,945 | 10,064 |
| Impairment of goodwill | 92,350 | | 92,350 | |
| Operating (loss) income | (94,330) | 8,492 | (93,404) | 18,643 |
| Interest income | 28 | 36 | 56 | 74 |
| Interest expense | (1,354) | (1,115) | (2,366) | (2,198) |
| Other income (expense), net | (4) | (93) | 42 | (124) |
| (Loss) income before income taxes | (95,660) | 7,320 | (95,672) | 16,395 |
| Benefit (provision) for taxes | 32,169 | (2,887) | 32,044 | (6,468) |
| Net (loss) income | $ (63,491) | $ 4,433 | $ (63,628) | $ 9,927 |
| Net (loss) income per share: | | | | |
| Basic | $ (1.48) | $ 0.09 | $ (1.49) | $ 0.21 |
| Diluted | $ (1.48) | $ 0.09 | $ (1.49) | $ 0.20 |
| Weighted average shares used in computing net (loss) income per share | | | | |
| Basic | 42,777 | 47,054 | 42,795 | 47,266 |
| Diluted | 42,777 | 47,937 | 42,795 | 48,442 |

[1] Cost of revenue and operating expenses include stock-based compensation expense as follows:

| | | | | |
|---|---|---|---|---|
| Cost of revenue | $ 963 | $ 1,197 | $ 1,886 | $ 2,376 |
| Product development | 698 | 682 | 1,391 | 1,342 |
| Sales and marketing | 858 | 841 | 1,623 | 1,620 |
| General and administrative | 510 | 801 | 899 | 1,557 |

See notes to condensed consolidated financial statements

Table of Contents

**QUINSTREET, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME**

**(In thousands)**

**(Unaudited)**

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net (loss) income | $ (63,491) | $ 4,433 | $ (63,628) | $ 9,927 |
| Other comprehensive (loss) income | | | | |
| Unrealized (loss) gain on investments | (12) | | (8) | 4 |
| Foreign currency translation adjustment | (160) | 3 | 93 | 28 |
| Interest rate swap | | | | |
| Change in unrealized gains | 185 | | (213) | |
| Less: reclassification adjustment for loss (gain) included in net income | 138 | | (8) | |
| Net change | 323 | | (221) | |
| Other comprehensive (loss) income | 151 | 3 | (136) | 32 |
| Comprehensive (loss) income | $ (63,340) | $ 4,436 | $ (63,764) | $ 9,959 |

5

Table of Contents

**QUINSTREET, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(In thousands)**

**(Unaudited)**

| | Six Months Ended December 31, 2012 | Six Months Ended December 31, 2011 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net (loss) income | $ (63,628) | $ 9,927 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 18,458 | 14,625 |
| Impairment of goodwill | 92,350 | |
| Provision for sales returns and doubtful accounts receivable | (468) | (32) |
| Stock-based compensation | 5,799 | 6,895 |
| Excess tax benefits from stock-based compensation | (50) | (97) |
| Other non-cash adjustments, net | 608 | 875 |
| Changes in assets and liabilities, net of effects of acquisitions: | | |
| Accounts receivable | 12,191 | 412 |
| Prepaid expenses and other assets | (4,615) | 1,668 |
| Other assets, noncurrent | 107 | (6) |
| Deferred taxes | (28,914) | |
| Accounts payable | (4,295) | 552 |
| Accrued liabilities | (5,650) | (10,287) |
| Deferred revenue | (598) | (493) |
| Other liabilities, noncurrent | 344 | 906 |
| Net cash provided by operating activities | 21,639 | 24,945 |
| **Cash Flows from Investing Activities** | | |
| Capital expenditures | (821) | (1,384) |
| Business acquisitions, net of notes payable and cash acquired | | (31,203) |
| Other intangibles | (2,500) | |
| Internal software development costs | (1,257) | (1,082) |
| Purchases of marketable securities | (28,431) | (22,686) |
| Proceeds from sales and maturities of marketable securities | 25,093 | 18,035 |
| Other investing activities | 15 | 30 |
| Net cash used in investing activities | (7,901) | (38,290) |
| **Cash Flows from Financing Activities** | | |
| Proceeds from exercise of common stock options | 269 | 2,187 |
| Proceeds from bank debt | | 5,884 |
| Principal payments on bank debt | (2,500) | (2,625) |
| Payment of bank loan upfront fees | | (1,370) |
| Principal payments on acquisition-related notes payable | (5,472) | (1,771) |
| Excess tax benefits from stock-based compensation | 50 | 97 |
| Withholding taxes related to restricted stock net share settlement | (148) | (262) |
| Repurchases of common stock | (6,157) | (15,556) |
| Net cash used in financing activities | (13,958) | (13,416) |

| | | |
|---|---|---|
| Effect of exchange rate changes on cash and cash equivalents | 12 | 28 |
| Net decrease in cash and cash equivalents | (208) | (26,733) |
| Cash and cash equivalents at beginning of period | 68,531 | 132,290 |
| Cash and cash equivalents at end of period | $ 68,323 | $ 105,557 |
| **Supplemental Disclosure of Cash Flow Information** | | |
| Cash paid for interest | 2,257 | 1,855 |
| Cash paid for taxes | 1,776 | 4,941 |
| **Supplemental Disclosure of Noncash Investing and Financing Activities** | | |
| Notes payable issued in connection with business acquisitions | | 3,167 |
| Retirement of treasury stock | 6,157 | |
| Short term payables | 2,500 | |

See notes to condensed consolidated financial statements

6

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. The Company**

QuinStreet, Inc. (the Company ) is an online vertical marketing and media company. The Company was incorporated in California in April 1999 and reincorporated in Delaware in December 2009. The Company provides vertically oriented customer acquisition programs for its clients. The Company also provides hosted solutions for direct selling companies. The corporate headquarters are located in Foster City, California, with additional offices throughout the United States, Brazil and India.

**2. Summary of Significant Accounting Policies**

**Basis of Presentation**

***Principles of Consolidation***

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. Intercompany balances and transactions have been eliminated in consolidation.

***Unaudited Interim Financial Information***

The accompanying condensed consolidated financial statements and the notes to the condensed consolidated financial statements as of December 31, 2012 and for the three and six months ended December 31, 2012 and 2011 are unaudited. These unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ( GAAP ) and applicable rules and regulations of the Securities and Exchange Commission ( SEC ) regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2012, as filed with the SEC on August 23, 2012. The condensed consolidated balance sheet at June 30, 2012 included herein was derived from the audited financial statements as of that date, but does not include all disclosures, including notes, required by GAAP.

The unaudited interim condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and, in the opinion of management, include all adjustments (consisting only of normal recurring adjustments) necessary for the fair statement of the Company s condensed consolidated balance sheet at December 31, 2012, its condensed consolidated statements of operations for the three and six months ended December 31, 2012 and 2011, its condensed consolidated statements of comprehensive (loss) income for the three and six months ended December 31, 2012 and 2011, and its condensed consolidated statements of cash flows for the six months ended December 31, 2012 and 2011. The results of operations for the six months ended December 31, 2012 are not necessarily indicative of the results to be expected for the fiscal year ending June 30, 2013, or any other future period.

***Use of Estimates***

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. On an ongoing basis, management evaluates these estimates, judgments and assumptions, including those related to revenue recognition, stock-based compensation, goodwill, intangible assets, long-lived assets, contingencies, and income taxes. The Company bases these estimates on historical and anticipated results and trends and on various other assumptions that the Company believes are reasonable under the circumstances, including assumptions as to future events. These estimates form the basis for making judgments about the carrying values of assets and liabilities and recorded revenue and expenses that are not readily apparent from other sources. Actual results could differ from those estimates, and such differences could affect the results of operations reported in future periods.

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

***Accounting Policies***

The significant accounting policies are described in Note 2 to the condensed consolidated financial statements included in the Annual Report on Form 10-K for the fiscal year ended June 30, 2012. There have been no significant changes in the accounting policies subsequent to June 30, 2012.

***Concentrations of Credit Risk***

No client accounted for 10% or more of net revenue for the three or six months ended December 31, 2012 or for the same period in fiscal year 2012. No client accounted for 10% or more of net accounts receivable as of December 31, 2012 or June 30, 2012.

***Fair Value of Financial Instruments***

The Company s financial instruments consist principally of cash equivalents, marketable securities, accounts receivable, accounts payable, acquisition-related promissory notes, an interest rate swap, short term payables, and a term loan. The fair value of the Company s cash equivalents is determined based on quoted prices in active markets for identical assets for its money market funds; and quoted prices for similar instruments in active markets for its U.S municipal securities and certificates of deposits that mature within 90 days. The recorded values of the Company s accounts receivable and accounts payable approximate their current fair values due to the relatively short-term nature of these accounts. The fair values of acquisition-related promissory notes and short term payables approximate their recorded amounts as the interest rates on similar financing arrangements available to the Company at December 31, 2012 approximate the interest rates implied when these acquisition-related promissory notes and short term payables were originally issued and recorded. The fair value of the interest rate swap is based upon fair value quotes from the issuing bank and the Company assesses the quotes for reasonableness by comparing them to the present values of expected cash flows. The present value approach is based on observable market interest rate curves that are commensurate with the terms of the interest rate swaps. The carrying value represents the fair value of the swaps, as adjusted for any non-performance risk associated with the Company at December 31, 2012. The Company believes that the fair value of the term loan approximates its recorded amount at December 31, 2012 as the interest rate on the term loan is variable and is based on market interest rates and after consideration of default and credit risk.

***Recent Accounting Pronouncements***

In September 2011, the FASB issued an update to the accounting standard for goodwill and intangibles. The revised standard allows entities to use a qualitative approach to test goodwill for impairment. It permits an entity to first perform a qualitative assessment to determine whether it is more-likely-than-not that the fair value of a reporting unit is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed two-step goodwill impairment test. The Company adopted this updated accounting standard during the second quarter of fiscal 2013 as a result of its market capitalization sustaining a significant decline subsequent to the quarterly period ended December 31, 2012 The Company determined that it was more-likely-than-not that the fair value of one of its reporting units was less than the carrying amount. As a result, the two-step impairment test related to goodwill was performed as of December 31, 2012. For additional information about the two-step impairment test related to goodwill, refer to Note 6 to the condensed consolidated financial statements.

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**3. Net (Loss) Income Attributable to Common Stockholders and Net (Loss) Income per Share**

Basic net (loss) income per share is computed by dividing net (loss) income by the weighted average number of shares of common stock outstanding during the period. Diluted net (loss) income per share is computed by using the weighted-average number of shares of common stock outstanding, including potential dilutive shares of common stock assuming the dilutive effect of outstanding stock options and restricted stock units using the treasury stock method.

The following table presents the calculation of basic and diluted net (loss) income per share:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| | (In thousands, except per share data) | | (In thousands, except per share data) | |
| Numerator: | | | | |
| Basic and Diluted: | | | | |
| Net (loss) income | $ (63,491) | $ 4,433 | $ (63,628) | $ 9,927 |
| Denominator: | | | | |
| Basic: | | | | |
| Weighted average shares of common stock used in computing basic net (loss) income per share | 42,777 | 47,054 | 42,795 | 47,266 |
| Diluted: | | | | |
| Weighted average shares of common stock used in computing basic net (loss) income per share | 42,777 | 47,054 | 42,795 | 47,266 |
| Weighted average effect of dilutive securities: | | | | |
| Stock options | | 883 | | 1,158 |
| Restricted stock units | | | | 18 |
| Weighted average shares of common stock used in computing diluted net (loss) income per share | 42,777 | 47,937 | 42,795 | 48,442 |
| Net (loss) income per share: | | | | |
| Basic | $ (1.48) | $ 0.09 | $ (1,49) | $ 0.21 |
| Diluted [(2)] | $ (1.48) | $ 0.09 | $ (1.49) | $ 0.20 |
| Securities excluded from weighted average shares used in computing diluted net (loss) income per share because the effect would have been anti-dilutive: [(1)] | 10,505 | 7,891 | 8,902 | 6,176 |

(1) These weighted shares relate to anti-dilutive stock options and restricted stock units as calculated using the treasury stock method and could be dilutive in the future.

(2) Diluted EPS does not reflect any potential common stock relating to stock options or restricted stock units due to operating loss. The assumed issuance of any additional shares would be antidiluted.

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**4. Fair Value Measurements and Marketable Securities**

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

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

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

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

The Company s financial instruments as of December 31, 2012 and June 30, 2012 were categorized as follows in the fair value hierarchy (in thousands):

| | Fair Value Measurements as of December 31, 2012 Using | | |
|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Total |
| **Assets:** | | | |
| U.S. municipal securities | $ | $ 27,985 | $ 27,985 |
| Certificates of deposit | | 14,960 | 14,960 |
| Money market funds | 20,963 | | 20,963 |
| | $ 20,963 | $ 42,945 | $ 63,908 |
| **Liabilities:** | | | |
| Acquisition-related promissory notes | $ | $ 6,534 | $ 6,534 |
| Term loan | | 93,127 | 93,127 |
| Interest rate swap | | 1,351 | 1,351 |
| Short term payable | | 2,441 | 2,441 |
| | $ | $ 103,453 | $ 103,453 |

| | Fair Value Measurements as of June 30, 2012 Using | | |
|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Total |
| **Assets:** | | | |
| U.S. municipal securities | $ | $ 30,861 | $ 30,861 |
| Certificates of deposit | | 11,470 | 11,470 |
| Money market funds | 21,458 | | 21,458 |
| | $ 21,458 | $ 42,331 | $ 63,789 |
| **Liabilities:** | | | |
| Acquisition-related promissory notes | $ | $ 12,215 | $ 12,215 |
| Term loan | | 95,381 | 95,381 |
| Interest rate swap | | 1,138 | 1,138 |

| | | | |
|---|---|---|---|
| | $ | $ 108,734 | $ 108,734 |

***Marketable Securities***

All liquid investments with maturities of three months or less at the date of purchase are classified as cash equivalents. Investments with maturities greater than three months at the date of purchase are classified as marketable securities. The Company s marketable securities have been classified and accounted for as available-for-sale. Management determines the appropriate classification of its investments at the time of purchase and reevaluates the available-for-sale designation as of each balance sheet date. Available-for-sale securities are carried at fair value, with unrealized gains and losses, net of tax, reported as a component of stockholders equity.

**Table of Contents**

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

The following table summarizes unrealized gains and losses related to available-for-sale securities held by the Company as of December 31, 2012 and June 30, 2012 (in thousands):

| | Gross Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| U.S. municipal securities | $ 27,988 | $ | 3 | $ 27,985 |
| Certificates of deposit | 14,965 | | 5 | 14,960 |
| Money market funds | 20,963 | | | 20,963 |
| | $ 63,916 | $ | $ 8 | $ 63,908 |

| | As of June 30, 2012 | | | |
|---|---|---|---|---|
| | Gross Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. municipal securities | $ 30,851 | $ 10 | $ | $ 30,861 |
| Certificates of deposit | 11,480 | | 10 | 11,470 |
| Money market funds | 21,458 | | | 21,458 |
| | $ 63,789 | $ 10 | $ 10 | $ 63,789 |

The Company did not realize any gains or losses from sales of its securities in the periods presented. As of December 31, 2012 and June 30, 2012, the Company did not hold securities that had maturity dates greater than one year.

**5. Acquisitions**

***Acquisitions in Fiscal Year 2013***

The Company did not complete any acquisitions during the six months ended December 31, 2012.

***Acquisitions in Fiscal Year 2012***

In fiscal year 2012, the Company acquired certain assets of Ziff Davis Enterprise from Enterprise Media Group, Inc., a New York-based online media and marketing company in the business-to-business technology market, to broaden its registered user database and brand name in the business-to-business technology market. Additionally, the Company acquired 100% of the outstanding equity interests of NarrowCast Group, LLC, or ITBE, to broaden its registered user database and media access in the business-to-business technology market. The Company also acquired the operations of eleven online publishing businesses. The Company recorded $4.6 million in earn-out payments related to a prior period acquisition as an addition to goodwill.

The total purchase prices recorded were as follows (in thousands):

| | Ziff Davis | ITBE | Other | Total |
|---|---|---|---|---|
| Cash | $ 17,270 | $ 23,961 | $ 14,620 | $ 55,851 |
| Fair value of debt (net of imputed interest) | | | 9,696 | $ 9,696 |
| | $ 17,270 | $ 23,961 | $ 24,316 | $ 65,547 |

12

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

The acquisitions were accounted for as business combinations. The Company allocated the purchase price to tangible assets acquired, liabilities assumed and identifiable intangible assets acquired based on their estimated fair values. The excess of the purchase price over the aggregate fair value was recorded as goodwill. The goodwill is deductible for tax purposes. The following table summarizes the allocation of the purchase price and the estimated useful lives of the identifiable intangible assets acquired as of the date of the acquisitions (in thousands):

| | Ziff Davis | ITBE | Other | Total | Estimated Useful Life |
|---|---|---|---|---|---|
| Tangible assets acquired | $ | $ 3,597 | $ | $ 3,597 | |
| Liabilities assumed | (255) | (1,868) | | (2,123) | |
| Customer/publisher/advertiser relationships | 4,120 | 3,230 | 435 | 7,785 | 3-5 years |
| Content | 500 | 420 | 4,541 | 5,461 | 2-5 years |
| Website/trade/domain names | 4,630 | 2,220 | 1,250 | 8,100 | 4-8 years |
| Registered user database | 6,320 | 4,220 | | 10,540 | 3 years |
| Acquired technology and other | | | 560 | 560 | 4-5 years |
| Noncompete agreements | | 100 | 87 | 187 | 1-3.5 years |
| Goodwill | 1,955 | 12,042 | 17,443 | 31,440 | Indefinite |
| | $ 17,270 | $ 23,961 | $ 24,316 | $ 65,547 | |

***Pro Forma Financial Information***

The unaudited pro forma financial information in the table below summarizes the combined results of operations for the Company and other companies that were acquired since the beginning of fiscal year 2012. The pro forma financial information includes the business combination accounting effects resulting from these acquisitions, including amortization charges from acquired intangible assets and the related tax effects as though the acquisitions were effected as of the beginning of fiscal year 2012. The unaudited pro forma financial information as presented below is for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of fiscal year 2012.

| | Three Months Ended December 31, (In thousands) | | Six Months Ended December 31, (In thousands) | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Net revenue | $ 73,319 | $ 92,041 | $ 151,945 | $ 197,399 |
| Net income | (63,355) | 2,642 | (64,742) | 7,320 |
| Basic net income per share | $ (1.53) | $ 0.06 | $ (1.51) | $ 0.15 |
| Diluted net income per share | $ (1.53) | $ 0.06 | $ (1.51) | $ 0.15 |

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**6. Intangible Assets, Net and Goodwill**

Intangible assets, net balances, excluding goodwill, consisted of the following:

| | December 31, 2012 | | | June 30, 2012 | | |
|---|---|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Customer/publisher/advertiser relationships | $ 37,049 | $ (26,237) | $ 10,812 | $ 37,045 | $ (23,017) | $ 14,028 |
| Content | 62,095 | (38,933) | 23,162 | 62,076 | (34,430) | 27,646 |
| Website/trade/domain names | 31,622 | (15,202) | 16,420 | 31,615 | (12,815) | 18,800 |
| Acquired technology and others | 36,411 | (25,079) | 11,332 | 31,477 | (19,507) | 11,970 |
| | $ 167,177 | $ (105,451) | $ 61,726 | $ 162,213 | $ (89,769) | $ 72,444 |

Amortization of intangible assets was $8.8 million and $15.7 million in the three and six months ended December 31, 2012, respectively, and $6.2 million and $11.9 million in the three and six months ended December 31, 2011, respectively.

The Company licensed certain patents for $4.9 million during the three months ended December 31, 2012, and these patents are recorded in other intangible assets, net on the condensed consolidated balance sheet. Based on the Company s analysis, using a relief from royalty method, the Company determined that a portion of the license fee for these patents represents the cumulative cost relating to prior years. As such, the Company recorded $2.4 million as a charge to cost of revenue during the three months ended December 31, 2012. The remaining amount will be amortized over the remaining life of the patents, and $0.1 million was amortized during the three months ended December 31, 2012.

Future amortization expense for the Company s intangible assets as of December 31, 2012 was as follows (in thousands):

| Year Ending June 30, | Amortization |
|---|---|
| 2013 (remaining six months) | $ 11,192 |
| 2014 | 19,539 |
| 2015 | 12,343 |
| 2016 | 8,779 |
| 2017 | 6,060 |
| Thereafter | 3,813 |
| | $ 61,726 |

The change in the carrying amount of goodwill for the Company s Direct Marketing Services (DMS) and Direct Selling Services (DSS) segments, discussed in Note 11, for the six months ended December 31, 2012 was as follows (in thousands):

| | DMS | DSS | Total |
|---|---|---|---|
| Balance at June 30, 2012 | $ 241,818 | $ 1,231 | $ 243,049 |

| | | | |
|---|---|---|---|
| Additions | | | |
| Impairment | (92,350) | | (92,350) |
| Other | (267) | | (267) |
| Balance at December 31, 2012 | $ 149,201 | $ 1,231 | $ 150,432 |

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

In the six months ended December 31, 2012, there were no additions to goodwill as the Company did not complete any acquisitions during such period. Any change in goodwill amounts resulting from foreign currency translation are presented as Other in the above table.

Goodwill is tested for impairment at the reporting unit level on an annual basis and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows and determining appropriate discount rates, growth rates, an appropriate control premium and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value for each reporting unit which could trigger impairment.

The Company has determined that DMS and DSS constitute two separate reporting units. The Company performs its annual goodwill impairment review during its fourth fiscal quarter or when indicators of impairment arise. The Company s public market capitalization sustained a decline after December 31, 2012, to a value below the net book carrying value of the Company s equity. As a result, the Company determined that this triggered the necessity to conduct an interim goodwill impairment test. The Company first tested the long-lived assets related to the DMS reporting unit as of December 31, 2012 and, based on the undiscounted cash flows, determined that these assets were not impaired.

A two-step process was then required to test goodwill impairment. The first step is to determine if there is an indication of impairment by comparing the estimated fair value to its carrying value including goodwill. Goodwill is considered impaired if the carrying value exceeds the estimated fair value. Upon indication of impairment, a second step is performed to determine the amount of the impairment by comparing the implied fair value of the reporting unit s goodwill with its carrying value.

To estimate the fair value for step one, the Company utilized a combination of income and market approaches evenly weighted to estimate the fair value of the reporting units. The income approach involves discounting future estimated cash flows. The discount rate used is the value-weighted average of the reporting unit s estimated cost of equity and debt ( cost of capital ) derived using, both known and estimated, customary market metrics. The Company performed sensitivity tests with respect to growth rates and discount rates used in the income approach. In applying the market approach, valuation multiples are derived from historical and projected operating data of selected peer companies; evaluated and adjusted, if necessary, based on the Company s strengths and weaknesses relative to the selected peer companies; and applied to the appropriate historical and/or projected operating data to arrive at a fair value.

The Company completed step one of the impairment analysis for each of its reporting units and concluded that as of December 31, 2012, the fair value of its DMS reporting unit was below its carrying value, including goodwill. As such, step two of the impairment test was initiated. The Company was unable to complete the step two analysis prior to filing its condensed consolidated financial statements for the three months ended December 31, 2012, in this quarterly report due to the time consuming nature of such analysis and the complexities of determining the implied fair value of goodwill for the DMS reporting unit, but based on the work performed as of the filing date, the Company recorded an estimated goodwill impairment charge of $92.4 million in the financial statements as of and for the three and six months ended December 31, 2012. Any material difference between this estimate and the final amount determined in the step two evaluation, either positive or negative, will be recorded in the third quarter of fiscal 2013.

**7. Debt**

***Promissory Notes***

During the six months ended December 31, 2011, the Company issued a total of $3.3 million in promissory notes for the acquisition of businesses, net of imputed interest amounts of $0.1 million. For these notes, interest was imputed such that the notes carry an interest rate commensurate with that available to the Company in the market for similar debt instruments. The Company recorded accretion of promissory notes of $0.1 million and $0.2 million for the three and six months ended December 31, 2011, respectively. Certain of the promissory notes are secured by the assets acquired in respect to which the notes were issued.

Table of Contents

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

***Credit Facility***

In November 2011, the Company entered into the Second Amended and Restated Revolving Credit and Term Loan Agreement ( Second Loan Agreement ) with Comerica Bank (the Bank ), the administrative agent and lead arranger. The Second Loan Agreement consists of a $100.0 million five-year term loan, with annual principal amortization of 5%, 10%, 15%, 20% and 50%, and a $200.0 million five-year revolving credit line. On February 15, 2013, the Company entered into the First Amendment to Credit Agreement and Amendment to Guaranty ( First Amendment ) with the Bank to, among other things: (1) amend the definition of adjusted EBITDA, effective as of December 31, 2012, to exclude extraordinary or non-recurring non-cash expenses of losses including, without limitation, goodwill impairments, and any extraordinary or non-recurring cash expenses in an aggregate amount not to exceed $5.0 million for the life of the Second Loan Agreement; and (2) reduce the $200.0 million five-year revolving credit line portion of the facility to $100.0 million, effective as of February 15, 2013.

Borrowings under the Second Loan Agreement are collateralized by substantially all of the Company s assets. Interest is payable at specified margins above either the Eurodollar Margin or the Prime Rate. The interest rate varies dependent upon the ratio of funded debt to adjusted EBITDA and ranges from Eurodollar Margin + 1.625% to 2.375% or Prime + 1.00% for the revolving credit line and from Eurodollar Margin + 2.00% to 2.75% or Prime + 1.00% for the term loan. Adjusted EBITDA is defined as net (loss) income less provision for taxes, depreciation expense, amortization expense, stock-based compensation expense, interest and other income (expense), acquisition costs for business combinations, extraordinary or non-recurring non-cash expenses of losses including, without limitation, goodwill impairments, and any extraordinary or non-recurring cash expenses in an aggregate amount not to exceed $5.0 million for the life of this Second Loan Agreement. The revolving credit line requires an annual facility fee of 0.375% of the revolving credit line capacity.

To reduce the Company s exposure to rising interest rates under the term loan, in February 2012, the Company entered into an interest rate swap encompassing the principal balances scheduled to be outstanding as of January 1, 2014, and, thereafter, such principal amount totaling $85.0 million in January 2014 and amortizing to $35.0 million in November 2016. The interest rate swap effectively fixes the Eurodollar Margin at 0.97%.

The Second Loan Agreement expires in November 2016. The Second Loan Agreement restricts the Company s ability to raise additional debt financing and pay dividends, and also requires the Company to comply with other nonfinancial covenants. In addition, the Company is required to maintain financial ratios computed as follows:

1. A minimum fixed charge coverage ratio of 1.15:1, calculated as the ratio of: (i) trailing twelve months of adjusted EBITDA to (ii) the sum of capital expenditures, net cash interest expense, cash taxes, cash dividends and trailing twelve months payments of indebtedness. Payment of unsecured indebtedness is excluded to the degree that sufficient unused revolving credit line exists such that the relevant debt payment could be made from the credit facility.

2. A maximum funded debt to adjusted EBITDA ratio of 3:1, calculated as the ratio of: (i) the sum of all obligations owed to lending institutions, the face amount of any letters of credit, indebtedness owed in connection with acquisition-related notes and indebtedness owed in connection with capital lease obligations to (ii) trailing twelve months of adjusted EBITDA.

Pursuant to the terms of the First Amendment, the Company was in compliance with the covenants of the First Amendment as of December 31, 2012. The Company was in compliance with the covenants of the Second Loan Agreement as of June 30, 2012.

Upfront arrangement fees incurred in connection with the Second Loan Agreement totaled $1.5 million and will be deferred and amortized over the remaining term of the arrangement. Upfront arrangement fees incurred in connection with the First Amendment totaled $0.2 million and will be deferred and amortized over the remaining term of the arrangement. The outstanding amount under the term loan at December 31, 2012 and June 30, 2012 was $95.0 million and $97.5 million, respectively. There were no outstanding balances under the revolving credit line at December 31, 2012 or June 30, 2012.

***Interest Rate Swap***

As discussed above, the Company entered into an interest rate swap to reduce its exposure to the financial impact of changing interest rates under its term loan. The Company does not speculate using derivative instruments. The Company entered into this derivative instrument arrangement solely for the purpose of risk management. The effective date of the swap was April 9, 2012 with a maturity date of November 4, 2016. At December 31, 2012, the Company had approximately $85.0 million of notional amount outstanding under the swap agreement that exchanges a variable interest rate base (Eurodollar margin) for a fixed interest rate of

**QUINSTREET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

0.97% over the term of the agreement. This interest rate swap is designated as a cash flow hedge of the interest rate risk attributable to forecasted variable interest payments. The effective portion of the fair value gains or losses on this swap are included as a component of accumulated other comprehensive (loss) income on the condensed consolidated balance sheet. Any hedge ineffectiveness will be immediately recognized in earnings in the current period. At December 31, 2012, the fair value of the interest rate swap was $1.4 million and the effective portion of the interest rate swap was $1.4 million.

***Debt Maturities***

The maturities of the Company s debt as of December 31, 2012 were as follows (in thousands):

| Year Ending June 30, | Promissory Notes | Credit Facility |
|---|---|---|
| 2013 (remaining six months) | $ 2,993 | $ 5,000 |
| 2014 | 3,364 | 12,500 |
| 2015 | 560 | 17,500 |
| 2016 | 50 | 20,000 |
| 2017 | | 40,000 |
| | 6,967 | 95,000 |
| Less: imputed interest and unamortized discounts | (433) | (1,873) |
| Less: current portion | (5,112) | (9,512) |
| Noncurrent portion of debt | $ 1,422 | $ 83,615 |

***Letters of Credit***

The Company has a $0.4 million letter of credit agreement with a financial institution that is used as collateral for fidelity bonds placed with an insurance company and a $0.5 million letter of credit agreement with a financial institution that is used as collateral for the Company s corporate headquarters operating lease. The letters of credit automatically renew annually without amendment unless cancelled by the financial institutions within 30 days of the annual expiration date.

**8. Commitments and Contingencies**

***Leases***

The Company leases office space and equipment under non-cancelable operating leases with various expiration dates through 2018. Rent expense for the three and six months ended December 31, 2012 was $0.8 million and $1.6 million, respectively, and for the three and six months ended December 31, 2011 was $0.8 million and $1.7 million, respectively. The Company recognizes rent expense on a straight-line basis over the lease period and accrues for rent expense incurred but not paid.

Table of Contents