STRATASYS INC
Form 10-Q
November 09, 2007

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

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2007

or

o **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: 1-13400

STRATASYS, INC.

(Exact name of registrant as specified in its charter)

Delaware	36-3658792
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
7665 Commerce Way, Eden Prairie, Minnesota	55344
(Address of principal executive offices)	(Zip Code)

(952) 937-3000
(Registrant s telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

þ Yes o No

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

As of November 1, 2007 the Registrant had 20,994,898 common stock, $.01 par value issued and outstanding.

Stratasys, Inc.

Table of Contents

STRATASYS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	September 30, 2007 (unaudited)	December 31, 2006
ASSETS		
Current assets		
Cash and cash equivalents	$ 19,216,040	$ 12,509,861
Short-term investments	24,000,609	21,367,316
Accounts receivable, less allowance for returns and doubtful accounts of $1,400,940 in 2007 and $1,265,837 in 2006	25,236,549	25,035,665
Inventories	13,122,741	9,925,217
Net investment in sales-type leases	3,316,646	2,858,054
Prepaid expenses	2,791,626	3,368,586

Deferred income taxes		426,524		459,000
Total current assets		88,110,735		75,523,699
Property and equipment, net		25,585,780		20,412,719
Other assets				
Intangible assets, net		6,464,730		4,868,923
Net investment in sales-type leases		3,399,018		3,271,015
Deferred income taxes		915,000		915,000
Long-term investments		13,255,307		10,747,689
Other		2,477,272		2,265,200
Total other assets		26,511,327		22,067,827
	$	140,207,842	$	118,004,245
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current liabilities				
Accounts payable and other current liabilities	$	10,988,255	$	10,335,607
Unearned revenues		10,175,526		9,876,719
Total current liabilities		21,163,781		20,212,326
Stockholders' equity				
Common stock, $.01 par value, authorized 15,000,000 shares, issued 25,594,954 shares in 2007 and 24,889,760 shares in 2006		255,946		248,898
Capital in excess of par value		86,638,260		75,602,267
Retained earnings		51,988,111		41,960,124
Accumulated other comprehensive loss		64,119		(116,995)
Less cost of treasury stock, 4,600,056 shares in 2007 and 2,300,028 in 2006		(19,902,375)		(19,902,375)
Total stockholders' equity		119,044,061		97,791,919
	$	140,207,842	$	118,004,245

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

1

STRATASYS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended September 30,				Nine Months Ended Sep		
		2007		2006		2007	
		(unaudited)		(unaudited)		(unaudited)	(u
Net Sales							
Product	$	20,690,590	$	19,781,371	$	64,579,560	$
Services		5,772,882		5,367,792		17,452,266	
		26,463,472		25,149,163		82,031,826	

Cost of goods sold				
Product	9,787,018	10,437,855	29,145,219	
Services	3,187,655	2,717,148	9,091,199	
	12,974,673	13,155,003	38,236,418	
Gross profit	13,488,799	11,994,160	43,795,408	
Costs and expenses				
Research and development	1,964,619	1,575,083	5,571,254	
Selling, general and administrative	7,435,325	6,878,793	24,667,240	
	9,399,944	8,453,876	30,238,494	
Operating income	4,088,855	3,540,284	13,556,914	
Other income (expense)				
Interest income	629,074	434,813	1,730,733	
Other	(103,901)	(85,098)	(311,188)	
	525,173	349,715	1,419,545	
Income before income taxes	4,614,028	3,889,999	14,976,459	
Income taxes	1,377,038	1,330,379	4,948,472	
Net income	$ 3,236,990	$ 2,559,620	$ 10,027,987	$
Earnings per common share				
Basic	$ 0.15	$ 0.13	$ 0.48	$
Diluted	$ 0.15	$ 0.12	$ 0.47	$
Weighted average number of common shares outstanding				
Basic	20,939,735	20,213,704	20,693,597	
Diluted	21,813,829	20,573,084	21,519,903	

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

STRATASYS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

	Nine months Ended September 30,	
	2007	**2006**
Cash flows from operating activities		
Net income	$ 10,027,987	$ 7,510,801
Adjustments to reconcile net income to net cash provided by operating activities:		

Deferred income taxes	32,476	382,891
Depreciation	2,580,350	2,009,182
Amortization	869,700	767,388
Stock-based compensation	723,000	981,274
Increase (decrease) in cash attributable to changes in operating assets and liabilities:		
Accounts receivable, net	(200,884)	(3,289,276)
Inventories	(2,826,344)	(2,537,992)
Net investments in sales-type leases	(586,593)	(556,709)
Prepaid expenses	576,960	772,695
Other assets	(212,073)	(87,668)
Accounts payable and other current liabilities	2,016,512	(848,164)
Unearned revenues	298,807	132,853
Net cash provided by operating activities	13,299,898	5,237,275
Cash flows from investing activities		
Proceeds from sale of investments	6,479,027	5,726,571
Payments for investments	(11,619,938)	(4,460,290)
Acquisition of property and equipment	(8,124,591)	(3,987,290)
Acquisition for intangible assets	(2,465,507)	(1,145,039)
Net cash provided by (used in) investing activities	(15,731,009)	(3,866,048)
Cash flows provided by financing activities		
Net proceeds from exercise of stock options	8,956,176	647,054
Purchase of treasury stock		(3,111,280)
Net cash provided by (used in) financing activities	8,956,176	(2,464,226)
Effect of exchange rate changes on cash	181,114	83,127
Net increase in cash and cash equivalents	6,706,179	(1,009,872)
Cash and cash equivalents, beginning of period	12,509,861	10,105,199
Cash and cash equivalents, end of period	$ 19,216,040	$ 9,095,327

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

STRATASYS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited) (CONTINUED)

	Six Months Ended June 30, 2007	Six Months Ended June 30, 2006
Supplemental disclosures of cash flow information:		
Cash paid during the period for income taxes	$ 6,017,546	$ 2,781,955

Supplemental schedule of noncash investing and financing activities:		
Inventory transferred to machinery and equipment	$ 371,180	$ 121,050

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

4

Notes to Consolidated Interim Financial Statements

Note 1-- Basis of Presentation and Consolidation

The consolidated interim financial statements include the accounts of Stratasys, Inc. and its wholly-owned subsidiaries (collectively, the Company). All intercompany accounts and transactions have been eliminated in consolidation. The consolidated interim financial information herein is unaudited; however, such information reflects all adjustments (consisting of normal, recurring adjustments), which are, in the opinion of management, necessary for a fair statement of results for the interim period. The results of operations for the three and nine months ended September 30, 2007 are not necessarily indicative of the results to be expected for the full year. On August 2, 2007, the Companys Board of Directors declared a two-for-one stock split in the form of a 100% stock dividend to shareholders of record on August 15, 2007. Net earnings per share, shares outstanding and weighted average shares outstanding have been restated to reflect the stock dividend. Certain financial information and footnote disclosures normally included in the consolidated interim financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The reader is referred to the audited consolidated financial statements and notes thereto for the year ended December 31, 2006, filed as part of the Companys Annual Report on Form 10-K for such year.

Note 2-- Inventories

Inventories consisted of the following at September 30, 2007 and December 31, 2006:

	2007	**2006**
Raw material	$ 7,449,888	$ 5,022,552
Finished Goods	5,672,853	4,902,665
Total	$ 13,122,741	$ 9,925,217

Note 3--Material Commitments

The Company has signed material commitments with several vendors for fixed delivery of selected inventory expected to be supplied in the ensuing twelve-month period. These commitments amount to approximately $9.5 million, some of which contain non-cancellation clauses.

Note 4--Earnings per Common Share

The Company complies with the accounting and reporting requirements of Statement of Financial Accounting Standard (SFAS) No. 128, *Earnings Per Share*. The difference between the number of shares used to compute basic earnings per common share and diluted earnings per common share relates to additional shares to be issued upon the assumed exercise of stock options and warrants, net of shares hypothetically repurchased at the average market price with the proceeds of exercise. The additional shares were as follows for the respective periods:

	Period Ended September 30,			
	Three Months		Nine Months	
	2007	**2006**	**2007**	**2006**
Additional shares	874,094	359,380	826,306	442,366

Note 5-- Stock-Based Compensation

Effective January 1, 2006, the Company began recording compensation expense associated with stock-based awards in accordance with SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No.123R), as interpreted by SEC Staff Accounting Bulletin (SAB) No. 107.

The amount of the stock-based compensation expense recorded and the associated future income tax benefit recognized were:

	Period Ended September 30,			
	Three Months		Nine Months	
	2007	**2006**	**2007**	**2006**
Stock based compensation expense	$ 241,000	$ 284,282	$ 723,000	$ 981,274
Future income tax benefit recognized	$ 38,124	$ 57,570	$ 176,812	$ 217,835

The following stock options were exercised for the respective periods:

	Period Ended September 30,			
	Three Months		Nine Months	
	2007	**2006**	**2007**	**2006**
Proceeds from exercise of stock options	$ 1,160,078	$ 33,514	$ 8,350,206	$ 647,054
Number of shares exercised	100,022	16,050	705,212	73,625
Weighted average share price	$ 11.60	$ 2.09	$ 11.84	$ 8.79
Tax benefit recognized in stockholders' equity from stock option exercises	$ 379,854	$ 41,019	$ 1,969,835	$ 384,470

No options were granted in the three and nine months ended September 30, 2007.

Note 6--Income Taxes

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN No. 48). This interpretation, as required to be adopted on January 1, 2007, clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Implementation of FIN No. 48 on January 1, 2007 resulted in no adjustment to the Company's income tax liability. As of the date of adoption, the total amount of unrecognized tax benefits was $563,000. This unrecognized tax benefit includes an estimate for interest and penalties totaling $52,000, both of which the Company classifies as a component of income tax expense.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

General

We are a leader in the rapid prototyping (RP) and the three-dimensional (3D) printing market. We develop, manufacture, market, and service a family of 3D printers and high-performance RP systems that enable engineers and designers to create physical models, tooling and prototypes out of plastic and other materials directly from a computer-aided design (CAD) workstation. Our 3D printers and high performance RP systems can be used in office environments without expensive facility modification.

In many industries, the models and prototypes required in product development are produced laboriously by hand-sculpting or machining, a traditional process that can take days or weeks. Our computerized modeling systems use our proprietary technology to make models and prototypes directly from a designer's three-dimensional CAD in a matter of hours. In addition to selling RP systems and 3D printers, we make and sell parts for RP and direct digital manufacturing ("DDM") applications through our RedEye service based on our customers' CAD files. All of our systems use proprietary consumables in the production of parts.

As previously announced, we discontinued the distribution of Eden PolyJet products at the beginning of 2007, and will continue to recognize a nominal level of Eden-related service revenue through the third quarter of this year. This decision has impacted year-over-year comparative analysis of our revenue growth and margins as Eden products and services were at substantially lower margins than our proprietary products and services. In the quarter ended September 30, 2007, our revenues increased to approximately $26.5 million, a 5% increase over the approximately $25.1 million that we reported in the third quarter of 2006. However, revenues from our proprietary products and services increased 27%. The number of units that we shipped in the quarter increased by approximately 36% to 521 units as compared with 383 units shipped in the third quarter of 2006. For the nine months ended September 30, 2007 the number of units that we shipped increased by approximately 24% to 1,633 units as compared with 1,313 units shipped in the first nine months of 2006. The higher shipment level was due to a continuing strong interest in our Dimension systems as well as our high-performance systems. Based on the Wohlers industry reports, we believe that since 2002 we have shipped more total RP systems than any other company in the world. Revenues derived from our proprietary consumable products increased significantly in the quarter ended September 30, 2007, as compared with the quarter ended September 30, 2006. We believe that our consumable sales should increase in future quarters due to the significant expansion of our active installed base over the past several years.

We believe that we are successfully implementing our marketing strategy by addressing the needs of both the high-performance and 3D printing ends of the market. Our sales growth in the first nine months of 2007 was derived from a number of industries, including consumer products, government agencies, educational institutions, electronics, general manufacturing, medical, automotive, and aerospace.

Our strategy for the remainder of 2007 will be to continue to expand our position in the 3D printing market through increased sales of our Dimension product line (our low-cost 3D printers). In January 2007, we introduced the Dimension Elite priced at $31,900, which offers finer feature detail and a more durable ABS plastic than the other Dimensions. We now have five Dimension models ranging in price from $18,900 to $31,900. With the introduction of the Dimension SST in February 2004, we initiated a highly successful distributor program involving resellers purchasing demonstration systems with extended payment terms on both the Dimension SST and Dimension BST. While the program impacted our accounts receivable days sales outstanding ("DSO") during portions of 2004, 2005 and 2006, it proved an effective tool in promoting and selling our systems. Given the success of the program in the past, we offered a similar program in 2007. Again, this program adversely impacted our DSO in the third quarter of 2007 as we expected. However, we believe our distributor program is an integral part of our strategy to expand the 3D printing market.

Our strategy also includes the expansion of our position in the RP market through the growth of our high performance systems, represented principally by our Titan, Vantage, and Maxum FDM® (fused deposition modeling) based systems. Prices for our FDM systems now range from $85,000 for the base model Vantage to $195,000 for the fully equipped Vantage SE. As a complement to our FDM systems, we also distribute the Arcam EBM systems in North America for Arcam AB. The Arcam system is a metal-based direct digital manufacturing and prototyping system.

In addition to expanding our penetration of the high-performance RP systems, our strategy is to expand into DDM. DDM is the manufacture of end-use parts using additive technologies. In August 2007, we introduced our second product specifically aimed at this market, the FDM 400mc. This is in addition to the FDM 200mc introduced in April 2007. We plan to have additional product offerings for this market in the next twelve months.

As we looked at the high-end productivity system mix in the quarter ended September 30, 2007 compared with the same 2006 period, we saw a 44% increase in sales of our proprietary systems as we successfully transition out of our distribution of the Eden products.

As our installed base has increased, we have derived an increasing amount of revenue from the sales of consumables, maintenance contracts, and other services. These represent recurring revenue for us. We expect that this trend will continue.

In the third quarter of 2007, gross profit increased 12% and, as a percentage of sales, was 51.0% compared with 47.7% in the third quarter of 2006. The increase was primarily due to a shift in our product mix weighted toward our proprietary products and away from the Eden PolyJet systems. In addition, margins benefited from strong growth in our paid parts service and proprietary consumable products.

Our 2007 strategy is based on the expectation that we will expand our gross profit faster than our operating expenses, with the intent to improve our operating income as compared with that recorded in 2006. In the third quarter of 2007 compared to the third quarter of 2006 operating expenses grew 11% while operating income grew by 15%.

During the quarter ended September 30, 2005, we announced that we received a $3.6 million order from a Fortune 100 global manufacturing company to advance our proprietary FDM technology for rapid manufacturing applications. This effort is based around our high-performance systems. We delivered our first prototype in December 2006. The agreement includes payments to us over four years as R&D milestones are achieved, as well as payments that are dependent upon future deliverables. R&D payments received offset accelerated R&D efforts aimed at rapid manufacturing advances and are not recognized as revenue. During the nine months ended September 30, 2007 and 2006, we offset approximately $630,000 and $876,000, respectively, of R&D expenses with payments received from this customer.

Our balance sheet continues to be strong. As of September 30, 2007, our cash and investment position was approximately $56 million, with no debt. We believe that we have adequate liquidity to fund our growth strategy for the remainder of 2007.

Our current and future growth is largely dependent upon our ability to penetrate new markets and develop and market new rapid prototyping and manufacturing systems, materials, applications, and services that meet the needs of our current and prospective customers. Our expense levels are based in part on our expectations of future revenues. While we have adjusted, and will continue to adjust, our expense levels based on both actual and anticipated revenues, fluctuations in revenues in a particular period could adversely impact our operating results. Our ability to implement our strategy for 2007 is subject to numerous uncertainties and risks, many of which are described in this Management's Discussion and Analysis of Financial Condition and Results of Operations, in the section below captioned "Forward Looking Statements and Factors That May Affect Future Results of Operations," and in Item 1A, "Risk Factors," of our Annual Report on Form 10-K for 2006. We cannot ensure that our efforts will be successful.

All dollar amounts set forth in the tables below, except for per share amounts, are stated in thousands of dollars.

8

Results of Operations

(All amounts in thousands) (unaudited)

The following table sets forth certain consolidated statements of operations data as a percentage of net sales for the periods indicated. All items are included in or derived from our consolidated interim statements of operations.

	For the three and nine-months ended September 30,			
	Three months		Nine months	
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	49.0%	52.3%	46.6%	50.8%
Gross profit	51.0%	47.7%	53.4%	49.2%
Research and development	7.4%	6.3%	6.8%	6.6%
Selling, general, and administrative	28.1%	27.3%	30.1%	28.5%
Operating income	15.4%	14.1%	16.5%	14.1%
Other income (expenses)	2.0%	1.4%	1.7%	1.3%

Income before taxes	17.4%	15.5%	18.2%	15.4%
Income taxes	5.2%	5.3%	6.0%	5.3%
Net income	12.2%	10.2%	12.2%	10.1%

Net Sales

Net sales of our products and services and changes in net sales were as follows:

	Period Ended September 30,					
	Three Months		Period-over Period Change	Nine Months		Period-over Period Change
	2007	**2006**		**2007**	**2006**	
Products	$ 20,691	$ 19,781	4.6%	$ 64,580	$ 59,003	9.5%
Services	5,773	5,368	7.5%	17,452	15,069	15.8%
Net sales	$ 26,464	$ 25,149	5.2%	$ 82,032	$ 74,072	10.7%
Units sold	521	383	36.0%	1,633	1,313	24.4%

In the third quarter of 2007 compared to the same year-ago period, sales of our high productivity proprietary systems increased 20% driven by strong demand for our new FDM 200mc and FDM 400mc. The increase in high-productivity proprietary systems revenue was offset by lower sales of the Eden products, which we have discontinued distributing. Eden product revenue was $49,000 in the third quarter of 2007 compared with $4.3 million in the prior year□s third quarter. For the nine months ended September 30, 2007 sales of our high productivity systems decreased 15% due to the discontinuance of the Eden Products partially offset by the growth in our proprietary high-end products. Eden product revenue was $642,000 in the first nine months of 2007 compared with $10.8 million in the same year-ago period.

Our Dimension systems unit growth was 44% for the three-month period when compared with the third quarter of 2006. For the nine months ended September 30, 2007, Dimension systems unit growth was 29% compared with first nine months of 2006. Dimension system revenue increased 50% and 40% for the three and nine months ended September 30, 2007, respectively, when compared to the same year-ago periods. The majority of system sales favored the higher-priced systems, including the new Dimension Elite.

For the three and nine months ended September 30, 2007, revenues from our proprietary consumables increased 20% and 21%, respectively, when compared to the same year-ago periods. The increase is due to our expanding installed base of systems.

Overall service revenue grew approximately 8% and 16% in the quarter and nine months ended September 30, 2007, respectively, compared to the same year-ago periods. Our revenue from our Paid Parts service increased 8% in the three months ended September 30, 2007 as compared with the same 2006 period. For the nine months ended September 30, 2007 compared to the first nine months of 2006, Paid Parts service revenue grew by 35%. We continue to expand our Paid Parts sales and marketing efforts. Maintenance service revenue increased 9% for both the third quarter and first nine months of 2007 when compared to the same periods in 2006.

North American sales, which include Canada and Mexico, accounted for approximately 58% and 57% of total revenue in the three and nine months ended September 30, 2007, respectively, as compared with approximately 67% and 63% in the three and nine months ended September 30, 2006, respectively. Total North American sales, which include systems, services, and consumables, declined by approximately 8% and 1% for the three and nine months ended September 30, 2007, respectively, compared to the same year-ago periods. International sales grew 32% and 30% for the three and nine months ended September 30, 2007, respectively, compared to the same periods last year. The shift in sales is primarily due to the discontinuation of the North American Eden product distribution agreement. Eden-related system, consumable and maintenance sales were approximately $310,000 in the third quarter of 2007 compared to $4.5 million in the third quarter of 2006. Eden-related system, consumable and maintenance sales were approximately $1.6 million in the first nine months of 2007 compared to $11.4 million in the same year-ago period.

Whereas we expect to report higher revenues and profits in 2007 over the results achieved in 2006, declining economic conditions could adversely impact our future sales and profitability.

Gross Profit

Gross profit and gross profit as a percentage of sales for our products and services, as well as the percentage changes in gross profit were as follows:

	Period Ended September 30,					
	Three Months		Period-over-Period Change	Nine Months		Period-over-Period Change
	2007	**2006**		**2007**	**2006**	
Products	$ 10,904	$ 9,344	16.7%	$ 35,434	$ 28,976	22.3%
Services	2,585	2,651	-2.5%	8,361	7,454	12.2%
Gross profit	$ 13,489	$ 11,994	12.5%	$ 43,795	$ 36,430	20.2%
Percent of sales	51.0%	47.7%		53.4%	49.2%	

The gross profit percentage benefited from improved mix within our high-performance system business as the decline in the sales of distributed Eden products was offset by an increase in our sales of proprietary high-performance systems. As we have indicated in the past, we maintained relatively low gross margins on the Eden distributed product line when compared to our proprietary products. The gross profit margin also benefited from better average prices for our Dimension products as well as a product mix favoring the higher-priced Dimension products. Last year, we did not have the Dimension Elite available in the third quarter. These machines have a higher average selling price than the Dimension BSTs. In addition, the gross margin benefited from increased sales of our proprietary consumable products.

Operating Expenses

Operating expenses and operating expense as a percentage of sales, as well as the percentage change in operating expenses were as follows:

	Period Ended September 30,					
	Three Months		Period-over-Period Change	Nine Months		Period-over-Period Change
	2007	**2006**		**2007**	**2006**	
Selling, general & administrative	$ 7,435	$ 6,879	8.1%	$ 24,667	$ 21,066	17.1%
Research and development	1,965	1,575	24.7%	5,571	4,867	14.5%
Total operating expenses	$ 9,400	$ 8,454	11.2%	$ 30,238	$ 25,933	16.6%
Percent of sales	35.5%	33.6%		36.9%	35.0%	

Research and development increased by 25% and increased by 15% for the three and nine months ended September 30, 2007, respectively, compared to the same 2006 periods. We remain committed to designing new products and materials, reducing costs on existing products, and improving the quality and reliability of all of our platforms. Increases are primarily the result of increases in engineering headcounts partially offset by an increase in internally capitalized software of $397,000 and $1.4 million for the three and nine months ended September 30, 2007, respectively. This compares to $496,000 and $1.4 million for the three and nine months ended September 30, 2006, respectively. During the quarter ended September 30, 2005, we announced that we received a $3.6 million order from a Fortune 500 global manufacturing company to advance our proprietary FDM technology for rapid manufacturing applications. This effort is based around our high-performance systems. The agreement includes payments to us over four years as R&D milestones are achieved, as well as payments that are dependent upon future deliverables. R&D payments received offset accelerated R&D efforts aimed at rapid manufacturing advances and are not recognized as revenue. During the three and nine months ended September 30, 2007, we offset approximately $181,000 and $630,000, respectively, of R&D expenses with monies received from this customer. This compares to $292,000 and $876,000 for the three and nine months ended September 30, 2006, respectively. As we continue our commitment to R&D throughout 2007, we expect to report higher R&D expenses than we incurred in 2007.

Increases in selling, general and administrative expenses are a result of additional spending to support our growth in our Dimension 3D printers and cost associated with the launch of the FDM 400mc. In addition, in the third quarter of 2007, we incurred a bad debt expense of $196,000 due to additional reserves based on an analysis of our outstanding receivables.

We expect the growth in selling, general and administrative expenses to be moderate over the remainder of 2007.

Operating Income

Operating income and operating income as a percentage of sales, as well as the percentage change in operating income, were as follows:

	Period Ended September 30,								
	Three Months				Period-over-Period Change	Nine Months				Period-over-Period Change
		2007		**2006**			**2007**		**2006**	
Operating income	$	4,089	$	3,540	15.5%	$	13,557	$	10,497	29.1%
Percent of sales		15.5%		14.1%			16.5%		14.2%	

Primarily due to the increase in net sales, changes in the product mix, along with the other reasons cited above, for the three and nine months ended September 30, 2007 compared with the same year-ago periods, operating income increased by 15% and 29%, respectively.

Other Income (Expense)

Other income (expense) as a percent of sales and changes in other income (expense) were as follows:

	Period Ended September 30,									
	Three Months				Period-over-Period Change	Nine Months				Period-over-Period Change
		2007		**2006**			**2007**		**2006**	
Interest income	$	629	$	435	44.7%	$	1,731	$	1,184	46.2%
Other		(104)		(85)	22.1%		(311)		(267)	16.7%
Total	$	525	$	350	50.2%	$	1,420	$	917	54.8%
Percent of sales		2.0%		1.4%			1.7%		1.2%	

Interest income increased compared to the same year-ago periods due to an increase in our cash and investments. Foreign currency gains and losses are principally due to currency fluctuations between the US dollar and the Euro. We enter into 30-day forward contracts to hedge our foreign currency exposure. In 2007 we hedged only a portion of our foreign currency exposure and the resulting loss was due to the weakening of the US dollar relative to the Euro. Our strategy is to continue to hedge a portion of our estimated Euro-denominated accounts receivable position throughout the remainder of 2007. At September 30, 2007, we had approximately €3.9 million in euro-denominated receivables and a €3.4 million 30-day forward contract.

Income Taxes

Income taxes and income taxes as a percent of net income before income taxes for the three and nine months ended September 30, 2007 and 2006, as well as the percentage change, were as follows:

	Period Ended September 30,					
	Three Months		Period-over-Period Change	Nine Months		Perio Perio Char
	2007	**2006**		**2007**	**2006**	
Income taxes	$ 1,377	$ 1,330	3.5%	$ 4,948	$ 3,904	26.8
Percent of income before taxes	29.8%	34.2%		33.0%	34.2%	

Income tax expense increased with the increase in income before income taxes. The lower effective rate in the third quarter and nine months ended September 30, 2007 was due to benefits from disqualifying dispositions of incentive stock options and an increase in the estimated research and development credit available. All other effective tax rates for periods presented are within our expected range.

Net Income

	Period Ended September 30,					
	Three Months		Period-over-Period Change	Nine Months		Period-over-Period Change
	2007	**2006**		**2007**	**2006**	
Net income	$ 3,237	$ 2,560	26.5%	$ 10,028	$ 7,511	33.5%
Percent of sales	12.2%	10.2%		12.2%	10.1%	

Net income increased for the three and nine months ended September 30, 2007 compared to the same year-ago periods primarily due to the increase in sales, a favorable product mix, and a lower effective tax rate.

Liquidity and Capital Resources

(all amounts in thousands) (unaudited)

A summary of our consolidated interim statements of cash flows for the nine months ended September 30, 2007 and 2006 are as follows**:**

	2007	**2006**
Net income	$ 10,028	$ 7,511
Deferred income taxes	32	383
Depreciation and amortization	3,450	2,777
Stock based compensation	723	981
Changes in operating assets and liabilities	(933)	(6,359)
Net cash flow from operating activities	13,300	5,293

Net cash provided by (used by) investing activities		(15,731)		(3,922)
Net cash provided by (used by) financing activities		8,956		(2,464)
Effect of exchange rates changes on cash		181		83
Net increase in cash and cash equivalents		6,706		(1,010)
Cash and cash equivalents, beginning of period		12,510		10,105
Cash and cash equivalents, beginning of period	$	19,216	$	9,095

We increased our cash, cash equivalents and short-term investment balances to approximately $43.2 million at September 30, 2007, from approximately $33.9 million at December 31, 2006. We increased our long-term investments, consisting principally of municipal bonds, to $13.3 million compared to $10.7 million at December 31, 2006. At September 30, 2007 total cash, cash equivalents and investments were approximately $56.5 million compared with approximately $44.6 million at December 31, 2006.

In the nine months ended September 30, 2007, net cash provided by our operating activities amounted to approximately $13.3 million compared with approximately $5.3 million in the comparable 2006 period. We generated cash from our net income, as adjusted to exclude the effects of non-cash charges. This was partially offset by cash used for changes in operating assets and liabilities, principally increases in accounts receivable and inventories somewhat offset by increases in accounts payable and other current liabilities and an increase in unearned revenue.

At September 30, 2007, our inventory balance increased to approximately $13.1 million compared with approximately $9.9 million at December 31, 2006. The increase in inventory is due to an increase in Dimension 3D printer finished goods because of a shift in product mix. The increase is also due to parts ordered to support the launch of our FDM 400mc at the beginning of August 2007, and inventory for a new product that will be introduced in the fourth quarter of 2007. A significant portion of our inventory is dedicated to fulfilling our service contract and warranty obligations. As we have introduced several new products over the last several quarters, there are many more platforms and models to service than in the past, which increases the requirement to maintain spare parts inventory. With the introduction of these new products, older products have been discontinued. However, inventory for these discontinued products is still required to fulfill our service contracts. Our procedures for dealing with this inventory are more fully explained in the section below captioned “Critical Accounting Policies.”

Our investing activities used cash of approximately $15.7 million. Buying and selling auction-rate securities as well as tax-free bonds, used cash of approximately $5.1 million. In addition, we used cash for fixed asset additions of approximately $8.1 million and payments for intangibles and other investments of approximately $2.5 million. Net cash used for payments for intangible assets and other investments included patents, acquisition of technology rights, and capitalized software. Much of the capital expenditure in 2007 was for equipment required by the growing components of our business, including manufacturing fixtures for new products, consumable manufacturing, and Paid Parts, and for improvements to our facilities. We are renovating the building we purchased in the fall of 2005 and it became our corporate headquarters in the third quarter of 2007.

Our financing activities provided cash of approximately $9.0 million from the exercise of stock options. For the remainder of 2007, we expect to use our cash as follows:

- for improvements to our facilities;
- for the continuation of our leasing program;
- for working capital purposes;
- for information systems (“I/S”) and infrastructure enhancements;
- for new product and materials development;
- for sustaining engineering;
- for the acquisition of equipment, including production equipment, tooling, and computers;
- for the purchase of intangible assets, including patents;
- for increased selling and marketing activities, especially as they relate to the continued market and channel development, as well as Arcam market development;

- for acquisitions and/or strategic alliances; and
- for our common stock buyback program.

While we believe that the primary source of liquidity during the remainder of 2007 will be derived from current cash balances and cash flows from operations, we have maintained a line of credit for the lesser of $4.0 million or a defined borrowing base. To date, we have not borrowed against this credit facility.

As of September 30, 2007, we had gross accounts receivable of approximately $27.8 million less an allowance of approximately $1.4 million for returns and doubtful accounts. Over our history, bad debt expense has generally been small as a percentage of sales. However, at September 30, 2007, large balances were concentrated with certain international distributors and some of these balances exceed our payment terms. Default by one or more of these distributors could result in a significant charge against our current reported earnings. We have reviewed our policies that govern credit and collections, and will continue to monitor them in light of current payment status and economic conditions. While we can give no assurances, we believe that most, if not all, of the accounts receivable balances will ultimately be collected. For further information, see the section below captioned Critical Accounting Policies.

Our total current assets amounted to approximately $88.1 million at September 30, 2007, most of which consisted of cash and cash equivalents, investments, inventories and accounts receivable. Total current liabilities amounted to approximately $21.2 million. We have no debt. We believe we have adequate resources to fund our foreseeable future growth.

Inflation

We believe that inflation has not had a material effect on our operations or on our financial condition during the three most recent fiscal years and current quarter.

Foreign Currency Transactions

We invoice sales to certain European distributors in Euros. Our reported results are therefore subject to fluctuations based upon changes in the exchange rates of that currency in relation to the United States dollar. In the nine months ended September 30, 2007 and 2006, the net loss on foreign currency amounted to approximately $346,000 and $267,000, respectively. During the quarter ended September 30, 2007, we hedged between €2.7 million and €3.4 million of our accounts receivable that were denominated in Euros. The hedge resulted in a currency loss of approximately $50,000 for that period. Our strategy is to hedge the majority of our Euro-denominated accounts receivable position throughout the remainder of 2007. We will continue to monitor our exposure to currency fluctuations. Instruments to hedge our risks may include foreign currency forward, swap, and option contracts. These instruments will be used to selectively manage risks, but there can be no assurances that we will be fully protected against material foreign currency fluctuations. We expect to continue to derive most of our sales from regions where the transactions are negotiated, invoiced, and paid in US dollars. Fluctuations in the currency exchange rates in these other countries may therefore reduce the demand for our products by increasing the price of our products in the currency of countries in which the local currency has declined in value.

Critical Accounting Policies

We have prepared our consolidated interim financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America. This has required us to make estimates, judgments, and assumptions that affected the amounts we reported.

We have identified several critical accounting policies that required us to make assumptions about matters that were uncertain at the time of our estimates. Had we used different estimates and assumptions, the amounts we recorded could have been significantly different. Additionally, if we had used different assumptions or different conditions existed, our financial condition or results of operations could have been materially different. The critical accounting policies that were affected by the estimates, assumptions, and judgments used in the preparation of our consolidated interim financial statements are listed below.

Revenue Recognition

We recognize revenue, consistent with the SAB 101, Revenue Recognition, amended by SAB 104 and Emerging Issues Task Force (EITF) 00-21, Revenue Arrangements with Multiple Deliverables when 1) persuasive evidence of a final agreement exists, 2) delivery has occurred or services have been rendered, 3) the selling price is fixed or determinable, and 4) collectibility is reasonably assured. Our standard terms are FOB shipping point, and as such most of our revenue from system sales is primarily recognized at time of shipment if the shipment conforms to the terms and conditions of the purchase agreement. Exceptions to this policy occur only if a customers purchase order indicates an alternative term or provides that the equipment sold would be subject to certain contingencies, such as formal acceptance. In these instances, revenues would be recognized only upon satisfying the conditions established by the customer in its purchase order to us. Revenue from sales-type leases of our FDM systems is recognized at the time of lessee acceptance, which follows installation. Revenue from sales-type leases of our Dimension systems is recognized at time of shipment, since either the customer or the reseller performs the installation. We recognize revenue from sales-type leases at the net present value of future lease payments. Revenue from operating leases is recognized ratably over the lease period. Revenue from maintenance contracts is recognized ratably over the term of the contract, usually one year. On certain sales that require a one-year warranty rather than our standard 90-day warranty, a percentage of the selling price that represents the fair value of the extended warranty is deferred and recognized ratably over the period of the extended warranty as an implied maintenance contract.

We assess collectibility as part of the revenue recognition process. We evaluate a number of factors to assess collectibility, including an evaluation of the creditworthiness of the customer, past payment history, and current economic conditions. If it is determined that collectibility cannot be reasonably assured, we would decline shipment, request a down payment, or defer recognition of revenue until ultimate collectibility is more determinable. We also record a provision for estimated product returns and allowances in the period in which the related revenue is recorded. This provision against current gross revenue is based principally on historical rates of sales returns, but also factors in changes in the customer base, geographic economic conditions, and changes in the financial conditions of our customers. If these trends were to change, we would potentially have to increase or decrease the amount of the provision for these returns. We have little history as to potential returns under our lease programs. We will monitor our lease sales in the future, and if necessary will record a provision for returns on leased systems.

Allowance for Doubtful Accounts

While we evaluate the collectibility of a sale as part of our revenue recognition process, we must also make judgments regarding the ultimate realization of our accounts receivable. A considerable amount of judgment is required in assessing the realization of these receivables, including the aging of the receivables and the creditworthiness of each customer. We may not be able to accurately and timely predict changes to a customers financial condition. If a customers financial condition should suddenly deteriorate, calling into question our ability to collect the receivable, our estimates of the realization of our receivables could be adversely affected. We might then have to record additional allowances for doubtful accounts, which could have an adverse effect on our results of operations in the period affected.

Our allowance for doubtful accounts is adjusted quarterly using two methods. First, our overall reserves are based on a percentage applied to certain aged receivable categories that are predominately based on historical bad debt write-off experience. Then, we make an additional evaluation of overdue customer accounts, for which we specifically reserve. In our evaluation we use a variety of factors, such as past payment history, the current financial condition of the customer, and current economic conditions. We also evaluate our overall concentration risk, which assesses the total amount owed by each customer, regardless of its current status.

Certain of our international distributors have carried large balances that have become overdue. Most of these distributors have continued to pay down their balances and are still considered performing. A default by one or more of these distributors could have a material effect, ranging from $.2 million to $1.0 million, on our reported operating results in the period affected.

Inventories

Our inventories are recorded at the lower of cost or market, with cost based on a first-in, first-out basis. We periodically assess this inventory for obsolescence and potential excess by reducing the difference between our cost and the estimated market value of the inventory based on assumptions about future demand and historical sales patterns. Our inventories consist of materials and products that are subject to technological obsolescence and competitive market conditions. If market conditions or future demand are less favorable than our current expectations, additional inventory write downs or reserves may be required, which could have an adverse effect on our reported results in the period the adjustments are made. Additionally, engineering or field change orders ("ECO" and "FCO", respectively) introduced by our engineering group could suddenly create extensive obsolete and/or excess inventory. Although our engineering group considers the estimated effect that an ECO or FCO would have on our inventories, a mandated ECO or FCO could have an immediate adverse affect on our reported financial condition if they required the use of different materials in either new production or our service inventory.

Some of our inventory is returned to us by our customers and refurbished. This refurbished inventory, once fully repaired and tested, is functionally equivalent to new production and is utilized to satisfy many of our requirements under our warranty and service contracts. Upon receipt of the returned material, this inventory is recorded at a discount from original cost, and further reduced by estimated future refurbishment expense. While we evaluate this service material in the same way as our stock inventory (i.e., we periodically test for obsolescence and excess), this inventory is subject to changing demand that may not be immediately apparent. Adjustments to this service inventory, following an obsolescence or excess review, could have an adverse effect on our reported financial condition in the period when the adjustments are made. We review the requirements for service inventory for discontinued products using the number of active maintenance contracts per product line as the key determinant for inventory levels and composition. A sudden decline in the number of customers renewing service agreements in a particular period could lead to an unanticipated write down of this service inventory for a particular product line.

Income Taxes

We comply with SFAS No. 109, "Accounting for Income Taxes," which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized. We have determined that it is more likely than not that our future taxable income will be sufficient to realize our deferred tax assets.

Our provision for income taxes is based on our effective income tax rate. The effective rate is highly dependent upon a number of factors, including our total earnings, the geographic location of sales, the availability of tax credits, and the effectiveness of our tax planning strategies. We monitor the effects of these variables throughout the year and adjust our income tax rate accordingly. However, if our actual results differ from our estimates, we could be required to adjust our effective tax rate or record a valuation adjustment on our deferred tax assets. This could have an adverse effect on our financial condition and results of operations.

Forward-looking Statements and Factors That May Affect Future Results of Operations

All statements herein that are not historical facts or that include such words as "expect", "anticipate", "project", "estimate" or "believe" or other similar words are forward-looking statements that we deem to be covered by and to qualify for the safe harbor protection covered by the Private Securities Litigation Reform Act of 1995 (the "1995 Act"). Investors and prospective investors in our Company should understand that several factors govern whether any forward-looking statement herein will be or can be achieved. Any one of these factors could cause actual results to differ materially from those projected herein.

These forward-looking statements include the expected increases in net sales of RP and 3D printing systems, services and consumables, and our ability to maintain our gross margins on these sales. The forward-looking statements include our assumptions about the size of the RP,and 3D printing and DDM markets, and our ability to penetrate, compete, and successfully sell our products in these markets. They include our plans and objectives to introduce new products, to control expenses, to improve the quality and reliability of our systems, to respond to new or existing competitive products, and to improve profitability. The forward-looking statements included herein are based on current expectations that involve a number of risks and uncertainties, some of which are described in Item 1A, "Risk Factors," in our Annual Report on Form 10-K for 2006. These forward-looking statements are based on assumptions, among others, that we will be able to:

- continue to introduce new RP, 3D printing, and DDM systems and materials acceptable to the market, and to continue to improve our existing technology and software in our current product offerings;
- successfully develop the 3D printing market with our Dimension BST, Dimension SST and Dimension Elite systems, and that the market will accept these systems;
- successfully develop and introduce high-performance systems to serve both the RP and DDM markets such as the FDM 200mc and FDM 400mc;
- maintain our revenues and gross margins on our present products;
- control our operating expenses;
- expand our manufacturing capabilities to meet the expected demand generated by Dimension BST, Dimension SST, Dimension Elite, Paid Parts, and our consumable products;
- successfully and profitably distribute and service the Arcam systems;
- successfully commercialize new materials, and that the market will accept these new materials; and
- recruit, retain, and develop employees with the necessary skills to produce, create, commercialize, market, and sell our products.

Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, geopolitical, competitive, market and technological conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of those assumptions could prove inaccurate, and therefore there is and can be no assurance that the results contemplated in any such forward-looking statement will be realized. The impact of actual experience and business developments may cause us to alter our marketing plans, our capital expenditure budgets, or our engineering, selling, manufacturing or other budgets, which may in turn affect our results of operations or the success of our new product development and introduction. We may not be able to alter our plans or budgets in a timely manner, resulting in reduced profitability or losses.

Due to the factors noted above and elsewhere in this Management's Discussion and Analysis of Financial Condition and Results of Operations, our future earnings and stock price may be subject to significant volatility, particularly on a quarterly basis. Additionally, we may not learn of revenue or earnings shortfalls until late in a fiscal quarter, since we frequently receive a significant number of orders very late in a quarter. This could result in an immediate and adverse effect on the trading price of our common stock. Past financial performance should not be considered a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our cash equivalents and short-term investments are exclusively in short-term money market, Auction Rate Certificates ("ARCs"), and sweep instruments with maturities of less than 90 days. These are subject to limited interest rate risk. A 10% change in interest rates would not have a material effect on our financial condition or results of operations. Our short- and long-term investments are invested in ARCs, municipal government bonds, and certificates of deposit that bear interest at rates of 3.1% to 5.5%. An immediate 10% change in interest rates would have no material effect on our financial condition or results of operations.

Foreign Currency Exchange Rate Risk

In the quarter ended September 30, 2007 we hedged between €2.7 million and €3.6 million of our accounts receivable balances that were denominated in Euros. A hypothetical 10% change in the exchange rates between the US dollar and the Euro could increase or decrease earnings before taxes by between $0.5 million and $0.6 million. A hypothetical 10% change in the exchange rates between the U.S. dollar and the Euro could increase or decrease our earnings before taxes by less than $0.3 million for the continued maintenance of our European facility.

Item 4. Controls and Procedures

Disclosure Controls and Procedures. Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report (the Evaluation Date). Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to us required to be disclosed in our Securities and Exchange Commission (SEC) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting. Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we are responsible for establishing and maintaining an adequate system of internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934). Our management has conducted an assessment of our 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. There have not been any changes in our internal control over financial reporting identified in connection with the assessment that occurred during the third quarter of 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II
OTHER INFORMATION

Item 6. Exhibits

(a) Exhibits.

31.1	Certification of the Chief Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a).
31.2	Certification of the Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a).
32.1	Certification of the Chief Executive Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350.
32.2	Certification of the Chief Financial Officer required by Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. 1350.

SIGNATURES

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

Date: November 9, 2007 **Stratasys, Inc.**

By: /s/ Robert F. Gallagher
Robert F. Gallagher
Chief Financial Officer

20