QUINSTREET, INC
Form 10-Q
February 07, 2014
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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, 2013

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	**(I.R.S. Employer**
Incorporation or Organization)	**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, 2014: 43,491,287

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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, 2013	June 30, 2013
Assets		
Current assets		
Cash and cash equivalents	$ 83,247	$ 90,117
Marketable securities	39,243	37,847
Accounts receivable, net	35,072	38,391
Deferred tax assets	981	6,753
Prepaid expenses and other assets	5,136	4,623
Total current assets	163,679	177,731
Property and equipment, net	10,866	9,707
Goodwill	151,092	150,456
Other intangible assets, net	40,819	50,486
Deferred tax assets, noncurrent	5,828	40,289
Other assets, noncurrent	937	878
Total assets	$ 373,221	$ 429,547
Liabilities and Stockholders Equity		
Current liabilities		
Accounts payable	$ 17,890	$ 18,722
Accrued liabilities	22,233	30,903
Deferred revenue	1,222	1,638
Debt	16,008	15,428
Total current liabilities	57,353	66,691
Deferred revenue, noncurrent	17	239
Debt, noncurrent	69,445	77,249
Other liabilities, noncurrent	6,263	6,473
Total liabilities	133,078	150,652

Commitments and contingencies (See Note 9)

Stockholders equity				
Common stock: $0.001 par value; 100,000,000 shares authorized; 43,485,157 and 42,886,884 shares issued and outstanding at December 31, 2013 and June 30, 2013, respectively		43		43
Additional paid-in capital		233,188		226,857
Accumulated other comprehensive loss		(1,127)		(1,012)
Retained earnings		8,039		53,007
Total stockholders equity		240,143		278,895
Total liabilities and stockholders equity	$	373,221	$	429,547

See notes to condensed consolidated financial statements

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QUINSTREET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2012	2013	2012
Net revenue	$ 66,145	$ 71,751	$ 143,106	$ 150,377
Cost of revenue [1]	56,116	61,712	119,708	126,902
Gross profit	10,029	10,039	23,398	23,475
Operating expenses: [1]				
Product development	4,776	4,504	9,935	9,397
Sales and marketing	3,659	3,496	7,815	7,187
General and administrative	4,411	4,019	8,545	7,945
Impairment of goodwill		92,350		92,350
Operating loss	(2,817)	(94,330)	(2,897)	(93,404)
Interest income	27	28	54	56
Interest expense	(976)	(1,354)	(2,002)	(2,366)
Other (expense) income, net	(29)	(4)	(48)	42
Loss before income taxes	(3,795)	(95,660)	(4,893)	(95,672)
(Provision for) benefit from taxes	(40,234)	32,169	(40,075)	32,044
Net loss	$ (44,029)	$ (63,491)	$ (44,968)	$ (63,628)
Net loss per share:				
Basic	$ (1.01)	$ (1.48)	$ (1.04)	$ (1.49)
Diluted	$ (1.01)	$ (1.48)	$ (1.04)	$ (1.49)
Weighted average shares used in computing net loss per share				
Basic	43,420	42,777	43,268	42,795
Diluted	43,420	42,777	43,268	42,795

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

Cost of revenue	$ 721	$ 963	$ 1,595	$ 1,886

Product development	610	698	1,342	1,391
Sales and marketing	598	858	1,368	1,623
General and administrative	697	510	1,356	899

See notes to condensed consolidated financial statements

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QUINSTREET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(In thousands)

(Unaudited)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2012	2013	2012
Net loss	$ (44,029)	$ (63,491)	$ (44,968)	$ (63,628)
Other comprehensive loss				
Unrealized (loss) gain on investments	(6)	(12)		(8)
Foreign currency translation adjustment	4	(160)	(71)	93
Interest rate swap				
Change in unrealized gain (loss)	93	185	(44)	(213)
Less: reclassification adjustment for loss (gain) included in net loss		138		(8)
Net change	93	323	(44)	(221)
Other comprehensive income (loss)	91	151	(115)	(136)
Comprehensive loss	$ (43,938)	$ (63,340)	$ (45,083)	$ (63,764)

See notes to condensed consolidated financial statements

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QUINSTREET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended December 31,	
	2013	**2012**
Cash Flows from Operating Activities		
Net loss	$ (44,968)	$ (63,628)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	13,344	18,458
Impairment of goodwill		92,350
Provision for sales returns and doubtful accounts receivable	(243)	(468)
Stock-based compensation	5,661	5,799
Excess tax benefits from stock-based compensation	(309)	(50)
Other non-cash adjustments, net	538	608
Changes in assets and liabilities, net of effects of acquisition:		
Accounts receivable	3,562	12,191
Prepaid expenses and other assets	(513)	(4,615)
Other assets, noncurrent	(59)	107
Deferred taxes	40,393	(28,914)
Accounts payable	(196)	(4,295)
Accrued liabilities	(5,861)	(5,650)
Deferred revenue	(638)	(598)
Other liabilities, noncurrent	(370)	344
Net cash provided by operating activities	10,341	21,639
Cash Flows from Investing Activities		
Capital expenditures	(4,179)	(821)
Business acquisition	(875)	
Other intangibles	(2,692)	(2,500)
Internal software development costs	(1,204)	(1,257)
Purchases of marketable securities	(23,236)	(28,431)
Proceeds from sales and maturities of marketable securities	21,345	25,108
Net cash used in investing activities	(10,841)	(7,901)
Cash Flows from Financing Activities		
Proceeds from exercise of common stock options	1,927	269
Principal payments on bank debt	(5,000)	(2,500)
Principal payments on acquisition-related notes payable	(2,237)	(5,472)

Excess tax benefits from stock-based compensation	309	50
Withholding taxes related to restricted stock net share settlement	(1,328)	(148)
Repurchases of common stock		(6,157)
Net cash used in financing activities	(6,329)	(13,958)
Effect of exchange rate changes on cash and cash equivalents	(41)	12
Net decrease in cash and cash equivalents	(6,870)	(208)
Cash and cash equivalents at beginning of period	90,117	68,531
Cash and cash equivalents at end of period	$ 83,247	$ 68,323
Supplemental Disclosure of Cash Flow Information		
Cash paid for interest	1,987	2,257
Cash paid for taxes	1,221	1,776
Supplemental Disclosure of Noncash Investing and Financing Activities		
Retirement of treasury stock		6,157
Short term payables		2,500

See notes to condensed consolidated financial statements

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QUINSTREET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. The Company

QuinStreet, Inc. (the Company) is an online performance marketing company. The Company was incorporated in California in April 1999 and reincorporated in Delaware in December 2009. The Company provides customer acquisition programs for clients in various industry verticals such as education and financial services. 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, 2013 and for the three and six months ended December 31, 2013 and 2012 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, 2013, as filed with the SEC on August 20, 2013. The condensed consolidated balance sheet at June 30, 2013 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, 2013, its condensed consolidated statements of operations for the three and six months ended December 31, 2013 and 2012, its condensed consolidated statements of comprehensive loss for the three and six months ended December 31, 2013 and 2012, and its condensed consolidated statements of cash flows for the six months ended December 31, 2013 and 2012. The results of operations for the three and six months ended December 31, 2013 are not necessarily indicative of the results to be expected for the fiscal year ending June 30, 2014, 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 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.

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QUINSTREET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Accounting Policies

The significant accounting policies are described in Note 2, Summary of Significant Accounting Policies, to the condensed consolidated financial statements included in the Annual Report on Form 10-K for the fiscal year ended June 30, 2013. There have been no significant changes in the accounting policies subsequent to June 30, 2013.

Concentrations of Credit Risk

No client accounted for 10% or more of net revenue for the three or six months ended December 31, 2013 or for the same period in fiscal year 2013. No client accounted for 10% or more of net accounts receivable as of December 31, 2013 or June 30, 2013.

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, 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 approximate their recorded amounts as the interest rates on similar financing arrangements available to the Company at December 31, 2013 approximate the interest rates implied when these acquisition-related promissory notes 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, 2013. The Company believes that the fair value of the term loan approximates its recorded amount at December 31, 2013 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 July 2012, the FASB issued an update to the accounting standard for intangibles. The revised standard update allows entities to use a qualitative approach to test indefinite-lived intangible assets 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 an indefinite-lived intangible asset is less than its carrying value. If it is concluded that this is the case, it is necessary to perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. Otherwise, the quantitative impairment test is not required. The Company plans to adopt this accounting standard in the fourth quarter of fiscal 2014 and does not believe that the adoption will have a material effect on the Company s consolidated financial statements.

In February 2013, the FASB issued an update to the accounting standard for accumulated other comprehensive loss. The revised standard update requires entities to present information about significant items reclassified out of accumulated other comprehensive loss by component either on the face of the statement where net loss is presented or as a separate disclosure in the notes to the financial statements. The Company s adoption of the new guidance in the first quarter of fiscal year 2014 did not have a material impact on its financial position, results of operations or cash flows.

In July 2013, the FASB issued a new accounting standard update on the financial presentation of unrecognized tax benefits. The new guidance provides that a liability related to an unrecognized tax benefit would be presented as reduction of a deferred tax asset for

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QUINSTREET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

a net operating loss carryforward, a similar tax loss or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. The new guidance becomes effective July 1, 2014 for the Company and it should be applied prospectively to unrecognized tax benefits that exist at the effective date, although retrospective application is permitted. The Company does not believe that the adoption will have a material effect on the Company s consolidated financial statements.

3. Net Loss Attributable to Common Stockholders and Net Loss per Share

Basic net loss per share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the period. Diluted net loss 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 per share:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	**2012**	**2013**	**2012**
	(In thousands, except per share data)		(In thousands, except per share data)	
Numerator:				
Basic and Diluted:				
Net loss	$ (44,029)	$ (63,491)	$ (44,968)	$ (63,628)
Denominator:				
Basic:				
Weighted average shares of common stock used in computing basic net loss per share	43,420	42,777	43,268	42,795
Diluted:				
Weighted average shares of common stock used in computing basic net loss per share	43,420	42,777	43,268	42,795
Weighted average effect of dilutive securities:				
Stock options				
Restricted stock units				
Weighted average shares of common stock used in computing diluted net loss per share	43,420	42,777	43,268	42,795

Net loss per share:								
Basic	$	(1.01)	$	(1.48)	$	(1.04)	$	(1.49)
Diluted [1]	$	(1.01)	$	(1.48)	$	(1.04)	$	(1.49)
Securities excluded from weighted average shares used in computing diluted net loss per share because the effect would have been anti-dilutive: [2]		8,248		10,505		7,856		8,902

(1) Diluted EPS does not reflect any potential common stock relating to stock options or restricted stock units due to net loss incurred for the three and six months ended December 31, 2013 and 2012. The assumed issuance of any additional shares would be anti-dilutive.

(2) 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.

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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, 2013, 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, 2013, the Company used Level 2 assumptions for its U.S. municipal securities, certificates of deposit, acquisition-related promissory notes, 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, 2013, the Company did not have any Level 3 financial assets or liabilities.

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QUINSTREET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Company s financial instruments as of December 31, 2013 and June 30, 2013 were categorized as follows in the fair value hierarchy (in thousands):

	Fair Value Measurements as of December 31, 2013 Using		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Total
Assets:			
U.S. municipal securities	$	$ 20,973	$ 20,973
Certificates of deposit		22,360	22,360
Money market funds	37,748		37,748
	$ 37,748	$ 43,333	$ 81,081
Liabilities:			
Acquisition-related promissory notes (1)	$	$ 1,470	$ 1,470
Term loan (1)		83,983	83,983
Interest rate swap		699	699
	$	$ 86,152	$ 86,152

	Fair Value Measurements as of June 30, 2013 Using		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Total
Assets:			
U.S. municipal securities	$	$ 25,544	$ 25,544
Certificates of deposit		16,923	16,923
Money market funds	38,465		38,465

	$	38,465	$	42,467	$	80,932
Liabilities:						
Acquisition-related promissory notes [1]	$		$	3,875	$	3,875
Term loan [1]				88,802		88,802
Interest rate swap				655		655
	$		$	93,332	$	93,332

[1] These liabilities are carried at historical cost on the Company s consolidated balance sheet.

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 accumulated other comprehensive loss within stockholders equity.

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, 2013 and June 30, 2013 (in thousands):

	As of December 31, 2013			
	Gross Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. municipal securities	$ 20,969	$ 4	$	$ 20,973
Certificates of deposit	22,380		20	22,360
Money market funds	37,748			37,748
	$ 81,097	$ 4	$ 20	$ 81,081

	As of June 30, 2013			
	Gross Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. municipal securities	$ 25,538	$ 6	$	$ 25,544
Certificates of deposit	16,945		22	16,923
Money market funds	38,465			38,465
	$ 80,948	$ 6	$ 22	$ 80,932

The Company did not realize any gains or losses from sales of its securities in the periods presented. As of December 31, 2013 and June 30, 2013, the Company did not hold securities that had maturity dates greater than one year.

5. Acquisitions

Acquisitions in Fiscal Year 2014

During the six months ended December 31, 2013, the Company acquired the operations of an online publishing business in exchange for $0.9 million in cash paid upon closing of the acquisition.

Acquisitions in Fiscal Year 2013

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

QUINSTREET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

6. Intangible Assets and Goodwill

Intangible assets, net balances, excluding goodwill, consisted of the following (in thousands):

	December 31, 2013			June 30, 2013		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer/publisher/advertiser relationships	$ 37,036	$ (29,764)	$ 7,272	$ 37,035	$ (28,321)	$ 8,714
Content	62,172	(46,974)	15,198	62,028	(43,054)	18,974
Website/trade/domain names	31,643	(19,459)	12,184	31,597	(17,403)	14,194
Acquired technology and others	36,716	(30,551)	6,165	36,425	(27,821)	8,604
	$ 167,567	$ (126,748)	$ 40,819	$ 167,085	$ (116,599)	$ 50,486

Amortization of intangible assets was $5.1 million and $10.2 million in the three and six months ended December 31, 2013 and $8.8 million and $15.7 million in the three and six months ended December 31, 2012.

Future amortization expense for the Company s intangible assets as of December 31, 2013 was as follows (in thousands):

Year Ending June 30,	Amortization
2014 (remaining six months)	$ 9,442
2015	12,496
2016	8,931
2017	6,109
2018	2,198
Thereafter	1,643
	$ 40,819

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, Segment Information, for the six months ended December 31, 2013 was as follows (in thousands):

	DMS	DSS	Total
Balance at June 30, 2013	$ 149,225	$ 1,231	$ 150,456
Additions	636		636
Balance at December 31, 2013	$ 149,861	$ 1,231	$ 151,092

In the six months ended December 31, 2013, the additions to goodwill relate to the Company s acquisition as described in Note 5, Acquisitions.

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QUINSTREET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

7. Income Taxes

The Company recorded a provision for income taxes of $40.2 million and $40.1 million for the three and six months ended December 31, 2013. The Company s estimated annual effective tax rate is negative 4%. This differs from the annual statutory rate of 35% primarily due to a one-time, non-cash charge to establish a valuation allowance for a significant portion of the Company s deferred tax assets.

The Company regularly assesses the need for a valuation allowance against its deferred tax assets. Significant judgment is required to determine whether a valuation allowance is necessary and the amount of such valuation allowance, if appropriate. The Company considers all available evidence, both positive and negative to determine, based on the weight of available evidence, whether it is more likely than not that some or all of the deferred tax assets will not be realized. In evaluating the need for a valuation allowance the Company considers, among other things, the nature, frequency and severity of current and cumulative losses, forecasts of future profitability, and the duration of statutory carryforward periods. The Company determined that the significant negative evidence associated with cumulative losses in recent periods and the current results outweighed the positive evidence as of December 31, 2013 and accordingly, the near-term realization of these assets was deemed unlikely and recorded a one-time, non-cash charge to income tax expense of $40.2 million to establish a valuation allowance against a significant portion of its deferred tax assets. The Company will continue to assess the likelihood that the deferred tax assets will be realizable at each reporting period and the valuation allowance will be adjusted accordingly.

The Company recorded a benefit from income taxes of $32.2 million and $32.0 million for the three and six months ended December 31, 2012. The Company recorded a goodwill impairment charge of $92.4 million in the financial statements as of and for the three and six months ended December 31, 2012 and had an associated tax benefit of $28.9 million due to the impairment of goodwill that is deductible for tax purposes. As of December 31, 2012 the Company s estimated annual effective tax rate was 33%. This differs from the annual statutory rate of 35% due to various permanent differences, most significantly stock-based compensation.

8. Debt

Credit Facility

In November 2011, the Company entered into the Second Amended and Restated Revolving Credit and Term Loan Agreement (the Second Loan Agreement) with Comerica Bank (the Bank), the administrative agent and lead arranger. The Second Loan Agreement consists of a $100 million five-year term loan, with annual principal amortization of 5%, 10%, 15%, 20%, and 50%, and a $200 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 to the Second Loan Agreement) 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 million for the life of the Second Loan Agreement; and (2) reduce the $200 million five-year revolving credit line portion of the facility to $100 million, effective as of February 15, 2013.

Borrowings under the Second Loan Agreement are secured by substantially all of the Company s assets. Interest is payable at a rate computed using either Base rate or a Eurodollar rate plus an applicable margin, at the Company s option. Base rate is defined as the applicable margin plus the greatest of (a) the Prime Rate for such day, (b) the Federal Funds Effective Rate in effect on such day, plus 1% and (c) the Daily Adjusting LIBOR Rate plus 1%. Base rate borrowings bear interest at a Base rate plus an applicable margin which varies from (1) 0.625% to 1.375% for revolving loans and (2) 1.00% to 1.75% for term loans, depending on the Company s funded debt to adjusted EBITDA ratio. Eurodollar rate borrowings bear interest at the Eurodollar rate plus an applicable margin which varies from (1) 1.625% to 2.375% for revolving loans and (2) 2.00% to 2.75% for term loans, depending on the Company s funded debt to adjusted EBITDA ratio. Adjusted EBITDA is defined as net (loss) income less (provision for) benefit from 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Second Loan Agreement expires in November 2016. The credit facility 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.

The Company was in compliance with the covenants of the Second Loan Agreement, as amended by the First Amendment, as of December 31, 2013 and June 30, 2013.

The outstanding amount under the term loan at December 31, 2013 and June 30, 2013 was $85 million and $90 million. There were no outstanding balances under the revolving credit line at December 31, 2013 or June 30, 2013.

Interest Rate Swap

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 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 swap encompasses the principal balances scheduled to be outstanding as of January 1, 2014 and thereafter, such principal and notional amount totaling $85 million in January 2014 and amortizing to $35 million in November 2016. The effective date of the swap was April 9, 2012 with a maturity date of November 4, 2016. At December 31, 2013, the Company had approximately $85 million of notional amount outstanding in the swap agreement that exchanges a variable interest rate base (Eurodollar rate) for a fixed interest rate of 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. Any hedge ineffectiveness will be immediately recognized in earnings in the current period.

At December 31, 2013, the fair value of the interest rate swap liability was $0.7 million and the hedge effective portion of the interest rate swap was $0.7 million.

Promissory Notes

During the six months ended December 31, 2013 and 2012, the Company did not issue any promissory notes for the acquisition of businesses. The outstanding amount under the promissory notes at December 31, 2013 and June 30, 2013 was $1.5 million and $4.0 million.

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Debt Maturities

The maturities of the Company s debt as of December 31, 2013 were as follows (in thousands):

Year Ending June 30,	Promissory Notes	Credit Facility
2014 (remaining six months)	$ 928	$ 7,500
2015	560	17,500
2016	50	20,000
2017		40,000
2018		
2019		
	1,538	85,000
Less: imputed interest and unamortized discounts	(68)	(1,017)
Less: current portion	(1,366)	(14,642)
Noncurrent portion of debt	$ 104	$ 69,341

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.

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9. Commitments and Contingencies

Leases

The Company leases office space and equipment under non-cancelable operating leases with various expiration dates through 2019. Rent expense for the three and six months ended December 31, 2013 was $0.8 million and $1.9 million and for the three and six months ended December 31, 2012 was $0.8 million and $1.6 million. The Company recognizes rent expense on a straight-line basis over the lease period and accrues for rent expense incurred but not paid.

Future annual minimum lease payments under noncancelable operating leases as of December 31, 2013 were as follows (in thousands):

Year Ending June 30,	**Operating Leases**
2014 (remaining six months)	$ 1,836
2015	3,476
2016	3,362
2017	2,911
2018	2,950
2019 and thereafter	1,099
	$ 15,634

Guarantor Arrangements

The Company has agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was, serving at the Company s request in such capacity. The term of the indemnification period is for the officer or director s lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer insurance policy that limits its exposure and enables the Company to recover a portion of any future amounts under certain circumstances and subject to deductibles and exclusions. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is not material. Accordingly, the Company had no liabilities recorded for these agreements as of December 31, 2013 and June 30, 2013.

In the ordinary course of its business, the Company from time to time enters into standard indemnification provisions in its agreements with its clients. Pursuant to these provisions, the Company may be obligated to indemnify its clients for certain losses suffered or incurred, including losses arising from violations of applicable law by the Company or by its third-party website publishers, losses arising from actions or omissions of the Company or its third-party publishers, and for third-party claims that a Company product infringed upon any United States patent, copyright or other intellectual property rights. Where applicable, the Company generally limits its liabilities under such indemnities. With respect to its DSS products, the Company also generally reserves the right to resolve intellectual property infringements claims by providing a non-infringing alternative or by obtaining a license on reasonable terms, and failing that, by terminating its relationship with the client and thus terminating the infringing activity. Subject to these limitations, the term of such indemnity provisions is generally coterminous with the corresponding agreements but in some cases survives for a period of time after termination of the agreement.

The potential amount of future payments to defend lawsuits or settle indemnified claims under these indemnification provisions is generally limited and the Company believes the estimated fair value of these indemnity provisions is not material, and accordingly, the Company had no liabilities recorded for these agreements as of December 31, 2013 and June 30, 2013.

QUINSTREET, INC.

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Litigation

In December 2012, Internet Patents Corporation (IPC) filed a patent infringement lawsuit against the Company in the United States District Court for the Northern District of California, seeking a judgment that the Company has infringed a patent held by IPC. The Company received the related summons and complaint from IPC in March 2013. In September 2013, the court dismissed a related case because it found that the patent is invalid, and on the same date, the court issued IPC an Order to Show Cause that the lawsuit against the Company should not be dismissed. In October 2013, IPC filed a response to the order and the court subsequently dismissed the case against the Company. In November 2013, IPC filed a Notice of Appeal to the United States Court of Appeals for the Federal Circuit. While the Company denies IPC s claims and believes that the probability of any loss is remote, there can be no assurance that the Company will prevail in this matter and any adverse ruling or settlement may have a significant impact on its business and operating results. In addition, regardless of the outcome of the matter, the Company may incur significant legal fees defending the action until it is resolved.

10. Stock Benefit Plans

Stock Incentive Plans

The Company may grant incentive stock options (ISOs), nonstatutory stock options (NQSOs), restricted stock, restricted stock units, stock appreciation rights, performance-based stock awards, and other forms of equity compensation, as well as performance cash awards, under its 2010 Equity Incentive Plan (the 2010 Incentive Plan) as well as NQSOs and restricted stock units to non-employee directors under the 2010 Non-Employee Directors Stock Award Plan (the Directors Plan). To date, the Company has issued only ISOs, NQSOs and restricted stock units under the plans.

As of December 31, 2013, 9,210,527 shares were reserved and 6,099,068 shares were available for issuance under the 2010 Incentive Plan; 1,593,162 shares were reserved and 1,187,035 shares were available for issuance under the Directors Plan.

Stock-Based Compensation

The Company estimates the fair value of stock options at the date of grant using the Black-Scholes option-pricing model. Options are granted with an exercise price equal to the fair value of the common stock at the date of grant. The weighted average Black-Scholes model assumptions and the weighted average grant date fair value of employee stock options for the three and six months ended December 31, 2013 and 2012 were as follows:

	Three Months Ended December 31,	**Six Months Ended December 31,**

	2013	2012	2013	2012
Expected term (in years)	4.6	4.6	4.6	4.6
Expected volatility	47%	54%	48%	55%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	1.3%	0.8%	1.4%	0.7%
Grant date fair value	$ 3.71	$ 3.07	$ 3.90	$ 3.97

The fair value of restricted stock units is determined based on the closing price of the Company s common stock on the grant date. Compensation expense is amortized net of estimated forfeitures on a straight-line basis over the requisite service period of the stock-based compensation awards.

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11. Segment Information

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company s chief operating decision maker is its chief executive officer. The Company s chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about operating segments, including net sales and operating (loss) income before depreciation, amortization and stock-based compensation expense.

The Company determined its reportable operating segments to be DMS, which derives revenue from fees earned through the delivery of qualified leads, clicks, calls, customers and, to a lesser extent, impressions, and DSS, which derives revenue from the sale of direct selling services through a hosted solution. The accounting policies of the two reportable operating segments are the same as those described in Note 2, Summary of Significant Accounting Policies.

The Company evaluates the performance of its operating segments based on operating income before depreciation, amortization and stock-based compensation expense.

The Company does not allocate most of its assets, nor its depreciation and amortization expense, stock-based compensation expense, interest income, interest expense or income tax expense by segment. Accordingly, the Company does not report such information.

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QUINSTREET, INC.

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Summarized information by segment was as follows (in thousands):

	Three Months Ended December 31, 2013	Three Months Ended December 31, 2012	Six Months Ended December 31, 2013	Six Months Ended December 31, 2012
Net revenue by segment:				
DMS	$ 65,841	$ 71,514	$ 142,537	$ 149,848
DSS	304	237	569	529
Total net revenue	66,145	71,751	143,106	150,377
Segment operating income before depreciation, amortization, and stock-based compensation expense:				
DMS	6,268	11,085	15,729	22,909
DSS	209	143	379	294
Total segment operating income before depreciation, amortization, and stock-based compensation expense	6,477	11,228	16,108	23,203
Depreciation and amortization	(6,668)	(10,179)	(13,344)	(18,458)
Stock-based compensation expense	(2,626)	(3,029)	(5,661)	(5,799)
Impairment of goodwill		(92,350)		(92,350)
Total operating loss	$ (2,817)	$ (94,330)	$ (2,897)	$ (93,404)

The following tables set forth net revenue and long-lived assets by geographic area (in thousands):

	Three Months Ended December 31, 2013	Three Months Ended December 31, 2012	Six Months Ended December 31, 2013	Six Months Ended December 31, 2012
Net revenue:				
United States	$ 65,523	$ 71,180	$ 141,940	$ 149,089
International	622	571	1,166	1,288
Total net revenue	$ 66,145	$ 71,751	$ 143,106	$ 150,377

	December 31, 2013	June 30, 2013
Property and equipment, net:		
United States	$ 10,607	$ 9,502
International	259	205
Total property and equipment, net:	$ 10,866	$ 9,707

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes appearing elsewhere in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the fiscal year ended June 30, 2013, filed with the Securities and Exchange Commission (SEC).

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they do not materialize or if they prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are often identified by the use of words such as, but not limited to, anticipate, believe, can, continue, could, estimate, expect, intend, may, will, plan, project, seek, should, target, will, would, and similar expressions or variations intended to identify forward-looking statements. These statements reflect the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified in Part II Item 1A. Risk Factors below, and those discussed in the sections titled Special Note Regarding Forward-Looking Statements and Risk Factors included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2013, filed with the SEC. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Management Overview

QuinStreet is a leader in performance marketing online. We have built a strong set of capabilities to engage Internet visitors with targeted media and to connect our marketing clients with their potential customers online. We focus on serving clients in large, information-intensive industry verticals where relevant, targeted media and offerings help visitors make informed choices, find the products that match their needs, and thus become qualified customer prospects for our clients.

We deliver cost-effective marketing results to our clients most typically in the form of a qualified lead or inquiry, in the form of a qualified click, or in the form of a call. Leads, clicks or calls can then convert into a customer or sale for clients at a rate that results in an acceptable marketing cost to them. We are typically paid by clients when we deliver qualified leads, clicks, calls or customers as defined by our agreements with them. References to the delivery of customers means the sale of completed customer transactions (e.g. bound insurance policies or customer appointments with clients). Because we bear the costs of media, our programs must deliver value to our clients and provide for a media yield, or generation of an acceptable margin on our media costs, that provides a sound financial outcome for us. To deliver leads, clicks, calls, and customers to our clients, generally we:

- own or access targeted media;

run advertisements or other forms of marketing messages and programs in that media to create visitor responses in the form most typically of leads (visitor generated contact information and requests), clicks (to further qualification or matching steps, or to online client applications or offerings) or calls (to our owned and operated call centers or that of our clients or their agents);

match these leads, clicks, calls or customers to client offerings or brands that we believe can meet visitor interests or needs, converting visitors into qualified leads, clicks, calls or customers for our clients; and

optimize client matches and media yield such that we achieve desired results for clients and a sound financial outcome for us.

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Our primary financial objective has been and remains creating revenue growth from sustainable sources, at target levels of profitability. Our primary financial objective is not to maximize profits, but rather to achieve target levels of profitability while investing in various growth initiatives, as we continue to believe we are in the early stages of a large, long-term market.

Our Direct Marketing Services (DMS) business accounted for substantially all of our net revenue in the three and six months ended December 31, 2013 and 2012. Our DMS business derives net revenue from fees earned through the delivery of qualified leads, clicks, calls or customers and, to a lesser extent, display advertisements, or impressions. Through a vertical focus, targeted media presence and our technology platform, we are able to deliver targeted, measurable marketing results to our clients.

Our two largest client verticals within our DMS business are education and financial services. Our education client vertical represented 45% and 44% of net revenue in the three and six months ended December 31, 2013 and 46% and 45% of net revenue for the three and six months ended December 31, 2012. Our financial services client vertical represented 37% and 39% of net revenue in the three and six months ended December 31, 2013 and 37% and 38% of net revenue for the three and six months ended December 31, 2012. Other DMS client verticals, consisting primarily of business-to-business technology, home services and medical, represented 18% and 17% of net revenue in the three and six months ended December 31, 2013 and 17% of net revenue in both the three and six months ended December 31, 2012.

In addition, we derived less than 1% of our net revenue in both the three and six months ended December 31, 2013, and for the same period last fiscal year, from the provision of a hosted solution and related services for clients in the direct selling industry, also referred to as our Direct Selling Services (DSS) business.

We generated substantially all of our revenue from sales to clients in the United States.

No client accounted for 10% or more of our net revenue in the three and six months ended December 31, 2013 or 2012.

Trends Affecting our Business

Client Verticals

To date, we have generated the majority of our revenue from clients in our education and financial services client verticals. We expect that a majority of our revenue for the remainder of fiscal year 2014 will continue to be generated from clients in these two client verticals.

Our education client vertical has been significantly affected by the adoption of regulations affecting for-profit educational institutions over the past several years. The regulations have affected, and are expected to continue to affect, our clients businesses and marketing practices, including an overall decrease in our clients external marketing expenditures. The effect of these regulations or any future regulations may continue to result in fluctuations in the volume and mix of our business with these clients. We are working to offset declines and volatility by diversifying our products, media and markets, including expansion into non-profit and international education markets.

Our financial services client vertical continued to be negatively affected due to reduced availability of high quality media at acceptable margins caused by changes in search engine algorithms, acquisition of media sources by competitors and increased competition for quality media. These effects may continue to impact our business in the near future. We are working to offset declines by diversifying our product base with additions of leads, calls and bound policies.

Acquisitions

Acquisitions in Fiscal Year 2014

During the six months ended December 31, 2013 we acquired the operations of an online publishing business.

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Acquisitions in Fiscal Year 2013

We did not complete any acquisitions in the six months ended December 31, 2012.

Development and Acquisition of Targeted Media

One of the primary challenges of our business is finding or creating media that is high quality and targeted enough to attract prospects for our clients at costs that work for our business model. In order to grow our business, we must be able to find, develop or retain quality targeted media on a cost-effective basis. Consolidation of media sources, changes in search engine algorithms and increased competition for available media has, during some periods, limited and may continue to limit our ability to generate revenue at acceptable margins.

Seasonality

Our results are subject to significant fluctuation as a result of seasonality. In particular, our quarters ending December 31 (our second fiscal quarter) are typically characterized by seasonal weakness. In our second fiscal quarters, there is lower availability of lead supply from some forms of media during the holiday period on a cost effective basis and some of our clients have lower budgets. In our quarters ending March 31 (our third fiscal quarter), this trend generally reverses with better lead availability and often new budgets at the beginning of the year for our clients with fiscal years ending December 31.

Regulations

Our revenue has fluctuated as a result of newly-adopted or amended regulations and the increased enforcement of existing regulations. Our business is affected directly because we operate websites and conduct telemarketing and email marketing, and indirectly as our clients adjust their operations as a result of regulatory changes that affect their industries.

One example of a recent regulatory change that may affect our business is the Telephone Consumer Protection Act (the TCPA), which the Federal Communications Commission recently amended to, among other things, impose heightened consent and opt-out requirements that companies conducting telemarketing must follow. Certain provisions of the regulations became effective in July 2012, and additional regulations requiring prior express written consent for telemarketing calls to wireless numbers became effective in October 2013. Our efforts to comply with the TCPA has had a relatively small negative effect on traffic conversion rates. Our clients may make business decisions based on their own experiences with the TCPA regardless of our products, and the changes we implemented to comply with the new regulations. Those decisions may negatively affect our revenue or profitability.

In addition, our education client vertical has been significantly affected by the adoption of regulations affecting for-profit educational institutions over the past several years, and a higher level of legislative scrutiny is expected to continue. Clients in our financial services vertical have increasingly been affected by laws and regulations as a result of the adoption of new regulations under The Dodd Frank Wall Street Reform and Consumer Protection Act and the increased enforcement of new and pre-existing laws and regulations. The effect of these regulations, or any future regulations, may continue to result in fluctuations in the volume and mix of our business with these clients.

Basis of Presentation

General

Our business is composed of two operating segments: DMS and DSS. For further discussion and financial information about our operating segments, see Note 11, Segment Information, to our condensed consolidated financial statements.

Net Revenue

DMS. Our DMS business generates revenue from fees earned through the delivery of qualified leads, clicks, calls, customers and, to a lesser extent, display advertisements, or impressions. We deliver targeted and measurable results through a vertical focus that we classify into the following client verticals: education, financial services and other (which includes business-to-business technology, home services and medical).

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DSS. Our DSS business generated less than 1% of net revenue in each of the three and six months ended December 31, 2013 and 2012. We expect DSS to continue to represent an immaterial portion of our business.

Cost of Revenue

Cost of revenue consists primarily of media costs, personnel costs, amortization of intangible assets, depreciation expense, and amortization of internal software development costs relating to revenue-producing technologies. Media costs consist primarily of fees paid to website publishers that are directly related to a revenue-generating event and pay-per-click, or PPC, ad purchases from Internet search companies. We pay these website publishers and Internet search companies on a revenue-share, a cost-per-lead, or CPL, cost-per-click, or CPC, and cost-per-thousand-impressions, or CPM, basis. Personnel costs include salaries, stock-based compensation expense, bonuses, and employee benefit costs. Personnel costs are primarily related to individuals associated with maintaining our servers and websites, our editorial staff, client management, creative team, content, compliance group, and media purchasing analysts. Costs associated with software incurred in the development phase or obtained for internal use are capitalized and amortized in cost of revenue over the software s estimated useful life.

Operating Expenses

We classify our operating expenses into three categories: product development, sales and marketing and general and administrative. Our operating expenses consist primarily of personnel costs and, to a lesser extent, professional services fees, rent and other costs. Personnel costs for each category of operating expenses generally include salaries, stock-based compensation expense, bonuses, commissions, and employee benefit costs.

Product Development. Product development expenses consist primarily of personnel costs and professional services fees associated with the development and maintenance of our technology platforms, development and launching of our websites, product-based quality assurance, and testing. In the current period of business challenges, we are constraining expenses generally to the extent practicable. However, we expect product development expenses to continue to increase in absolute dollars for the remainder of fiscal year 2014 as we believe that continued investment in technology is critical to attaining our strategic objectives.

Sales and Marketing. Sales and marketing expenses consist primarily of personnel costs and, to a lesser extent, professional services fees, travel costs and advertising. In the current period of business challenges, we are constraining expenses generally to the extent practicable. However, we expect sales and marketing expenses to continue to increase in absolute dollars for the remainder of fiscal year 2014 as we hire additional personnel in sales and marketing to support our offerings.

General and Administrative. General and administrative expenses consist primarily of personnel costs of our executive, finance, legal, employee benefits and compliance, technical support, and other administrative personnel, as well as accounting and legal professional services fees, and insurance. In the current period of business challenges, we are constraining expenses generally to the extent practicable. However, we expect general and administrative expenses, including increased legal and accounting costs to increase in absolute dollars for the remainder of fiscal year 2014 as we continue to invest in corporate infrastructure and expand our business internationally.

Interest and Other Income (Expense), Net

Interest and other income (expense), net, consists primarily of interest expense, other income and expense, net and interest income. Interest expense is related to our credit facility, including the related interest rate swap and promissory notes issued in connection with our acquisitions, and includes imputed interest on non-interest bearing notes. Borrowings under our credit facility, the aggregate principal amount of outstanding promissory notes and related interest expense could increase if, among other things, we make additional acquisitions through debt financing. Interest income represents interest earned on our cash, cash equivalents and marketable securities, which may increase or decrease depending on market interest rates and the amounts invested.

Other income (expense), net, includes foreign currency exchange gains and losses and other non-operating items.

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Income Tax (Provision for) Benefit from

We are subject to tax in the United States as well as other tax jurisdictions or countries in which we conduct business. Earnings from our limited non-U.S. activities are subject to local country income tax and may be subject to U.S. income tax.

Critical Accounting Policies, Estimates and Judgments

In presenting our consolidated financial statements in conformity with U.S. generally accepted accounting principles, or GAAP, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, expenses, and related disclosures.

Some of the estimates and assumptions we are required to make relate to matters that are inherently uncertain as they pertain to future events. We base these estimates and assumptions on historical experience or on various other factors that we believe to be reasonable and appropriate under the circumstances. On an ongoing basis, we reconsider and evaluate our estimates and assumptions. Actual results may differ significantly from these estimates.

We believe that the critical accounting policies listed below involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements.

- Revenue recognition;
- Valuation of goodwill and intangible assets;
- Stock-based compensation;
- Income taxes; and
- Valuation of long-lived assets.

There have been no material changes to our critical accounting policies, estimates and judgments disclosed in our Annual Report on Form 10-K subsequent to June 30, 2013. For further information on our critical and other significant accounting policies and estimates, see Part II, Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report on Form 10-K for the year ended June 30, 2013, filed with the SEC.

Recently Issued Accounting Standards

See Note 2, Summary of Significant Accounting Policies, to our condensed consolidated financial statements.

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Results of Operations

The following table sets forth our consolidated statement of operations for the periods indicated:

	Three Months Ended December 31,				Six Months Ended December 31,			
	2013		2012		2013		2012	
	(In thousands)				(In thousands)			
Net revenue	$ 66,145	100.0%	$ 71,751	100.0%	$ 143,106	100.0%	$ 150,377	100.0%
Cost of revenue (1)	56,116	84.8	61,712	86.0	119,708	83.6	126,902	84.4
Gross profit	10,029	15.2	10,039	14.0	23,398	16.4	23,475	15.6
Operating expenses: (1)								
Product development	4,776	7.2	4,504	6.3	9,935	6.9	9,397	6.2
Sales and marketing	3,659	5.5	3,496	4.9	7,815	5.5	7,187	4.8
General and administrative	4,411	6.7	4,019	5.6	8,545	6.0	7,945	5.3
Impairment of goodwill		0.0	92,350	128.7		0.0	92,350	61.4
Operating loss	(2,817)	(4.2)	(94,330)	(131.5)	(2,897)	(2.0)	(93,404)	(62.1)
Interest income	27	0.0	28	0.0	54	0.0	56	0.0
Interest expense	(976)	(1.5)	(1,354)	(1.9)	(2,002)	(1.4)	(2,366)	(1.6)
Other (expense) income, net	(29)	(0.0)	(4)	0.0	(48)	(0.0)	42	0.0
Loss before income taxes	(3,795)	(5.7)	(95,660)	(133.3)	(4,893)	(3.4)	(95,672)	(63.6)
(Provision for) benefit from taxes	(40,234)	(60.8)	32,169	44.8	(40,075)	(28.0)	32,044	21.3
Net loss	$ (44,029)	(66.5)%	$ (63,491)	(88.5)%	$ (44,968)	(31.4)%	$ (63,628)	(42.3)%

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

Cost of revenue	$ 721	1.1%	$963	1.3%	$1,595	1.1%	$1,886	1.3%
Product development	610	0.9	698	1.0	1,342	0.9	1,391	0.9
Sales and marketing	598	0.9	858	1.2	1,368	1.0	1,623	1.1
General and administrative	697	1.1	510	0.7	1,356	0.9	899	0.6

Net Revenue

	Three Months Ended December 31,		Six Months Ended December 31,		Three Months	Six Months
	2013	2012	2013	2012	% Change	% Change
	(in thousands)					