

APPFOLIO INC  
Form 10-Q  
November 06, 2017  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark one)

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

For the quarterly period ended September 30, 2017.

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 001-37468  
AppFolio, Inc.  
(Exact name of registrant as specified in its charter)

Delaware 26-0359894  
(State of incorporation or organization) (I.R.S. Employer Identification No.)  
50 Castilian Drive 93117  
Santa Barbara, California  
(Address of principal executive offices) (Zip Code)  
(805) 364-6093  
(Registrant’s telephone number, including area code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

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

Large accelerated filer  Accelerated filer  x

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act.

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

As of October 23, 2017, the number of shares of the registrant's Class A common stock outstanding was 14,506,412 and the number of shares of the registrant's Class B common stock outstanding was 19,440,672.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2017, or Quarterly Report, includes “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, which statements are subject to considerable risks and uncertainties. Forward-looking statements include all statements that are not statements of historical facts contained in this Quarterly Report and can be identified by words such as “anticipates,” “believes,” “seeks,” “estimates,” “expects,” “intends,” “may,” “plans,” “potential,” “predicts,” “projects,” “should” “would” or similar expressions and the negatives of those expressions. In particular, forward looking statements contained in this Quarterly Report relate to, among other things, our future or assumed financial condition, results of operations, business forecasts and plans, capital needs and financing plans, research and product development plans, growth in the size of our business and number of customers, strategic plans and objectives, acquisitions and investments, and the application of accounting guidance. We caution you that the foregoing list may not include all of the forward-looking statements made in this Quarterly Report.

Forward-looking statements represent our management’s current beliefs and assumptions based on information currently available. Forward-looking statements involve numerous known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. We discuss these risks and uncertainties in greater detail in the section entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of this Quarterly Report and in the section entitled “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016, or Annual Report, as well as in our other filings with the Securities and Exchange Commission, or SEC. You should read this Quarterly Report, and the other documents we have filed with the SEC, with the understanding that our actual future results may be materially different from the results expressed or implied by these forward-looking statements.

Moreover, we operate in an evolving environment. New risks and uncertainties emerge from time to time and it is not possible for our management to predict all risks and uncertainties, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual future results to be materially different from those expressed or implied by any forward-looking statements.

Except as required by applicable law or the rules of the NASDAQ Stock Market, we assume no obligation to update any forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

We qualify all of our forward-looking statements by these cautionary statements.

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## PART I. FINANCIAL INFORMATION

## Item 1. Condensed Consolidated Financial Statements

## APPFOLIO, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(in thousands, except par values)

|   | September 30,<br>2017 | December 31,<br>2016 |
|---|-----------------------|----------------------|
| Assets  |                       |                      |
| Current assets  |                       |                      |
| Cash and cash equivalents   | \$ 14,781             | \$ 10,699            |
| Investment securities—current   | 28,396                | 15,473               |
| Accounts receivable, net  | 3,419                 | 2,511                |
| Prepaid expenses and other current assets   | 4,393                 | 3,537                |
| Total current assets  | 50,989                | 32,220               |
| Investment securities—noncurrent  | 20,423                | 26,688               |
| Property and equipment, net   | 7,005                 | 7,077                |
| Capitalized software, net   | 17,320                | 15,539               |
| Goodwill  | 6,737                 | 6,737                |
| Intangible assets, net  | 2,054                 | 3,105                |
| Other assets  | 1,219                 | 1,217                |
| Total assets  | \$ 105,747            | \$ 92,583            |
| Liabilities and Stockholders' Equity  |                       |                      |
| Current liabilities   |                       |                      |
| Accounts payable  | \$ 1,164              | \$ 937               |
| Accrued employee expenses   | 8,169                 | 7,550                |
| Accrued expenses  | 5,908                 | 4,044                |
| Deferred revenue  | 7,508                 | 7,638                |
| Other current liabilities   | 1,083                 | 1,192                |
| Total current liabilities   | 23,832                | 21,361               |
| Other liabilities   | 1,238                 | 1,540                |
| Total liabilities   | 25,070                | 22,901               |
| Commitments and contingencies (Note 6)  |                       |                      |
| Stockholders' equity:   |                       |                      |
| Preferred stock, \$0.0001 par value, 25,000 authorized and no shares issued and outstanding as of September 30, 2017 and December 31, 2016  | —                     | —                    |
| Class A common stock, \$0.0001 par value, 250,000 shares authorized as of September 30, 2017 and December 31, 2016; 14,494 and 11,691 shares issued and outstanding as of September 30, 2017 and December 31, 2016, respectively; | 1                     | 1                    |
| Class B common stock, \$0.0001 par value, 50,000 shares authorized as of September 30, 2017 and December 31, 2016; 19,448 and 22,028 shares issued and outstanding as of September 30, 2017 and December 31, 2016, respectively;  | 3                     | 3                    |
| Additional paid-in capital  | 150,520               | 146,692              |
| Accumulated other comprehensive loss  | (23                   | ) (51                |
| Accumulated deficit   | (69,824               | ) (76,963            |
| Total stockholders' equity  | 80,677                | 69,682               |
| Total liabilities and stockholders' equity  | \$ 105,747            | \$ 92,583            |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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APPFOLIO, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (UNAUDITED)  
 (in thousands, except per share amounts)

|  | Three Months<br>Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|--|--|------------|------------------------------------|------------|
|  | 2017                                   | 2016       | 2017                               | 2016       |
| Revenue  | \$37,903                               | \$28,162   | \$105,906                          | \$77,576   |
| Costs and operating expenses:                                |  |            |                                    |            |
| Cost of revenue (exclusive of depreciation and amortization) | 14,053                                 | 11,645     | 40,747                             | 33,387     |
| Sales and marketing  | 7,257                                  | 6,979      | 21,556                             | 22,097     |
| Research and product development                             | 4,367                                  | 3,464      | 11,998                             | 9,531      |
| General and administrative                                   | 5,405                                  | 4,642      | 15,310                             | 12,580     |
| Depreciation and amortization                                | 3,237                                  | 2,636      | 9,347                              | 7,112      |
| Total costs and operating expenses                           | 34,319                                 | 29,366     | 98,958                             | 84,707     |
| Income (loss) from operations                                | 3,584                                  | (1,204 )   | 6,948                              | (7,131 )   |
| Other expense, net   | (5 )                                   | (12 )      | (93 )                              | (34 )      |
| Interest income, net   | 155                                    | 102        | 377                                | 221        |
| Income (loss) before provision for income taxes              | 3,734                                  | (1,114 )   | 7,232                              | (6,944 )   |
| Provision for income taxes                                   | 52                                     | 11         | 93                                 | 48         |
| Net income (loss)  | \$3,682                                | \$(1,125 ) | \$7,139                            | \$(6,992 ) |
| Net income (loss) per common share:                          |  |            |                                    |            |
| Basic  | \$0.11                                 | \$(0.03 )  | \$0.21                             | \$(0.21 )  |
| Diluted  | \$0.10                                 | \$(0.03 )  | \$0.20                             | \$(0.21 )  |
| Weighted average common shares outstanding:                  |  |            |                                    |            |
| Basic  | 33,905                                 | 33,600     | 33,817                             | 33,529     |
| Diluted  | 35,205                                 | 33,600     | 35,091                             | 33,529     |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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APPFOLIO, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
 (UNAUDITED)  
 (in thousands)

|   | Three Months  |           | Nine Months   |           |
|---|---------------|-----------|---------------|-----------|
|   | Ended         |           | Ended         |           |
|   | September 30, |           | September 30, |           |
|   | 2017          | 2016      | 2017          | 2016      |
| Net income (loss)   | \$3,682       | \$(1,125) | \$7,139       | \$(6,992) |
| Other comprehensive income (loss):                            |               |           |               |           |
| Changes in unrealized gains (losses) on investment securities | 26            | (96)      | 28            | 277       |
| Comprehensive income (loss)                                   | \$3,708       | \$(1,221) | \$7,167       | \$(6,715) |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.



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APPFOLIO, INC.

## CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(UNAUDITED)

(in thousands)

|   | Common Stock Class A |        | Common Stock Class B |        | Additional Paid-in Capital | Accumulated Other Comprehensive Income (Loss) | Accumulated Deficit | Total     |
|---|----------------------|--------|----------------------|--------|----------------------------|---|---------------------|-----------|
|   | Shares               | Amount | Shares               | Amount |                            |   |                     |           |
| Balance at December 31, 2016  | 11,691               | \$ 1   | 22,028               | \$ 3   | \$ 146,692                 | \$ (51 )                                      | \$ (76,963 )        | \$ 69,682 |
| Exercise of stock options   | 133                  | —      | —                    | —      | 508                        | —   | —                   | 508       |
| Stock-based compensation  | —                    | —      | —                    | —      | 4,674                      | —   | —                   | 4,674     |
| Vesting of restricted stock units, net of shares withheld for taxes | 81                   | —      | —                    | —      | (1,421 )                   | —   | —                   | (1,421 )  |
| Vesting of early exercised shares                                   | —                    | —      | —                    | —      | 67                         | —   | —                   | 67        |
| Conversion of Class B stock to Class A stock                        | 2,580                | —      | (2,580 )             | —      | —                          | —   | —                   | —         |
| Issuance of restricted stock awards                                 | 9                    | —      | —                    | —      | —                          | —   | —                   | —         |
| Other comprehensive income  | —                    | —      | —                    | —      | —                          | 28  | —                   | 28        |
| Net income  | —                    | —      | —                    | —      | —                          | —   | 7,139               | 7,139     |
| Balance at September 30, 2017                                       | 14,494               | \$ 1   | 19,448               | \$ 3   | \$ 150,520                 | \$ (23 )                                      | \$ (69,824 )        | \$ 80,677 |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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APPFOLIO, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (UNAUDITED)  
 (in thousands)

|  | Nine Months<br>Ended<br>September 30, |            |
|--|---------------------------------------|------------|
|  | 2017                                  | 2016       |
| Cash from operating activities   |                                       |            |
| Net income (loss)  | \$7,139                               | \$(6,992)  |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                       |            |
| Depreciation and amortization  | 9,347                                 | 7,112      |
| Purchased investment premium, net of amortization  | (22                                   | ) 185      |
| Amortization of deferred financing costs   | 48                                    | 48         |
| Loss on disposal of property and equipment   | 94                                    | 33         |
| Stock-based compensation   | 4,304                                 | 2,844      |
| Lease abandonment  | —                                     | 161        |
| Changes in operating assets and liabilities:   |                                       |            |
| Accounts receivable  | (908                                  | ) (659 )   |
| Prepaid expenses and other current assets  | (856                                  | ) (804 )   |
| Other assets   | (54                                   | ) (163 )   |
| Accounts payable   | 369                                   | (1,109 )   |
| Accrued employee expenses  | 846                                   | (144 )     |
| Accrued expenses   | 1,713                                 | 1,354      |
| Deferred revenue   | (130                                  | ) 1,674    |
| Other liabilities  | (334                                  | ) 1,183    |
| Net cash provided by operating activities  | 21,556                                | 4,723      |
| Cash from investing activities   |                                       |            |
| Purchases of property and equipment  | (1,680                                | ) (3,560 ) |
| Additions to capitalized software  | (8,085                                | ) (8,554 ) |
| Purchases of investment securities   | (17,597                               | ) (24,334) |
| Sales of investment securities   | 15                                    | 10,016     |
| Maturities of investment securities  | 10,974                                | 17,112     |
| Purchases of intangible assets   | (1                                    | ) (2 )     |
| Net cash used in investing activities  | (16,374                               | ) (9,322 ) |
| Cash from financing activities   |                                       |            |
| Proceeds from stock option exercises   | 508                                   | 260        |
| Tax withholding for net share settlement   | (1,608                                | ) (85 )    |
| Principal payments under capital lease obligations                                       | —                                     | (24 )      |
| Proceeds from issuance of debt   | 88                                    | 87         |
| Principal payments on debt   | (88                                   | ) (99 )    |
| Net cash (used in) provided by financing activities                                      | (1,100                                | ) 139      |
| Net increase (decrease) in cash and cash equivalents                                     | 4,082                                 | (4,460 )   |
| Cash and cash equivalents  |                                       |            |
| Beginning of period  | 10,699                                | 12,063     |
| End of period  | \$14,781                              | \$7,603    |



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APPFOLIO, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (UNAUDITED)  
 (in thousands)

|   | Nine<br>Months<br>Ended<br>September<br>30,<br>2017 2016 |       |
|---|--|-------|
| Noncash investing and financing activities  |  |       |
| Purchases of property and equipment included in accounts payable and accrued expenses                           | \$271  | \$112 |
| Additions of capitalized software included in accrued employee expenses   | 231  | 231   |
| Stock-based compensation capitalized for software development   | 548  | 308   |
| The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements. |  |       |

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APPFOLIO, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

1. Nature of Business

AppFolio, Inc. (“we” or “AppFolio”) provides industry-specific, cloud-based software solutions for small and medium-sized businesses (“SMBs”) in the property management industry and solo practitioners and small law firms in the legal industry. We refer to solo practitioners and small law firms as SMBs in connection with our legal vertical in this Quarterly Report. Our platform is designed to be the system of record to automate essential business processes and the system of engagement to enhance business interactions between our customers and their clients and vendors. We also offer optional, but often mission-critical, Value+ services, which are seamlessly built into our core solutions.

2. Summary of Significant Accounting Policies

Basis of Presentation and Significant Accounting Policies

The accompanying unaudited Condensed Consolidated Financial Statements were prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information. Certain information and disclosures normally included in consolidated financial statements prepared in accordance with GAAP have been condensed or omitted. Accordingly, these Condensed Consolidated Financial Statements should be read in conjunction with our audited consolidated financial statements and the related notes included in our Annual Report filed with the SEC on February 27, 2017. The year-end condensed balance sheet was derived from our audited consolidated financial statements. Our unaudited interim Condensed Consolidated Financial Statements have been prepared on a basis consistent with that used to prepare our audited annual consolidated financial statements and include, in the opinion of management, all adjustments, consisting of normal and recurring items, necessary for the fair statement of the Condensed Consolidated Financial Statements. The operating results for the nine months ended September 30, 2017, are not necessarily indicative of the results expected for the full year ending December 31, 2017.

Changes in Accounting Policies

Except as described below under Recently Adopted Accounting Pronouncements, there have been no significant changes in our accounting policies from those disclosed in our annual consolidated financial statements and the related notes included in our Annual Report.

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 and the disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. On an ongoing basis, management evaluates its estimates based on historical data and experience, as well as various other factors that management believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources.

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## Net Income (Loss) per Share

The net income (loss) per common share was the same for our Class A and Class B common shares because they are entitled to the same liquidation and dividend rights and are therefore combined in the table below. The following table presents a reconciliation of our weighted average number of Class A and Class B common shares used to compute net income (loss) per share (in thousands):

|   | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2017 | September 30, 2016 | September 30, 2017 | September 30, 2016 |
| Weighted average shares outstanding   | 33,923             | 33,668             | 33,848             | 33,617             |
| Less: Weighted average unvested restricted shares subject to repurchase                                 | 18                 | 68                 | 31                 | 88                 |
| Weighted average common shares outstanding; basic   | 33,905             | 33,600             | 33,817             | 33,529             |
| Weighted average common shares outstanding; basic   | 33,905             | 33,600             | 33,817             | 33,529             |
| Plus: Weighted average options, RSUs and restricted shares used to compute diluted net income per share | 1,300              | —                  | 1,274              | —                  |
| Weighted average common shares outstanding; diluted   | 35,205             | 33,600             | 35,091             | 33,529             |

Approximately 571,000 shares of performance based options ("PSOs") and performance based restricted stock units ("PSUs") are not included in the computations of diluted and anti-dilutive shares for the three and nine month periods ended September 30, 2017, as they are considered contingently issuable upon the satisfaction of pre-defined performance measures and their respective performance measures have not been met.

For the three and nine months ended September 30, 2016, we reported a net loss and therefore all potentially dilutive common shares are anti-dilutive and have been excluded from the calculation of net loss per share. The following table presents the number of anti-dilutive common shares excluded from the calculation of weighted average number of shares used to compute diluted net income (loss) per share for the three and nine months ended September 30, 2017 and 2016 (in thousands):

|   | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2017 | September 30, 2016 | September 30, 2017 | September 30, 2016 |
| Options to purchase common stock                              | —                  | 1,764              | —                  | 1,764              |
| Unvested restricted stock awards                              | —                  | 59                 | —                  | 59                 |
| Unvested restricted stock units                               | 13                 | 480                | 13                 | 480                |
| Contingent restricted stock units <sup>(1)</sup>              | 6                  | 27                 | 6                  | 27                 |
| Total shares excluded from net income (loss) per common share | 19                 | 2,330              | 19                 | 2,330              |

<sup>(1)</sup> Included in the anti-dilutive shares above are fixed price restricted stock unit ("RSU") commitments for which the number of shares has not been determined at the grant date. The number of RSU shares with a fixed price included in the table above are 6,000 and 27,000 shares at September 30, 2017 and 2016, respectively. The number of shares have been determined by dividing the fixed price commitment to issue shares in the future by the closing price of our stock as of the applicable reporting period date.

## Recently Adopted Accounting Pronouncements

Under the Jumpstart our Business Startups Act (the "JOBS Act"), we meet the definition of an emerging growth company. We have irrevocably elected to opt out of the extended transition period for complying with new or revised accounting standards pursuant to Section 107(b) of the JOBS Act.

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, Compensation - Stock Compensation (Topic 718), Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"), which amends and simplifies the accounting for share-based payment awards in three

areas: (1) income tax consequences, (2) classification of awards as either equity or liabilities, and (3) classification on the statement of cash flows. ASU 2016-19 also provides an accounting policy election to account for forfeitures as they occur. We adopted this guidance on January 1, 2017. The impact on the Company's consolidated financial statements was not material due to the full valuation allowance on

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our deferred tax assets. We have elected to continue to estimate forfeitures expected to occur to determine the amount of compensation cost to be recognized each period.

Recent Accounting Pronouncements Not Yet Adopted

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, as amended which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers (the "new revenue standard"). The new revenue standard will be effective on January 1, 2018 and early adoption is permitted. The standard permits the use of either a full retrospective or modified retrospective transition method.

The Company will adopt the new revenue standard as of January 1, 2018, using the modified retrospective transition method and is currently evaluating the expected impact of the adoption on its consolidated financial statements and related disclosures. Under the modified retrospective transition method, we will be required to calculate and record the cumulative effect of adopting the new revenue standard as an adjustment to our opening balance of our retained earnings on January 1, 2018, within our Quarterly Report on Form 10-Q for the first quarter of 2018. Prior periods will not be retrospectively adjusted.

Based on our ongoing assessment, we do not expect there will be a material impact on our revenue upon adoption. While we are continuing to assess all potential impacts of the standard, we believe the most significant impact relates to recognizing the costs of obtaining customer contracts. Under the Company's current policy election under GAAP, sales commissions and other incremental costs to acquire contracts are expensed as incurred. Under the new revenue standard, such costs will be deferred and recognized over a period of time. The Company is in the process of implementing the necessary changes to its accounting policies, processes, internal controls and information systems that will be required to meet the new standard's reporting and disclosure requirements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) ("ASU 2016-02"). Under ASU 2016-02, an entity will be required to recognize right-of-use assets and lease liabilities on its balance sheet and disclose key information about leasing arrangements. ASU 2016-02 offers specific accounting guidance for a lessee, a lessor and sale and leaseback transactions. Lessees and lessors are required to disclose qualitative and quantitative information about leasing arrangements to enable a user of the financial statements to assess the amount, timing and uncertainty of cash flows arising from leases. For public companies, ASU 2016-02 is effective for annual reporting periods beginning after December 15, 2018, including interim periods within that reporting period, and requires a modified retrospective adoption, with early adoption permitted. We anticipate this standard will have a material impact on our consolidated financial statements. While we are continuing to assess all potential impacts of the standard, we currently believe the most significant impact relates to our accounting and reporting of our operating leases on our balance sheet.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"), which amends the current accounting guidance and requires the measurement of all expected losses based on historical experience, current conditions and reasonable and supportable forecasts. This guidance amends the accounting for credit losses for available-for-sale securities and purchased financial assets with credit deterioration. ASU 2016-13 is effective for annual periods beginning after December 15, 2019, and interim periods within those annual periods. Early adoption is permitted for any interim or annual period after December 15, 2018. We do not expect the adoption of this guidance to have a material impact on our financial condition, results of operations, cash flows or disclosures.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"), which provides cash flow statement classification guidance for debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies;



distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. We have not determined the effect of this guidance on our statement of cash flows.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory ("ASU 2016-16"), which changes the timing of when certain intercompany transactions are recognized within the provision for income taxes. ASU 2016-16 is effective on January 1, 2018. Early adoption is permitted. We have not determined the effect of this guidance on our financial condition, results of operations, cash flows or disclosures.

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In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash ("ASU 2016-18"), which provides amendments to current guidance to address the classification and presentation of changes in restricted cash in the statement of cash flows. ASU 2016-18 is effective on January 1, 2018 and early adoption is permitted. We are still evaluating the effect of this guidance on our financial statements. We expect that adoption will change the current presentation of restricted cash on our statement of cash flows as well as require additional disclosures to reconcile cash and cash equivalents per the balance sheet to cash and cash equivalents on the statement of cash flows.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment ("ASU 2017-04"), which eliminates Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. ASU 2017-04 also eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. ASU 2017-04 is effective for public entities for fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on dates after January 1, 2017. We do not expect the adoption of this guidance to have a material impact on our financial condition, results of operations, cash flows or disclosures.

In March 2017, the FASB issued ASU No. 2017-08, Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities ("ASU 2017-08"). ASU 2017-08 shortens the amortization period for certain callable debt securities held at a premium. Specifically, ASU 2017-08 requires the premium to be amortized to the earliest call date. ASU 2017-08 does not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. For public companies, ASU 2017-08 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. We do not expect the adoption of this guidance to have a material impact on our financial condition, results of operations, cash flows or disclosures since our current accounting policy is in accordance with ASU 2017-08.

In May 2017, the FASB issued ASU 2017-09, Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting ("ASU 2017-09"). ASU 2017-09 clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. The new guidance will reduce diversity in practice and result in fewer changes to the terms of an award being accounted for as modifications. Under ASU 2017-09, an entity will not apply modification accounting to a share-based payment award if the award's fair value, vesting conditions and classification as an equity or liability instrument are the same immediately before and after the change. ASU 2017-09 will be applied prospectively to awards modified on or after the adoption date. The guidance is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted. We do not expect the adoption of this guidance to have a material impact on our financial condition, results of operations, cash flows or disclosures.

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## 3. Investment Securities and Fair Value Measurements

## Investment Securities

Investment securities classified as available-for-sale consisted of the following at September 30, 2017 and December 31, 2016 (in thousands):

|  | September 30, 2017 |                              |                               |                            |
|--|--------------------|------------------------------|-------------------------------|----------------------------|
|  | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| Corporate bonds                                | \$34,558           | \$ 11                        | \$ (19 )                      | \$ 34,550                  |
| Agency securities                              | 11,302             | —                            | (17 )                         | 11,285                     |
| Certificates of deposit                        | 2,982              | 3                            | (1 )                          | 2,984                      |
| Total available-for-sale investment securities | \$48,842           | \$ 14                        | \$ (37 )                      | \$ 48,819                  |
|  | December 31, 2016  |                              |                               |                            |
|  | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| Corporate bonds                                | \$30,492           | \$ 9                         | \$ (56 )                      | \$ 30,445                  |
| Agency securities                              | 6,248              | —                            | (20 )                         | 6,228                      |
| Certificates of deposit                        | 5,472              | 16                           | —                             | 5,488                      |
| Total available-for-sale investment securities | \$42,212           | \$ 25                        | \$ (76 )                      | \$ 42,161                  |

As of September 30, 2017, the unrealized losses on investment securities which have been in a net loss position for 12 months or greater were not material. These unrealized losses are considered temporary and there were no impairments considered to be "other-than-temporary" based on our evaluation of available evidence, which includes our intent to hold these investments to maturity or a recovery of the cost basis.

At September 30, 2017 and December 31, 2016, the contractual maturities of our investments did not exceed 36 months. The fair values of available-for-sale investments, by remaining contractual maturity, are as follows (in thousands):

|  | September 30,<br>2017 |                            | December 31,<br>2016 |                            |
|--|-----------------------|----------------------------|----------------------|----------------------------|
|  | Amortized<br>Cost     | Estimated<br>Fair<br>Value | Amortized<br>Cost    | Estimated<br>Fair<br>Value |
| Due in 1 year or less                          | \$28,398              | \$ 28,396                  | \$15,475             | \$ 15,473                  |
| Due after 1 year through 3 years               | 20,444                | 20,423                     | 26,737               | 26,688                     |
| Total available-for-sale investment securities | \$48,842              | \$ 48,819                  | \$42,212             | \$ 42,161                  |

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During the nine months ended September 30, 2017 and 2016, we had sales and maturities (which includes calls) of investment securities, as follows (in thousands):

|                         | Nine Months Ended September 30,<br>2017 |                             |                                    |   |
|-------------------------|---|-----------------------------|------------------------------------|---|
|                         | Gross<br>Realized<br>Gains              | Gross<br>Realized<br>Losses | Gross<br>Proceeds<br>from<br>Sales | Gross<br>Proceeds<br>from<br>Maturities |
| Agency securities       | \$1                                     | \$ —                        | \$ 15                              | \$ 1,044                                |
| Corporate bonds         | —                                       | —                           | —                                  | 7,440                                   |
| Certificates of deposit | —                                       | —                           | —                                  | 2,490                                   |
|                         | \$1                                     | \$ —                        | \$ 15                              | \$ 10,974                               |
|                         | Nine Months Ended September 30,<br>2016 |                             |                                    |   |
|                         | Gross<br>Realized<br>Gains              | Gross<br>Realized<br>Losses | Gross<br>Proceeds<br>from<br>Sales | Gross<br>Proceeds<br>from<br>Maturities |
| Agency securities       | \$5                                     | \$ —                        | \$ 3,005                           | \$ 9,557                                |
| Corporate bonds         | 1                                       | —                           | 5,011                              | 2,480                                   |
| Treasury bills          | —                                       | —                           | 2,000                              | 3,830                                   |
| Certificates of Deposit | —                                       | —                           | —                                  | 1,245                                   |
|                         | \$6                                     | \$ —                        | \$ 10,016                          | \$ 17,112                               |

Interest income from investment securities, net of the amortization and accretion of the premium and discount, for the three months ended September 30, 2017 and 2016, was \$0.2 million and \$0.1 million, respectively and \$0.5 million and \$0.3 million for the nine months ended September 30, 2017 and 2016, respectively.

## Fair Value Measurements

## Recurring Fair Value Measurements

Financial assets and financial liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The following tables summarize our financial assets measured at fair value on a recurring basis as of September 30, 2017 and December 31, 2016, by level within the fair value hierarchy (in thousands):

|   | September 30, 2017 |          |         |                  |
|---|--------------------|----------|---------|------------------|
|   | Level 1            | Level 2  | Level 3 | Total Fair Value |
| Cash equivalents:                         |                    |          |         |                  |
| Money market funds                        | \$3,910            | \$—      | \$ —    | \$ —             |
| Available-for-sale investment securities: |                    |          |         |                  |
| Corporate bonds                           | —                  | 34,550   | —       | 34,550           |
| Agency securities                         | —                  | 11,285   | —       | 11,285           |
| Certificates of deposit                   | 2,984              | —        | —       | 2,984            |
| Total                                     | \$6,894            | \$45,835 | \$ —    | \$ 52,729        |

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|   | December 31, 2016 |          |         | Total Fair Value |
|---|-------------------|----------|---------|------------------|
|   | Level 1           | Level 2  | Level 3 |                  |
| Cash equivalents:                         |                   |          |         |                  |
| Money market funds                        | \$4,849           | \$—      | \$—     | —\$ 4,849        |
| Available-for-sale investment securities: |                   |          |         |                  |
| Corporate bonds                           | —                 | 30,445   | —       | 30,445           |
| Agency securities                         | —                 | 6,228    | —       | 6,228            |
| Certificates of deposit                   | 5,488             | —        | —       | 5,488            |
| Total                                     | \$10,337          | \$36,673 | \$—     | —\$ 47,010       |

The carrying amounts of cash equivalents, restricted cash, accounts receivable, accounts payable and accrued liabilities approximate fair value because of the short maturity of these items.

There were no changes to our valuation techniques used to measure asset and liability fair values on a recurring basis during the nine months ended September 30, 2017. The valuation techniques for the items in the table above are as follows:

**Cash and Cash Equivalents**

As of September 30, 2017 and December 31, 2016, cash and cash equivalents include cash invested in money market funds. Fair value is based on market prices for identical assets.

**Available-for-Sale Investment Securities**

The fair value of our investment securities and certificates of deposit is based on pricing determined using inputs other than quoted prices that are observable either directly or indirectly such as yield curve, volatility factors, credit spreads, default rates, loss severity, current market and contractual prices for the underlying instruments or debt, broker and dealer quotes, as well as other relevant economic measures.

**Non-Recurring Fair Value Measurements**

Certain assets, including goodwill, intangible assets and our note receivable with SecureDocs, are also subject to measurement at fair value on a non-recurring basis using Level 3 measurement when they are deemed to be impaired as a result of an impairment review. For the nine months ended September 30, 2017 and 2016, no impairments were identified on those assets required to be measured at fair value on a non-recurring basis.

**4. Internal-Use Software Development Costs**

Internal-use software development costs were as follows (in thousands):

|  | September 30, 2017 | December 31, 2016 |
|--|--------------------|-------------------|
| Internal use software development costs, gross | \$ 41,902          | \$ 33,545         |
| Less: Accumulated amortization                 | (24,582 )          | (18,006 )         |
| Internal use software development costs, net   | \$ 17,320          | \$ 15,539         |

Capitalized software development costs were \$2.9 million and \$3.3 million for the three months ended September 30, 2017 and 2016, respectively, and were \$8.4 million and \$8.8 million for the nine months ended September 30, 2017 and 2016, respectively. Amortization expense with respect to software development costs totaled \$2.3 million and \$1.7 million for the three months ended September 30, 2017 and 2016, respectively, and \$6.6 million and \$4.4 million for the nine months ended September 30, 2017 and 2016, respectively.

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Future amortization expense with respect to capitalized software development costs as of September 30, 2017, is estimated as follows (in thousands):

|                            |          |
|----------------------------|----------|
| Years Ending December 31,  |          |
| 2017                       | \$2,409  |
| 2018                       | 8,431    |
| 2019                       | 5,153    |
| 2020                       | 1,327    |
| Total amortization expense | \$17,320 |

## 5. Intangible Assets

Intangible assets consisted of the following as of September 30, 2017 and December 31, 2016 (in thousands):

|                        | September 30, 2017   |                          |                    |
|------------------------|----------------------|--------------------------|--------------------|
|                        | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
| Customer relationships | \$790                | \$ (510)                 | ) \$ 280           |
| Technology             | 4,811                | (3,671)                  | ) 1,140            |
| Trademarks             | 930                  | (508)                    | ) 422              |
| Partner relationships  | 680                  | (567)                    | ) 113              |
| Non-compete agreements | 40                   | (33)                     | ) 7                |
| Domain names           | 273                  | (273)                    | ) —                |
| Patents                | 285                  | (193)                    | ) 92               |
|                        | \$7,809              | \$ (5,755)               | ) \$ 2,054         |

|                        | December 31, 2016    |                          |                    |
|------------------------|----------------------|--------------------------|--------------------|
|                        | Gross Carrying Value | Accumulated Amortization | Net Carrying Value |
| Customer relationships | \$790                | \$ (392)                 | ) \$ 398           |
| Technology             | 4,811                | (3,070)                  | ) 1,741            |
| Trademarks             | 930                  | (416)                    | ) 514              |
| Partner relationships  | 680                  | (397)                    | ) 283              |
| Non-compete agreements | 40                   | (23)                     | ) 17               |
| Domain names           | 273                  | (241)                    | ) 32               |
| Patents                | 284                  | (164)                    | ) 120              |
|                        | \$7,808              | \$ (4,703)               | ) \$ 3,105         |

Amortization expense for the three months ended September 30, 2017 and 2016 was \$0.4 million for each period and for the nine months ended September 30, 2017 and 2016 was \$1.1 million for each period.

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As of September 30, 2017, estimated future amortization of intangible assets was as follows (in thousands):

|                            |         |
|----------------------------|---------|
| Years Ending December 31,  |         |
| 2017                       | \$ 329  |
| 2018                       | 929     |
| 2019                       | 352     |
| 2020                       | 259     |
| 2021                       | 124     |
| Thereafter                 | 61      |
| Total amortization expense | \$2,054 |

## 6. Commitments and Contingencies

## Lease Obligations

As of September 30, 2017, we had operating lease obligations of approximately \$9.6 million through 2022. We recorded rent expense of \$0.5 million for each three month period ended September 30, 2017 and 2016, and \$1.5 million for each nine month period ended September 30, 2017 and 2016.

In February 2017, we signed a lease amendment relating to the property located at 50 Castilian Drive in Santa Barbara, California, our corporate headquarters. This amendment extends the term from February 2018 to December 2021. The total commitment under this lease extension is \$3.1 million. All of the other terms and conditions of the lease agreement remain the same.

## Line of Credit

We are party to a Credit Agreement with Wells Fargo, as administrative agent, and the lenders that are parties thereto (as amended, the "Credit Agreement"). Under the terms of the Credit Agreement, the lenders made available to us a \$25.0 million revolving line of credit (the "Revolving Facility"). Borrowings under the Revolving Facility are subject to the satisfaction of customary conditions. The Revolving Facility matures on October 9, 2020; however, we can make payments on, and cancel in full, the Revolving Facility at any time without premium or penalty.

As of September 30, 2017 and December 31, 2016, there was no outstanding balance under the Credit Agreement and we are in compliance with the financial covenants under the Revolving Facility.

## Insurance

We have a wholly owned subsidiary, Terra Mar Insurance Company, Inc. ("Terra Mar"), which was established to provide our customers with the option to purchase tenant liability insurance. If our customers choose to use our insurance services, they are issued an insurance policy underwritten by our third-party service provider. The policy has a limit of \$100,000 per incident for each insured residence. We have entered into a reinsurance agreement with our third-party service provider and, as a result, we assume a 100% quota share of the tenant liability insurance provided to our customers through our third-party service provider. Included in cost of revenue we accrue for reported claims and an estimate of losses incurred but not reported by our property manager customers, as we bear the risk related to claims. Our liability for reported claims and incurred but not reported claims as of September 30, 2017 and December 31, 2016 was \$0.4 million and \$0.3 million, respectively, and is included in Other current liabilities on the Condensed Consolidated Balance Sheets.

Included in Other assets as of September 30, 2017 and December 31, 2016, are \$1.5 million and \$1.2 million, respectively, of deposits held with a third party related to requirements to maintain collateral for our insurance services.

## Litigation

From time to time, we may become subject to certain legal proceedings, including without limitation claims and/or litigation matters, arising in the ordinary course of business. We are not currently a party to any such legal proceedings, nor are we aware of any pending or threatened litigation, that we believe would have a material adverse effect on our business, operating results, cash flows or financial condition should such proceedings be resolved unfavorably.





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## Indemnification

In the ordinary course of business, we may provide indemnification of varying scope and terms to customers, investors, directors and officers with respect to certain matters, including, but not limited to, losses arising out of our breach of any applicable agreements, services to be provided by us, or intellectual property infringement claims made by third parties. These indemnification provisions may survive termination of the underlying agreement and the maximum potential amount of future payments we could be required to make under these indemnification provisions may not be subject to maximum loss clauses. The maximum potential amount of future payments we could be required to make under these indemnification provisions is indeterminable. We have never paid a material claim, nor have any legal claims been brought against us in connection with these indemnification arrangements. As of September 30, 2017 and December 31, 2016, we had not accrued a liability for these indemnification arrangements because we determined that the likelihood of incurring a payment obligation, if any, in connection with these indemnification arrangements is not probable or reasonably possible and the amount or range of amounts of any such liability is not reasonably estimable.

## 7. Stock-Based Compensation

## Stock Options

A summary of our stock option activity for the nine months ended September 30, 2017, is as follows (number of shares in thousands):

|  | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price per Share | Weighted<br>Average<br>Remaining<br>Contractual Life<br>in Years |
|--|---------------------|--|--|
| Options outstanding as of December 31, 2016  | 1,718               | \$ 8.75  | 8.2  |
| Options granted                              | 172                 | 24.77  |  |
| Options exercised                            | (133 )              | 3.83   |  |
| Options cancelled/forfeited                  | (29 )               | 9.84   |  |
| Options outstanding as of September 30, 2017 | 1,728               | \$ 10.70   | 7.9  |

During the nine months ended September 30, 2017, we granted PSOs to purchase up to 172,000 shares of our Class A common stock. The PSOs have a weighted average exercise price of \$24.77 per share. Vesting of the PSOs is based on the achievement of pre-established performance metrics for the year ended December 31, 2019, and continued employment throughout the performance period. Of the PSOs granted during 2017, 132,000 shares would vest based upon the maximum payout of 165% when the 2019 free cash flow performance metric meets the maximum achievement of 150%. For performance at 100% of the targeted 2019 free cash flow metric, approximately 61% of the PSOs would vest. For performance at 80% of the targeted metric, approximately 48% of the PSOs would vest. For performance below 80% of the 2019 targeted metric, no PSOs would vest, all previously recognized compensation expense for the PSOs would be reversed, and no compensation expense would be recognized. The remaining 40,000 PSOs granted during 2017 have a pre-established adjusted gross margin target for 2019. PSOs tied to the gross margin performance metric have two levels of vesting, with 50% vesting based upon the achievement of 110% of the targeted amount and the remaining 50% vesting upon the achievement of 115% of the targeted amount. If the 110% performance target is not met, no shares will vest and all previously recognized expense for those PSOs would be reversed and no compensation expense would be recognized.

Included in the options outstanding as of September 30, 2017 are 500,000 PSOs granted in 2016, which vest based on the achievement of a pre-established free cash flow performance metric for the years ended December 31, 2017 and 2018. The number of PSOs granted in 2016 related to the performance metrics for the years ended December 31, 2017 and 2018, assumes achievement of the performance metric at the maximum level, which is 150% of the targeted performance metric. For performance at 100% of the targeted metric, approximately 67% of the PSOs would vest. For performance at 80% of the targeted metric, approximately 53% would vest. For performance below 50% of the 2017 targeted metric or 80% of the 2018 targeted metric, no PSOs would vest, all previously recognized compensation expense for PSOs would be reversed, and no compensation expense would be recognized.

During the nine months ended September 30, 2017, 247,000 of the PSOs vested based on the achievement of 148% of the pre-established free cash flow performance metric for the year ended December 31, 2016, and 3,000 PSOs were cancelled as a result of the PSOs being granted at 150% of the target metric. During the year ended December 31, 2016, \$1.0 million of expense was recognized related to the PSOs that vested during the nine months ended September 30, 2017.

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We recognize expense for the PSOs based on the grant date fair value of the PSOs that we determine are probable of vesting. Adjustments to compensation expense are made each period based on changes in our estimate of the number of PSOs that are probable of vesting. Our stock-based compensation expense for stock options, including the PSOs, for the three months ended September 30, 2017 and 2016, was \$0.7 million and \$0.7 million, respectively, and \$2.0 million and \$1.6 million for the nine months ended September 30, 2017 and 2016, respectively.

The fair value of stock options granted is estimated on the date of grant using the Black-Scholes option-pricing model. The following table summarizes information relating to our stock options granted during the three and nine months ended September 30, 2017 and 2016:

|   | Three<br>Months<br>Ended<br>September<br>30, |      | Nine Months<br>Ended<br>September 30,<br>2016 |         |
|---|--|------|---|---------|
|   | 2017   | 2016 | 2017  | 2016    |
| Stock options granted (in thousands)              | —  | —    | 172   | 750     |
| Weighted average exercise price per share         | \$ —   | \$ — | \$24.77                                       | \$12.85 |
| Weighted average grant-date fair value per share  | \$ —   | \$ — | \$9.58  | \$4.85  |
| Weighted average Black-Scholes model assumptions: |  |      |   |         |
| Risk-free interest rate                           | —%   | —%   | 2.02  | % 1.45  |
| Expected term (in years)                          | —  | —    | 6.4   | 5.9     |
| Expected volatility                               | —%   | —%   | 35  | % 37    |
| Expected dividend yield                           | —  | —    | —   | —       |

As of September 30, 2017, the total estimated remaining stock-based compensation expense for unvested stock options, including the PSOs, was \$2.7 million, which is expected to be recognized over a weighted average period of 1.5 years.

**Restricted Stock Units**

A summary of activity in connection with our RSUs for the nine months ended September 30, 2017, is as follows (number of shares in thousands):

|                                   | Number of<br>Shares | Weighted- Average<br>Grant Date<br>Fair Value per Share |
|-----------------------------------|---------------------|---|
| Unvested as of December 31, 2016  | 496                 | \$ 13.34  |
| Granted                           | 307                 | 25.64   |
| Vested                            | (139 )              | 12.81   |
| Forfeited                         | (46 )               | 16.17   |
| Unvested as of September 30, 2017 | 618                 | \$ 19.36  |

During the nine months ended September 30, 2017, we granted a total of 307,000 RSUs: 194,000 RSUs vest annually over four years; 100,000 PSUs vest based upon achievement of a pre-established free cash flow performance metric for the year ended December 31, 2019, and continued employment throughout the performance period; and 13,000 PSUs were granted and vested as a result of the attainment of the 2016 performance metric. The number of PSUs granted, as included in the above table, assumes achievement of the performance metric at 100% of the targeted performance metric. The actual number of shares to be issued at the end of the performance period will range from 0% to 165% of the initial target awards. For performance at 150% of the targeted metric in 2019, 165% of the PSUs would vest. For performance below 80% of the targeted metric in 2019, no PSUs would vest and no compensation expense would be recognized, and all previously recognized compensation expense for PSUs would be reversed. During the nine months ended September 30, 2017, 41,000 of the PSUs vested based on the achievement of 148% of the pre-established free cash flow performance metric for the year ended December 31, 2016, and an additional 13,000

PSUs were granted and vested as a result of the attainment of the 2016 performance metric as approved by our Board of Directors. During the year ended December 31, 2016, \$479,000 of expense was recognized related to the PSUs vested during the nine months ended September 30, 2017.

Included in the unvested RSUs as of September 30, 2017 are 56,000 PSUs granted in 2016, which vest based on the achievement of a pre-established free cash flow performance metric for the years ended December 31, 2017 and 2018, and continued employment throughout the performance period. The number of PSUs granted in 2016 related to the performance metrics for the

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years ended December 31, 2017 and 2018, and assumed achievement of the performance metric at 100% of the targeted performance metric. The actual number of shares to be issued at the end of the performance period will range from 0% to 150% of the initial target awards. For performance at 150% of the targeted metric, 150% of the PSUs would vest. For performance below 50% of the targeted metric for 2017 or 80% of the targeted metric for 2018, no PSUs would vest and no compensation expense would be recognized, and all previously recognized compensation expense for PSUs would be reversed.

We recognize expense for the PSUs based on the grant date fair value of the PSUs that we determine are probable of vesting. Adjustments to compensation expense are made each period based on changes in our estimate of the number of PSUs that are probable of vesting. Our stock-based compensation expense for the RSUs and PSUs for the three months ended September 30, 2017 and 2016, was \$1.0 million and \$571,000, respectively, and \$2.6 million and \$1.2 million for the nine months ended September 30, 2017 and 2016, respectively.

As of September 30, 2017, the total remaining estimated stock-based compensation expense for the RSUs and PSUs was \$9.2 million, which is expected to be recognized over a weighted average period of 2.6 years.

**Restricted Stock Awards**

A summary of activity in connection with our restricted stock awards for the nine months ended September 30, 2017, follows (number of shares in thousands):

|                                   | Number of<br>Shares | Weighted-Average<br>Grant Date<br>Fair Value per Share |
|-----------------------------------|---------------------|--|
| Unvested as of December 31, 2016  | 46                  | \$ 8.55  |
| Granted                           | 9                   | 33.30  |
| Vested                            | (38 )               | 9.33   |
| Forfeited                         | —                   | —  |
| Unvested as of September 30, 2017 | 17                  | \$ 19.79   |

We have the right to repurchase any unvested restricted stock awards. Restricted stock awards vest over a four-year period for employees and a one-year period for non-employee directors. We recognized stock-based compensation expense for restricted stock awards of \$84,000 and \$113,000 for the three months ended September 30, 2017 and 2016, respectively, and \$274,000 and \$342,000 for the nine months ended September 30, 2017 and 2016, respectively. As of September 30, 2017, the total remaining stock-based compensation expense for unvested restricted stock awards with a repurchasing right was \$268,000 which is expected to be recognized over a weighted average period of 0.8 years.

**8. Income Taxes**

Our effective tax rate differs from the U.S. Federal statutory rate of 34% primarily because our previously reported losses have been offset by a valuation allowance due to uncertainty as to the realization of those losses.

For the three and nine months ended September 30, 2017, we recorded income tax expense of \$52,000 and \$93,000, respectively, on pre-tax income of \$3.7 million and \$7.2 million, respectively, for an effective tax rate of 1.4% and 1.3%, respectively. The income tax expense is based on our payments of state minimum taxes, alternative minimum tax ("AMT") (net of available AMT credit), and the amortization of tax deductible goodwill that is not an available source of income to realize the deferred tax asset.

For the three and nine months ended September 30, 2016, we recorded income tax expense of \$11,000 and \$48,000, respectively, on pre-tax losses of \$1.1 million and \$6.9 million, respectively for an effective tax rate of (1.0)% and (0.7)%, respectively. The income tax expense is based on our payments of state minimum taxes and the amortization of tax deductible goodwill that is not an available source of income to realize the deferred tax asset.

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## 9. Revenue and Other Information

The following table presents our revenue categories for the three and nine months ended September 30, 2017 and 2016 (in thousands):

|                 | Three Months  |           | Nine Months   |           |
|-----------------|---------------|-----------|---------------|-----------|
|                 | Ended         |           | Ended         |           |
|                 | September 30, |           | September 30, |           |
|                 | 2017          | 2016      | 2017          | 2016      |
| Core solutions  | \$ 14,670     | \$ 11,302 | \$ 41,682     | \$ 31,637 |
| Value+ services | 21,752        | 15,684    | 60,053        | 42,338    |
| Other           | 1,481         | 1,176     | 4,171         | 3,601     |
| Total revenues  | \$ 37,903     | \$ 28,162 | \$ 105,906    | \$ 77,576 |

Core solutions revenue includes our subscription fees which are designed to scale to the size of our customers' businesses. We recognize subscription revenue ratably over the terms of the subscription agreements, which typically range from one month to one year. Revenue from subscription services is impacted by a number of factors, including the change in the number and type of our customers, the size and needs of our customers' businesses, and our customer renewal rates.

Value+ services revenue includes subscriptions and usage-based fees. Subscription Value+ services include website hosting services and contact center services. Usage-based Value+ services include fees for electronic payment processing, applicant screening services, our tenant liability insurance program, collections, and online vacancy advertising services. Revenue from Value+ services is impacted by a number of factors, including the number of new and existing customers that adopt and utilize our Value+ service, the size and needs of our customers and our customer renewal rates.

Other revenue includes revenue from one-time services related to on-boarding customers to our core solutions, website design services and online vacancy advertising services offered to legacy RentLinx customers.

Our revenue is generated primarily from U.S. customers. All of our property and equipment is located in the U.S.

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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 together with our Condensed Consolidated Financial Statements and the related notes included elsewhere in this Quarterly Report and in our Annual Report. This discussion and analysis contains forward-looking statements that are based on our current expectations and reflect our plans, estimates and anticipated future financial performance. These statements involve numerous risks and uncertainties. Our actual results may differ materially from those expressed or implied by these forward-looking statements as a result of many factors, including those set forth in the section entitled "Risk Factors" in Part I, Item 1A of our Annual Report. Please also refer to the section of this Quarterly Report entitled "Cautionary Note Regarding Forward-Looking Statements" for additional information.

Overview

AppFolio is a provider of industry-specific, cloud-based software solutions for SMBs in the property management and legal industries. We were formed in 2006 with a vision to revolutionize the way that SMBs grow and compete by enabling their digital transformation.

Our platform is designed to be the system of record to automate essential business processes and the system of engagement to enhance business interactions between our customers and their clients and vendors. Our property management software provides small and medium-sized property managers with an end-to-end solution to many of their business needs, enabling them to manage their portfolio of properties quickly and easily in a single, integrated environment. Our legal software provides solo practitioners and small law firms with a streamlined practice and case management solution, allowing them to manage much of their case load within a single system. We also offer optional, but often mission-critical, Value+ services, which are seamlessly built into our core solutions. We launched our first product, APM, a property management solution, in 2008. Recognizing that our customers would benefit from additional mission-critical services that they can purchase as needed, we launched our first Value+ service in 2009 by offering website design and hosting services to our property manager customers. Our websites give our customers a professional online presence and serve as the hub for our system of engagement. In 2010, we commenced the roll out of our electronic payments platform with the introduction of ACH payment processing and, in 2011, we launched resident screening as additional Value+ services. In 2012, we introduced our tenant liability insurance program as a further Value+ service. Also in 2012, after completing our market validation process, we decided to enter the legal market. We expedited our time-to-market by acquiring MyCase, a legal practice and case management solution, and we leveraged our AppFolio Business System, including our experience gained in the property management vertical, to advance our software solution in the legal vertical. In 2013, we extended our website design and hosting services to our law firm customers and expanded our electronic payments platform for property managers by allowing residents to pay rent by electronic cash payment and credit or debit card. In 2014, we launched an additional Value+ service for our property manager customers with our contact center to resolve or route incoming maintenance requests. In 2016, we launched premium leads and debt collection services as additional Value+ services to our property manager customers to assist with filling vacancies and collecting their tenants' unpaid rent. Also in 2016, we expanded our electronic payments platform in the legal vertical by allowing clients of our legal customers to pay their legal bills by credit card, debit card, or ACH. In September 2017, we announced the upcoming release of a new Value+ service, renters insurance, which expands on our existing tenant liability insurance program and offers additional coverage for tenant's personal belongings. We also enhanced our electronic payments platform with the addition of same day ACH payments for owner contributions and eCheck payables. Through our disciplined market validation approach and ongoing investment in product development, we continuously update our software solutions through new and innovative core functionality and Value+ services, as well as assess opportunities in adjacent markets and new verticals.

We have focused on growing our revenue by increasing the size of our customer base, retaining customers, introducing new or expanded Value+ services, increasing the adoption and utilization of our Value+ services by new and existing customers, and increasing the number of units under management. We define our customer base as the number of customers subscribing to our core solutions, exclusive of free trials. We intend to continue to invest in



revenue growth opportunities over time in our current markets, adjacent markets, and new verticals.

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Customer count and property manager units under management are summarized in the table below:

|   | September 30, 2017 | June 30, 2016 | March 31, 2016 | December 31, 2016 | September 30, 2016 | June 30, 2016 |
|---|--------------------|---------------|----------------|-------------------|--------------------|---------------|
| Property manager                                      | 11,258             | 10,820        | 10,468         | 10,038            | 9,612              | 9,275         |
| Property manager units under management (in millions) | 3.08               | 2.93          | 2.83           | 2.68              | 2.53               | 2.41          |
| Law firm  | 9,214              | 8,913         | 8,676          | 8,135             | 7,799              | 7,349         |

We have invested in growth in a disciplined manner across our organization, and intend to continue to do so. These investments to grow our business will continue to increase our costs and operating expenses on an absolute basis. Many of these investments will occur in advance of our realization of revenue or any other benefit and will make it difficult to determine if we are allocating our resources efficiently. We expect cost of revenue, research and product development expense, sales and marketing expense, and general and administrative expense to decrease as a percentage of revenue over the long term as revenue increases and we gain additional operating leverage in our business. As a result of this increased operating leverage, we expect our operating margins will improve over the long term.

To date, we have experienced rapid revenue growth due to our investments in research and product development, sales and marketing, customer service and support, and infrastructure. During the nine months ended September 30, 2017, we have derived more than 90% of our revenue from our property management solution.

We have managed, and plan to continue to manage, our business towards the achievement of long-term growth that we believe will positively impact long-term stockholder value, and not towards the realization of short-term financial or business metrics, or short-term stockholder value.

#### Key Components of Results of Operations

##### Revenue

We charge our customers on a subscription basis for our core solutions and certain of our Value+ services. Our subscription fees are designed to scale to the size of our customers' businesses. We recognize subscription revenue ratably over the terms of the subscription agreements, which typically range from one month to one year. We generally invoice our customers for subscription services in monthly, quarterly or annual installments, typically in advance of the subscription period. Revenue from subscription services is impacted by a number of factors, including the change in the number and type of our customers, the size and needs of our customers' businesses, our customer renewal rates, and the level of adoption of our Value+ subscription services by new and existing customers.

We also charge our customers usage-based fees for using certain Value+ services, although fees for electronic payment processing are generally paid by the clients of our customers. Usage-based fees are charged on a flat fee per transaction basis with no minimum usage commitments. We recognize revenue for usage-based services in the period the service is rendered. We generally invoice our customers for usage-based services on a monthly basis for services rendered in the preceding month. Revenue from usage-based services is impacted by a number of factors, including the number of new and existing customers that adopt and utilize our Value+ services, the size and needs of our customers and our customer renewal rates.

We experience some seasonality in our Value+ services revenue, primarily with respect to the screening services we provide to our property manager customers. These customers historically have processed fewer applications for new tenants during the fourth quarter holiday season; therefore, revenue associated with our screening services and new tenant applications typically declines in the fourth quarter of the year. As a result of this seasonal decline in revenue, we have typically experienced slower sequential revenue growth or a sequential decline in revenue in the fourth quarter of each of our most recent fiscal years. We expect this seasonality to continue in the foreseeable future. We also offer our assistance to our customers with on-boarding to our core solutions, as well as website design services. These services are generally purchased as part of a subscription agreement, and are typically performed within the first several months of the arrangement. We generally invoice our customers for other services in advance of the services being completed. We recognize revenue for these other services upon completion of the related service. We also generate revenue from legacy RentLinx customers by providing services that allow these customers to advertise rental houses and apartments online. Revenue



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derived from customers using the RentLinx services outside of our property manager core solution platform is being recorded under Other revenue.

### Costs and Operating Expenses

**Cost of Revenue.** Cost of revenue consists of personnel-related costs (including salaries, incentive-based compensation, benefits, and stock-based compensation) for our employees focused on customer service and the support of our operations, platform infrastructure costs (such as data center operations and hosting-related costs), fees paid to third-party service providers, payment processing fees, and allocated shared costs. We typically allocate shared costs across our organization based on headcount within the applicable part of our organization. Cost of revenue excludes amortization of capitalized software development costs and acquired technology. We intend to continue to invest in customer service and support, and the expansion of our technology infrastructure as we grow the number of our customers and roll out additional Value+ services. We also intend to expand our Value+ offerings over time, which will impact cost of revenue both in absolute dollars and overall percentage of revenue.

**Sales and Marketing.** Sales and marketing expense consists of personnel-related costs (including salaries, sales commissions, incentive-based compensation, benefits, and stock-based compensation) for our employees focused on sales and marketing, costs associated with sales and marketing activities, and allocated shared costs. Marketing activities include advertising, online lead generation, lead nurturing, customer and industry events, and the creation of industry-related content and collateral. Sales commissions and other incremental costs to acquire customers and grow adoption and utilization of our Value+ services by new and existing customers are expensed as incurred. We focus our sales and marketing efforts on generating awareness of our software solutions, creating sales leads, establishing and promoting our brands, and cultivating an educated community of successful and vocal customers. We intend to continue to invest in sales and marketing as we grow to increase the size of our customer base and increase the adoption and utilization of Value+ services by our new and existing customers.

**Research and Product Development.** Research and product development expense consists of personnel-related costs (including salaries, incentive-based compensation, benefits, and stock-based compensation) for our employees focused on research and product development, fees for third-party development resources, and allocated shared costs. Our research and product development efforts are focused on enhancing the ease of use and functionality of our existing software solutions by adding new core functionality, Value+ services and other improvements, as well as developing new products and services. We capitalize the portion of our software development costs that meets the criteria for capitalization. Amortization of capitalized software development costs is included in depreciation and amortization expense. We intend to continue to invest in research and product development as we continue to introduce new core functionality, roll out new Value+ services, develop new products and services, and expand into adjacent markets and new verticals.

**General and Administrative.** General and administrative expense consists of personnel-related costs (including salaries, incentive-based compensation, benefits, and stock-based compensation) for employees in our executive, finance, information technology, or IT, human resources, corporate development, legal and administrative organizations. In addition, general and administrative expense includes fees for third-party professional services (including consulting, legal and audit services), other corporate expenses, and allocated shared costs. We intend to incur incremental general and administrative costs associated with supporting the growth of our business.

**Depreciation and Amortization.** Depreciation and amortization expense includes depreciation of property and equipment, amortization of capitalized software development costs and amortization of intangible assets. We depreciate or amortize property and equipment, software development costs and intangible assets over their expected useful lives on a straight-line basis, which approximates the pattern in which the economic benefits of the assets are consumed. As we continue to invest in our research and product development organization and the development or acquisition of new technology, we expect to have increased capitalized software development costs and incremental amortization.

**Interest Income (Expense).** Interest income includes interest earned on investment securities, amortization and accretion of the premium and discounts paid from the purchase of investment securities, interest earned on notes

receivable and on cash deposited within our bank accounts. Interest expense includes interest paid on outstanding borrowings under our Credit Agreement.

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## Results of Operations

The following table sets forth our results of operations for the periods presented in dollars (in thousands) and as a percentage of revenue:

|   | Three Months Ended |         |            |         | Nine Months Ended |         |            |         |
|---|--------------------|---------|------------|---------|-------------------|---------|------------|---------|
|   | September 30,      |         | 2016       |         | September 30,     |         | 2016       |         |
|   | Amount             | %       | Amount     | %       | Amount            | %       | Amount     | %       |
| Consolidated Statements of Operations Data:                                 |                    |         |            |         |                   |         |            |         |
| Revenue   | \$37,903           | 100.0 % | \$28,162   | 100.0 % | \$105,906         | 100.0 % | \$77,576   | 100.0 % |
| Costs and operating expenses:   |                    |         |            |         |                   |         |            |         |
| Cost of revenue (exclusive of depreciation and amortization) <sup>(1)</sup> | 14,053             | 37.1    | 11,645     | 41.4    | 40,747            | 38.5    | 33,387     | 43.0    |
| Sales and marketing <sup>(1)</sup>  | 7,257              | 19.1    | 6,979      | 24.8    | 21,556            | 20.4    | 22,097     | 28.5    |
| Research and product development <sup>(1)</sup>                             | 4,367              | 11.5    | 3,464      | 12.3    | 11,998            | 11.3    | 9,531      | 12.3    |
| General and administrative <sup>(1)</sup>                                   | 5,405              | 14.3    | 4,642      | 16.5    | 15,310            | 14.5    | 12,580     | 16.2    |
| Depreciation and amortization   | 3,237              | 8.5     | 2,636      | 9.4     | 9,347             | 8.8     | 7,112      | 9.2     |
| Total costs and operating expenses  | 34,319             | 90.5    | 29,366     | 104.3   | 98,958            | 93.4    | 84,707     | 109.2   |
| Income (loss) from operations   | 3,584              | 9.5     | (1,204 )   | (4.3 )  | 6,948             | 6.6     | (7,131 )   | (9.2 )  |
| Other expense, net  | (5 )               | —       | (12 )      | —       | (93 )             | (0.1 )  | (34 )      | —       |
| Interest income, net  | 155                | 0.4     | 102        | 0.4     | 377               | 0.4     | 221        | 0.3     |
| Income (loss) before provision for income taxes                             | 3,734              | 9.9     | (1,114 )   | (4.0 )  | 7,232             | 6.8     | (6,944 )   | (9.0 )  |
| Provision for income taxes  | 52                 | 0.1     | 11         | —       | 93                | 0.1     | 48         | 0.1     |
| Net income (loss)   | \$3,682            | 9.7 %   | \$(1,125 ) | (4.0 )% | \$7,139           | 6.7 %   | \$(6,992 ) | (9.0 )% |

<sup>(1)</sup> Includes stock-based compensation expense as follows (in thousands):

|  | Three Months  |               | Nine Months   |               |
|--|---------------|---------------|---------------|---------------|
|  | Ended         |               | Ended         |               |
|  | September 30, | September 30, | September 30, | September 30, |
|  | 2017          | 2016          | 2017          | 2016          |
| Costs and operating expenses:                                |               |               |               |               |
| Cost of revenue (exclusive of depreciation and amortization) | \$189         | \$138         | \$527         | \$321         |
| Sales and marketing  | 186           | 124           | 516           | 296           |
| Research and product development                             | 173           | 109           | 471           | 264           |
| General and administrative                                   | 1,040         | 918           | 2,790         | 1,963         |
| Total stock-based compensation expense                       | \$1,588       | \$1,289       | \$4,304       | \$2,844       |

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## Comparison of the Three and Nine Months Ended September 30, 2017 and 2016

## Revenue

|                 | Three Months           |               |         |     | Nine Months   |               |          |     |
|-----------------|------------------------|---------------|---------|-----|---------------|---------------|----------|-----|
|                 | Ended                  |               | Change  |     | Ended         |               | Change   |     |
|                 | September 30,          | September 30, | Amount  | %   | September 30, | September 30, | Amount   | %   |
|                 | 2017                   | 2016          |         |     | 2017          | 2016          |          |     |
|                 | (dollars in thousands) |               |         |     |               |               |          |     |
| Core solutions  | \$14,670               | \$11,302      | \$3,368 | 30% | \$41,682      | \$31,637      | \$10,045 | 32% |
| Value+ services | 21,752                 | 15,684        | 6,068   | 39% | 60,053        | 42,338        | 17,715   | 42% |
| Other           | 1,481                  | 1,176         | 305     | 26% | 4,171         | 3,601         | 570      | 16% |
| Total revenues  | \$37,903               | \$28,162      | \$9,741 | 35% | \$105,906     | \$77,576      | \$28,330 | 37% |

Revenue increased \$9.7 million, or 35%, for the three months ended September 30, 2017 compared to the three months ended September 30, 2016, mainly reflecting a 17% increase in the number of property manager customers. The overall increase was mostly attributable to revenue from Value+ services, which increased by \$6.1 million, or 39%. The increase in Value+ services was mainly driven by increased usage of our electronic payments platform and screening services by a larger property manager customer base and an increase in units under management of 22%. We also experienced growth in our other Value+ services, including tenant liability insurance, customer contact center, website hosting services and premium lead services within our Value+ services. The overall increase in revenue was also attributable to growth in revenue from our Core solutions of \$3.4 million, or 30%, driven by growth in the number of our customers and units under management.

Revenue increased \$28.3 million, or 37%, for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016, mainly reflecting a 17% increase in the number of property manager customers. The overall increase was mostly attributable to revenue from Value+ services, which increased by \$17.7 million, or 42%. The increase in Value+ services was mainly driven by increased usage of our electronic payments platform and screening services by a larger property manager customer base and increase in the number of units under management. We also experienced revenue growth in our other Value+ services, including tenant liability insurance, customer contact center, website hosting services and premium lead services within our Value+ services. The overall increase in revenue was also attributable to growth in revenue from our Core solutions of \$10.0 million, or 32%, driven by growth in the number of our customers and units under management.

For the nine months ended September 30, 2017 and 2016, we derived more than 90% of our revenue from our property manager customers.

## Cost of Revenue (Exclusive of Depreciation and Amortization)

|  | Three Months Ended     |          |         |     | Nine Months Ended |          |         |     |
|--|------------------------|----------|---------|-----|-------------------|----------|---------|-----|
|  | September 30,          |          | Change  |     | September 30,     |          | Change  |     |
|  | 2017                   | 2016     | Amount  | %   | 2017              | 2016     | Amount  | %   |
|  | (dollars in thousands) |          |         |     |                   |          |         |     |
| Cost of revenue (exclusive of depreciation and amortization) | \$14,053               | \$11,645 | \$2,408 | 21% | \$40,747          | \$33,387 | \$7,360 | 22% |
| Percentage of revenue  | 37.1                   | % 41.4   | %       |     | 38.5              | % 43.0   | %       |     |

Cost of revenue (exclusive of depreciation and amortization) increased \$2.4 million, or 21%, for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. The increase was primarily due to increased expenditures to third parties of \$1.6 million directly associated with the increased adoption and utilization of our Value+ services, as evidenced by the 39% increase in Value+ services revenues. There was also an increase in personnel-related costs of \$0.6 million to support the continued growth of our business.

As a percentage of revenue, cost of revenue (exclusive of depreciation and amortization) improved to 37.1% from 41.4% for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. This improvement was primarily driven by our ability to increase revenue with a more moderate increase in personnel-related costs, and a slight improvement in pricing with our third-party service providers as we continue to

grow.

Cost of revenue (exclusive of depreciation and amortization) increased \$7.4 million, or 22%, for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. The increase was primarily due to increased third-

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party costs of \$4.9 million driven by increased Value+ services revenue and an increase in head-count and personnel-related costs of \$1.7 million due to the continued growth of our business.

As a percentage of revenue, cost of revenue (exclusive of depreciation and amortization) improved to 38.5% from 43.0% for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. This improvement was primarily driven by our ability to increase revenue with a more moderate increase in personnel-related costs, and an improvement in pricing with our third-party services providers as we continue to grow.

## Sales and Marketing

|                       | Three Months Ended September 30, |         |                | Nine Months Ended September 30, |          |                |
|-----------------------|----------------------------------|---------|----------------|---------------------------------|----------|----------------|
|                       | 2017                             | 2016    | Change Amount% | 2017                            | 2016     | Change Amount% |
|                       | (dollars in thousands)           |         |                |                                 |          |                |
| Sales and marketing   | \$7,257                          | \$6,979 | \$278 4%       | \$21,556                        | \$22,097 | \$(541) (2)%   |
| Percentage of revenue | 19.1 %                           | 24.8 %  |                | 20.4 %                          | 28.5 %   |                |

Sales and marketing expense increased by \$0.3 million or 4% for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. This increase was the result of an increase in personnel-related costs in our sales and marketing organization to support our revenue growth.

Sales and marketing expense decreased \$0.5 million, or 2%, for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. The decrease was the result of a decrease in allocated and other operating costs of \$0.3 million and a decrease in personnel related costs of \$0.2 million as we gain efficiencies in our expenses relative to revenue growth.

## Research and Product Development

|                                  | Three Months Ended September 30, |         |                | Nine Months Ended September 30, |         |                |
|----------------------------------|----------------------------------|---------|----------------|---------------------------------|---------|----------------|
|                                  | 2017                             | 2016    | Change Amount% | 2017                            | 2016    | Change Amount% |
|                                  | (dollars in thousands)           |         |                |                                 |         |                |
| Research and product development | \$4,367                          | \$3,464 | \$903 26%      | \$11,998                        | \$9,531 | \$2,467 26%    |
| Percentage of revenue            | 11.5 %                           | 12.3 %  |                | 11.3 %                          | 12.3 %  |                |

Research and product development expense increased \$0.9 million, or 26%, for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. The increase was the result of an increase in personnel-related costs, net of capitalized software development costs, due to headcount growth within our research and product development organizations.

Research and product development expense increased \$2.5 million, or 26%, for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. The increase was primarily the result of an increase in personnel-related costs, net of capitalized software development costs, due to headcount growth within our research and product development organizations.

## General and Administrative

|                            | Three Months Ended September 30, |         |                | Nine Months Ended September 30, |          |                |
|----------------------------|----------------------------------|---------|----------------|---------------------------------|----------|----------------|
|                            | 2017                             | 2016    | Change Amount% | 2017                            | 2016     | Change Amount% |
|                            | (dollars in thousands)           |         |                |                                 |          |                |
| General and administrative | \$5,405                          | \$4,642 | \$763 16%      | \$15,310                        | \$12,580 | \$2,730 22%    |
| Percentage of revenue      | 14.3 %                           | 16.5 %  |                | 14.5 %                          | 16.2 %   |                |

General and administrative expense increased \$0.8 million, or 16%, for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. The increase was primarily the result of increased

personnel-related costs of \$0.6 million due to headcount growth and an increase in incentive-based compensation.

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General and administrative expense increased \$2.7 million, or 22%, for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. The increase was primarily the result of an increase in personnel-related costs of \$2.8 million due to headcount growth and an increase in incentive-based compensation.

**Depreciation and Amortization**

|                               | Three Months             |         |                | Nine Months              |         |                |
|-------------------------------|--------------------------|---------|----------------|--------------------------|---------|----------------|
|                               | Ended September 30, 2017 | 2016    | Change Amount% | Ended September 30, 2017 | 2016    | Change Amount% |
|                               | (dollars in thousands)   |         |                |                          |         |                |
| Depreciation and amortization | \$3,237                  | \$2,636 | \$601 23%      | \$9,347                  | \$7,112 | \$2,235 31%    |
| Percentage of revenue         | 8.5 %                    | 9.4 %   |                | 8.8 %                    | 9.2 %   |                |

Depreciation and amortization expense increased \$0.6 million, or 23%, for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. The increase was the result of increased amortization expense of \$0.6 million associated with higher capitalized software development balances.

Depreciation and amortization expense increased \$2.2 million, or 31%, for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. The increase was the result of increased amortization expense of \$2.2 million associated with higher capitalized software development balances.

**Interest Income, net**

|                       | Three Months             |       |                | Nine Months              |       |                |
|-----------------------|--------------------------|-------|----------------|--------------------------|-------|----------------|
|                       | Ended September 30, 2017 | 2016  | Change Amount% | Ended September 30, 2017 | 2016  | Change Amount% |
|                       | (dollars in thousands)   |       |                |                          |       |                |
| Interest income       | \$155                    | \$102 | \$53 52%       | \$377                    | \$221 | \$156 71%      |
| Percentage of revenue | 0.4 %                    | 0.4 % |                | 0.4 %                    | 0.3 % |                |

Interest income, net, remained relatively flat for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. For the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016, interest income increased \$0.2 million and is primarily the result of higher investment security balances in the more recent period.

**Liquidity and Capital Resources****Cash and Cash Equivalents**

As of September 30, 2017, our principal sources of liquidity were cash and cash equivalents and investment securities, which had an aggregate balance of \$63.6 million.

**Working Capital**

As of September 30, 2017, we had working capital of \$27.2 million, compared to working capital of \$10.9 million as of December 31, 2016. The increase in our working capital was primarily due to an increase in the current portion of investment securities and in cash and cash equivalents, offset by increases in accrued expenses and accrued employee expenses from the continued growth of our business.

**Revolving Facility**

As of September 30, 2017, we had a \$25.0 million revolving line of credit, which we refer to as the Revolving Facility, under the terms of the Credit Agreement with Wells Fargo, as administrative agent, and the lenders and parties thereto. As of September 30, 2017 and December 31, 2016, we had no outstanding balance and were in compliance with the financial covenants under the Revolving Facility.

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## Liquidity Requirements

We believe that our existing cash and cash equivalents, investment securities, available borrowing capacity of \$25.0 million under the Revolving Facility, and cash generated from ongoing operations will be sufficient to meet our working capital and capital expenditure requirements for at least the next 12 months.

## Capital Requirements

Our future capital requirements will depend on many factors, including the continued market acceptance of our software solutions, the change in the number of our customers, the adoption and utilization of our Value+ services by new and existing customers, the timing and extent of the introduction of new core functionality and Value+ services in our existing markets and verticals, the timing and extent of our expansion into adjacent markets or new verticals and the timing and extent of our investments across our organization. In addition, we may in the future enter into arrangements to acquire or invest in complementary businesses, services, technologies or intellectual property rights, although we have no present plans with respect to any acquisitions or investments.

## Cash Flows

The following table summarizes our cash flows for the periods indicated (in thousands):

|  | Nine Months<br>Ended<br>September 30, |           |
|--|---------------------------------------|-----------|
|  | 2017                                  | 2016      |
| Net cash provided by operating activities            | \$21,556                              | \$4,723   |
| Net cash used in investing activities                | (16,374 )                             | (9,322 )  |
| Net cash (used in) provided by financing activities  | (1,100 )                              | 139       |
| Net increase (decrease) in cash and cash equivalents | \$4,082                               | \$(4,460) |

## Cash Provided by Operating Activities

Our primary source of operating cash inflows is cash collected from our customers in connection with their use of our software solutions. Our primary uses of cash from operating activities are for personnel-related expenditures and third-party costs incurred to support the delivery of our software solutions.

For the nine months ended September 30, 2017, cash provided by operating activities was \$21.6 million resulting from net income of \$7.1 million, adjusted by non-cash charges of \$13.8 million and a net increase in our operating assets and liabilities of \$0.6 million. The non-cash charges primarily consist of \$9.3 million of depreciation and amortization of our property and equipment and capitalized software development and \$4.3 million of stock based compensation. The net increase in our operating assets and liabilities was mostly attributable to a \$1.7 million increase in accrued expenses and a \$0.8 million increase in accrued employee expenses. The increase in our operating assets and liabilities was partially offset by a decrease in accounts receivable of \$0.9 million, and prepaid expenses and other current assets of \$0.9 million.

For the nine months ended September 30, 2016, cash provided by operating activities was \$4.7 million resulting from our net loss of \$7.0 million, adjusted by non-cash charges of \$10.4 million and a net increase in our operating assets and liabilities of \$1.3 million. The net increase in our non-cash charges was primarily the result of \$7.1 million of depreciation and amortization of our property and equipment and capitalized software and \$2.8 million of stock based compensation. The increase in our operating assets and liabilities was mostly attributed to an increase in deferred revenue of \$1.7 million related to our core solutions and an increase in accrued expenses of \$1.4 million and other liabilities of \$1.2 million, offset by a decline in accounts payable of \$1.1 million.

## Cash Used in Investing Activities

Cash used in investing activities is generally comprised of purchases, maturities and sales of investment securities, additions to capitalized software development and purchases and dispositions of capital expenditures.

For the nine months ended September 30, 2017, investing activities used \$16.4 million in cash primarily as a result of \$17.6 million of investment securities purchased, partially offset by \$11.0 million of maturities of investment securities. In addition, we incurred capitalized software development costs of \$8.1 million for the continued investment in our software development, and capital expenditures of \$1.7 million to purchase property and equipment for the continued growth and expansion of our business.



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For the nine months ended September 30, 2016, investing activities used \$9.3 million in cash primarily as a result of \$27.1 million of sales and maturities (which includes calls) of investment securities offset by \$24.3 million of investment securities purchased. In addition, we had an increase in capitalized software development costs of \$8.6 million and an increase in capital expenditures of \$3.6 million to purchase property and equipment to support the growth and expansion.

Cash (Used in) Provided by Financing Activities

Cash (used in) provided by financing activities is generally comprised of proceeds from the exercise of stock options, net share settlement for employee tax withholdings associated with the vesting of RSUs and activities associated with the Revolving Facility.

For the nine months ended September 30, 2017, financing activities used \$1.1 million in cash primarily as a result of net share settlements for employee tax withholdings associated with the vesting of RSUs of \$1.6 million, partially offset by proceeds from stock option exercises of \$0.5 million.

For the nine months ended September 30, 2016, financing activities provided \$0.1 million in cash primarily as a result of proceeds from stock option exercises.

Contractual Obligations and Other Commitments

In February 2017, we signed a lease amendment relating to the property located at 50 Castilian Drive in Santa Barbara, California, our corporate headquarters. This amendment extends the term from February 2018 to December 2021. The total commitment under this lease extension is \$3.1 million. All of the other terms and conditions of the original lease agreement remain the same.

There have been no other material changes to our contractual obligations and other commitments as disclosed in our Annual Report.

Off-Balance Sheet Arrangements

As of September 30, 2017, we did not have any off-balance sheet arrangements.

Critical Accounting Policies

Our Condensed Consolidated Financial Statements and the related notes are prepared in accordance with GAAP. The preparation of our Condensed Consolidated Financial Statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and operating expenses, provision for income taxes and related disclosures.

We adopted no new critical accounting policies during the nine months ended September 30, 2017. Please refer to our Critical Accounting Policies as included in our Annual Report.

Recent Accounting Pronouncements

For information regarding recent accounting pronouncements, refer to Note 2, Summary of Significant Accounting Policies within our Condensed Consolidated Financial Statements.

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### Item 3. Qualitative and Quantitative Disclosure about Market Risk

#### Interest Rate Risk

At September 30, 2017, we had cash and cash equivalents of \$14.8 million consisting of bank deposits and money market funds, and \$48.8 million of investment securities which are comprised of fixed rate debt securities and certificates of deposit. We did not purchase these investments for trading or speculative purposes and have not used any derivative financial instruments to manage our interest rate risk exposure.

As of September 30, 2017, a hypothetical 100 basis point decrease in interest rates would have resulted in an increase in the fair value of our investment securities of approximately \$0.5 million, and a hypothetical 100 basis point increase in interest rates would have resulted in a decrease in the fair value of our investment securities of approximately \$0.5 million. This estimate is based on a sensitivity model which measures an instant change in interest rates by 1% or 100 basis points at September 30, 2017.

The borrowings under our Revolving Facility are at variable interest rates. However, there was no outstanding balance under our Revolving Facility as of September 30, 2017. Accordingly, a hypothetical change in interest rates would not have impacted our debt service obligations as of September 30, 2017.

#### Inflation Risk

We have not been exposed to, nor do we anticipate being exposed to, material risks due to changes in inflation rates. As of September 30, 2017, there were no other material changes in the market risks described in the section of the Annual Report entitled “Quantitative and Qualitative Disclosure of Market Risk.”

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

Our management, with the supervision and participation of our principal executive officer and principal financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to provide reasonable assurance that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and other procedures designed to provide reasonable assurance that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Based on our management's evaluation, our principal executive officer and principal financial officer have concluded that, as of the end of the period covered by this Quarterly Report, our disclosure controls and procedures were effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

#### Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this Quarterly Report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### Inherent Limitations on Effectiveness of Controls

In designing and evaluating our disclosure controls and procedures, our management recognizes that no evaluation of controls can provide absolute assurance that all control issues within a company have been detected. In addition, the design of disclosure controls and procedures must reflect the fact that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs. Accordingly, our disclosure controls

and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure controls system are met.



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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are involved in legal proceedings arising from or related to claims incident to the normal course of our business activities. Although the results of such legal proceedings and claims cannot be predicted with certainty, we believe that we are not currently a party to any legal proceeding(s) which, if determined adversely to us, would, individually or taken together, have a material adverse effect on our business, operating results, financial condition or cash flows. However, regardless of the merit of any claims raised or the ultimate outcome, legal proceedings may generally have an adverse impact on us as a result of defense and settlement costs, diversion of management resources, and other factors.

Item 1A. Risk Factors

An investment in our Class A common stock involves risks. Before making an investment decision, you should carefully consider all of the information in this Quarterly Report, including in the section entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the Condensed Consolidated Financial Statements and related notes. In addition, you should carefully consider the risks and uncertainties described in the section entitled “Risk Factors” in our Annual Report, which was filed with the SEC on February 27, 2017, as well as in our other public filings with the SEC. If any of the identified risks are realized, our business, financial condition, operating results and prospects could be materially and adversely affected. In that case, the trading price of our Class A common stock may decline, and you could lose all or part of your investment. In addition, other risks of which we are currently unaware, or which we do not currently view as material, could have a material adverse effect on our business, financial condition, operating results and prospects.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

See the Exhibit Index immediately following the signature page of this Quarterly Report, which is incorporated herein by reference.

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SIGNATURES

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

AppFolio, Inc.

Date: November 6, 2017 By: /s/ Ida Kane

Ida Kane

Chief Financial Officer

(Principal Financial and Accounting Officer)

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EXHIBIT INDEX

| Exhibit<br>Number | Description of Document   |
|-------------------|---|
| 31.1              | <u>Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.</u>                         |
| 31.2              | <u>Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.</u>                         |
| 32.1*             | <u>Certifications of Chief Executive Officer and Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| 101.INS           | XBRL Instance Document.   |
| 101.SCH           | XBRL Taxonomy Extension Schema Document.  |
| 101.CAL           | XBRL Taxonomy Extension Calculation Linkbase Document.  |
| 101.DEF           | XBRL Taxonomy Extension Definition Linkbase Document.   |
| 101.LAB           | XBRL Taxonomy Extension Label Linkbase Document.  |
| 101.PRE           | XBRL Taxonomy Extension Presentation Linkbase Document.   |

The certifications attached as Exhibit 32.1 accompany this Quarterly Report pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, and shall not be deemed “filed” by the registrant for purposes of Section 18 of the Exchange Act, and are not to be incorporated by reference into any of the registrant’s filings under the Securities Act or the Exchange Act, whether made before or after the date of this Quarterly Report, irrespective of any general incorporation language contained in any such filing.