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STRATASYS INC
Form 10-Q
November 09, 2010

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, 2010

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

For the transition period from _____ to _____

Commission File Number: 1-13400

STRATASYS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

36-3658792
(I.R.S. Employer
Identification No.)

7665 Commerce Way, Eden Prairie, Minnesota
(Address of principal executive offices)

55344
(Zip Code)

(952) 937-3000

(Registrant's telephone number, including area code)

Not Applicable

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerate 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

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

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As of October 27, 2010 the Registrant had 20,658,437 shares of common stock, \$.01 par value, issued and outstanding.

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Stratasys, Inc.

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STRATASYS, INC. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

Consolidated Balance Sheets

| | September 30, 2010 (unaudited) | December 31, 2009 |
|--|--------------------------------------|-----------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 22,731,928 | \$ 48,315,926 |
| Short-term investments - held to maturity | 14,424,152 | 16,073,718 |
| Accounts receivable, less allowance for returns and doubtful accounts of \$1,199,523 at September 30, 2010 and \$903,101 at December 31, 2009 | 19,726,401 | 19,249,813 |
| Inventories | 18,719,342 | 14,608,014 |
| Net investment in sales-type leases, less allowance for doubtful accounts of \$197,421 at September 30, 2010 and \$222,011 at December 31, 2009 | 3,285,795 | 3,618,876 |
| Prepaid expenses and other current assets | 2,444,239 | 2,247,612 |
| Deferred income taxes | 2,277,000 | 2,277,000 |
| Total current assets | 83,608,857 | 106,390,959 |
| Property and equipment, net | 25,225,896 | 26,326,012 |
| Other assets | | |
| Intangible assets, net | 6,766,557 | 7,653,269 |
| Net investment in sales-type leases | 2,872,144 | 3,477,039 |
| Deferred income taxes | 688,000 | 688,000 |
| Long-term investments - available for sale | 1,030,750 | 1,055,750 |
| Long-term investments - held to maturity | 45,791,189 | 5,467,318 |
| Other non-current assets | 1,229,761 | 2,078,165 |
| Total other assets | 58,378,401 | 20,419,541 |
| Total assets | \$ 167,213,154 | \$ 153,136,512 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities | | |
| Accounts payable and other current liabilities | \$ 13,514,422 | \$ 12,874,798 |
| Unearned revenues | 10,883,944 | 10,678,427 |
| Total current liabilities | 24,398,366 | 23,553,225 |
| Commitments and contingencies | | |
| Stockholders' equity | | |
| Common stock, \$.01 par value, authorized 30,000,000 shares; 26,346,068 and 26,053,318 issued as of September 30, 2010 and December 31, 2009, respectively | 263,461 | 260,533 |

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| | | |
|---|----------------|----------------|
| Capital in excess of par value | 102,568,773 | 94,329,398 |
| Retained earnings | 79,080,546 | 74,015,940 |
| Accumulated other comprehensive loss | (93,567) | (18,159) |
| Less cost of treasury stock, 5,687,631 shares as of September 30, 2010 and December 31, 2009 | (39,004,425) | (39,004,425) |
| Total stockholders' equity | 142,814,788 | 129,583,287 |
| Total liabilities and stockholders' equity | \$ 167,213,154 | \$ 153,136,512 |

See accompanying notes to consolidated financial statements.

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STRATASYS, INC. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS

Consolidated Statements of Operations and Comprehensive Income (Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|---------------|---------------------------------|---------------|
| | 2010 | 2009 | 2010 | 2009 |
| Net sales | | | | |
| Products | \$ 23,966,937 | \$ 18,046,184 | \$ 69,526,507 | \$ 53,197,716 |
| Services | 6,291,609 | 6,283,212 | 18,785,660 | 18,924,759 |
| Fair value of warrant related to OEM agreement | - | - | (4,987,806) | - |
| | 30,258,546 | 24,329,396 | 83,324,361 | 72,122,475 |
| Cost of sales | | | | |
| Products | 12,695,679 | 9,918,263 | 35,805,842 | 30,883,158 |
| Services | 2,853,879 | 2,542,879 | 8,627,451 | 8,225,489 |
| | 15,549,558 | 12,461,142 | 44,433,293 | 39,108,647 |
| Gross profit | 14,708,988 | 11,868,254 | 38,891,068 | 33,013,828 |
| Operating expenses | | | | |
| Research and development | 2,242,263 | 1,983,420 | 7,191,594 | 5,510,385 |
| Selling, general and administrative | 8,403,902 | 7,481,311 | 24,385,683 | 25,257,138 |
| | 10,646,165 | 9,464,731 | 31,577,277 | 30,767,523 |
| Operating income | 4,062,823 | 2,403,523 | 7,313,791 | 2,246,305 |
| Other income (expense) | | | | |
| Interest income, net | 217,651 | 230,429 | 596,541 | 754,695 |
| Foreign currency transaction gains (losses), net | 227,623 | (5,930) | (570,184) | (169,148) |
| Other | 48,078 | (9,021) | 42,093 | 16,780 |
| | 493,352 | 215,478 | 68,450 | 602,327 |
| Income before income taxes | 4,556,175 | 2,619,001 | 7,382,241 | 2,848,632 |
| Income taxes | 1,380,625 | 1,040,201 | 2,317,635 | 1,124,191 |
| Net income | \$ 3,175,550 | \$ 1,578,800 | \$ 5,064,606 | \$ 1,724,441 |
| Net income per common share | | | | |
| Basic | \$ 0.15 | \$ 0.08 | \$ 0.25 | \$ 0.09 |
| Diluted | 0.15 | 0.08 | 0.24 | 0.09 |
| Weighted average common shares outstanding | | | | |
| Basic | 20,586,695 | 20,229,357 | 20,519,189 | 20,224,889 |
| Diluted | 21,000,804 | 20,231,033 | 21,035,559 | 20,233,234 |
| Comprehensive Income | | | | |
| Net income | \$ 3,175,550 | \$ 1,578,800 | \$ 5,064,606 | \$ 1,724,441 |
| Foreign currency translation adjustment | 221,975 | \$ 127,053 | (75,408) | \$ 179,816 |
| Comprehensive income | \$ 3,397,525 | \$ 1,705,853 | \$ 4,989,198 | \$ 1,904,257 |

See accompanying notes to consolidated financial statements.

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STRATASYS, INC. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS

Consolidated Statements of Cash Flows (Unaudited)

| | Nine Months Ended September 30, | |
|--|---------------------------------|----------------------|
| | 2010 | 2009 |
| Cash flows from operating activities | | |
| Net income | \$ 5,064,606 | \$ 1,724,441 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 4,847,219 | 4,362,310 |
| Amortization | 1,948,406 | 1,877,739 |
| Stock-based compensation | 931,632 | 907,174 |
| Fair value of warrant related to OEM agreement | 4,987,806 | - |
| Gain on disposal of property and equipment | - | 46,082 |
| Increase (decrease) in cash attributable to changes in operating assets and liabilities: | | |
| Accounts receivable, net | (476,588) | 5,651,975 |
| Inventories | (5,597,357) | 4,212,013 |
| Net investment in sales-type leases | 937,976 | 791,142 |
| Prepaid expenses | (196,627) | (94,087) |
| Other assets | 848,405 | 655,287 |
| Accounts payable and other current liabilities | 1,140,693 | (3,416,041) |
| Unearned revenues | 205,517 | (2,523,280) |
| Net cash provided by operating activities | 14,641,688 | 14,194,755 |
| Cash flows from investing activities | | |
| Proceeds from sale of investments | 19,731,121 | 4,962,211 |
| Purchase of investments | (58,443,732) | (9,920,000) |
| Proceeds from sale of property and equipment | - | 1,000 |
| Acquisition of property and equipment | (2,270,462) | (1,203,874) |
| Acquisition of intangible and other assets | (998,389) | (1,329,213) |
| Net cash used in investing activities | (41,981,462) | (7,489,876) |
| Cash flows from financing activities | | |
| Proceeds from exercise of stock options and warrants | 3,958,400 | 201,257 |
| Cash paid for vested stock option repurchases | (2,136,605) | - |
| Net cash provided by financing activities | 1,821,795 | 201,257 |
| Effect of exchange rate changes on cash | (66,019) | 141,205 |
| Net increase (decrease) in cash and cash equivalents | (25,583,998) | 7,047,341 |
| Cash and cash equivalents, beginning of period | 48,315,926 | 27,945,799 |
| Cash and cash equivalents, end of period | \$ 22,731,928 | \$ 34,993,140 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for taxes | \$ 3,195,953 | \$ 216,180 |

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| | | |
|---------------------------------------|-----------|---------|
| Transfer of fixed assets to inventory | 275,375 | 194,856 |
| Transfer of inventory to fixed assets | 1,761,405 | 484,092 |

See accompanying notes to consolidated financial statements.

STRATASYS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Basis of Presentation and Consolidation

The consolidated interim financial statements include the accounts of Stratasys, Inc. and its wholly-owned subsidiaries (collectively, the "Company"). All intercompany accounts and transactions have been eliminated in consolidation. The consolidated interim financial information herein is unaudited; however, such information reflects all adjustments (consisting of normal, recurring adjustments), which are, in the opinion of management, necessary for a fair statement of results for the interim period. The results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results to be expected for the full year. Certain financial information and footnote disclosures normally included in the annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted. The reader is referred to the audited consolidated financial statements and notes thereto for the year ended December 31, 2009, filed as part of the Company's Annual Report on Form 10-K for such year.

Note 2 Recently Issued Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2010-06, Improving Disclosures About Fair Value Measurements, that amends existing disclosure requirements under FASB Accounting Standards Codification™ ("ASC") 820 by adding required disclosures about items transferring into and out of levels 1 and 2 in the fair value hierarchy; adding separate disclosures about purchases, sales, issuances, and settlements relative to level 3 measurements; and clarifying, among other things, the existing fair value disclosures about the level of disaggregation. This ASU is effective for interim and annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures, which are effective for interim and annual periods beginning after December 15, 2010. Additional disclosures required by this standard for 2010 are included in Note 10 – Fair Value Measurements. Since this standard impacts disclosure requirements only, the adoption of this standard did not have a material impact on the Company's consolidated results of operations or financial condition.

In July 2010, the FASB issued ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. ASU 2010-20 requires further disaggregated disclosures that improve financial statement users' understanding of (1) the nature of an entity's credit risk associated with its financing receivables and (2) the entity's assessment of that risk in estimating its allowance for credit losses as well as changes in the allowance and the reasons for those changes. The new and amended disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The adoption of ASU 2010-20 will only impact disclosures and is not expected to have a material impact on the Company's consolidated results of operations and financial condition.

Note 3 Warrant Charge to Revenue

In connection with a Master OEM Agreement (the "Agreement") and a Protective Rights Agreement with Hewlett-Packard Company ("HP"), the Company issued a warrant to HP in the first quarter of 2010 to purchase 500,000 shares of common stock at an exercise price of \$17.78 per share (the "Warrant"), which vested immediately. The Company used the Black-Scholes pricing model to calculate the fair value of the Warrant, which is the same methodology used to calculate the fair value of stock-based compensation grants. The Company accounted for the fair value of this Warrant under the guidance of ASC 605, Revenue Recognition, and recognized the fair value as a reduction of revenues at the date of the grant.

Note 4 Investments

Classification of investments as current or non-current is dependent upon management's intended holding period, the investment's maturity date and liquidity considerations based on market conditions. These investments are then evaluated and classified as available-for-sale or held-to-maturity in accordance with the provisions of ASC 320, Investments - Debt and Equity Securities. This evaluation takes into consideration the Company's past history of holding investments until maturity, projected cash flow estimates, future capital requirements, the existence of credit deterioration of the issuer and the Company's overall investment strategy as established by management and approved by the Company's Board of Directors.

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STRATASYS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

If management has the positive intent and ability to hold its debt securities until maturity, they are classified as “held-to-maturity” and accounted for using the amortized-cost method. All other securities are classified as “available-for-sale” and accounted for at fair value with the unrealized gain or loss, net of tax, reported in other comprehensive income. The Company does not hold any investments for trading purposes and had no unrecognized gains or losses related to held-to-maturity investments at September 30, 2010 or December 31, 2009, as the fair value of those investments approximated cost.

The Company invests in certificates of deposit, corporate bonds, tax-free government bonds, and Auction Rate Securities (“ARS”), all of which are insured. The following is a summary of amounts recorded on the Consolidated Balance Sheet for marketable securities (current and non-current) at September 30, 2010 and December 31, 2009.

| | September 30, 2010 (unaudited) | December 31, 2009 |
|---|--------------------------------------|----------------------|
| Bonds | \$ 11,728,795 | \$ 8,113,361 |
| Other securities | 357 | 357 |
| Certificates of deposit | 2,695,000 | 7,960,000 |
| Short-term investments - held to maturity | 14,424,152 | 16,073,718 |
| Auction rate securities | 1,030,750 | 1,055,750 |
| Long-term investments - available for sale securities | 1,030,750 | 1,055,750 |
| Auction rate securities | 2,400,000 | 2,400,000 |
| Bonds | 43,391,189 | 1,107,318 |
| Certificates of deposit | - | 1,960,000 |
| Long-term investments - held to maturity | 45,791,189 | 5,467,318 |
| Total investments | \$ 61,246,091 | \$ 22,596,786 |

Short-term and long-term investments consist of certificates of deposit, corporate bonds, tax-free government bonds, and ARS. At September 30, 2010, the Company’s investments included:

- approximately \$55.1 million in bonds maturing between November 2010 and November 2013, all of which have ratings between AAA and BAA1 at September 30, 2010;
- approximately \$2.7 million in certificates of deposit maturing between November 2010 and February 2011.
- approximately \$2.4 million of a tax-free ARS, which re-prices approximately every 35 days. The ARS had a rating of A1 at September 30, 2010; and
- approximately \$1.0 million of a tax-free ARS, which does not currently have an active trading market and matures in February 2042. This ARS had a rating of Caa3 at September 30, 2010 and is further explained below.

The balance sheet caption titled “Long-term investments – available for sale securities” consists of a tax-free ARS. This balance represents the current estimated fair value of an ARS issued by Jefferson County, Alabama with a face value of \$2.6 million. The investment is part of a multi-billion series of bonds issued by Jefferson County to build its sewer and water treatment system (“system”). The County entered into interest rate swaps to protect itself from rising interest rates, but the swaps proved ineffective and the revenue from the system will not adequately support the higher interest rates. The bond is insured by Financial Guaranty Insurance Company (“FGIC”) and matures in 2042. However, with the collapse of the ARS market, the weakened financial condition of FGIC, and the County’s financial condition, the rating of this ARS has gone from Aaa to Caa3. The Company has received \$50,000 in principal payments on this ARS and no additional principal payments have become due. The Company has received all scheduled interest payments on this ARS through September 30, 2010. Due to the current financial condition

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of the County and the absence of an active market for this security, the Company only records interest income as cash payments are received.

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STRATASYS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

With the assistance of outside consultants, the Company has reviewed this ARS, including expected cash flows, assessed the credit risk, analyzed and extrapolated yield information on comparable composites, and reviewed independent research from various public sources concerning the ARS market. From that assessment, the Company concluded that during 2008 it had incurred both a temporary and other-than-temporary impairment and recognized impairments of \$195,000 and \$1,270,750, respectively. Based upon a reevaluation that occurred in late 2009, a portion of the previously recognized temporary impairment was considered other-than-temporary and an additional portion of the net carrying amount was considered as impaired on an other-than-temporary basis. The following table summarizes the activity of this investment from December 31, 2007 to September 30, 2010.

| | |
|---|--------------|
| Face value of investment as of December 31, 2007 | \$ 2,600,000 |
| Principal payment | (25,000) |
| Temporary impairment - recognized in other comprehensive income | (195,000) |
| Other-than-temporary impairment - recognized in other income | (1,270,750) |
| Net carrying value at December 31, 2008 | 1,109,250 |
| Temporary impairment transferred to other-than-temporary impairment | 40,500 |
| Other-than-temporary impairment - recognized in other income | (94,000) |
| Net carrying value at December 31, 2009 | 1,055,750 |
| Principal payment | (25,000) |
| Net carrying value at September 30, 2010 | \$ 1,030,750 |

Note 5 Inventories

Inventories consisted of the following at September 30, 2010 and December 31, 2009 respectively:

| | 2010 | 2009 |
|-----------------|---------------|---------------|
| Finished goods | \$ 6,469,032 | \$ 6,288,314 |
| Raw materials | 12,250,310 | 8,319,700 |
| Total Inventory | \$ 18,719,342 | \$ 14,608,014 |

Note 6 Material Commitments

The Company estimates that as of September 30, 2010, it had approximately \$22.0 million of purchase commitments for inventory from selected vendors. In addition to purchase commitments for inventory, the Company also has future commitments for leased facilities of approximately \$0.8 million. The Company intends to finance its purchase commitments from existing cash and investments and from cash flows from operations.

Note 7 Earnings per Common Share

The Company complies with ASC 260, Earnings Per Share, which requires dual presentation of basic and diluted income per common share for all periods presented. Basic net income per share excludes dilution and is computed by dividing net income by the weighted average number of shares outstanding for the periods that have net income. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then share in the income of the Company. The difference between the number of common shares used to compute basic net income per share and diluted net income per share relates to additional common shares that would be issued upon the assumed exercise of stock options and warrants, net of the common shares that would hypothetically be repurchased using the proceeds received from the original exercise.

| | Periods Ended September 30, | | | |
|-------------------|-----------------------------|-------|-------------|-------|
| | Three Months | | Nine Months | |
| | 2010 | 2009 | 2010 | 2009 |
| Additional Shares | 414,109 | 1,676 | 516,370 | 8,345 |

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STRATASYS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A total of 16,600 and 14,600 options were excluded from the dilution calculation for the three- and nine-month periods ended September 30, 2010, respectively, since their inclusion would not have had a dilutive effect. A total of 1,473,778 and 952,578 options were excluded from the dilution calculation for the three- and nine-month periods ended September 30, 2009, respectively, for the same reason.

The following table provides information relative to stock options that were exercised in the respective periods:

| | Periods Ended September 30, | | | |
|--|-----------------------------|------------|--------------|------------|
| | Three Months | | Nine Months | |
| | 2010 | 2009 | 2010 | 2009 |
| Proceeds from exercise of stock options | \$ 1,364,813 | \$ 155,880 | \$ 3,958,400 | \$ 201,257 |
| Number of options exercised | 100,750 | 12,000 | 292,750 | 15,900 |
| Weighted average exercise price | \$ 13.55 | \$ 12.99 | \$ 13.52 | \$ 12.66 |
| Tax benefit recognized in stockholders' equity from stock option exercises | \$ 4,928 | \$ - | \$ 501,069 | \$ - |

Note 8 Stock-Based Compensation

The Company accounts for stock-based compensation under the guidance of ASC 718, Compensation-Stock Compensation. ASC 718 establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services and transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. The stock-based compensation expense amount recorded and associated future estimated income tax benefits were as follows for the respective periods:

| | Periods Ended September 30, | | | |
|----------------------------------|-----------------------------|------------|-------------|------------|
| | Three Months | | Nine Months | |
| | 2010 | 2009 | 2010 | 2009 |
| Stock-based compensation expense | \$ 310,544 | \$ 238,032 | \$ 931,632 | \$ 956,503 |
| Income tax benefit | (48,288) | (28,000) | (257,408) | (189,218) |
| | \$ 262,256 | \$ 210,032 | \$ 674,224 | \$ 767,285 |

Options for 300,000 and 326,250 shares were granted in the nine months ended September 30, 2010 and 2009, respectively. The income tax benefit relates to stock-based compensation recorded on nonqualified stock options and any tax benefit derived from disqualifying dispositions of incentive stock options in the specific period.

Note 9 Income Taxes

The effective tax rate of 30.3% for the three months ended September 30, 2010 was lower than the 39.7% effective rate for the same period in 2009 due to a reduction in contingency reserves pertaining to positions taken on the Company's 2006 tax return for which the statute of limitations expired during the current quarter. The effective tax rate of 31.4% for the nine months ended September 30, 2010 was lower than the 34.5% effective rate for the same period in 2009 due to favorable tax liability adjustments in the first quarter of 2010 resulting from the disqualifying dispositions of incentive stock options and the reduction in contingency reserves in the third quarter of 2010 as noted above.

STRATASYS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Effective January 1, 2007, the Company adopted the provisions of ASC 740, Income Taxes, and began using a two-step approach to recognizing and measuring uncertain tax positions (tax contingencies). The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The Company reevaluates these tax positions quarterly and makes adjustments as required. At September 30, 2010 and December 31, 2009, the Company had unrecognized tax benefits of \$1.1 million and \$1.2 million, respectively.

Note 10 Fair Value Measurements

Fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. A hierarchy has been established for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available.

Observable inputs are inputs market participants would use in valuing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the factors market participants would use in valuing the asset or liability developed based upon the best information available in the circumstances. The hierarchy is broken down into three levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Assets and Liabilities that are Measured at Fair Value on a Recurring Basis:

For financial assets held by the Company, fair value principally applies to available-for-sale marketable securities. These items were previously, and will continue to be, marked-to-market at each reporting period. The information in the following paragraphs and tables primarily addresses matters relative to these financial assets. The Company does not have any financial liabilities that are subject to fair value measurements. Separately, there were no material fair value measurements with respect to non-financial assets or liabilities that are recognized or disclosed at fair value in the Company's financial statements on a recurring basis subsequent to the effective date of such accounting guidance.

The Company uses various valuation techniques, which are primarily based upon the market approach, with respect to its financial assets. As discussed in Note 4, one of the auction rate securities held by the Company has experienced a significant credit rating reduction since its acquisition. As a result, investments in auction rate securities are valued utilizing a quantitative and qualitative third-party analysis. The Company therefore classifies these securities as Level 3.

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STRATASYS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table provides a reconciliation of the beginning and ending balances of items measured at fair value on a recurring basis that used significant unobservable inputs:

| | Nine Months ended September 30, | |
|---|---------------------------------|--------------|
| | 2010 | 2009 |
| Auction rate securities | | |
| Beginning balance | \$ 3,455,750 | \$ 3,509,250 |
| Total gains or (losses): | | |
| Included in earnings | - | - |
| Included in other comprehensive income | - | - |
| Settlements | (25,000) | - |
| Ending balance | \$ 3,430,750 | \$ 3,509,250 |
| | | |
| | As of September 30, | |
| | 2010 | 2009 |
| Balance sheet classification of auction rate securities | | |
| Classified as long-term investments - available for sale securities | \$ 1,030,750 | \$ 1,109,250 |
| Classified as long-term investments - held to maturity | 2,400,000 | 2,400,000 |
| | \$ 3,430,750 | \$ 3,509,250 |

Assets and Liabilities that are Measured at Fair Value on a Nonrecurring Basis:

During the quarter ended September 30, 2010, the Company had no significant measurements of assets or liabilities at fair value on a nonrecurring basis subsequent to their initial recognition.

Note 11 Foreign Currency Hedge

The Company invoices sales to certain European distributors in Euros and reported results are therefore subject to fluctuations in the exchange rates of that currency in relation to the United States dollar. The Company's strategy is to hedge most of its Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that its earnings will be adversely affected by changes in currency exchange rates. The Company does not use derivative financial instruments for speculative or trading purposes. The Company enters into 30-day foreign currency forward contracts on the last day of each month and therefore the notional value of the contract equals the fair value at the end of the reporting period. As such, there is no related asset or liability or unrealized gains or losses recorded on the Balance Sheet as of the end of the period. All realized gains and losses related to hedging activities are recorded in current period earnings under the Statement of Operations caption "Foreign currency transaction gains (losses), net".

The Company hedged between €2.8 million and €3.5 million for the three months ended September 30, 2010 and between €2.8 million and €3.7 million for the nine months ended September 30, 2010 of accounts receivable that were denominated in Euros. The foreign currency forward contracts resulted in a currency translation loss of approximately \$438,000 and \$205,000 for the three months ended September 30, 2010 and 2009, respectively. Foreign currency forward contracts resulted in currency translation gain of approximately \$252,000 for the nine months ended September 30, 2010 and a loss of approximately \$161,000 for the nine months ended September 30, 2009. The resulting gain or loss from foreign currency forward contracts only partially offset the total foreign currency transactions gains or losses recorded by the Company.

The Company will continue to monitor exposure to currency fluctuations. Instruments that may be used to hedge future risks may include foreign currency forward, swap, and option contracts. These instruments may be used to selectively manage risks, but there can be no assurance that we will be fully protected against material foreign currency fluctuations.

STRATASYS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 12 Product Warranties

The Company's products are covered by warranties with periods ranging from ninety days to one year from the date of sale to the end customer. A liability is recorded for future warranty costs in the same period in which related revenue is recognized. The liability is based on anticipated parts and labor costs utilizing historical experience. The Company periodically assesses the adequacy of the warranty reserves based on changes in these factors and records any necessary adjustments if actual experience indicates that adjustments are necessary. Future claims experience could be materially different from prior results because of the introduction of new, more complex products, a change in the Company's warranty policy in response to industry trends, competition or other external forces, or manufacturing changes that could impact product quality. In the event that the Company determines that its current or future product repair and replacement costs exceed estimates, an adjustment to these reserves would be charged to earnings in the period in which such a determination is made.

A summary of product warranty activity is as follows for the respective periods:

| | Periods Ended September 30, | | | |
|--|-----------------------------|------------|--------------|------------|
| | Three Months | | Nine Months | |
| | 2010 | 2009 | 2010 | 2009 |
| Beginning balance | \$ 708,711 | \$ 442,837 | \$ 677,757 | \$ 321,874 |
| Accruals for warranties issued during the period | 988,857 | 471,948 | 1,454,784 | 947,070 |
| Warranty costs incurred during the period | (616,111) | (312,175) | (1,051,083) | (666,333) |
| Ending balance | \$ 1,081,457 | \$ 602,611 | \$ 1,081,457 | \$ 602,611 |

Note 13 Accounting for Collaborative Arrangements

In 2008, the Company fulfilled its responsibilities under a three-year, \$3.6 million agreement with a Fortune 500 global manufacturing company to jointly advance its proprietary FDM technology for rapid manufacturing applications. This agreement entitled the Company to receive reimbursement payments as it achieved specific milestones stated in the agreement. This effort was focused around the Company's high-performance systems and resulted in the commercial release of the Fortus 900mc. Because receipt of these payments represents reimbursement of costs actually incurred under this joint development project, all payments received were recorded as offsets to the research and development expenditures and are therefore not recognized as revenue.

Due to the success of this initial arrangement, the Company is continuing this relationship. In July 2010, the Company extended the collaborative agreement with this Fortune 500 partner to develop new platforms for direct digital manufacturing ("DDM") applications. This extension has similar terms and objectives as the previous agreements and entitles the Company to receive approximately \$800,000 in reimbursement payments as it achieves specific milestones. During the three months ended September 30, 2010 and 2009, approximately \$352,000 and \$405,000, respectively, of research and development expenses were offset by payments that were received from this company. During the nine months ended September 30, 2010 and 2009, approximately \$889,000 and \$1.9 million, respectively, of research and development expenses were offset by payments that were received from this company.

Note 14 Restructuring Activities

Beginning January 1, 2009, the Company began selling its Fortus 3D Production Systems in North America through a select group of resellers from its established reseller channel, which formerly distributed only the Dimension 3D Printer line. This restructuring of the Company's sales organization included costs related to workforce reductions, closure of certain leased facilities, rebranding expenses, and other contract termination charges that were recognized in 2008 and were settled during the first quarter of 2009.

STRATASYS, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

In addition, the Company took certain cost-saving measures in the first quarter of 2009 that lowered fixed costs and curtailed some discretionary spending while maintaining a focus on the key goals and objectives of the Company's long-term strategy. These cost-saving measures resulted in a charge of \$779,000 in the first quarter of 2009, consisting primarily of severance costs related to a reduction in force. Final severance payments were completed during the third quarter of 2009 and the unused portion of the provision, noted as "adjustments" in the table below, was recorded in income during the fourth quarter of 2009.

A summary of the activity of these restructuring and other costs recognized in the Statement of Operations caption "Selling, general and administrative" is as follows:

| | Employee- Related Items and Benefits | Contract Terminations and Other | Total |
|---|--|---------------------------------------|------------|
| Accrued balance as of December 31, 2008 | \$ 306,014 | \$ 66,881 | \$ 372,895 |
| Expenses incurred | 779,000 | - | 779,000 |
| Cash payments | (810,707) | (66,881) | (877,588) |
| Adjustments | (274,307) | - | (274,307) |
| Accrued balance as of December 31, 2009 | \$ - | \$ - | \$ - |

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

Overview

Description of Business

We are a worldwide leading manufacturer of three-dimensional ("3D") printers and high-performance rapid prototyping ("RP") systems for the office-based RP and direct digital manufacturing ("DDM") markets. Our 3D printers and high-performance RP systems provide 3D computer-aided design ("CAD") users a fast, office-friendly, and low-cost alternative for building functional 3D parts. We develop, manufacture and sell a broad product line of 3D printers and DDM systems (and related proprietary consumable materials) that create physical models from CAD designs. We also offer rapid prototyping and production part manufacturing services through our centers located in North America, Europe and Australia.

Summary of Financial Results

For the quarter ended September 30, 2010, we recorded net income of \$3.2 million, or \$0.15 per diluted share, as compared to net income of \$1.6 million, or \$0.08 per diluted share, for the quarter ended September 30, 2009. Due to the cost reduction efforts that were initiated in the first quarter of 2009 and our continued focus on controlling discretionary spending, we have delivered steady improvements in profitability and operating cash flow. These actions, along with our revenue growth, have allowed us to continue our investment in product development and to fully support the expansion of our sales channels.

Our revenues for the current quarter increased to \$30.3 million, or 24.4%, from the \$24.3 million that we reported in the third quarter of 2009. Gross profit also increased by \$2.8 million, or 23.9%, to \$14.7 million as compared with \$11.9 million in the prior year. This increase was primarily attributed to the recovering economy, which drove growth in system sales, as well as higher consumable usage rates across our installed base.

Our balance sheet continues to be strong. As of September 30, 2010, our cash and investments balance was approximately \$84.0 million, up from \$70.9 million at December 31, 2009. We also have no debt and believe that we have adequate liquidity to fund our growth strategy throughout 2010.

Our Market Strategy and Description of Current Conditions

It is our belief that we are successfully implementing our overall marketing strategy by addressing the needs of both the high-performance and 3D printing ends of the market.

3D Printers Over the last three years, we have been the volume leader in the commercial 3D printer market and have followed a strategy of moving down the price elasticity curve, most recently evidenced by our introduction of the uPrint and uPrint Plus systems and the expansion of our distribution channel. We believe that this strategy is appropriate for the long-term success of our company while at the same time, we recognize the short-term challenges that it presents. Although some of our competitors have also recently introduced low-cost 3D printers, we believe our strategy of offering low-priced 3D printing systems combined with higher reliability and increased functionality will continue to make our 3D printers an attractive alternative to our competitors' products.

We believe that the recent introduction of our lower priced uPrint and uPrint Plus systems and the expansion of our distribution channel, especially with the addition of a Master OEM agreement & with HP as discussed in the "Developments in Our Business During the Period" section below, will increase awareness of our products, but will reduce our margins as a percentage of revenue from the levels we have previously achieved. We intend to compensate for these lower margins by expanding the market for our 3D printers (and our related proprietary consumables), thereby substantially increasing the number of 3D printers sold and our overall revenues and profits. Although we believe that there is a large market for our 3D printers, there can be no assurance that we will be able to increase our revenues sufficiently to maintain or increase our profitability.

We continue to offer a distributor program that allows resellers to purchase demonstration systems with extended payment terms. While this program negatively impacts our accounts receivable days sales outstanding ("DSO"), it has proven to be an effective tool in promoting and selling our systems. Given the success of the program in the past, we offered a similar program for the launch of the uPrint and uPrint Plus, but these programs have shorter extended payment terms than in prior years. Although this program has a negative effect on our DSO, we believe that it remains an integral part of our strategy to expand our share of the market.

High-Performance 3D Production Systems Our strategy in the high-performance market is to expand our installed base of RP systems, represented principally by our Fortus 360mc, 400mc, and 900mc models, by offering improved system capabilities and new and improved material properties. End-user prices for our Fortus systems range from \$80,000 for the base model 360mc to \$400,000 for the fully equipped 900mc.

We also have opportunities for the Fortus line in DDM applications. DDM involves the manufacture of parts fabricated directly from our systems that are subsequently incorporated into the user's end product or process. DDM is particularly attractive in applications that require short-run or low-volume parts that require rapid turnaround and for which tooling would not be cost effective due to small volumes.

An emerging portion of the DDM market segment is the production of fabrication and assembly tools that aid in the customer's production and assembly process. We believe this fabrication and assembly tool market is substantially larger than the \$1.1 global billion rapid prototyping market we currently serve. In addition, we have seen a growing number of applications for end-use parts.

Recurring Revenues As our installed base has increased, we expect an increasing amount of revenue from the sales of consumables, maintenance contracts, and other services. Despite a history of growth in this area, we saw a temporary decline in this trend during the first part of 2009 as our existing customers curtailed some discretionary or variable spending in response to the economic slow down. During the most recent three quarters, we have seen an increase in consumable sales and believe that this is a leading indicator for our business going forward.

Our RedEye paid parts service makes and sells physical models, tooling and functional prototypes for RP and DDM applications based on our customers' CAD files. Growth in our RedEye paid parts service has resulted from the general economic upturn and continued recovery from a period of overly competitive pricing that occurred during the recent recession.

Developments in Our Business During the Period

Our third quarter results reflected the revenue growth trends that began late in 2009 and continued through the first two quarters of 2010. This was led by a 34% growth in consumables and a 40% growth in system unit sales as compared to the third quarter of 2009. These volume increases were driven by the recent economic recovery, our focus on the expansion of our sales channel and our continued investment in product development.

Throughout the 2009 economic downturn, most manufacturers were focused on survival and preserving cash instead of taking a calculated risk on the new technologies and new processes that our product line offers. With the recent economic upturn, we believe that our customers have been more willing to make investments in innovative new processes that save them time and money.

In July 2010, we extended our collaborative agreement with a Fortune 500 global manufacturing company to develop new platforms for DDM applications. This extension has similar terms and objectives as the previous agreements and entitles us to receive approximately \$800,000 in reimbursement payments as we achieve specific milestones.

During the first quarter of 2010, we signed a Master OEM Agreement (the "OEM Agreement") with HP to develop and manufacture an HP-branded 3D printer. During the initial term of the Agreement, which expires on September 30, 2011, we have developed and are manufacturing a line of FDM ("Fused Deposition Modeling") 3D printers and related accessories and consumables exclusively for HP for resale under the HP brand in France, Germany, Italy, Spain and the United Kingdom. In March of 2010, we delivered our first shipment of 3D printers to HP under this OEM Agreement.

HP has agreed not to sell any other 3D printers manufactured by other companies throughout the world for the term of the OEM Agreement. The term of the OEM Agreement will be extended for additional one-year periods unless terminated on advance notice by either party. During the term of the OEM Agreement, we have agreed not to sell comparable products covered by the Agreement directly or indirectly in the territory covered by the OEM Agreement. The OEM Agreement does not require HP to purchase any minimum quantity of products. After the initial term, or by mutual agreement, the territory in which HP will have the exclusive right to sell the 3D printers covered by the OEM Agreement may be expanded to additional countries. Ultimately, our mutual intention is for HP to sell our low-cost 3D printers globally.

Under this OEM Agreement, HP is selling our 3D printers and related products through its own reseller network. Accordingly, the prices we charge to HP for those products is less than the prices we presently charge to our own reseller network. As a result, our margins are lower on our sales to HP. In the longer-term, we expect to compensate for these lower margins by expanding the market for our 3D printers (and related proprietary consumables), thereby substantially increasing the number of 3D printers sold and our overall revenues and profits. Although we believe that there is a large market for our 3D printers, there can be no assurance that we will be able to increase our revenue sufficiently to maintain or increase our profitability.

We have also entered into a Protective Rights Agreement with HP in which we have agreed to notify HP if (i) we decide to engage in negotiations in response to an acquisition offer, (ii) we decide to investigate a potential acquisition of our company, or (iii) we become aware of an offer to purchase securities that would result in our acquisition. The Protective Rights Agreement will terminate on the earlier of three months after termination of the OEM Agreement or our acquisition. In connection with the OEM Agreement and the Protective Rights Agreement, we issued a warrant to HP during the first quarter of 2010 to purchase 500,000 shares of common stock at an exercise price of \$17.78 per share, which vested immediately and has a seven-year term.

In January 2010, we expanded the Dimension uPrint product line by introducing the uPrint Plus. This system offers the same small footprint as the previously introduced uPrint but offers a 33% larger build envelop. It also allows the user to print in seven additional colors and offers two resolution settings. Concurrent with the launch of the uPrint Plus, we also introduced two support-material enhancements. The first, Smart Supports, is a software feature that can reduce support material usage by 40%. The second is a new soluble support material called SR-30, which can dissolve 69% faster than the current soluble support material.

Concurrent with the launch of the uPrint in January 2009, we lowered the price of our other Dimension systems and discontinued the production of our SST768 and BST768 models, although we will continue to provide support and service for these discontinued systems going forward. Our current 3D printing line now consists of five system types that have an end-customer price range of \$14,900 to \$32,900. Based upon data and estimates furnished in the Wohlers Report released in May of 2010, we shipped approximately 32% of all RP systems globally in 2009 and 33% of all 3D printers shipped globally in 2009.

Cautionary Note Concerning Factors that May Affect Future Results

Our current and future growth is largely dependent upon our ability to penetrate new markets and develop and market new rapid prototyping and manufacturing systems, materials, applications, and services that meet the needs of our current and prospective customers. Our expense levels are based in part on our expectations of future revenues. While we have adjusted, and will continue to adjust, our expense levels based on both actual and anticipated revenues, fluctuations in revenues in a particular period could adversely impact our operating results. Our ability to continue to implement our strategy in 2010 is subject to numerous uncertainties and risks, many of which are described in this Management's Discussion and Analysis of Financial Condition and Results of Operations, in the section below captioned "Forward Looking Statements and Factors That May Affect Future Results of Operations," and in Item 1A, "Risk Factors," of our Annual Report on Form 10-K for 2009. We cannot ensure that our efforts will be successful.

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Results of Operations (unaudited)

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

Three- and Nine-Month Periods Ended September 30,

| | Three Months | | Nine Months | |
|--------------------------------------|--------------|--------|-------------|--------|
| | 2010 | 2009 | 2010 | 2009 |
| Net sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of sales | 51.4% | 51.2% | 53.3% | 54.2% |
| Gross profit | 48.6% | 48.8% | 46.7% | 45.8% |
| Research and development | 7.4% | 8.2% | 8.6% | 7.6% |
| Selling, general, and administrative | 27.8% | 30.8% | 29.3% | 35.0% |
| Operating income | 13.4% | 9.9% | 8.8% | 3.1% |
| Other income | 1.6% | 0.9% | 0.1% | 0.8% |
| Income before income taxes | 15.1% | 10.8% | 8.9% | 3.9% |
| Income taxes | 4.6% | 4.3% | 2.8% | 1.6% |
| Net income | 10.5% | 6.5% | 6.1% | 2.4% |

Net Sales

Our revenues increased to \$30.3 million in the third quarter of 2010, a 24.4% increase from the \$24.3 million that we reported in the third quarter of 2009. Revenues for the first nine months of 2010 were \$83.3 million, a 15.5% increase from the \$72.1 million reported in the prior year. The following is a breakdown of our net revenues by products and services:

Three- and Nine-Month Periods Ended September 30,

| (In Thousands) | Three Months | | | Period-over-period change | Nine Months | | Period-over-period change |
|-----------------------|--------------|-----------|-------|---------------------------|-------------|---------|---------------------------|
| | 2010 | 2009 | | | 2010 | 2009 | |
| Products | \$ 23,967 | \$ 18,046 | 32.8% | \$ 69,526 | \$ 53,197 | 30.7% | |
| Services | \$ 6,292 | \$ 6,283 | 0.1% | \$ 18,786 | \$ 18,925 | -0.7% | |
| Fair value of warrant | \$ - | \$ - | - | \$ (4,988) | \$ - | -100.0% | |
| | \$ 30,259 | \$ 24,329 | 24.4% | \$ 83,324 | \$ 72,122 | 15.5% | |

Revenues derived from products increased \$5.9 million, or 32.8%, in the quarter ended September 30, 2010, as compared with the quarter ended September 30, 2009. System revenue grew by \$3.5 million as a result of a general economic upturn that generated higher unit sales, which were weighted towards our 3D printer line of products. The number of units that we shipped in the quarter increased by 40.0%, or 177 units, to 631 as compared with 454 units shipped in the third quarter of 2009. 3D printer unit sales in the quarter increased by 39.6% when compared to the third quarter of 2010, driven by strong sales of our Stratasys-branded products, as well as the new HP Designjet line.

For the nine months ended September 30, 2010, revenues derived from products increased \$16.3 million, as compared with the nine months ended September 30, 2009. The number of units that we shipped in the first nine months of 2010 increased by 29.3%, or 436 units, to 1,923 units as compared with 1,487 units shipped in the first nine months of 2009. The increase in units for the 2010 periods compared to the 2009 periods was principally attributable to the worldwide economic recovery, strong sales of our Stratasys-brand 3D printer products and the new HP Designjet line. Consumable revenue increased by \$2.0 million and \$4.8 million for the three and nine months ended September 30, 2010, respectively, primarily driven by the economic upturn which has increased the usage of our installed base of systems.

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Revenues from our service offerings in the three and nine months ended September 30, 2010 were relatively flat as compared to revenue from services in the prior year. Growth in our RedEye service bureau business resulted from the general economic upturn and continued recovery from a period of highly competitive pricing that occurred during the recent recession. This growth was offset by a decrease in maintenance revenue, which resulted from our expansion of the warranty period for our domestic Fortus systems from three months to one year.

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A \$5.0 million charge to revenue was recorded in the first quarter of 2010 representing the fair value of a warrant issued to the Hewlett-Packard Company (“HP”) in connection with an OEM Agreement that was signed in January 2010.

Revenues in the Americas region, which includes North and South America, accounted for approximately 55.6% and 52.9% of total revenue for the quarters ended September 30, 2010 and 2009, respectively. The increase in revenues in the Americas region as a percentage of total revenues is primarily attributable to strong system sales in the current quarter. Revenues in the Americas region accounted for 55.8% and 56.0% of total revenue for the nine months ended September 30, 2010 and 2009, respectively.

Revenues outside the Americas region accounted for approximately 44.4% and 47.1% of total revenues for the quarters ended September 30, 2010 and 2009, respectively. Revenues outside the Americas region accounted for approximately 44.2% and 44.0% of total revenues for the nine months ended September 30, 2010 and 2009, respectively.

Gross Profit

Three- and Nine-Month Periods Ended September 30,

| (In Thousands) | Three Months | | Period-over- period change | Nine Months | | Period-over- period change |
|-----------------------|--------------|-----------|----------------------------------|-------------|-----------|----------------------------------|
| | 2010 | 2009 | | 2010 | 2009 | |
| Products | \$ 11,271 | \$ 8,128 | 38.7% | \$ 33,721 | \$ 22,315 | 51.1% |
| Services | 3,438 | 3,740 | -8.1% | 10,158 | 10,699 | -5.1% |
| Fair value of warrant | - | - | - | (4,988) | - | -100.0% |
| Total | \$ 14,709 | \$ 11,868 | 23.9% | \$ 38,891 | \$ 33,014 | 17.8% |

Gross Profit as a Percentage of Related Sales

| | | | | |
|----------|-------|-------|-------|-------|
| Products | 47.0% | 45.0% | 48.5% | 41.9% |
| Services | 54.6% | 59.5% | 54.1% | 56.5% |
| Total | 48.6% | 48.8% | 46.7% | 45.8% |

Gross profit increased by \$2.8 million, or 23.9%, to \$14.7 million in the quarter ended September 30, 2010 as compared with \$11.9 million in the same prior-year period. Gross profit increased by \$5.9 million, or 17.8%, to \$38.9 million in the nine months ended September 30, 2010 as compared with \$33.0 million in the same prior-year period. A \$5.0 million charge to revenue was recorded in the first quarter of 2010 representing the fair value of a warrant issued to the Hewlett-Packard Company (“HP”) in connection with an OEM Agreement that was signed in January 2010.

Product gross profit increased by 38.7% and 51.1% for the three and nine months ended September 30, 2010, respectively, as compared to the same prior-year periods. This increase is primarily attributable to increased volume to cover fixed overhead, a product mix that favored consumables and our higher priced Fortus systems and a focus on controlling production overhead costs.

Gross profit from services decreased by 8.1% and 5.1% for the three and nine months ended September 30, 2010, respectively, as compared to the same prior-year periods. This decrease was primarily attributable to a decrease in maintenance revenue, which resulted from our expansion of the warranty period for our domestic Fortus systems from three months to one year. This decrease was partially offset by growth in our RedEye service bureau business resulted from the general economic upturn and continued recovery from a period of highly competitive pricing that occurred during the recent recession.

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Operating Expenses

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

Three- and Nine-Month Periods Ended September 30,

| (In Thousands) | Three Months | | Period-over- period change | Nine Months | | Period-over- period change |
|-----------------------------------|--------------|----------|----------------------------------|-------------|-----------|----------------------------------|
| | 2010 | 2009 | | 2010 | 2009 | |
| Research & development | \$ 2,242 | \$ 1,984 | 13.0% | \$ 7,191 | \$ 5,511 | 30.5% |
| Selling, general & administrative | 8,404 | 7,481 | 12.3% | 24,386 | 25,257 | -3.4% |
| | \$ 10,646 | \$ 9,465 | 12.5% | \$ 31,577 | \$ 30,768 | 2.6% |
| Percentage of sales | 35.2% | 38.9% | | 37.9% | 42.7% | |

Research and development expense increased by 13.1% and 30.5% for the three months and nine months ended September 30, 2010, respectively, compared to the same prior-year periods. The increase resulted primarily from increased development activities in support of the HP OEM Agreement, development of the uPrint Plus, and development of our new support removal system that will be distributed by both us and HP under separate brands. Capitalized research and development expenditures for the three months ended September 30, 2010 relating to internally developed software was approximately \$287,000 as compared to \$360,000 for the same prior-year period. Capitalized software for the nine months ended September 30, 2010 was approximately \$0.9 million as compared to \$1.0 million for the same prior-year period.

In 2008, we satisfied our responsibilities under a three-year, \$3.6 million agreement with a Fortune 500 global manufacturing company to jointly advance our proprietary FDM technology for rapid manufacturing applications. This agreement entitled us to receive reimbursement payments as we achieved specific milestones stated in the agreement. This effort was focused around our high-performance systems and resulted in the commercial release of the Fortus 900mc.

Due to the success of this initial arrangement, we are continuing our working relationship with this company. In July 2010, we extended our collaborative agreement with the Fortune 500 global manufacturing company to develop new platforms for DDM applications. This extension has similar terms and objectives as the previous agreements and entitles us to receive approximately \$800,000 in reimbursement payments as we achieve specific milestones. During the three months ended September 30, 2010 and September 30, 2009, approximately \$352,000 and \$405,000, respectively, of research and development expenses were offset by payments that were received from this company. During the nine months ended September 30, 2010 and September 30, 2009, approximately \$889,000 and \$1.9 million, respectively, of research and development expenses were offset.

Selling, general and administrative expenses increased by 12.3% and decreased by 3.5% for the three and nine months ended September 30, 2010, respectively, compared to the same prior-year periods. The increase in the current quarter resulted primarily from commission and incentive compensation expenses, which resulted from strong sales and earnings growth. The decrease in the first nine months of 2010 was primarily attributable to cost savings that have resulted from our continued effort to lower discretionary spending. During the first quarter of 2009, we eliminated our North American direct sales force. This resulted in a charge of approximately \$779,000, consisting primarily of severance costs related to these headcount reductions.

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Operating Income

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

Three- and Nine-Month Periods September 30,

| (In Thousands) | Three Months | | Period-over- period change | Nine Months | | Period-over- period change |
|---------------------|--------------|----------|----------------------------------|-------------|----------|----------------------------------|
| | 2010 | 2009 | | 2010 | 2009 | |
| Operating income | \$ 4,063 | \$ 2,404 | 69.0% | \$ 7,314 | \$ 2,246 | 225.6% |
| Percentage of sales | 13.4% | 9.9% | | 8.8% | 3.1% | |

We recorded operating income of \$4.1 million for the three months ended September 30, 2010 as compared to operating income of \$2.4 million for the same prior-year period. This favorable change was primarily due to increased product sales resulting from the general economic upturn. Operating income for the nine months ended September 30, 2010 was \$7.3 million as compared to \$2.2 million for the same prior year period. This favorable change was primarily due to increased product sales resulting from the general economic upturn and was net of a \$5.0 million non-cash charge to revenue in the first quarter of 2010 related to a warrant issued to HP in connection with the OEM Agreement.

Other Income (Expense)

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

Three- and Nine-Month Periods Ended September 30,

| (In Thousands) | Three Months | | Period-over- period change | Nine Months | | Period-over- period change |
|----------------------------|--------------|--------|----------------------------------|-------------|--------|----------------------------------|
| | 2010 | 2009 | | 2010 | 2009 | |
| Interest income | \$ 217 | \$ 230 | -5.7% | \$ 596 | \$ 754 | -21.0% |
| Foreign currency | | | | | | |
| transaction gains (losses) | 228 | (6) | N/M | (570) | (169) | -237.3% |
| Other | 48 | (9) | N/M | 42 | 17 | 147.1% |
| | \$ 493 | \$ 215 | -129.3% | \$ 68 | \$ 602 | -88.7% |
| Percentage of sales | 1.6% | 0.9% | | 0.1% | 1.3% | |

N/M - Not meaningful

While cash and investment balances increased over the prior-year periods, interest income decreased for the three and nine months ended September 30, 2010 compared to the same prior-year periods due to the lower effective interest rate of our investment portfolio. As of September 30, 2010, we had approximately \$20.1 million invested in US Treasury money market accounts with a current annualized yield of approximately 1%.

Foreign currency gains for the third quarter of 2010 resulted primarily from the weakening US dollar during the period. We invoice sales to certain European distributors in Euros and our reported results are therefore subject to fluctuations in the exchange rates of that currency in relation to the US dollar. Our strategy is to hedge most of our Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that our earnings will be adversely affected by changes in currency exchange rates. In addition to our Euro-denominated accounts receivable, we also have net Euro-denominated assets related to our foreign subsidiaries that are also subject to fluctuations in exchange rates. We do not use derivative financial instruments for speculative or trading purposes.

We will continue to monitor exposure to currency fluctuations. Instruments that we may use to hedge risks could include foreign currency forward, swap, and option contracts. These instruments may be used to selectively manage risks, but there can be no assurance that we will be

fully protected against material foreign currency fluctuations.

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Income Taxes

Income taxes and income taxes as a percentage of net income before income taxes, as well as the percentage changes, were as follows:

Three- and Nine-Month Periods Ended September 30,

| (In Thousands) | Three Months | | Period-over-period change | Nine Months | | Period-over-period change |
|--------------------|--------------|----------|---------------------------|-------------|----------|---------------------------|
| | 2010 | 2009 | | 2010 | 2009 | |
| Income taxes | \$ 1,381 | \$ 1,040 | 32.7% | \$ 2,318 | \$ 1,124 | 106.2% |
| Effective tax rate | 30.3% | 39.7% | | 31.4% | 39.5% | |

The effective tax rate of 30.3% for the three months ended September 30, 2010 was lower than the 39.7% effective rate for the same period in 2009 due to a reduction in contingency reserves pertaining to positions taken on our 2006 tax return for which the statute of limitations expired during the current quarter. The effective tax rate of 31.4% for the nine months ended September 30, 2010 was lower than the 39.5% effective rate for the same period in 2009 due to favorable tax liability adjustments in the first quarter of 2010 resulting from the disqualifying dispositions of incentive stock options and the reduction in contingency reserves in the third quarter of 2010 as noted above.

Net Income

Net income and net income as a percentage of sales, as well as the percentage changes in net income, were as follows:

Three- and Nine-Month Periods Ended September 30,

| (In Thousands) | Three Months | | Period-over-period change | Nine Months | | Period-over-period change |
|---------------------|--------------|----------|---------------------------|-------------|----------|---------------------------|
| | 2010 | 2009 | | 2010 | 2009 | |
| Net income | \$ 3,176 | \$ 1,579 | 101.1% | \$ 5,065 | \$ 1,724 | 193.8% |
| Percentage of sales | 10.5% | 6.5% | | 6.1% | 2.4% | |

Net income in the current period increased during the three and nine months ended September 30, 2010 primarily from increased product revenue and cost reductions and were partially offset by a \$5.0 million non-cash charge to revenue in the first quarter of 2010 related to a warrant issued to HP in connection with the OEM Agreement.

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Liquidity and Capital Resources (unaudited)

A summary of our consolidated interim statements of cash flows for the nine months ended September 30, 2010 and 2009 are as follows:
(In Thousands)

| | 2010 | 2009 |
|--|-----------|-----------|
| Net income | \$ 5,065 | \$ 1,724 |
| Depreciation and amortization | 6,796 | 6,240 |
| Gain on sale of equipment | - | 46 |
| Stock-based compensation | 932 | 907 |
| Fair value of warrant related to OEM agreement | 4,988 | - |
| Changes in operating assets and liabilities | (3,139) | 5,278 |
| Net cash provided by operating activities | 14,642 | 14,195 |
| Net cash provided by (used in) investing activities | (41,981) | (7,490) |
| Net cash provided by financing activities | 1,822 | 201 |
| Effect of exchange rate changes on cash | (67) | 141 |
| Net increase (decrease) in cash and cash equivalents | (25,584) | 7,047 |
| Cash and cash equivalents, beginning of period | 48,316 | 27,946 |
| Cash and cash equivalents, end of period | \$ 22,732 | \$ 34,993 |

Our cash and cash equivalents balance decreased by \$25.6 million to \$22.7 million at September 30, 2010, from \$48.3 million at December 31, 2009. The decrease is primarily due to \$58.4 million of cash spent for the purchase of investments.

In the nine months ended September 30, 2010, net cash provided by our operating activities was \$14.6 million compared to cash provided by operations of \$14.2 million during the comparable 2009 period.

Our net accounts receivable balance increased to \$19.7 million at September 30, 2010 from \$19.3 million as of December 31, 2009. This increase was principally due to sales growth but was offset by increased collection efforts that reduced the number of days sales outstanding.

At September 30, 2010, our inventory balance increased to \$18.7 million compared to \$14.6 million at December 31, 2009. This increase was principally due to increased sales volume, product build up in preparation for the release of a new support removal system and growth in our OEM products manufactured for HP.

Our investing activities used cash of \$42.0 million in the first nine months of 2010 as compared to \$7.5 million in the first nine months of 2009. We used net cash of approximately \$38.7 million for the purchase of investments with maturities of one to three years. Most of these investments are government and corporate issued bonds classified as long-term investments. We used cash of approximately \$2.3 million for fixed asset additions in the first nine months of 2010 as compared to \$1.2 million in the first nine months of 2009. Net cash used for payments for intangible assets and other investments, including patents and capitalized software, was \$998,000 as compared to \$1.3 million for the same prior-year period. Much of the capital expenditures in 2010 have been for equipment required by the ongoing needs of our business, including manufacturing fixtures for new products and consumables manufacturing.

In the nine months ended September 30, 2010, we had net cash provided by financing activities of \$1.8 million that resulted from proceeds from the exercise of stock options, which was mostly offset by the repurchase of vested stock options.

For the remainder of 2010, we expect to use our cash flows from operations and/or our cash and investments as follows:

- for the acquisition of equipment, including production equipment, tooling, and computers;

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- for the purchase of additional manufacturing facilities;
- for the purchase, development and protection of intangible assets, including patents;
- for the continuation of our leasing program;

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- for working capital purposes;
- for increased selling and marketing activities, especially as they relate to the continued market and channel development;
- for new product and materials development;
- for sustaining engineering;
- for information systems (“I/S”) and infrastructure enhancements;
- for improvements to our existing facilities;
- for acquisitions and/or strategic alliances; and
- for our common stock buyback program, which has \$10.9 million available for the purchase of shares

Our total current assets amounted to approximately \$83.6 million at September 30, 2010, most of which consisted of cash and cash equivalents, investments, inventories and accounts receivable. Total current liabilities amounted to approximately \$24.4 million and we have no debt. We believe that we have adequate resources to fund our foreseeable future growth.

Inflation

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

Foreign Currency Transactions

We invoice sales to certain European distributors in Euros, and reported results are therefore subject to fluctuations in the exchange rates of that currency in relation to the United States dollar. Our strategy is to hedge most of our Euro-denominated accounts receivable positions by entering into 30-day foreign currency forward contracts on a month-to-month basis to reduce the risk that our earnings will be adversely affected by changes in currency exchange rates. We do not use derivative financial instruments for speculative or trading purposes. We enter into 30-day foreign currency forward contracts on the last day of each month and therefore the notional value of the contract equals the fair value. As such, there is no related asset or liability or unrealized gains or losses recorded on the Balance Sheet as of the end of the period. All realized gains and losses related to hedging activities are recorded in current period earnings under the Statement of Operations caption “Foreign currency transactions gains (losses), net.”

We hedged between €2.8 million and €3.5 million for the three months ended September 30, 2010 and between €2.8 million and €3.7 million for the nine months ended September 30, 2010 of accounts receivable that were denominated in Euros. The foreign currency forward contracts resulted in a currency translation loss of approximately \$438,000 and \$205,000 for the three months ended September 30, 2010 and 2009, respectively. Foreign currency forward contracts resulted a in currency translation gain of approximately \$252,000 for the nine months ended September 30, 2010 and a loss of approximately \$161,000 for the nine months ended September 30, 2009. The resulting gain or loss from foreign currency forward contracts only partially offset our total foreign currency transaction gains or losses.

We will continue to monitor exposure to currency fluctuations. Instruments that we may use to hedge risks could include foreign currency forward, swap, and option contracts. These instruments may be used to selectively manage risks, but there can be no assurance that we will be fully protected against material foreign currency fluctuations.

Critical Accounting Policies

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

We have identified several critical accounting policies that required us to make assumptions about matters that were uncertain at the time of our estimates. Had we used different estimates and assumptions, the amounts we recorded could have been significantly different. Additionally,

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if we had used different assumptions or if different conditions existed, our financial condition or results of operations could have been materially different. Certain critical accounting policies that were affected by the estimates, assumptions, and judgments used in the preparation of our consolidated interim financial statements are described in our Annual Report on Form 10-K for 2009.

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

All statements herein that are not historical facts or that include such words as “expects”, “anticipates”, “projects”, “estimates”, “vision”, “could”, “potential”, “planning” or “believes” or similar words constitute forward-looking statements that we deem to be covered by and to qualify for the safe harbor protection covered by the Private Securities Litigation Reform Act of 1995 (the “1995 Act”). Investors and prospective investors in our Company should understand that several factors govern whether any forward-looking statement herein will be or can be achieved. Any one of these factors could cause actual results to differ materially from those projected herein.

These forward-looking statements include the expected increases in net sales of RP, DDM, and 3D printing systems, services and consumables, and our ability either increase sales at lower gross margins or to maintain our gross margins on these sales. The forward-looking statements include projected revenue and income in future quarters; the size of the 3D printing market; our objectives for the marketing and sale of our uPrint™ and Dimension™ 3D printers and our Fortus™ 3D Production Systems, particularly for use in direct digital manufacturing (DDM); the demand for our proprietary consumables; the expansion of our RedEye paid parts service; and our beliefs with respect to the growth in the demand for our products and the impact of our OEM Agreement on sales of our products. They include our plans and objectives to introduce new products, to control expenses, to improve the quality and reliability of our systems, to respond to new or existing competitive products, and to improve profitability. The forward-looking statements included herein are based on current expectations that involve a number of risks and uncertainties, some of which are described in Item 1A, “Risk Factors,” in our Annual Report on Form 10-K for 2009. These forward-looking statements are based on assumptions, among others, that we will be able to:

- continue to introduce new high-performance and 3D printing systems and materials acceptable to the market, and to continue to improve our existing technology and software in our current product offerings;
- successfully develop the 3D printing market with our Dimension BST, Dimension SST, Dimension Elite, uPrint Plus, and uPrint systems, and that the market will accept these systems;
- successfully develop the DDM market with our Fortus 360mc, 400mc and 900mc, and that the market will accept these systems;
- maintain or improve our revenues and gross margins on our present products;
- control our operating expenses;
- expand our manufacturing capabilities to meet the expected demand generated by our uPrint Plus, uPrint, Dimension BST, Dimension SST and Dimension Elite systems, our consumable products and our Paid Parts service and sales under our OEM Agreement with HP;
- successfully commercialize new materials and gain market acceptance for these new materials; and
- recruit, retain, and develop employees with the necessary skills to produce, create, commercialize, market, and sell our products.

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Interest Rate Risk

Our cash and cash equivalent investments are exclusively in short-term money market and sweep instruments with maturities of less than 90 days and are subject to limited interest rate risk. A 10% change in interest rates would not have a material effect on our financial condition or results of operations. Our short- and long-term investments are invested in auction rate securities, bonds and certificates of deposit that bear interest at rates of 0.6% to 6.4%. An immediate 10% change in interest rates would have no material effect on our financial condition or results of operations.

Foreign Currency Exchange Rate Risk

We have not historically hedged sales from or expenses incurred by our European operations that have a functional currency in Euros. Therefore, a hypothetical 10% change in the exchange rates between the U.S. dollar and the Euro could increase or decrease our income before taxes by less than \$0.4 million for the continued maintenance of our European facility.

We hedged between €2.8 million and €3.5 million for the three months ended September 30, 2010 and between €2.8 million and €3.7 million for the nine months ended September 30, 2010 of accounts receivable that were denominated in Euros. The foreign currency forward contracts resulted in a currency translation loss of approximately \$438,000 and \$205,000 for the three months ended September 30, 2010 and 2009, respectively. Foreign currency forward contracts resulted in a currency translation gain of approximately \$252,000 for the nine months ended September 30, 2010 and a loss of approximately \$161,000 for the nine months ended September 30, 2009. The resulting gain or loss from foreign currency forward contracts only partially offset our total foreign currency transaction gains or losses.

A hypothetical 10% change in the exchange rates between the US dollar and the Euro could increase or decrease income before taxes by between \$0.5 million and \$1.0 million.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

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

Internal Control over Financial Reporting

An evaluation was also performed under the supervision and with the participation of management, including the CEO and CFO, of any change in our internal controls over financial reporting that occurred during the last fiscal quarter and that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting. That evaluation did not identify any changes in our internal control over financial reporting during our most recently completed fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934).

PART II OTHER INFORMATION

Item 6. Exhibits

(a) Exhibits.

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

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SIGNATURES

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

Date: November 9, 2010

Stratasys, Inc.

By:

/s/ ROBERT F. GALLAGHER
Robert F. Gallagher
Chief Financial Officer