NETSUITE INC
Form 10-Q
October 30, 2013
Table of Contents

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

FORM 10-Q

(Mark one)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from to .

Commission file number 001-33870

NetSuite Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-3310471 (I.R.S. Employer Identification No.)
2955 Campus Drive, Suite 100 San Mateo, California (Address of principal executive offices)	94403-2511 (Zip Code)

(650) 627-1000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). (Check one): Yes S 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 definition of “large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

On October 25, 2013, 74,684,153 shares of the registrant's Common Stock, $0.01 par value, were issued and outstanding.

Table of Contents

NetSuite Inc.

Index

Part I – Financial Information		
Item 1.	Financial Statements:	
	Condensed Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012 (unaudited)	1
	Condensed Consolidated Statements of Operations and Comprehensive Loss for the Nine and Three Months Ended September 30, 2013 and 2012 (unaudited)	2
	Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2013 and 2012 (unaudited)	3
	Notes to Condensed Consolidated Financial Statements (unaudited)	4
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	27
Item 4.	Controls and Procedures	28
Part II – Other Information		
Item 1.	Legal Proceedings	29
Item 1A.	Risk Factors	29
Item 6.	Exhibits	41
Signatures		42

Table of Contents

PART I – Financial Information

ITEM 1. Financial Statements

NetSuite Inc.
Condensed Consolidated Balance Sheets
(dollars in thousands)
(unaudited)

	September 30, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$467,130	$185,859
Accounts receivable, net of allowances of $501 and $701 as of September 30, 2013 and December 31, 2012, respectively	65,118	64,861
Deferred commissions	30,617	26,959
Other current assets	17,276	9,049
Total current assets	580,141	286,728
Property and equipment, net	42,957	27,210
Deferred commissions, non-current	6,782	4,784
Goodwill	63,175	35,661
Other intangible assets, net	19,524	12,420
Other assets	10,159	2,972
Total assets	$722,738	$369,775
Liabilities and total equity		
Current liabilities:		
Accounts payable	$5,604	$3,476
Deferred revenue	178,624	154,051
Accrued compensation	20,273	18,806
Accrued expenses	14,987	11,974
Other current liabilities (including note payable to related party of $3,005 and $1,584 as of September 30, 2013 and December 31, 2012, respectively)	16,951	9,948
Total current liabilities	236,439	198,255
Long-term liabilities:		
Convertible 0.25% senior notes, net	251,201	—
Deferred revenue, non-current	10,982	7,365
Other long-term liabilities (including note payable to related party of $9,376 and $401 as of September 30, 2013 and December 31, 2012, respectively)	15,893	5,386
Total long-term liabilities	278,076	12,751
Total liabilities	514,515	211,006
Commitments and contingencies (Note 4)		
Total equity:		
Common stock, par value $0.01, 500,000,000 shares authorized; 74,681,585 and 72,675,265 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	747	727
Additional paid-in capital	636,286	535,853
Accumulated other comprehensive income	150	950
Accumulated deficit	(428,960)	(378,761)
Total equity	208,223	158,769

Total liabilities and total equity	$722,738	$369,775

See accompanying Notes to Condensed Consolidated Financial Statements.

1

Table of Contents

NetSuite Inc.
Condensed Consolidated Statements of Operations and Comprehensive Loss
(dollars and shares in thousands, except per share data)
(unaudited)

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012
Revenue:				
Subscription and support	$239,994	$184,368	$85,795	$65,329
Professional services and other	59,506	39,451	21,080	14,462
Total revenue	299,500	223,819	106,875	79,791
Cost of revenue:				
Subscription and support	40,102	30,722	14,276	10,880
Professional services and other	58,141	38,218	20,916	14,211
Total cost of revenue	98,243	68,940	35,192	25,091
Gross profit	201,257	154,879	71,683	54,700
Operating expenses:				
Product development	55,425	38,311	19,979	13,943
Sales and marketing	153,027	111,731	52,315	38,591
General and administrative	37,407	28,334	12,233	9,458
Total operating expenses	245,859	178,376	84,527	61,992
Operating loss	(44,602)	(23,497)	(12,844)	(7,292)
Other income / (expense), net:				
Interest income	51	127	11	36
Interest expense	(4,924)	(156)	(3,497)	(52)
Other expense, net	(251)	(185)	(69)	(73)
Total other income / (expense), net	(5,124)	(214)	(3,555)	(89)
Loss before income taxes	(49,726)	(23,711)	(16,399)	(7,381)
Provision for income taxes	473	1,896	373	603
Net loss	$(50,199)	$(25,607)	(16,772)	(7,984)
Net loss per common share, basic and diluted	$(0.68)	$(0.36)	$(0.23)	$(0.11)
Weighted average number of shares used in computing net loss per share	73,827	70,288	74,379	71,161
Comprehensive loss:				
Foreign currency translation gains / (loss), net of taxes	(895)	83	33	295
Accumulated pension liability	95	3	31	1
Comprehensive loss	$(50,999)	$(25,521)	$(16,708)	$(7,688)

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

NetSuite Inc.
Condensed Consolidated Statements of Cash Flows
(dollars in thousands)
(unaudited)

	Nine Months Ended September 30, 2013	2012
Cash flows from operating activities:		
Net loss	$(50,199)	$(25,607)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	11,272	8,048
Amortization of other intangible assets	4,761	3,393
Amortization of debt discount and transaction costs	4,179	—
Provision for accounts receivable allowances	625	505
Stock-based compensation	53,597	35,939
Amortization of deferred commissions	39,971	33,269
Excess tax benefit on stock-based compensation	(330)	(259)
Changes in operating assets and liabilities, net of acquired assets and assumed liabilities:		
Accounts receivable	(153)	(9,476)
Deferred commissions	(45,627)	(32,876)
Other current assets	(8,118)	(137)
Other assets	(520)	797
Accounts payable	2,111	3,241
Accrued compensation	1,784	(1,398)
Deferred revenue	28,307	23,842
Other current liabilities	2,426	1,790
Other long-term liabilities	811	(181)
Net cash provided by operating activities	44,897	40,890
Cash flows from investing activities:		
Purchases of property and equipment	(11,581)	(7,730)
Capitalized internal use software	(1,569)	(1,172)
Cash paid in business combination, net of amounts received, and equity investment	(33,907)	(4,227)
Net cash used in investing activities	(47,057)	(13,129)
Cash flows from financing activities:		
Proceeds from issuance of convertible 0.25% senior notes	310,000	—
Payments of issuance costs on convertible 0.25% senior notes	(8,260)	—
Payments under capital leases	(556)	(542)
Payments under capital leases and long-term debt - related party	(1,987)	(1,160)
Payments to repurchase common stock	(30,000)	—
RSUs acquired to settle employee withholding liability	(147)	(191)
Excess tax benefit on stock-based compensation	330	259
Proceeds from issuance of common stock	14,868	10,523
Net cash provided by financing activities	284,248	8,889
Effect of exchange rate changes on cash and cash equivalents	(817)	354
Net change in cash and cash equivalents	281,271	37,004
Cash and cash equivalents at beginning of period	185,859	141,448
Cash and cash equivalents at end of period	$467,130	$178,452

Supplemental cash flow disclosure:		
Cash paid for interest to related parties	$297	$63
Cash paid for interest to other parties	$59	$29
Cash paid for income taxes, net of tax refunds	$908	$924
Noncash financing and investing activities:		
Fixed assets acquired under related party agreement	$11,581	$—

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

NetSuite Inc.
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 1. Organization
NetSuite Inc. (the “Company”) provides cloud-based financials/Enterprise Resource Planning (“ERP”) and omnichannel commerce software suites. In addition to financials/ERP and omnichannel commerce software suites, the Company offers a broad suite of applications, including accounting, Customer Relationship Management (“CRM”), Professional Services Automation (“PSA”) and Ecommerce that enable companies to manage most of their core business operations in its single integrated suite. The Company’s "real-time dashboard" technology provides an easy-to-use view into up-to-date, role-specific business information. The Company also offers customer support and professional services related to implementing and supporting its suite of applications. The Company delivers its suite over the Internet as a subscription service using the software-as-a-service ("SaaS") model. The Company’s headquarters are located in San Mateo, California. The Company conducts its business worldwide, with international locations in Canada, Europe, Asia, South America and Australia.

Note 2. Basis of Presentation

The Condensed Consolidated Financial Statements as of and for the nine and three months ended September 30, 2013 included in this Quarterly Report on Form 10-Q have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). The condensed consolidated balance sheet data as of December 31, 2012 was derived from the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2012 filed on February 28, 2013. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America (“GAAP”) have been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures contained in this Quarterly Report comply with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended, for a Quarterly Report on Form 10-Q and are adequate to make the information presented not misleading. These Condensed Consolidated Financial Statements are meant to be, and should be, read in conjunction with the Consolidated Financial Statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2012 filed on February 28, 2013.

The unaudited Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q reflect all adjustments (which include only normal, recurring adjustments and those items discussed in these Notes) that are, in the opinion of management, necessary to state fairly the financial position and results for the dates and periods presented. The results for such periods are not necessarily indicative of the results to be expected for the full fiscal year.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its majority- and wholly-owned subsidiaries. Intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, as well as reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Recent Accounting Pronouncements

In 2013, the Financial Accounting Standards Board ("FASB") issued new accounting guidance clarifying the accounting for the release of cumulative translation adjustment into net income when a parent either sells a part or all of its investment in a foreign entity or no longer holds a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business within a foreign entity. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2013. The Company does not anticipate that this adoption will have a significant impact on its financial position, results of operations or cash flows.

Table of Contents

In 2013, FASB issued new accounting guidance clarifying the accounting for obligations resulting from joint and several liability arrangements for which the total amount under the arrangement is fixed at the reporting date. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2013. The Company does not anticipate that this adoption will have a significant impact on its financial position, results of operations or cash flows.

Revenue Recognition

The Company generates revenue from two sources: (1) subscription and support; and (2) professional services and other. Subscription and support revenue includes subscription fees from customers accessing its on-demand application suite and support fees from customers purchasing support. Arrangements with customers do not provide the customer with the right to take possession of the software supporting the on-demand application service at any time. Professional services and other revenue includes fees generated from training and consulting services such as business process mapping, configuration, data migration and integration. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met. For the most part, subscription and support agreements are entered into for 12 to 36 months. In aggregate, more than 90% of the professional services component of the arrangements with customers is performed within 300 days of entering into a contract with the customer.

The subscription agreements provide service level commitments of 99.5% uptime per period, excluding scheduled maintenance. The failure to meet this level of service availability may require the Company to credit qualifying customers up to the value of an entire month of their subscription and support fees. In light of the Company’s historical experience with meeting its service level commitments, the Company has not accrued any liabilities on its balance sheet for these commitments.

The Company commences revenue recognition when all of the following conditions are met:
- There is persuasive evidence of an arrangement;
- The service is being provided to the customer;
- The collection of the fees is reasonably assured; and
- The amount of fees to be paid by the customer is fixed or determinable.

In most instances, revenue from new customer acquisition is generated under sales agreements with multiple elements, comprised of subscription and support fees from customers accessing the Company's on-demand application suite and professional services associated with consultation services. The Company evaluates each element in a multiple-element arrangement to determine whether it represents a separate unit of accounting. An element constitutes a separate unit of accounting when the delivered item has standalone value and delivery of the undelivered element is probable and within the Company’s control. Subscription and support have standalone value because they are routinely sold separately by the Company. Professional services have standalone value because the Company has sold professional services separately and there are several third-party vendors that routinely provide similar professional services to its customers on a standalone basis.

The Company allocates revenue to each element in an arrangement based on a selling price hierarchy. The selling price for a deliverable is based on its vendor-specific objective evidence (“VSOE”), if available, third-party evidence (“TPE”), if VSOE is not available, or estimated selling price (“ESP”), if neither VSOE nor TPE is available. As the Company has been unable to establish VSOE or TPE for the elements of its arrangements, the Company establishes the ESP for each element primarily by considering the weighted average of actual sales prices of professional services sold on a standalone basis and subscription and support including various add-on modules when sold together without professional services, and other factors such as gross margin objectives, pricing practices and growth strategy. The consideration allocated to subscription and support is recognized as revenue over the contract period commencing when the subscription service is made available to the customer. The consideration allocated to professional services is recognized as revenue using the proportional performance method.

The total arrangement fee for a multiple element arrangement is allocated based on the relative ESP of each element. However, since the professional services are generally completed prior to completion of delivery of subscription and support services, the revenue recognized for professional services in a given reporting period does not include fees subject to delivery of subscription and support services. This results in the recognition of revenue for professional services that is generally no greater than the contractual fees for those professional services.

For single element sales agreements, subscription and support revenue is recognized ratably over the contract term beginning on the provisioning date of the contract. The Company recognizes professional services revenue using the proportional performance method for single element arrangements.

Table of Contents

Sales and other taxes collected from customers to be remitted to government authorities are excluded from revenues.

Concentration of Credit Risk and Significant Customers

Financial instruments potentially exposing the Company to concentration of credit risk consist primarily of cash and cash equivalents, restricted cash and trade accounts receivable. The Company maintains an allowance for doubtful accounts receivable balances. The allowance is based upon historical loss patterns and an evaluation of the potential risk of loss associated with problem accounts. The Company generally charges off the receivable balances of uncollectible accounts when accounts are 120 days past-due based on the account’s contractual terms. Credit risk arising from accounts receivable is mitigated due to the large number of customers comprising the Company’s customer base and their dispersion across various industries. As of September 30, 2013 and December 31, 2012, there were no customers that represented more than 10% of the net accounts receivable balance. There were no customers that individually exceeded 10% of the Company’s revenue in any of the periods presented. As of September 30, 2013 and December 31, 2012, long-lived assets located outside the United States were not significant.

Revenue by geographic region, based on the billing address of the customer, was as follows for the periods presented:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012
	(dollars in thousands)			
United States	$223,246	$164,609	$79,544	$58,668
International	76,254	59,210	27,331	21,123
Total revenue	$299,500	$223,819	$106,875	$79,791
Percentage of revenue generated outside of the United States	25 %	26 %	26 %	26 %

No single country outside the United States represented more than 10% of revenue during the nine and three months ended September 30, 2013 or 2012.

The Company maintains cash balances at several banks. Accounts located in the United States are insured by the Federal Deposit Insurance Corporation (“FDIC”), up to $250,000. Certain operating cash accounts may exceed the FDIC limits.

Intellectual Property Rights Indemnification

The Company’s arrangements include provisions indemnifying customers against liabilities if the Company's products infringe a third-party’s intellectual property rights. The Company has not incurred any costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in the accompanying condensed consolidated financial statements.

Qualified Operating Expense Reimbursements

At the Company's product development facility in the Czech Republic, the Company participates in a government subsidy program for employing local residents. Under the program, the Czech government will reimburse the Company for certain operating expenses it incurs. In the period the Company incurs the reimbursable operating expense, it records a reduction in product development expense and a receivable from the Czech government. During the nine and three months ended September 30, 2013, the Company's product development operating expenses were reduced by approximately by $1.9 million and $659,000, respectively, for reimbursement of eligible operating expenses incurred during the period from January 1, 2013 to September 30, 2013. In the first quarter of 2012, the

Company determined that the Czech government receivables were collectible and began to reduce operating expenses. During the nine and three months ended September 30, 2012, the Company's product development operating expenses were reduced by approximately by $1.4 million and $421,000, respectively, for reimbursements of eligible operating expenses incurred during the period from November 2010 to September 30, 2012. During the nine and three months ended September 30, 2013, the Company received $1.3 million and $679,000, respectively, from the Czech Republic government. During the nine months and three months ended September 30, 2012, the Company received $652,000 and $353,000, respectively, in payments from the Czech Republic government. As of September 30, 2013, $1.5 million in reimbursements, adjusted for foreign currency valuations, are due the Company and included in other current assets. The Company accrues for the reimbursements as the eligible operating expenses are incurred.

Table of Contents

Business Combination

On May 3, 2013, the Company completed the purchase of all the outstanding equity of Order Motion ("OM"). OM provides online eCommerce Order Management Services (“OMS”) that performs the back-end process for eCommerce web stores. The OM product augments the Company's existing product offering, which allows the Company to expand its business capabilities in Ecommerce technology and services. The assets and operating results of OM are reflected in the Company’s condensed consolidated financial statements from the date of acquisition. On the closing date, the Company paid the former owners $23.5 million in cash. Additional consideration of $3.5 million in cash is being withheld up to the next 15 months following the close of the transaction as indemnification against certain losses the Company may incur in the event of certain breaches of representations and warranties covered in the purchase agreement. The Company also withheld $1.1 million as indemnification against losses the Company may incur from certain tax related matters of OM. This consideration is restricted until the Company determines that the matters have been properly settled. During the second quarter of 2013, the Company recorded $311,000 in employee termination costs and $1.1 million in operating expenses related to transaction costs associated with this business combination.

Under the acquisition method of accounting, the Company allocated the purchase price to the identifiable assets and liabilities based on their estimated fair value at the date of acquisition. To determine the value of the intangible assets, the Company made various estimates and assumptions. Methodologies used in valuing the intangible assets include, but are not limited to, the with-and-without excess earnings for customer relationships, relief of royalty for trademarks and multiple period excess earnings method for developed technology. The excess of the purchase price over the total net identifiable assets has been recorded as goodwill which includes synergies expected from the expanded service capabilities and the value of the assembled work force in accordance with generally accepted accounting principles. The Company did not record any in-process research and development charges in connection with the acquisition.

The allocation of the OM consideration to the assets acquired and obligations assumed was as follows:

	(dollars in thousands)
Cash	$1,069
Accounts receivable	804
Developed technology	5,100
Customer relationships	3,000
Trademarks	400
Goodwill	18,176
Other assets / liabilities, net	(433)
Total purchase price	$28,116

The Company will amortize the intangible assets on a straight-line basis over the following periods: developed technology, four years, customer relationships, four years and trademarks, two years. The Company is also undertaking an analysis of certain tax matters associated with the OM acquisition which could result in an adjustment to the acquisition price allocation. The allocation of the consideration may be adjusted upon settlement of these matters. Comparative pro forma financial information for this acquisition has not been presented because OM is not material to the Company's consolidated results of operations.

On March 6, 2013, the Company completed the purchase of all the outstanding equity of a website hosting provider company ("WH") that specializes in Ecommerce technology and services. The WH workforce augments the Company's existing product development teams, which allows the Company to expand its business capabilities in Ecommerce technology and services. The assets and operating results of the WH are reflected in the Company’s condensed consolidated financial statements from the date of acquisition. On the closing date, the Company paid $10.2 million in cash. Additional consideration of $1.8 million in cash is being withheld for various periods up to the next 24 months following the close of the transaction as indemnification against certain losses the Company may incur in the event of certain breaches of representations and warranties covered in the purchase agreement. During the first quarter of 2013, the Company recorded $560,000 in operating expenses related to transaction costs associated with this business combination.

Table of Contents

Under the acquisition method of accounting, the Company allocated the purchase price to the identifiable assets and liabilities based on their estimated fair value at the date of acquisition. To determine the value of the intangible assets, the Company made various estimates and assumptions. Methodologies used in valuing the intangible assets include, but are not limited to, the expected costs to recreate the assets, present value of future payments, relief of royalty and multiple period excess earnings. The excess of the purchase price over the total identifiable assets has been recorded as goodwill which includes synergies expected from the expanded service capabilities and the value of the assembled work force in accordance with generally accepted accounting principles. Additionally, the Company recognized $1.1 million in federal and $204,000 in state deferred tax liabilities related to the acquired identifiable intangible assets which resulted in a $1.1 million decrease in the Company's income tax expense in the first quarter of 2013. The Company did not record any in-process research and development charges in connection with the acquisition.

The allocation of the WH consideration to the assets acquired and obligations assumed was as follows:

	(dollars in thousands)	
Developed technology	$1,100	
Customer relationships	2,100	
Trademarks	200	
Goodwill	9,721	
Other assets / liabilities, net	189	
Deferred income tax liabilities	(1,322	)
Total purchase price	$11,988	

The Company will amortize the intangible assets on a straight-line basis over the following periods: trademarks, two years; customer relationships, four years and developed technology, three years. Comparative pro forma financial information for this acquisition has not been presented because WH is not material to the Company's consolidated results of operations.

The following table details the Company's goodwill activity during the nine months ended September 30, 2013:

	(dollars in thousands)	
Beginning balance as of January 1, 2013	$35,661	
Acquisition of WH in March 2013	9,721	
Acquisition of OM in May 2013	18,176	
Foreign currency adjustment	(383	)
Ending balance as of September 30, 2013	$63,175	

The Company does not have a history of goodwill impairments.

Accumulated Other Comprehensive Income

Accumulated other comprehensive income is comprised of foreign currency translation gains and losses, net of tax, and an accumulated pension liability for employees located in the Philippines. There were no significant reclassification adjustments out of accumulated other comprehensive income to the condensed consolidated statement of operations and comprehensive loss.

Note 3. Financial Instruments

Fair Value Measurements

The Company measures certain financial assets at fair value on a recurring basis based on a fair value hierarchy that requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of inputs that may be used to measure fair value are:

• Level 1 - Quoted prices in active markets for identical assets or liabilities.

Table of Contents

- Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 - Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

The fair value of the Company’s investments in certain money market funds approximates their face value. Such instruments are classified as Level 1 and are included in cash and cash equivalents.

The fair value of the Company’s foreign currency forward contracts is based on foreign currency rates quoted by banks or foreign currency dealers and other public data sources. Such instruments are classified as Level 2 and are included in other current assets and liabilities.

As of September 30, 2013, financial assets stated at fair value on a recurring basis were comprised of money market funds included within cash and cash equivalents and foreign exchange forward contracts included within other current assets and liabilities. The fair value of these financial assets was determined using the following inputs as of September 30, 2013 and December 31, 2012:

	September 30, 2013				December 31, 2012			
	Fair value measurements at reporting date using				Fair value measurements at reporting date using			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
	(in thousands)				(in thousands)			
Assets:								
Money market funds	$72,514	$—	$—	$72,514	$72,467	$—	$—	$72,467
Foreign exchange contracts	—	20	$—	20	$—	$97	$—	97
Total	$72,514	$20	$—	$72,534	$72,467	$97	$—	$72,564
Liabilities:								
Foreign exchange contracts	$—	$463	$—	$463	$—	$231	$—	$231
Total	$—	$463	$—	$463	$—	$231	$—	$231

Restricted Cash

As of September 30, 2013, restricted cash consisted of $715,000 in long-term other assets. As of December 31, 2012, restricted cash was $541,000. Of the $541,000 restricted cash balance as of December 31, 2012, $266,000 is classified as other current assets and $275,000 is classified as long-term other assets. These restricted cash accounts secure letters of credit applied against certain of the Company’s facility lease agreements.

Balance Sheet Hedging - Hedging of Foreign Currency Assets and Liabilities

During the nine months ended September 30, 2013, the Company hedged certain of its nonfunctional currency denominated assets and liabilities to reduce the risk that earnings would be adversely affected by changes in exchange rates. Gains and losses from these forward contracts are recorded each period as a component of other income / (expense) in the consolidated statements of operations. The notional amount of derivative instruments acquired during the period was $142.4 million. The Company accounts for derivative instruments as other current assets and liabilities on the balance sheet and measures them at fair value with changes in the fair value recorded as other income / (expense). These derivative instruments do not subject the Company to material balance sheet risk due to exchange rate movements because gains and losses on these derivatives are intended to offset gains and losses on the assets and liabilities being economically hedged.

Table of Contents

As of September 30, 2013 and December 31, 2012, the Company had the following outstanding foreign exchange forward contracts:

	September 30, 2013		December 31, 2012	
	Notional Value Sold	Notional Value Purchased	Notional Value Sold	Notional Value Purchased
	(US dollars in thousands)		(US dollars in thousands)	
British pound	$6,577	$4,301	$7,188	$3,435
Australian dollar	8,556	5,156	9,360	4,793
Philippines peso	5,440	5,440	4,085	4,085
Euro	1,214	527	883	256
Canadian dollar	983	1,279	531	515
Japanese yen	1,895	—	1,260	—
Czech crown	4,150	2,580	3,440	1,895
Mexican peso	161	—	161	—
New Zealand dollar	272	—	73	—
Total	$29,248	$19,283	$26,981	$14,979

The fair value of the derivative instruments reported on the Company’s Condensed Consolidated Balance Sheet were as follows:

	Asset Derivatives			Liability Derivatives		
Derivatives and forward contracts	Balance Sheet Location	September 30, 2013 Fair Value	December 31, 2012 Fair Value	Balance Sheet Location	September 30, 2013 Fair Value	December 31, 2012 Fair Value
	(in thousands)			(in thousands)		
Foreign exchange contracts	Other current assets	$20	97	Other current liabilities	$463	$231
Total		$20	97		$463	$231

The effect of derivative instruments on the Statement of Operations and Comprehensive Loss was as follows for the periods presented:

		Amount of net gain (loss) recognized in income on derivatives during the			
		Nine Months Ended September 30,		Three Months Ended September 30,	
Derivatives and forward contracts	Location of net gain (loss) recognized in income on derivatives	2013	2012	2013	2012
		(in thousands)			
Foreign exchange contracts	Other income/ (expense), net	$784	$56	$(353)	$(361)
Total		$784	$56	$(353)	$(361)

The Company has entered into all of its foreign exchange contracts with a single counterparty. During the periods such contracts are open, the Company is subject to a potential maximum amount of loss due to credit risk equal to the gross fair value of the derivative instrument, if the counterparty to the instruments failed completely to perform according to the terms of the contracts. Generally, the Company has the right of offset for gains earned and losses incurred under these agreements. The agreements with the counterparty do not require either party to provide collateral to mitigate the credit risk of the agreements.

Table of Contents

Note 4. Commitments and Contingencies

The Company is involved in various legal proceedings and receives claims from time to time, arising from the normal course of business activities. The Company has accrued for estimated losses in the accompanying condensed consolidated financial statements for matters with respect to which it believes the likelihood of an adverse outcome is probable and the amount of the loss is reasonably estimable.

During the third quarter of 2013, the Company entered into a consulting agreement with a business consulting firm. The consulting firm will provide various services to assist the Company with growing our business. The agreement is non-cancellable through August 31, 2014 and the Company will pay approximately $5.2 million through this date. The agreement is cancellable at any time after the first 12 months, subject to a small termination fee.

During the nine months ended September 30, 2013, the Company entered into various office space leases to expand its operations in San Mateo, CA and other locations within the United states and Australia. The corresponding lease term for these agreements expire at various dates through 2020. The Company will pay a total of $12.6 million, net of any lessor lease incentives, over the corresponding lease terms.

Note 5. Stock-based Compensation

During the first quarter of 2012, the Company awarded certain executives and other key employees a total of 170,875 performance shares (“PS”) related to 2013. In the first quarter of 2013, the Company's Board of Directors ("BoD") set the performance metrics for these PS. The PS vesting is contingent upon the Company meeting certain company-wide revenue performance goals (performance-based) in 2013. These shares are subject to term vesting conditions. The PS fair value of $75.18 per share and the related stock-based compensation expense are determined based on the value of the underlying shares on the date of grant, which is in the first quarter of 2013 when the performance metrics were set by the BoD, and is recognized over the vesting term. During the interim financial periods, management estimates the probable number of PS that will be granted until the achievement of the performance goals is known at year end December 31, 2013.

Table of Contents

Note 6. Debt

0.25% Convertible Senior Notes

In June 2013, the Company issued at par value $310.0 million of 0.25% convertible senior notes due June 1, 2018 (the “Notes”). Interest is payable semi-annually in arrears on December 1 and June 1 of each year, commencing December 1, 2013.

The Notes are governed by an indenture dated as of June 4, 2013, between the Company, as issuer, and Wells Fargo Bank, National Association, as trustee. The Notes do not contain any financial covenants or any restrictions on the payment of dividends, the incurrence of senior debt or other indebtedness, or the issuance or repurchase of securities by the Company. The Notes are unsecured and rank senior in right of payment to the Company's future indebtedness that is expressly subordinated in right of payment to the Notes, rank equal in right of payment to the Company's existing and future unsecured indebtedness that is not so subordinated. The Notes are effectively subordinated in right of payment to any of the Company's secured indebtedness to the extent of the value of the assets securing such indebtedness and are structurally subordinated to all existing and future indebtedness, liabilities incurred by our subsidiaries including trade payables, and preferred stock of the Company.

Upon conversion, the Company may choose to pay or deliver, as the case may be, either cash, shares of the Company's common stock or a combination of cash and shares of the Company's common stock. If converted, holders will receive, at the Company's election, cash and/or shares of the Company's common stock for the principal amount of the Notes and any amounts in excess of the principal amounts. The Company intends to settle the principal amount of the Notes with cash if converted.

The initial conversion rate is 8.6133 shares of the Company's common stock per $1,000 principal amount of Notes, subject to anti-dilution adjustments. The initial conversion price is approximately $116.10 per share of the Company's common stock and represents a conversion premium of approximately 35% based on the last reported sale price of the Company's common stock of $86.00 on May 29, 2013, the date the Notes offering was priced. The conversion rate is subject to adjustment from time to time upon the occurrence of certain events, including, but not limited to, the issuance of stock dividends and payment of cash dividends. Holders of the Notes will not receive any cash payment representing accrued and unpaid interest upon conversion of a Note unless the conversion date occurs after a regular record date related to the Notes and prior to the related interest payment date. At any time prior to the close of business on the business day immediately preceding March 1, 2018, holders may convert their Notes at their option only under the following circumstances:

- during any calendar quarter commencing after the calendar quarter ending on September 30, 2013 (and only during such calendar quarter), if the last reported sale price of the common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day;

- during the five business day period after any five consecutive trading day period (the “measurement period”) in which the trading price per $1,000 principal amount of Notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of the Company's common stock and the conversion rate on each such trading day; or

- upon the occurrence of certain corporate transactions described in the indenture governing the Notes.

On and after March 1, 2018 until the close of business on the business day immediately preceding the maturity date, holders may convert their Notes at any time, regardless of the foregoing circumstances. If a make-whole fundamental change (as defined in the Indenture governing the Notes) occurs when the Company's stock price is between $86.00 and $275.00 per share and a holder elects to convert its Notes in connection with such make-whole fundamental change, such holder may be entitled to an increase in the conversion rate as provided for in the Indenture governing the Notes.

As of September 30, 2013, circumstances that would give rise to a conversion option for the holders of Notes do not exist.

Holders of the Notes have the right to require the Company to purchase with cash all or a portion of the Notes upon the occurrence of any event that constitutes a fundamental change (as defined in the Indenture governing the Notes) at a purchase price equal to 100% of the principal amount of the Notes plus accrued and unpaid interest.

Table of Contents

In accounting for the issuance of the Notes, the Company separated the Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the par value of the Notes as a whole. The excess of the principal amount of the liability component over its carrying amount ("debt discount") is amortized to interest expense using the effective interest method over the term of the Note. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

In accounting for the $8.4 million in transaction costs related to the Note issuance, the Company allocated the total amount incurred to the liability and equity components based on their relative values. The $6.7 million in transaction costs attributable to the liability component included in other assets are being amortized to interest expense over the term of the Notes, and the $1.7 million in transaction costs attributable to the equity component were netted with the equity component in additional paid-in capital. Debt issuance costs, net of amortization, were $6.2 million as of September 30, 2013. The Notes consisted of the following as of September 30, 2013:

	(in thousands)
Equity component (1)	$60,931
Liability component :	
Principal	310,000
Less: debt discount, net	(58,799)
Net carrying amount	$251,201
Fair value - level 2	$354,206

(1) Included in the consolidated balance sheets within additional paid-in capital, net of the $1.7 million in equity issuance costs.

The Notes are carried at face value less any unamortized debt discount and also require disclosure of an estimate of fair value. The Company considers the fair value of the Notes at each balance sheet date to be a level 2 measurement because it is determined based on a recent quoted market price or dealer quote for the Notes. The Notes quoted market price or dealer quote is based on the trading price of the Company's common stock and market activity that is less than an active exchange.

As of September 30, 2013, the remaining life of the Notes is approximately 4.75 years.

The following table sets forth total interest expense recognized related to the Notes during the nine and three months ended September 30, 2013:

	Nine Months Ended September 30, 2013 (in thousands)	Three Months Ended September 30, 2013
Contractual interest expense	$258	$194
Amortization of debt issuance costs	396	286
Amortization of debt discount	3,783	2,837
Total	$4,437	$3,317
Effective interest rate	5.4%	

In connection with issuing at par value $310.0 million of 0.25% convertible senior notes due June 1, 2018, our Board of Directors approved the use of $30.0 million of the net proceeds to repurchase 348,837 shares of our common stock for $30.0 million or $86.00 per share. The Company has since retired these shares.

13

Table of Contents

Note 7. Income Taxes

The Company has incurred annual operating losses since inception. As a result of those continuing losses, management has determined insufficient evidence exists to support that it is more likely than not that the Company will realize the benefits of its U.S. net deferred tax assets and therefore has recorded a valuation allowance to reduce the net carrying value of these deferred tax assets to zero. Accordingly, the Company has not recorded a provision for income taxes for any of the periods presented other than provisions for state and foreign income taxes.

During the nine months ended September 30, 2013, the Company recorded approximately $1.1 million of additional net deferred tax liabilities related to the WH acquisition. These additional deferred tax liabilities create a new source of taxable income, thereby requiring us to release a portion of our deferred tax asset valuation allowance with a related reduction in income tax expense for the nine months ended September 30, 2013 of approximately $1.1 million. Additionally, the Company recorded $204,000 in state deferred tax liabilities related to the WH acquisition that did not affect the Company's income tax expense for the nine months ended September 30, 2013.

As of September 30, 2013, the Company had net deferred tax assets in certain foreign jurisdictions of $406,000 included primarily in other assets. Based on all available evidence, both positive and negative, management believes that it is more likely than not that the benefits of those foreign deferred tax assets will be realized in full. The Company also had deferred tax assets of $4.3 million for Japan where it had a full valuation allowance as of September 30, 2013, reducing its carrying value to zero.

The Company does not anticipate a material change in the total amount or composition of its unrecognized tax benefits within 12 months of the reporting date.
The Company files federal, state and foreign income tax returns in jurisdictions with varying statutes of limitations. Due to the carry forward of net operating losses, the Company's income tax returns generally remain subject to examination by federal and most state tax authorities. In most of the Company's significant foreign jurisdictions, the 2007 through 2012 tax years remain subject to examination by their respective tax authorities.

Note 8. Net Loss Per Share of Common Stock

Basic net loss per common share is computed by dividing net loss by the weighted-average number of shares of common stock outstanding during the period. Diluted net loss per share of common stock is computed by giving effect to all potential dilutive shares of common stock, including options, restricted stock units ("RSUs"), performance share units ("PSUs"), performance shares ("PS") and convertible debt shares. Basic and diluted net loss per share of common stock were the same for all periods presented as the impact of all potentially dilutive securities outstanding was anti-dilutive.

The following table presents the calculation of the numerator and denominator used in the basic and diluted net loss per share of common stock:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012
	(dollars and shares in thousands, except per share amounts)			
Numerator:				
Net loss	$(50,199)	$(25,607)	$(16,772)	$(7,984)
Denominator:				

Weighted-average number of shares of common stock outstanding used in computing basic and diluted net loss per share of common stock	73,827	70,288	74,379	71,161
Net loss per share of common stock, basic and diluted	$(0.68)	$(0.36)	$(0.23)	$(0.11)

14

Table of Contents

The Company's unvested RSUs, PSUs and PS do not contain non-forfeitable rights to dividends and dividend equivalents. As such, unvested RSUs, PSUs and PS are not participating securities and the Company is not required to use the two-class method to calculate diluted earnings per share in periods when the Company has net income.

The following table presents the weighted average potential shares that are excluded from the computation of diluted net loss per common share for the periods presented because including them would have had an anti dilutive effect:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012
	(Shares in thousands)			
Options to purchase shares of common stock	2,276	3,795	2,072	3,415
Unvested RSUs, PSUs and PS awards	3,120	3,796	3,031	3,623
Total	5,396	7,591	5,103	7,038

The effect of the convertible Notes is reflected in diluted earnings per share by application of the treasury stock method as the Company intends to settle the principal amount of the Note in cash upon conversion. During the nine and three months ended September 30, 2013, the Company's weighted average common stock price was below the Notes conversion price for the periods during which the Notes were outstanding.

Note 9. Related Party Transactions

On February 28, 2013, the Company entered into the third amendment to the perpetual software license agreement with Oracle USA ("Amendment"). The Amendment provides for a 48 month extension to the May 2010 second amendment to the Oracle unlimited license agreement. The Amendment provides that the Company will pay a one-time fee of $13.1 million to extend the term for unlimited licenses from May 31, 2014 to May 31, 2018. The Amendment also provides for technical support services. The Company will pay $2.4 million for the support services from February 28, 2013 to February 27, 2014. The Company may renew support services for four subsequent annual periods for a fee of $4.3 million per year. The support services to be provided to the Company by Oracle automatically renew unless the Company provides written notice of cancellation at least 60 days prior to the support renewal date. The Company financed the license fees due under the Amendment pursuant to a note issued to Oracle Credit Corporation. The note bears interest at a rate of 2.00% per annum with payments scheduled over the term of the amendment. The Company discounted the note at a rate of 4.5% because it approximates the interest rate the Company would obtain on the open market. The $12.4 million discounted note value was recorded as an asset addition to property and equipment that will be depreciated over seven years.

Future debt payments under notes payable (including $807,000 in payments related to the May 10, 2010 second amendment) as of September 30, 2013 are as follows:

	(dollars in thousands)
Years ending:	
Remainder of 2013	$760
2014	3,522
2015	3,119
2016	3,119
2017	3,119
Future debt payments	13,639
Amount representing interest	1,258
Present value of future debt payments	$12,381

Table of Contents

The following table details payments to Oracle USA and Oracle Credit Corporation:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012
	(dollars in thousands)			
License fee	$1,987	$1,200	621	$389
Support	1,787	1,800	593	589
Interest	297	64	139	24
Total paid	$4,071	$3,064	$1,353	$1,002

The Company has entered into various software license agreements with RightNow Technologies. In October 2011, RightNow Technologies was acquired by Oracle Corporation. During the nine and three months ended September 30, 2013, the Company purchased $411,000 and $319,000, respectively, in services from RightNow Technologies. During the nine months ended September 30, 2013 and 2012, the Company received payments totaling $123,000 and $112,000, respectively, from RightNow Technologies for services it performed. During nine months ended September 30, 2013 and 2012, the Company paid RightNow Technologies $239,000 and $214,000, respectively, for services it received or expects to receive.

In addition to the companies affiliated with Lawrence J. Ellison, the Company enters into sales and purchases agreements with various companies that have a relationship with the Company's executive officers or members of the Company's board of directors. The relationships are typically an equity investment by the executive officer or board member in the customer / vendor company or the Company's executive officer or board member is a member of the customer / vendor company's board of directors. The Company has renewed the license agreements and sold additional services to these customers or purchased services from these vendors at various points in time. Below is a summary of transactions between the Company and related parties other than Mr. Ellison:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012
	(dollars in thousands)			
Revenue earned from related party	$1,692	$1,714	$727	$549
Fees NetSuite paid for services	$591	$539	$194	$457

Additional related party transactions entered into prior to December 31, 2012 are described in the Notes to Consolidated Financial Statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2012 filed on February 28, 2013.

Table of Contents

ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis is intended to provide greater details of our results of operations and financial condition and should be read in conjunction with our condensed consolidated financial statements and the notes thereto included elsewhere in this document and the discussion contained in our Annual Report on Form 10-K for the year ended December 31, 2012 as filed with the SEC on February 28, 2013. Certain statements in this Quarterly Report constitute forward-looking statements and as such, involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues or other financial items; any statements of the plans, strategies and objectives of management for future operations; factors that may affect our operating results; statements concerning new products or services; statements related to adding employees; statements related to future capital expenditures; statements related to future economic conditions or performance; statements related to the integration of acquired companies; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as “anticipate,” “believe,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” or “will,” and similar expressions or variations. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to those discussed in the section titled “Risk Factors” included in Item 1A of Part II of this Quarterly Report on Form 10-Q, and the risks discussed in our other SEC filings.

We urge you to consider these factors carefully in evaluating the forward-looking statements contained in this Quarterly Report on Form 10-Q. These statements are based on the beliefs and assumptions of our management based on information currently available to management. The forward-looking statements included in this Quarterly Report are made only as of the date of this Quarterly Report. All subsequent written or oral forward-looking statements attributable to our company or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. We do not undertake, and specifically disclaim, any obligation to update any forward-looking statements to reflect the occurrence of events or circumstances after the date of such statements except as required by law.

Overview

NetSuite Inc. ("NetSuite" or the "Company" is the industry's leading provider of cloud-based financials / Enterprise Resource Planning (“ERP”) and omnichannel commerce software suites. In addition to financials/ERP and omnichannel commerce software suites, we offer a broad suite of applications, including accounting, Customer Relationship Management (“CRM”), Professional Services Automation (“PSA”) and Ecommerce that enable companies to manage most of their core business operations in our single integrated suite. Our "real-time dashboard" technology provides an easy-to-use view into up-to-date, role-specific business information. We also offer customer support and professional services related to implementing and supporting our suite of applications. We deliver our suite over the Internet as a subscription service using the software-as-a-service ("SaaS") model.

In 1999, we released our first application, NetLedger, focused on accounting applications. We then released Ecommerce functionality in 2000 and CRM and sales force automation functionality in 2001. In 2002, we released our next generation suite under the name NetSuite and we have regularly added features and functionality. In 2008, we acquired OpenAir and in 2009 we acquired QuickArrow, both of which offer professional services automation and project portfolio management products.

Our headquarters are located in San Mateo, California. We were incorporated in California in September 1998 and reincorporated in Delaware in November 2007. We conduct our business worldwide, with international locations in Canada, Europe, Asia, South America and Australia.

In June 2013, we issued at par value $310.0 million of 0.25% convertible senior notes due June 1, 2018 (the “Notes”). Interest is payable semi-annually in arrears on December 1 and June 1 of each year, commencing December 1, 2013.

The initial conversion rate is 8.6133 shares of our common stock per $1,000 principal amount of Notes, subject to anti-dilution adjustments. The initial conversion price is approximately $116.10 per share of our common stock and represents a conversion premium of approximately 35% based on the last reported sale price of our common stock of $86.00 on May 29, 2013, the date the Notes offering was priced.

In connection with issuing the Notes, our Board of Directors approved the use of $30.0 million of the Note proceeds to repurchase 348,837 shares of our common stock for $86.00 per share. We have since repurchased and retired these shares. We intend to use the remaining net proceeds from the offering for working capital and other general corporate purposes, including to fund possible acquisitions of, or investments in, complementary businesses, products, services, technologies and capital expenditures.

On May 3, 2013, we completed the purchase of all the outstanding equity of Order Motion ("OM"). OM provides online eCommerce Order Management Services that performs the back-end process for eCommerce web stores. The OM product augments our existing product offering which allows us to expand our business capabilities in Ecommerce technology

Table of Contents

and services. The assets and operating results of the OM are reflected in our condensed consolidated financial statements from the date of acquisition. On the closing date, we paid the former owners $23.5 million in cash. Additional consideration of $3.5 million in cash is being withheld up to the next 15 months following the close of the transaction as indemnification against certain losses we may incur in the event of certain breaches of representations and warranties covered in the purchase agreement. We also withheld $1.1 million as indemnification against losses the Company may incur from certain tax related matters of OM. This consideration is restricted until we determine that the matters have been properly settled. During the second quarter of 2013, we recorded $311,000 in employee termination costs and $1.1 million in operating expenses related to transaction costs associated with this business combination.

On February 28, 2013, we entered into the third amendment to the perpetual software license agreement with Oracle USA ("Amendment"). The Amendment provides for a 48 month extension to the May 2010 second amendment to the Oracle unlimited license agreement. The Amendment provides that we will pay a one-time fee of $13.1 million to extend the term for unlimited licenses from May 31, 2014 to May 31, 2018. The Amendment also provides for technical support services. We will pay $2.4 million for the support services from February 28, 2013 to February 27, 2014. We may renew Oracle support services for four subsequent annual periods for a fee of $4.3 million per year. The support services to be provided us by Oracle automatically renew unless we provide written notice of cancellation at least 60 days prior to the support renewal date. We financed the fees due under the Amendment pursuant to a note issued to Oracle Credit Corporation. The note bears interest at a rate of 2% per annum with payments scheduled over the term of the Amendment.

In March 2013, we completed the purchase of all the outstanding equity of a website hosting provider company ("WH") that specializes in Ecommerce technology and services. The WH workforce augments our existing product development teams which allows us to expand our business capabilities in Ecommerce technology and services. The assets and operating results of the WH are reflected in our condensed consolidated financial statements from the date of acquisition. On the closing date, we paid $10.2 million in cash. Additional consideration of $1.8 million in cash is being withheld for various periods up to the next 24 months following the close of the transaction as indemnification against certain losses we may incur in the event of certain breaches of representations and warranties covered in the purchase agreement. During the first quarter of 2013, we recorded $560,000 in operating expenses related to transaction costs associated with this business combination.

Key Components of Our Results of Operations

Revenue

We generate sales directly through our sales team and, to a lesser extent, indirectly through channel partners. We sell our service to customers across a broad spectrum of industries, and we have tailored our service for wholesalers/distributors, manufacturers, e-tailers, services companies and software companies. The primary target customers for our service are medium-sized businesses and divisions of large companies. An increasing percentage of our customers and our revenue have been derived from larger businesses within this market. For the nine and three months ended September 30, 2013, we did not have any single customer that accounted for more than 3% of our revenue.

We are pursuing a number of strategies that we believe will enable us to continue to grow. The goals of those strategic objectives are to continue to move up market; to increase use of NetSuite as a platform; and to extend the verticalization of our product line. Although we have made progress towards our goals in recent periods, there are still many areas where we believe that we can continue to grow. To achieve these goals, we are focused on the following initiatives:

- Growth of sales of OneWorld, our platform for ERP, CRM and Ecommerce capabilities in multi-currency environments across multiple subsidiaries and legal entities, which supports the needs of large, standalone companies, and divisions of very large enterprises;

- Strengthening our offerings for targeted industries such as wholesale/distribution, manufacturing, e-tail, retail, technology and professional services by adding deeper verticalized functionality; and
- Developing our SuiteCloud ecosystem to enable third parties to extend our offerings with their vertical expertise or horizontal solution.

We experience competitive pricing pressure when our products are compared with solutions that address a narrower range of customer needs or are not fully integrated (for example, when compared with Ecommerce or CRM stand-alone solutions). In addition, since we sell primarily to medium-sized businesses, we also face pricing pressure in terms of the more limited financial resources or budgetary constraints of many of our target customers. We do not currently experience significant pricing pressure from competitors that offer a similar on-demand, integrated business management suite.

We sell our application suite pursuant to subscription agreements. For the most part, the duration of subscription and support agreements is 12 to 36 months. We rely in part on a large percentage of our customers to renew their agreements to drive our revenue growth. Our customers have no obligation to renew their subscriptions after the expiration of their subscription period.

We generally invoice our customers in advance in monthly, annual or quarterly installments, and typical payment terms provide that our clients pay us within 30 to 60 days of invoice. Amounts that have been invoiced where the customer has

Table of Contents

a legal obligation to pay are recorded in accounts receivable and deferred revenue. As of September 30, 2013, we had deferred revenue of $189.6 million.

Our subscription agreements provide service level commitments of 99.5% uptime per period, excluding scheduled maintenance. The failure to meet this level of service availability may require us to credit qualifying customers up to the value of an entire month of their subscription and support fees. In light of our historical experience with meeting our service level commitments, we have not accrued any liabilities on our balance sheet for these commitments.

As part of our overall growth, we expect the percentage of our revenue generated outside of the United States to increase as we invest in and enter new markets. Revenue by geographic region, based on the billing address of the customer, was as follows for the periods presented:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012
	(dollars in thousands)			
United States	$ 223,246	$ 164,609	$ 79,544	$ 58,668
International	76,254	59,210	27,331	21,123
Total revenue	$ 299,500	$ 223,819	$ 106,875	$ 79,791
Percentage of revenue generated outside of the United States	25 %	26 %	26 %	26 %

Employees

The number of full-time employees as of September 30, 2013 was 2,291 as compared to 1,778 at December 31, 2012 and 1,630 at September 30, 2012. As of September 30, 2013, our headcount included 685 employees in sales and marketing; 843 employees in operations, professional services, training and customer support; 533 employees in product development; and 230 employees in a general and administrative capacity.

Cost of Revenue

Subscription and support cost of revenue primarily consists of costs related to hosting our application suite, providing customer support, data communications expenses, personnel and related costs of operations, stock-based compensation, software license fees, outsourced subscription services, costs associated with website development activities, allocated overhead, amortization expense associated with capitalized internal use software and acquired developed technology, and related plant and equipment depreciation and amortization expenses.

Professional services and other cost of revenue primarily consists of personnel and related costs for our professional services employees and executives, external consultants, stock-based compensation and allocated overhead.

We allocate overhead such as rent, information technology costs and employee benefit costs to all departments based on headcount. Recruiting costs are systematically allocated to the respective departments that utilize recruiting services during the period. As such, general overhead expenses are reflected in cost of revenue and each operating expense category.
We expect cost of revenue to increase in absolute dollars over the near term; however, it could fluctuate period to period depending on the growth of our professional services business.

Operating Expenses - Product Development

Product development expenses primarily consist of personnel and related costs for our product development employees and executives, including salaries, stock-based compensation, employee benefits and allocated overhead. Our product development efforts have been devoted primarily to increasing the functionality and enhancing the ease of use of our on-demand application suite, as well as localizing our product for international use. A key component of our strategy is to expand our business internationally. This will require us to conform our application suite to comply with local regulations and languages, causing us to incur additional expenses related to translation and localization of our application for use in other countries.

Table of Contents

At our product development facility in the Czech Republic, we participate in a government program that subsidizes us for employing local residents. Under the program, the Czech government will reimburse us for certain operating expenses we incur. Since the first quarter of 2012, we have reduced our product development expenses for eligible operational expenses we expect the Czech government to reimburse. On a quarterly basis, we will accrue our expected subsidies for the duration of the program.

We expect product development expenses to increase in absolute dollars as we continue to extend our service offerings internationally and as we expand and enhance our application suite technologies. Such expenses may vary due to the timing of these offerings and technologies.

Operating Expenses - Sales and Marketing

Sales and marketing expenses primarily consist of personnel and related costs for our sales and marketing employees and executives, including wages, benefits, bonuses, commissions and training, stock-based compensation, commissions paid to our channel partners, the cost of marketing programs such as on-line lead generation, promotional events, webinars and other meeting costs, amortization of intangible assets related to trade name and customer relationships and allocated overhead. We market and sell our application suite worldwide through our direct sales organization and indirect distribution channels such as strategic resellers. We capitalize and amortize our direct and channel sales commissions over the period the related revenue is recognized.

We believe we have sufficient sales and marketing staff to meet our revenue goals for the remainder of 2013. We expect to continue to invest in sales and marketing to pursue new customers and expand relationships with existing customers. As such, we expect our sales and marketing expenses to increase in terms of absolute dollars for the remainder of 2013.

Operating Expenses - General and Administrative

General and administrative expenses primarily consist of personnel and related costs for executive, finance, human resources and administrative personnel, stock-based compensation, legal and other professional fees, other corporate expenses and IT, facility and recruiting costs allocated to other departments.

We expect our general and administrative expenses to increase in terms of absolute dollars for the remainder of 2013.

Income Taxes

Since inception, we have incurred annual operating losses and, accordingly, have not recorded a provision for income taxes for any of the periods presented other than provisions for state and foreign income taxes and the federal benefit recorded as part of the WH acquisition in the first quarter of 2013.

Critical Accounting Policies and Judgments

Our condensed consolidated financial statements are prepared in accordance with GAAP. The preparation of these condensed consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period-to-period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected.

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application, while in other cases, significant judgment is required in selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. We consider these policies requiring significant management judgment to be critical accounting policies. These critical accounting policies are:

- Revenue recognition;
- Internal use software and website development costs;
- Deferred commissions;
- Accounting for stock-based compensation; and

Table of Contents

• Goodwill and other intangible assets

There have been no significant changes in our critical accounting policies and estimates during the nine months ended September 30, 2013 as compared to the critical accounting policies and estimates disclosed in "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Judgments" included in our Annual Report on Form 10-K for the year ended December 31, 2012 filed on February 28, 2013. In addition, please see Note 2 of Notes to the Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q and Note 2 of the Notes to Consolidated Financial Statements included in our 2012 Annual Report on Form 10-K filed on February 28, 2013 for a description of our accounting policies.

Results of Operations

Revenue, Cost of Revenue, Gross Profit and Gross Margin

Information about revenue, cost of revenue, gross profit and gross margin was as follows for the periods presented:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2013	2012	2013	2012
	(dollars in thousands)			
Revenue:				
Subscription and support	$239,994	$184,368	$85,795	$65,329
Professional services and other	59,506	39,451	21,080	14,462
Total revenue	299,500	223,819	106,875	79,791
Cost of revenue (1):				
Subscription and support	40,102	30,722	14,276	10,880
Professional services and other	58,141	38,218	20,916	14,211
Total cost of revenue	98,243	68,940	35,192	25,091
Gross profit	$201,257	$154,879	$71,683	$54,700
Gross margin	67 %	69 %	67 %	69 %

(1) Includes stock-based compensation expense and amortization of intangible assets of:

Cost of revenue:				
Subscription and support	$4,402	$3,557	$1,687	$1,169
Professional services and other	6,489	4,365	2,191	1,688
	$10,891	$7,922	$3,878	$2,857

Nine Months Ended September 30, 2013 as Compared to the Nine Months Ended September 30, 2012

Revenue for the nine months ended September 30, 2013 increased $75.7 million, or 34%, compared to the same period in 2012.

Subscription and support revenue: Subscription and support revenue for the nine months ended September 30, 2013 increased $55.6 million, or 30%, compared to the same period in 2012. The increase was primarily the result of a $40.6 million increase in revenue resulting from the acquisition of new customers, the continued adoption of OneWorld and a $15.0 million increase in revenue from existing customers.

Professional services and other revenue: Professional services and other revenue for the nine months ended September 30, 2013 increased $20.1 million, or 51%, compared to the same period in 2012. The increase was primarily the result of a $32.2 million increase in revenue resulting from the acquisition of new customers. As we move up market to larger customers, the scope of our professional services engagements have increased resulting in an increase in demand for our professional services. Additionally, existing customers have purchased additional product modules which has also resulted in an increase in demand for our professional services. The increase in professional services and other revenue was partially offset by a $12.1 million decrease in revenue from existing customers related to services purchased in connection with the initial implementation of our product in 2012 that did not recur for those customers in 2013.

Table of Contents

Revenue generated outside of the United States was $76.3 million, or 25%, of our total revenue for the nine months ended September 30, 2013 as compared to $59.2 million, or 26%, for the same period in 2012. Revenue generated outside of the United States increased primarily due to an increase in revenue generated in Australia and the United Kingdom.

Cost of revenue for the nine months ended September 30, 2013 increased $29.3 million, or 43%, compared to the same period in 2012.

Subscription and support cost of revenue: Subscription and support cost of revenue for the nine months ended September 30, 2013 increased $9.4 million, or 31%, compared to the same period in 2012. The increase was primarily due to a $4.8 million increase in personnel costs resulting from an increase in headcount and annual salary increases. Additionally, data center and other costs increased by $5.0 million due to an increase in support costs, depreciation, amortization of intangibles related to our 2012 and 2013 business acquisitions, amortization of capitalized internal use software costs, and other operational costs associated with an increase in our data center capacity and activity. These data center and other cost increases were offset by a decrease in amortization expense due to certain intangible assets becoming fully amortized and a $401,000 charge related to the impairment of a developed technology intangible asset that occurred in 2012 that did not occur in 2013.

Professional services and other cost of revenue: Professional services and other cost of revenue for the nine months ended September 30, 2013 increased $19.9 million, or 52%, compared to the same period in 2012. The increase was primarily the result of a $14.2 million increase in personnel costs, a $4.7 million increase in fees related to outsourced consulting services and a $1.0 million increase in IT, facility and other operating expenses. Personnel costs increased due to an increase in headcount, annual merit increases, incentive bonuses and training costs. Headcount increased as a result of an increase in the demand for our professional services. Outsourced consulting fees increased due to an increase in demand for our professional services and an increase in training expenses for external consultants. IT, facility and other operating expenses related to our professional services increased by $1.0 million due to an increase in vendor costs and an increase in recruiting and other costs incurred to grow our business.

Our gross margin decreased to 67% during the nine months ended September 30, 2013 from 69% during the same period in 2012. Our professional services, which has a lower gross margin than subscription and support services, represented a larger portion of total revenue during the nine months ended September 30, 2013 when compared to the same period in 2012.

Three Months Ended September 30, 2013 as Compared to the Three Months Ended September 30, 2012

Revenue for the three months ended September 30, 2013 increased $27.1 million, or 34%, compared to the same period in 2012.

Subscription and support revenue: Subscription and support revenue for the three months ended September 30, 2013 increased $20.5 million, or 31%, compared to the same period in 2012. The increase was primarily the result of a $14.2 million increase in revenue resulting from the acquisition of new customers, the continued adoption of OneWorld and a $6.3 million increase in revenue from existing customers.

Professional services and other revenue: Professional services and other revenue for the three months ended September 30, 2013 increased $6.6 million, or 46%, compared to the same period in 2012. The increase was primarily the result of a $10.1 million increase in revenue resulting from the acquisition of new customers. As we move up market to larger customers, the scope of our professional services engagements have increased resulting in an increase in demand for our professional services. Additionally, existing customers have purchased additional product modules, which has also resulted in an increase in demand for our professional services. The increase in professional services and other revenue was partially offset by a $3.5 million decrease in revenue from existing customers related to services purchased in connection with the initial implementation of our product in 2012 that did not recur for those customers in 2013.

Revenue generated outside of the United States was $27.3 million, or 26%, of our total revenue for the three months ended September 30, 2013 as compared to $21.1 million, or 26%, for the same period in 2012. Revenue generated outside of the United States increased primarily due to an increase in revenue generated in Australia and the United Kingdom.

Cost of revenue for the three months ended September 30, 2013 increased $10.1 million, or 40%, compared to the same period in 2012.

Subscription and support cost of revenue: Subscription and support cost of revenue for the three months ended September 30, 2013 increased $3.4 million, or 31%, compared to the same period in 2012. The increase was primarily due to a

Table of Contents

$1.4 million increase in personnel costs resulting from an increase in headcount and annual salary increases. Additionally, data center and other costs increased by $2.0 million due to an increase in support costs, depreciation, amortization of intangibles related to our 2012 and 2013 business acquisitions, amortization of capitalized internal use software costs and other operational costs associated with an increase in our data center capacity and activity.

Professional services and other cost of revenue: Professional services and other cost of revenue for the three months ended September 30, 2013 increased $6.7 million, or 47%, compared to the same period in 2012. The increase was primarily the result of a $4.3 million increase in personnel costs, a $2.2 million increase in fees related to outsourced consulting services and a $247,000 increase in IT, facility and other operating expenses. Personnel costs increased due to an increase in headcount, annual merit increases, incentive bonuses and training costs. Outsourced consulting fees increased due to an increase in demand for our professional services and an increase in training expenses for external consultants. IT, facility and other operating expenses related to our professional services increased due to rising vendor costs and an increase in recruiting and other costs incurred to grow our business.

Our gross margin decreased to 67% during the three months ended September 30, 2013 from 69% during the same period in 2012. Our professional services, which has a lower gross margin than subscription and support services, represented a larger portion of total revenue during the three months ended September 30, 2013 when compared to the same period in 2012.

Operating Expenses

Operating expenses were as follows for the periods presented:

	Nine Months Ended September 30,					
	2013			2012		
	Amount	% of revenue		Amount	% of revenue	
	(dollars in thousands)					
Operating expenses (1):						
Product development	$ 55,425	19	%	$ 38,311	17	%
Sales and marketing	153,027	51	%	111,731	50	%
General and administrative	37,407	12	%	28,334	13	%
Total operating expenses	$ 245,859	82	%	$ 178,376	80	%

	Three Months Ended September 30,		
	2013		2012
	Amount	% of revenue	