SEACHANGE INTERNATIONAL INC
Form 10-K
April 09, 2010

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

-For the fiscal year ended January 31, 2010

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

Commission File Number: 0-21393

SEACHANGE INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	04-3197974 (IRS Employer Identification No.)

50 Nagog Park, Acton, MA 01720
(Address of principal executive offices, including zip code)

(978)-897-0100
(Registrant's telephone number, including area code)

Securities Registered Pursuant To Section 12(b) Of The Act:

Common Stock, $.01 par value

Securities Registered Pursuant To Section 12(g) Of The Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 o

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o	Smaller reporting company o

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

As of July 31, 2009, the aggregate market value of the voting stock held by non-affiliates of the registrant, based upon the closing price for the registrant’s Common Stock on the Nasdaq Global Select Market on such date was $260,485,787. The number of shares of the registrant’s Common Stock outstanding as of the close of business on March 25, 2010 was 31,072,068.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the definitive Proxy Statement (which is expected to be filed within 120 days after the Company’s fiscal year end) relating to the registrant’s Annual Meeting of Stockholders to be held on or about July 15, 2010 to be filed pursuant to Regulation 14A are incorporated by reference into Part III of this Annual Report on Form 10-K.

PART I

ITEM 1. Business

SeaChange International, Inc. (“SeaChange”, “we” or “us”), a Delaware corporation founded on July 9, 1993, is a leading developer, manufacturer and marketer of digital video systems and services. These products and services facilitate the aggregation, licensing, storage, management and distribution of video, television programming and advertising content. We sell our products and services worldwide to cable system operators, including Cablevision, Comcast, Cox Communications, Virgin Media, and Rogers; telecommunications companies, including Telekom Austria, Turk Telekom and Verizon Communications; and broadcast television companies, including ABC Disney, Ascent Media, Clear Channel, China Central Television and Viacom.

Our digital video systems are designed to enable our customers to reduce subscriber turnover and access new revenue-generating opportunities from subscribers, advertisers and electronic commerce initiatives. Using our products and services, we believe our customers can increase their revenues by offering additional services such as on demand television, which allows, for example, the operator to offer a variety of programming for viewing whenever a subscriber chooses and incorporates the ability for subscribers to pause, rewind and fast-forward on demand content. Our systems also allow our customers to insert advertising into broadcast and on demand programming. Our advertising systems allow our customers to target advertising segments to specific subscribers in a particular geographic and/or demographic market. In addition, our systems enable broadband system operators to offer other interactive television services that allow subscribers to customize and/or dynamically interact with their television, enhancing their viewing experience.

The primary thrust of our business has been supplying systems to deliver video assets in the evolving “On Demand” television environment. Through acquisitions and partnerships we have expanded our capabilities, products and services to address the needs of video content owners, broadcasters, and content aggregators, and to address the delivery of content to devices other than the television, such as mobile phones and PCs. Our products and services include hardware and software for content management and delivery systems, middleware that drives set top box applications such as games, advertising systems that help pay for content and services that involve the acquisition and distribution of video content. We believe that our strategy of expanding our product line will position SeaChange to support and maintain our existing customer base, take advantage of new customers entering the on demand marketplace and to enter adjacent markets.

Our core technologies provide a foundation for products and services that can be deployed in next generation systems capable of increased levels of subscriber interactivity. We have received several awards for technological excellence, including Emmy Awards for our patented MediaCluster ® technology and for our role in the growth of video on demand.

Industry Background

Cable System Operators and Telecommunications Companies

According to SNL Kagan, the number of households paying for TV access today, such as cable subscription but excluding satellite, has been estimated at 111 million in the Americas and approximately 600 million worldwide. Over the last several years, cable system operators and telecommunications companies have spent billions of dollars to upgrade their networks from analog to digital, yielding a significant increase in available bandwidth, channel capacity and two-way interactive capability. We believe this investment reflects their intent to provide video on demand, advertising insertion, internet access and other value-added services to their customers that will differentiate them from competing service providers, including satellite delivery systems.

In 2001, North American cable system operators and telecommunications companies began the deployment of residential video on demand capability allowing subscribers to watch video programming at any time with pause, rewind, fast forward and a number of additional interactive capabilities. All of the major North American cable system operators have deployed video on demand services in one or more major residential markets. The various on demand applications offered by cable system operators and, increasingly, telecommunications operators, include movies-on-demand, subscription video on demand, such as Home Box Office (HBO), as well as news, sports, music videos, games, niche programming and time-shifted broadcast programming.

Cable companies have also begun to market telephone services. In response, telecommunications operators, notably AT&T and Verizon in the U.S., are aggressively providing competitive digital television and video services. Elsewhere, international telecommunications companies with high-speed network capacity are actively exploring and launching similar television services.

In addition, because cable television programming is transmitted over broadband (high bandwidth networks), cable system and telecom operators have the opportunity to segment and target their programming to viewers in selected geographies. In the future, we believe that the ability of operators to target viewers will extend to individual household-level targeting of advertisements in video on demand applications, generating revenue which may help support the worldwide deployment and growth of video on demand content and services.

Increased demand for video and audio content over the internet will also require a substantial increase in storage capacity and bandwidth over time. We believe that cable system operators and telecommunications companies will play an integral role in providing these broadband internet applications. We also believe that in order to offer high quality video applications over the internet, cable system operators and telecommunications companies will need more storage and delivery systems capable of complex management and scheduling of video streams.

Broadcast Television Companies

Both domestically and internationally, broadcast television companies face a number of new challenges to their business. In digital broadcasting, changing ownership trends, new consumer alternatives (e.g., cable television, satellite television, or internet) and evolving viewership models (e.g., Personal Video Recorders (PVR), cell phones, Personal Digital Assistants (PDA), etc.) are creating a more complex competitive environment for our customers that calls for greater efficiencies and business innovation. We believe broadcast television companies are therefore turning away from their out-dated tape-based systems with robotic libraries, which are cumbersome and require high levels of maintenance and manual intervention.

Some television broadcasters are using digital bandwidth to originate multiple program streams. As this application further develops, television broadcasters will require more video storage and delivery systems that can effectively manage and deliver these multiple television signals. As a result, we believe that television broadcasters will continue to automate their entire programming and advertising to reduce overall operating costs and improve reliability. We expect new opportunities to emerge for broadcasters and video on demand operators to create new business synergies that will likely require digital video storage and delivery systems.

SeaChange Business Segments

In fiscal 2009, we realigned our business segments and financial reporting structure to better portray the Company’s strategic direction and potential areas for growth. The Company now reports its financial results within three segments: Software, Servers and Storage, and Media Services. Financial information about our business segments is included in Management’s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements.

	Year ended January 31, 2010 Amount	%	2009 Amount	%	2008 Amount	%
	(in thousands, except percentages)					
Revenues by segment:						
Software	$ 131,314	65%	$ 132,237	65%	$ 113,269	63%
Servers and Storage	50,557	25%	53,640	27%	48,997	27%
Media Services	19,794	10%	15,959	8%	17,627	10%
Total	$ 201,665		$ 201,836		$ 179,893	

Software

In 2006, we began selling our SeaChange Axiom® On Demand software independent of our hardware and offering subscription services for the software in an effort to increase market share and enhance revenue stability through more recurring revenues. Additionally, by porting our software to other third party hardware platforms, we expect to increase our market share with opportunities at competitive vendors' installations.

We also develop, sell and support software products in the middleware and advertising categories. Our middleware and application business is focused on producing set-top box client middleware software products and end-to-end interactive television applications, and performing system integration and software customization services. Our client middleware solutions include the VODlink® Platform Suite built for and deployed on common North American cable set top boxes, and the TV Navigator™ platform deployed in Europe and Asia.

Our advertising insertion software products are available for both the traditional analog environment (the way that video signals have been transmitted for the past 60 years), and for the digital environment, which provides the cable operator with a significant increase in available bandwidth, channel capacity and two-way capability. Based on currently available industry sources and our internal data, we believe our Spot System is the leading analog video insertion system in the United States in the multichannel television market for advertisements and other short-form video. Over the last several years, our customers have begun to migrate to digital video ad insertion, and we believe our digital video ad insertion system is establishing a strong market position as well. Our SeaChange AdPulse™ On Demand Advertising software platform allows operators to generate new advertising revenue from inserting ads, dynamically, in on demand content while it provides detailed tracking and reporting on views and usage of inserted ads.

In September of 2009 we acquired a private software company, eventIS Group B.V. ("eventIS"), in Eindhoven, the Netherlands. eventIS is Europe's leading provider of video on demand back-office software supporting operators in 25 countries. This software complements and extends the capabilities of our video on demand products.

We expect that eventIS's leading market position in Europe will foster increased revenue growth as VOD investments in Europe are forecasted to grow significantly over the next several years. According to SNL Kagan, there are 80 million cable television subscribers in Europe compared to 70 million in the United States. However, unlike in the U.S., digital cable penetration rates are quite low. Penetration rates in Europe are expected to rise with the increased investments in VOD products and services from European cable television providers.

In February 2010, we acquired VividLogic Inc ("VividLogic"), a private California software provider. VividLogic's products and services will allow the Company to expand its software product portfolio to participate more competitively in the middleware and home network markets. VividLogic provides applications and development services for Consumer Electronics ("CE") manufacturers, cable television, equipment manufacturers and cable television providers. VividLogic's software products and services focus on home networking applications and "tru2way" development. In the home networking area, VividLogic's emphasis is on the development of software to meet the content protection requirements under the IEEE 1394 requirements. In addition, VividLogic is working with CE manufacturers and service providers to develop software to be used in next generation home media gateways. In the tru2way area, VividLogic provides products and services for CE and set top box manufacturers who are looking to migrate their hardware for tru2way capability. Tru2way is a technology software platform sponsored by the U.S. cable television industry that is expected to foster interactive television applications for consumers.

Revenue sources from the Software segment fall into two categories:

- product revenues such as licensing, and software development for those products; and
- related services such as subscriptions (annual software subscriptions for upgrades), professional services, installation, training, project management, product maintenance, and technical support for those software products.

Servers and Storage

Combining the advantages of standards-based hardware with our patented MediaCluster® technology, our hardware products deliver high-density streaming, clustered ingest and scalable storage for video on demand, time-shifted TV, network PVR (Personal Video Recorder) applications, as well as broadcast play to air and archiving.

Revenue sources for our Servers and Storage segment fall into several categories. New deployments are typically sold on a capacity basis and include one year of maintenance. As our customers add more content and more users, they return to purchase more streaming and storage capacity. The additional content usually also leads to increased usage levels by the subscribers which also translates in to add-on-sales. Recurring revenue consists of maintenance contracts after the first year.

We offer several configurations of our MediaCluster video servers to meet the evolving needs of our customers for independently scalable ingest, streaming and storage.

Servers and Storage segment includes:

- product revenues from video on demand (“VOD”) and broadcast server product lines and
- related services such as professional services, installation, training, project management, product maintenance, and technical support for those products.

Media Services

Through the acquisitions of On Demand Group Limited (ODG), in fiscal 2006, and Mobix Interactive Ltd., in fiscal 2009, SeaChange expanded its media content services, consisting of content aggregation and distribution. ODG is a leader in Europe in the development and deployment of Pay TV services. This division specializes in aggregating content for video on demand and Pay-Per-View platforms, and provides marketing, promotional and production services to cable operators and telecommunications providers throughout Europe.

As an example, we source, acquire, package, and market Virgin Media’s video on demand services by providing access to content from local and Hollywood studio providers in multiple formats including music, television programs and feature length movies. Through ODG, we have a content rights management system and a content preparation center for incorporating video content for VOD services from the major content suppliers around the world.

Revenue from the Media Services segment is generated from customer contracts depending on the services rendered.

Key Products and Services

SeaChange Video On Demand System

We have developed and are deploying a video on demand system to cable television companies and telecommunications companies. Our video on demand system consists of:

- MediaCluster video servers that reside at various points in a broadband network system and are used to ingest, store and play or stream videos as requested;
- SeaChange Axiom® On Demand video software to manage and control the system and to support integration with third-party systems and applications;
- Spot Advertising Systems hardware and software and AdPulse On Demand Advertising System;
- Interactive middleware that enables operators to run multiple services, including video on demand and personal video recorders on multiple platforms;
- Record System, a time-shifting television application that enables broadcasted programming to be automatically encoded by broadband operators, with complete trick-mode functionality (fast-forward, pause and rewind); and
- Interfaces to digital headend modulators, control systems and subscriber management systems.

Our video on demand system allows our customers to offer interactive services such as the following to their subscribers:

- Video on demand. This interactive service allows residential users and commercial users (e.g., hotel guests) to review lists of available movies and/or programming content, order individual movies and/or programs and view them in real-time. Users have full control over the video stream.
- Subscription Video on demand. This service provides premium channel offerings, such as those offered by HBO, Showtime or Starz, in an on-demand manner, as well as on a scheduled basis. Similar to our video on demand service, our subscription video on demand service allows subscribers to review lists of available premium channel content, order individual programs and watch them at home with full video player control.
- Networked Digital Video Recording. This service provides users with interactive control over broadcasted television programming, enabling viewers to watch sports, news, and other program types with full video cassette recorder and personal video recorder-like (e.g., TiVo® recorders) control over the video stream. We enable the provision of this service through our servers and software located in broadband local transmission sites known as headends. We believe this service also has the potential to accommodate new advertising techniques, such as ad replacement or limited fast-forward functionality.
- Targeted and Interactive Advertising. This service supports interactive advertising or advertising where the subscriber controls the path and delivery of an advertisement, in a video on demand service and in other forms of programming that result in a dedicated communications link between the subscribers' set top box and the video on demand system itself. This service allows purchases over the television, such as one might do with a web browser over the internet.
- DVD Now™ on Demand Service. This interactive service brings DVD functionality to video on demand applications and provides a common standard for distributing and presenting video content. Our software tools and applications provide the capability to transform DVDs, including their menus and content chapter and options, into video on demand applications.

SeaChange Axiom® On Demand video software is the end-to-end business solution for video on demand services. Software modules act in unison to manage and automate every aspect of operations – streams, subscribers, billing, network load and more. The product is built on an open architecture, meaning it can be deployed by any service provider regardless of streaming, storage or network architectures. SeaChange Axiom On Demand video software is comprised of three components:

- On Demand Services manage and deliver rich media content to a variety of consumer devices.

- Personalized Applications Platform enables operators to provide subscribers with innovative services such as games and movies on demand.

- Advanced Management Tools give operators the ability to reduce their costs and garner operational efficiencies through sophisticated system management tools.

SeaChange Axiom On Demand Services consist of the essential functions that manage core on demand network resources such as servers, bandwidth and storage. Modules administer network bandwidth through session and resource management to ensure efficient content delivery. Content propagation optimizes both network usage and storage by continually monitoring demand for content, and moving content to locations where it is needed most. The Connection Manager Service software mediates client requests, establishing the shortest path between the client and the requested content. Asset Management is responsible for managing the life cycle of content stored on the system. The Asset Manager provides full visibility into the location and state of the content in the system through a browser-based graphical user interface (GUI). Additional Axiom On Demand Services include the Recording System that captures broadcast programs and publishes them as VOD content and the Axiom Content Dynamics module that automates dynamic insertion of advertisement and other content into VOD streams.

SeaChange Axiom Personalized Applications software provides a broad range of on-demand applications to enhance the viewer experience.

SeaChange Axiom Advance Management Tools provide engineering and operations personnel with tools that aid in the control of the system. Problem identification and resolution, data warehouse management, subscriber management and a configuration suite all help in reducing operational costs while improving overall system efficiencies.

Advertising Products

Our family of Spot Systems automates the complex process of advertisement and other video insertion across multiple channels and geographic zones for cable system operators and telecommunications providers. Through our embedded proprietary software, our Spot System allows cable system and telecom operators to insert local and regional advertisements and other videos into a specific time allocated by television networks such as CNN, MTV, ESPN, BET, Discovery Channel and Nickelodeon. The Spot System is capable of inserting advertising into digital and analog channels including HD and delivering targeted advertising, as well as advertising with interactive links to content on video on demand systems, as well as to other interactive advertising systems.

The Spot System is an integrated solution comprised of hardware platforms, software applications, data networks and easy to use graphical interfaces. Our Spot System is designed to be installed at local transmission sites, known as headends, and advertising sales business offices. Our video insertion process consists of six steps:

- Encoding. The process begins with our encoding software, which in real time transforms and compresses analog to digital short- and long-form video.

- Storage. Our Spot System organizes, manages and stores these video streams in a disk-based video library capable of storing thousands of advertisements.

- Scheduling. Our advertising management software coordinates with the traffic and billing application to determine the designated time slot, channel and geographic zone for each video stream.

- Distribution. Our strategic digital video software then copies the video files from the master video library and distributes them over the operator’s data network to appropriate headends, where they are stored in video servers for future play.

- Insertion. Following a network cue, our video switch module automatically inserts the video stream into the network feed (initiating the analog conversion, if necessary), where they are then seen by television viewers.

- Verification. After the video streams run, our proprietary software and hardware verifies the content, accuracy, timing and placement of these video streams to facilitate proper customer billing.

SeaChange AdPulse™ On Demand Advertising System

The SeaChange AdPulse System consists of an advertising and inventory management system called the SeaChange AdPulse On Demand Ad Manager and a package of enhancements for the core VOD system called SeaChange Axiom® Content Dynamics software that provide functions tailored to the special needs of managing, propagating, playing out and tracking of ads.

Key features of the AdPulse On Demand Ad Manager include:

- Inventory Management—the ability to define advertising avails (slots) in on demand content. The inventory is managed by creating an inventory definition that specifies a content group (by program, provider, or content category) to which the inventory definition will apply, then specifying the number and placement of ad breaks and the number of spots per break for programs in that content group.
- Order Entry—the ability to specify the rules by which different ad copy will be inserted into on demand content by assigning advertising copy to defined inventory.
- Dynamic Ad Placement Decisions—the ability to modify a playlist at run-time to add, delete, or change ads played with assets based on defined ad placement rules.
- Interior Ad Breaks – ad insertion and /or replacement at ad breaks within an on demand content stream if interior ad breaks are marked with SCTE-35 descriptors.
- Operational Reporting—the ability to view and track aspects of the overall operation of the SeaChange AdPulse Manager, such as whether advertising copy required to execute an order has been received and propagated.
- Business Reporting—the ability to view and track specific business aspects of the SeaChange AdPulse Manager, such as which inventory has been sold and which is unsold, a summary of orders from a specific client, etc.
- Verification Reporting—the ability to track and view data about execution of orders, views of ad copy, and user action during the ad views.

This system allows operators to generate new advertising revenue inserting ads, dynamically, in on demand content while it provides detailed tracking and reporting on views and usage of inserted ads. During 2007, we saw the first commercial deployment of our SeaChange AdPulse On Demand advertising software platform. Since then, we have had successful trials and deployments with several operators including: Virgin Media, Cox Communications, and Sunflower Broadband.

SeaChange Middleware Software Products

Middleware provides seamless, access across devices made by different manufacturers to content across wired and/or wireless devices. We offer two middleware software products to operators and content developers: VODlink software and TV Navigator software.

SeaChange VODlink software is comprised of three software modules that work together to enhance the user experience. The three components: VODlink Platform Suite, VODlink Portal and VODlink Games help operators jump-start their VOD offerings with a collection of games, a pop-up portal to ease navigation and provide marketing of content, and a suite of tools that allow easy development and integration of custom applications.

SeaChange TV Navigator software is a platform that incorporates an optional Electronic Program Guide (EPG – the user interface) that is completely customizable, communications applications such as TV-mail, chat, ticker display and messaging, and audience measurement tools that collect and report on usage statistics.

SeaChange Servers and Storage

Designed for enterprise-wide video system deployments the patented SeaChange MediaCluster architecture delivers massive, independently scalable, storage, streaming and ingest capabilities. MediaCluster dramatically reduces the cost of storing and delivering video assets. We offer several configurations of the MediaCluster to meet the demands of different video delivery applications.

SeaChange Flash MediaServers

Our flash memory-based servers provide 100% non-volatile, diskless edge streaming, stream expansion and time-shifted TV. These servers allow operators to deploy diskless streamers at the edge locations and locate centralized storage and storage management at the head-end locations in their networks. The Flash MediaServers also reduce operational costs. Compared to traditional spinning hard disk drives, flash memory has no moving parts, therefore it is more reliable and consumes less power.

SeaChange MDS MediaServers

Combining the advantages of standards-based hardware with the SeaChange patented MediaCluster technology, the MDS products provide high density streaming, clustered memory ingest and scalable storage. The MDS complements our widely deployed disk-based video servers while providing independent scalable streaming, storage and memory and can be deployed as a standalone system or a streaming booster for existing systems.

Broadcast and Specialty Servers

Additionally, we supply special function servers based on our MediaCluster technology for the broadcast industry. Our Broadcast MediaCluster System is composed of multiple individual video servers arranged in a cluster acting as one system. This system is designed to provide high-quality digital video storage and playback for use with automation systems in broadcast television stations. This product is intended to replace on-air tape decks used to store and play back advertising, movies and other programming from video tape cart systems and, in some cases, to replace the cart systems themselves. Our Broadcast MediaCluster System is designed for customers both in larger broadcast television markets, which use station automation systems, and in smaller markets, which use control software included in the system.

As with the video on demand system, our Broadcast MediaCluster System is designed to simultaneously record, encode, store to a disk and play video content using compression and decompression hardware. These products seamlessly integrate into television broadcasters’ current tape-based operations and meet the high performance requirements of television broadcasters. Our Broadcast MediaCluster System has features that enable the television broadcaster to have end-to-end functionality and reliability, including the capability to schedule programming for a week of television content.

Media Services

The Media Services segment encompasses the business activities of the On Demand Group and Mobix Interactive, U.K. based wholly-owned subsidiaries of SeaChange. The Media Services group focuses on the acquisition, licensing, preparation, management and marketing of content as well as custom consulting services. Virgin Media in the U.K. is ODG’s largest customer. In the past two years, ODG also added the Hellenic Telecommunication Organisation (OTE), Telekom Austria, TTnet, Du Telekom, and Neuf Telecom.

ODG also has established joint ventures to provide specialized content and services. In 2005, ODG launched FilmFlex in the U.K., a joint venture with Walt Disney and Sony Pictures to provide an on demand movie service to Virgin Media. In December of 2007, ODG sold its interest in the FilmFlex joint venture to the other investors for approximately $18 million.

In Germany, ODG entered into a joint venture with the TeleMunchen Gruppe, a German media company whose activities include the production and acquisition of German-language feature films, television productions and classical music programs. This joint venture has launched a pay-per-view service for Kabel Deutschland Gruppe (KDG). KDG has approximately nine million subscribers and has begun to deploy digital services. We expect to transition the pay-per-view service to a full-fledged VOD service as the digital rollout occurs. In addition to providing pay-per-view services to KDG, the joint venture also provides pay-per-view services to Unity Media and Telekom Austria. The joint venture also announced that it will be providing VOD content and services in 2010 to Kabel BW, one of Germany’s largest cable television operators.

In November 2008, through ODG, we acquired Mobix Interactive Limited in the U.K. Mobix complements ODG’s television VOD services business by offering mobile VOD services to wireless network operators. Today, Mobix supports mobile subscribers for its customers 3 in the U.K. and Vodacom in South Africa.

Service and Support

We install, maintain and support our hardware and software products worldwide. We offer basic and advanced on-site training for customer employees. We currently provide installation, maintenance and technical support to all our customers. We offer maintenance and technical support to customers, agents and distributors of our hardware, software and systems on a 24-hour, seven-day a week basis. Generally, our systems sales include at least one year of free maintenance.

A separate professional services group provides network design and architecture as well as systems integration services.

Customer support centers worldwide provide 24/7 coverage. We have support centers in the U.S., the Netherlands, Philippines, China, Japan, U.K., France, Turkey and Ireland.

Strategy

Our strategy is to be the leading provider of video solutions in the television industry. We develop, manufacture and market digital video systems and services that include the management, aggregation, licensing, storage, and distribution of video, television, gaming and advertising content. The key elements of our strategy are to:

- Develop, Maintain and Extend Long-term Customer Relationships. We focus our product development, marketing and direct sales efforts on maintaining and extending long-term customer relationships with cable system operators, telecommunications companies and television broadcasters across the world. We have formed important relationships with customers that have grown from advertisement and other short-form video insertion to video on demand systems and other interactive television services, storage systems and streaming systems. We believe that the fundamental shift from broadcast to on demand applications and the growing emphasis on interactive technologies will continue to present opportunities for us to develop, market and support solutions to our existing customers as well as to new additional markets.

- Offer Integrated Solutions. Our customers operate complex networks that require the delivery and management of video programming across multiple channels and target zones. We believe that our integrated solutions can provide advantages in cost and implementation for digital video applications while interoperating with existing and emerging third-party equipment and software. To continue to address these needs, we intend to provide and further develop, internally and with our partners, integrated applications and support services for our customers. We believe that providing complete integrated solutions has been a significant factor in our success in the advertising and video on demand markets to date.

- Establish and Maintain Technological Leadership. We believe our competitive position is dependent in large part on the features and performance of our systems. As a result, we focus our research and development efforts on introducing systems with improved hardware and software capabilities. We have been granted patents and have patents pending for our various technologies. We have received several awards for technological excellence, including Emmy Awards for our patented MediaCluster ® technology and for our role in the growth of video on demand. As of January 31, 2010, 41% of our employees were focused on research and product development efforts.

- Provide Superior Customer Service and Support. Our products operate in customer environments where continuous operation is critical. As a result, we believe that providing a high level of service and support gives us a competitive advantage and is a differentiating factor in developing and maintaining key customer relationships. Our in-depth industry and application knowledge allows us to better understand the service needs of our customers. As of January 31, 2010, 37% of our employees were dedicated to customer service and support, including project design and implementation, maintenance, installation and training. Customers have access to service personnel via 24/7 telephone support. In addition, we believe that the acquisitions and investments that we have made in media services and in system integration and customization services have positioned us as an integral partner with our customers to ensure optimal performance of their systems.

Customers

We currently sell our products primarily to cable system operators, broadcast and telecommunications companies.

Our customer base is highly concentrated among a limited number of large customers, primarily due to the fact that the cable, movie, broadcast, and telecommunications industries in the United States are dominated by a limited number of large companies. A significant portion of our revenues across each of our segments in any given fiscal period have been derived from substantial orders placed by these large organizations. For the year ended January 31, 2010, Comcast and Virgin Media comprised 27% and 12%, respectively, of our total sales. We expect that we will continue to be dependent upon a limited number of customers for a significant portion of our revenues in future periods. As a result of this customer concentration, our business, financial condition and results of operations could be materially adversely affected by the failure of anticipated orders to materialize and by deferrals or cancellations of orders as a result of changes in customer requirements or new product announcements or introductions. In addition, the concentration of customers may cause variations in revenue, expenses and operating results on a quarterly basis due to seasonality of orders or the timing and relative size of orders received and shipped during a fiscal quarter.

We do not believe that our backlog at any particular time is meaningful as an indicator of our future level of sales for any particular period. Because of the nature of our products and our use of standard components, substantially the entire backlog at the end of a quarter can be manufactured and shipped to the customer before the end of the following quarter. However, because of the requirements of particular customers these orders may not be shipped or, if shipped, the related revenues may not be recognized in the ensuing quarter. Therefore, there is no direct correlation between the backlog at the end of any quarter and our total sales for the following quarter or other periods.

Selling and Marketing

We sell and market our products in the United States primarily through a direct sales organization and internationally through direct sales and independent agents and distributors, complemented by a coordinated marketing effort of our product marketing personnel. Direct sales activities in the United States are conducted from our Massachusetts headquarters and through sales representatives deployed across the country. We also market certain of our products to systems integrators and value-added resellers.

In light of the complexity of our digital video products, we primarily employ a consultative direct sales process. Working closely with customers to understand and define their needs enables us to obtain better information regarding market requirements, enhance our expertise in our customers' industries, and more effectively and precisely convey to customers how our solutions address the customer's specific needs. In addition to the direct sales process, customer references and visits by potential customers to sites where our products are in place are often critical in the sales process.

We use several marketing programs focused on our targeted markets to support the sale and distribution of our products. We use exhibitions at a limited number of prominent industry trade shows and conferences and presentations at technology seminars to promote awareness of us and our products. We also publish articles in trade and technical journals and we produce promotional product literature.

Research and Product Development

Our management believes that our success will depend to a substantial degree upon our ability to develop and introduce in a timely fashion new integrated solutions and enhancements to our existing products that meet changing customer requirements in our current and new markets. We have made, and intend to continue to make, substantial investments in product and technological development. Our direct sales and marketing groups closely monitor changes in customer needs, changes in the marketplace and emerging industry standards, and are therefore better able to focus our research and development efforts to address these evolving industry requirements.

We believe that the experience of our product development personnel is an important factor in our success. We perform our research and product development activities at our headquarters and in offices in New Hampshire, Pennsylvania, California, the Netherlands, Philippines, and China.

Manufacturing

Our manufacturing operation is located at our facility in Acton, Massachusetts. This manufacturing operation consists primarily of component and subassembly procurement, systems integration and final assembly, testing and quality control of the complete systems. We rely on independent contractors to manufacture components and subassemblies to our specifications. Each of our products undergoes testing and quality inspection at the final assembly stage.

Competition

The markets in which we compete are characterized by intense competition, with a large number of suppliers providing different types of products to different segments of the markets. In new markets for our products, we compete principally based on price. In markets in which we have an established presence, we compete principally on the basis of the breadth of our products' features and benefits, including the flexibility, scalability, professional quality, ease of use, reliability and cost effectiveness of our products, and our reputation and the depth of our expertise, customer service and support. While we believe that we currently compete favorably overall with respect to these factors and that our ability to provide integrated solutions to manage, store and distribute digital video differentiates us from our competitors, in the future we may not be able to continue to compete successfully with respect to these factors. In the market for long-form video products including video on demand, we compete with various companies offering video server platforms such as Concurrent Computer Corp., Arris Group Inc. (through its 2007 acquisition of C-Cor Corporation), Cisco Systems, Inc. (through its 2006 acquisition of Arroyo Video Solutions, Inc.), Motorola, Inc. (through its 2006 acquisition of Broadbus Technologies, Inc.) and Ericsson (through its 2007 acquisition of Tandberg Television). In the television broadcast market, we compete against Thomson, Omneon Video Networks, Sony Corporation and Harris Incorporated. In the digital advertisement insertion market, we generally compete with Ericsson and Arris Group Inc. We expect the competition in each of these markets to intensify in the future as existing and new competitors with significant market presence and financial resources, including computer hardware and software companies and television equipment manufacturers, enter these rapidly evolving markets.

Many of our current and prospective competitors have significantly greater financial, technical, manufacturing, sales, marketing and other resources. As a result, these competitors may be able to devote greater resources to the development, promotion, sale and support of their products. Moreover, these companies may introduce additional products that are competitive with ours or enter into strategic relationships to offer complete solutions, and in the future our products may not be able to compete effectively with these products.

Proprietary Rights

Our success and our ability to compete are dependent, in part, upon our proprietary rights. We have been granted sixteen U.S. patents and have filed foreign patent applications related thereto for various technologies developed and used in our products. In addition, we rely on a combination of contractual rights, trademark laws, trade secrets and copyright laws to establish and protect our proprietary rights in our products. It is possible that in the future not all of these patent applications will be issued or that, if issued, the validity of these patents would not be upheld. It is also possible that the steps taken by us to protect our intellectual property will be inadequate to prevent misappropriation of our technology or that our competitors will independently develop technologies that are substantially equivalent or superior to our technology. In addition, the laws of some foreign countries in which our products are or may be distributed do not protect our proprietary rights to the same extent as do the laws of the United States. We have been involved in significant intellectual property litigation, and we may be a party to litigation in the future to enforce our intellectual property rights or as a result of an allegation that we infringe others' intellectual property.

Employees

As of January 31, 2010, we employed 1,223 persons, including 502 in research and development, 458 in customer service and support, 93 in selling and marketing, 31 in manufacturing and 139 in general and administration functions. We believe that our relations with our employees are good. None of our employees are represented by a collective bargaining agreement.

Geographic Information

Geographic information is included in Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements.

Available Information

SeaChange is subject to the informational requirements pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). SeaChange files periodic reports, proxy statements and other information with the Securities and Exchange Commission (SEC). Such reports, proxy statements and other information may be obtained by visiting the Public Reference Room of the SEC at 100 F Street, N.E., Washington, DC 20549 or by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an internet site (http://www.sec.gov) that contains reports, proxy and information statements and other information regarding issuers that file electronically.

Financial and other information about SeaChange, including SeaChange's Code of Ethics and Business Conduct and charters for SeaChange's Audit Committee, Compensation Committee and Corporate Governance and Nominating Committee, is available on our website (www.schange.com). We make available free of charge on our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. The information contained on our web site is not incorporated by reference into this document and should not be considered a part of this Annual Report. Our web site address is included in this document as an inactive textual reference only.

ITEM 1A. Risk Factors

Any statements contained in this Form 10-K that do not describe historical facts may constitute forward-looking statements as that term is defined in the Private Securities Litigation Reform Act of 1995. These statements relate to future events or our future financial performance and are identified by words such as “may,” “will,” “could,” “should,” “expect,” “plan,” “intend,” “seek,” “anticipate,” “believe,” “estimate,” “potential,” or “co comparable terms or the negative of those terms. Forward-looking statements in this Form 10-K include certain statements regarding the effect of certain accounting standards on our financial position and results of operations, the effect of certain legal claims against us, projected changes in our revenues, earnings and expenses, exchange rate sensitivity, interest rate sensitivity, liquidity, product introductions, industry changes and general market conditions. Our actual future results may differ significantly from those stated in any forward-looking statements. Any such forward-looking statements contained herein are based on current expectations, but are subject to a number of risks and uncertainties that may cause actual results to differ materially from expectations. Factors that may cause such differences include, but are not limited to, the factors discussed below. Each of these factors, and others, are discussed from time to time in our filings with the SEC.

Our business is dependent on customers’ continued spending on video systems and services, and reductions by customers in spending adversely affect our business.

Our performance is dependent on customers’ continued spending for video systems and services. Spending for these systems and services is cyclical and can be curtailed or deferred on short notice. A variety of factors affect the amount of spending, and, therefore, our sales and profits, including:

- general economic conditions;
- customer specific financial or stock market conditions;
- availability and cost of capital;
- governmental regulation;
- demand for services;
- competition from other providers of video systems and services;
- acceptance of new video systems and services by our customers; and
- real or perceived trends or uncertainties in these factors.

Any reduction in spending by our customers would adversely affect our business. We continue to have limited visibility into the capital spending plans of our current and prospective customers. Fluctuations in our revenue can lead to even greater fluctuations in our operating results. Our planned expense levels depend in part on our expectations of future revenue. Our planned expenses include significant investments, particularly within the research and development organization, which we believe are necessary to continue to provide innovative solutions to meet our current and prospective customers’ needs. As a result, it is difficult to forecast revenue and operating results. If our revenue and operating results are below the expectations of our investors and market analysts, it could cause a decline in the price of our common stock.

Our future success is dependent on the continued development of the video-on-demand market and if video-on-demand does not continue to gain broad market acceptance, our business may not continue to grow.

An increasing portion of our revenue in the last year has come from sales and services related to our video-on-demand products. However, the video-on-demand market continues to develop as a commercial market, both within and outside North America, and may not gain broad market acceptance. The potential size of the video-on-demand market and the timing of its development are uncertain. The success of this market requires that broadband system operators continue to upgrade their cable networks to support digital two-way transmission service and successfully market video-on-demand and similar services to their cable television subscribers. Some cable system operators, particularly outside of North America, are still in the early stages of commercial deployment of video-on-demand service to major residential cable markets and, accordingly, to date our digital video systems have been commercially available only to a limited number of subscribers. Also, the telecommunications companies have also begun to adapt their networks to support digital two-way transmission and begun marketing video-on-demand services. If cable system operators and telecommunications companies fail to make the capital expenditures necessary to upgrade their networks or determine that broad deployment of video-on-demand services is not viable as a business proposition or if our digital video systems cannot support a substantial number of subscribers while maintaining a high level of performance, our revenues will not grow as we have planned.

Our business is impacted by worldwide economic cycles, which are difficult to predict.

The global economy and financial markets experienced disruption in 2009, including, among other things, extreme volatility in security prices, severely diminished liquidity and credit availability, rating downgrades of certain investments and declining valuations of others. Governments have taken historic actions intended to address extreme market conditions that include severely restricted credit. There may be a further deterioration in financial markets and confidence in major economies. We are unable to predict the likely duration and severity of the current disruptions in financial markets, credit availability, and adverse economic conditions throughout the world. These economic developments affect businesses such as ours and those of our customers and vendors in a number of ways that could result in unfavorable consequences to us. Further disruption and deterioration in economic conditions may reduce customer purchases of our products and services, thereby reducing our revenues and earnings. In addition, such adverse decline in economic conditions may, among other things, result in increased price competition for our products and services, increased risk in the collectability of our accounts receivable from our customers, increased risk in potential reserves for doubtful accounts and write-offs of accounts receivable, and higher operating costs as a percentage of revenues. In 2009 and 2010, we have taken actions to address the effects of the economic crisis, including implementing cost control and reduction measures. It is possible that we may need to take further cost control and reduction measures. We cannot predict whether these measures will be sufficient to offset certain of the negative trends that might affect our business.

We have taken measures to address slowdowns in the market for our products and services, which could have long-term negative effects on our business or impact our ability to adequately address a rapid increase in customer demand.

We have taken measures to address slowdowns in the market for our products and services. These measures include shifting more of our operations to lower cost regions, outsourcing manufacturing processes, implementing cost reduction programs, reducing the number of our employees, and reducing planned capital expenditures and expense budgets. We cannot ensure that the measures we have taken will not impair our ability to effectively develop and market products and services, to remain competitive in the industries in which we compete, to operate effectively, to operate profitably during slowdowns or to effectively meet a rapid increase in customer demand. These measures may have long-term negative effects on our business by reducing our pool of technical talent, decreasing or slowing improvements in our products and services, making it more difficult to hire and retain talented individuals and to quickly respond to customers or competitors in an upward cycle.

Because our customer base is highly concentrated among a limited number of large customers, the loss of or reduced demand of these customers could have a material adverse effect on our business, financial condition and results of operations.

Our customer base is highly concentrated among a limited number of large customers, and, therefore, a limited number of customers account for a significant percentage of our revenues in any year. We generally do not have written agreements that require customers to purchase fixed minimum quantities of our products. Our sales to specific customers tend to vary significantly from year to year depending upon these customers' budgets for capital expenditures and our new product introductions. We believe that a significant amount of our revenues will continue to be derived from a limited number of large customers in the future. The loss of, or reduced demand for products or related services from, any of our major customers could have a material adverse effect on our business, financial condition and results of operations.

In addition, the industry has experienced consolidation among our customers which may cause delays or reductions in capital expenditure plans and/or increased competitive pricing pressures as the number of available customers decline and their relative purchasing power increases in relation to suppliers. Any of these factors could adversely affect our business.

Cancellation or deferral of purchases of our products could cause our operating results to be below the expectations of the public market stock analysts who cover our stock, resulting in a decrease in the market price of our common stock.

We derive a substantial portion of our revenues from purchase orders that exceed $1.0 million in value. Therefore, any significant cancellation or deferral of purchases of our products could have a material adverse effect on our business, financial condition and results of operations in any particular quarter due to the resulting decrease in revenue and gross margin and our relatively fixed costs. In addition, to the extent significant sales occur earlier than expected, operating results for subsequent quarters may be adversely affected because our operating costs and expenses are based, in part, on our expectations of future revenues, and we may be unable to adjust spending in a timely manner to compensate for any revenue shortfall. Because of these factors, in some future quarter our operating results may be below the expectations of public market analysts and investors which may adversely affect the market price of our common stock.

Timing of significant customer orders may cause our quarterly operating results to fluctuate, making period-to-period comparisons of our operating results less meaningful.

We have experienced significant variations in the revenue, expenses and operating results from quarter to quarter and these variations are likely to continue. We believe that fluctuations in the number and size of orders being placed from quarter to quarter are principally attributable to the buying patterns and budgeting cycles of broadband system operators, including telecommunications companies, and broadcast companies, the primary buyers of the digital video-on-demand, advertising and broadcast systems, respectively. We expect that there will continue to be fluctuations in the number and value of orders received. As a result, our results of operations have in the past and likely will, at least in the near future, fluctuate in accordance with this purchasing activity making period-to-period comparisons of our operating results less meaningful. In addition, because these factors are difficult for us to forecast, our business, financial condition and results of operations for one quarter or a series of quarters may be adversely affected and below the expectations of public market analysts and investors, resulting in a decrease in the market price of our common stock.

Due to the lengthy sales cycle involved in the sale of our products, our quarterly results may vary and should not be relied on as an indication of future performance.

Digital video-on-demand, advertising, movie and broadcast products are relatively complex and their purchase generally involve a significant commitment of capital, with attendant delays frequently associated with large capital expenditures and implementation procedures within an organization. Moreover, the purchase of these products typically requires coordination and agreement among a potential customer’s corporate headquarters and its regional and local operations. For these and other reasons, the sales cycle associated with the purchase of our digital video-on-demand, advertising, movie and broadcast products is typically lengthy and subject to a number of significant risks, including customers’ budgetary constraints and internal acceptance reviews, over which we have little or no control. Based upon all of the foregoing, we believe that our quarterly revenues and operating results are likely to vary significantly in the future, that period-to-period comparisons of our results of operations are not necessarily meaningful and that these comparisons should not be relied upon as indications of future performance.

If there were a decline in demand or average selling prices for our products, including our Video-On-Demand Systems and Advertising Systems, our revenues and operating results would be materially affected.

We expect our VOD and advertising products to continue to account for a significant portion of our revenues. Accordingly, a decline in demand or average selling prices for these products, whether as a result of new product introductions by others, price competition, technological change, inability to enhance the products in a timely fashion, or otherwise, could have a material adverse effect on our business, financial condition and results of operations.

If we are unable to manage our growth and the related expansion in our operations effectively, our business may be harmed through a diminished ability to monitor and control effectively our operations, and a decrease in the quality of work and innovation of our employees.

Our ability to successfully offer new products and services and implement our business plan in a rapidly evolving market requires effective planning and management. We are also continuing to transition towards greater reliance on our video-on-demand products and services for an increased portion of our total revenue. In light of the growing complexities in managing our expanding portfolio of products and services, our anticipated future operations will continue to strain our operational and administrative resources. To manage future growth effectively, we must continue to improve our operational controls and internal controls over financial reporting, and to integrate the businesses we have acquired and our new personnel and to manage our expanding international operations. A failure to manage our growth may harm our business through a decreased ability to monitor and control effectively our operations, and a decrease in the quality of work and innovation of our employees upon which our business is dependent.

Because our business is susceptible to risks associated with international operations, we may not be able to maintain or increase international sales of our products, and we may not realize the full amount of the anticipated savings in connection with our continued trend towards the manufacture and assembly of our products outside of North America and EMEA.

Our international operations are expected to continue to account for a significant portion of our business in the future. However, in the future we may be unable to maintain or increase international sales of our products and services. Our international operations are subject to a variety of risks, including:

- difficulties in establishing and managing international distribution channels;
- difficulties in selling, servicing and supporting overseas products and in translating products into foreign languages;
- the uncertainty of laws and enforcement in certain countries relating to the protection of intellectual property;
- multiple and possibly overlapping tax structures;
- negative tax consequences such as withholding taxes and employer payroll taxes;
- changes in labor laws and regulations affecting our ability to hire and retain employees; and
- economic or political changes in international markets.

We are exposed to fluctuations in currency exchange rates that could negatively impact our financial results and cash flows.

To date, most of our revenues have been denominated in U.S. dollars, while a significant portion of our international expenses are incurred in the local currencies of countries in which we operate. Because a portion of our business is conducted outside the United States and the post-closing-payments to the former shareholders of eventIS Group B.V. are partially denominated in Euros, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. An increase in the value of the dollar could increase the real cost to our customers of our products in those markets outside the United States where we often sell in dollars, and a weakened dollar could increase local currency operating costs.

Currency exchange rate fluctuations could reduce our overall profits.

With the exception of On Demand Group (and its wholly-owned subsidiaries), eventIS Group B.V. and SeaChange B.V. the United States dollar is the functional currency for our international subsidiaries; therefore, all foreign translation currency gains and losses are included in our Consolidated Statements of Operations. In preparing our consolidated financial statements, certain financial information is required to be translated from foreign currencies to the United States dollar using either the spot rate or the weighted-average exchange rate. If the United States dollar changes relative to applicable local currencies, there is a risk our reported sales, operating expenses, and net income could significantly fluctuate. We are not able to predict the degree of exchange rate fluctuations, nor can we estimate the effect any future fluctuations may have upon our future operations.

Our ability to compete could be jeopardized if we are unable to protect our intellectual property rights from third-party challenges.

Our success and ability to compete depends upon our ability to protect our proprietary technology that is incorporated into our products. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. Although we have issued patents, we cannot assure that any additional patents will be issued or that the issued patents will not be invalidated. We also enter into confidentiality or license agreements with our employees, consultants and corporate partners, and control access to and distribution of our software, documentation and other proprietary information. Despite these precautions, it may be possible for a third party to copy or otherwise misappropriate and use our products or technology without authorization, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. We may need to resort to litigation in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. If competitors are able to use our technology, our ability to compete effectively could be harmed.

We have been and in the future could become subject to litigation regarding intellectual property rights, which could seriously harm our business and require us to incur significant legal costs to defend our intellectual property rights.

The industry in which we operate is characterized by vigorous protection and pursuit of intellectual property rights or positions, which on occasion, have resulted in significant and often protracted litigation. We have from time to time received, and may in the future receive, communications from third parties asserting infringements on patent or other intellectual property rights covering our products or processes. We have been involved in significant intellectual property litigation, and we may be a party to litigation in the future to enforce our intellectual property rights or as a result of an allegation that we infringe others' intellectual property. Any parties asserting that our products infringe upon their proprietary rights would force us to defend ourselves and possibly our customers or manufacturers against the alleged infringement, as many of our commercial agreements require us to defend and/or indemnify the other party against intellectual property infringement claims brought by a third party with respect to our products. These claims and any resulting lawsuit, if successful, could subject us to significant liability for damages and invalidation of our proprietary rights. This possibility of multiple damages serves to increase the incentive for plaintiffs to bring such litigation. In addition, these lawsuits, regardless of their success, would likely be time-consuming and expensive to resolve and would divert management time and attention away from our operations.

Although we carry general liability insurance, our insurance may not cover potential claims of this type or may not be adequate to indemnify us for all liability that may be imposed. In addition, any potential intellectual property litigation also could force us to stop selling, incorporating or using the products that use the infringed intellectual property or obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology, although this license may not be available on reasonable terms, or at all, or redesign those products that use the infringed intellectual property. If we are forced to take any of the foregoing actions, our business may be seriously harmed.

If content providers, such as movie studios, limit the scope of content licensed for use in the digital video-on-demand market, our business, financial condition and results of operations could be negatively affected because the potential market for our products would be more limited than we currently believe and have communicated to the financial markets.

The success of the video-on-demand market is contingent on content providers, such as movie studios, permitting their content to be licensed for use in this market. Content providers may, due to concerns regarding either or both marketing and illegal duplication of the content, limit the extent to which they provide content to the video-on-demand market. A limitation of content for the video-on-demand market would indirectly limit the market for our video-on-demand system which is used in connection with that market.

If we are unable to successfully introduce new products or enhancements to existing products, our financial condition and operating results may be adversely affected by a decrease in sales of our products.

Because our business plan is based on technological development of new products and enhancements to our existing products, our future success is dependent on our successful introduction of these new products and enhancements. In the future we may experience difficulties that could delay or prevent the successful development, introduction and marketing of these and other new products and enhancements, or find that our new products and enhancements do not adequately meet the requirements of the marketplace or achieve market acceptance. Announcements of currently planned or other new product offerings may cause customers to defer purchasing our existing products. Moreover, despite testing by us and by current and potential customers, errors or failures may be found in our products, and, even if discovered, may not be successfully corrected in a timely manner. These errors or failures could cause delays in product introductions and shipments, or require design modifications that could adversely affect our competitive position. Our inability to develop new products or enhancements on a timely basis or the failure of these new products or enhancements to achieve market acceptance could have a material adverse effect on our business, financial condition and results of operations.

Because we purchase certain material components used in manufacturing our products from sole suppliers and we use a limited number of third party manufacturers to manufacture our products, our business, financial condition and results of operations could be materially adversely affected by a failure of these suppliers or manufacturers.

Certain key components of our products are currently purchased from a sole supplier, including computer chassis, switching gear, an interface controller video transmission board, encoder and decoder hardware, and operating system and applications software. We have in the past experienced quality control problems, where products did not meet specifications or were damaged in shipping, and delays in the receipt of these components. These problems were generally of short duration and did not have a material adverse effect on our business and results of operations. However, we may i>
)

(1,378
)

(1,614
)
Other Income/ (Expense)
11

(129
)

(15
)

(266
)
Total Other Income/ (Expense)
440

(5,027
)

65

(5,155
)
Income Before Income Taxes
12,392

11,204

33,574

37,276

Income Tax Expense
471

748

2,938

2,402

Net Income
11,921

10,456

30,636

34,874

Less: Net Income Attributable to Non-Controlling Interests
9,756

8,534

25,443

29,408

Net Income Attributable to Pzena Investment Management, Inc.
$
2,165

$
1,922

$
5,193

$
5,466

Net Income for Basic Earnings per Share
$
2,165

$
1,922

$

5,193

$
5,466

Basic Earnings per Share
$
0.13

$
0.13

$
0.33

$
0.40

Basic Weighted Average Shares Outstanding[1]
16,390,298

14,585,650

15,807,340

13,591,432

Net Income for Diluted Earnings per Share
$
8,192

$
8,932

$
21,167

$
25,391

Diluted Earnings per Share
$
0.12

$
0.13

$
0.31

$
0.37

Diluted Weighted Average Shares Outstanding[1]
68,656,042

68,036,216

68,609,667

68,136,888

Cash Dividends per Share of Class A Common Stock
$
0.03

$
0.03

$
0.38

$
0.38

1 The Company issues restricted shares of Class A common stock and restricted Class B units that have non-forfeitable dividend rights. Under the "two-class method," these shares and units are considered participating securities and are required to be included in the computation of basic and diluted earnings per share.

See accompanying notes to unaudited consolidated financial statements.

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PZENA INVESTMENT MANAGEMENT, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
NET INCOME	$11,921	$10,456	$30,636	$34,874
OTHER COMPREHENSIVE LOSS				
Foreign Currency Translation Adjustment	(16)	(3)	(57)	(3)
Total Other Comprehensive Loss	(16)	(3)	(57)	(3)
Comprehensive Income	11,905	10,453	30,579	34,871
Less: Comprehensive Income Attributable to Non-Controlling Interests	9,744	8,532	25,400	29,406
Total Comprehensive Income Attributable to Pzena Investment Management, Inc.	$2,161	$1,921	$5,179	$5,465

See accompanying notes to unaudited consolidated financial statements.

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PZENA INVESTMENT MANAGEMENT, INC.
UNAUDITED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
(in thousands, except share and per-share amounts)

	Shares of Class A Common Stock	Shares of Class B Common Stock	Class A Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Non-Controlling Interests	Total Equity
Balance at December 31, 2015	15,218,355	52,089,472	$ 152	$ 5,819	$ (2)	$ 12,453	$ 67,040	$ 85,462
Adjustment for the Cumulative Effect of Applying ASU 2015-02 for the Deconsolidation of a Legal Entity	—	—	—	—	—	—	(10,835)	(10,835)
Adjusted Balance at January 1, 2016	15,218,355	52,089,472	152	5,819	(2)	12,453	56,205	74,627
Unit Conversion	1,369,811	(1,369,811)	14	1,243	—	—	(1,071)	186
Amortization of Non-Cash Compensation	24,934	22,723	—	518	—	—	1,551	2,069
Sale of Shares under Equity Incentive Plan	—	81,871	—	91	—	—	286	377
Directors' Share Grants	—	—	—	87	—	—	289	376
Net Income	—	—	—	—	—	5,193	25,443	30,636
Foreign Currency Translation Adjustments	—	—	—	—	(14)	—	(43)	(57)
Options Exercised	—	24,027	—	12	—	—	39	51
Repurchase and Retirement of Class A Common Stock	(258,279)	—	(2)	(2,005)	—	—	—	(2,007)
Repurchase and Retirement of Class B Units	—	(8,574)	—	(16)	—	—	(50)	(66)
Class A Cash Dividends Declared and Paid ($0.38 per share)	—	—	—	—	—	(5,794)	—	(5,794)
Contributions from Non-Controlling Interests	—	—	—	—	—	—	584	584
Distributions to Non-Controlling Interests	—	—	—	—	—	—	(39,695)	(39,695)
Effect of Deconsolidation	—	—	—	—	—	—	(80)	(80)
Other	—	—	—	(281)	—	—	281	—
Balance at September 30, 2016	16,354,821	50,839,708	$ 164	$ 5,468	$ (16)	$ 11,852	$ 43,739	$ 61,207

See accompanying notes to unaudited consolidated financial statements.

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PZENA INVESTMENT MANAGEMENT, INC.
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
OPERATING ACTIVITIES				
Net Income	$11,921	$10,456	$30,636	$34,874
Adjustments to Reconcile Net Income to Cash Provided by Operating Activities:				
Depreciation	263	269	802	521
Disposal of Fixed Assets	—	—	—	428
Non-Cash Compensation	1,765	1,300	4,947	4,334
Directors' Share Grants	99	82	376	310
(Gains)/ Losses and Other Investment Income	(1,533)	4,398	(1,131)	3,923
Foreign Currency Translation Adjustments	(16)	(3)	(57)	(3)
Change in Liability to Selling and Converting Shareholders	1,200	697	1,378	1,614
Deferred Income Taxes	(282)	127	1,215	767
Changes in Operating Assets and Liabilities:				
Advisory Fees Receivable	(4,067)	(781)	(3,336)	(1,632)
Due from Broker	294	(26)	(41)	(463)
Restricted Cash	(41)	110	45	(849)
Prepaid Expenses and Other Assets	219	(71)	(3)	(15)
Non-Cash Compensation Modification	—	—	—	(713)
Due to Broker	(91)	(454)	254	96
Accounts Payable, Accrued Expenses, and Other Liabilities	5,066	5,299	9,433	11,351
Change in Lease Liability	—	(496)	—	(107)
Purchases of Equity Securities and Securities Sold Short	(6,857)	(6,350)	(20,218)	(35,173)
Proceeds from Equity Securities and Securities Sold Short	6,911	6,803	18,082	31,452
Net Cash Provided by Operating Activities	14,851	21,360	42,382	50,715
INVESTING ACTIVITIES				
Purchases of Investments	(225)	(1,376)	(2,097)	(8,149)
Proceeds from Sale of Investments	220	1,229	2,383	8,289
Payments to Related Parties	217	(12)	(76)	(218)
Purchases of Property and Equipment	—	(643)	(95)	(6,190)
Net Cash Provided by/ (Used in) Investing Activities	212	(802)	115	(6,268)
FINANCING ACTIVITIES				
Repurchase and Retirement of Class A Common Stock	(501)	(2,680)	(2,007)	(5,023)
Repurchase and Retirement of Class B Units	—	(147)	(66)	(1,731)
Sale of Shares under Equity Incentive Plan	55	372	377	372
Option Exercise	51	—	51	1,688
Distributions to Non-Controlling Interests	(7,993)	(8,544)	(39,695)	(40,682)
Contributions from Non-Controlling Interests	115	111	584	496
Dividends	(491)	(468)	(5,794)	(5,033)
Net Cash Used in Financing Activities	(8,764)	(11,356)	(46,550)	(49,913)
NET CHANGE IN CASH	$6,299	$9,202	$(4,053)	$(5,466)
CASH AND CASH EQUIVALENTS - Beginning of Period	$24,838	$24,441	$35,417	$39,109

Adjustment for the Cumulative Effect of Applying ASU 2015-02 for the Deconsolidation of a Legal Entity	—	—	(227)	—
Effect of Deconsolidation	(75)	—	(75)	—
Net Change in Cash	6,299	9,202	(4,053)	(5,466)
CASH AND CASH EQUIVALENTS - End of Period	$31,062	$33,643	$31,062	$33,643
Supplementary Cash Flow Information:				
Income Taxes Paid	$295	$262	$665	$1,031

See accompanying notes to unaudited consolidated financial statements.

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements

Note 1—Organization

Pzena Investment Management, Inc. (the "Company") is the sole managing member of its operating company, Pzena Investment Management, LLC (the "operating company"). As a result, the Company: (i) consolidates the financial results of the operating company and reflects the membership interests that it does not own as a non-controlling interest in its consolidated financial statements; and (ii) recognizes income generated from its economic interest in the operating company's net income.

The operating company is an investment adviser registered under the Investment Advisers Act of 1940 and is headquartered in New York, New York. As of September 30, 2016, the operating company managed assets in a variety of value-oriented investment strategies across a wide range of market capitalizations in both U.S. and non-U.S. capital markets.

The Company also serves as the general partner of Pzena Investment Management, LP, a partnership formed with the objective of aggregating employee ownership in the operating company into one entity.

The Company, through its interest in the operating company, has consolidated the results of operations and financial condition of the following entities as of September 30, 2016:

Legal Entity	Type of Entity (Date of Formation)	Ownership at September 30, 2016	
Pzena Investment Management, Pty	Australian Proprietary Limited Company (12/16/2009)	100.0	%
Pzena Financial Services, LLC	Delaware Limited Liability Company (10/15/2013)	100.0	%
Pzena Investment Management, LTD	England and Wales Private Limited Company (01/08/2015)	100.0	%
Pzena Investment Management Special Situations, LLC	Delaware Limited Liability Company (12/01/2010)	99.9	%
Pzena Mid Cap Value Fund, a series of Advisors Series Trust	Open-end Management Investment Company, series of Delaware Statutory Trust (3/31/2014)	87.1	%
Pzena Long/Short Value Fund, a series of Advisors Series Trust	Open-end Management Investment Company, series of Delaware Statutory Trust (3/31/2014)	80.2	%
Pzena International Value Service, a series of Pzena Investment Management International, LLC	Delaware Limited Liability Company (12/22/2003)	53.5	%

Note 2—Significant Accounting Policies

Basis of Presentation:

Principles of Consolidation:

The consolidated financial statements are prepared in conformity with U.S. generally accepted accounting principles ("GAAP") and related Securities and Exchange Commission ("SEC") rules and regulations. The Company's policy is to consolidate those entities in which it has a direct or indirect controlling financial interest based on either the voting interest model or the variable interest model. As such, the Company consolidates majority-owned subsidiaries in which it has a controlling financial interest, and certain investment vehicles the operating company sponsors for which it is the investment adviser that are considered to be variable-interest entities (“VIEs”) and for which the Company is deemed to be the primary beneficiary.

For equity investments where the Company does not control the investee, and where it is not the primary beneficiary of a VIE, but can exert significant influence over the financial and operating policies of the investee, the Company follows the equity method of accounting. The evaluation of whether the Company exerts control or significant influence over the financial and operating policies of the investee requires significant judgment based on the facts and circumstances surrounding each investment. Factors considered in these evaluations may include the type of investment, the legal structure of the investee, the terms of the investment agreement, or other agreements with the investee.

Adoption of ASU 2015-02

Effective January 1, 2016, the Company adopted Financial Accounting Standards Board ("FASB") Accounting Standards Update No. 2015-02, Amendments to the Consolidation Analysis ("ASU 2015-02") under the modified retrospective approach. Restatement of prior period results was not required.

For legal entities evaluated for consolidation, the Company must determine whether interests it holds and fees paid to it qualify as a variable interest. Pursuant to ASU 2015-02, fees, including fees that are determined based on expense reimbursements, that are customary and commensurate with the level of services provided are not considered a variable interest when the Company does not hold other economic interests in the entity that would absorb more than an insignificant amount of the expected losses or returns of the entity. The Company factors in all economic interests, including proportionate interests through related parties, to determine if fees are considered variable interests. If it is determined that the Company does not have a variable interest in the entity, no further analysis is required and the Company does not consolidate the entity. If it is determined that the Company has a variable interest, it considers its direct economic interests and the proportionate indirect interests through related parties to determine if it is the primary beneficiary of the VIE.

Also pursuant to ASU 2015-02, the FASB clarifies the treatment of entities structured as series funds which comply with the requirements included in the Investment Company Act of 1940 for registered mutual funds. These entities are now considered voting interest entities because the shareholders are deemed to have the ability to direct the activities of the fund that most significantly impact the fund's economic performance.

As a result of the adoption of ASU 2015-02, the Company deconsolidated certain previously consolidated entities as the Company either did not have a variable interest in the entity or the Company did not own more than 50% of a series fund now required to be considered for consolidation under the voting interest model. In addition, upon adoption of ASU 2015-02, the Company is no longer considered to have fee-based variable interests in certain private investment partnerships the operating company sponsors and these entities are no longer considered VIE's.

Consolidated Entities

The Company consolidates the financial results of the operating company and records in its own equity its pro-rata share of transactions that impact the operating company’s net equity, including unit and option issuances, repurchases, and retirements. The operating company’s pro-rata share of such transactions are recorded as an adjustment to additional paid-in capital or non-controlling interests, as applicable, on the consolidated statements of financial condition.

The majority-owned subsidiaries in which the Company, through its interest in the operating company, has a controlling financial interest and the VIEs for which the Company is deemed to be the primary beneficiary are collectively referred to as “consolidated subsidiaries.” Non-controlling interests recorded on the consolidated financial statements of the Company include the non-controlling interests of the outside investors in each of these entities, as well as those of the operating company. All significant inter-company transactions and balances have been eliminated through consolidation.

During 2014, the Company provided the initial cash investment for three Pzena Mutual Funds in an effort to generate an investment performance track record to attract third-party investors. During the three months ended June 30, 2016, the Company provided the initial cash investment for the launch of a fourth Pzena Mutual Fund: the Pzena Small Cap

Value Fund. Due to their series fund structure, registration, and compliance with the requirements of the Investment Company Act of 1940, these funds are analyzed for consolidation under the voting interest model. As a result of the Company's interests, it consolidated the Pzena Mid Cap Value Fund, Pzena Long/Short Value Fund and Pzena Small Cap Value Fund. On July 11, 2016, due to additional subscriptions into the Pzena Small Cap Value Fund, the Company's ownership decreased to 36.1%. As the entity was no longer deemed to control the fund, the Company deconsolidated the entity, removed the related assets, liabilities and non-controlling interest from its balance sheet and classified the Company's remaining investment as an equity method investment. The Pzena Mid Cap Value Fund and Pzena Long/Short Value Fund will continue to be consolidated to the extent the Company has a majority ownership interest in them. At September 30, 2016, the aggregate of these funds' $7.6 million in net assets was included in the Company's consolidated statements of financial condition.

The operating company is the managing member of Pzena International Value Service, a series of Pzena Investment Management International, LLC. The operating company is considered the primary beneficiary of this entity. At September 30, 2016, Pzena International Value Service’s $3.3 million in net assets were included in the Company’s consolidated statements of financial condition.

Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

Deconsolidated Entities as a Result of the Adoption of ASU 2015-02

Certain funds that have historically been consolidated in the financial statements are no longer consolidated. The Company had consolidated the Pzena Investment Funds Trust, Pzena Large Cap Value Fund ("Pzena Large Cap Value Fund") in its consolidated financial statements in accordance with the Consolidation Topic of the FASB Accounting Standards Codification (“FASB ASC”). The Company reconsidered the consolidation conclusion for the Pzena Large Cap Value Fund as a result of ASU 2015-02 and determined that, although the Pzena Large Cap Value Fund continues to be a VIE, the Company is no longer considered the primary beneficiary.

Prior to January 1, 2016, the Company had consolidated the Pzena Emerging Markets Value Fund as the fund previously met the definition of VIE due to its series fund structure, as the shareholders of the fund lacked the ability to make decisions regarding the trustees and key activities of the fund. The Company reconsidered the consolidation conclusion as a result of the adoption of ASU 2015-02, and determined that, as the Pzena Emerging Markets Value Fund is a series and registered mutual fund that complies with the requirements of the Investment Company Act of 1940, it will be analyzed for consolidation under the voting interest model. The Company is deemed to not have a controlling interest in the Pzena Emerging Markets Value Fund.

The deconsolidation of these previously consolidated entities had the following impact on the consolidated statement of financial condition as of January 1, 2016:

	As of December 31, 2015	Impact of Deconsolidation	Adjusted as of January 1, 2016
	(in thousands)		
Number of entities	11	(2)	9
Total Assets	$114,309	$ (10,910)	$103,399
Total Liabilities	$28,847	$ (75)	$28,772
Total Equity	$85,462	$ (10,835)	$74,627

Non-Consolidated Variable Interest Entities

VIEs that are not consolidated receive investment management services from the operating company and are generally private investment partnerships sponsored by the operating company. The total net assets of these VIEs was approximately $41.2 million and $390.1 million at September 30, 2016 and December 31, 2015, respectively.

As of September 30, 2016 and December 31, 2015, in order to satisfy certain of the Company's obligations under its deferred compensation programs, the operating company had $3.0 million and $1.7 million in investments, respectively, in certain of these firm-sponsored vehicles, for which the Company was not deemed to be primary beneficiary.

Management’s Use of Estimates:

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses for the period. Actual results could differ from those estimates.

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

Revenue Recognition:

Revenue, comprised of advisory fee income, is recognized over the period in which advisory services are provided. Advisory fee income includes management fees that are calculated based on percentages of assets under management (“AUM”), generally billed quarterly, either in arrears or advance, depending on the applicable contractual terms. Advisory fee income also includes performance fees that may be earned by the Company depending on the investment return of the AUM, as well as fulcrum fee arrangements. Performance fee arrangements generally entitle the Company to participate, on a fixed-percentage basis, in any returns generated in excess of an agreed-upon benchmark. The Company’s participation percentage in such return differentials is then multiplied by AUM to determine the performance fees earned. In general, returns are calculated on an annualized basis over the contract’s measurement period, which usually extends to three years. Performance fees are generally payable annually. Fulcrum fee arrangements require a reduction in the base fee, or allow for a performance fee if the relevant investment strategy underperforms or outperforms, respectively, the agreed-upon benchmark over the contract's measurement period, which extends to three years. Fulcrum fees are generally payable quarterly. Following the preferred method identified in the Revenue Recognition Topic of the FASB ASC, fee income is recorded at the conclusion of the contractual performance period, when all contingencies are resolved. For the three months ended September 30, 2016, the Company did not recognize performance fee income. For the nine months ended September 30, 2016, the Company recognized approximately $0.1 million in performance fee income. For the three and nine months ended September 30, 2015, the Company recognized approximately $3.2 million and $3.9 million in performance fee income, respectively. For each of the three and nine months ended September 30, 2016, the Company recognized a $0.7 million reduction in base fees related to fulcrum fee arrangements. For the three and nine months ended September 30, 2015, the Company did not recognized a reduction in base fees related to fulcrum fee arrangements.

Cash and Cash Equivalents:

At September 30, 2016 and December 31, 2015, Cash and Cash Equivalents was $31.1 million and $35.4 million, respectively. The Company considers all money market funds and highly-liquid debt instruments with an original maturity of three months or less at the time of purchase to be cash equivalents. The Company maintains its cash in bank deposits and other accounts whose balances often exceed federally insured limits.

Interest on cash and cash equivalents is recorded as interest income on an accrual basis in the consolidated statements of operations.

Restricted Cash:

At September 30, 2016 and December 31, 2015, the Company had $3.5 million and $3.6 million, respectively, of compensating balances recorded in Restricted Cash in the consolidated statements of financial condition.

Included in this balance at September 30, 2016 is a $1.0 million letter of credit issued by a third party in lieu of a cash security deposit, as required by the Company’s lease for its corporate headquarters. At December 31, 2015, this balance included $1.4 million in such letters of credit required by the Company's leases for both is current and former headquarters.

Also included in these balances at September 30, 2016 and December 31, 2015, were amounts of cash collateral for margin accounts established by the Pzena Long/Short Value Fund required to maintain to support securities sold short, not yet purchased of $2.5 million and $2.2 million, respectively.

Due to/from Broker:

Due to/from Broker consists primarily of amounts payable/receivable for unsettled securities transactions held/initiated at the clearing brokers of the Company's consolidated subsidiaries.

Investments:

Investment Securities, trading
Investments classified as trading securities consist of equity securities held by the Company and its consolidated subsidiaries. Certain of the Company's investments are held to satisfy the Company's obligations under its deferred compensation program. Dividends associated with the Company's investments and the investments of the Company's consolidated subsidiaries are recognized as dividend income on an ex-dividend basis in the consolidated statements of operations.

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

Securities Sold Short represents securities sold short, not yet purchased by the Pzena Long/Short Value Fund, which is consolidated with the Company's financial statements. Dividend expense associated with these investments is recognized in Other Expense on an ex-dividend basis in the consolidated statements of operations.

All such investments are recorded at fair value, with net realized and unrealized gains and losses reported in earnings. Net realized and unrealized gains and losses are recognized as a component of Gains/ (Losses) and Other Investment Income in the consolidated statements of operations.

Investments in equity method investees
During the three and nine months ended September 30, 2016, the Company accounted for its investments in certain private investment partnerships, the Pzena Emerging Markets Value Fund, and, as of July 11, 2016, the Pzena Small Cap Value Fund, in which the Company has non-controlling interests and exercises significant influence, using the equity method. These investments are included in Investments in the Company's consolidated statements of financial condition. The carrying value of these investments are recorded at the amount of capital reported by the private investment partnership or mutual fund. The capital account reflects any contributions paid to, distributions received from, and equity earnings of, the entities. The earnings of these investments are recognized as equity in the earnings of affiliates and reflected as a component of Gains/ (Losses) and Other Investment Income in the consolidated statements of operations.

Investments in equity method investees are evaluated for impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. If the carrying amounts of the assets exceed their respective fair values, additional impairment tests are performed to measure the amounts of impairment losses, if any. During the three and nine months ended September 30, 2016 and 2015, no impairment losses were recognized.

Fair Value Measurements:

The Fair Value Measurements and Disclosures Topic of the FASB ASC defines fair value as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. The Fair Value Measurements and Disclosures Topic of the FASB ASC also establishes a framework for measuring fair value and a valuation hierarchy based upon the transparency of inputs used in the valuation of an asset or liability. Classification within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The valuation hierarchy contains three levels: (i) valuation inputs are unadjusted quoted market prices for identical assets or liabilities in active markets (Level 1); (ii) valuation inputs are quoted prices for identical assets or liabilities in markets that are not active, quoted market prices for similar assets and liabilities in active markets, and other observable inputs directly or indirectly related to the asset or liability being measured (Level 2); and (iii) valuation inputs are unobservable and significant to the fair value measurement (Level 3).

Included in the Company’s consolidated statements of financial condition are investments in equity securities and securities sold short, both of which are exchange-traded securities with quoted prices in active markets. The fair value measurements of the equity securities, securities sold short, have been classified as Level 1. The investments in equity method investees are held at their carrying value.

As of December 31, 2015, the Company consolidated the Pzena Emerging Markets Value Fund which was deconsolidated upon the adoption of ASU 2015-02 as discussed above. As of December 31, 2015, included in the

Company's consolidated statements of financial condition are investments in participatory notes (“P-notes”) held by the Pzena Emerging Markets Value Fund. P-notes are generally issued by a bank or broker-dealer (the “counterparty”) and are designed to offer a return linked to a particular underlying equity security, especially in markets where direct investments are not possible. The risks associated with investing in a P-note may include the possible failure of the counterparty to perform its obligations under the terms of the agreement, an inability to liquidate or transfer the notes, and an imperfect correlation between the value of the P-note and the underlying security. P-notes are valued based on the value of the underlying equity security and have been classified as Level 2.

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Pzena Investment Management, Inc.

Notes to Unaudited Consolidated Financial Statements (Continued)

The following table presents these instruments' fair value at September 30, 2016:

	Level 1	Level 2	Level 3	Other Assets Not Held at Fair Value	Total
	(in thousands)				
Assets:					
Equity Securities	$12,717	$ —	$ —	$—	$12,717
Investments in Equity Method Investees	—	—	—	7,365	7,365
Total	$12,717	$ —	$ —	$7,365	$20,082

	Level 1	Level 2	Level 3	Other Liabilities Not Held at Fair Value	Total
	(in thousands)				
Liabilities:					
Securities Sold Short	$2,483	$ —	$ —	$ —	$2,483

The following table presents these instruments' fair value at December 31, 2015:

	Level 1	Level 2	Level 3	Other Assets Not Held at Fair Value	Total
	(in thousands)				
Assets:					
Equity Securities	$24,835	$904	$ —	$—	$25,739
Investments in Equity Method Investees	—	—	—	1,713	1,713
Total	$24,835	$904	$ —	$1,713	$27,452

	Level 1	Level 2	Level 3	Other Liabilities Not Held at Fair Value	Total
	(in thousands)				
Liabilities:					
Securities Sold Short	$2,231	$ —	$ —	$ —	$2,231

For the three and nine months ended September 30, 2016 and 2015, there were no transfers between levels. In addition, the Company did not hold any Level 3 securities during these periods. The Company did not hold any Level 2 securities during the three or nine months ended September 30, 2016.

Securities Valuation:

Investments in equity securities and securities sold short for which market quotations are available are valued at the last reported price or closing price on the primary market or exchange on which they trade. If no reported equity sales occurred on the valuation date, equity investments are valued at the bid price. Transactions are recorded on a trade date basis.

The net realized gain or loss on sales of equity securities and securities sold short is determined on a specific identification basis and is included in Gains/ (Losses) and Other Investment Income in the consolidated statements of operations.

Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

Concentrations of Credit Risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, amounts due from brokers, and advisory fees receivable. The Company maintains its cash and cash equivalents in bank deposits and other accounts whose balances often exceed federally insured limits.

The concentration of credit risk with respect to advisory fees receivable is generally limited due to the short payment terms extended to clients by the Company. On a periodic basis, the Company evaluates its advisory fees receivable and establishes an allowance for doubtful accounts, if necessary, based on a history of past write-offs, collections, and current credit conditions. For the three and nine months ended September 30, 2016, approximately 8.7% and 10.1% of the Company's advisory fees, respectively, were generated from advisory agreements with one client relationship. For each of the three and nine months ended September 30, 2015, approximately 10.0% and 10.6% of the Company's advisory fees, respectively, were generated from advisory agreements with one client relationship. At September 30, 2016 and December 31, 2015, no allowance for doubtful accounts was deemed necessary.

Property and Equipment:

Property and equipment is carried at cost, less accumulated depreciation and amortization. Depreciation is provided on a straight-line basis over the estimated useful lives of the respective assets, which range from three to seven years. Leasehold improvements are amortized on a straight-line basis over the shorter of the useful life of the improvements or the remaining lease term.

Business Segments:

The Company views its operations as comprising one operating segment.

Income Taxes:

The Company is a “C” corporation under the Internal Revenue Code, and thus liable for federal, state, and local taxes on the income derived from its economic interest in its operating company. The operating company is a limited liability company that has elected to be treated as a partnership for tax purposes. It has not made a provision for federal or state income taxes because it is the individual responsibility of each of the operating company’s members (including the Company) to separately report their proportionate share of the operating company’s taxable income or loss. The operating company has made a provision for New York City Unincorporated Business Tax (“UBT”) and it's consolidated subsidiary Pzena Investment Management, LTD has made a provision for U.K. income taxes.

Judgment is required in evaluating the Company's uncertain tax positions and determining its provision for income taxes. The Company establishes liabilities for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes will be due. These liabilities are established when the Company believes that certain positions might be challenged despite its belief that its tax return positions are in accordance with applicable tax laws. The Company adjusts these liabilities in light of changing facts and circumstances, such as the closing of a tax audit, new tax legislation or the change of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will affect the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the effect of reserve provisions and changes to reserves that are considered appropriate. It is also the Company’s policy to recognize accrued interest, and penalties associated with uncertain tax positions in Income Tax Expense on the consolidated statements of operations. As of September 30, 2016 and December 31, 2015, the Company had $3.1 million and $2.3 million in unrecognized tax benefits that, if recognized, would affect the provision for income taxes. As of September 30, 2016, we had interest related to unrecognized tax benefits of $0.3 million. As December 31, 2015, no such accruals were recorded.

The Company and its consolidated subsidiaries account for all U.S. federal, state, local, and U.K. taxation pursuant to the asset and liability method, which requires deferred income tax assets and liabilities to be recorded for temporary differences between the carrying amount and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future, based on enacted tax laws and rates applicable to the periods in which the temporary differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount more likely than not to be realized. At September 30, 2016, the Company had a $57.2 million valuation allowance against deferred tax assets recorded as part of the Company’s initial public offering and the subsequent exchanges of Class B units for shares of its Class A common stock. At December 31, 2015, the Company had a $54.0 million valuation allowance against these deferred tax assets. The income tax expense, or benefit, is the tax payable or refundable for the period, plus or minus the change during the period in deferred tax assets and liabilities. The Company records its deferred tax liabilities as a component of other liabilities in the consolidated statements of financial condition.

Excess tax benefits related to stock- and unit-transactions are not recognized until they result in a reduction of cash taxes payable. The benefit of these excess tax benefits will be recorded in equity when they reduce cash taxes payable. The Company will only recognize a tax benefit from stock- and unit-based awards in Additional Paid-In Capital if an incremental tax benefit is realized after all other tax benefits currently available have been utilized. For the three and nine months ended September 30, 2015 the Company had $0.1 million and $0.3 million, respectively, in tax benefits associated with stock- and unit-based awards that it was not able to recognize. For the three and nine months ended September 30, 2016, the Company recognized no such benefits.

Foreign Currency:

The functional currency of the Company is the U.S. Dollar. Assets and liabilities of foreign operations whose functional currency is not the U.S. Dollar are translated at the exchange rate in effect at the applicable reporting date, and the consolidated statements of operations are translated at the average exchange rates in effect during the applicable period. A charge or credit is recorded to other comprehensive income/ (loss) to reflect the translation of these amounts to the extent the non-U.S. currency is designated the functional currency of the subsidiary. Non-functional currency related transaction gains and losses are immediately recorded in the consolidated statements of operations. For the three and nine months ended September 30, 2016 the Company recorded less than $0.1 million and $0.1 million, respectively, of other comprehensive income/ (loss) associated with foreign currency translation adjustments. For each of the three and nine months ended September 30, 2015, the Company recorded less than $0.1 million of other comprehensive income/ (loss).

Investment securities and other assets and liabilities denominated in foreign currencies are remeasured into U.S. Dollar amounts at the date of valuation. Purchases and sales of investment securities, and income and expense items denominated in foreign currencies, are remeasured into U.S. Dollar amounts on the respective dates of such transactions.

The Company does not isolate the portion of the results of its operations resulting from the impact of fluctuations in foreign exchange rates on its non-U.S. investments. Such fluctuations are included in Gains/ (Losses) and Other Investment Income in the consolidated statements of operations.

Reported net realized foreign exchange gains or losses arise from sales of foreign currencies, currency gains or losses realized between the trade and settlement dates on securities transactions, and the difference between the amounts of dividends, interest, foreign withholding taxes, and other receivables and payables recorded on the Company’s consolidated statements of financial condition and the U.S. Dollar equivalent of the amounts actually received or paid. Net unrealized foreign exchange gains and losses arise from changes in the fair values of assets and liabilities resulting from changes in exchange rates.

Recently Issued Accounting Pronouncements Not Yet Adopted:

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230)." This update provides specific guidance on cash flow classification issues, which is intended to reduce the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The guidance is effective for the fiscal years and interim periods within those years beginning after December 15, 2017. The guidance should be applied using a modified retrospective approach. The Company is assessing the impact this standard will have on the consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses (Topic 326)." This new guidance requires the use of an “expected loss” model, rather than an “incurred loss” model, for financial instruments measured at amortized cost and also requires companies to record allowances for available-for-sale debt securities rather than reduce the carrying amount. The guidance is effective for the fiscal years and interim periods within those years beginning after December 15, 2019. The guidance should be applied using a retrospective approach. The Company is assessing the impact this standard will have on the consolidated financial statements and related disclosures.

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In March 2016, the FASB issued ASU No. 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." This update involves amendments related to several aspects of accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The guidance is effective for the fiscal years and interim periods within those years beginning after December 15, 2016, and requires transition methods specific to each amendment in either a modified retrospective, retrospective, or prospective method. The Company is assessing the impact this standard will have on the consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." This amended standard was written to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The new standard requires lessees to recognize a right-of-use asset and lease liability for all leases with terms of more than 12 months. Recognition, measurement and presentation of expenses will depend on classification as a finance or operating lease. The amendments also require certain quantitative and qualitative disclosure. Accounting guidance for lessors is largely unchanged. This guidance is effective for the fiscal years and interim periods within those years beginning after December 15, 2018, and requires a modified retrospective approach to adoption. The Company is assessing the impact this standard will have on the consolidated financial statements and related disclosures.

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." The core principle of the revenue model is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the goods or services. In July 2015, the FASB postponed the effective date of this new guidance from January 1, 2017 to January 1, 2018. Early application is not permitted. The standard permits the use of either the retrospective or cumulative effect transition method. The Company is currently evaluating the potential impact on the consolidated statements and related disclosures, as well as the available transition methods.

Note 3—Compensation and Benefits

Compensation and benefits expense to employees and members is comprised of the following:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Cash Compensation and Other Benefits	$10,002	$10,345	$31,017	$31,181
Non-Cash Compensation	1,765	1,300	4,947	4,334
Total Compensation and Benefits Expense	$11,767	$11,645	$35,964	$35,515

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

All non-cash compensation awards granted have varying vesting schedules and are issued at prices equal to the assessed fair market value at the time of issuance, as discussed below. Details of non-cash compensation awards granted during the three and nine months ended September 30, 2016 and 2015 are as follows:

	For the Three Months Ended September 30,			
	2016		2015	
	Amount	Fair Value (1)	Amount	Fair Value (1)
Options to Purchase Shares of Class A Common Stock[2]	—	$ —	2,000,000	$ 1.23

	For the Nine Months Ended September 30,			
	2016		2015	
	Amount	Fair Value[1]	Amount	Fair Value[1]
Restricted Class B Units	5,812	$ 8.60	23,782	$ 9.46
Options to Purchase Shares of Class A Common Stock[2]	—	$ —	3,000,000	$ 1.18
Deferred Compensation Phantom Delayed Exchange Class B Units[3]	149,533	$ 5.12	—	$ —
Participating Shares of Restricted Class A Common Stock[4]	—	$ —	29,868	$ 8.37
Restricted Shares of Class A Common Stock[5]	—	$ —	100,000	$ 6.08

[1] Represents the grant date fair value per share or unit.
[2] Represents contingently vesting options to purchase shares of Class A common stock. These share options vest over a period of seven years contingent on meeting various performance goals.
[3] Represents phantom Delayed Exchange Class B units issued under the Bonus Plan. These units vest ratably over four years and become Delayed Exchange Class B units upon vesting which may not be exchanged pursuant the Amended and Restated Operating Agreement until the seventh anniversary of the vesting date and are not entitled to any benefits under the Tax Receivable Agreement.
[4] Represents restricted shares of Class A common stock that receive nonforfeitable rights to dividends.
[5] Represents restricted shares of Class A common stock issued under the 2007 Equity Incentive Plan. These shares vest ratably over ten years and are not entitles to receive dividend or dividend equivalents until vested.

Pursuant to the Pzena Investment Management, LLC Amended and Restated 2006 Equity Incentive Plan ("the 2006 Equity Incentive Plan"), the operating company issues Class B units, phantom Class B units and options to purchase Class B units. The Company also issues Delayed Exchange Class B units pursuant to the 2006 Equity Incentive Plan. These Class B units vest immediately upon grant, but may not be exchanged pursuant to the Amended and Restated Operating Agreement of the operating company until at least the seventh anniversary of the date of grant. These units are also not entitled to any benefit under the Tax Receivable Agreement between the Company and members of the operating company. Under the Pzena Investment Management, Inc. 2007 Equity Incentive Plan ("the 2007 Equity Incentive Plan"), the Company issues shares of restricted Class A common stock and contingently vesting options to acquire shares of Class A common stock. During the three and nine months ended September 30, 2016, 48,000 phantom Class B units were forfeited in connection with an employee departure. No units were forfeited during the three months ended September 30, 2015. During the nine months ended September 30, 2015, 5,775 restricted Class B units were forfeited in connection with employee departures. During each of the three and nine months ended September 30, 2016 and 2015, no contingently vesting options vested. During the three and nine months ended

September 30, 2016, 11,893 and 81,871 Delayed Exchange Class B units were issued to certain employee members, respectively, for approximately $0.1 million and $0.4 million in cash, respectively. During the three and nine months ended September 30, 2015, 78,093 Delayed Exchange Class B units were issued for approximately $0.4 million in cash to certain employee members. During the nine months ended September 30, 2015, 142,315 Delayed Exchange Class B units issued to one employee during 2014 were canceled and replaced with cash compensation. Additional compensation expense of less than $0.1 million was recognized upon cancellation and replacement of the award. No Class B units were canceled during the three months ended September 30, 2016 and 2015 or the nine months ended September 30, 2016.

Under the Pzena Investment Management, LLC Amended and Restated Bonus Plan (the “Bonus Plan”), eligible employees whose compensation is in excess of certain thresholds are required to defer a portion of that excess. These deferred amounts may be invested, at the employee’s discretion, in certain investment options designated by the Compensation Committee of the Company's Board of Directors. Amounts deferred in any calendar year reduce that year’s compensation expense and are

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amortized and vest ratably over a four-year period commencing the following year. The Company also issued to certain of its employees deferred compensation with certain investment options that also vest ratably over a four-year period. As of both September 30, 2016 and December 31, 2015, the liability associated with all deferred compensation investment accounts was $2.9 million. During the three and nine months ended September 30, 2016, approximately $0.1 million and $0.2 million, respectively, in deferred compensation investments were forfeited in connection with employee departures. No deferred compensation was forfeited during the three and nine months ended September 30, 2015.

Pursuant to the Pzena Investment Management, Inc. Non-Employee Director Deferred Compensation Plan (the "Director Plan"), non-employee directors may elect to have all or part of their compensation otherwise payable in cash, deferred in the form of phantom shares of Class A common stock of the Company issued under the 2007 Equity Incentive Plan. Elections to defer compensation under the Director Plan are made on a year-to-year basis. Distributions under the Director Plan are made in a single distribution of shares of Class A common stock at such time as elected by the participant when the deferral was made. Since inception of the Director Plan in 2009, the Company's directors have elected to defer 100% of their compensation in the form of phantom shares of Class A common stock. Amounts deferred in any calendar year are amortized over the calendar year and reflected as General and Administrative Expense. As of September 30, 2016 and December 31, 2015, there were 290,315 and 232,585 phantom shares of Class A common stock outstanding, respectively. For the three and nine months ended September 30, 2016 and 2015, no distributions were made under the Director Plan.

The Company has issued to certain of its employees delayed-vesting cash awards. For the three and nine months ended September 30, 2016 and 2015, no such awards were granted. During the year ended December 31, 2015, $0.4 million was paid in conjunction with previously awarded delayed-vesting cash awards with varying vesting schedules. As of September 30, 2016, no such awards were outstanding.

As of September 30, 2016 and December 31, 2015, the Company had approximately $26.3 million and $31.0 million, respectively, in unrecorded compensation expense related to unvested awards issued pursuant to its Bonus Plan and certain agreements; Class B units, Delayed Exchange Class B units, and phantom Class B units issued under the 2006 Equity Incentive Plan; and restricted Class A common stock and contingently vesting option grants issued under the 2007 Equity Incentive Plan. The Company anticipates that this unrecorded cost will amortize over the respective vesting periods of the awards.

Note 4 – Employee Benefit Plans

The operating company has a Profit Sharing and Savings Plan for the benefit of substantially all employees. The Profit Sharing and Savings Plan is a defined contribution profit sharing plan with a 401(k) deferral component. All full-time employees and certain part-time employees who have met the age and length of service requirements are eligible to participate in the plan. The plan allows participating employees to make elective deferrals of compensation up to the annual limits which are set by law. The plan provides for a discretionary annual contribution by the operating company which is determined by a formula based on the salaries of eligible employees as defined by the plan. For each of the three and nine months ended September 30, 2016 and 2015, the expense recognized in connection with this plan was $0.2 million and $0.7 million, respectively.

Note 5—Earnings per Share

Basic earnings per share is computed by dividing the Company's net income attributable to its common stockholders by the weighted average number of shares outstanding during the reporting period.

Under the two-class method of computing basic earnings per share, basic earnings per share is calculated by dividing net income for basic earnings per share by the weighted average number of common shares outstanding during the period. The two-class method includes an earnings allocation formula that determines earnings per share for each participating security according to dividends declared and undistributed earnings for the period. The Company's net income for basic earnings per share is reduced by the amount allocated to participating restricted shares of Class A common stock which participate for purposes of calculating earnings per share.

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

For the three and nine months ended September 30, 2016 and 2015, the Company’s basic earnings per share was determined as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands, except share and per share amounts)			
Net Income for Basic Earnings per Share Allocated to:				
Class A Common Stock	$2,163	$ 1,918	$5,187	$ 5,457
Participating Shares of Restricted Class A Common Stock	2	4	6	9
Total Net Income for Basic Earnings per Share	$2,165	$ 1,922	$5,193	$ 5,466
Basic Weighted-Average Shares Outstanding	16,375,364	14,555,782	15,788,809	10,568,566
Add: Participating Shares of Restricted Class A Common Stock [1]	14,934	29,868	18,531	22,866
Total Basic Weighted-Average Shares Outstanding	16,390,298	14,585,650	15,807,340	10,591,432
Basic Earnings per Share	$0.13	$ 0.13	$0.33	$ 0.40

[1] Certain unvested shares of Class A common stock granted to employees have nonforfeitable rights to dividends and therefore participate fully in the results of the Company from the date they are granted. They are included in the computation of basic earnings per share using the two-class method for participating securities.

Diluted earnings per share adjusts this calculation to reflect the impact of all outstanding membership units of the operating company, phantom Class B units, phantom Delayed Exchange Class B units, phantom Class A common stock, outstanding Class B unit options, options to purchase Class A common stock, and restricted Class A common stock, to the extent they would have a dilutive effect on net income per share for the reporting period. Net income for diluted earnings per share assumes that all outstanding operating company membership units are converted into Company stock at the beginning of the reporting period and the resulting change to the Company's net income associated with its increased interest in the operating company is taxed at the Company’s effective tax rate, exclusive of one-time charges and adjustments associated with both the valuation allowance and the liability to selling and converting shareholders and other one-time charges.

For the three and nine months ended September 30, 2016 and 2015, the Company’s diluted net income was determined as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Net Income Attributable to Non-Controlling Interests of Pzena Investment Management, LLC	$9,547	$11,139	$25,307	$31,703
Less: Assumed Corporate Income Taxes	3,520	4,129	9,333	11,778
Assumed After-Tax Income of Pzena Investment Management, LLC	6,027	7,010	15,974	19,925
Net Income of Pzena Investment Management, Inc.	2,165	1,922	5,193	5,466
Diluted Net Income	$8,192	$8,932	$21,167	$25,391

Under the two-class method of computing diluted earnings per share, diluted earnings per share is calculated by dividing net income for diluted earnings per share by the weighted average number of common shares outstanding during the period, plus the dilutive effect of any potential common shares outstanding during the period using the more dilutive of the treasury method or two-class method. The two-class method includes an earnings allocation formula that determines earnings per share for each participating security according to dividends declared and undistributed earnings for the period. The Company’s net income for diluted earnings per share is reduced by the amount allocated to participating restricted Class B units for purposes of calculating earnings per share. Dividend equivalent distributions paid per share on the operating company’s unvested restricted Class B units are equal to the dividends paid per Company Class A common stock.

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

For the three and nine months ended September 30, 2016 and 2015, the Company’s diluted earnings per share were determined as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands, except share and per share amounts)			
Diluted Net Income Allocated to:				
Class A Common Stock	$8,185	$ 8,916	$21,148	$ 25,349
Participating Shares of Restricted Class A Common Stock	2	4	6	9
Participating Class B Units	5	12	13	33
Total Diluted Net Income Attributable to Shareholders	$8,192	$ 8,932	$21,167	$ 25,391
Total Basic Weighted-Average Shares Outstanding	16,390,298	14,585,650	15,807,340	13,591,432
Dilutive Effect of B Units	50,828,791	51,370,086	51,442,921	52,491,854
Dilutive Effect of Options [1]	150,991	470,287	160,067	590,794
Dilutive Effect of Phantom Class B Units & Phantom Shares of Class A Common Stock	1,205,981	1,468,225	1,121,225	1,327,820
Dilutive Effect of Restricted Shares of Class A Common Stock [2]	38,924	58,888	37,057	50,004
Dilutive Weighted-Average Shares Outstanding	68,614,985	67,953,136	68,568,610	68,051,904
Add: Participating Class B Units[3]	41,057	83,080	41,057	84,984
Total Dilutive Weighted-Average Shares Outstanding	68,656,042	68,036,216	68,609,667	68,136,888
Diluted Earnings per Share	$0.12	$ 0.13	$0.31	$ 0.37

[1] Represents the dilutive effect of options to purchase operating company Class B units and Company Class A common stock.
[2] Certain restricted shares of Class A common stock granted to employees are not entitled to dividend or dividend equivalent payments until they are vested and are therefore non-participating securities and are not included in the computation of basic earnings per share. They are included in the computation of diluted earnings per share when the effect is dilutive using the treasury stock method.
[3] Unvested Class B Units granted to employees have nonforfeitable rights to dividend equivalent distributions and therefore participate fully in the results of the operating company's operations from the date they are granted. They are included in the computation of diluted earnings per share using the two-class method for participating securities.

Approximately 1.0 million options to purchase Class B units were excluded from the calculation of diluted earnings per share for each of the three and nine months ended September 30, 2016, as their inclusion would have had an antidilutive effect based on current market prices. Approximately 0.7 million options to purchase shares of Class A common stock were also excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2016, as their inclusion would have an an antidilutive effect based on current market prices. For each of the three and nine months ended September 30, 2015, approximately 0.6 million options to purchase Class B units were excluded from the calculation of diluted earnings per share as their inclusion would have an an antidilutive effect based on current market prices.

Note 6—Shareholders’ Equity

The Company functions as the sole managing member of the operating company. As a result, the Company: (i) consolidates the financial results of the operating company and reflects the membership interest in it that it does not own as a non-controlling interest in its consolidated financial statements; and (ii) recognizes income generated from its economic interest in the operating company's net income. Class A and Class B units of the operating company have the same economic rights per unit. As of September 30, 2016, the holders of Class A common stock of the Company and the holders of Class B units of the operating company held approximately 24.3% and 75.7%, respectively, of the economic interests in the operations of the business. As of December 31, 2015, the holders of Class A common stock of the Company and the holders of Class B units of the operating company held approximately 22.6% and 77.4%, respectively, of the economic interests in the operations of the business.

Each Class B unit of the operating company is issued with a corresponding share of the Company's Class B common stock, par value $0.000001 per share. Each share of the Company's Class B common stock entitles its holder to five votes, until the first time that the number of shares of Class B common stock outstanding constitutes less than 20% of the number of all shares of the Company’s common stock outstanding. From such time and thereafter, each share of the Company’s Class B common stock entitles its holder to one vote. When a Class B unit is exchanged for a share of the Company’s Class A common stock or forfeited, a corresponding share of the Company’s Class B common stock will automatically be redeemed and canceled. Conversely, to the extent that the Company causes the operating company to issue additional Class B units to employees pursuant to its equity incentive plan, these additional holders of Class B units would be entitled to receive a corresponding number of shares of the Company’s Class B common stock (including if the Class B units awarded are subject to vesting).

All holders of the Company’s Class B common stock have entered into a stockholders’ agreement, pursuant to which they agreed to vote all shares of Class B common stock then held by them, with the majority of votes of Class B common stockholders taken in a preliminary vote of the Class B common stockholders.

The outstanding shares of the Company’s Class A common stock represent 100% of the rights of the holders of all classes of the Company’s capital stock to receive distributions, except that holders of Class B common stock will have the right to receive the class’s par value upon the Company’s liquidation, dissolution or winding up.

Pursuant to the operating agreement of the operating company, each vested Class B unit is exchangeable for a share of the Company’s Class A common stock, subject to certain exchange timing and volume limitations. On May 12, 2016, certain of the operating company's members exchanged an aggregate of 1,369,811 Class B units for an equivalent number of shares of Class A common stock. On July 27, 2015, certain of the operating company's members exchanged an aggregate of 2,772,171 Class B units for an equivalent number of shares of Company Class A common stock. These acquisition of additional operating company membership was treated as a reorganization of entities under common control as required by the Business Combinations Topic of the FASB ASC.

The Company’s share repurchase program was announced on April 24, 2012. The Board of Directors authorized the Company to repurchase up to an aggregate of $10 million of the Company’s outstanding Class A common stock and the operating company’s Class B units on the open market and in private transactions in accordance with applicable securities laws. On February 11, 2014, the Company announced that its Board of Directors approved an increase of $20 million in the aggregate amount authorized under the program. The timing, number and value of common shares and units repurchased are subject to the Company’s discretion. The Company’s share repurchase program is not subject to an expiration date and may be suspended, discontinued, or modified at any time, for any reason.

During the nine months ended September 30, 2016, the Company purchased and retired 258,279 shares of Class A common stock and 8,574 Class B units under the current repurchase authorization at a weighted average price per share of $7.77 and $7.81, respectively. During the nine months ended September 30, 2015, the Company purchased and retired 550,855 shares of Class A common stock and 158,716 Class B units under the repurchase authorization at a weighted average price per unit of $9.12 and $10.90, respectively. The Company records the repurchase of shares and units at cost based on the trade date of the transaction.

During the nine months ended September 30, 2016, 47,490 Class B units exercised resulted in the issuance of 24,027 net Class B units as a result of the redemption of 23,463 Class B units for the cashless exercise of options and $0.1 million in cash. During the nine months ended September 30, 2015, 954,764 Class B unit options and 3,375 Class A common stock options were exercised and resulted in the issuance of 715,706 net Class B units and 962 shares of Class A common stock, respectively, as a result of the redemption of 239,058 Class B units and 2,413 shares of Class A common stock for the cashless exercise of the options, and $1.7 million in cash.

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

Note 7—Non-Controlling Interests

Net Income Attributable to Non-Controlling Interests in the operations of the Company's operating company and consolidated subsidiaries is comprised of the following:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Non-Controlling Interests of Pzena Investment Management, LLC	$9,547	$11,139	$25,307	$31,703
Non-Controlling Interests of Consolidated Subsidiaries	209	(2,605)	136	(2,295)
Net Income Attributable to Non-Controlling Interests	$9,756	$8,534	$25,443	$29,408

Distributions to non-controlling interests represent tax allocations and dividend equivalents paid to the members of the operating company, as well as withdrawals from the Company's consolidated subsidiaries. Contributions from non-controlling interests represent contributions to the Company's consolidated subsidiaries.

Note 8—Investments

The following is a summary of Investments:

	As of September 30, 2016	December 31, 2015
	(in thousands)	
Investment Securities, Trading		
Equity Securities	$12,717	$ 25,739
Total Investment Securities, Trading	12,717	25,739
Investments in Equity Method Investees	7,365	1,713
Total	$20,082	$ 27,452

Investment Securities, Trading

Investments, at Fair Value consisted of the following at September 30, 2016:

	Cost	Unrealized Gain/(Loss)	Fair Value
	(in thousands)		
Equity Securities	$12,592	$ 125	$12,717
Total	$12,592	$ 125	$12,717

Securities Sold Short, at Fair Value consisted of the following at September 30, 2016:

	Proceeds	Unrealized (Gain)/ Loss	Fair Value

	(in thousands)		
Securities Sold Short	$2,316	$ 167	$2,483
Total	$2,316	$ 167	$2,483

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

Investments, at Fair Value consisted of the following at December 31, 2015:

	Cost	Unrealized Gain/(Loss)	Fair Value
	(in thousands)		
Equity Securities	$30,029	$ (4,290)	$25,739
Total	$30,029	$ (4,290)	$25,739

Securities Sold Short, at Fair Value consisted of the following at December 31, 2015:

	Proceeds	Unrealized (Gain)/ Loss	Fair Value
	(in thousands)		
Securities Sold Short	$2,391	$ (160)	$2,231
Total	$2,391	$ (160)	$2,231

Investments in Equity Method Investees

The operating company sponsors and provides investment management services to certain private investment partnerships and Pzena Mutual funds through which it offers its investment strategies. The Company has made investments in certain of these private investment partnerships and mutual funds to satisfy its obligations under the Company's deferred compensation program and provide the initial cash investment in our mutual funds. The Company holds a non-controlling interest and exercises significant influence in these entities, and accounts for its investments as equity method investments which are included in Investments on the consolidated statements of financial condition. On July 11, 2016, due to additional subscriptions into the Pzena Small Cap Value Fund, the Company's ownership decreased to 36.1%. As the entity was no longer deemed to control the fund, the Company deconsolidated the entity, removed the related assets, liabilities and non-controlling interest from its balance sheet and classified the Company's remaining investment as an equity method investment. As of September 30, 2016, the Company's investments range between 2% and 36% of the capital of these entities and have an aggregate carrying value of $7.4 million. As of December 31, 2015, prior to the adoption of ASU 2015-02, the Company only accounted for one investment as an equity method investment and owned approximately 4.4% of a private investment partnership with a carrying value of $1.7 million.

Note 9—Property and Equipment

Property and Equipment, Net of Accumulated Depreciation is comprised of the following:

	As of September 30, 2016	December 31, 2015
	(in thousands)	
Leasehold Improvements	$6,832	$ 6,826
Furniture and Fixtures	1,190	1,190
Computer Hardware	750	689
Computer Software	239	220

Office Equipment	189	180
Total	9,200	9,105
Less: Accumulated Depreciation and Amortization	(2,004)	(1,202)
Total	$7,196	$ 7,903

In April of 2015, the Company moved to its new corporate headquarters, as discussed further in Note 11—Commitments and Contingencies, and began depreciating approximately $6.8 million in leasehold improvements and $1.2 million in furniture and fixtures related to its new office space. During the nine months ended September 30, 2015, the Company recognized a $0.4 million loss on the disposal of fixed assets associated with the retirement of assets in its former headquarters, which is included in general and administrative expense. No such losses were recognized during the three or nine months ended September 30, 2016.

Depreciation is included in general and administrative expense and totaled approximately $0.3 million and $0.8 million for the three and nine months ended September 30, 2016, respectively, and $0.3 million and $0.5 million for the three and nine months ended September 30, 2015, respectively.

Note 10—Related Party Transactions

For the three months ended September 30, 2016 and 2015, the Company earned $0.1 million and $0.8 million, respectively, in investment advisory fees from unconsolidated VIEs that receive investment management services from the Company. For the nine months ended September 30, 2016 and 2015, the Company earned $0.2 million and $2.4 million, respectively, in such fees.

At both September 30, 2016 and December 31, 2015, the Company had approximately $0.1 million remaining of advances to an international investment company for organization and start-up costs, which are included in receivable from related parties on the consolidated statements of financial condition. The Company is the sponsor and investment manager of this entity.

In 2015, the Company began offering loans to employees, excluding executive officers, for the purpose of financing tax obligations associated with compensatory stock and unit vesting. Loans are full recourse, are generally written for a seven-year period, at a market rate of interest, payable in annual installments, and collateralized by shares and units held by the employee. As of September 30, 2016 and December 31, 2015, the Company had approximately $0.8 million of such loans outstanding.

At September 30, 2016 and December 31, 2015, Receivable from Related Parties included approximately $0.1 million of a forgivable loan associated with an initial employment agreement. At September 30, 2016, the remainder of the loan becomes forgivable over a period of approximately 1 month.

The operating company, as investment adviser for certain Pzena branded SEC-registered mutual funds, private placement funds, and non-U.S. funds, has contractually agreed to waive a portion or all of its management fees and pay fund expenses to ensure that the annual operating expenses of the funds stay below certain established total expense ratio thresholds. For each of the three and nine months ended September 30, 2016 and 2015, the Company recognized $0.3 million and $0.8 million of such expenses, respectively.

The operating company manages personal funds of certain of the Company's employees, including the CEO, its two Presidents, and its Executive Vice President. The operating company also manages accounts beneficially owned by a private fund in which certain of the Company's executive officers invest. Investments by employees in individual accounts are permitted only at the discretion of the executive committee of the operating company, but are generally not subject to the same minimum investment levels that are required of outside investors. The operating company also manages personal funds of some of its employees' family members. Pursuant to the respective investment management agreements, the operating company waives or reduces its regular advisory fees for these accounts and personal funds. In addition, the operating company pays custody and administrative fees for certain of these accounts and personal funds in order to incubate products or preserve performance history. The aggregate value of the fees that the Company waived related to the Company's executive officers, other employees, and family members, was approximately $0.2 million for each of the three months ended September 30, 2016 and 2015, respectively. For each of the nine months ended September 30, 2016 and 2015, the Company waived $0.5 million in such fees. The aggregate value of the custody and administrative fees paid related to the Company's executive offers, other employees, and family members was less than $0.1 million for each of the three and nine months ended September 30, 2016 and 2015.

Note 11—Commitments and Contingencies

In the normal course of business, the Company enters into agreements that include indemnities in favor of third parties, such as engagement letters with advisers and consultants. In certain cases, the Company may have recourse against third parties with respect to these indemnities. The Company maintains insurance policies that may provide coverage against certain claims under these indemnities. The Company has had no claims or payments pursuant to these agreements, and it believes the likelihood of a claim being made is remote. Utilizing the methodology in the Guarantees Topic of the FASB ASC, the Company's estimate of the value of such guarantees is de minimis, therefore, no accrual has been made in the consolidated financial statements.

In April of 2015, the Company moved to its new corporate headquarters. The new office space is leased under a non-cancelable operating lease agreement that became effective in October 2014. The Company recognizes minimum lease expense for its headquarters on a straight-line basis over the lease term, which expires on December 31, 2025. During the three months ended September 30, 2016, the Company terminated its five-year sublease agreement which commenced on May 1, 2015. The Company entered into a new four-year sublease agreement commencing on October 1, 2016 that is cancelable by either the Company or sublessee given appropriate notice after the thirty-first month following the commencement of the sublease agreement. The sublease agreement is for certain office space associated with the Company's operating lease agreement in its corporate headquarters. Sublease income will continue to decrease annual lease expense by approximately $0.4 million per year.

The Company's former headquarters were leased under a non-cancelable operating lease agreement that expired on October 31, 2015. During the nine months ended September 30, 2015, the Company recognized $1.4 million in non-recurring lease related expenses associated with its former corporate headquarters. No such expenses were recognized for the three and nine months ended September 30, 2016.

During the three and nine months ended September 30, 2016, lease expenses were $0.5 million and $1.4 million, respectively, and are included in general and administrative expense. Lease expenses, including the losses and expenses recorded during the nine months ended September 30, 2015, which we do not expect to recur, were $0.5 million and $2.7 million for the three and nine months ended September 30, 2015. Lease expenses for the three and nine months ended September 30, 2016 were net of $0.1 million and $0.3 million of sublease income, respectively. During the three and nine months ended September 30, 2015, lease expenses were net of $0.1 million and $0.2 million of sublease income, respectively.

Note 12—Income Taxes

The operating company is a limited liability company that has elected to be treated as a partnership for tax purposes. Neither it nor the Company's other consolidated subsidiaries have made a provision for federal or state income taxes because it is the individual responsibility of each of these entities' members (including the Company) to separately report their proportionate share of the respective entity's taxable income or loss. The operating company has made a provision for New York City UBT and its U.K. consolidated subsidiary has made a provision for U.K. corporate taxes. The Company, as a "C" corporation under the Internal Revenue Code, is liable for federal, state and local taxes on the income derived from its economic interest in the operating company, which is net of UBT and U.K. taxes. As a result, in its consolidated financial statements, the Company reports both the operating company's provision for UBT and U.K. taxes, as well as its provision for corporate federal, state and local taxes.

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

The components of the income tax expense are as follows:

	For the Three Months Ended September 30, 2016	2015	For the Nine Months Ended September 30, 2016	2015
	(in thousands)			
Current Provision:				
Unincorporated and Other Business Taxes	$753	$621	$1,723	$1,635
Local Corporate Tax	—	—	—	—
State Corporate Tax	—	—	—	—
Federal Corporate Tax	—	—	—	—
Total Current Provision	$753	$621	$1,723	$1,635
Deferred Provision:				
Unincorporated and Other Business Taxes	$5	$(8)	$12	$41
Local Corporate Tax	74	79	187	229
State Corporate Tax	54	45	140	139
Federal Corporate Tax	998	885	2,529	2,571
Total Deferred Provision	$1,131	$1,001	$2,868	$2,980
Change in Valuation Allowance	(1,413)	(874)	(1,653)	(2,213)
Total Income Tax Expense	$471	$748	$2,938	$2,402

The Income Taxes Topic of the FASB ASC establishes the minimum threshold for recognizing, and a system for measuring, the benefits of tax return positions in financial statements.

As of September 30, 2016 and December 31, 2015, the Company had available for U.S. federal income tax reporting purposes, a net operating loss carryforward of $8.7 million and $10.2 million, respectively, which expires in varying amounts during the tax years 2028 through 2035.
As of September 30, 2016 and December 31, 2015, approximately $2.8 million, respectively, of deductions for excess stock- and unit- based transactions were included in net operating losses. The $1.1 million of tax benefit associated with these deductions will be credited to Additional Paid-In Capital when such deductions reduce taxes payable. Although these net operating losses are included in the total carryforward amount, they are not reflected in the table of deferred tax assets as the excess tax benefits are not yet realized.
The Company and the operating company are generally no longer subject to U.S. federal, state, or local income tax examinations by tax authorities for any year prior to 2012. All tax years subsequent to, and including, 2012 are considered open and subject to examination by tax authorities. During 2013, the Company extended the examination statue of limitations for the 2009 to 2011 tax years in association with the amendment of prior year tax returns to change the methodology for state and local receipts. For the operating company, for the years 2009 to 2011, the statute of limitations for New York City UBT remains open through December 31, 2016.

The acquisition of operating company Class B units, noted below, has allowed the Company to make an election under Section 754 of the Internal Revenue Code (“Section 754”) to step up its tax basis in the net assets acquired. This step up is deductible for tax purposes over a 15-year period. Based on the net proceeds of the initial public offering and tax basis of the operating company, this election gave rise to an initial deferred tax asset of approximately $68.7 million.

Pursuant to a tax receivable agreement between the members of the operating company and the Company, 85% of the cash savings generated by this election will be distributed to the selling and converting shareholders upon the realization of this benefit.

If the Company exercises its right to terminate the tax receivable agreement early, the Company will be obligated to make an early termination payment to the selling and converting shareholders, based upon the net present value (based upon certain assumptions and deemed events set forth in the tax receivable agreement) of all payments that would be required to be paid by the Company under the tax receivable agreement. If certain change of control events were to occur, the Company would be obligated to make an early termination payment.

As discussed in Note 6 — Shareholders' Equity, on May 12, 2016 and July 27, 2015, certain of the operating company's members exchanged an aggregate of 1,369,811 and 2,772,171 of their Class B units, respectively, for an equivalent number of shares of Class A common stock. The Company elected to step up its tax basis in the incremental assets acquired in accordance with Section 754. Based on the exchange-date fair value of the Company's common stock and the tax basis of the operating company, these elections gave rise to $6.1 million and $14.3 million deferred tax assets and corresponding $5.2 million and $12.2 million liabilities to selling and converting shareholders on May 12, 2016 and July 27, 2015, respectively. The Company assessed the realizability of the deferred tax assets associated with the exchanges and determined that a portion of the benefits would go unutilized. Consequently, the Company established $4.8 million and $11.0 million valuation allowances, respectively, to reduce the deferred tax assets to an amounts more likely than not to be realized. These deferred tax assets remain available to the Company and can be used in future years. The Company similarly reduced the associated liability to selling and converting shareholders by $4.1 million and $9.4 million, respectively, to reflect the changes in the estimated realization of these assets. As required by the Income Taxes Topic of the FASB ASC, the Company recorded the effects of these transactions in equity.

During the three and nine months ended September 30, 2016, after giving effect to the exchange discussed earlier, the Company’s valuation allowance was reduced by approximately $1.4 million and $1.7 million, respectively, due to revised estimates of future taxable income. These changes are reflected as a net adjustment to the Company's Section 754 deferred tax asset, valuation allowance, and other deferred tax assets. To reflect these changes in the estimated realization of the asset and its liability for future payments, the Company increased its liability to selling and converting shareholders by $1.2 million and $1.4 million for the three and nine months ended September 30, 2016, respectively. The effects of these changes to the deferred tax asset and liability to selling and converting shareholders were recorded as a component of the income tax expense and other expense, respectively, on the consolidated statements of operations.

During the three and nine months ended September 30, 2015, after giving effect to the exchange discussed earlier, the Company’s valuation allowance was reduced by approximately $0.9 million and $2.2 million, respectively, due to revised estimates of future taxable income. These changes are reflected as a net adjustment to the Company's Section 754 deferred tax asset, valuation allowance, and other deferred tax assets. To reflect these changes in the estimated realization of the asset and its liability for future payments, the Company increased its liability to selling and converting shareholders by $0.7 million and $1.6 million for the three and nine months ended September 30, 2015, respectively. The effects of these changes to the deferred tax asset and liability to selling and converting shareholders were recorded as a component of the income tax expense and other expense, respectively, on the consolidated statements of operations.

As of both September 30, 2016 and December 31, 2015, the net values of all deferred tax assets were approximately $15.0 million.

The change in the Company’s deferred tax asset, net of valuation allowance, for the three and nine months ended September 30, 2016, is summarized as follows:

	Section 754	Other	Valuation Allowance	Total
	(in thousands)			

Balance at December 31, 2015	$64,877	$4,086	$(53,968)	$14,995
Deferred Tax (Expense)/Benefit	(1,111)	273	—	(838)
Change in Valuation Allowance	—	—	1,060	1,060
Balance at March 31, 2016	$63,766	$4,359	$(52,908)	$15,217
Deferred Tax (Expense)/Benefit	(1,133)	233	—	(900)
Unit Exchange	6,080	—	(4,837)	1,243
Change in Valuation Allowance	—	—	(820)	(820)
Balance at June 30, 2016	$68,713	$4,592	$(58,565)	$14,740
Deferred Tax (Expense)/Benefit	(1,180)	66	—	(1,114)
Change in Valuation Allowance	—	—	1,413	1,413
Balance at September 30, 2016	$67,533	$4,658	$(57,152)	$15,039

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Pzena Investment Management, Inc.
Notes to Unaudited Consolidated Financial Statements (Continued)

The change in the Company's deferred tax liability, which is included in other liabilities on the Company's consolidated statements of financial condition, for the three and nine months ended September 30, 2016, is summarized as follows:

	Total (in thousands)
Balance at December 31, 2015	$ (4)
Deferred Tax (Expense)/Benefit	1
Balance at March 31, 2016	$ (3)
Deferred Tax (Expense)/Benefit	—
Balance at June 30, 2016	$ (3)
Deferred Tax (Expense)/Benefit	1
Balance at September 30, 2016	$ (2)

The change in the Company's deferred tax asset, net of valuation allowance, for the three and nine months ended September 30, 2015, is summarized as follows:

	Section 754	Other	Valuation Allowance	Total
	(in thousands)			
Balance at December 31, 2014	$54,783	$4,074	$(44,239)	$14,618
Deferred Tax (Expense)/Benefit	(923)	(80)	—	(1,003)
Change in Valuation Allowance	—	—	366	366
Balance at March 31, 2015	$53,860	$3,994	$(43,873)	$13,981
Deferred Tax (Expense)/Benefit	(923)	(64)	—	(987)
Change in Valuation Allowance	—	—	973	973
Balance at June 30, 2015	$52,937	$3,930	$(42,900)	$13,967
Deferred Tax (Expense)/Benefit	(1,029)	26	—	(1,003)
Unit Exchange	14,304	—	(11,003)	3,301
Change in Valuation Allowance	—	—	874	874
Balance at September 30, 2015	$66,212	$3,956	$(53,029)	$17,139

The change in the Company's deferred tax liability for the three and nine months ended September 30, 2015, is summarized as follows:

	Total (in thousands)
Balance at December 31, 2014	$ (18)
Deferred Tax (Expense)/Benefit	11
Balance at March 31, 2015	$ (7)
Deferred Tax (Expense)/Benefit	—
Balance at June 30, 2015	$ (7)
Deferred Tax (Expense)/Benefit	2

Balance at September 30, 2015	$	(5)

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Note 13—Subsequent Events

On October 18, 2016, the Company declared a quarterly dividend of $0.03 per share of its Class A common stock that will be paid on November 23, 2016 to holders of record on October 28, 2016.

No other subsequent events necessitated disclosures and/or adjustments.

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

Overview

We are an investment management firm that utilizes a classic value investment approach across all of our investment strategies. We currently manage assets in a variety of value-oriented investment strategies across a wide range of market capitalizations in both U.S. and non-U.S. capital markets. At September 30, 2016, our assets under management, or AUM, was $27.4 billion. We manage separate accounts on behalf of institutions, act as sub-investment adviser for a variety of SEC-registered mutual funds and non-U.S. funds, and act as investment adviser for the Pzena Mutual Funds, private placement funds and non-U.S. funds.

We function as the sole managing member of our operating company, Pzena Investment Management, LLC (the "operating company"). As a result, we: (i) consolidate the financial results of our operating company with our own, and reflect the membership interest in it that we do not own as a non-controlling interest in our consolidated financial statements; and (ii) recognize income generated from our economic interest in our operating company's net income. As of September 30, 2016, the holders of Class A common stock (through the Company) and the holders of Class B units of our operating company held approximately 24.3% and 75.7%, respectively, of the economic interests in the operations of our business.

The Company also serves as the general partner of Pzena Investment Management, LP, a partnership formed with the object of aggregating employee ownership in one entity.

Certain of our named executive officers and employees have interests in Pzena Investment Management, LP and certain estate planning vehicles through which they indirectly own Class B units of our operating company. As of September 30, 2016, through direct and indirect interests, our six named executive officers; 32 other employee members; and certain other members of our operating company, including one of our directors, his related entities, and certain former employees, collectively held 54.8%, 4.1%, and 16.8% of the economic interests in our operating company, respectively.

GAAP and Non-GAAP Net Income

GAAP diluted net income and GAAP diluted earnings per share were $8.2 million and $0.12, respectively, for the three months ended September 30, 2016, and $8.9 million and $0.13, respectively, for the three months ended September 30, 2015. GAAP diluted net income and GAAP diluted earnings per share were $21.2 million and $0.31, respectively, for the nine months ended September 30, 2016, and $25.4 million and $0.37, respectively, for the nine months ended September 30, 2015. Our results for the three and nine months ended September 30, 2016 and 2015 include recurring adjustments related to our deferred tax asset generated by the Company's initial public offering and subsequent Class B unit conversions, as well as our tax receivable agreement and the associated liability to our selling and converting shareholders, in addition to adjustments related to certain non-recurring charges recognized in operating expenses during the nine months ended September 30, 2015. We believe that these accounting adjustments add a measure of non-operational complexity that partially obscures a clear understanding of the underlying performance of our business. Therefore, in evaluating our financial condition and results of operations, we also review certain non-GAAP measures of earnings, which exclude these items. Excluding these items, non-GAAP diluted net income and non-GAAP diluted earnings per share were $8.0 million and $0.12, respectively, for the three months ended September 30, 2016, and $1.8 million and $0.12, respectively, for the three months ended September 30, 2015. Excluding these items, non-GAAP diluted net income and non-GAAP diluted earnings per share were $20.9 million and $0.30, respectively, for the nine months ended September 30, 2016, and $26.2 million and $0.38, respectively, for the nine months ended September 30, 2015.

GAAP and non-GAAP net income for diluted earnings per share generally assumes all operating company membership units are converted into Company stock at the beginning of the reporting period, and the resulting change to our net income associated with our increased interest in the operating company is taxed at our historical effective tax rate, exclusive of the adjustments related to our tax receivable agreement and the associated liability to selling and converting shareholders, the adjustments related to the non-recurring charges recognized in operating expenses, and other adjustments. Our effective tax rate, exclusive of these adjustments, was 36.9% for each of the three and nine months ended September 30, 2016. Our effective tax rates, exclusive of these adjustments, were 37.1% and 37.2% for the three and nine months ended September 30, 2015, respectively. See “Operating Results - Income Tax Expense” below.

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We use these non-GAAP measures to assess the strength of the underlying operations of the business. We believe that these adjustments, and the non-GAAP measures derived from them, provide information to better analyze our operations between periods and over time. We also use non-GAAP net income as one factor in determining the amount of dividends we pay. See “Dividend Policy” below. Investors should consider these non-GAAP measures in addition to, and not as a substitute for, financial measures prepared in accordance with GAAP.

A reconciliation of the most comparable GAAP measures to the non-GAAP measures is included below:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands, except share and per share data)			
GAAP Net Income	$2,165	$ 1,922	$5,193	$ 5,466
Net Effect of Tax Receivable Agreement	(211)	(123)	(269)	(293)
Net Effect of Non-Recurring Lease Expenses	—	—	—	183
Non-GAAP Net Income	$1,954	$ 1,799	$4,924	$ 5,356
GAAP Net Income Attributable to Non-Controlling Interest of Pzena Investment Management, LLC	$9,547	$ 11,139	$25,307	$ 31,703
Effect of Non-Recurring Lease Expenses	—	—	—	1,475
Non-GAAP Net Income Attributable to Non-Controlling Interest of Pzena Investment Management, LLC	9,547	11,139	25,307	33,178
Less: Assumed Corporate Income Taxes	3,520	4,129	9,333	12,326
Assumed After-Tax Income of Pzena Investment Management, LLC	6,027	7,010	15,974	20,852
Non-GAAP Net Income of Pzena Investment Management, Inc.	1,954	1,799	4,924	5,356
Non-GAAP Diluted Net Income	$7,981	$ 8,809	$20,898	$ 26,208
Non-GAAP Diluted Earnings Per Share Attributable to Pzena Investment Management, Inc. Common Stockholders:				
Non-GAAP Net Income for Diluted Earnings per Share[1]	$7,981	$ 1,799	$20,898	$ 26,208
Non-GAAP Diluted Earnings Per Share[1]	$0.12	$ 0.12	$0.30	$ 0.38
Non-GAAP Diluted Weighted-Average Shares Outstanding[1]	68,656,042	14,585,650	68,609,667	68,136,888

1 During the three months ended September 30, 2015 the calculations of non-GAAP diluted earnings per share resulted in an increase in earnings per share. Therefore, diluted net income and diluted earnings per share are assumed to be equal to basic earnings per share for the period.

Revenue

We generate revenue primarily from management fees and performance fees, which we collectively refer to as our advisory fees, by managing assets on behalf of institutional accounts and for retail clients, which are generally open-end mutual funds catering primarily to retail investors. Our advisory fee income is recognized over the period in which investment management services are provided. Following the preferred method identified in the Revenue Recognition Topic of the Financial Accounting Standards Board Accounting Standards Codification (“FASB ASC”), income from performance fees is recorded at the conclusion of the contractual performance period, when all contingencies are resolved.

Our advisory fees are primarily driven by the level of our AUM. Our AUM increases or decreases with the net inflows or outflows of funds into our various investment strategies and with the investment performance thereof. In order to increase our AUM and expand our business, we must develop and market investment strategies that suit the investment needs of our target clients, and provide attractive returns over the long term. The value and composition of our AUM, and our ability to continue to attract clients depends on a variety of factors as described in "Item 1 — Risk Factors — Risks Related to Our Business — Our primary source of revenue is derived from management fees, which are directly tied to the levels of our assets under management. Fluctuations in AUM therefore will directly impact our revenue." of our Annual Report on Form 10-K for the year ended December 31, 2015.

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For our institutional accounts, we are paid fees according to a schedule, which varies by investment strategy. The substantial majority of these accounts pay us management fees pursuant to a schedule by which the rate we earn on the AUM declines as the amount of AUM increases.

Pursuant to our sub-investment advisory agreements with our retail clients and advisory agreements with Pzena branded funds, we are generally paid a management fee according to a schedule in which the rate we earn on the AUM declines as the amount of AUM increases. Certain of these funds pay us fixed-rate management fees. Due to the substantially larger account size of certain of these accounts, the average advisory fees we earn on them, as a percentage of AUM, are lower than the advisory fees we earn on our institutional accounts.

Advisory fees we earn on institutional accounts are generally based on the value of AUM at a specific date on a quarterly basis. Certain of our institutional accounts, and all of our retail accounts, are calculated based on the average of the monthly or daily market value. Advisory fees are also generally adjusted for any cash flows into or out of a portfolio, where the cash flow represents greater than 10% of the value of the portfolio. While a specific group of accounts may use the same fee rate, the calculation methodology may differ as described above.

Certain of our clients pay us performance fees according to the performance of their accounts relative to certain agreed-upon benchmarks, which results in a lower base fee, but allows for us to earn higher fees if the relevant investment strategy outperforms the agreed-upon benchmark. Some performance-based fee arrangements include high-water mark provisions, which generally provide that if a client account underperforms relative to its performance target, it must gain back such underperformance before we can collect future performance-based fees. Fulcrum fee arrangements require a reduction in the base fee, or allow for a performance fee if the relevant investment strategy underperforms or outperforms, respectively, the agreed-upon benchmark.

Our advisory fees may fluctuate based on a number of factors, including the following:

- changes in AUM due to appreciation or depreciation of our investment portfolios, and the levels of the contribution and withdrawal of assets by new and existing clients;

- distribution of AUM among our investment strategies, which have differing fee schedules;

- distribution of AUM between institutional accounts and retail accounts, for which we generally earn lower overall advisory fees; and

- the level of our performance with respect to accounts on which we are paid performance fees.

Expenses

Our expenses consist primarily of Compensation and Benefits Expense, as well as General and Administrative Expense. Our largest expense is Compensation and Benefits, which includes the salaries, bonuses, equity-based compensation, and related benefits and payroll costs attributable to our employee members and employees. Compensation and benefits packages are benchmarked against relevant industry and geographic peer groups in order to attract and retain qualified personnel. General and Administrative Expense includes lease expenses, professional and outside services fees, depreciation, the costs associated with operating and maintaining our research, trading and portfolio accounting systems, the costs associated with being a public company, and other expenses. Our occupancy-related costs and professional services expenses, in particular, generally increase or decrease in relative proportion to the overall size and scale of our business operations.

Our expenses may fluctuate due to a number of factors, including the following:

- variations in the level of total compensation expense due to, among other things, bonuses, awards of equity to our employees and employee members of our operating company, changes in our employee count and mix, and competitive factors; and
- general and administrative expenses, such as rent, professional service fees and data-related costs, incurred, as necessary, to run our business.

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Other Income/ (Expense)

Other Income/ (Expense) is derived primarily from investment income or loss arising from our consolidated entities, income or loss generated by our investments, and interest income generated on our cash balances. Other Income/ (Expense) is also affected by changes in our estimates of the liability due to our selling and converting shareholders associated with payments owed to them under the tax receivable agreement, which was executed in connection with our reorganization and initial public offering on October 30, 2007. As discussed further below under "Tax Receivable Agreement," this liability represents 85% of the amount of cash savings, if any, in U.S. federal, state, and local income tax that we realize as a result of the amortization of the increases in tax basis generated from our acquisitions of our operating company's units from our selling and converting shareholders. We expect the interest and investment components of Other Income/ (Expense), in the aggregate, to fluctuate based on market conditions and the performance of our consolidated entities and other investments.

Non-Controlling Interests

Our operating company consolidates the results of operations of the private investment partnerships and Pzena-branded mutual funds over which we exercise a controlling influence. We are the sole managing member of our operating company and control its business and affairs and, therefore, consolidate its financial results with ours. In light of our employees' and outside investors' direct and indirect interests in our operating company, we have reflected their membership interests as non-controlling interests in our consolidated financial statements. As a result, our income is primarily generated by our economic interest in our operating company's net income. As of September 30, 2016, the holders of Class A common stock of the Company and the holders of Class B units of the operating company held approximately 24.3% and 75.7%, respectively, of the economic interests in the operations of the business.

Operating Results

Assets Under Management and Flows

As of September 30, 2016, our AUM of approximately $27.4 billion was invested in a variety of value-oriented investment strategies, representing distinct capitalization segments of U.S. and non-U.S. equity markets. The assets under management and performance of our largest investment strategies as of September 30, 2016 are further described below. We follow the same investment process for each of these strategies. Our investment strategies are distinguished by the market capitalization ranges from which we select securities for their portfolios, which we refer to as each strategy's investment universe, as well as the regions in which we invest and the degree to which we concentrate on a limited number of holdings. While our investment process includes ongoing review of companies in the investment universes described below, our actual investments may include companies outside of the relevant market capitalization range at the time of our investment. In addition, the number of holdings typically found in the portfolios of each of our investment strategies may vary, as described below.

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The following tables describe the allocation of our AUM among our investment strategies and the domicile of our accounts, as of September 30, 2016 and 2015:

Strategy[1]	AUM at September 30, 2016	2015
	(in billions)	
U.S. Value Strategies		
Large Cap Value	$9.1	$9.6
Mid Cap Value	2.3	1.7
Value	1.8	1.5
Small Cap Value	1.3	1.1
Other U.S. Strategies	—	0.1
Total U.S. Value Strategies	14.5	14.0
Global and Non-U.S. Value Strategies		
International (ex-U.S.) Value	4.5	4.1
Global Value	4.4	4.5
Emerging Markets Value	2.5	1.7
European Value	1.4	1.1
Other Non-U.S. Strategies	0.1	0.1
Total Global and Non-U.S. Value Strategies	12.9	11.5
Total	$27.4	$25.5

1 Inclusive of our Expanded Value, Focused Value and variations thereof.

Account Domicile	AUM at September 30, 2016	2015
	(in billions)	
U.S.	$19.7	$18.4
Non-U.S.	7.7	7.1
Total	$27.4	$25.5

The following table indicates the annualized returns, gross and net (which represents annualized returns prior to, and after, payment of advisory fees, respectively), of our largest investment strategies from their inception to September 30, 2016, and in the five-year, three-year, and one-year periods ended September 30, 2016, as well as the performance of the market index which is most commonly used by our clients to compare the performance of the relevant investment strategy:

Investment Strategy (Inception Date)	Period Ended September 30, 2016[1] Since Inception	5 Years	3 Years	1 Year
Large Cap Expanded Value (July 2012)				
Annualized Gross Returns	14.5 %	N/A	9.1 %	14.6%
Annualized Net Returns	14.3 %	N/A	8.9 %	14.4%
Russell 1000® Value Index	13.6 %	N/A	9.7 %	16.2%
Large Cap Focused Value (October 2000)				
Annualized Gross Returns	6.7 %	16.2%	8.7 %	15.3%
Annualized Net Returns	6.3 %	15.7%	8.2 %	14.9%

Russell 1000® Value Index	6.3 %	16.2%	9.7 %	16.2%
Global Focused Value (January 2004)				
Annualized Gross Returns	4.8 %	12.8%	3.5 %	8.9 %

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Annualized Net Returns	4.0%	12.1%	2.9%	8.2%
MSCI® All Country World Index—Net/U.S.$[2]	6.2%	10.6%	5.2%	12.0%
International (ex-U.S) Expanded Value (November 2008)				
Annualized Gross Returns	10.3%	9.7%	0.5%	5.9%
Annualized Net Returns	10.0%	9.4%	0.2%	5.5%
MSCI® EAFE Index—Net/U.S.$[2]	7.2%	7.4%	0.5%	6.5%
Focused Value (January 1996)				
Annualized Gross Returns	10.6%	17.2%	9.1%	16.1%
Annualized Net Returns	9.8%	16.5%	8.5%	15.5%
Russell 1000® Value Index	8.7%	16.2%	9.7%	16.2%
Emerging Markets Focused Value (January 2008)				
Annualized Gross Returns	1.2%	5.3%	(1.7)%	19.8%
Annualized Net Returns	0.3%	4.6%	(2.4)%	18.9%
MSCI® Emerging Markets Index—Net/U.S.$[2]	(1.2)%	3.0%	(0.6)%	16.8%
Global Expanded Value (January 2010)				
Annualized Gross Returns	7.8%	12.4%	4.4%	9.6%
Annualized Net Returns	7.5%	12.1%	4.0%	9.2%
MSCI® World Index—Net/U.S.$[2]	8.2%	11.6%	5.8%	11.4%
Mid Cap Expanded Value (April 2014)				
Annualized Gross Returns	6.3%	N/A	N/A	18.1%
Annualized Net Returns	6.1%	N/A	N/A	17.8%
Russell Mid Cap® Value Index	6.9%	N/A	N/A	17.3%
Small Cap Focused Value (January 1996)				
Annualized Gross Returns	13.9%	20.1%	10.7%	18.5%
Annualized Net Returns	12.6%	18.9%	9.6%	17.3%
Russell 2000® Value Index	9.7%	15.5%	6.8%	18.8%
European Focused Value (August 2008)				
Annualized Gross Returns	4.0%	10.2%	(1.6)%	1.9%
Annualized Net Returns	3.6%	9.8%	(2.0)%	1.5%
MSCI® Europe Index—Net/U.S.$[2]	0.9%	7.5%	(0.6)%	2.5%
International (ex-U.S) Focused Value (January 2004)				
Annualized Gross Returns	5.7%	10.2%	0.3%	6.7%
Annualized Net Returns	4.9%	9.5%	(0.3)%	6.1%
MSCI® All Country World ex-U.S. Index—Net/U.S.$[2]	5.5%	6.0%	0.2%	9.3%
Mid Cap Focused Value (September 1998)				
Annualized Gross Returns	12.8%	20.0%	9.4%	18.3%
Annualized Net Returns	12.0%	19.2%	8.7%	17.6%
Russell Mid Cap® Value Index	10.4%	17.4%	10.5%	17.3%

[1] The historical returns of these investment strategies are not necessarily indicative of their future performance, or the future performance of any of our other current or future investment strategies.

[2] Net of applicable withholding taxes and presented in U.S. Dollars.

Large Cap Expanded Value. This strategy reflects a portfolio composed of approximately 50 to 80 stocks drawn from a universe of 500 of the largest U.S. listed companies, based on market capitalization. This strategy was launched in July 2012. At September 30, 2016, the Large Cap Expanded Value strategy generated a one-year annualized gross return of 14.6%, underperforming its benchmark. The underperformance was driven primarily by our stock selection in the financial services sector, partially offset by the positive performance of certain securities in the technology sector.

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Large Cap Focused Value. This strategy reflects a portfolio composed of approximately 30 to 40 stocks drawn from a universe of 500 of the largest U.S. listed companies, based on market capitalization. This strategy was launched in October 2000. At September 30, 2016, the Large Cap Focused Value strategy generated a one-year annualized gross return of 15.3%, underperforming its benchmark. The underperformance was driven primarily by our stock selection in the financial services sector, partially offset by our stock selection in the energy sector and the positive performance and overweight position of certain securities in the technology sector.

Global Focused Value. This strategy reflects a portfolio composed of approximately 40 to 60 stocks drawn from a universe of 2,000 of the largest companies across the world, based on market capitalization. This strategy was launched in January 2004. At September 30, 2016, the Global Focused Value strategy generated a one-year annualized gross return of 8.9%, underperforming its benchmark. This main contributors to this underperformance were certain positions in the financial services sector and the performance of certain U.K. stocks, partially offset by our stock selection in the information technology sector and our underweight position in the health care sector.

International (ex-U.S.) Expanded Value. This strategy reflects a portfolio composed of approximately 60 to 80 stocks drawn from a universe of 1,500 of the largest companies across the world excluding the United States, based on market capitalization. This strategy was launched in November 2008. At September 30, 2016, the International (ex-U.S.) Expanded Value strategy generated a one-year annualized gross return of 5.9%, underperforming its benchmark. This underperformance was primarily driven by our overweight position in the financial services sector and the performance certain U.K. stocks, partially offset by our stock selection in the consumer discretionary and information technology sectors.

Focused Value. This strategy reflects a portfolio composed of a portfolio of approximately 30 to 40 stocks drawn from a universe of 1,000 of the largest U.S. listed companies, based on market capitalization. This strategy was launched in January 1996. At September 30, 2016, the Focused Value strategy generated a one-year annualized gross return of 16.1%, relatively flat compared to its benchmark. The relative performance was driven primarily by our stock selection in the financial services sector, offset by our stock selection in the energy sector and our overweight position in the technology sector.

Emerging Markets Focused Value. This strategy reflects a portfolio composed of approximately 40 to 80 stocks drawn from a universe of 1,500 of the largest emerging market companies, based on market capitalization. This strategy was launched in January 2008. At September 30, 2016, the Emerging Markets Focused Value strategy generated a one-year annualized gross return of 19.8%, outperforming its benchmark. The main contributors to this outperformance include our stock selection in the materials, energy and telecommunication sectors, and certain stocks in Brazil and Korea. This relative outperformance was partially offset by our stock selection in the consumer discretionary and information technology sectors and the performance of certain Chinese stocks.

Global Expanded Value. This strategy reflects a portfolio composed of approximately 60 to 95 stocks drawn from a universe of 2,000 of the largest companies across the world, based on market capitalization. This strategy was launched in January 2010. At September 30, 2016, the Global Expanded Value strategy generated a one-year annualized gross return of 9.6%, underperforming its benchmark. This underperformance was primarily driven by certain positions in the financial services sector and certain U.K. stocks, partially offset by our stock selection in the health care and information technology sectors.

Mid Cap Expanded Value. This strategy reflects a portfolio composed of approximately 50 to 80 stocks drawn from a universe of U.S. listed companies ranked from the 201st to 1,200th largest, based on market capitalization. This strategy was launched in April 2014. At September 30, 2016, the Mid Cap Expanded Value strategy generated a one-year annualized gross return of 18.1%, outperforming its benchmark. This outperformance was driven by our overweight position in the technology sector, partially offset by our stock selection in the financial services sector.

Small Cap Focused Value. This strategy reflects a portfolio composed of approximately 40 to 50 stocks drawn from a universe of U.S. listed companies ranked from the 1,001st to 3,000th largest, based on market capitalization. This strategy was launched in January 1996. At September 30, 2016, the Small Cap Focused Value strategy generated a one-year annualized gross return of 18.5%, underperforming its benchmark. The main contributors to this underperformance include certain positions in the financial services and technology sectors. This relative underperformance was partially offset by the positive performance of our positions in the energy and health care sectors.

European Focused Value. This strategy reflects a portfolio composed of approximately 40 to 50 stocks drawn from a universe of 750 of the largest European companies, based on market capitalization. This strategy was launched in August 2008. At September 30, 2016, the European Focused Value strategy generated a one-year annualized gross return of 1.9%, underperforming its benchmark. This underperformance was driven primarily by our stock selection in the industrials sector, performance of certain stocks in the consumer staples sector and certain U.K. stocks. This relative underperformance was partially offset by our stock selection in the consumer discretionary sector, lack of exposure to the health care sector and performance of certain stocks in the information technology sector and certain stocks in France.

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International (ex-U.S.) Focused Value. This strategy reflects a portfolio composed of approximately 30 to 50 stocks drawn
from a universe of 1,500 of the largest companies across the world excluding the United States, based on market capitalization.
This strategy was launched in January 2004. At September 30, 2016, the International (ex-U.S.) Expanded Value strategy
generated a one-year annualized gross return of 6.7%, underperforming its benchmark. This relative underperformance was driven by our stock selection in the financial services and industrials sectors and certain U.K. stocks, partially offset by our stock selection in the consumer discretionary sector, our lack of exposure to the health care sector and certain Korea stocks.

Mid Cap Focused Value. This strategy reflects a portfolio composed of approximately 30 to 40 stocks drawn from a universe of U.S. listed companies ranked from the 201th to 1,200th largest, based on market capitalization. This strategy was launched in September 1998. At September 30, 2016, the Mid Cap Focused Value strategy generated a one-year annualized gross return of 18.3%, outperforming its benchmark. This relative performance was driven by the outperformance of our positions in technology sector, as well as our stock selection in the energy sector, partially offset by certain position in the financial services sector.

Our earnings and cash flows are heavily dependent upon prevailing financial market conditions. Significant increases or decreases in the various securities markets, particularly the equities markets, can have a material impact on our results of operations, financial condition, and cash flows.

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The change in AUM in our institutional and retail accounts for the three and nine months ended September 30, 2016 and 2015 is described below. Inflows are composed of the investment of new or additional assets by new or existing clients. Outflows consist of redemptions of assets by existing clients.

Assets Under Management
($ billions)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
Institutional Accounts				
Assets				
Beginning of Period	$14.3	$15.9	$14.9	$15.6
Inflows	1.1	1.5	1.9	2.9
Outflows	(0.9)	(0.6)	(1.9)	(2.1)
Net Flows	0.2	0.9	—	0.8
Market Appreciation/(Depreciation)	1.4	(1.9)	1.0	(1.5)
End of Period	$15.9	$14.9	$15.9	$14.9
Retail Accounts				
Assets				
Beginning of Period	$11.1	$12.1	$11.1	$12.1
Inflows	0.1	0.2	1.1	0.9
Outflows	(0.7)	(0.3)	(1.7)	(1.3)
Net Flows	(0.6)	(0.1)	(0.6)	(0.4)
Market Appreciation/(Depreciation)	1.0	(1.4)	1.0	(1.1)
End of Period	$11.5	$10.6	$11.5	$10.6
Total				
Assets				
Beginning of Period	$25.4	$28.0	$26.0	$27.7
Inflows	1.2	1.7	3.0	3.8
Outflows	(1.6)	(0.9)	(3.6)	(3.4)
Net Flows	(0.4)	0.8	(0.6)	0.4
Market Appreciation/(Depreciation)	2.4	(3.3)	2.0	(2.6)
End of Period	$27.4	$25.5	$27.4	$25.5

Three Months Ended September 30, 2016 and September 30, 2015

At September 30, 2016, we managed $15.9 billion in institutional accounts and $11.5 billion in retail accounts, for a total of $27.4 billion in assets under management. For the three months ended September 30, 2016, we experienced market appreciation of $2.4 billion and total gross inflows of $1.2 billion, partially offset by total gross outflows of $1.6 billion. Assets in institutional accounts increased by $1.6 billion, or 11.2%, from $14.3 billion at June 30, 2016, due to $1.4 billion in market appreciation and $1.1 billion in gross inflows, partially offset by $0.9 billion in gross outflows. Assets in retail accounts increased by $0.4 billion, or 3.6%, from $11.1 billion at June 30, 2016, due to $1.0 billion in market appreciation and $0.1 billion in gross inflows, partially offset by $0.7 billion in gross outflows.

At September 30, 2015, we managed $14.9 billion in institutional accounts and $10.6 billion in retail accounts, for a total of $25.5 billion in assets under management. For the three months ended September 30, 2015, we experienced market

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depreciation of $3.3 billion and total gross outflows of $0.9 billion, partially offset by total gross inflows of $1.7 billion. Assets in institutional accounts decreased by $1.0 billion, or 6.3%, from $15.9 billion due to $1.9 billion in market depreciation and $0.6 billion in gross outflows, partially offset by $1.5 billion in gross inflows. Assets in retail accounts decreased by $1.5 billion, or 12.4%, from $12.1 billion due to $1.4 billion in market depreciation and $0.3 billion in gross outflows, partially offset by $0.2 billion in gross inflows.

Nine Months Ended September 30, 2016 and September 30, 2015

For the nine months ended September 30, 2016, we experienced total gross inflows of $3.0 billion and market appreciation of $2.0 billion, which were partially offset by total gross outflows of $3.6 billion. Assets in institutional accounts increased by $1.0 billion, or 6.7%, from $14.9 billion at December 31, 2015 due to $1.9 billion in gross inflows and $1.0 billion in market appreciation, partially offset by $1.9 billion in gross outflows. Assets in retail accounts increased by $0.4 billion, or 3.6%, from $11.1 billion due to $1.1 billion in gross inflows and $1.0 billion in market appreciation, partially offset by $1.7 billion in gross outflows.

For the nine months ended September 30, 2015, we experienced total gross outflows of $3.4 billion and market depreciation of $2.6 billion, which were partially offset by total gross inflows of $3.8 billion. Assets in institutional accounts decreased by $0.7 billion, or 4.5%, from $15.6 billion at December 31, 2014 due to $2.1 billion in gross outflows and $1.5 billion in market depreciation, partially offset by $2.9 billion in gross inflows. Assets in retail accounts decreased by $1.5 billion, or 12.4%, from $12.1 billion due to $1.3 billion in gross outflows and $1.1 billion in market depreciation, partially offset by $0.9 billion in gross inflows.

Revenues

Our revenue from advisory fees earned on our institutional accounts and our retail accounts for the three and nine months ended September 30, 2016 and 2015 is described below:

Revenue	For the Three Months Ended September 30, 2016	2015	For the Nine Months Ended September 30, 2016	2015
	(in thousands)			
Institutional Accounts	$20,513	$23,233	$58,679	$65,694
Retail Accounts	6,477	7,539	20,584	23,241
Total	$26,990	$30,772	$79,263	$88,935

Three Months Ended September 30, 2016 and September 30, 2015

Our total revenue decreased by $3.8 million, or 12.3%, to $27.0 million for the three months ended September 30, 2016, from $30.8 million for the three months ended September 30, 2015. This change was driven primarily by a decrease in performance fees recognized for the three months ended September 30, 2016, as well as a decrease in average assets. We did not recognize performance fees during the three months ended September 30, 2016 compared to $3.2 million in performance fees recognized during the three months ended September 30, 2015. Average AUM decreased 1.1% to $26.8 billion from $27.1 billion for the three months ended September 30, 2016 and 2015, respectively.

Our weighted average fees were 0.403% and 0.454% for the three months ended September 30, 2016 and 2015, respectively.

Average assets in institutional accounts decreased $0.2 billion to $15.4 billion for the three months ended September 30, 2016, from $15.6 billion for the three months ended September 30, 2015, and had weighted average fees of 0.533% and 0.596% for the three months ended September 30, 2016 and 2015, respectively. The decrease in weighted average fee rates primarily reflects the decrease in institutional performance fees recognized during the three months ended September 30, 2016. We did not recognize any performance fees during the three months ended September 30, 2016, compared to $2.8 million recognized during the three months ended September 30, 2015.

Average assets in retail accounts decreased $0.1 billion to $11.4 billion for the three months ended September 30, 2016, from $11.5 billion for the three months ended September 30, 2015, and had weighted average fees of 0.227% and 0.262% for the three months ended September 30, 2016 and 2015, respectively. The decrease in retail weighted average fee rates was

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driven by the reduction of base fees related to the fulcrum fee arrangements of certain accounts related to one retail client relationship and a decrease in retail performance fees recognized in 2016. We recognized a $0.7 million reduction in base fees related to fulcrum fees during the three months ended September 30, 2016, compared to $0.3 million in performance fees recognized during the three months ended September 30, 2015.

Nine Months Ended September 30, 2016 and September 30, 2015

Our total revenue decreased by $9.7 million, or 10.9%, to $79.3 million for the nine months ended September 30, 2016, from $88.9 million for the nine months ended September 30, 2015. This change was driven primarily by a decrease in our average AUM due to market depreciation. Average AUM decreased 5.4% to $26.1 billion from $27.6 billion for the nine months ended September 30, 2016 and 2015, respectively. The decrease from the nine months ended September 30, 2015 also reflected a decrease in performance fees recognized. Performance fees decreased to $0.1 million from $3.9 million for the nine months ended September 30, 2016 and 2015, respectively.

Our weighted average fees were 0.405% and 0.430% for the nine months ended September 30, 2016 and 2015, respectively.

Average assets in institutional accounts decreased $0.9 billion to $14.8 billion for the nine months ended September 30, 2016, from $15.7 billion for the nine months ended September 30, 2015, and had weighted average fees of 0.530% and 0.557% for the nine months ended September 30, 2016 and 2015, respectively. The decrease in weighted average fees was primarily reflects the decrease in institutional performance fees recognized during 2016. We recognized $0.1 million in performance fees during the nine months ended September 30, 2016, compared to $2.9 million recognized during the nine months ended September 30, 2015.

Average assets in retail accounts decreased $0.6 billion to $11.3 billion for the nine months ended September 30, 2016, from $11.9 billion for the nine months ended September 30, 2015, and had weighted average fees of 0.243% and 0.261% for the nine months ended September 30, 2016 and 2015, respectively. The decrease in retail weighted average fee rates primarily reflects the impact of the fulcrum fee relationships of certain accounts and a decrease in retail performance fees recognized in 2016. We recognized a $0.7 million reduction in base fees related to fulcrum fees during the nine months ended September 30, 2016, compared to $1.0 million in performance fees recognized during the nine months ended September 30, 2015.

Expenses

Our operating expenses are driven primarily by our compensation and benefits costs. The table below describes the components of our operating expenses for the three and nine months ended September 30, 2016 and 2015.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Cash Compensation and Other Benefits	$10,002	$10,345	$31,017	$31,181
Other Non-Cash Compensation	1,765	1,300	4,947	4,334
Total Compensation and Benefits Expense	11,767	11,645	35,964	35,515
General and Administrative Expense	3,271	2,896	9,790	10,989
Total Operating Expenses	$15,038	$14,541	$45,754	$46,504

Three Months Ended September 30, 2016 and September 30, 2015

Total operating expenses increased by $0.5 million, or 3.4%, to $15.0 million for the three months ended September 30, 2016, from $14.5 million for the three months ended September 30, 2015. This increase was attributable primarily to an increase in general and administrative costs.

Compensation and benefits expense increased by approximately $0.1 million, or 1.0%, to $11.8 million for the three months ended September 30, 2016, from $11.6 million for the three months ended September 30, 2015.

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General and administrative expense increased by $0.4 million, or 12.9%, to $3.3 million for the three months ended September 30, 2016 from $2.9 million for the three months ended September 30, 2015. This increase primarily reflects an increase in expenses during 2016 associated with new business initiatives.

Nine Months Ended September 30, 2016 and September 30, 2015

Total operating expenses decreased by $0.8 million, or 1.6%, to $45.8 million for the nine months ended September 30, 2016, from $46.5 million for the nine months ended September 30, 2015. This decrease was attributable to a a decrease in general and administrative costs, partially offset by an increase in our compensation and benefits expenses.

Compensation and benefits expense increased by approximately $0.4 million, or 1.3%, to $36.0 million for the nine months ended September 30, 2016, from $35.5 million for the nine months ended September 30, 2015.

General and administrative expense decreased by $1.2 million, or 10.9%, to $9.8 million for the nine months ended September 30, 2016 from $11.0 million for the nine months ended September 30, 2015. This decrease primarily reflects $1.8 million in non-recurring lease expenses associated with our former corporate headquarters in the first half of 2015 and certain non-recurring operational expenses, partially offset by an increase in expenses during 2016 associated with new business initiatives.

Other Income/ (Expense)

Three Months Ended September 30, 2016 and September 30, 2015

Other Income/ (Expense) was income of $0.4 million for the three months ended September 30, 2016, and consisted primarily of $1.5 million in gains and other investment income from investments and $0.1 million in dividend income, partially offset by $1.2 million in expense related to adjustments to our liability to our selling and converting shareholders. Other Income/ (Expense) was an expense of $5.0 million for the three months ended September 30, 2015, and consisted primarily of $4.4 million in losses and other investment income from investments and $0.7 million in expense related to adjustments to our liability to our selling and converting shareholders, partially offset by $0.2 million in dividend income. As discussed further below, the liability to our selling and converting shareholders represents 85% of the amount of cash savings, if any, in U.S. federal, state and local income tax that we realize as a result of the amortization of the increases in tax basis generated from our purchase of operating company units from our selling shareholders.

Nine Months Ended September 30, 2016 and September 30, 2015

Other Income/ (Expense) was income of $0.1 million for the nine months ended September 30, 2016, and consisted primarily of $1.1 million in gains and other investment income from investments and $0.3 million in dividend income, partially offset by $1.4 million in expense related to adjustments to our liability to our selling and converting shareholders. Other Income/ (Expense) was an expense of $5.2 million for the nine months ended September 30, 2015, and consisted primarily of $3.9 million in losses and other investment income from investments, $1.6 million in expense related to adjustments to our liability to our selling and converting shareholders and $0.3 million in other expense, partially offset by $0.6 million in dividend income. As discussed further below, the liability to our selling and converting shareholders represents 85% of the amount of cash savings, if any, in U.S. federal, state and local income tax that we realize as a result of the amortization of the increases in tax basis generated from our purchase of operating company units from our selling shareholders.

Income Tax Expense

For the three and nine months ended September 30, 2016 and 2015, components of our income tax expense are as follows :

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	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Unincorporated and Other Business Tax Expenses	$758	$613	$1,735	$1,676
Corporate Tax Expense:				
Corporate Income Tax Expense	1,126	1,009	2,855	2,939
Change in Valuation Allowance	(1,413)	(874)	(1,652)	(2,213)
Total Corporate Tax (Benefit)/ Expense	(287)	135	1,203	726
Total Income Tax Expense	$471	$748	$2,938	$2,402

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Our results for the three and nine months ended September 30, 2016 and 2015 included the effects of adjustments related to our tax receivable agreement and the associated liability as well as non-recurring lease expenses discussed in "Expenses" above. Details of corporate tax expenses excluding these items and reconciliations between our GAAP and non-GAAP corporate tax items are as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
	(in thousands)			
Corporate Tax (Benefit)/ Expense	$(287)	$135	$1,203	$726
Effects of One Time Adjustments	—	—	—	133
Less: Change in the Valuation Allowance Associated with the Tax Receivable Agreement	1,411	821	1,647	1,908
Non-GAAP Corporate Tax Expense	$1,124	$956	$2,850	$2,767

Our effective tax rate, exclusive of adjustments related to our tax receivable agreement and the associated liability to selling and converting shareholders and adjustments related to non-recurring expenses recognized in operating expense in the third quarter of 2016, was 36.5% and 34.7% for the three months ended September 30, 2016 and 2015, respectively, and 36.7% and 34.1% for the nine months ended September 30, 2016 and 2015, respectively, and was determined as follows:

	For the Three Months Ended September 30,			
	2016		2015	
	Tax	% of Non-GAAP Pre-tax Income	Tax	% of Non-GAAP Pre-tax Income
	(in thousands)		(in thousands)	
Federal Corporate Tax	$1,046	34.0 %	$937	34.0 %
State and Local Taxes, Net of Federal Benefit	90	2.9 %	85	3.1 %
Other Adjustments	(12)	(0.4)%	(66)	(2.4)%
Non-GAAP Effective Taxes	$1,124	36.5 %	$956	34.7 %

	For the Nine Months Ended September 30,			
	2016		2015	
	Tax	% of Non-GAAP Pre-tax Income	Tax	% of Non-GAAP Pre-tax Income
	(in thousands)		(in thousands)	
Federal Corporate Tax	$2,643	34.0 %	$2,761	34.0 %
State and Local Taxes, Net of Federal Benefit	225	2.9 %	256	3.2 %
Other Adjustments	(18)	(0.2)%	(250)	(3.1)%
Non-GAAP Effective Taxes	$2,850	36.7 %	$2,767	34.1 %

A comparison of the GAAP effective tax rates for the three and nine months ended September 30, 2016 and 2015 is not meaningful due to the valuation allowance adjustments.

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Three Months Ended September 30, 2016 and September 30, 2015

Income Tax Expense was $0.5 million for the three months ended September 30, 2016 and $0.7 million for the three months ended September 30, 2015. Income Tax Expense for the three months ended September 30, 2016 and 2015 included $1.4 million and $0.9 million of benefits, respectively, associated with decreases to the valuation allowance recorded against our deferred tax asset. The remaining income tax expense for the three months ended September 30, 2016 consisted of $0.8 million in operating company unincorporated and other business taxes and $1.1 million of corporate income taxes. The remaining income tax expense for the three months ended September 30, 2015 consisted of $0.6 million in operating company unincorporated and other business taxes and $1.0 million of corporate income taxes.

Nine Months Ended September 30, 2016 and September 30, 2015

Income Tax Expense was $2.9 million for the nine months ended September 30, 2016 and $2.4 million for the nine months ended September 30, 2015. Income Tax Expense for the nine months ended September 30, 2016 and 2015 included $1.7 million and $2.2 million of benefits, respectively, associated with decreases to the valuation allowance recorded against our deferred tax asset. The remaining income tax expense for the nine months ended September 30, 2016 consisted of $1.7 million in operating company unincorporated and other business taxes and $2.9 million of corporate income taxes. The remaining income tax expense for the nine months ended September 30, 2015 consisted of $1.7 million of operating company unincorporated and other business taxes and $2.9 million of corporate income taxes.

Net Income Attributable to Non-Controlling Interests

Three Months Ended September 30, 2016 and September 30, 2015

Net income attributable to non-controlling interests was $9.8 million for the three months ended September 30, 2016, and consisted of $9.5 million associated with our employees' and outside investors' approximately 75.6% weighted average interest in the income of the operating company and $0.2 million associated with the non-controlling interest in the income of our consolidated entities. Net income attributable to non-controlling interests was $8.5 million for the three months ended September 30, 2015, and consisted of $11.1 million associated with our employees' and outside investors' approximately 77.9% weighted average interest in the income of the operating company, partially offset by approximately $2.6 million associated with the non-controlling interest in the losses of our consolidated entities. The change in net income attributable to non-controlling interests primarily reflects the increase in net income for the three months ended September 30, 2016, partially offset by the decrease in our employees' and outside investors' weighted average interest in the income of the operating company. We expect the interests in our operating company in subsequent periods to depend on changes in our shareholder's equity and the size and composition of Class B units awarded by our operating company's compensation plans.

Nine Months Ended September 30, 2016 and September 30, 2015

Net income attributable to non-controlling interests was $25.4 million for the nine months ended September 30, 2016, and consisted primarily of $25.3 million associated with our employees' and outside investors' approximately 76.5% weighted average interest in the income of the operating company. Net income attributable to non-controlling interests was $29.4 million for the nine months ended September 30, 2015, and consisted of $31.7 million associated with our employees' and outside investors' approximately 79.5% weighted average interest in the income of the operating company, partially offset by approximately $2.3 million associated with the non-controlling interest in the losses of our consolidated entities. The change in net income attributable to non-controlling interests primarily reflects the decrease in net income for the nine months ended September 30, 2016 and the decrease in our employees' and outside investors' weighted average interest in the income of the operating company. We expect the interests in our operating company in subsequent periods to depend on changes in our shareholder's equity and the size and composition of Class B units awarded by our operating company's compensation plans.

Liquidity and Capital Resources

Historically, the working capital needs of our business have primarily been met through the cash generated by our operations. Distributions to members of our operating company are our largest use of cash. Other activities include purchases and sales of investments to fund our deferred compensation program, capital expenditures, and supporting strategic growth initiatives such as providing the initial cash investment in our mutual funds.

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We expect to fund the liquidity needs of our business in the next twelve months, and over the long term, primarily through cash generated from operations. As an investment management company, our business is materially affected by conditions in the global financial markets and economic conditions throughout the world. Our liquidity is highly dependent on the revenue and income from our operations, which is directly related to our levels of AUM. For the three months ended September 30, 2016, our average AUM and revenues decreased by 1.1% and 12.3%, respectively, compared to our average AUM and revenues for the three months ended September 30, 2015. At September 30, 2016, cash and cash equivalents was $31.1 million, inclusive of $4.0 million in cash held by our consolidated subsidiaries. Advisory fees receivable was $25.6 million. We also had approximately $10.6 million in investments set aside to satisfy our obligations under our deferred compensation programs.

In determining the sufficiency of liquidity and capital resources to fund our business, we regularly monitor our liquidity position, including, among other things, cash, working capital, investments, long-term liabilities, lease commitments, and operating company distributions. Compensation is our largest expense. To the extent we deem necessary and appropriate to run our business, recognizing the need to retain our key personnel, we have the ability to change the absolute levels of our compensation packages, as well as change the mix of their cash and non-cash components. Historically, we have not tied our level of compensation directly to revenue, as many Wall Street firms do. Correspondingly, there is not a linear relationship between our compensation and the revenues we generate. This generally has the effect of increasing operating margins in periods of increased revenues, but can reduce operating margins when revenue declines.

We regularly evaluate our staffing requirements and compensation levels with reference to our own liquidity position and external peer benchmarking data. The result of this review directly influences management's recommendations to our Board of Directors with respect to such staffing and compensation levels.

We anticipate that tax allocations and dividend equivalent payments to the members of our operating company, which consist of certain of our employees, unaffiliated persons, former employees, and us, will continue to be a material financing activity. Cash distributions to operating company members for partnership tax allocations would increase should the taxable income of the operating company increase. Dividend equivalent payments will depend on our dividend policy and the discretion of our Board of Directors, as discussed below.

We believe that our lack of long-term debt, and ability to vary cash compensation levels, have provided us with an appropriate degree of flexibility in providing for our liquidity needs.

Dividend Policy

We are a holding company and our primary investment is our ownership of membership interests in our operating company. As a result, we depend upon distributions from our operating company to pay any dividends that our Board of Directors may declare to be paid to our Class A common stockholders. When, and if, our Board of Directors declares any such dividends, we then cause our operating company to make distributions to us in an amount sufficient to cover the dividends declared. Our dividend policy has certain risks and limitations, particularly with respect to liquidity. We may not pay dividends to our Class A common shareholders in amounts that have been paid to them in the past, or at all, if, among other things, we do not have the cash necessary to pay our intended dividends. To the extent we do not have cash on hand sufficient to pay dividends in the future, we may decide not to pay dividends. By paying cash dividends rather than investing that cash in our future growth, we risk slowing the pace of our growth, or not having a sufficient amount of cash to fund our operations or unanticipated capital expenditures, should the need arise.

On an annual basis, our Board of Directors has targeted a cash dividend payout ratio of approximately 70% to 80% of our non-GAAP diluted net income, subject to growth initiatives and other funding needs. Our ability to pay dividends is subject to the Board of Directors' discretion and may be limited by our holding company structure and applicable provisions of Delaware law.

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Tax Receivable Agreement

Our purchase of membership units of our operating company concurrent with our initial public offering, and the subsequent and future exchanges by holders of Class B units of our operating company for shares of our Class A common stock (pursuant to the exchange rights provided for in the operating company's operating agreement), has resulted in, and is expected to continue to result in, increases in our share of the tax basis of the tangible and intangible assets of our operating company, which will increase the tax depreciation and amortization deductions that otherwise would not have been available to us. These increases in tax basis and tax depreciation and amortization deductions have reduced, and are expected to continue to reduce, the amount of cash taxes that we would otherwise be required to pay in the future. We entered into a tax receivable agreement with the current members of our operating company, the one member of our operating company immediately prior to our initial public offering who sold all membership units to us in connection with our initial public offering and any future holders of Class B units. This tax receivable agreement requires us to pay these members 85% of the amount of cash savings, if any, in U.S. federal, state and local income tax that we actually realize (or are deemed to realize in the case of an early termination payment by us, or a change in control, as described in the tax receivable agreement) as a result of the increases in tax basis described above and certain other tax benefits related to entering into the tax receivable agreement, including tax benefits attributable to payments under the tax receivable agreement.

Cash Flows

Three Months Ended September 30, 2016 and September 30, 2015

Cash and cash equivalents increased $6.3 million to $31.1 million during the three months ended September 30, 2016 compared to a $9.2 million increase in cash and cash equivalents to $33.6 million during the three months ended September 30, 2015. Net cash provided by operating activities decreased $6.5 million in the three months ended September 30, 2016 to $14.9 million from $21.4 million in the three months ended September 30, 2015. The decrease was primarily due to a decrease in revenues and changes in operating assets and liabilities, and working capital.

Net cash provided by investing activities was $0.2 million for the three months ended September 30, 2016, an increase of $1.0 million compared to the three months ended September 30, 2015. The increase was primarily due to a $0.6 million decrease in cash used in the purchases of property and equipment, a $0.2 million increase in payments from related parties, and a $0.1 million decrease in net purchases of investments during the three months ended September 30, 2016.

Net cash used in financing activities decreased $2.6 million for the three months ended September 30, 2016 to $8.8 million from $11.4 million for the three months ended September 30, 2015. The decrease is primarily due to a $2.3 million decrease in the repurchase and retirement of shares of Class A common stock and Class B units during the three months ended September 30, 2016.

Nine Months Ended September 30, 2016 and September 30, 2015

Cash and cash equivalents decreased $4.3 million to $31.1 million during the nine months ended September 30, 2016 compared to a $5.5 million decrease in cash and cash equivalents to $33.6 million during the nine months ended September 30, 2015. Net cash provided by operating activities decreased $8.3 million in the nine months ended September 30, 2016 to $42.4 million from $50.7 million in the nine months ended September 30, 2015. The decrease was primarily due to a decrease in revenues and net income and changes in operating assets and liabilities, and working capital.

Net cash provided by investing activities increased $6.4 million for the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015. The increase was primarily due to a $6.1 million decrease in cash used in the purchases of property and equipment during the nine months ended September 30, 2016.

Net cash used in financing activities decreased $3.4 million for the nine months ended September 30, 2016 to $46.6 million from $49.9 million for the nine months ended September 30, 2015. The decrease reflects a $4.7 million decrease in the repurchase and retirement of shares of Class A common stock and Class B units during the nine months ended September 30, 2016. During the nine months ended September 30, 2015, net cash used in financing activities also reflected $1.7 million of cash received for the exercise of options to purchase Class B units.

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Contractual Obligations

The lease for our former corporate headquarters expired in October 2015. We entered into an 11-year lease agreement in June 2014, the term of which commenced in October 2014. Annual minimum rent during the term is approximately $2.0 million. During the three months ended September 30, 2016, we terminated a five-year sublease agreement which commenced on May 1, 2015. We entered into a new four-year sublease agreement commencing on October 1, 2016, which is cancelable by either the Company or sublessee given appropriate notice after the thirty-first month following the commencement of the sublease agreement. Sublease income will continue to decrease annual lease expense by approximately $0.4 million per year.

Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements as of September 30, 2016.

Critical Accounting Policies and Estimates

The preparation of our consolidated financial statements, in accordance with U.S. generally accepted accounting principles ("GAAP"), requires management to make estimates and judgments that affect our reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under current circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily available from other sources. We evaluate our estimates on an ongoing basis. Actual results may differ from these estimates under different assumptions or conditions.

Accounting policies are an integral part of our financial statements. A thorough understanding of these accounting policies is essential when reviewing our reported results of operations and our financial condition. Management believes that the critical accounting policies discussed below involve additional management judgment due to the sensitivity of the methods and assumptions used.

Consolidation

Our policy is to consolidate all majority-owned subsidiaries in which we have a controlling financial interest and variable-interest entities of which we are deemed to be the primary beneficiary. We assess our consolidation practices regularly, as circumstances dictate. All significant inter-company transactions and balances have been eliminated.

During the first quarter of 2016, the Company adopted ASU No. 2015-02, “Consolidation (Topic 810): Amendments to the Consolidation Analysis,” issued by the FASB in February 2015. This standard modifies consolidation guidance for reporting organizations that are required to evaluate whether certain legal entities should be consolidated. The Company elected to adopt ASU No. 2015-02 under a modified retrospective approach by recording a cumulative-effect adjustment to equity as of the January 1, 2016. The adoption of ASU No. 2015-02 resulted in the deconsolidation of entities previously included in our consolidated results as the Company no longer has a controlling financial interest in those entities. The effects of ASU No. 2015-02 on the Company’s consolidated financial statements are included in “Note 2 — Significant Accounting Policies” of this Quarterly Report on Form 10-Q.

Income Taxes

We are a “C” corporation under the Internal Revenue Code, and thus liable for federal, state and local taxes on the income derived from our economic interest in our operating company. The operating company is a limited liability company that has elected to be treated as a partnership for tax purposes. Our operating company has not made a provision for federal or state income taxes because it is the responsibility of each of the operating company's members (including us) to separately report their proportionate share of the operating company's taxable income or loss. Similarly, the income of our consolidated subsidiaries is not subject to income taxes, as such income is allocated to each partnership's individual partners. The operating company has made a provision for New York City Unincorporated Business Tax.

We recognize deferred tax assets and liabilities for the future tax consequences attributable to differences between the carrying amounts of existing assets and liabilities and their respective tax bases, net operating loss carryforwards and tax credits. A valuation allowance is maintained for deferred tax assets that we estimate are more likely than not to go unrealizable based on available evidence at the time the estimate is made. Determining the valuation allowance requires management to make significant judgments and assumptions. In determining the valuation allowance, we use historical and forecasted future operating results, based upon approved business plans, including a review of the eligible carryforward periods, tax planning

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opportunities and other relevant considerations. Each quarter, we re-evaluate our estimate related to the valuation allowance, including our assumptions about future taxable income.

We believe that the accounting estimate related to the $57.2 million valuation allowance, recorded against the deferred tax asset associated with our acquisition of operating company membership units, is a critical accounting estimate because the underlying assumptions can change from period to period. For example, tax law changes, or variances in future projected operating performance, could result in a change in the valuation allowance. If we are not able to realize all or part of our net deferred tax assets in the future, an adjustment to our deferred tax asset valuation allowance would be charged to income tax expense in the period such determination was made.

Tax benefits related to stock option windfall deductions are not recognized until they result in a reduction of cash taxes payable. The benefit of these excess tax benefits will be recorded in equity when they reduce cash taxes payable. We will only recognize a tax benefit from stock- and unit-based awards in Additional Paid-in Capital if an incremental tax benefit is realized after all other tax benefits currently available have been utilized. During the each of the three and nine months ended September 30, 2016, we had less than $0.1 million in tax benefits associated with stock- and unit-based awards that we were not able to recognize. This amount is reflected as an unrecognized tax benefit and is not included in the balance of our deferred tax asset. Approximately $0.1 million and $0.3 million of such benefits occurred in the three and nine months ended September 30, 2015, respectively.

Management's judgment is required in determining our provision for income taxes, evaluating our tax positions and establishing deferred tax assets and liabilities. The calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. If the ultimate resolution of uncertainties is different from currently estimated, it could affect income tax expense and the effective tax rate.

Recently Issued Accounting Pronouncements Not Yet Adopted

See Note 2, "Significant Accounting Policies — Recently Issued Accounting Pronouncements Not Yet Adopted" of the consolidated financial statements included in this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Market Risk

Our exposure to market risk is directly related to our role as investment adviser for the institutional separate accounts we manage and the retail clients for which we act as sub-investment adviser.

Our revenue for the three and nine months ended September 30, 2016 and 2015 was generally derived from advisory fees, which are typically based on the market value of our AUM, which can be affected by adverse changes in interest rates, foreign currency exchange and equity prices. Accordingly, a decline in the prices of securities would cause our revenue and income to decline, due to a decrease in the value of the assets we manage. In addition, such a decline could cause our clients to withdraw their funds in favor of investments offering higher returns or lower risk, which would cause our revenue and income to decline further.

The value of our AUM was $27.4 billion as of September 30, 2016. A 10% increase or decrease in the value of our AUM, if proportionately distributed over all of our investment strategies, products, and client relationships, would cause an annualized increase or decrease in our revenues of approximately $11.3 million at our current weighted average fee rate excluding the impact of performance fees and fulcrum fees of 0.413%. There are differences in our fee rates across distribution channels, investment strategies and the size of client relationships. As such, a change in the composition of our AUM, in particular an increase in the proportion of our total assets under management attributable to strategies, clients or relationships with lower effective fee rates, could have a material negative impact on our overall weighted average fee rates and thus different impact to revenues on the same 10% increase or decrease in the value of our AUM.

We are also subject to market risk due to a decline in the value of the our holdings and the holdings of our consolidated subsidiaries, which, as of September 30, 2016, consist primarily of marketable securities, investments in equity method investees, and securities sold short. At September 30, 2016, the value of our assets subject to market risk was $20.1 million. At September 30, 2016, the value of our liabilities subject to market risk was $2.5 million. Assuming a 10% increase or decrease, the fair value of assets and liabilities would have increased or decreased by $2.0 million and $0.2 million, respectively, at September 30, 2016.

Exchange Rate Risk

A substantial portion of the accounts that we advise, or sub-advise, hold investments that are denominated in currencies other than the U.S. Dollar. Movements in the rate of exchange between the U.S. Dollar and the underlying foreign currency affect the values of assets held in accounts that we manage, thereby affecting the amount of revenues we earn. The value of our AUM was $27.4 billion as of September 30, 2016 and approximately 31% of our assets under management across our investment strategies were invested in strategies that primarily invest in securities of non-U.S. companies and approximately 36% of our assets under management were invested in securities denominated in currencies other than the U.S. Dollar. To the extent our assets under management are denominated in currencies other than the U.S. Dollar, the value of those assets under management will decrease with an increase in the value of the U.S. Dollar, or increase with a decrease in the value of the U.S. Dollar. Because we believe that many of our clients invest in those strategies in order to gain exposure to non-U.S. currencies, or may implement their own hedging programs, we do not hedge an investment portfolio’s exposure to a non-U.S. currency.

We have not adopted a corporate-level risk management policy to manage this exchange rate risk. Assuming that 36% of our assets under management is invested in securities denominated in currencies other than the U.S. Dollar and excluding the impact of any hedging arrangements, a 10% increase or decrease in the value of the U.S. Dollar would decrease or increase the fair value of our assets under management by $1.0 billion, which would cause an annualized increase or decrease in revenues of approximately $4.1 million at our current weighted average fee rate excluding the impact of performance fees and fulcrum fees of 0.413%.

We operate in several foreign countries, but mainly in the United Kingdom. We incur operating expenses and have foreign currency-denominated assets and liabilities associated with these operations, although our revenues are predominately realized in U.S. Dollar. We do not believe that foreign currency fluctuations materially affect our results of operations and, as such, have not adopted a corporate-level risk management policy to manage this exchange rate risk.

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Interest Rate Risk

As of September 30, 2016, our $31.1 million in cash and cash equivalents was primarily held in demand deposit accounts. As such, interest rate changes would not have a material impact on the income we earn from these deposits. Since the Company does not have any debt that bears interest at a variable rate, it did not have any direct exposure to interest rate risk at September 30, 2016.

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Item 4. Controls and Procedures.

During the course of the review of our consolidated financial statements as of September 30, 2016, our management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2016, our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) were effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information 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.

There have not been any changes in our internal control over financial reporting during the three and nine months ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

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

Issuances

During the three months ended September 30, 2016, in connection with employee equity purchases we issued an aggregate of 11,893 Class B units of our operating company and the corresponding number of shares of Class B common stock. Certain of these Class B units are Delayed Exchange Class B units, which have the right to receive dividend payments; but cannot be exchanged for shares of the Company's Class A common stock until seven years after the date of grant and do not carry rights associated with the tax receivable agreement.

During the three months ended September 30, 2016, the exercise by certain members of our operating company of 10,451 options to acquire Class B units of our operating company resulted in the issuance of 10,451 Class B units and the corresponding number of shares of Class B common stock for approximately $0.1 million in cash.

These issuances did not involve any public offering, general advertising or general solicitation. The certificates representing the securities bear a restrictive legend. The securities were issued in a transaction not involving a public offering and were issued in reliance upon the exemption from registration provided by Section 4(a)(2) of the Securities Act of 1933, as amended.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

The table below sets forth information regarding purchases of our Class A Common Stock on a monthly basis during the three months ended September 30, 2016.

Period	(a) Total Number of Shares of Class A Common Stock Purchased	(b) Average Price Paid per Share of Class A Common Stock	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs[1]	(d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (in millions)
July 1, 2016 - July 31, 2016	67,499	$ 7.44	67,499	$ 8.7
August 1, 2016 - August 31, 2016	—	—	—	8.7
September 1, 2016 - September 30, 2016	—	—	—	8.7
Total	67,499	$ 7.44	67,499	$ 8.7

[1] Our share repurchase program was announced on April 24, 2012. The Board of Directors authorized us to repurchase an aggregate of $10 million of our outstanding Class A common stock and the operating company's Class B units on the open market and in private transactions in accordance with applicable securities laws. In February 2014, the Company announced an increase of $20 million in the aggregate amount authorized under the repurchase program. The timing, number and value of common shares and units repurchased are subject to the Company’s discretion. The Company’s share repurchase program is not subject to an expiration date and may be suspended, discontinued, or modified at any time, for any reason.

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Item 6. Exhibits.

Exhibit	Description of Exhibit
31.1	Certification of Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) (filed herewith)
31.2	Certification of Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) (filed herewith)
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith)
101	Materials from the Pzena Investment Management, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Statements of Financial Condition, (ii) Consolidated Statements of Operations, (iii) Consolidated Statement of Changes in Equity, (iv) Consolidated Statements of Cash Flows, and (vi) related Unaudited Notes to the Consolidated Financial Statements, tagged in detail (furnished herewith).

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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.

Dated: November 4, 2016

PZENA INVESTMENT MANAGEMENT, INC.

By: /s/ RICHARD S. PZENA
Name: Richard S. Pzena
Title: Chief Executive Officer
(Principal Executive Officer)

By: /s/ JESSICA R. DORAN
Name: Jessica R. Doran
Title: Chief Financial Officer
(Principal Financial and Accounting Officer)