Zumiez Inc
Form 10-K
March 27, 2007

UNITED STATES
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: February 3, 2007

or

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

Commission File Number: 000-51300

ZUMIEZ INC.

(Exact name of Registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	**91-1040022** (IRS Employer Identification No.)
6300 Merrill Creek Parkway, Suite B, Everett, Washington (Address of principal executive offices)	**98203** (Zip Code)

Registrant s telephone number, including area code: **(425) 551-1500**

Securities registered under Section 12(b) of the Act: **Common Stock**

Name of each exchange on which registered: **The NASDAQ Stock Market LLC**

Securities registered under 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 last ninety days Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10 K. o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act). Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

As of the last business day of the second fiscal quarter, July 28, 2006, the aggregate market value of the Registrant s voting and non-voting stock held by non-affiliates of the Registrant was approximately $579,481,527 using the closing sales price on that day of $31.03.

As of March 15, 2007, there were 27,880,512 shares of the Registrant s common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this report is incorporated by reference from the Registrant s definitive proxy statement, relating to the Annual Meeting of Shareholders tentatively scheduled to be held May 30, 2007, which definitive proxy statement will be filed not later than 120 days after the end of the fiscal year to which this report relates.

ZUMIEZ INC.
FORM 10-K
PART I.

This Form 10-K contains forward-looking statements. These statements relate to our expectations for future events and future financial performance. Generally, the words anticipate, expect, intend and similar expressions identify forward-looking statements. Forward-looking statements involve risks and uncertainties, and future events and circumstances could differ significantly from those anticipated in the forward-looking statements. These statements are only predictions. Actual events or results may differ materially. Factors which could affect our financial results are described in Item 1A below and in Item 7 of Part II of this Form 10-K. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assume responsibility for the accuracy and completeness of the forward-looking statements. We undertake no duty to update any of the forward-looking statements after the date of this report to conform such statements to actual results or to changes in our expectations.

***Comment regarding our fiscal year end*: The Company s fiscal year is based on a 52/53-week year ending on the Saturday closest to January 31. This change first became effective for fiscal year 2003, which ended on January 31, 2004.**

Zumiez, the Company, we, us, our and similar references refer to Zumiez Inc.

Item 1. BUSINESS

We are a mall based specialty retailer of action sports related apparel, footwear, equipment and accessories operating under the Zumiez brand name. As of February 3, 2007 we operated 235 stores primarily located in shopping malls, giving us a presence in 23 states. We were founded in 1978 by Thomas D. Campion, our Chairman. Our current President and Chief Executive Officer, Richard M. Brooks joined us as Chief Financial Officer in 1993. Our stores cater to young men and women between the ages of 12 and 24 who seek popular brands representing a lifestyle centered on activities that include skateboarding, surfing, snowboarding, BMX and motocross. We support the action sports lifestyle and promote our brand through a multi-faceted marketing approach that is designed to integrate our brand image with our customers activities and interests. This approach, combined with our differentiated merchandising strategy, store design, comprehensive training programs and passionate employees, allows us to provide an experience for our customers that we believe is consistent with their attitudes, fashion tastes and identities and is otherwise unavailable in most malls.

Our stores bring the look and feel of an independent specialty shop to the mall by emphasizing the action sports lifestyle through a distinctive store environment and high-energy sales personnel. We seek to staff our stores with store associates who are knowledgeable users of our products, which we believe provides our customers with enhanced customer service and supplements our ability to identify and react quickly to emerging trends and fashions. We design our stores to appeal to teenagers and to serve as a destination for our customers. Most of our stores, which average approximately 2,800 square feet, feature couches and action sports oriented video game stations that are intended to encourage our customers to shop for longer periods of time and to interact with each other and our store associates. To increase customer traffic, we generally locate our stores near busy areas of the mall such as food courts, movie theaters, music or game stores and other popular teen retailers. We believe that our distinctive store concept and compelling store economics will provide continued opportunities for growth in both new and existing markets.

We believe that our customers desire merchandise and fashion that is rooted in the action sports lifestyle and reflects their individuality. We strive to keep our merchandising mix fresh by continuously introducing new brands and styles. Our focus on a diverse collection of brands allows us to quickly adjust to changing fashion trends. We believe that our strategic mix of both apparel and hardgoods, including skateboards, snowboards, bindings, components and other equipment, allows us to strengthen the potential of the brands we sell and helps to affirm our credibility with our customers. In addition, we supplement our stores with a select offering of private label apparel and products as a value proposition that we believe complements our overall merchandise selection.

Over our 28-year history, we have developed a corporate culture based on a passion for the action sports lifestyle. Our management philosophy emphasizes an integrated combination of results measurement, training and incentive programs, all designed to drive sales productivity at the individual store associate level. We empower our store managers to make store-level business decisions and consistently reward their success. We seek to enhance the productivity of our employees and encourage their advancement by offering comprehensive in-store, regional and national training programs, which we refer to collectively as Zumiez University. We have:

- increased our store count from 80 as of the end of fiscal 2001 to 235 as of the end of fiscal 2006;
- maintained net sales per square foot in excess of $440 for our last five fiscal years ending with fiscal 2006;
- increased net sales from approximately $84.7 million in fiscal 2001 to approximately $298.2 million in fiscal 2006, representing a compound annual growth rate of 28.6%;
- increased operating profit from $6.7 million in fiscal 2001 to $32.4 million in fiscal 2006, representing a compound annual growth rate of 37.1%; and
- been profitable in every fiscal year of our 28-year history.

Competitive Strengths

We believe that the following competitive strengths differentiate us from our competitors and are critical to our continuing success.

Attractive Lifestyle Retailing Concept. We target a large and growing population of 12 to 24 year olds, many of whom we believe are attracted to the action sports lifestyle and desire to promote their personal independence and style through the apparel they wear and the equipment they use. We believe that action sports are a permanent and growing aspect of youth culture, reaching not only consumers that actually participate in action sports, but also those who seek brands and styles that fit a desired action sports image. We believe we have developed a brand image that our customers view as consistent with their attitudes, fashion tastes and identity that should allow us to benefit from our market s anticipated growth.

Differentiated Merchandising Strategy. We have created a highly differentiated retailing concept by offering an extensive selection of current and relevant action sports brands encompassing apparel, equipment and accessories. The breadth of merchandise offered at our stores exceeds that offered by many other action sports specialty stores and includes some brands and products that are available within many malls only at our stores. The action sports lifestyle includes activities that are popular at different times throughout the year, providing us the opportunity to shift our merchandise selection seasonally. Many of our customers desire to update their wardrobes and equipment as fashion trends evolve or the action sports season dictates. We believe that our ability to quickly recognize changing brand and style preferences and transition our merchandise offerings allows us to continually provide a compelling offering to our customers.

Deep-rooted Corporate Culture. Our culture and brand image enable us to successfully attract and retain high quality employees who are passionate and knowledgeable about the products we sell. We place great emphasis on customer service and satisfaction, and we have made this a defining feature of our corporate culture. To preserve our culture, we strive to promote store managers from within and they are given extensive responsibility for most aspects of store level management. We provide these managers with the knowledge and tools to succeed through our comprehensive training programs and the flexibility to manage their stores to meet localized customer demand.

Distinctive Store Experience. We strive to provide a convenient shopping environment that is appealing and clearly communicates our distinct brand image. Our stores are designed to reflect an organized chaos that we believe is consistent with many teenagers lifestyles. We seek to attract knowledgeable store associates who identify with the action sports lifestyle and are able to offer superior customer service, advice and product expertise. To further enhance our customers experience, most of our stores feature areas with couches and action sports oriented video game stations that are intended to encourage our customers to shop for longer periods of time, to interact with each other and our store associates in a familiar and comfortable setting and to visit our stores more frequently. We believe that our distinctive store environment enhances our image as a leading source for apparel and equipment for the action sports lifestyle.

Disciplined Operating Philosophy. We have an experienced senior management team. Our management team has built a strong operating foundation based on sound retail principles that underlie our unique culture. Our philosophy emphasizes an integrated combination of results measurement, training and incentive programs, all designed to drive sales productivity down to the individual store associate level. Our comprehensive training programs are designed to provide our managers and store associates with enhanced product knowledge, selling skills and operational expertise. We believe that our merchandising team s immersion in the actions sports lifestyle, supplemented with feedback from our customers, store associates and managers, allows us to consistently identify and react to emerging fashion trends. We believe that this, combined with our inventory planning and allocation processes and systems, helps us mitigate markdown risk.

High-Impact, Integrated Marketing Approach. We seek to build relationships with our customers through a multi-faceted marketing approach that is designed to integrate our brand image with the action sports lifestyle. Our marketing efforts focus on reaching our customers in their environment and feature extensive grassroots marketing events, such as the Zumiez Couch Tour, which is a series of interactive sports, music and lifestyle events held at various locations throughout the United States. Our marketing efforts also incorporate local sporting and music event promotions, advertising in magazines popular with our target market, interactive contest sponsorships that actively involve our customers with our brands and products, and distribution of over 10 million Zumiez stickers in the past fiscal year. Events and activities such as these provide opportunities for our customers to develop a strong identity with our culture and brand. We believe that our immersion in the action sports lifestyle allows us to build credibility with our customers and gather valuable feedback on evolving customer preferences.

Growth Strategy

We intend to expand our presence as a leading action sports lifestyle retailer by:

Opening New Store Locations. We believe that the action sports lifestyle has national appeal that provides store expansion opportunities throughout the country. Since the end of fiscal 2002 through the year ended February 3, 2007 (fiscal 2006) we have opened 139 new stores, consisting of 15 new stores in fiscal 2003, 27 new stores in fiscal 2004, 35 new stores in fiscal 2005, and 42 new stores in fiscal 2006. We also acquired 100% of the ownership of 20 stores (17 in Texas, 2 in Oklahoma and 1 in California) from Action Concepts Fast Forward, Ltd. (a limited partnership) (Fast Forward), an apparel and accessory

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retail sales company. We have successfully opened stores in diverse markets throughout the United States, which we believe demonstrates the portability and growth potential of our concept. We plan to open approximately 50 stores in fiscal 2007, including stores in our existing markets and in new markets, to take advantage of what we believe to be a compelling economic store model. We plan to continue to increase the size of our average store by opening new store locations that average approximately 3,000 square feet. These larger locations will accommodate an expanded merchandise mix, while maintaining our unique in-store experience and culture.

Continuing to Generate Sales Growth through Improved Store Level Productivity. We seek to maximize our comparable store sales and net sales per square foot by maintaining consistent store-level execution and offering our customers a broad and relevant selection of action sports brands and products. We also intend to continue to expand our brand awareness in an effort to maintain high levels of customer traffic.

Enhancing our Operating Efficiency. As we continue to expand our business and open new stores, we plan to improve our operating results by taking advantage of economies of scale in purchasing our inventory, leveraging our existing infrastructure and continually optimizing and improving our operations in areas such as inventory and supply chain management. We seek to better leverage our expenses, particularly general corporate overhead and fixed costs such as non-variable occupancy costs, through increases in both comparable store sales and total net sales.

Enhancing our Brand Awareness through Continued Marketing and Promotion. We believe that a key component of our success is the brand exposure that we receive from our marketing events, promotions and activities that embody the action sports lifestyle. These are designed to assist us in increasing brand awareness in our existing markets and expanding into new markets by strengthening our connection with our target customer base. We believe that our marketing efforts have also been successful in generating and promoting interest in our product offerings. In addition, we use our internet presence, designed to convey our passion for the action sports lifestyle, to increase our brand awareness. We plan to continue to expand our integrated marketing efforts by promoting more events and activities in our existing and new markets.

The Action Sports Market

We believe that action sports are a permanent and growing aspect of youth culture, reaching not only consumers that actually participate in action sports, but also those who seek brands and styles that fit a desired action sports image. We believe that teens enjoy shopping in malls and purchasing clothing and fashion-related merchandise.

Merchandising and Purchasing

Merchandising. Our goal is to be viewed by our customers, both young men and young women, as the definitive source of merchandise for the action sports lifestyle. We believe that the breadth of merchandise offered at our stores, which includes apparel, footwear, equipment and accessories, exceeds that offered by many other action sports specialty stores at a single location, and makes our stores a single-stop purchase destination for our target customers. Our apparel offerings include tops, bottoms, outerwear and accessories such as caps, belts and sunglasses. Our footwear offerings primarily consist of action sports related athletic shoes and sandals. Our equipment offerings, or hardgoods, include skateboards, snowboards and ancillary gear such as boots and bindings. We also offer a selection of other items, such as miscellaneous novelties and DVDs.

We seek to identify action sports oriented fashion trends as they develop and to respond in a timely manner with a relevant in-store product assortment. We strive to keep our merchandising mix fresh by continuously introducing new brands or styles in response to the evolving desires of our customers. We also take advantage of the change in action sports seasons during the year to maintain an updated product selection. Our merchandise mix may vary by region, reflecting the specific action sports preferences and seasons in different parts of the country.

We believe that offering an extensive selection of current and relevant brands used and sometimes developed by professional action sports athletes is integral to our overall success. No single brand accounted for more than 7.8% and 7.1% of our net sales in fiscal 2005 and fiscal 2006, respectively. We believe that our strategic mix of both apparel and hardgoods, including skateboards, snowboards, bindings, components and other equipment, allows us to strengthen the potential of the brands we sell and affirms our credibility with our customers.

We believe that our ability to maintain an image consistent with the action sports lifestyle is important to our key vendors. Given our scale and market position, we believe that many of our key vendors view us as an important retail partner. This position helps ensure our ability to procure a relevant product assortment and quickly respond to the changing fashion interests of our customers. Additionally, we believe we are presented with a greater variety of products and styles by some of our vendors, as well as certain specially designed items that are only distributed to our stores.

We supplement our merchandise assortment with a select offering of private label products across many of our apparel product categories. Our private label products complement the branded products we sell, and allow us to cater to the more value-oriented customer. For fiscal 2004, 2005, and 2006 our private label merchandise represented approximately 12.8%, 12.9% and 14.3% respectively, of our net sales.

Purchasing Our merchandising staff consists of a general merchandising manager, planning staff and a staff of buyers and assistant buyers. Our purchasing approach focuses on quality, speed and cost in order to provide timely delivery of merchandise to our stores. We have developed a disciplined approach to buying and a dynamic inventory planning and allocation process to support our merchandise strategy. We utilize a broad vendor base that allows us to shift our merchandise purchases as required to react quickly to changing market conditions. We manage the purchasing and allocation process by reviewing branded merchandise lines from new and existing vendors, identifying emerging fashion trends and selecting branded merchandise styles in quantities, colors and sizes to meet inventory levels established by management. We also coordinate inventory levels in connection with our promotions and seasonality. Our management information systems provide us with current inventory levels at each store and for our company as a whole, as well as current selling history within each store by merchandise classification and by style. We purchase most of our branded merchandise from domestic vendors.

Our merchandising staff remains in tune with the action sports culture by participating in action sports, attending relevant events and concerts, watching action sports related programming and reading action sports publications. In order to identify evolving trends and fashion preferences, our staff spends considerable time analyzing sales data by category and brand down to the stock keeping unit, or SKU (an identification used for inventory tracking purposes) level, gathering feedback from our stores and customers, shopping in key markets and soliciting input from our vendors. As part of our feedback collection process, our merchandise team receives merchandise requests from both customers and store associates and meets with our store managers two to three times per year to discuss current customer trends.

We source our private label merchandise from foreign manufacturers around the world. We have cultivated our private brand sources with a view towards high quality merchandise, production reliability and consistency of fit. We believe that our knowledge of fabric and production costs combined with a flexible sourcing base enables us to source high-quality private label goods at favorable costs.

Distribution and Fulfillment

Timely and efficient distribution of merchandise to our stores is an important component of our overall business strategy. We process all of our merchandise through our distribution center in Everett, Washington. At this facility, merchandise is inspected, allocated to stores, ticketed when necessary, and boxed for distribution to our stores or segregated in our e-commerce fulfillment area for delivery to our internet customers. A significant percentage of our merchandise is currently pre-ticketed by our vendors, which allows us to ship merchandise more quickly, reduces labor costs and enhances our inventory management. We continue to work with our vendors to increase the percentage of pre-ticketed merchandise. Each store is typically shipped merchandise five times a week, providing our stores with a steady flow of new merchandise. We currently use United Parcel Service to ship merchandise to our stores. We believe our current distribution infrastructure is sufficient to accommodate our expected store growth and expanded product offerings over the next several years.

Stores

As of February 3, 2007 we operated 235 stores with an average of approximately 2,800 square feet per store in 23 states. All of our stores are leased and substantially all are located in shopping malls of different types. All references in this Annual Report on Form 10-K to square footage of our stores refers to gross square footage, including retail selling, storage and back-office space.

The following store list shows the number of stores we operated in each state as of February 3, 2007:

State	Number of Stores
Alaska	2
Arizona	10
California	45
Colorado	16
Delaware	1
Florida	5
Idaho	5
Illinois	11
Iowa	1
Minnesota	10
Montana	4
Nevada	5
New Jersey	10
New Mexico	4
New York	24
Oklahoma	2
Oregon	11
Pennsylvania	7
Texas	22
Utah	11
Washington	22
Wisconsin	6
Wyoming	1

As of February 3, 2007 approximately 76.6% of our stores had been opened or remodeled within the previous five years. The following table shows the number of stores (excluding temporary stores that we operate from time to time for special events) opened and closed in each of our last five fiscal years including 20 stores acquired in the fiscal 2006 Fast Forward acquisition:

Fiscal Year	Stores Opened	Stores Closed	Total Number of Stores at End of Period
2002	19		99
2003	15	1	113
2004	27		140
2005	35	1	174
2006	62	1	235

Store Design and Environment. We design our stores to create a distinctive and engaging shopping environment that we believe resonates with our customers and reflects an organized chaos that is consistent with many teenagers lifestyles. Our stores feature an industrial look with concrete floors and open ceilings, dense merchandise displays, action sports focused posters and signage and popular music, all of which are consistent with the look and feel of an independent action sports specialty shop. Most of our stores have couches and action sports oriented video game stations that are intended to encourage our customers to shop for longer periods of time, to interact with each other and our store associates and to visit our stores more frequently. Our stores are constructed and finished to allow us to efficiently shift merchandise displays throughout the year as the action sports season dictates. To further enhance our customers experience, we seek to attract enthusiastic store associates who are knowledgeable about our products and are able to offer superior customer service and expertise. We believe that our store atmosphere enhances our image as a leading provider of action sports lifestyle merchandise.

As of February 3, 2007 our stores averaged 2,800 square feet. We have been, and plan to continue, opening new stores that average approximately 3,000 square feet, slightly larger than our historical average size. These larger stores are intended to enable us to offer an expanded merchandise selection while maintaining our distinctive store environment.

Expansion Opportunities and Site Selection. Since the end of fiscal 2002, we have opened 139 stores, including 20 acquired in fiscal 2006 through the Fast Forward acquisition to enhance our position in existing markets and to enter into new markets, to build our brand awareness and to capitalize on our successful store model. We plan to open 50 new stores in fiscal 2007 and to continue to open a significant number of new stores in future years. Our new store openings are planned in both existing and new markets.

In selecting a location for a new store, we target high-traffic mall space with suitable demographics and favorable lease terms. We seek locations near busy areas of the mall such as food courts, movie theaters, music or game stores and other popular teen retailers. We generally locate our stores in malls in which other teen-oriented retailers have performed well. We also focus on evaluating the market and mall-specific competitive environment for potential new store locations. We seek to diversify our store locations regionally and by caliber of mall. We have currently identified a significant number of potential sites for new stores in malls with appropriate market characteristics.

We have successfully and consistently implemented our store concept across a variety of mall classifications and geographic locations. Our new stores opened during fiscal 2005 generated average net sales of approximately $1.3 million during their first full year of operations. On average, our net investment to open these stores was approximately $372,000 which includes capital expenditures, net of landlord contributions, and initial inventory, net of payables. However, our net investment to open new stores and net sales generated by new stores vary significantly and depend on a number of factors, including the geographic location and size of those stores. Accordingly, net sales and other operating results for stores that we open or have opened subsequent to the end of fiscal 2005, as well as our net investment to open those stores, may differ substantially from net sales and other operating results and our net investment for the stores we opened in fiscal 2005.

Store Management, Operations and Training. We believe that our success is dependent in part on our ability to attract, train, retain and motivate qualified employees at all levels of our organization. We have developed a corporate culture that we believe empowers the individual store managers to make store-level business decisions and consistently rewards their success. We are committed to improving the skills and careers of our workforce and providing advancement opportunities for employees, as evidenced by a significant number of our store managers that began their careers with us as store associates.

Our store operations are currently organized into regions and districts. Each region is managed by a regional manager, responsible for approximately 50 stores. We employ one district sales manager per district, responsible for the sales and operations of approximately 10 stores. Each of our stores is typically staffed with one store manager, one or more assistant managers and two or more store associates, depending on the season. The number of store associates we employ generally increases during peak selling seasons, particularly the back-to-school and the winter holiday seasons, and will increase to the extent that we open new stores.

We provide our managers with the knowledge and tools to succeed through our comprehensive training programs and the flexibility to manage their stores to meet customer demands. While general guidelines for our merchandise assortments, store layouts and in-store visuals are provided by our home office, we give our store managers substantial discretion to tailor their stores to the individual market and empower them to make store-level business decisions. We design group training programs for our managers, such as our Zumiez Managers Retreat, to improve both operational expertise and supervisory skills. Our comprehensive training programs are offered at the store, regional and national levels. Our programs allow managers from all geographic locations to interact with each other and exchange ideas to better operate stores. Our regional, district and store managers are compensated in part based on the sales volume of the store or stores they manage.

Our store associates generally have an interest in the action sports lifestyle and are knowledgeable about our products. Through our training, evaluation and incentive programs, we seek to enhance the productivity of our store associates. Our store associates receive extensive training from their managers to improve their product expertise and selling skills. We evaluate our store associates weekly on measures such as sales per hour, items per transaction and dollars per transaction to ensure consistent productivity, to reward top performers, and to identify potential training opportunities. We provide sales incentives for store associates such as sales-based commissions in addition to hourly wages and our annual Zumiez 100K event, which recognizes outstanding sales performance in a resort setting that combines recreation and education. These and other incentive programs are designed to promote a competitive, yet fun, corporate culture that is consistent with the action sports lifestyle we seek to promote.

Internet Operations. We use our website primarily as an information source for our customers. Our website provides current information on our upcoming events and promotions, store locations and merchandise selection. We also sell products directly through our website, although Internet sales currently comprise, and are expected to continue to comprise, a small portion of our overall net sales. In fiscal 2003, fiscal 2004, fiscal 2005 and fiscal 2006, internet sales represented less than 1% of our total net sales.

Marketing and Advertising

We seek to reach our target customer audience through a multi-faceted marketing approach that is designed to integrate our brand image with the action sports lifestyle. Our marketing efforts focus on reaching our customers in their environment, and feature extensive grassroots marketing events, such as the Zumiez Couch Tour, which give our customers an opportunity to experience and participate in the action sports lifestyle. Our marketing efforts also incorporate local sporting and music event promotions, advertising in magazines popular with our target market such as Transworld Snowboarding and Transworld Skateboarding, interactive contest sponsorships that actively involve our customers with our brands and products, and the distribution of over 10 million Zumiez stickers in the past fiscal year. We believe that our immersion in the action sports lifestyle allows us to build credibility with our target audience and gather valuable feedback on evolving customer preferences.

Our grassroots marketing events are built around the demographics of our customer base and offer an opportunity for our customers to develop a strong identity with our brand and culture. For example, the Zumiez Couch Tour is a series of entertainment events that includes skateboarding demonstrations from top professionals, autograph sessions, competitions and live music, and has featured some of today s most popular teenage personalities in action sports and music. The Zumiez Couch Tour provides a high-impact platform where customers can interact with some of their favorite action sports athletes and vendors can showcase new products. In 2006 our Zumiez Couch Tour completed a twelve city tour across the United States. Advertising expense was approximately, $235,000, $250,000 and $651,000 in fiscal 2004, 2005 and 2006, respectively. The marketing expense increase in fiscal 2006 over fiscal 2005 of approximately $400,000 was primarily due to signage associated with the increase in store openings of an additional 27 stores in fiscal 2006 over fiscal 2005 and additional costs to support fiscal 2006 marketing initiatives.

Management Information Systems

Our management information systems provide integration of store, merchandising, distribution, financial and human resources functions. We use software licensed from ANT USA for merchandise planning and software licensed from CRS Retail, owned by Epicor, that is used for SKU and classification inventory tracking, purchase order management, merchandise distribution, automated ticket making and sales audit functions. Our financial systems are licensed from SAGE and are used for general ledger, accounts payable, payroll, budgeting, financial reporting and asset management. We believe that our information systems are scalable, flexible and have the capacity to accommodate our current growth plans.

Sales are updated daily in our merchandising reporting systems by polling sales information from each store s point-of-sale, or POS, terminals. Our POS system consists of registers providing processing of retail transactions, price look-up, time and attendance and e-mail. Sales information, inventory tracking and payroll hours are uploaded to our central host system. The host system downloads price changes, performs system maintenance and provides software updates to the stores through automated nightly two-way electronic communication with each store. We evaluate information obtained through nightly polling to implement merchandising decisions, including product purchasing/reorders, markdowns and allocation of merchandise on a daily basis.

In addition to our home office staff, each of our regional and district managers can access relevant business information, including current and historical sales by store, district and region, transaction information and payroll data.

Competition

The teenage and young adult retail apparel, hardgoods and accessories industry is highly competitive. We compete with other retailers for vendors, teenage and young adult customers, suitable store locations and qualified store associates and management personnel. In the softgoods markets, which includes apparel, accessories and footwear, we currently compete with other teenage-focused retailers such as Abercrombie & Fitch Co., Aeropostale, Inc., American Eagle Outfitters, Inc., Anchor Blue Clothing Company, Charlotte Russe Inc., Claire s Stores, Inc., Forever 21, Inc., Hollister Co., Hot Topic, Inc., Old Navy, Inc., Pacific Sunwear of California, Inc., The Buckle, Inc., The Wet Seal, Inc. and Urban Outfitters, Inc. In addition, in the softgoods markets we compete with independent specialty shops, department stores and direct marketers that sell similar lines of merchandise and target customers through catalogs and e-commerce. In the hardgoods markets, which includes skateboards, snowboards, bindings, components and other equipment, we compete directly or indirectly with the following categories of companies: other specialty retailers that compete with us across a significant portion of our merchandising categories, such as local snowboard and skate shops; large-format sporting goods stores and chains, such as Big 5 Sporting Goods Corporation, Dick s Sporting Goods, Inc., Sport Chalet, Inc. and The Sports Authority Inc., which operates stores under the brand names Sports Authority, Gart Sports, Oshman s and Sportmart; and Internet retailers.

Competition in our sector is based on, among other things, merchandise offerings, store location, price and the ability to identify with the customer. We believe that we compete favorably with many of our competitors based on our differentiated merchandising strategy, compelling store environment and deep-rooted culture. However, some of our competitors are larger than we are and have substantially greater financial, marketing and other resources than we do. See Item 1A Risk Factors. We may be unable to compete favorably in the highly competitive retail industry, and if we lose customers to our competitors, our sales could decrease.

Trademarks

Zumiez, Free World, O-Three , ALab and Limelight are among our trademarks registered with the United States Patent and Trademark Offic
We regard our trademarks as valuable and intend to maintain such marks and any related registrations. We are currently in the process of filing an application to register the Empyre , Empyre Girl and Alibi marks. We are not aware of any claims of infringement or other challenges to our right to use our marks in the United States. We vigorously protect our trademarks. We also own numerous domain names which have been registered with Corporation for Assigned Names and Numbers.

Employees

As of February 3, 2007 we employed approximately 786 full-time and approximately 2,220 part-time employees, of which approximately 303 were employed at our home office and approximately 2,703 at our store locations. However, the number of part-time employees fluctuates depending on our seasonal needs and, in fiscal 2006, varied from between approximately 1,444 and 2,856 part-time employees. None of our employees are represented by a labor union and we consider our relationship with our employees to be good.

Our principal website address is www.zumiez.com. We make available at this address under investor relations, free of charge, our proxy statement, annual report to shareholders, annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC at http://ir.zumiez.com. Information available on our website is not incorporated by reference in and is not deemed a part of this Form 10-K.

Item 1A. RISK FACTORS

Investing in our securities involves a high degree of risk. The following risk factors, issues and uncertainties should be considered in evaluating our future prospects. In particular, keep these risk factors in mind when you read forward-looking statements elsewhere in this report. Forward-looking statements relate to our expectations for future events and time periods. Generally, the words anticipate, believe, expect, intend and similar expressions identify forward-looking statements. Forward looking statements involve risks and uncertainties, and future events and circumstances could differ significantly from those anticipated in the forward looking statements. Any of the following risks could harm our business, operating results or financial condition and could result in a complete loss of your investment. Additional risks and uncertainties that are not yet identified or that we currently think are immaterial may also harm our business and financial condition in the future.

Our growth strategy depends on our ability to open and operate a significant number of new stores each year, which could strain our resources and cause the performance of our existing stores to suffer.

Our growth largely depends on our ability to open and operate new stores successfully. However, our ability to open new stores is subject to a variety of risks and uncertainties, and we may be unable to open new stores as planned, and any failure to successfully open and operate new stores would have a material adverse effect on our results of operations and on the market price of our common stock. We intend to continue to open a significant number of new stores in future years while remodeling a portion of our existing store base annually. In addition, our proposed expansion will place increased demands on our operational, managerial and administrative resources. These increased demands could cause us to operate our business less effectively, which in turn could cause deterioration in the financial performance of our individual stores and our overall business. To the extent our new store openings are in markets where we already have stores, we may experience reduced net sales in existing stores in those markets. In addition, successful execution of our growth strategy may require that we obtain additional financing, and we cannot assure you that we will be able to obtain that financing onnd-color:#cceeff;">

1,391

6,782

(226
)
Loss from discontinued operations, net of tax
(27
)

(841
)

(255
)

(966
)
Net income (loss)
$
4,816

$
550

$
6,527

$

(1,192
)
Income (loss) per common share, basic and diluted

Income (loss) from continuing operations
$
0.13

$
0.04

$
0.18

$
(0.01
)
Loss from discontinued operations
—

(0.03
)

—

(0.02
)
Net income (loss)
$
0.13

$
0.01

$
0.18

$
(0.03
)
Weighted average number of common shares outstanding, basic
37,108,486

36,950,000

37,101,968

36,950,000

Weighted average number of common shares outstanding, diluted
37,252,344

37,122,904

37,247,784

36,950,000

See accompanying notes to these condensed consolidated financial statements.

Civitas Solutions, Inc.
Condensed Consolidated Statements of Comprehensive Income
(Amounts in thousands)
(Unaudited)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
Net income (loss)	$4,816	$550	$6,527	$(1,192)
Other comprehensive income (loss), net of tax:				
Gain (loss) on derivative instrument classified as cash flow hedge, net of tax for the three and nine months ended June 30, 2016 of ($595) and ($1,699), respectively, and $770 and $939 for the three and nine months ended June 30, 2015, respectively	(877)	1,132	(2,503)	1,381
Comprehensive income	$3,939	$1,682	$4,024	$189

See accompanying notes to these condensed consolidated financial statements.

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Civitas Solutions, Inc.
Condensed Consolidated Statements of Stockholders’ Equity
(Amounts in thousands, except share amounts)
(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Income (Loss) on Derivatives	Accumulated Deficit	Total Stockholders' Equity
Balance at September 30, 2014	36,950,000	$ 370	$ 272,943	$ —	$ (157,775)	$ 115,538
Change in estimate of initial public offering costs	—	—	576	—		576
Stock-based compensation	—	—	3,761	—		3,761
Other comprehensive income, net of tax	—	—	—	1,381		1,381
Net loss	—	—	—	—	(1,192)	(1,192)
Balance at June 30, 2015	36,950,000	$ 370	$ 277,280	$ 1,381	$ (158,967)	$ 120,064
Balance at September 30, 2015	37,093,237	$ 371	$ 277,311	$ (1,704)	$ (154,703)	$ 121,275
Issuance of common stock under employee incentive plans, net of shares surrendered	18,770	—	60	—	—	60
Stock-based compensation	—	—	15,200	—	—	15,200
Excess tax benefits from stock-based compensation awards	—	—	745	—	—	745
Other comprehensive loss, net of tax	—	—	—	(2,503)	—	(2,503)
Net income	—	—	—	—	6,527	6,527
Balance at June 30, 2016	37,112,007	$ 371	$ 293,316	$ (4,207)	$ (148,176)	$ 141,304

See accompanying notes to these condensed consolidated financial statements.

Civitas Solutions, Inc.
Condensed Consolidated Statements of Cash Flows
(Amounts in thousands)
(Unaudited)

	Nine Months Ended June 30,	
	2016	2015
Operating activities:		
Net income (loss)	$6,527	$(1,192)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for accounts receivable allowances	10,834	11,573
Depreciation and amortization	54,985	53,781
Amortization and write-off of original issue discount and initial purchasers discount	210	4,829
Amortization and write-off of financing costs	1,169	2,749
Stock-based compensation	15,200	3,761
Deferred income taxes	2,476	2,437
Loss on disposal of assets	722	422
Non-cash impairment charge	—	10,611
Change in fair value of contingent consideration	(556)	317
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(27,356)	(20,381)
Other assets	(7,393)	(12,489)
Accounts payable	3,881	87
Accrued payroll and related costs	(4,156)	(1,397)
Other accrued liabilities	7,462	(7,967)
Other long-term liabilities	(3,364)	3,573
Net cash provided by operating activities	60,641	50,714
Investing activities:		
Acquisition of businesses, net of cash acquired	(44,481)	(38,738)
Purchases of property and equipment	(31,655)	(30,310)
Change in restricted cash	(121)	446
Proceeds from sale of assets	1,219	1,068
Net cash used in investing activities	(75,038)	(67,534)
Financing activities:		
Issuance of long-term debt, net of original issue discount	—	54,450
Repayments of long-term debt	(4,916)	(216,778)
Proceeds from borrowings under senior revolver	45,900	206,700
Repayments of borrowings under senior revolver	(45,900)	(206,700)
Repayments of capital lease obligations	(371)	(334)
Cash paid for settlement of acquisition contingent consideration	(3,565)	—
Proceeds from issuance of common stock under employee equity incentive plans	142	—
Excess tax benefits from stock-based compensation	745	—
Taxes paid related to net share settlements of restricted stock unit awards	(82)	—
Net cash used in financing activities	(8,047)	(162,662)
Net decrease in cash and cash equivalents	(22,444)	(179,482)
Cash and cash equivalents at beginning of period	41,690	196,147
Cash and cash equivalents at end of period	$19,246	$16,665
Supplemental disclosure of cash flow information		

Cash paid for interest	$23,664	$29,508
Cash paid for call premium on redemption of senior notes	$—	$11,688
Cash paid for income taxes	$11,993	$1,498
Supplemental disclosure of non-cash activities:		
Accrued property and equipment	$1,166	$996
Fair value of contingent consideration related to acquisitions	$—	$6,100
Tenant reimbursements for leasehold improvements	$2,130	$—

See accompanying notes to these condensed consolidated financial statements.

Civitas Solutions, Inc.
Notes to Condensed Consolidated Financial Statements
June 30, 2016
(Unaudited)

1. Business Overview
Civitas Solutions, Inc. ("Civitas"), through its wholly-owned subsidiaries (collectively, the "Company"), is the leading provider of home- and community-based health and human services to individuals with intellectual and/or developmental disabilities, acquired brain injury and other catastrophic injuries and illnesses; and to youth with emotional, behavioral and/or medically complex challenges. Since the Company's founding in 1980, the Company has evolved into a diversified national network providing an array of high-quality services and care in large, growing and highly-fragmented markets. The Company currently provides services to individuals with intellectual and/or developmental disabilities ("I/DD"), individuals with catastrophic injuries and illnesses, particularly acquired brain injury ("ABI"), youth with emotional, behavioral and/or medically complex challenges, or at-risk youth ("ARY") and elders in need of day health services to support their independence, or adult day health ("ADH"). Since the Company's founding in 1980, the Company's operations have grown to 35 states. The Company provides residential services to approximately 11,500 clients and approximately 16,300 clients receive periodic services from the Company in non-residential settings.
The Company designs customized service plans to meet the individual needs of its clients, which it delivers in home- and community-based settings. Most of the Company's service plans involve residential support, typically in small group homes, host home settings, or specialized community facilities, designed to improve the clients' quality of life and to promote their independence and participation in community life. Other services offered include supported living, day and transitional programs, vocational services, case management, family-based and outpatient therapeutic services, post-acute treatment and neurorehabilitation, neurobehavioral rehabilitation and physical, occupational and speech therapies, among others. The Company's customized service plans offer its clients as well as the payors of these services, an attractive, cost-effective alternative to health and human services provided in large, institutional settings.

Civitas is the parent of a consolidated group of subsidiaries that market their services under The MENTOR Network tradename. Prior to October 1, 2015, Civitas was a partially owned subsidiary of NMH Investment, LLC ("NMH Investment"), which was formed in connection with the acquisition of our business by affiliates of Vestar Capital Partners ("Vestar") in 2006. The equity interests of NMH Investment were owned by Vestar and certain executive officers, directors and other members of management. On October 1, 2015, in connection with an underwritten secondary offering, NMH Investment distributed all of the 25,250,000 shares of common stock of Civitas it held to its existing members in accordance with their respective membership interests. NMH Holdings, LLC ("NMHH") is a wholly-owned subsidiary of Civitas and National Mentor Holdings, Inc. ("NMHI") is a wholly-owned subsidiary of NMHH. The financial results of Civitas are primarily composed of the financial results of NMHI and its subsidiaries on a consolidated basis.
2. Significant Accounting Policies
Basis of Presentation
The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with generally accepted accounting principles ("GAAP") for interim financial information and pursuant to the applicable rules and regulations of the Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The unaudited condensed consolidated financial statements herein should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2015, which is on file with the SEC. In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of normal and recurring adjustments, necessary to present fairly the financial statements in accordance with GAAP. Intercompany balances and transactions between the Company and its subsidiaries have been eliminated in

consolidation. Operating results for the three and nine months ended June 30, 2016 may not necessarily be indicative of results to be expected for any other interim period or for the full year.

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

Our financial results are affected by the selection and application of accounting policies and methods. There were no material changes in the nine months ended June 30, 2016 to the application of significant accounting policies as described in our audited financial statements for the year ended September 30, 2015.

3. Recent Accounting Pronouncements

Revenue from Contracts with Customers— In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers Topic 606 (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation.

Subsequent to issuing ASU No. 2014-09, the FASB issued the following amendments concerning the adoption and clarification of ASU No. 2014-09. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which delayed the effective date of the new standard for the Company from October 1, 2017 to October 1, 2018. The FASB also agreed to allow entities to choose to adopt the standard as of the original effective date. In March 2016, the FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which further clarifies the implementation guidance on principal versus agent considerations. The new guidance requires either a retrospective or a modified retrospective approach to adoption. In April 2016, the FASB issued ASU No. 2016-10 Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, which clarifies the identification of the performance obligations and licensing implementation guidance, while retaining the related principals of those areas. In May 2016, the FASB issued ASU No. 2016-12 Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, which provides clarification on assessing the collectability criterion, presentation of sales taxes, measurement date for noncash consideration and completed contracts at transition. The Company is evaluating the method of adoption and the potential impact that these ASUs will have on our financial position, results of operations, cash flows, and liquidity.

Imputation of Interest— In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The new standard requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. In August 2015, the FASB issued ASU No. 2015-15, Interest - Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements, which clarified that debt issuance costs related to line-of-credit arrangements can be presented in the balance sheet as an asset and amortized over the term of the line-of-credit arrangement. The standard is to be applied retrospectively and is effective for fiscal years beginning after December 15, 2015, and interim periods within those years. As of June 30, 2016 and September 30, 2015, the Company had deferred financing costs of $6.3 million and $7.5 million, respectively, within other assets.

Business Combinations— In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments. The new standard requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined and sets forth new disclosure requirements related to the adjustments. The standard is to be applied prospectively and is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. Although the impact of applying this standard to prior acquisitions would have been immaterial, the standard could have a significant impact on the accounting for future business combinations after it becomes effective for the Company on October 1, 2016.

Income Taxes— In November 2015, the FASB issued ASU No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes. The new standard requires that deferred tax liabilities and assets be classified as non-current in a classified statement of financial position. The amendments in this update apply to all entities that present a classified statement of financial position. The standard can be applied prospectively or retrospectively and is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. As of June 30, 2016 and September 30, 2015, the Company had current deferred tax assets, net of current deferred tax liabilities, of $17.5 million and $19.6 million, respectively.

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Leases— In February 2016, the FASB issued ASU No. 2016-02—Leases (Topic 842). The new standard requires that all lessees recognize the assets and liabilities that arise from leases on the balance sheet and disclose qualitative and quantitative information about its leasing arrangements. The standard is to be applied using a modified retrospective approach and is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the potential impact that this standard may have on its consolidated financial statements.
Stock Compensation— In March 2016, the FASB issued ASU No. 2016-09—Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. The areas for simplification in this Update involve several aspects of the 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 new standard is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The Company is currently evaluating the potential impact that this standard may have on its consolidated financial statements.
4. Long-Term Debt
As of June 30, 2016 and September 30, 2015, the Company's long-term debt consisted of the following:

(in thousands)	June 30, 2016	September 30, 2015
Term loan principal; principal and interest are due in quarterly installments through January 31, 2021	$640,669	$ 645,585
Original issue discount on term loan, net of accumulated amortization	(1,247)	(1,457)
	639,422	644,128
Less current portion	6,554	6,554
Long-term debt	$632,868	$ 637,574

Senior Secured Credit Facilities
NMHI's senior credit agreement (the "senior credit agreement"), as amended, governs a $655.0 million term loan facility (the "term loan facility"), of which $50.0 million was deposited in a cash collateral account in support of the issuance of letters of credit under an institutional letter of credit facility (the "institutional letter of credit facility"), and a $120.0 million senior secured revolving credit facility (the "senior revolver"). The term loan facility has a seven year maturity and the senior revolver has a five year maturity from the effective date, or January 31, 2014. All of the obligations under the senior secured credit facilities are guaranteed by NMHH and the subsidiary guarantors named therein. The senior credit agreement provides that NMHI may make one or more offers to the lenders, and consummate transactions with individual lenders that accept the terms contained in such offers, to extend the maturity date of the lender's term loans and/or revolving commitments, subject to certain conditions, and any extended term loans or revolving commitments will constitute a separate class of term loans or revolving commitments.
The senior revolver includes borrowing capacity available for letters of credit and for borrowings on same-day notice, referred to as the "swingline loans." Any issuance of letters of credit or borrowing on a swingline loan will reduce the amount available under the senior revolver. As of June 30, 2016, NMHI had no loans under the senior revolver and $47.4 million of letters of credit issued under the institutional letter of credit facility and $2.9 million of letters of credit issued under the senior revolver.
Borrowings under the senior secured credit facilities bear interest, at our option, at: (i) an alternate base rate ("ABR") equal to the greater of (a) the prime rate of Barclays Bank PLC, (b) the federal funds rate plus 1/2 of 1.0%, and (c) the Eurodollar rate for an interest period of one-month plus 100 basis points, plus 2.25% (provided that the ABR rate applicable to the term loan facility will not be less than 2.00% per annum); or (ii) the Eurodollar rate (provided that the Eurodollar rate applicable to the term loan facility will not be less than 1.00% per annum), plus 3.25%. NMHI is also required to pay a commitment fee to the lenders under the senior revolver at an initial rate of 0.50% of the average daily unutilized commitments thereunder. NMHI must also pay customary letter of credit fees.
The senior credit agreement requires NMHI to make mandatory prepayments, subject to certain exceptions, on a percentage of NMHI's annual Excess Cash Flow, as defined in the senior credit agreement. NMHI determines whether or not a mandatory prepayment is required at the end of each fiscal year. NMHI was not required to make a

prepayment for the fiscal year ended September 30, 2015.

Covenants
The senior credit agreement contains negative covenants, including, among other things, limitations on the Company's ability to incur additional debt, create liens on assets, transfer or sell assets, pay dividends, redeem stock or make other distributions or investments, and engage in certain transactions with affiliates. The senior credit agreement contains a springing financial covenant. If, at the end of any fiscal quarter, the Company's outstanding borrowings under the senior revolver exceeds 30% of the commitments thereunder, it is required to maintain at the end of each such fiscal quarter a consolidated first lien leverage ratio of not more than 5.50 to 1.00. This consolidated first lien leverage ratio will step down to 5.00 to 1.00 commencing with the fiscal quarter ending March 31, 2017. The springing financial covenant was not in effect as of June 30, 2016 or September 30, 2015 as NMHI's outstanding borrowings on the senior revolver did not exceed the threshold.
Derivatives

On January 20, 2015, NMHI entered into two interest rate swap agreements in an aggregate notional amount of $375.0 million in order to reduce the variability of cash flows of our variable rate debt. NMHI entered into these interest rate swaps to hedge the risk of changes in the floating rate of interest on borrowings under the term loan. Under the terms of the swaps, NMHI will receive from the counterparty a quarterly payment based on a rate equal to the greater of 3-month LIBOR or 1.00% per annum, and NMHI will make payments to the counterparty based on a fixed rate of 1.795% per annum, in each case on the notional amount of $375.0 million, settled on a net payment basis. The swap agreements expire on March 31, 2020.

The fair value of the swap agreements, representing the price that would be received to transfer the liability in an orderly transaction between market participants, was $7.1 million and $2.9 million as of June 30, 2016 and September 30, 2015, respectively. The fair value was recorded in Other accrued liabilities and was determined based on pricing models and independent formulas using current assumptions. Hedge ineffectiveness, if any, associated with the swap will be reported by the Company in interest expense. There was no ineffectiveness associated with the swap during the nine months ended June 30, 2016, nor was any amount excluded from ineffectiveness testing for the period.

5. Stock-Based Compensation

2014 Plan

Civitas maintains a 2014 Omnibus Incentive Plan ("2014 Plan"). The 2014 Plan authorizes the issuance of stock-based awards, including incentive stock options ("ISOs"), non-qualified stock options ("NSOs"), and restricted stock units ("RSUs") to purchase up to 5,546,797 shares authorized in the 2014 Plan.

Stock option activity for the nine months ended June 30, 2016 is presented below:

(in thousands, except share and per share amounts)	Number of Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Life (Years)	Aggregate Intrinsic Value
Outstanding at September 30, 2015	567,900	$ 16.98		
Granted	216,357	25.22		
Forfeited	58,469	17.94		
Exercised	28,480	17.02		
Expired	1,858	17.00		
Outstanding at June 30, 2016	695,450	$ 19.46	8.6	$ 1,887
Vested or expected to vest as of June 30, 2016	670,727	$ 19.38	8.6	$ 1,844
Exercisable at June 30, 2016	160,145	$ 16.97	8.2	$ 618

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The Company utilizes the Black-Scholes valuation model for estimating the fair value of stock options. Options granted under the 2014 Plan during the nine months ended June 30, 2016 were valued using the following assumptions:

	2016
Risk-free interest rate	1.32% to 1.92%
Expected term	6 years
Expected volatility	35.12% to 36.20%
Expected dividend yield	— %

Restricted stock unit activity for the nine months ended June 30, 2016 is presented below:

	Number of Restricted Stock Units	Weighted Average Grant-Date Fair Value
Non-vested units at September 30, 2015	385,935	$ 17.10
Granted	265,806	24.42
Forfeited	43,493	18.45
Vested	9,415	16.84
Non-vested units at June 30, 2016	598,833	$ 20.26

The Company recognizes the fair value of stock options and restricted stock units in net income over the requisite service period of the individual grantee, which generally equals the vesting period.

Under the 2014 Plan, the Company may also grant awards of performance based restricted stock units (“PRSUs”). The number of PRSUs earned is determined based on the Company's attainment of predefined performance targets set by the Compensation Committee. During the nine months ended June 30, 2016 the Company awarded 42,467 PRSUs. The number of PRSUs earned will be determined based on (1) the Company's actual performance against established performance targets in the third year of the three year performance period (the “Performance Condition”) and (2) may be further adjusted based on the performance of the Company’s common stock in relation to the Russell 2000 Healthcare Index (the “Market Condition”). The number of PRSUs earned based on the Performance Condition may range from 0% to 200% of the initial award and thereafter may be increased or decreased by 25% based on the Market Condition. All of the PRSUs will be settled in shares of the Company’s common stock, which will be issued following the end of the three-year performance period, subject to the actual achievement of the predefined performance targets. The Company utilized a Monte Carlo simulation methodology to determine the per share fair value of the PRSU's on the grant date. To calculate compensation expense, the Company forecasts the likelihood of achieving the predefined performance targets and calculates the number of PRSUs expected to be earned.

A summary of PRSU activity for the nine months ended June 30, 2016 is as follows:

	Initial Number of Performance Based Restricted Stock Units	Adjustment [1]	Total Number of Performance Based Restricted Stock Units	Weighted Average Grant-Date Fair Value
Non-vested units at September 30, 2015	—	—	—	$ —
Granted	42,467	—	42,467	19.84
Forfeited	—	—	—	—
Vested	—	—	—	—
Non-vested units at June 30, 2016	42,467	—	42,467	$ 19.84

[1] Represents an increase or decrease in the number of PRSUs awarded based on either (a) the final performance criteria achievement at the end of the defined performance period or (b) a change in estimated awards based on the forecasted performance against the predefined targets.

The Company recorded stock-based compensation expense for awards issued under the 2014 Plan of $1.8 million and $4.7 million during the three and nine months ended June 30, 2016, and $1.4 million and $3.8 million during the three and nine months ended June 30, 2015. Stock-based compensation expense is included in general and administrative expense in the consolidated statements of operations.

Unit Plan

Prior to October 1, 2015, NMH Investment maintained the Amended and Restated 2006 Unit Plan (the "Unit Plan"). Under the plan NMH Investment issued units of limited liability company interests pursuant to such plan, consisting of Class B Common Units, Class C Common Units, Class D Common Units, Class E Common Units, Class F Common Units, Class G Common Units and Class H Common Units. These units derived their value from the value of the Company.

On October 1, 2015, in connection with a secondary offering, NMH Investment distributed all of the 25,250,000 shares of our common stock it held to its existing members in accordance with their respective membership interests and pursuant to the terms of the NMH Investment's Limited Liability Company Agreement and the management unitholders agreements (the "Distribution"). The Distribution triggered the vesting condition for the Class H Common Units and the acceleration of unvested Class F Common Units. As a result, the Company recorded compensation expense of $10.5 million related to these awards during the quarter ended December 31, 2015. This expense is not deductible for tax purposes. During the nine months ended June 30, 2016 the Company recorded compensation expense of $10.5 million for the Distribution, and during the three and nine months ended June 30, 2015 the Company recorded compensation expense of $33 thousand and $112 thousand, respectively, for awards issued under the Unit Plan. The expense is included in general and administrative expense in the consolidated statements of operations. As a result of the Distribution, the Unit Plan has concluded and there will be no future issuances under this plan.

6. Business Combinations

The operating results of the businesses acquired are included in the consolidated statements of operations from the date of acquisition. The Company accounted for the acquisitions under the acquisition method and, as a result, the purchase price was allocated to the assets acquired and liabilities assumed based upon their respective fair values. The excess of the purchase price over the estimated fair value of net tangible assets was allocated to specifically identified intangible assets, with the residual being allocated to goodwill.

Fiscal 2016 Acquisitions

During the nine months ended June 30, 2016, the Company acquired the assets of ten companies complementary to its business for a total fair value consideration of $44.5 million.

Mother's Touch, LLC ("Mother's Touch"). On November 30, 2015, the Company acquired the assets of Mother's Touch for $3.4 million. Mother's Touch is located in Indiana and provides residential and community-based services to individuals with developmental disabilities. The Company acquired $2.7 million of identified intangible assets which included $2.7 million of agency contracts with a weighted average useful life of 12 years and $14 thousand of other intangible assets. The estimated fair values of the intangible assets acquired at the date of acquisition are determined based on a valuation that has been finalized. As a result of the acquisition, the Company recorded $0.7 million of goodwill in the Human Services segment, which is expected to be deductible for tax purposes.

Winways, LLC ("Winways"). On December 31, 2015, the Company acquired the assets of Winways for $0.8 million. Winways is located in California and provides residential and day treatment services to individuals with traumatic brain injuries, neurological illnesses and similar conditions. The Company acquired $0.6 million of identified intangible assets which included $0.5 million of agency contracts with a weighted average useful life of 12 years and $0.1 million of other intangible assets. The estimated fair values of the intangible assets acquired at the date of acquisition are determined based on a valuation that has been finalized. As a result of this acquisition, the Company recorded $0.1 million of goodwill in the Post Acute Specialty-Rehabilitation Services segment, which is expected to be deductible for tax purposes.

Triumph Rehabilitation, LLC ("Triumph"). On February 1, 2016, the Company acquired the assets of Triumph for $2.6 million. Triumph is located in Michigan and provides physical therapy, rehabilitation and related services to individuals with traumatic brain injuries, neurological illnesses, and similar conditions. The Company acquired $2.3 million of identified intangible assets which included $2.2 million of agency contracts with a weighted average useful life of 12 years and $0.1 million of other intangible assets. The estimated fair values of the intangible assets acquired at the date of acquisition are determined based on a valuation that has been finalized. As a result of this acquisition, the Company recorded $0.3 million of goodwill in the Post Acute Specialty-Rehabilitation Services segment, which is expected to be deductible for tax purposes.

Brighton Worcester Massachusetts Adult Day Health, Inc. ("Brighton Worcester ADH"). On February 1, 2016 the Company acquired the assets of Brighton Worcester ADH for $13.6 million. Brighton Worcester ADH is located in Massachusetts and provides nursing and health oversight, medication management, therapy services,

nutritional and dietary services, counseling and case management to elders. The Company acquired $10.6 million of identified intangible assets which included $9.9 million of agency contracts with a weighted average useful life of 12 years, $0.7 million of tradenames with a weighted average useful life of 5 years and $40 thousand of other intangible assets. The estimated fair values of the intangible assets acquired at the date of acquisition are determined based on a valuation that has been finalized. As a result of this acquisition, the Company recorded $2.7 million of goodwill in adult day health services as part of the Human Services segment, which is expected to be deductible for tax purposes.
Tender Loving Care Duluth, LLC ("TLC Duluth"). On February 29, 2016, the Company acquired the assets of TLC Duluth for $8.5 million. TLC Duluth is located in Minnesota and provides full-time services in the community residential setting for individuals with developmental disabilities, traumatic brain injuries or mental illness. The Company acquired $7.1 million of identified intangible assets which included $6.2 million of agency contracts with a weighted average useful life of 12 years and $1.0 million of other intangible assets. The estimated fair values of the intangible assets acquired at the date of acquisition are determined based on a valuation that has been finalized. As a result of this acquisition, the Company recorded $1.3 million of goodwill in the Human Services segment, which is expected to be deductible for tax purposes.
Maryland Adult Day Health, Inc. ("Maryland ADH"). On March 14, 2016, the Company acquired the assets of Maryland ADH for $12.3 million. Maryland ADH is located in Maryland and provides adult day health care services to the Medicaid eligible elderly population. The Company acquired $7.7 million of identified intangible assets which included $6.7 million of agency contracts with a weighted average useful life of 12 years, $1.0 million of tradenames with a weighted average useful life of 5 years, and $40 thousand of other intangible assets. In addition, the Company acquired total tangible assets, consisting primarily of vehicles, of $0.7 million. The estimated fair values of the intangible assets acquired at the date of acquisition are determined based on a valuation that has been finalized. As a result of this acquisition, the Company recorded $3.9 million of goodwill in adult day health services as part of the Human Services segment, which is expected to be deductible for tax purposes.
Eagle Crest Center, LLC ("Eagle Crest"). On March 15, 2016, the Company acquired the assets of Eagle Crest for $2.0 million. Eagle Crest is located in California and provides skilled nursing services and related services to individuals with traumatic brain injuries, spinal cord injuries, neuro-muscular or congenital anomalies, and similar conditions. The Company acquired $1.7 million of intangible assets which included $1.4 million of agency contracts with a weighted average useful life of 12 years and $0.3 million of other intangible assets. The estimated fair values of the intangible assets acquired at the date of acquisition are determined based on a valuation that has been finalized. As a result of this acquisition, the Company recorded $0.3 million of goodwill in the Post Acute Specialty-Rehabilitation Services segment, which is expected to be deductible for tax purposes.
CRM Habilitative Services, Inc. ("CRM"). On March 31, 2016, the Company acquired the assets of CRM for $1.1 million. CRM is located in Pennsylvania and provides group home services and day program services and related services to individuals with intellectual and developmental disabilities. The Company acquired $0.9 million of intangible assets which included $0.8 million of agency contracts with a weighted average useful life of 12 years and $0.2 million of other intangible assets. The estimated fair values of the intangible assets acquired at the date of acquisition are determined based on a valuation that has been finalized. As a result of this acquisition, the Company recorded $0.1 million of goodwill in the Human Services segment, which is expected to be deductible for tax purposes.
Other acquisitions. During fiscal 2016, the Company acquired the assets of Resources for Human Development ("RHD"), and Learning Services, Inc. ("Learning Services"). RHD is in the business of providing residential group home services to individuals with developmental disabilities and similar conditions and is included in our Human Services segment. Learning Services is engaged in the business of providing supported living and rehabilitation services for individuals with acquired brain injuries and similar conditions and is included in our Post Acute Specialty-Rehabilitation Services segment. Total cash consideration for these companies was $161 thousand.

The following table summarizes the recognized amounts of identifiable assets acquired at the date of each acquisition:

(in thousands)	Identifiable Intangible Assets	Tangible Assets	Total Identifiable Assets	Goodwill	Purchase Consideration
Mother's Touch	$ 2,741	$ 9	$ 2,750	$ 650	$ 3,400
Winways	619	29	648	108	756
Triumph	2,335	—	2,335	265	2,600
Brighton Worcester ADH	10,600	363	10,963	2,677	13,640
TLC Duluth	7,132	26	7,158	1,342	8,500
Maryland ADH	7,680	748	8,428	3,856	12,284
Eagle Crest	1,698	—	1,698	302	2,000
CRM	934	87	1,021	119	1,140
RHD	18	43	61	—	61
Learning Services	100	—	100	—	100
Total	$ 33,857	$ 1,305	$ 35,162	$ 9,319	$ 44,481

The Company has not separately disclosed the operating results of these businesses during the three and nine months ended June 30, 2016 because they are immaterial.

7. Pro Forma Results of Operations

The following table reflects the unaudited pro forma results of operations for the three and nine months ended June 30, 2016 and 2015 assuming that the acquisitions made during the three and nine months ended June 30, 2016 and 2015 had occurred on October 1, 2014 and 2013, respectively.

	Three Months Ended June 30,		Nine Months Ended June 30,	
(in thousands)	2016	2015	2016	2015
Net revenue	$355,024	$357,647	$1,062,972	$1,063,290
Net income	4,872	2,670	9,790	7,795

The unaudited pro forma information is presented for informational purposes only and is not necessarily indicative of the actual results that would have been achieved had the acquisitions occurred as of October 1, 2014 and 2013, or the results that may be achieved in future periods.

8. Goodwill and Intangible Assets

Goodwill

The changes in goodwill for the nine months ended June 30, 2016 are as follows (in thousands):

	Human Services	Post -Acute Specialty Rehabilitation Services	Total
Balance as of September 30, 2015	$193,286	$ 81,234	$274,520
Goodwill acquired through acquisitions	8,644	675	9,319
Balance as of June 30, 2016	$201,930	$ 81,909	$283,839

Intangible Assets

Intangible assets consist of the following as of June 30, 2016 (in thousands):

Description	Weighted Average Amortization Period	Gross Carrying Value	Accumulated Amortization	Intangible Assets, Net
Agency contracts	8 years	$499,094	$ 248,989	$250,105
Non-compete/non-solicit agreements	2 years	6,438	4,242	2,196
Relationship with contracted caregivers	—	7,521	7,479	42
Trade names	2 years	6,516	3,818	2,698
Trade names (indefinite life)	—	45,800	—	45,800
Licenses and permits	2 years	49,711	40,005	9,706
Intellectual property	—	452	451	1
		$615,532	$ 304,984	$310,548

Intangible assets consist of the following as of September 30, 2015 (in thousands):

Description	Weighted Average Amortization Period	Gross Carrying Value	Accumulated Amortization	Intangible Assets, Net
Agency contracts	8 years	$468,549	$ 225,383	$243,166
Non-compete/non-solicit	2 years	6,097	3,477	2,620
Relationship with contracted caregivers	1 year	7,521	6,915	606
Trade names	2 years	4,883	3,343	1,540
Trade names (indefinite life)	—	45,800	—	45,800
Licenses and permits	2 years	48,395	36,314	12,081
Intellectual property	1 year	452	409	43
		$581,697	$ 275,841	$305,856

Amortization expense was $10.1 million and $29.2 million for the three and nine months ended June 30, 2016, respectively, and $9.9 million and $29.2 million for the three and nine months ended June 30, 2015, respectively. The estimated remaining amortization expense related to intangible assets with finite lives for the three months remaining in fiscal 2016 and each of the four succeeding years and thereafter is as follows:

(in thousands)	
2016	$9,026
2017	35,817
2018	34,956
2019	34,673
2020	33,877
Thereafter	116,399
Total	$264,748

9. Related Party Transactions

Lease Agreements

The Company leases several offices, homes and other facilities from its employees, or from relatives of employees, primarily in the states of Minnesota, California and Wisconsin. These leases were entered into in the ordinary course of business and negotiated at an arm’s length. These leases have various expiration dates extending out through September 2020. Related party lease expense was $0.2 million and $0.5 million for the three and nine months ended June 30, 2016 and $0.2 million and $0.6 million for the three and nine months ended June 30, 2015.

10. Fair Value Measurements

The Company measures and reports its financial assets and liabilities on the basis of fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

A three-level hierarchy for disclosure has been established to show the extent and level of judgment used to estimate fair value measurements, as follows:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Significant other observable inputs (quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability).

Level 3: Significant unobservable inputs for the asset or liability. These values are generally determined using pricing models which utilize management estimates of market participant assumptions.

Valuation techniques for assets and liabilities measured using Level 3 inputs may include methodologies such as the market approach, the income approach or the cost approach, and may use unobservable inputs such as projections, estimates and management's interpretation of current market data. These unobservable inputs are only utilized to the extent that observable inputs are not available or cost-effective to obtain.

A description of the valuation methodologies used for instruments measured at fair value as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

The following table sets forth the Company's assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2016.

(in thousands)	Total	Quoted Market Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities				
Interest rate swap agreements	$(7,063)	$ —	$ (7,063)	$ —
Contingent consideration	$(4,954)	$ —	$ —	$ (4,954)

The following table sets forth the Company's assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2015.

(in thousands)	Total	Quoted Market Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Liabilities				
Interest rate swap agreements	$(2,861)	$ —	$ (2,861)	$ —
Contingent consideration	$(9,075)	$ —	$ —	$ (9,075)

Interest rate-swap agreements. The Company's interest rate-swap agreements are classified within Level 2 of the fair value hierarchy. The fair value of the swap agreements is recorded in current liabilities (under other accrued liabilities) in the Company's consolidated balance sheets. The fair value of these agreements is determined based on pricing models and independent formulas using current assumptions that included swap terms, interest rates and forward LIBOR curves and the Company's credit risk.

Contingent consideration. In connection with the acquisition of Mass Adult Day Health ("Adult Day Health") in September 2014 and Cassell in January 2015, the Company recorded contingent consideration pertaining to the amounts potentially payable to the former owners upon the businesses achieving certain performance targets.

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The fair values of the Company's contingent consideration obligations are based on a probability-weighted approach derived from the overall likelihood of achieving certain performance targets. The resultant probability-weighted earn-out payments are discounted using a discount rate based upon the weighted-average cost of capital. The fair value measurement is based on significant inputs not observable in the market, which represent Level 3 inputs within the fair value hierarchy. The valuation of contingent consideration uses assumptions the Company believes would be made by a market participant. The Company assesses these estimates on an ongoing basis as additional data impacting the assumptions is obtained. Increases or decreases in the fair values of the contingent consideration obligations may result from changes in discount periods and rates, changes in the timing and amount of earn-out criteria and changes in probability assumptions with respect to the likelihood of achieving the various earn-out criteria. Changes in the fair value of contingent consideration related to updated assumptions and estimates are recognized in General and administrative expense within the consolidated statements of operations.
The following table presents a summary of changes in fair value of the Company’s Level 3 liabilities measured on a recurring basis for the nine months ended June 30, 2016.

(in thousands)	Nine Months Ended June 30, 2016		
Balance at September 30, 2015	$	9,075	
Present value accretion	(211		)
Cassell fair value adjustment	(2,945		)
Balance at December 31, 2015	$	5,919	
Payment	(1,307		)
Balance at March 31, 2016	$	4,612	
Cassell and Mass ADH fair value adjustment	2,600		
Payment	(2,258		)
Balance at June 30, 2016	$	4,954	

As of June 30, 2016 and September 30, 2015, the Company had $5.0 million and $9.1 million of contingent consideration, of which approximately $5.0 million and $3.9 million were reflected in Other accrued liabilities, respectively. As of September 30, 2015, $5.2 million was reflected in Other long-term liabilities. The $0.6 million fair value adjustment and reversal of present value accretion during the nine months ended June 30, 2016 relates to the Cassell and Mass ADH acquisitions and reflects the revised estimate from the date of acquisition of expected operating performance during the two year earn out period which ends January 31, 2017.

During the nine months ended June 30, 2016, the Company made payments of $1.3 million and $2.3 million for contingent consideration related to the Adult Day Health and Cassell acquisitions, respectively.

At June 30, 2016 and September 30, 2015, the carrying values of cash, accounts receivable, accounts payable and variable rate debt approximated fair value.

11. Income Taxes

The Company’s effective income tax rate for the interim periods is based on management’s estimate of the Company’s annual effective tax rate for the applicable year. It is also affected by discrete items that may occur in any given period. For the three and nine months ended June 30, 2016, the Company’s effective income tax rate was 47.0% and

65.8%, respectively, as compared to an effective tax rate of 46.1% and 45.0% for the three and nine months ended June 30, 2015, respectively. These rates differ from the federal statutory income tax rate primarily due to state income taxes and nondeductible permanent differences such as meals and nondeductible compensation. The higher effective tax rate for the nine months ended June 30, 2016 is primarily due to $10.5 million of stock-based compensation expense related to certain awards under our former equity compensation plan that vested in October 2015. This expense is not deductible for tax purposes and was considered a discrete item. Therefore, the entire impact of the expense on income taxes was recorded during the first quarter of fiscal 2016 and is included in the nine months ended June 30, 2016.

The Company files a federal consolidated return and files various state income tax returns and, generally, is no longer subject to income tax examinations by the taxing authorities for years prior to September 30, 2013. The Company did not have a reserve for uncertain income tax positions at June 30, 2016 and September 30, 2015. The Company does not expect any significant changes to unrecognized tax benefits within the next twelve months. The Company’s policy is to recognize interest and penalties related to unrecognized tax benefits as charges to income tax expense.

12. Segment Information
The Company conducts its business through two reportable business segments: the Human Services Segment and the Post-Acute Specialty Rehabilitation Services (“SRS”) Segment.
Through the Human Services Segment, the Company primarily provides home- and community-based human services to adults and children with intellectual and developmental disabilities (“I/DD”), and to youth with emotional, behavioral and/or medically complex challenges (“ARY”) and, beginning in fiscal 2014, to elders. The operations of the Human Services Segment have been organized by management into three operating segments based upon geography and clients served.
Through the SRS Segment, the Company delivers services to individuals who have suffered acquired brain injury, spinal injuries and other catastrophic injuries and illnesses. The operations of the SRS Segment have been organized by management into two operating segments, NeuroRestorative and CareMeridian, based upon service type. The NeuroRestorative operating group provides behavioral therapies to brain injured clients in post-acute community settings and the CareMeridian operating group provides a higher level of medical support to traumatically injured clients.
Each operating segment is aligned with the Company’s reporting structure and has a segment manager that is directly accountable for its operations and regularly reports results to the chief operating decision maker, which is the Company's Chief Operating Officer, for the purpose of evaluating these results and making decisions regarding resource allocations.

The Company evaluates performance based on EBITDA. EBITDA for each segment is defined as income (loss) from continuing operations for the segment before income taxes, before depreciation and amortization, intangible impairments, and interest income (expense).

Activities classified as “Corporate” in the table below relate primarily to unallocated home office expenses, management fees, and debt extinguishment costs.
The following table is a financial summary by reportable segments for the periods indicated (in thousands):

For the three months ended June 30,	Human Services	Post-Acute Specialty Rehabilitation Services	Corporate	Consolidated
2016				
Net revenue	$280,457	$ 73,506	$ —	$ 353,963
EBITDA	42,463	14,391	(20,591)	36,263
Total assets	642,423	257,254	182,950	1,082,627
Depreciation and amortization	12,148	5,827	659	18,634
Purchases of property and equipment	7,684	2,492	2,460	12,636
2015				
Net revenue	$278,398	$ 67,596	$ —	$ 345,994
EBITDA[(1)]	40,873	12,776	(15,961)	37,688
Depreciation and amortization	19,790	5,995	630	26,415
Purchases of property and equipment	5,800	4,200	599	10,599

[(1)] The performance measures previously reported for the three months ended June 30, 2015 have been revised from Income (loss) from continuing operations before income taxes to EBITDA.

A reconciliation of EBITDA to income from continuing operations on a consolidated basis is as follows (in thousands):

For the three months ended

	June 30,	
	2016	2015
EBITDA	$36,263	$37,688
Less:		
Depreciation and amortization	18,634	26,415
Interest expense, net	8,490	8,691
Income from continuing operations before income taxes	$9,139	$2,582

For the nine months ended June 30,	Human Services	Post-Acute Specialty Rehabilitation Services	Corporate	Consolidated
2016				
Net revenue	$831,844	$ 213,549	$ —	$ 1,045,393
EBITDA	122,879	40,471	(63,284)	100,066
Total assets	642,423	257,254	182,950	1,082,627
Depreciation and amortization	35,281	17,639	2,032	54,952
Purchases of property and equipment	19,691	7,769	4,195	31,655
2015				
Net revenue	$820,112	$ 195,652	$ —	$ 1,015,764
EBITDA[(1)]	123,115	36,366	(66,496)	92,985
Depreciation and amortization	45,303	17,137	1,838	64,278
Purchases of property and equipment	15,803	12,162	2,345	30,310

[(1)] The performance measures previously reported for the nine months ended June 30, 2015 have been revised from Income (loss) from continuing operations before income taxes to EBITDA.

A reconciliation of EBITDA to income (loss) from continuing operations on a consolidated basis is as follows (in thousands):

	For the nine months ended June 30,	
	2016	2015
EBITDA	$100,066	$92,985
Less:		
Depreciation and amortization	54,952	64,278
Interest expense, net	25,300	29,118
Income (loss) from continuing operations before income taxes	$19,814	$(411)

Revenue derived from contracts with state and local governmental payors in the state of Minnesota, the Company's largest state operation, which is included in the Human Services segment, accounted for approximately 15% of the Company's net revenue for the three and nine months ended June 30, 2016 and 2015.

13. Disposition of Business

During fiscal 2015, the Company decided to discontinue ARY services in the states of Florida, Louisiana, Indiana, North Carolina and Texas. These operations are included in the Human Services Segment. On December 1, 2015, the Company completed the sale of our ARY operations in the state of North Carolina. As consideration, the buyer assumed our lease and service delivery obligations in exchange for the assets of the business, excluding working capital items, and a cash payment of $1.3 million to the buyer. Upon the completion of the sale, the Company recorded a loss of $1.3 million. The closures of the ARY operations in Florida and Louisiana were complete as of December 31, 2015 and the closures of our ARY operations in Indiana and Texas were completed in January 2016. During the nine months ended June 30, 2016 the Company recorded cash charges of approximately $2.0 million, consisting of severance costs of $0.5 million and lease termination costs of $1.5 million.

The Company assessed the disposal group under the guidance of ASU 2014-08, Discontinued Operations and Disclosures of Disposals of Components of an Entity and concluded that the closure of the disposal group does not represent a "strategic shift" and therefore has not been classified as discontinued operations for any of the periods presented. However, the Company has concluded that the disposal group was an individually significant disposal group. Pretax losses for this disposal group were $0.2 million and $5.8 million for the three and nine months ended June 30, 2016, respectively, and $8.8 million and $11.2 million for the three and nine months ended June 30, 2015, respectively. Pretax losses for the nine months ended June 30, 2016 included exit costs of $2.0 million disclosed above.

14. Net Income (Loss) Per Share

Basic net income (loss) per common share is computed by dividing net income (loss) by the basic weighted average number of common shares outstanding during the period. Diluted net income per common share, if applicable, is computed by dividing net income by the diluted weighted average number of common shares and common

equivalent shares outstanding during the period. The weighted average number of common equivalent shares outstanding has been determined in accordance with the treasury-stock method. Common equivalent shares consist of common stock issuable on the exercise of outstanding options and vesting of restricted stock units when dilutive.
The following table sets forth the computation of basic and diluted earnings per share ("EPS"):

	Three Months Ended June 30,		Nine Months Ended June 30,	
(in thousands, except share and per share amounts)	2016	2015	2016	2015
Numerator				
Net income (loss)	$4,816	$ 550	$6,527	$ (1,192)
Denominator				
Weighted average shares outstanding, basic	37,108,486	36,950,000	37,101,968	36,950,000
Weighted average common equivalent shares	143,858	172,904	145,816	—
Weighted average shares outstanding, diluted	37,252,344	37,122,904	37,247,784	36,950,000
Net income (loss) per share, basic and diluted	$0.13	$ 0.01	$0.18	$ (0.03)
Equity instruments excluded from diluted net income (loss) per share calculation as the effect would have been anti-dilutive:				
Stock options	699,171	571,491	483,620	567,664
Restricted stock units	129,252	—	111,435	570,601

15. Other Commitments and Contingencies

The Company is in the health and human services business and, therefore, has been and continues to be subject to numerous claims alleging that the Company, its employees or its independently contracted host-home caregivers ("Mentors") failed to provide proper care for a client. The Company is also subject to claims by its clients, its employees, its Mentors or community members against the Company for negligence, intentional misconduct or violation of applicable laws. Included in the Company's recent claims are claims alleging personal injury, assault, abuse, wrongful death and other charges. Regulatory agencies may initiate administrative proceedings alleging that the Company's programs, employees or agents violate statutes and regulations and seek to impose monetary penalties on the Company. The Company could be required to incur significant costs to respond to regulatory investigations or defend against civil lawsuits and, if the Company does not prevail, the Company could be required to pay substantial amounts of money in damages, settlement amounts or penalties arising from these legal proceedings.

The Company is also subject to potential lawsuits under the False Claims Act and other federal and state whistleblower statutes designed to combat fraud and abuse in the health care industry. These lawsuits can involve significant monetary awards that may incentivize private plaintiffs to bring these suits. If the Company is found to have violated the False Claims Act, it could be excluded from participation in Medicaid and other federal healthcare programs. The Patient Protection and Affordable Care Act provides a mandate for more vigorous and widespread enforcement activity to combat fraud and abuse in the health care industry.

The Company is also subject to employee-related claims under state and federal law, including claims for discrimination, wrongful discharge or retaliation; claims for wage and hour violations under the Fair Labor Standards Act or state wage and hour laws.

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

The following discussion of our financial condition and results of operations should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended September 30, 2015, as well as our reports on Form 8-K and other publicly available information. This discussion may contain forward-looking statements about our markets, the demand for our services and our future results. We based these statements on assumptions that we consider reasonable. Actual results may differ materially from those suggested by our forward-looking statements for various reasons, including those discussed in the “Risk Factors” and “Forward-Looking Statements” sections of this report.

Overview

We are the leading national provider of home- and community-based health and human services to must-serve individuals with intellectual, developmental, physical or behavioral disabilities and other special needs. Since our founding in 1980, we have been a pioneer in the movement to provide home- and community-based services for people who would otherwise be institutionalized. During our 35-year history, we have evolved from a single residential program serving at-risk youth to a diversified national network providing an array of high-quality services and care in large, growing and highly-fragmented markets. While we have the capabilities to serve individuals with a wide variety of special needs and disabilities, we currently provide our services to individuals with intellectual and/or developmental disabilities ("I/DD"), individuals with catastrophic injuries and illnesses, particularly acquired brain injury ("ABI"), youth with emotional, behavioral and/or medically complex challenges, or at-risk youth ("ARY"), and elders in need of day health services to support their independence, or adult day health (“ADH”). As of June 30, 2016, we operated in 35 states, serving approximately 11,500 clients in residential settings and approximately 16,300 clients in non-residential settings. We have a diverse group of hundreds of public payors which fund our services with a combination of federal, state and local funding, as well as, an increasing number of non-public payors related to our services for ABI and other catastrophic injuries and illnesses.

We have two reportable business segments: the Human Services Segment and the Post-Acute Specialty Rehabilitation Services (“SRS”) Segment. Through the Human Services Segment, we provide home- and community-based human services to adults and children with intellectual and developmental disabilities, to youth with emotional, behavioral and/or medically complex challenges and, beginning in fiscal 2014, to elders. The operations of the Human Services Segment have been organized by management into three operating segments based upon geography and clients served. Through the SRS Segment, we deliver services to individuals who have suffered acquired brain injury, spinal injuries and other catastrophic injuries and illnesses. The operations of the SRS Segment have been organized by management into two operating segments, NeuroRestorative and CareMeridian, based upon service type. Each operating segment is aligned with the Company’s reporting structure and has a segment manager that is directly accountable for its operations and regularly reports results to the chief operating decision maker, which is the Company's Chief Operating Officer, for the purpose of evaluating these results and making decisions regarding resource allocations.

Delivery of services to individuals with I/DD is the largest portion of our Human Services segment. Our I/DD programs include residential support, day habilitation, vocational services, case management, crisis intervention and hourly support care. Our Human Services segment also includes the delivery of ARY services. Our ARY programs include therapeutic foster care, family preservation, adoption services, early intervention, school-based services and juvenile offender programs. Our newest service line, ADH, delivers elder services including case management, nursing oversight, medication management, nutrition, daily living assistance, transportation, and therapeutic services. Within our SRS segment, our NeuroRestorative operating segment is focused on rehabilitation and transitional living services and our CareMeridian operating segment is focused on the more medically-intensive post-acute care services. Our SRS services range from sub-acute healthcare for individuals with intensive medical needs to day treatment programs, and include: neurorehabilitation; neurobehavioral rehabilitation; specialized nursing; physical, occupational and speech therapies; supported living; outpatient treatment; and pre-vocational services.

Factors Affecting our Operating Results

Demand for Home and Community-Based Health and Human Services

Our growth in revenue has historically been primarily related to increases in the number of individuals served, as well as increases in the rates we receive for our services. This growth has depended largely upon development-driven activities, including the maintenance and expansion of existing contracts and the award of new contracts, our new start program and acquisitions. We also attribute the long-term growth in our client base to certain trends that are increasing demand in our industry, including demographic, health-care and political developments.

Demographic trends have a particular impact on our I/DD business. Increases in the life expectancy of individuals with I/DD, we believe, have resulted in steady increases in the demand for I/DD services. In addition, caregivers currently caring for their relatives at home are aging and many may soon be unable to continue with these responsibilities. Many states continue to downsize or close large, publicly-run facilities for individuals with I/DD and refer those individuals to private providers of community-based services. Each of these factors affects the size of the I/DD population in need of services. Demand for our SRS services has also grown as emergency response and improved medical techniques have resulted in more people surviving a catastrophic injury. SRS services are increasingly sought out as a clinically-appropriate and less-expensive alternative to institutional care and as a "step-down" for individuals who no longer require care in acute settings.

Our residential ARY services were negatively impacted by a substantial decline in the number of children and adolescents in foster care placements during the last decade, although the population has stabilized in recent years. This decline has contributed to increased demand for periodic, non-residential services to support at-risk youth and their families. In connection with a strategic review of our ARY service line in fiscal 2015, we completed the sale of our ARY business in North Carolina in December 2015 and completed the closures of our ARY operations in Florida and Louisiana in December 2015 and in Indiana and Texas in January 2016.

Political and economic trends can also affect our operations. Budgetary pressures facing state governments, especially within Medicaid programs, as well as other economic, industry and political factors could cause state governments to limit spending, which could significantly reduce our revenue, referrals, margins and profitability, and adversely affect our growth strategy. Government agencies generally condition their contracts with us upon a sufficient budgetary appropriation. If the government agency does not receive an appropriation sufficient to cover its obligations with us, it may terminate a contract or defer or reduce our reimbursements. For example, during the economic downturn that began in 2008, our government payors in several states responded to deteriorating revenue collections by implementing service reductions, rate freezes and/or rate reductions. Beginning in fiscal 2012, the rate environment improved and, as a result, pricing increases contributed to revenue growth during each of the fiscal years from 2012 through 2015. While this trend is continuing in fiscal 2016 as the rate climate remains stable to favorable in all but one of our key markets, the financial impact is expected to be significantly more modest than in prior years due to a redesign of the I/DD Waiver program in West Virginia. Through June 30, 2016, this redesign has been the primary driver of an $8.8 million and $4.3 million reduction to our West Virginia revenue and income from operations, respectively, as compared to the comparable period a year ago. We anticipate that this operation will experience continued reduction in revenue and income from operations in the fourth quarter, estimated to be in a range of $3.0 to $3.5 million and $1.5 to $2.5 million dollars, respectively.

Historically, our business has benefited from the trend toward privatization and the efforts of groups that advocate for the populations we serve. These groups lobby governments to fund residential services that use our small group home or host home models, rather than large, institutional models. Furthermore, we believe that successful lobbying by advocacy groups has preserved I/DD and ARY services and, therefore, our revenue base for these services, from significant reductions as compared with certain other human services, although we did suffer rate reductions during and after the recession that began in 2008. In addition, a number of states have developed community-based waiver programs to support long-term care services for survivors of a traumatic brain injury. However, the majority of our specialty rehabilitation services revenue is derived from non-public payors, such as commercial insurers, managed care and other private payors.

Expansion of Services

We have grown our business through expansion of existing markets and programs, entry into new geographical markets, as well as through acquisitions.

Organic Growth

Various economic, fiscal, public policy and legal factors are contributing to an environment with an increased number of organic growth opportunities, particularly within the Human Services segment, and, as a result, we have a continued emphasis on growing our business organically and making investments to support the effort. Our future growth will depend heavily on our ability to expand our current programs and identify and execute upon new opportunities. Our organic expansion activities consist of both new program starts in existing markets and expansion into new geographical markets. Our new programs in new and existing geographic markets typically require us to incur and fund operating losses for a period of approximately 18 to 24 months (we refer to these new programs as "new starts"). Net operating loss or income of a new start is defined as its revenue for the period less direct expenses but not including allocated overhead costs. The aggregation of all programs with net operating losses that are less than 18 months old comprises the new start operating loss and the aggregation of all programs with net operating income that are less than 18 months old comprises the new start operating income for such period. During the three months ended June 30, 2016 and 2015, new starts generated operating losses of $2.2 million and $1.4 million, respectively, and operating income of $1.1 million and $0.7 million, respectively. During the nine months ended June 30, 2016 and 2015, new starts generated operating losses of $5.4 million and $3.9 million, respectively, and operating income of $2.8 million and $2.0 million, respectively.

Acquisitions

From the beginning of fiscal 2010 through June 30, 2016, we have completed 56 acquisitions, including several acquisitions of small providers, which we have integrated with our existing operations. We have pursued larger strategic acquisitions in the past and may opportunistically do so in the future. Acquisitions could have a material impact on our consolidated financial statements.

During the nine months ended June 30, 2016, we acquired the assets of ten companies complementary to our business for total cash consideration of $44.5 million.

During the nine months ended June 30, 2015, we acquired the assets of ten companies complementary to our business for total fair value consideration of $44.8 million, including $6.1 million of contingent consideration.

Divestitures

We regularly review and consider the divestiture of underperforming or non-strategic businesses to improve our operating results and better utilize our capital. We have made divestitures from time to time and expect that we may make additional divestitures in the future. Divestitures could have a material impact on our consolidated financial statements.

During fiscal 2015, the Company decided to discontinue ARY services in the states of Florida, Louisiana, Indiana, North Carolina and Texas. As a result, we sold our ARY operations in North Carolina on December 1, 2015 and closed our ARY operations in Florida, Louisiana, Indiana and Texas during the first two quarters of fiscal 2016. In connection with these divestitures, we recorded exit costs of $2.0 million, consisting of severance costs of $0.5 million and lease termination costs of $1.5 million, and a loss on the sale of our ARY business in North Carolina of $1.3 million during the first half of fiscal 2016.

Revenue

Revenue is reported net of allowances for unauthorized sales and estimated sales adjustments, and net of any state provider taxes or gross receipts taxes levied on services we provide. We derive revenue from contracts with state, local and other government payors and non-public payors. During both the three and nine months ended June 30, 2016, we derived 88% of our net revenue from contracts with state, local and other government payors and 12% of our net revenue from non-public payors, as compared to 89% of our net revenue from contracts with state, local and other government payors and 11% of our net revenue from non-public payors during both the three and nine months ended June 30, 2015. Substantially all of our non-public revenue is generated by our SRS business through contracts with commercial insurers, workers' compensation carriers and other private payors. The payment terms and rates of our contracts vary widely by jurisdiction and service type. We have four types of contractual arrangements with payors which include negotiated contracts, fixed fee contracts, retrospective reimbursement contracts and prospective payments contracts. Our revenue may be affected by adjustments to our billed rates as well as adjustments to previously billed amounts. Revenue in the future may be affected by changes in rates, rate-setting structures, methodologies or interpretations that may be proposed in states where we operate or by the federal government which provides matching funds. We cannot determine the impact of such changes or the effect of any possible governmental actions. In general, we take prices set by our payors and do not compete based on pricing.

We bill the majority of our residential services on a per person per-diem basis. We believe important performance measures of revenues in our residential service business include average daily residential census and average daily billing rates. We bill the majority of our non-residential service on a per service unit basis. These service units, which vary in length, are converted to billable units which are the hourly equivalent for the service provided. We believe important performance measures of revenues in our non-residential service business include billable units and average billable unit rates. We calculate the impact of these factors on gross revenue rather than net revenue because the timing of sales adjustments, both positive and negative, is unpredictable. We define these measures and gross revenue as follows:

- Gross Revenue: Revenues before adjusting for sales adjustments and state provider and gross receipts taxes.
- Average Residential Census: The average daily residential census over the respective period.
- Average Daily Rate: A mathematical calculation derived by dividing the gross residential revenue by the residential census and the resulting quotient by the number of days during the respective period.
- Non-Residential Billable Units: The hourly equivalent of non-residential services provided.
- Average Billable Unit Rate: Gross non-residential revenue divided by the billable units provided during the period.

A comparative summary of gross revenues by service line and our key metrics is as follows (dollars in thousands, except for daily and billable unit rates):

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
I/DD Services				
Gross Revenues	$237,718	$227,942	$704,254	$668,883
Average Residential Census	8,103	7,926	8,047	7,818
Average Daily Rate	$244.10	$234.96	$240.44	$233.64
Non-Residential Billable Units	3,200,631	3,210,055	9,502,337	9,342,956
Average Non-Residential Billable Unit Rate	$18.04	$18.22	$18.33	$18.22
Gross Revenue Growth %	4.3 %		5.3 %	
Gross Revenue growth due to:				
Volume Growth	1.6 %		2.6 %	
Average Rate Growth	2.7 %		2.7 %	
At-Risk Youth Services				
Gross Revenues	$35,767	$49,381	$114,055	$147,772
Average Residential Census	2,139	3,434	2,382	3,594
Average Daily Rate	$127.89	$111.33	$124.22	$106.81
Non-residential Billable Units	135,314	171,810	411,118	506,970
Average Non-Residential Billable Unit Rate	$80.34	$84.92	$80.21	$84.78
Gross Revenue Growth %	(27.6)%		(22.8)%	
Gross Revenue growth due to:				
Volume Growth	(32.9)%		(29.4)%	
Average Rate Growth	5.3 %		6.6 %	
Adult Day Health				
Gross Revenues	$11,399	$5,076	$24,425	$13,998
Non-residential Billable Units	680,536	333,312	1,523,440	920,052
Average Non-Residential Billable Unit Rate	$16.75	$15.23	$16.03	$15.21
Gross Revenue Growth %	124.6 %		74.5 %	
Gross Revenue growth due to:				
Volume Growth	104.2 %		65.6 %	
Average Rate Growth	20.4 %		8.9 %	
Specialty Rehabilitation Services				
Gross Revenues	$73,688	$68,663	$214,660	$197,845
Average Residential Census	1,271	1,193	1,247	1,166
Average Daily Rate	$610.06	$611.78	$604.12	$608.74
Non-residential Billable Units	41,342	35,734	116,899	66,779
Average Non-Residential Billable Unit Rate	$75.78	$63.52	$70.86	$62.17
Gross Revenue Growth %	7.3 %		8.5 %	
Gross Revenue growth due to:				
Volume Growth	6.9 %		8.4 %	
Average Rate Growth	0.4 %		0.1 %	

Expenses
Expenses directly related to providing services are classified as cost of revenue. These expenses consist of direct labor costs which principally include salaries and benefits for service provider employees and per diem payments to our Mentors; client program costs such as food, medicine and professional and general liability and employment practices liability expenses; residential occupancy expenses which are primarily comprised of rent and utilities related to facilities providing direct care; travel and transportation costs for clients requiring services; and other ancillary direct costs associated with the provision of services to clients including workers' compensation expense.
Wages and benefits to our employees and per diem payments to our Mentors constitute the most significant operating cost in each of our operations. Most of our employee caregivers are paid on an hourly basis, with hours of work generally tied to client need. Our Mentors are paid on a per diem basis, but only if the Mentor is currently caring for a client. Our labor costs are generally influenced by levels of service, and these costs can vary in material respects across regions. In addition, our labor costs are expected to rise as a result of recent regulatory actions at both the state and Federal levels. For example, the Department of Labor recently adopted a final rule effective December 1, 2016 setting an adjusted base minimum salary of $47,476 ($913 per week) required to classify an employee as exempt from overtime eligibility. Automatic adjustments are expected every three years beginning in January, 2020. Given the increase in the minimum salary, we expect to incur significant additional labor costs in the form of overtime pay for previously exempt employees, increased salaries and additional hires to minimize overtime exposure. Compliance with the final rule is expected to impact our results in the first quarter of fiscal 2017 and thereafter. The potential annual costs that could be incurred as a result of the final rule are difficult to quantify and predict but are currently estimated to be in a range of $7.0 million to $9.0 million per year and will negatively affect our margin. We are actively working on mitigation strategies and strategies to engage with our payors to reduce this impact but there can be no assurance that we will be able to do so.
Occupancy costs represent a significant portion of our operating costs. As of June 30, 2016, we owned 364 facilities and three offices, and we leased 1,621 facilities and 219 offices. We expect occupancy costs to increase during fiscal 2016 as a result of new leases entered into in connection with acquisitions and new starts. We incur no facility costs for services provided in the home of a Mentor.
Professional and general liability expense totaled 0.7% and 0.9% of gross revenue for the three and nine months ended June 30, 2016, respectively, as compared to 0.8% and 0.7% for the three and nine months ended June 30, 2015, respectively. We incurred professional and general liability expenses of $2.6 million and $9.2 million during the three and nine months ended June 30, 2016, respectively, and $2.8 million and $7.7 million during the three and nine months ended June 30, 2015, respectively. These expenses are incurred in connection with our claims reserve and insurance premiums. The increase in expense during the nine months ended June 30, 2016, as compared to the same periods of the prior year, was due to unfavorable claims experience.
General and administrative expenses primarily include salaries and benefits for administrative employees, or employees that are not directly providing services, administrative occupancy costs as well as professional expenses such as accounting, consulting and legal services, and stock-based compensation expense. Depreciation and amortization includes depreciation for fixed assets utilized in both facilities providing direct care and administrative offices, and amortization related to intangible assets.

Results of Operations

The following table sets forth our consolidated results of operations as a percentage of total gross revenues for the periods indicated.

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
Gross revenue	100.0 %	100.0 %	100.0 %	100.0 %
Sales adjustments	(1.3)%	(1.4)%	(1.1)%	(1.2)%
Net revenue	98.7 %	98.6 %	98.9 %	98.8 %
Cost of revenue	76.6 %	76.5 %	76.7 %	76.4 %
Operating expenses:				
General and administrative	12.0 %	11.3 %	12.5 %	11.6 %
Depreciation and amortization	5.2 %	7.5 %	5.2 %	6.2 %
Total operating expense	17.2 %	18.8 %	17.7 %	17.8 %
Income from operations	5.0 %	3.3 %	4.4 %	4.6 %
Other income (expense):				
Management fee of related party	— %	— %	— %	— %
Other expense, net	— %	(0.1)%	(0.1)%	— %
Extinguishment of debt	— %	— %	— %	(1.7)%
Interest expense	(2.4)%	(2.4)%	(2.4)%	(2.9)%
Income (loss) from continuing operations before income taxes	2.6 %	0.8 %	1.9 %	— %
Provision (benefit) for income taxes	1.2 %	0.3 %	1.2 %	— %
Income (loss) from continuing operations	1.4 %	0.5 %	0.7 %	— %
Loss from discontinued operations, net of tax	— %	(0.2)%	— %	(0.1)%
Net income (loss)	1.4 %	0.3 %	0.7 %	(0.1)%

Three Months Ended June 30, 2016 and 2015

Consolidated Overview

(in thousands)	Three Months Ended June 30, 2016	2015	Increase (Decrease)
Gross revenue	$358,572	$351,062	$7,510
Sales adjustments	(4,609)	(5,068)	459
Net revenue	353,963	345,994	7,969
Income from operations	$17,772	$11,515	$6,257
Operating margin	5.0 %	3.3 %	1.7 %

Consolidated gross revenue for the three months ended June 30, 2016 increased by $7.5 million, or 2.1%, compared to gross revenue for the three months ended June 30, 2015. Sales adjustments as a percentage of gross revenue decreased by 0.1% from 1.4% during three months ended June 30, 2015 to 1.3% during three months ended June 30, 2016. The growth in gross revenue was negatively impacted by the divestitures or our ARY operations in Illinois in the third quarter of fiscal 2015, and in Florida, Louisiana, Indiana, North Carolina and Texas during the first half of fiscal 2016 ("ARY Divestitures"), which resulted in a decrease of $13.8 million in gross revenue. Excluding these operations, gross revenue increased by $21.3 million, or 6.3%, of which $12.5 million was from acquisitions that closed during and after the third quarter ending June 30, 2015 and $8.9 million from organic growth.

Consolidated income from operations was $17.8 million for three months ended June 30, 2016 compared to $11.5 million for the three months ended June 30, 2015. Income from operations increased from 3.3% of gross revenue during the three months ended June 30, 2015 to 5.0% of gross revenue during the three months ended June 30, 2016. The increase in our operating margin as a percentage of gross revenue was primarily due to the positive impact of divesting our lower margin ARY operations, and a decrease in depreciation and amortization expense. Depreciation and amortization expense for the three months ended June 30, 2015 included an intangible asset impairment charge of $8.2 million related to the ARY Divestitures.

Revenues by segment

The following table sets forth revenue for the Human Services segment for the periods indicated (in thousands):

	Three Months Ended June 30,		Increase	Percentage Increase
	2016	2015	(Decrease)	(Decrease)
I/DD gross revenue	$237,718	$227,942	$ 9,776	4.3 %
ARY gross revenue	35,767	49,381	(13,614)	(27.6)%
ADH gross revenue	11,399	5,076	6,323	124.6 %
Total Human Services gross revenue	284,884	282,399	2,485	0.9 %
Sales adjustments	(4,427)	(4,001)		
Sales adjustments as a percentage of gross revenue	(1.6)%	(1.4)%		
Total Human Services net revenue	$280,457	$278,398	$ 2,059	0.7 %

Human Services gross revenue for the three months ended June 30, 2016 increased by $2.5 million, or 0.9%, compared to the three months ended June 30, 2015. The increase in gross revenue was driven by a $9.8 million increase in I/DD gross revenue while ARY gross revenue decreased by $13.6 million compared to the three months ended June 30, 2015. Gross revenue for ADH increased $6.3 million during the three months ended June 30, 2016 to $11.4 million.

The increase in I/DD gross revenue included $4.5 million from organic growth and $5.3 million from acquisitions that closed during and after the three months ended June 30, 2015. The organic growth was the result of a 2.0% increase in average billing rates compared to the three months ended June 30, 2015.

The $13.6 million decrease in ARY gross revenue was driven by a 32.9% decrease in volume due to the ARY Divestitures. These divestitures resulted in a decrease of $13.8 million in gross revenue, which was partially offset by an increase in revenue in the remaining ARY states.

The increase in ADH gross revenue included $1.0 million from organic growth and $5.4 million from acquisitions that closed after the three months ended June 30, 2015. The organic growth was the result of a 17.5% increase in volume and a 1.5% increase in the average billing rate compared to the three months ended June 30, 2015. The increase in volume was driven by new starts.

Sales adjustments for the three months ended June 30, 2016 increased by $0.4 million, or 0.2% as a percentage of gross revenue, compared to the three months ended June 30, 2015.

The following table sets forth revenue for the SRS segment for the periods indicated (in thousands):

	Three Months Ended June 30,		Increase	Percentage Increase
	2016	2015	(Decrease)	(Decrease)
SRS gross revenue	$73,688	$68,663	$ 5,025	7.3 %
Sales adjustments	(182)	(1,067)		
Sales adjustments as a percentage of gross revenue	(0.2)%	(1.6)%		
SRS net revenue	$73,506	$67,596	$ 5,910	8.7 %

The SRS segment's gross revenue for the three months ended June 30, 2016 increased by $5.0 million, or 7.3%, compared to the three months ended June 30, 2015. The increase included $3.2 million from organic growth and $1.8 million from acquisitions that closed during and after the three months ended June 30, 2015. The organic growth was driven by an increase in volume of 5.7% partially offset by a decrease in the average billing rate of 0.7% as a result of changes in our consumer mix. The increase in volume was primarily driven by lower levels of open occupancy resulting from the maturation of programs started in recent years.

Sales adjustments for the three months ended June 30, 2016 decreased from $1.1 million for the three months ended June 30, 2015 to $0.2 million.

Cost of revenues by segment

The following table sets forth cost of revenues for the Human Services segment for the periods indicated (in thousands):

	Three Months Ended June 30,					
	2016		2015			
	Amount	% of gross revenue	Amount	% of gross revenue	Increase (Decrease)	Change in % of gross revenue
Direct labor costs	$178,626	62.7 %	$179,443	63.5 %	$ (817)	(0.8)%
Client program costs	11,657	4.1 %	11,135	3.9 %	522	0.2 %
Client occupancy costs	18,205	6.4 %	16,193	5.7 %	2,012	0.7 %
Travel & transportation costs	7,141	2.5 %	7,412	2.6 %	(271)	(0.1)%
Other direct costs	6,267	2.2 %	5,421	1.9 %	846	0.3 %
Total cost of revenues	$221,896	77.9 %	$219,604	77.6 %	$ 2,292	0.3 %

Human Services cost of revenues for the three months ended June 30, 2016 increased as a percentage of gross revenue by 0.3%, as compared to the three months ended June 30, 2015. This was primarily due to an increase in client occupancy costs of 0.7% and in other direct costs of 0.3%, offset by a decrease in direct labor costs of 0.8%. The increase in occupancy costs as a percentage of gross revenue was primarily due to the impact of programs with higher levels of open occupancy. The increase in other direct costs as a percentage of gross revenue was primarily due to higher workers' compensation expense resulting from unfavorable claims experience during three months ended June 30, 2016. The decrease in direct labor costs as a percentage of gross revenue was primarily due to a decrease in direct service consultants costs resulting from our ARY Divestitures, partially offset by higher amounts of overtime pay as compared to the three months ended June 30, 2015. The higher amounts of overtime were the result of vacant positions, primarily within our I/DD business, due to increased competition for labor in some markets.

The following table sets forth cost of revenues for the SRS segment for the periods indicated (in thousands):

	Three Months Ended June 30,					
	2016		2015			
	Amount	% of gross revenue	Amount	% of gross revenue	Increase (Decrease)	Change in % of gross revenue
Direct labor costs	$37,307	50.6 %	$34,466	50.2 %	$ 2,841	0.4 %
Client program costs	5,013	6.8 %	4,714	6.9 %	299	(0.1)%
Client occupancy costs	8,057	10.9 %	7,463	10.9 %	594	— %
Travel & transportation costs	922	1.3 %	862	1.3 %	60	— %
Other direct costs	1,335	1.8 %	1,147	1.7 %	188	0.1 %
Total cost of revenues	$52,634	71.4 %	$48,652	71.0 %	$ 3,982	0.4 %

SRS segment's cost of revenues for the three months ended June 30, 2016 increased as a percentage of gross revenue by 0.4% as compared to the three months ended June 30, 2015. The increase was primarily due to an increase in direct labor costs of 0.4%. The increase in direct labor costs as a percentage of gross revenue was primarily due an increase in direct service consultants costs.

Consolidated operating expenses

General and administrative and depreciation and amortization expense were as follows (in thousands):

	Three Months Ended June 30,					
	2016		2015			Change in %
	Amount	% of gross revenue	Amount	% of gross revenue	Increase (Decrease)	of gross revenue
General and administrative	$42,988	12.0 %	$39,671	11.3 %	$ 3,317	0.7 %
Depreciation and amortization	18,634	5.2 %	26,415	7.5 %	(7,781)	(2.3)%
Total operating expense	$61,622	17.2 %	$66,086	18.8 %	$ (4,464)	(1.6)%

General and administrative expenses as a percentage of gross revenue increased by 0.7% during the three months ended June 30, 2016. The increase in general and administrative expenses during the three months ended June 30, 2016 is primarily due to a $2.6 million charge related to the increase in the fair value of acquisition related contingent consideration liabilities and an increase in professional service fees.

Depreciation and amortization expense as a percentage of gross revenue decreased to 5.2% as compared to 7.5% during the three months ended June 30, 2015. Depreciation and amortization expense for the three months ended June 30, 2015 included an intangible asset impairment charge of $8.2 million related to the ARY Divestitures.

Other (income) expense

Other expense, net, which primarily consists of interest income and mark to market adjustments of the cash surrender value of Company owned life insurance policies and the accretion of interest on acquisition related contingent consideration liabilities, was $0.1 million for the three months ended June 30, 2016 compared to $0.4 million for the three months ended June 30, 2015.

Provision (benefit) for income taxes

For the three months ended June 30, 2016, our effective income tax rate was 47.0% compared to an effective tax rate of 46.1% for the three months ended June 30, 2015. The Company's effective income tax rate for the interim periods is based on management's estimate of the Company's annual effective tax rate for the applicable year. It is also affected by discrete items that may occur in any given period, but are not consistent from year to year. These rates differ from the federal statutory income tax rate primarily due to state income taxes and nondeductible permanent differences such as meals and nondeductible compensation.

Nine Months Ended June 30, 2016 and 2015

Consolidated Overview

	Nine Months Ended June 30,		Increase
(in thousands)	2016	2015	(Decrease)
Gross revenue	$1,057,394	$1,028,498	$28,896
Sales adjustments	(12,001)	(12,734)	733
Net revenue	1,045,393	1,015,764	29,629
Income from operations	$46,442	$46,010	$432
Operating margin	4.4 %	4.5 %	(0.1)%

Consolidated gross revenue for the nine months ended June 30, 2016 increased by $28.9 million, or 2.8%, compared to gross revenue for the nine months ended June 30, 2015. Sales adjustments as a percentage of gross revenue decreased from 1.2% during the nine months ended June 30, 2015 to 1.1% during the nine months ended June 30, 2016. The growth in gross revenue was negatively impacted by the ARY Divestitures, which resulted in a decrease of $36.8 million in gross revenue. Excluding these operations, gross revenue increased by $65.7 million, or 6.7%, of which $30.9 million was from acquisitions that closed during and after the nine months ended June 30, 2015 and $34.8 million was from organic growth.

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Consolidated income from operations was $46.4 million for the nine months ended June 30, 2016 compared to $46.0 million for the nine months ended June 30, 2015. Income from operations decreased from 4.5% of gross revenue for the nine months ended June 30, 2015 to 4.4% of gross revenue for the nine months ended June 30, 2016. The decrease in our operating margin during the nine months ended June 30, 2016 was partly due to an increase in direct labor costs resulting from $6.6 million of favorable adjustments to our health insurance reserves and accruals for incentive compensation in the prior year period. In addition, our operating margin during the nine months ended June 30, 2016 was negatively impacted by an increase of $11.4 million in stock-based compensation expense, $10.5 million of which was related to Class H Common Units that vested during the first quarter of fiscal 2016 and $2.0 million of exit costs associated with the ARY Divestitures. The effect of these items was offset by the positive impact of divesting lower margin ARY operations and a decrease in depreciation and amortization expense. Depreciation and amortization expense for the nine months ended June 30, 2015 included intangible asset impairment charges of $10.4 million related to the ARY Divestitures.

Revenues by segment

The following table sets forth revenue for the Human Services segment for the periods indicated (in thousands):

	Nine Months Ended June 30, 2016	2015	Increase (Decrease)	Percentage Increase (Decrease)
I/DD gross revenue	$704,254	$668,883	$ 35,371	5.3 %
ARY gross revenue	114,055	147,772	(33,717)	(22.8)%
ADH gross revenue	24,425	13,998	10,427	74.5 %
Total Human Services gross revenue	842,734	830,653	12,081	1.5 %
Sales adjustments	(10,890)	(10,541)		
Sales adjustments as a percentage of gross revenue	(1.3)%	(1.3)%		
Total Human Services net revenue	$831,844	$820,112	$ 11,732	1.4 %

Human Services gross revenue for the nine months ended June 30, 2016 increased by $12.1 million, or 1.5%, compared to the nine months ended June 30, 2015. The increase in gross revenue was driven by a $35.4 million increase in I/DD gross revenue while ARY gross revenue decreased by $33.7 million compared to the nine months ended June 30, 2015. Gross revenue for ADH increased $10.4 million during the nine months ended June 30, 2016 to $24.4 million.

The increase in I/DD gross revenue included $20.0 million from organic growth and $15.3 million from acquisitions that closed during and after the nine months ended June 30, 2015. The organic growth was the result of a 0.9% increase in volume coupled with a 2.1% increase in average billing rates compared to the nine months ended June 30, 2015.

The $33.7 million decrease in ARY gross revenue was driven by a 29.4% decrease in volume due to the ARY Divestitures. These divestitures resulted in a decrease of $36.8 million in gross revenue, which was partially offset by an increase in revenue in the remaining ARY states.

The increase in ADH gross revenue included $3.1 million from organic growth and $7.3 million from acquisitions that closed after the nine months ended June 30, 2015. The organic growth was the result of a 20.7% increase in volume and a 1.8% increase in the average billing rate compared to the nine months ended June 30, 2015. The increase in volume was driven by new starts.

Sales adjustments for the nine months ended June 30, 2016 were flat at 1.3%, as a percentage of gross revenue, compared to the nine months ended June 30, 2015.

The following table sets forth revenue for the SRS segment for the periods indicated (in thousands):

Nine Months Ended June 30, 2016	2015	Increase (Decrease)	Percentage Increase (Decrease)

SRS gross revenue	$214,660	$197,845	$ 16,815	8.5 %
Sales adjustments	(1,111)	(2,193)		
Sales adjustments as a percentage of gross revenue	(0.5)%	(1.1)%		
SRS net revenue	$213,549	$195,652	$ 17,897	9.1 %

The SRS segment's gross revenue for the nine months ended June 30, 2016 increased by $16.8 million, or 8.5%, compared to the nine months ended June 30, 2015. The increase included $8.5 million from organic growth and $8.3 million

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from acquisitions that closed during and after the nine months ended June 30, 2015. The organic growth was driven by a 4.3% increase in volume and a 0.2% increase in average billing rate compared to the nine months ended June 30, 2015. The increase in volume was primarily driven by lower levels of open occupancy resulting from the maturation of programs started in recent years.

Cost of revenues by segment

The following table sets forth cost of revenues for the Human Services segment for the periods indicated (in thousands):

	Nine Months Ended June 30,					
	2016		2015			Change in %
	Amount	% of gross revenue	Amount	% of gross revenue	Increase (Decrease)	of gross revenue
Direct labor costs	$534,580	63.4 %	$525,706	63.3 %	$ 8,874	0.1 %
Client program costs	33,917	4.0 %	31,480	3.8 %	2,437	0.2 %
Client occupancy costs	51,827	6.1 %	47,497	5.7 %	4,330	0.4 %
Travel & transportation costs	20,519	2.4 %	21,760	2.6 %	(1,241)	(0.2)%
Other direct costs	16,807	2.0 %	17,786	2.1 %	(979)	(0.1)%
Total cost of revenues	$657,650	77.9 %	$644,229	77.5 %	$ 13,421	0.4 %

Human Services cost of revenues for the nine months ended June 30, 2016 increased as a percentage of gross revenue by 0.4%, compared to the nine months ended June 30, 2015. This was primarily due to an increase in client program costs of 0.2% and client occupancy costs of 0.4%, partially offset by a decrease in travel and transportation costs. The increase in our client program costs as a percentage of gross revenue is primarily the result of increased professional and general liability expense due to an unfavorable claims experience during the nine months ended June 30, 2016. The increase in client occupancy costs as a percentage of gross revenue was primarily due to the impact of programs with higher levels of open occupancy. The decrease in travel and transportation costs was primarily due to lower employee mileage costs as compared to the nine months ended June 30, 2015.

The following table sets forth cost of revenues for the SRS segment for the periods indicated (in thousands):

	Nine Months Ended June 30,					
	2016		2015			Change in %
	Amount	% of gross revenue	Amount	% of gross revenue	Increase (Decrease)	of gross revenue
Direct labor costs	$108,324	50.5 %	$99,336	50.2 %	$ 8,988	0.3 %
Client program costs	14,996	7.0 %	13,886	7.0 %	1,110	— %
Client occupancy costs	24,325	11.3 %	22,207	11.2 %	2,118	0.1 %
Travel & transportation costs	2,611	1.2 %	2,494	1.3 %	117	(0.1)%
Other direct costs	3,356	1.6 %	3,429	1.7 %	(73)	(0.1)%
Total cost of revenues	$153,612	71.6 %	$141,352	71.4 %	$ 12,260	0.2 %

SRS segment's cost of revenues for the nine months ended June 30, 2016 increased as a percentage of gross revenue by 0.2% as compared to the nine months ended June 30, 2015. The increase was primarily due to an increase in direct labor costs of 0.3%, partially offset by decreases in travel and transportation costs and other direct costs. The increase in direct labor costs as a percentage of gross revenue was primarily due to an increase in direct service consultants costs and an increase in expense for the self-insured portion of employee health insurance plans as compared to the nine months ended June 30, 2015. The increase in our health insurance expense is the result of a favorable adjustment to our self-insurance reserves during the nine months ended June 30, 2015 resulting from lower than expected claims. The decrease in other direct costs as a percentage of gross revenue was primarily due to lower workers' compensation costs as compared to the nine months ended June 30, 2015. The decrease in our workers' compensation costs is the result a favorable settlement experience on prior period claims during the nine months ended June 30, 2016.

Consolidated operating expenses

General and administrative and depreciation and amortization expense were as follows (in thousands):

	Nine Months Ended June 30,					
	2016		2015			Change in %
	Amount	% of gross revenue	Amount	% of gross revenue	Increase (Decrease)	of gross revenue
General and administrative	$132,614	12.5 %	$119,452	11.6 %	$13,162	0.9 %
Depreciation and amortization	54,952	5.2 %	64,278	6.2 %	(9,326)	(1.0)%
Total operating expense	$187,566	17.7 %	$183,730	17.8 %	$3,836	(0.1)%

General and administrative expense as a percentage of gross revenue increased by 0.9% during the nine months ended June 30, 2016. The increase was primarily due to an $11.4 million increase in stock-based compensation expense, lease termination charges of $1.5 million associated with the ARY Divestitures and an increase in professional service fees. The increase in stock-based compensation was primarily the result of the Class H Common Units vesting during the first quarter of fiscal 2016.

Depreciation and amortization expense decreased to 5.2% as a percentage of gross revenue as compared to 6.2% during the nine months ended June 30, 2015. Depreciation and amortization expense for the nine months ended June 30, 2015 included an intangible asset impairment charge of $10.4 million related to the ARY Divestitures.

Other (income) expense

Other expense, net, which primarily consists of interest income, mark to market adjustments of the cash surrender value of Company owned life insurance policies and the accretion of interest on acquisition related contingent consideration liabilities, increased from an expense of $0.3 million during the nine months ended June 30, 2015 to an expense of $1.1 million during the nine months ended June 30, 2016. Other expense, net for the nine months ended June 30, 2016, includes a $1.3 million loss on the sale of ARY operations in the state of North Carolina.

Interest expense decreased by $3.3 million during the nine months ended June 30, 2016 as compared to the nine months ended June 30, 2015 due to lower interest expense as a result of the redemption of $162.0 million and $50.0 million of senior notes on October 17, 2014, and March 4, 2015, respectively.

Provision (benefit) for income taxes

For the nine months ended June 30, 2016, our effective income tax rate was 65.8% compared to an effective tax rate of 45.0% for the nine months ended June 30, 2015. The Company’s effective income tax rate for the interim periods is based on management’s estimate of the Company’s annual effective tax rate for the applicable year. It is also affected by discrete items that may occur in any given period, but are not consistent from year to year. These rates differ from the federal statutory income tax rate primarily due to state income taxes and nondeductible permanent differences such as meals and nondeductible compensation. The change in the effective tax rate during the nine months ended June 30, 2016 compared to the nine months ended June 30, 2015 is primarily due to a $10.5 million stock-based compensation charge related to certain awards under our former equity compensation plan that vested in October 2015. This expense was not deductible for tax purposes and was considered a discrete item. Therefore, the entire impact of the expense on income taxes was recorded during the first quarter of fiscal 2016 and is included in the nine months ended June 30, 2016, which resulted in an abnormally high tax rate.

Liquidity and Capital Resources

Our principal uses of cash are to meet working capital requirements, fund debt obligations and finance capital expenditures and acquisitions. Cash flows from operations have historically been sufficient to meet these cash requirements. Our principal sources of funds are cash flows from operating activities, cash on hand, available borrowings under our senior revolver and proceeds from the sale of equity securities.

Operating activities

Net cash provided by operating activities was $60.6 million for the nine months ended June 30, 2016, compared to cash provided by operating activities of $50.7 million for the nine months ended June 30, 2015. The increase in cash provided by operating activities was primarily due to lower interest expense as a result of redeeming our senior notes and the impact of the associated call premiums that were paid during the nine months ended June 30, 2015. The increase was partially offset by the impact of making estimated tax payments for federal income taxes during the nine months ended June 30, 2016.

Investing activities

Net cash used in investing activities was $75.0 million and $67.5 million for the nine months ended June 30, 2016 and 2015, respectively. Cash paid for property and equipment for the nine months ended June 30, 2016 was $31.7 million, or 3.0% of net revenue, compared to $30.3 million, or 3.0% of net revenue, for the nine months ended June 30, 2015. During the nine months ended June 30, 2016 we acquired ten companies for $44.5 million. During the nine months ended June 30, 2015, we paid $38.7 million for ten acquisitions.

Financing activities

Net cash used in financing activities was $8.0 million for the nine months ended June 30, 2016 as compared to $162.7 million for the nine months ended June 30, 2015. During the nine months ended June 30, 2015, we redeemed $212.0 million of our senior notes, partially offset by the net proceeds received from the incremental term loan of $55.0 million.

During the nine months ended June 30, 2016, we borrowed an aggregate of $45.9 million under our senior revolver and repaid $45.9 million during the same period. During the nine months ended June 30, 2015, we borrowed an aggregate of $206.7 million under our senior revolver and repaid $206.7 million during the same period. At June 30, 2016, we had no outstanding loans and $117.1 million of availability under the senior revolver due to $2.9 million in standby letters of credit issued under the senior revolver, which reduce the availability under the senior revolver. Letters of credit can be issued under our institutional letter of credit facility up to the $50.0 million limit, subject to certain maintenance and issuance limitations and letters of credit in excess of that amount reduce availability under our senior revolver. As of June 30, 2016, $47.4 million of letters of credit were issued under the institutional letter of credit facility and $2.9 million of letters of credit were issued under the senior revolver.

We believe that available borrowings under our senior revolver and cash flow from operations will provide sufficient liquidity and capital resources to meet our financial obligations for the next twelve months, including scheduled principal and interest payments, as well as to provide funds for working capital, acquisitions, capital expenditures and other needs. No assurance can be given, however, that this will be the case.

Debt and Financing Arrangements

Senior Secured Credit Facilities

On January 31, 2014, NMHI and NMHH, wholly-owned subsidiaries of Civitas, entered into a new senior credit agreement (the “senior credit agreement”) with Barclays Bank PLC, as administrative agent, and the other agents and lenders named therein, for the new senior secured credit facilities (the “senior secured credit facilities”). The senior credit agreement, as amended, governs a $655.0 million term loan facility (the “term loan facility”), of which $50.0 million was deposited in a cash collateral account in support of issuance of letters of credit under an institutional letter of credit facility (the “institutional letter of credit facility”), and a $120.0 million senior secured revolving credit facility (the “senior revolver”). As of June 30, 2016, NMHI had $640.7 million of borrowings under the term loan. The aggregate amount of the revolving commitment under the senior revolver as of June 30, 2016 was $120.0 million.

Covenants

The senior credit agreement contains negative financial and non-financial covenants, including, among other things, limitations on the ability of NMHI and its restricted subsidiaries to incur additional debt, create liens on assets, transfer or sell assets, pay dividends, redeem stock or make other distributions or investments, and engage in certain transactions with affiliates. NMHI was in compliance with these covenants as of June 30, 2016 and September 30, 2015.

In addition, the senior credit agreement contains a springing financial covenant. If, at the end of any fiscal quarter, NMHI's usage of the senior revolver exceeds 30% of the commitments thereunder, NMHI is required to maintain at the end of each such fiscal quarter a consolidated first lien leverage ratio of not more than 5.50 to 1.00. This consolidated first lien leverage ratio will step down to 5.00 to 1.00 commencing with the fiscal quarter ending March 31, 2017. The springing financial covenant was not in effect as of June 30, 2016 or September 30, 2015 as NMHI's usage of the senior revolver did not exceed the threshold for that quarter.

The senior credit agreement also contains a number of covenants that, among other things, restrict, subject to certain exceptions, NMHI's ability and the ability of its subsidiaries to: (i) incur additional indebtedness; (ii) create liens on assets; (iii) engage in mergers or consolidations; (iv) sell assets; (v) pay dividends and distributions or repurchase our capital stock; (vi) enter into swap transactions; (vii) make investments, loans or advances; (viii) repay certain junior indebtedness; (ix) engage in certain transactions with affiliates; (x) enter into sale and leaseback transactions; (xi) amend material agreements governing certain of our junior indebtedness; (xii) change our lines of business; (xiii) make certain acquisitions; and (xiv) limitations on the letter of credit cash collateral account. NMHI was in compliance with these covenants as of June 30, 2016 and September 30, 2015. If NMHI withdraws any of the $50.0 million from the cash collateral account supporting the issuance of letters of credit, NMHI must use the cash to either prepay the term loan facility or to secure any other obligations under the senior secured credit facilities in a manner reasonably satisfactory to the administrative agent. The senior credit agreement contains customary affirmative covenants and events of default.

Contractual Commitments Summary

The following table summarizes our contractual obligations and commitments as of June 30, 2016:

(in thousands)	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Long-term debt obligations [1]	$764,618	$34,055	$67,263	$663,300	$ —
Operating lease obligations [2]	283,549	63,931	98,513	58,400	62,705
Capital lease obligations	8,580	1,124	2,248	2,248	2,960
Purchase obligations [3]	4,514	3,412	1,102	—	—
Standby letters of credit	50,354	50,354	—	—	—
Contingent consideration obligations [4]	4,954	4,954	—	—	—
Total obligations and commitments	$1,116,569	$157,830	$169,126	$723,948	$ 65,665

(1) Represents the principal amount of our long-term debt and the expected cash payments for interest on our long-term debt based on the interest rates in place and amounts outstanding at June 30, 2016. The interest payments do not reflect the projected impact of interest rate swap agreements. The principal and interest payments are due in quarterly installments through January 31, 2021. See Note 4 to our unaudited condensed consolidated financial statements included elsewhere herein for further information about our senior secured credit facilities.

(2) Includes the fixed rent payable under the leases and does not include additional amounts, such as taxes, that may be payable under the leases.

(3) Represents purchase obligations related to information technology services and maintenance contracts.

(4) In connection with certain of our acquisitions, additional contingent consideration may become payable to the sellers upon the satisfaction of certain performance milestones. Amounts represent the estimated fair value of these obligations. For further information pertaining to our contingent consideration arrangements see Note 10 to our unaudited condensed consolidated financial statements included elsewhere herein.

Inflation

We do not believe that general inflation in the U.S. economy has had a material impact on our financial position or results of operations.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet transactions or interests.

Critical Accounting Policies

Our financial results are affected by the selection and application of critical accounting policies and methods. There were no material changes in the nine months ended June 30, 2016 to the application of critical accounting policies and estimates as described in our audited financial statements for the year ended September 30, 2015, which were included in our Annual Report on Form 10-K for the year ended September 30, 2015.

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles (“GAAP”). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

We believe our application of accounting policies, and the estimates inherently required therein, are reasonable. These accounting policies and estimates are constantly reevaluated, and adjustments are made when facts and circumstances dictate a change.

As of June 30, 2016, there has been no material change in our accounting policies or the underlying assumptions or methodology used to fairly present our financial position, results of operations and cash flows for the periods covered by this report. In addition, no triggering events have come to our attention pursuant to our review of goodwill that would indicate a test for impairment is necessary as of June 30, 2016.

Forward-Looking Statements

Some of the matters discussed in this report may constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

These statements relate to future events or our future financial performance, and include statements about our expectations for future periods with respect to our markets, demand for our services, the political climate and budgetary and rate environment, our expansion efforts and the impact of our recent acquisitions, our plans for investments to further grow and develop our business, our margins, our liquidity and our labor costs. Terminology such as “may,” “will,” “should,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential” or “continue,” or s expressions are intended to identify these forward looking statements. These statements are only predictions. Actual events or results may differ materially.

The information in this report is not a complete description of our business or the risks associated with our business. There can be no assurance that other factors will not affect the accuracy of these forward-looking statements or that our actual results will not differ materially from the results anticipated in such forward-looking statements. While it is not possible to identify all such factors, factors that could cause actual results to differ materially from those estimated by us include, but are not limited to, those factors or conditions described in our Annual Report on Form 10-K for the year ended September 30, 2015, as well as the following:

- reductions or changes in Medicaid or other funding or changes in budgetary priorities by federal, state and local governments;
- substantial claims, litigation and governmental proceedings;
- reductions in reimbursement rates, policies or payment practices by our payors;
- an increase in labor costs or labor-related liability;
- matters involving employees that expose us to potential liability;

- our substantial amount of debt, our ability to meet our debt service obligations and our ability to incur additional debt;

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- our history of losses;
- our ability to maintain effective internal controls;
- our ability to comply with complicated billing and collection rules and regulations;
- failure to comply with reimbursement procedures and collect accounts receivable;
- changes in economic conditions;
- an increase in our self-insured retentions and changes in the insurance market for professional and general liability, workers' compensation and automobile liability and our claims history and our ability to obtain coverage at reasonable rates;
- an increase in workers' compensation related liability;
- our ability to control labor costs, including healthcare costs imposed by the Patient Protection and Affordable Care Act;
- our ability to attract and retain experienced personnel;
- our ability to establish and maintain relationships with government agencies and advocacy groups;
- negative publicity or changes in public perception of our services;
- our ability to maintain our status as a licensed service provider in certain jurisdictions;
- our ability to maintain, expand and renew existing services contracts and to obtain additional contracts or acquire new licenses;
- our ability to successfully integrate acquired businesses;
- our inability to successfully expand into adjacent markets;
- government regulations, changes in government regulations and our ability to comply with such regulations;
- increased competition;
- decrease in popularity of home- and community-based human services among our targeted client populations and/or state and local governments;
- our susceptibility to any reduction in budget appropriations for our services in Minnesota or any other adverse developments in that state;
- our ability to operate our business due to constraints imposed by covenants in our senior credit agreement;
- our ability to retain the continued services of certain members of our management team;
- our ability to manage and integrate key administrative functions;
- failure of our information systems or failure to upgrade our information systems when required;
- information technology failure, inadequacy, interruption or security failure;
- write-offs of goodwill or other intangible assets; and
- natural disasters or public health catastrophes.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, we do not assume responsibility for the accuracy and completeness of the forward-looking statements. All written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the "Risk Factors" and other cautionary statements referenced and included herein. We are under no duty to update any of the forward-looking statements after the date of this report to conform such statements to actual results or to changes in our expectations.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

We are exposed to changes in interest rates as a result of our outstanding variable rate debt. The variable rate debt outstanding relates to the term loan, which bears interest at (i) a rate equal to the greater of (a) the prime rate, (b) the federal funds rate plus 1/2 of 1% and (c) the Eurodollar rate for an interest period of one-month beginning on such day plus 100 basis points plus 2.25%; or (ii) the Eurodollar rate (subject to a LIBOR floor of 1.00%), plus 3.25%, at our option. A 1% increase in the interest rate on our floating rate debt as of June 30, 2016 would have increased cash interest expense on the floating rate debt by approximately $6.5 million per annum, without giving effect to the interest rate swap agreement discussed below.

To reduce the interest rate exposure related to our variable debt, NMHI entered into two interest rate swaps in an aggregate notional amount of $375.0 million, effective on January 20, 2015. Under the terms of the swaps, we receive from the counterparty a quarterly payment based on a rate equal to the greater of 3-month LIBOR or 1.00% per annum, and we make payments to the counterparty based on a fixed rate of 1.795% per annum, in each case on the notional amount of $375.0 million, settled on a net payment basis.

Item 4. Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e)) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), that are intended to ensure that information that would be required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. As of June, 2016, the end of the period covered by this Quarterly Report on Form 10-Q, our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) under the Exchange Act. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of June 30, 2016, because they are not yet able to conclude that we have remediated the material weakness in internal control over financial reporting identified in Item 9A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2015.

As disclosed in Item 9A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2015, management, with the participation of our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of our internal control over financial reporting as of September 30, 2015 based on the framework and criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management identified a material weakness in internal control over financial reporting as of September 30, 2015 related to information technology general controls described below.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis. The material weakness relates to a number of deficiencies in the design and operating effectiveness of information technology (“IT”) general controls for certain information systems that comprise part of our system of internal control over financial reporting and are relevant to the preparation of our consolidated financial statements (such information technology systems are referred to as the “affected IT systems”). These deficiencies involve user access controls and program change management controls that are intended to ensure that access to financial applications and data is adequately restricted to appropriate personnel, and that changes affecting the financial applications and underlying account records are identified, authorized, tested and implemented appropriately. As a result of the deficiencies identified, there is a possibility that the effectiveness of business process controls, certain of which are dependent on the affected IT systems, or electronic data and financial reports, generated from the affected IT systems, could be adversely affected.

We are actively engaged in the implementation of a remediation plan to ensure that controls contributing to this material weakness are designed appropriately and will operate effectively. We have retained an outside consultant to assist management in conducting an evaluation of the design of the IT user access controls and program change management controls, and to develop specific recommendations to remediate the identified deficiencies. The material weakness will not be considered remediated until new controls are implemented and tested, and management concludes that the new controls are operating effectively. As disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2015, we are working towards having these remediation efforts completed by the time we issue our September 30, 2016 financial statements.

Notwithstanding the identified material weakness and the conclusion above that our disclosure controls and procedures were not effective as of June 30, 2016, management believes that the unaudited consolidated financial statements contained in this Quarterly Report on Form 10-Q fairly present, in all material respects, our financial condition, results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the United States of America.

(b) Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

We are in the health and human services business and, therefore, we have been and continue to be subject to numerous claims alleging that we, our employees or our Mentors failed to provide proper care for a client. We are also subject to claims by our clients, our employees, our Mentors or community members against us for negligence, intentional misconduct or violation of applicable laws. Included in our recent claims are claims alleging personal injury, assault, abuse, wrongful death and other charges. Regulatory agencies may initiate administrative proceedings alleging that our programs, employees or agents violate statutes and regulations and seek to impose monetary penalties on us. We could be required to incur significant costs to respond to regulatory investigations or defend against civil lawsuits and, if we do not prevail, we could be required to pay substantial amounts of money in damages, settlement amounts or penalties arising from these legal proceedings.

We also are subject to potential lawsuits under the False Claims Act and other federal and state whistleblower statutes designed to combat fraud and abuse in the health care industry. These lawsuits can involve significant monetary awards that may incentivize private plaintiffs to bring these suits. If we are found to have violated the False Claims Act, we could be excluded from participation in Medicaid and other federal healthcare programs. The Patient Protection and Affordable Care Act provides a mandate for more vigorous and widespread enforcement activity to combat fraud and abuse in the health care industry.

Finally, we are also subject to employee-related claims under state and federal law, including claims for discrimination, wrongful discharge or retaliation and claims for wage and hour violations under the Fair Labor Standards Act or state wage and hour laws.

We reserve for costs related to contingencies when a loss is probable and the amount is reasonably estimable. While we believe our provision for legal contingencies is adequate, the outcome of our legal proceedings is difficult to predict, and we may settle legal claims or be subject to judgments for amounts that differ from our estimates. In addition, legal contingencies could have a material adverse impact on our results of operations in any given future reporting period.

See “Part II. Item 1A. Risk Factors” and “Part I. Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations” for additional information.

Item 1A. Risk Factors

There have been no material changes during the period covered by this Quarterly Report on Form 10-Q to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended September 30, 2015, except that under our risk factor “Matters involving employees may expose us to potential liability,” we are supplementing the portion of such risk factor regarding the Department of Labor’s proposed rule regarding classification of employees as exempt to state the following:

In May 2016, the Department of Labor issued a final rule that significantly raised the minimum salary required to classify an employee as exempt from overtime eligibility. The Department of Labor raised the current base salary minimum to be exempt from overtime pay for all hours worked over 40 hours in a designated work-week from $23,660 ($455 per week) to $47,476 ($913/week) effective December 1, 2016, with adjustments thereafter every three years based on a standard metric, with the first adjustment to be no earlier than January 2020. Given the increase in the minimum salary level for administrative, professional, and executive exempt employees, we expect to incur significant additional labor costs in the form of overtime pay for previously exempt employees, increased salaries and additional hires to minimize overtime exposure. Compliance with the final rule is expected to impact our results in the first quarter of fiscal 2017 and thereafter. The potential annual costs that may be incurred as a result of the adoption of this final rule and our compliance therewith are difficult to quantify and predict but are currently estimated to be in a range of $7.0 million to $9.0 million and will negatively affect our margin. We are actively working on mitigation strategies and strategies to engage with our payors to reduce this impact but there can be no assurance that we will be able to do so.

For more information regarding the risks regarding our business and industry, please see our Annual Report on Form 10-K for the year ended September 30, 2015.

Item 2. Unregistered Sales of Equity Securities

Unregistered Sales of Equity Securities

No unregistered equity securities of the Company were sold during the three months ended June 30, 2016.

Repurchases of Equity Securities

The following table provides information about purchases we made during the three months ended June 30, 2016 of equity securities that are registered by us pursuant to Section 12 of the Exchange Act:

	Total Number of Shares Purchased [1]	Average Price Paid per Share
4/1/2016 - 4/30/2016	—	—
5/1/2016 - 5/31/2016	15,983	$ 21.46
6/1/2016 - 6/30/2016	272	$ 21.99

[1] Our employees surrendered an aggregate of 16,255 shares to us in satisfaction of minimum tax withholding obligations associated with the vesting of restricted stock units during the three months ended June 30, 2016.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

The Exhibit Index is incorporated herein by reference.

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.

	CIVITAS SOLUTIONS, INC.	
August 9, 2016	By:	/s/ Denis M. Holler
		Denis M. Holler
		Its: Chief Financial Officer and duly authorized officer

EXHIBIT INDEX

Exhibit No.	Description	
10.1	Letter Agreement dated as of April 12, 2016 by and among National Mentor Holdings, Inc., as borrower and Barclays Bank, PLC, as Administrative Agent under the Borrower's Credit Agreement dated as of January 31, 2014 (as amended, supplemented, amended or restated or otherwise modified from time to time).	Filed herewith
31.1	Certification of principal executive officer.	Filed herewith
31.2	Certification of principal financial officer.	Filed herewith
32	Certifications furnished pursuant to 18 U.S.C. Section 1350.	Filed herewith
101.INS	XBRL Instance Document.	Filed herewith
101.SCH	XBRL Taxonomy Extension Schema Document.	Filed herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	Filed herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	Filed herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.	Filed herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	Filed herewith