ZIX CORP
Form 10-Q
August 08, 2008

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2008

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

For the transition period from ____________________ to ____________________

Commission File Number: 0-17995
ZIX CORPORATION
(Exact Name of Registrant as Specified in its Charter)

Texas	**75-2216818**
(State of Incorporation)	**(I.R.S. Employer Identification Number)**

2711 North Haskell Avenue
Suite 2200, LB 36
Dallas, Texas 75204-2960
(Address of Principal Executive Offices)
(214) 370-2000
(Registrant s Telephone Number, Including Area Code)

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

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

Large accelerated filer o	**Accelerated filer þ**	**Non-accelerated filer o (Do not check if a smaller reporting company)**	**Smaller reporting company o**

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at August 1, 2008**
Common Stock, par value $0.01 per share	**63,012,726**

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ZIX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2008 (unaudited)	December 31, 2007 (audited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 13,007,000	$ 10,524,000
Marketable securities		1,734,000
Receivables, net	697,000	1,119,000
Prepaid and other current assets	1,341,000	1,545,000
Total current assets	15,045,000	14,922,000
Restricted cash	25,000	25,000
Property and equipment, net	2,131,000	2,297,000
Goodwill	2,161,000	2,161,000
Other assets	42,000	69,000
Total assets	$ 19,404,000	$ 19,474,000
LIABILITIES AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 276,000	$ 231,000
Accrued expenses	2,791,000	3,064,000
Deferred revenue	13,588,000	12,606,000
Total current liabilities	16,655,000	15,901,000
Long-term liabilities:		
Deferred revenue	3,334,000	3,497,000
Deferred rent	345,000	365,000
Total long-term liabilities	3,679,000	3,862,000
Total liabilities	20,334,000	19,763,000
Commitments and contingencies (see Note 14)		
Stockholders deficit:		
Preferred stock, $1 par value, 10,000,000 shares authorized; none issued and outstanding		
Common stock, $0.01 par value, 175,000,000 shares authorized; 65,314,420 issued and 62,987,239 outstanding in 2008 and 64,959,649 issued and 62,632,468 outstanding in 2007	653,000	650,000
Additional paid-in capital	331,596,000	329,186,000
Treasury stock, at cost; 2,327,181 common shares in 2008 and 2007	(11,507,000)	(11,507,000)
Accumulated deficit	(321,672,000)	(318,618,000)
Total stockholders deficit	(930,000)	(289,000)
Total liabilities and stockholders deficit	$ 19,404,000	$ 19,474,000

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Revenues	$ 6,958,000	$ 5,555,000	$ 14,157,000	$ 10,942,000
Cost of revenues	2,542,000	2,647,000	5,122,000	5,500,000
Gross margin	4,416,000	2,908,000	9,035,000	5,442,000
Operating expenses:				
Research and development expenses	1,381,000	1,343,000	2,926,000	2,642,000
Marketing expenses	805,000	938,000	1,690,000	1,857,000
Sales expenses	2,281,000	2,225,000	4,553,000	4,535,000
General and administrative expenses	1,521,000	1,486,000	3,181,000	3,057,000
Customer deposit forfeiture				(2,000,000)
Loss on impairment of operating lease		100,000		100,000
Total operating expenses	5,988,000	6,092,000	12,350,000	10,191,000
Operating loss	(1,572,000)	(3,184,000)	(3,315,000)	(4,749,000)
Other (expense) income:				
Investment and other income	222,000	139,000	338,000	294,000
Interest expense		(56,000)		(106,000)
Loss on extinguishment of debt				(178,000)
Total other income	222,000	83,000	338,000	10,000
Loss before income taxes	(1,350,000)	(3,101,000)	(2,977,000)	(4,739,000)
Income taxes expense		(34,000)	(77,000)	(37,000)
Net loss	$ (1,350,000)	$ (3,135,000)	$ (3,054,000)	$ (4,776,000)
Basic and diluted loss per common share	$ (0.02)	$ (0.05)	$ (0.05)	$ (0.08)
Basic and diluted weighted average common shares outstanding	62,903,431	60,338,839	62,803,638	60,110,662

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS DEFICIT
(Unaudited)

	Stockholders Deficit					
	Common Stock		Additional			Total
	Shares	Amount	Paid-In Capital	Treasury Stock	Accumulated Deficit	Stockholders Deficit
Balance, January 1, 2008	64,959,649	$ 650,000	$ 329,186,000	$ (11,507,000)	$ (318,618,000)	$ (289,000)
Issuance of common stock upon exercise of stock options	62,759	1,000	149,000			150,000
Common stock issued to employees as compensation in lieu of cash	292,012	2,000	996,000			998,000
Employee share-based compensation costs			1,265,000			1,265,000
Net loss					(3,054,000)	(3,054,000)
Balance, June 30, 2008	65,314,420	$ 653,000	$ 331,596,000	$ (11,507,000)	$ (321,672,000)	$ (930,000)

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30, 2008	2007
Operating activities:		
Net loss	$ (3,054,000)	$ (4,776,000)
Non-cash items in net loss:		
Depreciation and amortization	649,000	881,000
Employee share-based compensation costs	1,265,000	826,000
Common stock issued to employees as compensation in lieu of cash	576,000	
Amortization of debt discount/premium, financing costs and other		16,000
Non-employee share-based compensation costs		66,000
Loss on extinguishment of debt		178,000
Loss on impairment of operating lease		100,000
Customer deposit forfeiture		(2,000,000)
Changes in deferred taxes	27,000	(89,000)
Changes in operating assets and liabilities:		
Receivables	422,000	(65,000)
Prepaid and other current assets	220,000	436,000
Accounts payable	90,000	385,000
Deferred revenue	819,000	4,118,000
Accrued and other liabilities	129,000	(64,000)
Net cash provided by operating activities	1,143,000	12,000
Investing activities:		
Purchases of property and equipment	(544,000)	(543,000)
Restricted cash investments and marketable securities, net	1,734,000	(1,665,000)
Net cash provided (used) by investing activities	1,190,000	(2,208,000)
Financing activities:		
Proceeds from exercise of stock options	150,000	
Payment of short-term notes payable		(151,000)
Net cash provided (used) by financing activities	150,000	(151,000)
Increase (decrease) in cash and cash equivalents	2,483,000	(2,347,000)
Cash and cash equivalents, beginning of period	10,524,000	12,783,000
Cash and cash equivalents, end of period	$ 13,007,000	$ 10,436,000

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Zix Corporation (ZixCorp or the Company) should be read in conjunction with the audited consolidated financial statements included in the Company s 2007 Annual Report to Shareholders on Form 10-K. These financial statements are unaudited, but have been prepared in the ordinary course of business for the purpose of providing information with respect to the interim periods. Management of the Company believes that all adjustments necessary for a fair presentation for such periods have been included and are of a normal recurring nature. The results of operations for the three and six-month periods ended June 30, 2008, are not necessarily indicative of the results to be expected for the full year.

2. Recent Accounting Standards and Pronouncements

In December 2007, the SEC issued Staff Accounting Bulletin (SAB) 110 *Share-Based Payment.* SAB 110 amends and replaces Question 6 of Section D.2 of Topic 14, Share-Based Payment, of the Staff Accounting Bulletin series. Question 6 of Section D.2 of Topic 14 expresses the views of the staff regarding the use of the simplified method in developing an estimate of the expected term of plain vanilla share options and allows usage of the simplified method for share option grants prior to December 31, 2007. SAB 110 allows public companies which do not have historically sufficient experience to provide a reasonable estimate to continue use of the simplified method for estimating the expected term of plain vanilla share option grants after December 31, 2007. SAB 110 was effective January 1, 2008. The Company has used the simplified method to estimate the expected term for share option grants as it does not have enough historical experience to provide a reasonable estimate. The Company will continue to use the simplified method until it has enough historical experience to provide a reasonable estimate of expected term in accordance with SAB 110. The adoption of SAB110 did not have a material impact on its consolidated balance sheets, statements of operations and cash flows.

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement No. 141R, *Business Combinations*, and Statement No. 160, *Non-controlling Interests in Consolidated Financial Statements, an amendment of ARB No. 51*. Statement No. 141R modifies the accounting and disclosure requirements for business combinations and broadens the scope of the previous standard to apply to all transactions in which one entity obtains control over another business. Statement No. 160 establishes new accounting and reporting standards for non-controlling interests in subsidiaries. The Company will be required to apply the provisions of the new standards in the first quarter of 2009. Early adoption is not permitted for these new standards.

3. Company Overview and Liquidity

ZixCorp is a provider of hosted Internet applications, delivered via a Software as a Service (SaaS) model. Our core competency is the ability to deliver these complex service offerings with a high level of availability, reliability, integrity, and particularly security. We are currently targeting two lines of business that require these core competencies: Email Encryption and e-Prescribing. We offer these services on a subscription basis to our customers who subscribe to use the services for a specified term.

A typical subscription business requires a significant up-front investment of cash and other resources to establish the service. Until a sufficient mass of subscriber users is obtained, the subscription business will typically operate at a loss. However, once a sufficient mass of users is obtained, the recurring subscription fees exceed the costs of providing the service and the subscription business begins to provide better economic returns as the cost of adding new users is low relative to the incremental subscription revenue.

In keeping with the typical subscription business model, we have invested significant up-front cash and other resources in our Email Encryption and e-Prescribing businesses. These costs include the costs to initially develop and then maintain our SysTrust certification and SAS 70 (Type II audit report) frameworks for applicable services provided by our Zix Data Center, which operates on a 24/7 basis at a 99.99% level of availability and is the backbone of our Email Encryption and e-Prescribing businesses. Also, in the e-Prescribing line of business, we incur significant costs to build an information technology (IT) platform to establish real-time access and connectivity in our prescribers offices throughout the country, as well as costs for prescriber recruitment and training, and selling to the healthcare payors, who typically pay for the prescribers use of our e-Prescribing service.

Although the financial models of our two core lines of business are similar, they are at different stages of their development. Our Email Encryption business is now generating significant excess cash. In the first half 2008, it generated enough cash to cover its costs, our entire Company-wide overhead costs, and the net cash consumed by our e-Prescribing business. Our e-Prescribing business is not

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as mature as our Email Encryption business, does not have sufficient paying customers to cover its costs, and consumes cash. Nevertheless, at this time we believe that our e-Prescribing business will ultimately achieve sufficient customers to generate cash and contribute to profit and, accordingly, we are continuing to invest cash in this line of business. In the first and second quarters of 2008, we achieved Company-wide positive cash flow from operations (although we sustained an overall operating loss on a Generally Accepted Accounting Principles (GAAP) basis).

The Company has total contractual obligations over the next year of $1,254,000 and $3,267,000 over the next three years consisting of various office lease contracts (see Note 14). Cash usage in excess of these commitments represents operating spending to satisfy existing customer contracts and cover various corporate overhead costs, as well as investments that the Company chooses to make to secure new orders. The Company believes that a significant portion of the spending in excess of contractual commitments is discretionary and flexible.

On June 30, 2008, the Company s total cash, cash equivalents and restricted cash totaled $13,032,000. The Company believes it has adequate resources and liquidity to maintain growth in the Email Encryption business and to sustain the e-Prescribing business for at least the next twelve months. The Company s cash resources could be negatively affected as described below:

The key metrics upon which the operational success of the Company is primarily dependent are set forth under the caption Overview, which appears on page 14 of this Form 10-Q. Failure of the Company to perform satisfactorily relative to these key metrics or to decrease its spending will negatively affect the Company s overall cash resources.

The Company hopes to begin recruiting prescribers as part of the announced HighMark initiative in Pennsylvania and to obtain new payor sponsorship contracts to deploy its e-Prescribing service to a significant number of new prescriber (users). There are significant upfront variable costs associated with establishing the service. The Company has historically asked its health care payor sponsors to pay all (or most) of these variable costs either before or as they are incurred. In the case of the HighMark initiative and, in the case of possible new sponsorships being proposed, the Company would pay a substantial portion of these variable costs upfront in exchange for cash and revenue streams that commence or payments that are made upon achievement of active prescribers. Of course, our business plan in these instances would be designed such that future payments exceed our variable costs and provide net contribution to our fixed costs and, with sufficient volume of active prescribers, would become profitable. However, with significant increases to the number of orders under these new business models, the Company s use of its cash resources will increase significantly.

The Company may increase its research and development spending to develop new functionality and services for one or both of its lines of business.

New business opportunities may require significant investments for new technology or infrastructure.

4. Revenue and Significant Customers

The Company recognizes revenue in accordance with accounting principles generally accepted in the United States of America, as promulgated by Statement of Position (SOP) 97-2, *Software Revenue Recognition,* SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With respect to Certain Transactions,* EITF Abstract No. 00-21, *Revenue Arrangements with Multiple Deliverables,* and Securities and Exchange Commission Staff Accounting Bulletin No. 104, *Revenue Recognition in Financial Statements,* and other related pronouncements. Accounting for revenue is complex due to the long-term and often multiple element nature of ZixCorp s contracts with customers and the potential for incorrect application of accounting guidance. This requires that revenue recognition be considered a critical accounting policy.

The Company develops, markets, licenses and supports services that require high security. The Company s services can be placed into several key revenue categories where each category has similar revenue recognition traits: Email Encryption service, e-Prescribing service, various transaction fees and related professional services. A majority of the revenues generated by the Company are through direct sales; however, for its Email Encryption Service, the Company also employs a network of distributors and resellers and distributes its offerings through a number of OEM contracts.

Under all product categories and distribution models, the Company recognizes revenue after all of the following occur: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable, and collectibility is reasonably assured. In the event the arrangement has multiple elements with delivered and undelivered elements, revenue for the delivered elements are recognized under the residual method only when vendor-specific objective evidence of fair value (VSOE) exists to allocate the fair value of the total fees to the undelivered elements of the arrangement. Occasionally, when the Company is engaged in a complex product deployment, customer acceptance may have to occur before the transaction is considered complete. In this situation no revenue is recognized until the customer accepts the product. Discounts provided to customers are recorded as reductions in revenue.

The Email Encryption Service is a subscription-based service. Providing these services includes delivering licensed software and providing secure electronic communications and customer support throughout the subscription period. In the case of the Company s ZixVPM service, typically, as part of the service, an appliance with pre-installed software is installed at the customer site at the beginning of the subscription period. In the case of services provided through OEM partners, the appliances are housed either in ZixCorp s data center, or the data center of the OEM Partner. For ZixCorp s Email Encryption Service, the customer or OEM partner does not own a perpetual right to a software license, but is instead granted the use of that license during the period of the service subscription. Direct customer subscriptions are generally multiple-year contracts that are irrevocable and non-refundable in nature and require annual, up-front payments. In all cases the subscription period begins on the date specified by the parties or when the service is fully functional for the customer, which is consequently deemed to be the date of acceptance. Revenues from subscription services are recorded ratably over the subscription period commencing with the date of acceptance. Subscription fees received from customers in advance are recorded as deferred revenue and then recognized as revenue ratably over the subscription period.

e-Prescribing service arrangements contain multiple deliverables including both hardware and services. Due to the lack of VSOE, these elements are combined into a single unit of accounting and, similar to Email Encryption, are recognized as revenue ratably over the longer of the subscription term or expected renewal period. Revenue recognition begins upon installation of the required hardware and commencement of service.

Some of the Company s services incorporate a transaction fee per event occurrence or when predetermined usage levels have been reached. These fees are recognized as revenue when the transaction occurs or when the predetermined usage levels have been achieved, and when the amounts are fixed and determinable. The Company does not offer stand alone services. Further, the Company s services include various warranty provisions; however, warranty expense was not material to any period presented.

For the three months ended June 30, 2008, no single customer accounted for more than 10% of revenue. For the three months ended June 30, 2007, e-Prescribing customer Blue Cross and Blue Shield of Massachusetts, Inc., accounted for approximately $595,000, or 11% of total revenues and 41% of e-Prescribing revenue. For the six months ended June 30, 2008, no single customer accounted for more than 10% of revenue. For the six months ended June 30, 2007, e-Prescribing customer Blue Cross Blue Shield of Massachusetts, Inc., accounted for approximately $1,165,000, or 11% of total revenue and 40% of e-Prescribing revenue.

5. Segment Information

The Company manages the business in two reportable lines or business or segments: Email Encryption and e-Prescribing as discussed in Note 3. The Company s Chief Executive Officer and Chief Financial Officer have been identified as the chief operating decisions makers (CODM) in assessing the performance of each segment and determining the related allocation of resources.

To determine the allocation of resources the CODM generally assesses the performance of each segment based on revenue, gross margin, and direct expenses which include research and development expenses and selling and marketing expenses that are directly attributable to the segments. Most assets and most corporate costs are not allocated to the segments and are not used to determine resource allocation. Any transactions that are considered a one-time occurrence or not likely to be repeated in future periods are excluded from the CODM s assessments. The accounting policies of the reportable segments are the same as those applied to the condensed consolidated financial statements. Corporate includes charges such as corporate management, compliance and other non-operational activities that cannot be directly attributed to a reporting segment.

	Three Months Ended June 30, 2008				Three Months Ended June 30, 2007			
	Email Encryption	e-Prescribing	Corporate	Total	Email Encryption	e-Prescribing	Corporate	Total
Revenues	$ 5,667,000	$ 1,291,000	$	$ 6,958,000	$ 4,120,000	$ 1,435,000	$	$ 5,555,000
	1,059,000	1,483,000		2,542,000	1,031,000	1,616,000		2,647,000

Cost of Revenues								
Gross margin (loss)	4,608,000	(192,000)		4,416,000	3,089,000	(181,000)		2,908,000
Direct expenses	2,756,000	1,717,000		4,473,000	2,743,000	1,762,000		4,505,000
Segment contribution (loss)	1,852,000	(1,909,000)		(57,000)	346,000	(1,943,000)		(1,597,000)
Unallocated (expense) / income								
Marketing, general and administrative expense			(1,515,000)	(1,515,000)			(1,487,000)	(1,487,000)
Loss on impairment of operating lease							(100,000)	(100,000)
Investment and other income			222,000	222,000			139,000	139,000
Interest expense							(56,000)	(56,000)
Total			(1,293,000)	(1,293,000)			(1,504,000)	(1,504,000)
Income (loss) before income taxes	$ 1,852,000	$ (1,909,000)	$ (1,293,000)	$ (1,350,000)	$ 346,000	$ (1,943,000)	$ (1,504,000)	$ (3,101,000)

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	Six Months Ended June 30, 2008				Six Months Ended June 30, 2007			
	Email Encryption	e-Prescribing	Corporate	Total	Email Encryption	e-Prescribing	Corporate	Total
Revenues	$ 10,956,000	$ 3,201,000	$	$ 14,157,000	$ 8,054,000	$ 2,888,000	$	$ 10,942,000
Cost of Revenues	2,109,000	3,013,000		5,122,000	2,226,000	3,274,000		5,500,000
Gross margin (loss)	8,847,000	188,000		9,035,000	5,828,000	(386,000)		5,442,000
Direct expenses	5,623,000	3,552,000		9,175,000	5,409,000	3,619,000		9,028,000
Segment contribution (loss)	3,224,000	(3,364,000)		(140,000)	419,000	(4,005,000)		(3,586,000)
Unallocated (expense) / income								
Marketing, general and administrative expense			(3,175,000)	(3,175,000)			(3,063,000)	(3,063,000)
Loss on extinguishment of debt							(178,000)	(178,000)
Loss on impairment of operating lease							(100,000)	(100,000)
Customer deposit forfeiture							2,000,000	