MARCHEX INC
Form 10-Q
November 04, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

September 30, 2011 For the quarterly period ended September 30, 2011

or

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

For the transition period from to .

Commission File Number 000-50658

Marchex, Inc.

(Exact name of Registrant as specified in its charter)

Delaware	**35-2194038**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

520 Pike Street, Suite 2000

Seattle, Washington 98101

(Address of principal executive offices)

Registrant s telephone number, including area code: (206) 331-3300

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 and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its Corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

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

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

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 November 2, 2011**
Class A common stock, par value $.01 per share	9,631,882
Class B common stock, par value $.01 per share	27,635,861

Marchex, Inc.

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Part I Financial Information

Item 1. Condensed Consolidated Financial Statements (unaudited)

MARCHEX, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(unaudited)

	December 31, 2010	September 30, 2011
Assets		
Current assets:		
Cash and cash equivalents	$ 37,328,052	$ 35,488,333
Accounts receivable, net	20,213,886	29,289,426
Prepaid expenses and other current assets	3,567,504	3,075,837
Refundable taxes	3,248,908	2,518,052
Deferred tax assets	868,629	1,156,741
Total current assets	65,226,979	71,528,389
Property and equipment, net	4,709,907	5,412,733
Deferred tax assets	50,768,525	45,942,241
Intangible and other assets, net	2,070,217	1,315,636
Goodwill	35,337,428	85,313,035
Intangible assets from acquisitions, net	1,576,687	9,786,642
Total assets	$ 159,689,743	$ 219,298,676
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 11,165,616	$ 14,259,304
Accrued expenses and other current liabilities	5,106,021	8,845,556
Deferred acquisition payment		17,397,419
Deferred revenue	1,649,851	1,811,535
Total current liabilities	17,921,488	42,313,814
Deferred acquisition payment		17,638,888
Other non-current liabilities	2,076,332	2,176,792
Total liabilities	19,997,820	62,129,494
Stockholders equity:		
Class A common stock	105,006	98,944
Class B common stock	254,802	275,014
Treasury stock	(1,360,238)	(50,147)
Additional paid-in capital	281,421,696	295,603,564
Accumulated deficit	(140,729,343)	(138,758,193)
Total stockholders equity	139,691,923	157,169,182
Total liabilities and stockholders equity	$ 159,689,743	$ 219,298,676

See accompanying notes to condensed consolidated financial statements.

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MARCHEX, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

(unaudited)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Three Months Ended September 30, 2010	Three Months Ended September 30, 2011
Revenue	$ 69,590,175	$ 107,703,081	$ 24,194,841	$ 39,862,443
Expenses:				
Service costs (1)	40,909,245	60,221,049	14,604,200	21,848,208
Sales and marketing (1)	10,605,457	11,175,232	3,183,374	4,547,584
Product development (1)	12,482,042	16,957,961	4,193,428	6,131,515
General and administrative (1)	12,809,459	17,154,129	4,683,639	5,860,029
Amortization of intangible assets from acquisitions (2)	2,119,479	3,755,514	704,106	1,671,719
Acquisition related costs		1,513,109		61,869
Total operating expenses	78,925,682	110,776,994	27,368,747	40,120,924
Gain on sales and disposals of intangible assets, net	4,650,182	7,111,678	2,632,634	2,486,242
Income (loss) from operations	(4,685,325)	4,037,765	(541,272)	2,227,761
Other income (expense):				
Interest income	55,556	140,785	17,891	3,271
Interest and line of credit expense	(79,894)	(407,273)	(27,256)	(198,208)
Other	158,226	(1,453)	111,968	(1,397)
Total other income (expense)	133,888	(267,941)	102,603	(196,334)
Income (loss) before provision for income taxes	(4,551,437)	3,769,824	(438,669)	2,031,427
Income tax expense (benefit)	(863,176)	1,798,676	54,202	778,113
Net income (loss)	(3,688,261)	1,971,148	(492,871)	1,253,314
Dividends paid to participating securities	(146,229)	(191,523)	(54,540)	(66,785)
Net income (loss) applicable to common stockholders	$ (3,834,490)	$ 1,779,625	$ (547,411)	$ 1,186,529
Basic net income (loss) per share applicable to Class A and Class B common stockholders	$ (0.12)	$ 0.05	$ (0.02)	$ 0.04
Diluted net income (loss) per share applicable to Class A and Class B common stockholders	$ (0.12)	$ 0.05	$ (0.02)	$ 0.03
Dividends paid per share	$ 0.06	$ 0.06	$ 0.02	$ 0.02
Shares used to calculate basic net income (loss) per share applicable to common stockholders				
Class A	10,725,333	10,027,418	10,556,988	9,851,012
Class B	22,037,273	23,135,566	21,948,520	23,672,807
Shares used to calculate diluted net income (loss) per share applicable to common stockholders				
Class A	10,725,333	10,027,418	10,556,988	9,851,012
Class B	32,762,606	35,179,794	32,505,508	35,943,756

(1) Excludes amortization of intangible assets from acquisitions

(2) Components of amortization of intangible assets from acquisitions:

Service costs	$ 2,119,479	$ 3,136,956	$ 704,106	$ 1,358,992
Sales and marketing		590,385		298,077
General and administrative		28,173		14,650
Total	$ 2,119,479	$ 3,755,514	$ 704,106	$ 1,671,719

See accompanying notes to condensed consolidated financial statements.

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MARCHEX, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(unaudited)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2011
Cash flows from operating activities:		
Net income (loss)	$ (3,688,261)	$ 1,971,148
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization and depreciation	5,991,304	6,803,584
Accretion of interest expense		340,925
Leasehold improvement incentive	779,100	163,542
Gain on sales of fixed assets, net	(198)	(2,383)
Gain on sales and disposals of intangible assets, net	(4,650,182)	(7,111,678)
Allowance for doubtful accounts and advertiser credits	988,936	681,262
Stock-based compensation	7,906,255	11,408,664
Deferred income taxes, net of acquisition	2,060,558	1,106,767
Excess tax benefits related to stock-based compensation		(802,441)
Change in certain assets and liabilities, net of acquisition:		
Accounts receivable, net	(6,942,250)	(5,098,077)
Refundable taxes	(1,208,053)	1,576,835
Prepaid expenses, other current assets and other assets	(1,425,984)	203,421
Accounts payable	3,052,390	(202,312)
Accrued expenses and other current liabilities	358,987	1,875,970
Deferred revenue	(420,750)	91,981
Other non-current liabilities	665,762	100,459
Net cash provided by operating activities	3,467,614	13,107,667
Cash flows from investing activities:		
Purchases of property and equipment	(2,727,614)	(2,610,092)
Cash paid for acquisition, net of cash acquired		(15,801,314)
Proceeds from sales of property and equipment	198	7,475
Proceeds from sales of intangible assets	4,652,208	7,152,720
Purchases of intangible assets	(65,599)	(78,513)
Net cash provided by (used in) investing activities	1,859,193	(11,329,724)
Cash flows from financing activities:		
Capital lease obligation principal payments	(6,161)	
Excess tax benefits related to stock-based compensation		802,441
Common stock dividend payments	(2,114,763)	(2,193,362)
Repurchase of Class B common stock	(4,882,930)	(3,233,471)
Proceeds from exercises of stock options	30,458	988,959
Proceeds from employee stock purchase plan	12,350	17,771
Net cash used in financing activities	(6,961,046)	(3,617,662)
Net decrease in cash and cash equivalents	(1,634,239)	(1,839,719)
Cash and cash equivalents at beginning of period	33,638,002	37,328,052
Cash and cash equivalents at end of period	$ 32,003,763	$ 35,488,333

Supplemental disclosure of cash flow information:		
Cash (received) paid during the period for income taxes, net of refunds	$ (1,651,963)	$ (732,147)
Non-cash investing and financing activities:		
Fair value of Class B common stock issued in connection with acquisition	$	$ 7,602,508
Deferred payments related to acquisition	$	$ 34,695,382

See accompanying notes to condensed consolidated financial statements.

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Marchex, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(1) Description of Business and Basis of Presentation

Marchex, Inc. (the Company) was incorporated in the state of Delaware on January 17, 2003. The Company is a call advertising and small business marketing company. The Company delivers call and click-based advertising products and services to tens of thousands of advertisers. The accompanying unaudited condensed consolidated financial statements of Marchex, Inc. and its wholly-owned subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for annual financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011, or for any other period. The balance sheet at December 31, 2010 has been derived from the audited consolidated financial statements at that date but does not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. These condensed consolidated financial statements and notes should be read in conjunction with the Company s audited consolidated financial statements and accompanying notes included in the Annual Report on Form 10-K for the year ended December 31, 2010 filed with the SEC.

The condensed consolidated financial statements include the accounts of Marchex and its wholly-owned subsidiaries. Acquisitions are included in the Company s consolidated financial statements as of and from the date of acquisition. All inter-company transactions and balances have been eliminated in consolidation. Certain reclassifications have been made to the condensed consolidated financial statements in the prior period to conform to the current period presentation.

The Company s condensed consolidated financial statements presented include the condensed consolidated balance sheets as of December 31, 2010 and September 30, 2011, the condensed consolidated statements of operations for the three and nine months ended September 30, 2010 and 2011 and the condensed consolidated statements of cash flows for the nine months ended September 30, 2010 and 2011.

Acquisition

In April 2011, the Company acquired 100% of the stock of Jingle Networks, Inc. (Jingle), a provider of mobile voice search performance advertising and technology solutions in North America. See Note 11 for further discussion.

(2) Significant Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) in the United States 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 revenues and expenses during the reporting period. These judgments are difficult as matters that are inherently uncertain directly impact their valuation and accounting. Actual results may vary from management s estimates and assumptions.

There have been no changes to the Company s significant accounting policies as disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2010 filed with the SEC.

Deferred Acquisition Payment

The Company s deferred acquisition payments represent consideration payable related to a business combination, which may be paid in either cash or shares of the Company s Series B common stock at the Company s discretion. Any deferred acquisition payments settled in common stock will be increased by 5%. The deferred acquisition payments were originally recognized at fair value at the date of the business combination and are recorded as liabilities on the balance sheet. Interest expense on the principal amounts due is accreted each period using the effective interest rate method.

Recently Issued Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04). ASU 2011-04 amended Accounting Standards Codification Topic 820 (ASC 820) to converge the fair value measurement guidance in U.S. GAAP and International Financial Reporting Standards (IFRSs). Some of the amendments clarify the application of existing fair value measurement requirements, while other amendments change a particular principle in ASC 820. In addition, ASU 2011-04 requires additional fair value disclosures. The amendments are to be applied prospectively and are effective for annual periods beginning after December 15, 2011. The Company is currently evaluating the effect that the provisions of ASU 2011-04 will have on the consolidated financial statements.

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In June 2011, the FASB issued Accounting Standards Update No. 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income* (ASU 2011-05), to require an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of equity. The amendment is effective for fiscal years beginning after Dec. 15, 2011, and interim periods within that year. The Company is evaluating the impact of the adoption of ASU 2011-05.

In September 2011, the FASB issued Accounting Standards Update No. 2011-08, *Testing Goodwill for Impairment* (ASU 2011-08). ASU 2011-08 amended Accounting Standards Codification Topic 350 (ASC 350) to allow companies to first assess qualitative factors to determine whether existence of events or circumstances leads to a conclusion that it is not more likely than not that the fair value of a reporting unit is less than the carrying value. If such a conclusion is reached, then the two-step impairment test is not required to be performed. ASU 2011-08 is effective for the Company in 2012 and earlier adoption is permitted. We are currently evaluating the impact that the provisions of ASU 2011-08 will have on the consolidated financial statements.

Revenues

The following table presents the Company s revenues, by revenue source, for the periods presented:

	Nine months ended September 30, 2010	Nine months ended September 30, 2011	Three months ended September 30, 2010	Three months ended September 30, 2011
Partner and Other Revenue Sources	$ 49,894,781	$ 91,881,194	$ 17,999,797	$ 34,820,087
Proprietary Web site Traffic Sources	19,695,394	15,821,887	6,195,044	5,042,356
Total Revenue	$ 69,590,175	$ 107,703,081	$ 24,194,841	$ 39,862,443

The Company s partner network revenues are primarily generated using third-party distribution networks to deliver the advertisers listings. The distribution network includes mobile and online search engines and applications, directories, destination sites, shopping engines, third-party Internet domains or web sites, other targeted Web-based content, mobile carriers and other offline sources. The Company generates revenue upon delivery of qualified and reported phone calls or click-throughs to our advertisers or to advertising services providers listings. The Company pays a revenue share to the distribution partners to access their mobile, online, offline and other user traffic. Other revenues include the Company s call provisioning and call tracking services, presence management services, campaign management services and natural search optimization services.

The Company s proprietary web site traffic revenues are generated from the Company s portfolio of owned web sites which are monetized with pay-for-call or pay-per-click listings that are relevant to the web sites, as well as other forms of advertising, including banner advertising and sponsorships. When an online user navigates to one of the Company s owned and operated web sites and calls or clicks on a particular listing or completes the specified action, the Company receives a fee.

(3) Stock-based Compensation Plans

The Company accounts for stock-based compensation for employees and non-employees under the fair value method.

Stock-based compensation expense was included in the following operating expense categories as follows:

	Nine months ended September 30, 2010	Nine months ended September 30, 2011	Three months ended September 30, 2010	Three months ended September 30, 2011
Service costs	$ 608,304	$ 924,181	$ 223,672	$ 325,235
Sales and marketing	602,995	1,100,598	221,901	461,446
Product development	740,553	1,174,028	280,377	469,456

General and administrative	5,954,403	8,209,857	2,199,285	2,696,078
Total stock-based compensation	$ 7,906,255	$ 11,408,664	$ 2,925,235	$ 3,952,215

The per share fair value of time-vested stock options granted during the three and nine months ended September 30, 2010 and 2011 was determined on the date of grant using the Black-Scholes option-pricing model. The following weighted average assumptions were used in determining the fair value of time-vested stock option grants for the periods presented:

	Nine months ended September 30,		Three months ended September 30,	
	2010	2011	2010	2011
Expected life (in years)	4.5	4.0	4.0	4.0
Risk-free interest rate	1.71%	1.33%	1.00%	0.69%
Expected volatility	66%	69%	68%	70%
Expected dividend yield	1.1%	0.91%	1.1%	0.91%

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During 2010, the Company issued stock options that have vesting based on a combination of certain service and market conditions. The compensation costs and derived service periods for stock option grants with vesting based on a combination of service and market conditions are estimated using the binomial lattice model to determine the fair value and a Monte Carlo simulation to determine the derived service period. The risk-free interest rate is based on the 10 year bond rate as of the valuation date based on the contractual life of the option. No stock options were granted during the nine months ended September 30, 2011 that have vesting based on a combination of certain service and market conditions. During the nine months ended September 30, 2011, 102,000 stock options vested that met a combination of certain service and market conditions.

Stock option activity during the nine months ended September 30, 2011 is summarized as follows:

	Shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Balance at December 31, 2010	6,410,548	$ 8.48	7.20	$ 14,340,943
Options granted	500,600	9.06		
Options forfeited	(197,764)	6.38		
Options expired	(282,060)	10.76		
Options exercised	(259,036)	4.17		
Balance at September 30, 2011 (1)	6,172,288	$ 8.66	6.78	$ 10,464,816

(1) Includes 765,000 options that have vesting based on a combination of service and market conditions of which 102,000 options have met vesting conditions.

The Company issues restricted stock to employees for future services and in connection with acquisitions. Restricted stock award grants are generally measured at fair value on the date of grant based on the number of awards granted and the quoted price of the Company s common stock. Restricted shares issued are accounted for under FASB ASC 718 using the straight-line method net of estimated forfeitures.

During 2010, the Company issued restricted stock units which entitle the holder to receive one share of the Company s Class B common stock upon satisfaction of a combination of certain service and market conditions. The compensation costs and derived service periods for restricted stock units with vesting based on a combination of service and market conditions are estimated using the binomial lattice model to determine the fair value and a Monte Carlo simulation to determine the derived service period. No restricted stock units were granted during the nine months ended September 30, 2011 that have vesting based on a combination of certain service and market conditions. During the nine months ended September 30, 2011, 34,000 shares of restricted stock units vested that met a combination of certain service and market conditions.

Restricted stock awards and restricted stock units activity during the nine months ended September 30, 2011 is summarized as follows:

	Shares	Weighted average grant date fair value
Unvested balance at December 31, 2010	3,468,750	$ 8.13
Granted	804,299	8.04
Vested (1)	(500,625)	4.66
Forfeited	(62,125)	6.42
Unvested balance at September 30, 2011 (2)	3,710,299	$ 8.61

(1) Includes 34,000 of restricted stock units that have met vesting based on a combination of service and market conditions.
(2) Includes 221,000 restricted stock units that have vesting based on a combination of service and market conditions.

The following table summarizes stock-based compensation expense related to all stock-based awards under the fair value method during the three and nine months ended September 30, 2010 and 2011:

	Nine months ended September 30,		Three months ended September 30,	
	2010	2011	2010	2011
Total stock-based compensation included in net income (loss)	$ 7,906,000	$ 11,409,000	$ 2,925,000	$ 3,952,000
Income tax benefit related to stock-based compensation included in net income (loss)	$ 2,186,000	$ 3,989,000	$ 822,000	$ 1,800,000

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(4) Net Income (Loss) Per Share

We compute net income (loss) per share of Class A and Class B common stock using the two class method. Under the provisions of the two class method, basic net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common and dilutive common equivalent shares outstanding during the period. The computation of the diluted net income (loss) per share of Class B common stock assumes the conversion of Class A common stock to Class B common stock, while the diluted net income (loss) per share of Class A common stock does not assume the conversion of those shares.

In accordance with the two class method, the undistributed earnings for each period are allocated based on the contractual participation rights of the Class A and Class B common shares and the restricted shares as if the earnings for the period had been distributed. Considering the terms of the Company s charter which provides that, if and when dividends are declared on our common stock in accordance with Delaware General Corporation Law, equivalent dividends shall be paid with respect to the shares of Class A common stock and Class B common stock and that both classes of common stock have identical dividend rights and would share equally in our net assets in the event of liquidation, we have allocated undistributed losses on a proportionate basis. Additionally, the Company has paid dividends equally to both classes of common stock and the unvested restricted shares since it initiated a quarterly cash dividend in November 2006.

Instruments granted in unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are participating securities prior to vesting. As such, the Company s restricted stock awards are considered participating securities for purposes of calculating earnings per share. Under the two class method, dividends paid on unvested restricted stock are allocated to these participating securities and therefore impacts the calculation of amounts allocated to common stock.

The following table includes net income (loss) applicable to common stockholders used to compute basic net income (loss) per share for the periods ended:

	Nine months ended September 30,			
	2010		2011	
	Class A	Class B	Class A	Class B
Numerator:				
Net income (loss)	$ (1,255,278)	$ (2,432,983)	$ 538,101	$ 1,433,047
Dividends paid to participating securities		(146,229)		(191,523)
Net income (loss) applicable to common stockholders	$ (1,255,278)	$ (2,579,212)	$ 538,101	$ 1,241,524
Denominator:				
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	10,725,333	22,037,273	10,027,418	23,135,566
Basic net income (loss) per share applicable to common stockholders	$ (0.12)	$ (0.12)	$ 0.05	$ 0.05

	Three months ended September 30,			
	2010		2011	
	Class A	Class B	Class A	Class B
Numerator:				
Net income (loss)	$ (177,786)	$ (315,085)	$ 348,663	$ 904,651
Dividends paid to participating securities		(54,540)		(66,785)
Net income (loss) applicable to common stockholders	$ (177,786)	$ (369,625)	$ 348,663	$ 837,866
Denominator:				
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	10,556,988	21,948,520	9,851,012	23,672,807
	$ (0.02)	$ (0.02)	$ 0.04	$ 0.04

Basic net income (loss) per share applicable to common stockholders	

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The following table calculates net loss to diluted net income (loss) applicable to common stockholders used to compute diluted net income (loss) per share for the periods ended:

	Nine months ended September 30,			
	2010		2011	
	Class A	Class B	Class A	Class B
Numerator:				
Net income (loss)	$ (1,255,278)	$ (2,432,983)	$ 507,253	$ 1,463,895
Dividends paid to participating securities		(146,229)		(191,523)
Reallocation of net income (loss) for Class A shares as a result of conversion of Class A to Class B shares		(1,255,278)		507,253
Net income (loss) applicable to common stockholders	$ (1,255,278)	$ (3,834,490)	$ 507,253	$ 1,779,625
Denominator:				
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	10,725,333	22,037,273	10,027,418	23,135,566
Weighted average stock options and warrants and common shares subject to repurchase or cancellation				2,016,810
Conversion of Class A to Class B common shares outstanding		10,725,333		10,027,418
Weighted average number of shares outstanding used to calculate diluted net income (loss) per share	10,725,333	32,762,606	10,027,418	35,179,794
Diluted net income (loss) per share applicable to common stockholders	$ (0.12)	$ (0.12)	$ 0.05	$ 0.05

	Three months ended September 30,			
	2010		2011	
	Class A	Class B	Class A	Class B
Numerator:				
Net income (loss)	$ (177,786)	$ (315,085)	$ 325,189	$ 928,125
Dividends paid to participating securities		(54,540)		(66,785)
Reallocation of net income (loss) for Class A shares as a result of conversion of Class A to Class B shares		(177,786)		325,189
Net income (loss) applicable to common stockholders	$ (177,786)	$ (547,411)	$ 325,189	$ 1,186,529
Denominator:				
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	10,556,988	21,948,520	9,851,012	23,672,807
Weighted average stock options and warrants and common shares subject to repurchase or cancellation				2,419,937
Conversion of Class A to Class B common shares outstanding		10,556,988		9,851,012
Weighted average number of shares outstanding used to calculate diluted net income (loss) per share	10,556,988	32,505,508	9,851,012	35,943,756
Diluted net income (loss) per share applicable to common stockholders	$ (0.02)	$ (0.02)	$ 0.03	$ 0.03

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The weighted average number of shares used to calculate the diluted net income (loss) per share includes the weighted average number of shares from the assumed conversion of Class A common stock to Class B common stock.

The computation of diluted net income (loss) per share excludes the following because their effect would be anti-dilutive:

For the three and nine months ended September 30, 2010, outstanding options to acquire 4,810,941 and 4,483,907 shares of Class B common stock with a weighted average exercise price of $9.37 and $9.89 per share, respectively. For the three and nine months ended September 30, 2011, outstanding options to acquire 3,165,159 and 3,318,930 shares of Class B common stock with a weighted average exercise price of $12.04 and $11.95 per share, respectively.

For the three and nine months ended September 30, 2010, 2,721,000 shares of unvested Class B restricted common shares issued to employees and in connection with acquisitions. For the three and nine months ended September 30, 2011, 3,489,000 shares of unvested Class B restricted common shares issued to employees and in connection with acquisitions. Unvested shares were excluded from the denominator of the computation of basic net loss per share.

For the three and nine months ended September 30, 2010, 405,000 stock options and 135,000 restricted stock units with vesting based on satisfaction of certain service and market conditions. For the three and nine months ended September 30, 2011, 147,000 stock options and 49,000 restricted stock units with vesting based on satisfaction of certain service and market conditions. 663,000 stock options and 221,000 restricted stock units with vesting based on satisfaction of certain service and market conditions were excluded from the denominator of the computation of basic net income per share for the three months ended September 30, 2011.

For the three and nine months ended September 30, 2011, 4,402,465 shares of Class B common stock based on the September 30, 2011 closing stock price that may be issued in lieu of cash for the deferred payments related to the acquisition of Jingle using the if converted method. See Note 11 for further discussion.

(5) Concentrations

The Company maintains substantially all of their cash and cash equivalents with one financial institution and are all considered at Level 1 fair value with observable inputs that reflect quoted prices for identical assets or liabilities in active markets.

A significant portion of the Company s revenue earned from advertisers is generated through arrangements with distribution partners. The Company may not be successful in renewing any of these agreements, or if they are renewed, they may not be on terms as favorable as current agreements. The Company may not be successful in entering into agreements with new distribution partners or advertisers on commercially acceptable terms. In addition, several of these distribution partners or advertisers may be considered potential competitors.

There were no distribution partners representing more than 10% of consolidated revenue for the three and nine months ended September 30, 2010 and 2011.

The advertisers representing more than 10% of consolidated revenue are as follows:

	Nine months ended September 30,		Three months ended September 30,	
	2010	**2011**	**2010**	**2011**
Advertiser A	23%	30%	20%	31%

Advertiser A is also a distribution partner.

The outstanding receivable balance for each advertiser representing more than 10% of accounts receivable is as follows:

	At December 31, 2010	At September 30, 2011
Advertiser A	40%	42%
Advertiser B	11%	*

* Less than 10% of accounts receivable.

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(6) Segment Reporting and Geographic Information

Operating segments are revenue-producing components of the enterprise for which separate financial information is produced internally for the Company s management. For all periods presented the Company operated as a single segment, principally in domestic markets providing digital advertiser transaction services to enterprises.

Revenues from advertisers by geographical areas are tracked on the basis of the location of the advertiser. The vast majority of the Company s revenue and accounts receivable are derived from domestic sales to advertisers engaged in various mobile, online and other digital activities.

Revenues by geographic region are as follows (in percentages):

	Nine months ended September 30,		Three months ended September 30,	
	2010	2011	2010	2011
United States	96%	94%	95%	95%
Canada	4%	5%	4%	5%
Other countries	*	*	*	*
	100%	100%	100%	100%

* Less than 1% of revenue.

(7) Property and Equipment

Property and equipment consisted of the following:

	At December 31, 2010	At September 30, 2011
Computer and other related equipment	$ 10,709,539	$ 12,456,980
Purchased and internally developed software	6,202,642	6,615,849
Furniture and fixtures	1,129,410	1,227,457
Leasehold improvements	1,665,030	1,788,358
	$ 19,706,621	$ 22,088,644
Less: accumulated depreciation and amortization	(14,996,714)	(16,675,911)
Property and equipment, net	$ 4,709,907	$ 5,412,733

The Company has capitalized certain costs of internally developed software for internal use. The estimated useful life of costs capitalized is evaluated for each specific project. Amortization begins in the period in which the software is ready for its intended use.

Depreciation and amortization expense, related to property and equipment was approximately $738,000 and $698,000 for the three months ended September 30, 2010 and 2011, respectively and was $2.3 million and $2.1 million for the nine months ended September 30, 2010 and 2011, respectively.

(8) Commitments

The Company has commitments for future payments related to office facilities leases and other contractual obligations. The Company leases its office facilities under operating lease agreements expiring through 2018. Certain of these lease agreements have free or escalating rent payment provisions or fund certain leasehold improvements which the Company accounts for as a lease incentive. The Company recognizes rent expense under such agreements on a straight-line basis over the lease term with any lease incentive amortized as a reduction of rent expense over the lease term. The Company also has other contractual obligations expiring over varying time periods through 2015. Other contractual obligations primarily relate to minimum contractual payments due to distribution partners and other outside service providers.

	Facilities operating leases	**Other contractual obligations**	**Total**
2011	$ 503,041	$ 595,547	$ 1,098,588
2012	2,123,980	1,800,067	3,924,047
2013	2,235,148	408,911	2,644,059
2014	2,287,470	39,655	2,327,125
2015	2,225,694	1,827	2,227,521
2016 and after	5,176,332		5,176,332
Total minimum payments	$ 14,551,665	$ 2,846,007	$ 17,397,672

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In the third quarter of 2010 and 2011, the lessor paid $779,000 and $164,000, respectively, towards certain leasehold improvements which the Company accounted for as a lease incentive and is amortizing as a reduction of rent expense over the lease term.

Rent expense incurred by the Company was approximately $414,000 and $547,000 for the three months ended September 30, 2010 and 2011, respectively, and was $1.3 million and $1.6 million for the nine months ended September 30, 2010 and 2011, respectively.

(9) Credit Agreement

In April 2008, the Company entered into a credit agreement providing for a senior secured $30 million revolving credit facility (Credit Agreement). Interest on outstanding balances under the Credit Agreement will accrue at LIBOR plus an applicable margin rate, as determined under the agreement and there is an unused commitment fee. The Credit Agreement contains certain customary representations and warranties, financial covenants, events of default and is secured by substantially all of the assets of the Company. During the first quarter of 2011, the Company signed an amendment to the Credit Agreement which extended the maturity period through to April 1, 2014 and increased the applicable margin rate by 25 basis points. As of September 30, 2011, the Company had no borrowings under the Credit Agreement.

(10) Contingencies and Taxes

(a) Contingencies

The Company is involved in legal and administrative proceedings and claims of various types from time to time. While any litigation contains an element of uncertainty, the Company is not aware of any legal proceedings or claims which are pending that the Company believes, based on current knowledge, will have, individually or taken together, a material adverse effect on the Company s financial condition or results of operations or liquidity.

In some agreements to which we are a party, we have agreed to indemnification provisions of varying scope and terms with advertisers, vendors and other parties with respect to certain matters, including, but not limited to, losses arising out of the Company s breach of agreements or representations and warranties made by the Company, services to be provided by the Company and intellectual property infringement claims made by third parties. As a result of these provisions, we may from time to time provide certain levels of financial support to our contract parties to seek to minimize the impact of any associated litigation in which they may be involved. To date, there have been no known events or circumstances that have resulted in any material costs related to these indemnification provisions and no liabilities therefore have been recorded in the accompanying unaudited condensed consolidated financial statements. However, the maximum potential amount of the future payments we could be required to make under these indemnification provisions could be material.

(b) Taxes

From time to time, various state, federal and other jurisdictional tax authorities undertake audits of the Company and its filings. In evaluating the exposure associated with various tax filing positions, the Company on occasion accrues charges for uncertain positions. The Company adjusts these contingencies in light of changing facts and circumstances, such as the outcome of tax audits. Audits of the Company s federal tax returns for 2005 through 2007 were concluded in the first quarter of 2011 which resulted in certain tax adjustments. In connection with these tax adjustments, the Company reduced its gross tax contingencies by $285,000 and recognized $181,000 of tax benefit in the first quarter of 2011. The Company does not have any significant interest or penalty accruals. The provision for income taxes includes the impact of contingency provisions and changes to contingencies that are considered appropriate. The Company files U.S. federal, certain U.S. states, and certain foreign tax returns. Generally, U.S. federal, U.S. state, and foreign tax returns filed for years after 2005 are within the statue of limitations and are under examination or may be subject to examination.

(11) Acquisition

On April 7, 2011, the Company acquired 100% of the stock of Jingle, a provider of mobile voice search performance advertising and technology solutions in North America for the following consideration:

- Approximately $15.8 million in cash, net of cash acquired, and 1,019,103 shares of the Company s Class B common stock paid at closing; and

Future consideration of (i) $17.6 million, net of certain working capital adjustments, on the first annual anniversary of the closing, and (ii) $18.0 million on the 18th month anniversary of closing, with the future consideration payable in either cash or shares of the Company s Class B common stock or some combination to be determined by the Company. Any shares issued in payment of the future consideration will be increased by 5%. The future consideration is recorded as current and long term deferred acquisition payments in the balance sheet. Following the closing, the Company issued 462,247 shares of restricted stock at an aggregate value of approximately $3.3 million to employees of Jingle, subject to vesting for up to four years.

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The Company accounted for the Jingle acquisition as a business combination. As a result of the acquisition, the Company added additional sources of mobile distribution to its call advertising network. The Company has already commenced integration of Jingle s operations, including sales activities, and accordingly, revenues of the acquired operations are not readily separable. However, revenues of customers existing prior to the acquisition, net of intercompany activities, were approximately $5.8 million and $11.4 million and pretax losses were estimated to be $2.2 million and $3.6 million for the three and nine months ended September 30, 2011 from the date of acquisition.

The fair value of the shares of Class B common stock issued as part of the consideration paid was valued at $7.6 million using the Company s closing stock price of $7.46 per share at the acquisition date. The fair value of the future consideration payments of $34.7 million was discounted using a rate of approximately 2% based on the Company s incremental borrowing rate and is recorded on the balance sheet as deferred payments. Acquisition related costs of approximately $1.5 million for the nine months ended September 30, 2011 were primarily for professional fees to perform due diligence, historical audits and other procedures associated with the acquisition.

In connection with the acquisition, the Company acquired federal net operating loss carryforwards. The Tax Reform Act of 1986 limits the use of net operating loss (NOL) and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. The Company believes that such a change had occurred at Jingle, and that the utilization of the carryforwards is limited such that the majority of the NOL carryforwards will never be utilized. No deferred tax assets relating to these NOL carryforwards have been recorded, and the allocation of the purchase price is preliminary because we have not completed our analysis of limitations associated with these NOL carryfowards or our ability to utilize them.

A summary of the consideration for the acquisition is as follows:

Cash	$ 16,562,734
Stock issued	7,602,508
Future consideration	34,695,382
Total	$ 58,860,624

The following summarizes the preliminary allocation of the fair value of the assets acquired and the liabilities assumed at September 30, 2011:

Cash acquired	$ 761,420
Accounts receivable	4,658,725
Current assets	61,730
Property and equipment	198,676
Other non-current assets	146,559
Intangible assets	11,965,600
Goodwill	50,003,462
Total assets acquired	67,796,172
Current liabilities	(5,504,143)
Non-current deferred tax liabilities	(3,431,405)
Total liabilities assumed	(8,935,548)
Net assets acquired	$ 58,860,624

The acquired intangible assets of approximately $12.0 million consist primarily of customer and partner relationships, technology, trademarks and patents which will be amortized over 12 to 36 months (weighted average of 2.4 years) using the straight line method. The goodwill and acquired intangible assets will not be deductible for federal tax purposes.

The following unaudited pro forma financial information summarizes the combined results of operations of the Company and Jingle and is based on the historical results of operations of the Company and Jingle. The pro forma information reflects the results of operations of the Company as if the acquisition of Jingle had taken place on January 1, 2010. The pro forma information includes adjustments for amortization of intangible assets, intercompany activity and accretion of interest expense related to the future consideration. The unaudited pro forma financial information is provided for information purposes only and is not necessarily indicative of the combined results that would have occurred had the acquisition taken place on the dates indicated, nor is it necessarily indicative of results that may occur in the future.

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	Nine months ended September 30,		Three months ended September 30,	
	2010	2011	2010	2011
Revenue	$ 80,730,908	$ 113,493,990	$ 28,313,927	$ 39,862,443
Net income (loss)	(12,906,850)	509,069	(2,648,152)	1,568,541
Net income (loss) applicable to common stockholders	(13,053,079)	317,546	(2,702,692)	1,501,756

(12) Intangible Assets from Acquisitions

Intangible assets from acquisitions consisted of the following:

	As of December 31, 2010		
	Gross Carrying Amount	Accumulated Amortization (1)	Net
Trademarks/domains	$ 41,992,305	$ (40,415,618)	$ 1,576,687
	$ 41,992,305	$ (40,415,618)	$ 1,576,687

	As of September 30, 2011		
	Gross Carrying Amount	Accumulated Amortization (1)	Net
Advertiser relationship	$ 3,070,000	$ (590,385)	$ 2,479,615
Patents	318,000	(153,016)	164,984
Distribution partner relationship	4,830,000	(774,038)	4,055,962
Non-compete agreements	58,600	(28,173)	30,427
Trademarks/domains	42,454,421	(41,495,306)	959,115
Acquired technology	2,760,000	(663,462)	2,096,538
	$ 53,491,021	$ (43,704,380)	$ 9,786,641

(1) Excludes the original cost and accumulated amortization of fully-amortized intangible assets which were $41.7 million at December 31, 2010 and September 30, 2011, respectively.

Amortizable intangible assets are amortized on a straight-line basis over their useful lives. Amortization expense incurred by the Company was approximately $704,000 and $1.7 million for the three months ended September 30, 2010 and 2011, respectively, and was $2.1 million and $3.8 million for the nine months ended September 30, 2010 and 2011, respectively. Based upon the current amount of intangible assets subject to amortization, the estimated amortization expense for the next five years is as follows: $1.7 million for the remainder of 2011, $4.7 million in 2012, $2.9 million in 2013 and $433,000 in 2014.

(13) Goodwill

Changes in the carrying amount of goodwill for the nine months ended September, 2011 are as follows:

Balance as of December 31, 2010	$ 35,337,428
Jingle acquisition	50,003,462
Other	(27,855)
Balance as of September 30, 2011	$ 85,313,035

Goodwill is tested annually for impairment and is tested for impairment more frequently if events and circumstances indicate that the goodwill is more likely than not impaired. Events and circumstances considered in determining whether the carrying value of goodwill may be impaired include, but are not limited to: significant changes in performance relative to expected operating results; significant changes in the use of the assets; significant negative industry or economic trends; or a significant decline in the Company s stock price and/or market capitalization for a sustained period of time.

No impairment of the Company s goodwill and intangible assets have been identified to date in 2011. The current business environment is subject to evolving market conditions and requires significant management judgment to interpret the potential impact to our assumptions. To the extent that changes in the current business environment impact the Company s ability to achieve levels of forecasted operating results and cash flows, or should other events occur indicating the remaining carrying value of its assets might be impaired, the Company would test its goodwill and intangible assets for impairment and may recognize an impairment loss.

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(14) Intangible and other assets, net

Intangible and other assets, net consisted of the following:

	At December 31, 2010	At September 30, 2011
Internet domain names	$ 15,683,320	$ 15,546,260
Less accumulated amortization	(13,877,115)	(14,577,135)
Internet domain names, net	1,806,205	969,125
Other assets:		
Registration fees, net	35,143	18,575
Other	228,869	327,936
Total intangibles and other assets, net	$ 2,070,217	$ 1,315,636

The Company capitalizes costs incurred to acquire domain names or URLs, which include the initial registration fees, to other intangible assets which excludes intangible assets acquired through business combinations. The capitalized costs are amortized over the expected useful life of the domain names on a straight-line basis.

The Company also capitalizes costs incurred to renew or extend the term of the domain names or URLs to prepaid expenses and other current assets or registration fees, net. The capitalized costs are amortized over the renewal or extended period on a straight-line basis. The total amount of costs incurred for the three and nine months ended September 30, 2011 to renew or extend the term for domain names was $388,000 and $1.3 million, respectively. The weighted average renewal period for registration fees as of September 30, 2011 was approximately one year.

Amortization expense for internet domain names was approximately $378,000 and $274,000 for the three months ended September 30, 2010 and 2011, respectively, and was $1.2 million and $886,000 for the nine months ended September 30, 2010 and 2011, respectively. Based upon the current amount of domains subject to amortization, the estimated expense for the next five years is as follows: $311,000 for the remainder of 2011, $443,000 in 2012, $175,000 in 2013, $40,000 in 2014 and $0 thereafter.

(15) Common Stock

In July 2011, the Company s board of directors declared a regular quarterly dividend in the amount of $0.02 per share on the Company s Class A and Class B common stock. The Company paid these dividends on August 15, 2011 to the holders of record as of the close of business on August 5, 2011. The Company paid approximately $738,000.

In November 2006, the Company s board of directors authorized a share repurchase program for the Company to repurchase up to 3 million shares of the Company s Class B common stock as well as the initiation of a quarterly cash dividend for the holders of the Class A and Class B common stock. The Company s board of directors have authorized increases to the share repurchase program for the Company to repurchase up to 11 million shares in the aggregate (less shares previously repurchased under the share repurchase program) of the Company s Class B common stock. Under the share repurchase program, repurchases may take place in the open market and in privately negotiated transactions and at times and in such amounts as the Company deems appropriate. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, capital availability, and other market conditions. This stock repurchase program does not have an expiration date and may be expanded, limited or terminated at any time without prior notice.

During the nine months ended September 30, 2011, the Company repurchased 424,000 shares of Class B common stock for approximately $3.2 million at an average stock price of $7.63 per share. The 424,000 shares have been recorded as treasury stock in the condensed consolidated balance sheet as of September 30, 2011.

During the nine months ended September 30, 2011, the Company s board of directors approved the retirement of approximately 704,000 shares of treasury stock. The excess of purchase price over par value of $4.5 million was recorded as a deduction to additional paid in capital on the condensed consolidated balance sheet.

(16) Subsequent Events

In October 2011, the Company s board of directors declared a regular quarterly dividend in the amount of $0.02 per share on the Company s Class A and Class B common stock. The Company will pay these dividends on November 15, 2011 to the holders of record as of the close of business on November 4, 2011. The Company expects to pay approximately $742,000 for these quarterly dividends.

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

This Quarterly Report on Form 10-Q contains 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. We use words such as believes , intends , expects , anticipates , plans , may , will and similar expressions to identify forward-looking statements. All forward-looking statements, including, but not limited to, statements regarding our future operating results, financial position, prospects, acquisitions and business strategy, expectations regarding our growth and the growth of the industry in which we operate, and plans and objectives of management for future operations, are inherently uncertain as they are based on our expectations and assumptions concerning future events. Any or all of our forward-looking statements in this report may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including but not limited to the risks, uncertainties and assumptions described in this report, in Part II, Item 1A. under the caption Risk Factors and elsewhere in this report and in our Annual Report on Form 10-K for the year ended December 31, 2010 and those described from time to time in our future reports filed with the SEC. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements. All forward-looking statements in this report are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement.

The following discussion and analysis provides information that we believe is relevant to an assessment and understanding of our results of operation and financial condition. You should read this analysis in conjunction with the attached condensed consolidated financial statements and related notes thereto, and with our audited consolidated financial statements and the notes thereto, included in our Annual Report on Form 10-K for the year ended December 31, 2010.

Overview

We are a call advertising and small business marketing company. We deliver call and click-based advertising products and services to tens of thousands of advertisers, ranging from small businesses to Fortune 500 companies. Our technology-based products and services facilitate the efficient and cost-effective marketing and selling of goods and services for small and national advertisers who want to market and sell their products through mobile, online and offline channels; and a proprietary, locally-focused web site network where we help consumers find local information, as well as fulfill our advertiser marketing campaigns:

Call Advertising Services. We deliver a variety of call advertising products and services to national advertisers, advertising agencies and small advertiser reseller partners. These services include pay-for-call and mobile voice search through the Marchex Pay-For-Call Exchange and Marchex Call Analytics solutions, which include phone number and call tracking, call mining, keyword-level tracking, click-to-call, web site proxying, and other call-based products which enable our customers to utilize mobile, online and offline advertising to drive calls as well as clicks into their businesses and to measure the effectiveness of their advertising campaigns. Advertisers pay us a fee for each call they receive from call-based ads we distribute through our sources of call distribution or for each phone number tracked based on a pre-negotiated rate.

Small Business Marketing Products. Our small business marketing products enable reseller partners of small business advertisers, such as Yellow Pages providers and vertical marketing service providers, to sell call advertising and/or search marketing products through their existing sales channels, which are then fulfilled by us across our distribution network, including mobile sources, leading search engines and our own proprietary traffic sources. By creating a solution for companies who have relationships with small businesses, it is easier for these small businesses to participate in mobile, online, offline call advertising. The lead services we offer to small business advertisers through our small business marketing products include products typically available only to national advertisers, including pay-for-call, call tracking, presence management ad creation, keyword selection, geo-targeting, advertising campaign management, reporting, and analytics. The small business marketing products have the capacity to support hundreds of thousands of advertiser accounts. Reseller partners and publishers generally pay us account fees and also agency fees for our products in the form of a percentage of the cost of every click or call delivered to their advertisers. Through our contract with Yellowpages.com LLC d/b/a AT&T Interactive which is a subsidiary of AT&T (collectively, AT&T), AT&T is our largest reseller partner and was responsible for 31% and 30% of our total revenues for the three and nine months ended September 30, 2011, respectively, of which the majority is derived from our small business marketing products.

Pay-Per-Click Advertising. We deliver pay-per-click advertisements to online users in response to their keyword search queries or on pages they visit throughout our distribution network of search engines, shopping engines, certain third party vertical and local web sites, mobile distribution and our own Publishing Network. In addition to distributing their ads, we offer account management services to help our advertisers optimize their pay-per-click campaigns, including editorial and keyword selection recommendations and report analysis. The pay-per-click advertisements are generally ordered based on the amount our advertisers choose to pay for a placement and the relevancy of their ads to the keyword search. Advertisers pay us when a user clicks on their advertisements in our distribution network and we pay publishers or distribution partners a percentage of the revenue generated by the click-throughs on their site(s). In addition, we generate revenue

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from cost-per-action events that take place on our distribution network. Cost-per-action revenue occurs when the user is redirected from one of our web sites or a third-party web site in our distribution network to an advertiser s web site and completes a specified action. We also offer a private-label platform for publishers, separate and distinct from our small business marketing products which enable them to monetize their web sites with contextual advertising from their own customers or from our advertising relationships. We sell pay-per-click contextual advertising placements on specialized vertical and branded publisher web sites on a pay-per-click basis. Advertisers can target the placements by category, site- or page-specific basis. We believe our site- and page-specific approach provides publishers with an opportunity to generate revenue from their traffic while protecting their brand. Our approach gives advertisers greater transparency into the source of the traffic and relevancy for their ads and enables them to optimize the return on investment from their advertising campaign. The contextual advertisement placements are generally ordered based on the amount our advertisers choose to pay for a placement and the relevance of the advertisement, based on historic click-through rates. Advertisers pay us when a user clicks on their advertisements in our network and we pay publishers a percentage of the revenue generated by the click-throughs on their site.

Publishing Network. We believe our Publishing Network is a significant source of local information online and a source of calls within the Marchex Pay-For-Call Exchange. It includes more than 200,000 of our owned and operated web sites focused on helping users make informed decisions about where to get local products and services. It features listings from more than 10 million small businesses in the U.S. and millions of expert and user-generated reviews on small businesses. The more than 200,000 web sites in our network include more than 75,000 U.S. ZIP code sites, including 98102.com and 90210.com, covering ZIP code areas nationwide, as well as tens of thousands of other locally-focused sites such as Yellow.com, OpenList.com and geo-targeted sites. Traffic to our Publisher Network is primarily monetized with pay-for-call and pay-per-click listings that are relevant to the web sites, as well as other forms of advertising, including banner advertising and sponsorships.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date.

We currently have offices in Seattle, Washington; Las Vegas, Nevada; Billerica, Massachusetts; and New York, New York.

Acquisition

On April 7, 2011, the Company acquired 100% of the stock of Jingle Networks, Inc. (Jingle) a provider of mobile voice search performance advertising and technology solutions in North America for the following consideration:

Approximately $15.8 million in cash, net of cash acquired, and 1,019,103 shares of the Company s Class B common stock paid at closing; plus

Future consideration of (i) $17.6 million, net of certain working capital adjustments on the first anniversary of the closing, and (ii) $18.0 million on the 18th month anniversary of closing, with the future consideration payable in either cash or shares of the Company s Class B common stock or some combination to be determined by Marchex. Any shares issued in payment of the future consideration will be increased by 5%.

Following the closing, we issued 462,247 shares of restricted stock at an aggregate value of approximately $3.3 million to employees of Jingle, subject to vesting for up to four years.

The fair value of the shares of Class B common stock issued as part of the consideration paid was valued at $7.6 million using the Company s closing stock price of $7.46 per share at the acquisition date. The fair value of the future consideration payments of $34.7 million, was determined using a rate of approximately 2% based on the Company s incremental borrowing rate and is recorded as current and long term deferred acquisition payments in the balance sheet.

Consolidated Statements of Operations

The assets, liabilities and operations of our acquisitions are included in our consolidated financial statements as of the date of the respective acquisitions.

All inter-company transactions and balances within Marchex have been eliminated in consolidation. Our purchase accounting resulted in all assets and liabilities from our acquisitions being recorded at their estimated fair values on the respective acquisition dates. All goodwill, intangible assets and liabilities resulting from the acquisitions have been recorded in our financial statements.

Presentation of Financial Reporting Periods

The comparative periods presented are for the three and nine months ended September 30, 2010 and 2011.

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Revenue

We currently generate revenue through our call advertising services, pay-per-click advertising, small business marketing products which include our call and click services, and publishing network.

Our primary sources of revenue are the performance-based advertising services, which include pay-for-call services, pay-per-click services, cost-per-action services and historically our feed management and related services. These primary sources amounted to greater than 75% of our revenues in all periods presented. Our secondary sources of revenue are our small business marketing products which enable partner resellers to sell call advertising and/or search marketing products, campaign management services, and natural search optimization services. These secondary sources amounted to less than 25% of our revenues in all periods presented. We have no barter transactions.

We recognize revenue upon the completion of our performance obligation, provided that: (1) evidence of an arrangement exists; (2) the arrangement fee is fixed and determinable; and (3) collection is reasonably assured.

In certain cases, we record revenue based on available and reported preliminary information from third parties. Collection on the related receivables may vary from reported information based upon third party refinement of the estimated and reported amounts owing that occurs subsequent to period ends.

Performance-Based Advertising Services

In providing call advertising services and pay-per-click advertising, we generate revenue upon our delivery of qualified and reported phone calls or click-throughs to our advertisers or advertising service providers listings. These advertisers and advertising service providers pay us a designated transaction fee for each phone call or click-through, which occurs when a user makes a phone call or clicks on any of their advertisement listings after it has been placed by us or by our distribution partners. Each phone call or click-through on an advertisement listing represents a completed transaction. The advertisement listings are displayed within our distribution network, which includes mobile and online search engines and applications, directories, destination sites, shopping engines, third-party Internet domains or web sites, our portfolio of owned web sites, other targeted Web-based content and offline sources. We also generate revenue from cost-per-action services, which occurs when the online user is redirected from one of our web sites or a third-party web site in our distribution network to an advertiser web site and completes the specified action.

We generate revenue from reseller partners and publishers utilizing our small business marketing products to sell call advertising and/or search marketing products. We are paid account fees and also agency fees for our products in the form of a percentage of the cost of every call or click delivered to advertisers. The reseller partners or publishers engage the advertisers and are the primary obligor, and we, in certain instances, are only financially liable to the publishers in our capacity as a collection agency for the amount collected from the advertisers. We recognize revenue for these fees under the net revenue recognition method. In limited arrangements resellers pay us a fee for fulfilling an advertiser s campaign in our distribution network and we act as the primary obligor. We recognize revenue for these fees under the gross revenue recognition method.

In providing pay-per-click contextual targeting services, advertisers purchase keywords or keyword strings, based on an amount they choose for a targeted placement on vertically-focused web sites or specific pages of a web site that are specific to their products or services and their marketing objectives. The contextual results distributed by our services are prioritized for users by the amount the advertiser is willing to pay each time a user clicks on the merchant s advertisement and the relevance of the merchant s advertisement, which is dictated by historical click-through rates. Advertisers pay us when a click-through occurs on their advertisement.

Search Marketing Services

Advertisers pay us additional fees for services such as campaign management and natural search engine optimization. Advertisers generally pay us on a click-through basis, although in certain cases we receive a fixed fee for delivery of these services. In some cases we also deliver banner campaigns for select advertisers. We may also charge initial set-up, account, service or inclusion fees as part of our services.

Banner advertising revenue may be based on a fixed fee per click and is generated and recognized on click-through activity. In other cases, banner payment terms are volume-based with revenue generated and recognized when impressions are delivered.

Non-refundable account set-up fees are paid by advertisers and are recognized ratably over the longer of the term of the contract or the average expected advertiser relationship period, which generally ranges from twelve months to more than two years. Other account and service fees are recognized in the month or period the account fee or services relate to.

Other inclusion fees are generally associated with monthly or annual subscription-based services where an advertiser pays a fixed amount to be included in our index of listings or our distribution partners index of listings. Revenues from these subscription arrangements are recognized ratably over the service period.

Industry and Market Factors

We enter into agreements with various mobile, online and offline distribution partners to provide distribution for pay-for-call and pay-per-click advertisement listings which contain call tracking numbers and/or URL strings of our advertisers. We generally pay distribution partners based on a percentage of revenue or a fixed amount for each phone call or per click-through on these listings. The level of phone calls and click-throughs contributed by our distribution partners has varied, and we expect it will continue to vary, from quarter to quarter and year to year, sometimes significantly. If we do not add new distribution partners, renew our current distribution partner agreements, replace traffic lost from terminated distribution agreements with other sources or if our distribution partners search businesses do not grow or are adversely affected, our revenue and results of operations may be materially and adversely affected. Our ability to grow will be impacted by our ability to increase our distribution, which impacts the number of mobile and Internet users who have access to our advertisers listings and the rate at which our advertisers are able to convert calls and clicks from these mobile and Internet users into completed transactions, such as a purchase or sign up. Our ability to grow also depends on our ability to continue to increase the number of advertisers who use our services and the amount these advertisers spend on our services.

We anticipate that these variables will fluctuate in the future, affecting our ability to grow and our financial results. In particular, it is difficult to project the number of phone calls or click-throughs we will deliver to our advertisers and how much advertisers will spend with us, and it is even more difficult to anticipate the average revenue per phone call or click-through. It is also difficult to anticipate the impact of worldwide economic conditions on advertising budgets, including due to the economic uncertainty resulting from recent disruptions in global financial markets.

In addition, we believe we will experience seasonality. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of Internet usage and seasonal purchasing cycles of many advertisers. It is generally understood that during the spring and summer months, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and results. Additionally, the current business environment has generally resulted in advertisers and reseller partners reducing advertising and marketing services budgets, which we expect will impact our quarterly results of operations in addition to the typical seasonality seen in our industry.

Service Costs

Our service costs represent the cost of providing our performance-based advertising services and our search marketing services. The service costs that we have incurred in the periods presented primarily include:

- user acquisition costs;
- amortization of intangible assets;
- license and content fees;
- credit card processing fees;
- network operations;
- serving our search results;
- telecommunication costs, including the use of phone numbers relating to our call products and services;

maintaining our Web sites;

domain name registration renewal fees;

network fees;

fees paid to outside service providers;

delivering customer service;

depreciation of our Web sites, network equipment and internally developed software;

colocation service charges of our Web site equipment;

bandwidth and software license fees;

payroll and related expenses of related personnel; and

stock-based compensation of related personnel.

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User Acquisition Costs

For the periods presented the largest component of our service costs consist of user acquisition costs that relate primarily to payments made to distribution partners for access to their online, mobile, offline, or other user traffic. We enter into agreements of varying durations with distribution partners that integrate our services into their Web sites and indexes. The primary economic structure of the distribution partner agreements is a variable payment based on a specified percentage of revenue. These variable payments are often subject to minimum payment amounts per phone call or click-through. Other payment structures that to a lesser degree exist include:

- fixed payments, based on a guaranteed minimum amount of usage delivered;
- variable payments based on a specified metric, such as number of paid phone calls or click-throughs; and
- a combination arrangement with both fixed and variable amounts that may be paid in advance.

We expense user acquisition costs based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments with minimum guaranteed amounts of usage are expensed as the greater of the pro-rata amount over the term of arrangement or the actual usage delivered to date based on the contractual revenue share. Agreements with variable payments based on a percentage of revenue, number of paid phone calls, click-throughs, or other metrics are expensed as incurred based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

Sales and Marketing

Sales and marketing expenses consist primarily of:

- payroll and related expenses for personnel engaged in marketing and sales functions;
- advertising and promotional expenditures including online and outside marketing activities;
- cost of systems used to sell to and serve advertisers; and
- stock-based compensation of related personnel.

Product Development

Product development costs consist primarily of expenses incurred in the research and development, creation and enhancement of our web sites and services.

Our research and development expenses include:

- payroll and related expenses for personnel;
- costs of computer hardware and software;

- costs incurred in developing features and functionality of the services we offer; and

- stock-based compensation of related personnel.

For the periods presented, substantially all of our product development expenses are research and development.

Product development costs are expensed as incurred or capitalized into property and equipment in accordance with FASB ASC 350. This statement requires that costs incurred in the preliminary project and post-implementation stages of an internal use software project be expensed as incurred and that certain costs incurred in the application development stage of a project be capitalized.

General and Administrative

General and administrative expenses consist primarily of:

- payroll and related expenses for executive and administrative personnel;

- professional services, including accounting, legal and insurance;

- bad debt provisions;

- facilities costs;

- other general corporate expenses; and

- stock-based compensation of related personnel.

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Stock-Based Compensation

We account for stock-based compensation under the fair value method. As a result, stock-based compensation consists of the following:

- all share-based compensation arrangements granted after January 1, 2006 (adoption date of FASB ASC 718) and for any such arrangements that are modified, cancelled, or repurchased after that date, and

- the portion of previous share-based awards for which the requisite service has not been rendered as of January 1, 2006.

Stock-based compensation expense has been included in the same lines as compensation paid to the same employees in the consolidated statement of operations.

Amortization of Intangibles from Acquisitions

Amortization of intangible assets excluding goodwill relates to intangible assets identified in connection with our acquisitions.

The intangible assets have been identified as:

- non-competition agreements;

- trade and Internet domain names;

- distributor relationships;

- customer relationships;

- advertising relationships;

- patents; and

- acquired technology.

These assets are amortized over useful lives ranging from 12 to 84 months.

Provision for Income Taxes

We utilize the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax law is recognized in results of operations in the period that includes the enactment date.

Each reporting period we must assess the likelihood that our deferred tax assets will be recovered from existing deferred tax liabilities or future taxable income, and to the extent that realization is not more likely than not, a valuation allowance must be established. The establishment of a valuation allowance and increases to such an allowance may result in either an increase to income tax expense or reduction of income tax benefit in the statement of operations. Although realization is not assured, we believe it is more likely than not, based on operating performance, existing deferred tax liabilities, projections of future taxable income and tax planning strategies, that our net deferred tax assets, excluding certain state and foreign net operating loss carryforwards, will be realized. In determining that it was more likely than not that we would realize the deferred tax assets, factors considered included: historical taxable income, historical trends related to advertiser usage rates, projected revenues and expenses, macroeconomic conditions and issues facing our industry, existing contracts, our ability to project future results and any appreciation of our other assets. The majority of our deferred tax assets are from goodwill and intangible assets recorded in connection with various acquisitions that are tax-deductible over 15 year periods. Based on projections of future taxable income and tax planning strategies, we expect to be able to recover these assets. The amount of the net deferred tax assets considered realizable, however, may be reduced in the near term from tax attributes and operating results of acquired businesses, if our projections of future taxable income are reduced or if we do not perform at the levels we are projecting. This may result in increases to the valuation allowance for deferred tax assets and may increase income tax expense of up to the entire net amount of deferred tax assets.

From time to time, various state, federal, and other jurisdictional tax authorities undertake reviews of us and our filings. We believe any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

As of September 30, 2011, we have net deferred tax assets of $47.1 million, relating primarily to the impairment of goodwill, amortization of intangibles assets, certain other temporary differences and research and development credits. Although realization is not assured, we believe it is more likely than not that our net deferred tax assets, excluding certain state and foreign net operating loss carryforwards, will be realized. As of September 30, 2011, based upon both positive and negative evidence available, we have determined it is not more likely than not that certain deferred tax assets primarily relating to net operating loss carryforwards

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in certain state and foreign jurisdictions will be realizable and accordingly, have recorded a 100% valuation allowance of $4.3 million against these deferred tax assets. We do not have a history of taxable income in the relevant jurisdictions and the state and foreign net operating loss carryforwards will more likely than not expire unutilized. Should we determine in the future that we will be able to realize these deferred tax assets, or not be able to realize all or part of our remaining net deferred tax assets recorded as of September 30, 2011, an adjustment to the net deferred tax assets would impact net income or stockholders equity in the period such determination was made.

As of September 30, 2011, excluding Jingle, we had federal net operating loss, or NOL, carryforwards of $1.7 million which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. We believe that such a change has occurred, and that approximately $1.7 million of NOL carryforwards is limited such that substantially all of these federal NOL carryforwards will never be available. Accordingly, we have not recorded a deferred tax asset for these NOL s.

In connection with the Jingle acquisition, we acquired federal net operating loss carryforwards. We believe that changes in the stock ownership of Jingle have occurred, and that the utilization of the carryforwards is limited such that the substantial majority of the NOL carryforwards will never be available. No deferred tax assets relating to these NOL carryforwards have been recorded, and the allocation of the purchase price is preliminary because we have not completed our analysis of limitations associated with these NOL carryfowards or our ability to utilize them.

Results of Operations

The following table presents certain financial data, derived from our unaudited consolidated statements of operations, as a percentage of total revenue for the periods indicated. The operating results for the three and nine months ended September 30, 2010 and 2011 and are not necessarily indicative of the results that may be expected for the full year or any future period.

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2010	2011	2010	2011
Revenue	100%	100%	100%	100%
Expenses:				
Service costs	59%	56%	60%	55%
Sales and marketing	15%	10%	13%	11%
Product development	18%	16%	17%	15%
General and administrative	18%	16%	19%	15%
Amortization of intangible assets from acquisitions	3%	3%	3%	4%
Acquisition related costs	0%	1%	0%	0%
Total operating expenses	113%	103%	113%	100%
Gain on sales and disposals of intangible assets, net	7%	7%	11%	6%
Income (loss) from operations	-7%	4%	-2%	6%
Other income (expense):				
Interest income	0%	0%	0%	0%
Interest expense	0%	0%	0%	-1%
Other	0%	0%	1%	0%