MARCHEX INC
Form 10-Q
November 10, 2008
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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**
For the quarterly period ended September 30, 2008

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.)**

413 Pine Street, Suite 500

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 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 7, 2008
Class A common stock, par value $.01 per share	10,959,216
Class B common stock, par value $.01 per share	27,517,985

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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, 2007	September 30, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 36,456,307	$ 29,088,528
Accounts receivable, net	18,307,386	19,555,766
Prepaid expenses and other current assets	2,118,390	3,357,625
Refundable taxes	1,693,695	3,717,520
Deferred tax assets	867,465	1,207,027
Total current assets	59,443,243	56,926,466
Property and equipment, net	7,357,903	6,406,618
Deferred tax assets	7,447,315	8,245,650
Intangible and other assets, net	17,381,827	14,584,907
Goodwill	204,766,826	204,785,718
Intangible assets from acquisitions, net	23,797,231	12,892,421
Total assets	$ 320,194,345	$ 303,841,780
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 11,625,779	$ 11,075,737
Accrued expenses and other current liabilities	3,668,342	6,319,468
Deferred revenue	2,906,379	2,323,834
Total current liabilities	18,200,500	19,719,039
Other non-current liabilities	105,370	42,253
Total liabilities	18,305,870	19,761,292
Commitments and contingencies		
Stockholders equity:		
Convertible preferred stock	1,446,649	964,689
Class A common stock	113,717	112,217
Class B common stock	321,061	286,655
Treasury stock	(22,116,275)	(8,526,660)
Additional paid-in capital	329,835,529	298,412,133
Accumulated deficit	(7,712,206)	(7,168,546)
Total stockholders equity	301,888,475	284,080,488
Total liabilities and stockholders equity	$ 320,194,345	$ 303,841,780

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, 2007	Nine months ended September 30, 2008	Three months ended September 30, 2007	Three months ended September 30, 2008
Revenue	$ 102,382,626	$ 111,563,744	$ 33,493,588	$ 37,157,530
Expenses:				
Service costs (1), (2)	50,821,449	51,745,487	18,815,633	15,443,871
Sales and marketing (1), (2)	19,651,548	23,330,681	5,028,698	8,462,898
Product development (1), (2)	8,563,161	13,189,709	3,302,726	4,750,136
General and administrative (1), (2)	12,791,276	15,190,526	4,552,858	5,156,542
Amortization of intangible assets from acquisitions (3)	12,604,730	10,879,203	4,007,342	3,165,566
Facility relocation	121,124			
Total operating expenses	104,553,288	114,335,606	35,707,257	36,979,013
Gain on sales and disposals of intangible assets, net	282,079	3,766,608	126,569	1,611,341
Income (loss) from operations	(1,888,583)	994,746	(2,087,100)	1,789,858
Other income (expense):				
Interest income	2,130,433	599,374	663,513	149,592
Interest and line of credit expense	(5,524)	(62,490)	(2,148)	(28,259)
Other	(3,243)	879,740		877,885
Total other income, net	2,121,666	1,416,624	661,365	999,218
Income (loss) before provision for income taxes	233,083	2,411,370	(1,425,735)	2,789,076
Income tax expense	982,077	1,824,396	95,311	1,431,120
Net income (loss)	(748,994)	586,974	(1,521,046)	1,357,956
Convertible preferred stock dividends and discount on preferred stock redemption, net	(113,039)	(32,657)	16,991	11,928
Net income (loss) applicable to common stockholders	$ (635,955)	$ 619,631	$ (1,538,037)	$ 1,346,028
Basic and diluted net income (loss) applicable to Class A and Class B common stockholders	$ (0.02)	$ 0.02	$ (0.04)	$ 0.04
Shares used to calculate basic net income (loss) per share applicable to common stockholders				
Class A	11,614,527	10,965,238	11,559,216	10,959,216
Class B	27,835,316	25,860,205	27,544,679	25,207,357
Shares used to calculate diluted net income (loss) per share applicable to common stockholders				
Class A	11,614,527	10,965,238	11,559,216	10,959,216
Class B	39,449,843	37,484,212	39,103,895	36,852,998

(1) Excludes amortization of intangible assets from acquisitions

(2) Includes stock-based compensation as follows:

Service costs	$ 302,066	$ 414,222	$ 151,790	$ 188,564

Sales and marketing		836,606		1,443,728		374,448		587,014
Product development		1,543,017		1,360,011		603,073		553,013
General and administrative		5,534,195		5,766,743		1,856,638		1,919,405
Total	$	8,215,884	$	8,984,704	$	2,985,949	$	3,247,996

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

Service costs	$	9,480,510	$	9,528,725	$	3,135,890	$	2,970,010
Sales and marketing		2,145,000		1,116,667		715,000		162,223
General and administrative		979,220		233,811		156,452		33,333
Total	$	12,604,730	$	10,879,203	$	4,007,342	$	3,165,566

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, 2007	Nine months ended September 30, 2008
Cash flows from operating activities:		
Net income (loss)	$ (748,994)	$ 586,974
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization and depreciation	19,216,650	18,446,956
Facility relocation costs	113,043	2,918
Loss (gain) on sales of fixed assets, net	3,243	(2,874)
Gain on sales and disposals of intangible assets, net	(282,079)	(3,766,608)
Allowance for doubtful accounts and advertiser credits	833,270	2,520,978
Stock-based compensation	8,215,884	8,984,704
Deferred income taxes	(3,988,557)	(1,137,897)
Excess tax benefit related to stock options	(2,462,978)	(60,263)
Change in certain assets and liabilities, net of acquisitions:		
Trade accounts receivable, net	2,411,867	(3,769,358)
Refundable taxes	1,623,819	(1,739,002)
Prepaid expenses, other current assets and restricted cash	977,551	(2,405,503)
Accounts payable	356,279	(372,277)
Accrued expenses and other current liabilities	799,611	2,677,238
Deferred revenue	510,682	(586,418)
Other non-current liabilities	(6,822)	(19,476)
Net cash provided by operating activities	27,572,469	19,360,092
Cash flows from investing activities:		
Purchases of property and equipment	(2,973,292)	(2,685,493)
Cash paid, net of recoveries, for acquisitions	(12,945,544)	(127,522)
Proceeds from sales of property and equipment	8,115	38,043
Proceeds from sales of intangible assets	686,506	3,918,889
Purchases of intangibles and changes in other non-current assets	(10,573,926)	(200,245)
Net cash (used in) provided by investing activities	(25,798,141)	943,672
Cash flows from financing activities:		
Deferred financing costs paid		(89,955)
Capital lease obligation principal payments	(14,872)	(35,173)
Excess tax benefit related to stock options	2,462,978	60,263
Preferred stock dividends payments	(56,374)	(43,314)
Repurchase of convertible preferred stock	(732,368)	(408,964)
Repurchase of Class B common stock for treasury stock	(13,592,482)	(25,719,732)
Common stock dividends payments	(2,483,456)	(2,417,063)
Proceeds from exercises of stock options	3,672,499	949,055
Proceeds from employee stock purchase plan	60,260	33,340
Net cash used in financing activities	(10,683,815)	(27,671,543)
Net decrease in cash and cash equivalents	(8,909,487)	(7,367,779)
Cash and cash equivalents at beginning of period	46,105,827	36,456,307
Cash and cash equivalents at end of period	$ 37,196,340	$ 29,088,528

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 local search and advertising company and a leading publisher of local content. The Company s search- and call-based advertising solutions enable tens of thousands of local and national advertisers to reach consumers searching for products and services through a mix of search and shopping engines, search- and call-based marketing services, publisher Web sites and the Company s own Web sites.

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, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008, or for any other period. The balance sheet at December 31, 2007 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, 2007 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. The Company s purchase accounting resulted in all assets and liabilities of acquired businesses being recorded at their estimated fair values on the acquisition dates. All significant inter-company transactions and balances have been eliminated in consolidation. Certain reclassifications have been made to the condensed consolidated financial statements in the prior year to conform to the current year presentation.

The Company s condensed consolidated financial statements presented include the condensed consolidated balance sheets as of December 31, 2007 and September 30, 2008, the condensed consolidated statements of operations for the three and nine months ended September 30, 2007 and 2008 and the condensed consolidated statements of cash flows for the nine months ended September 30, 2007 and 2008.

(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, 2007 filed with the SEC.

Recently Issued Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157), which clarifies the definition of fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. In February 2008, the FASB issued a FASB Staff Position (FSP) SFAS 157-2, *Effective Date of FASB Statement No. 157*, which delays the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Accordingly, the Company adopted the required provisions of SFAS 157 on January 1, 2008 and the remaining provisions will be adopted by the Company at the beginning of fiscal year 2009. The 2008 fiscal year adoption of the required provisions did not result in a material impact to the Company s financial statements. The remaining aspects of SFAS 157 for which the effective date was deferred under FSP SFAS 157-2 are currently being evaluated by the Company.

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* (SFAS 141R), which replaces SFAS 141. SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, liabilities assumed and any resulting goodwill in the acquiree. The pronouncement also provides for disclosures to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R will be effective for the Company on January 1, 2009. The Company is in the process of evaluating the effect that SFAS 141R will have on its financial statements.

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In April 2008, the FASB issued FSP SFAS 142-3, *Determination of the Useful Life of Intangible Assets* (FSP SFAS 142-3), which amends the factors that should be considered in developing renewal or extension assumptions used in determining the useful life of a recognized intangible asset. FSP SFAS 142-3 also adds additional disclosures to be included in financial statements. FSP SFAS 142-3 is effective for fiscal years beginning after December 15, 2008 and interim periods within those years. The Company is currently evaluating the impact, if any, that FSP SFAS 142-3 will have on its financial statements.

In June 2008, the FASB issued FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1), which addresses whether instruments granted in share-based payment transaction are participating securities prior to vesting and would need to be included in the earnings allocation in computing earnings per share under the two-class method of SFAS No. 128, *Earnings per Share.* FSP EITF 03-6-1 is effective for fiscal years beginning after December 15, 2008 and interim periods within those years. The Company is currently evaluating the impact, if any, that FSP EITF 03-6-1 will have on its financial statements.

Revenues

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

	Nine months ended September 30, 2007	Nine months ended September 30, 2008	Three months ended September 30, 2007	Three months ended September 30, 2008
Proprietary Traffic Sources	$ 38,611,137	$ 50,986,358	$ 9,971,511	$ 19,719,923
Partner and Other Revenue Sources	63,771,489	60,577,386	23,522,077	17,437,607
Total Revenue	$ 102,382,626	$ 111,563,744	$ 33,493,588	$ 37,157,530

The Company s proprietary traffic revenues are generated from the Company s portfolio of owned Web sites which are monetized with pay-per-click, cost-per-action listings and graphical ad units that are relevant to the Web sites. When an online user navigates to one of the Company s owned and operated Web sites and clicks on a particular listing or completes the specified action, the Company receives a fee.

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

(3) Stock-based Compensation Plans

Under SFAS 123R, *Share-Based Payment,* the Company recognizes stock-based compensation expense using the straight-line method for all stock awards issued after January 1, 2006.

The per share fair value of stock options granted during the three and nine months ended September 30, 2007 and 2008 was determined on the date of grant using the Black Scholes option-pricing model with the following weighted average assumptions:

	Nine months ended September 30, 2007	Nine months ended September 30, 2008	Three months ended September 30, 2007	Three months ended September 30, 2008
Expected life (in years)	4.0	4.0	4.0	4.0
Risk-free interest rate	4.15 - 4.91%	2.34%	4.15%	2.63%
Expected volatility	52%	53.6%	52%	53%
Expected dividend yield	0.6%	0.6%	0.6%	0.6%

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Stock option activity during the nine months ended September 30, 2008 is summarized as follows:

	Shares	Weighted average exercise price	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Balance at December 31, 2007	4,872,788	$ 12.94	7.61	$ 5,881,886
Options granted	1,217,250	10.32		
Options exercised	(162,465)	5.84		
Options canceled	(313,972)	16.57		
Options forfeited	(462,981)	13.72		
Balance at September 30, 2008	5,150,620	$ 12.25	6.71	$ 4,585,139

Restricted stock activity during the nine months ended September 30, 2008 is summarized as follows:

	Shares	Weighted average grant date fair value
Unvested at December 31, 2007	3,240,266	$ 12.44
Granted	163,600	10.43
Vested	(629,437)	12.16
Forfeited	(216,000)	9.51
Unvested at September 30, 2008	2,558,429	$ 12.62

The following table summarizes stock-based compensation expense related to all stock-based awards under SFAS 123R during the three and nine months ended September 30, 2007 and 2008:

	Nine months ended September 30,		Three months ended September 30,	
	2007	2008	2007	2008
Total stock-based compensation included in net income (loss)	$ 8,216,000	$ 8,985,000	$ 2,986,000	$ 3,248,000
Income tax benefit related to stock-based compensation included in net income (loss)	$ 2,148,000	$ 2,415,000	$ 755,000	$ 901,000

(4) Net Income (Loss) Per Share

We compute net income (loss) per share of Class A and Class B common stock in accordance with SFAS No. 128, *Earnings per Share* (SFAS 128) using the two class method. Under the provisions of SFAS 128, 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 year. 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 EITF 03-06, *Participating Securities and the Two Class Method under FASB Statement No. 128*, the undistributed earnings for each year are allocated based on the contractual participation rights of the Class A and Class B common shares as if the earnings for the year 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 and have been 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 earnings (losses) on a proportionate basis. Additionally, the Company has paid dividends equally to both classes of common stock since it initiated a quarterly cash dividend in November 2006.

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The following table reconciles the Company s reported net income (loss) to 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, 2007		Nine months ended September 30, 2008		Three months ended September 30, 2007		Three months ended September 30, 2008	
	Class A	Class B	Class A	Class B	Class A	Class B	Class A	Class B
Numerator:								
Allocation of net income (loss)	$ (220,513)	$ (528,481)	$ 174,779	$ 412,195	$ (449,625)	$ (1,071,421)	$ 411,489	$ 946,467
Convertible preferred stock dividends	(14,964)	(35,864)	(12,010)	(28,324)	(5,023)	(11,968)	(3,614)	(8,314)
Discount on redemption of preferred stock	48,244	115,623	21,734	51,257				
Net income (loss) applicable to common stockholders	$ (187,233)	$ (448,722)	$ 184,503	$ 435,128	$ (454,648)	$ (1,083,389)	$ 407,875	$ 938,153
Denominator:								
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	11,614,527	27,835,316	10,965,238	25,860,205	11,559,216	27,544,679	10,959,216	25,207,357
Basic net income (loss) per share applicable to common stockholders	$ (0.02)	$ (0.02)	$ 0.02	$ 0.02	$ (0.04)	$ (0.04)	$ 0.04	$ 0.04

The following table reconciles the Company s reported net income (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, 2007		Nine months ended September 30, 2008		Three months ended September 30, 2007		Three months ended September 30, 2008	
	Class A	Class B	Class A	Class B	Class A	Class B	Class A	Class B
Numerator:								
Allocation of net income (loss)	$ (220,513)	$ (528,481)	$ 174,779	$ 412,195	$ (449,625)	$ (1,071,421)	$ 411,489	$ 946,467
Convertible preferred stock dividends	(14,964)	(35,864)	(12,010)	(28,324)	(5,023)	(11,968)	(3,614)	(8,314)
Discount on redemption of preferred stock	48,244	115,623						
Convertible preferred stock dividends on redeemed preferred stock			1,912	4,509				
Reallocation of net income (loss) for Class A shares as a result of conversion of Class A to Class B shares		(187,233)		164,681		(454,648)		407,875
Net income (loss) applicable to common stockholders	$ (187,233)	$ (635,955)	$ 164,681	$ 553,061	$ (454,648)	$ (1,538,037)	$ 407,875	$ 1,346,028

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	Nine months ended September 30,				Three months ended September 30,			
	2007		2008		2007		2008	
	Class A	Class B	Class A	Class B	Class A	Class B	Class A	Class B
Denominator:								
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	11,614,527	27,835,316	10,965,238	25,860,205	11,559,216	27,544,679	10,959,216	25,207,357
Weighted average stock options and warrants and common shares subject to repurchase or cancellation				650,358				686,425
Weighted average number of shares from assumed conversion of preferred stock redeemed				8,411				
Conversion of Cl								