

Digimarc CORP
Form 10-Q
November 01, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018

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: 001-34108

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

Oregon 26-2828185
(State or other jurisdiction of (I.R.S. Employer

incorporation or organization) Identification No.)

9405 SW Gemini Drive, Beaverton, Oregon 97008

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(Address of principal executive offices) (Zip Code)

(503) 469-4800

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of October 26, 2018, there were 11,886,444 shares of the registrant's common stock, par value \$0.001 per share, outstanding.

Table of Contents

PART I FINANCIAL INFORMATION

| | |
|--|----|
| Item 1. <u>Financial Statements (Unaudited):</u> | 3 |
| <u>Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017</u> | 3 |
| <u>Consolidated Statements of Operations for the three and nine months ended September 30, 2018 and 2017</u> | 4 |
| <u>Consolidated Statements of Shareholders' Equity for the nine months ended September 30, 2018 and 2017</u> | 5 |
| <u>Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 and 2017</u> | 6 |
| <u>Notes to Consolidated Financial Statements</u> | 7 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 18 |
| Item 4. <u>Controls and Procedures</u> | 31 |

PART II OTHER INFORMATION

| | |
|--|----|
| Item 1. <u>Legal Proceedings</u> | 32 |
| Item 1A. <u>Risk Factors</u> | 32 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 32 |
| Item 6. <u>Exhibits</u> | 33 |
| <u>SIGNATURES</u> | 34 |

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.
DIGIMARC CORPORATION

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

(UNAUDITED)

| | September 30, 2018 | December 31, 2017 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 33,775 | \$ 40,823 |
| Marketable securities | 15,640 | 26,915 |
| Trade accounts receivable, net | 2,957 | 6,404 |
| Other current assets | 2,453 | 2,171 |
| Total current assets | 54,825 | 76,313 |
| Property and equipment, net | 4,096 | 4,236 |
| Intangibles, net | 6,602 | 6,381 |
| Goodwill | 1,114 | 1,114 |
| Other assets | 516 | 326 |
| Total assets | \$ 67,153 | \$ 88,370 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable and other accrued liabilities | \$ 1,576 | \$ 1,914 |
| Deferred revenue | 1,846 | 3,124 |
| Total current liabilities | 3,422 | 5,038 |
| Deferred rent and other long-term liabilities | 887 | 985 |
| Total liabilities | 4,309 | 6,023 |
| Commitments and contingencies (Note 12) | | |
| Shareholders' equity: | | |
| Preferred stock (par value \$0.001 per share, 2,500 authorized, 10 shares | | |
| issued and outstanding at September 30, 2018 and December 31, 2017) | 50 | 50 |
| Common stock (par value \$0.001 per share, 50,000 authorized, 11,888 and | | |
| 11,651 shares issued and outstanding at September 30, 2018 and December 31, | | |
| 2017, | | |
| respectively) | 12 | 12 |

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| | | |
|--|-----------|-----------|
| Additional paid-in capital | 160,643 | 155,793 |
| Accumulated deficit | (97,861) | (73,508) |
| Total shareholders' equity | 62,844 | 82,347 |
| Total liabilities and shareholders' equity | \$ 67,153 | \$ 88,370 |

The accompanying notes are an integral part of these consolidated financial statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(UNAUDITED)

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|--|---|---|--|--|
| Revenue: | | | | |
| Service | \$ 2,787 | \$ 2,986 | \$ 9,630 | \$ 9,935 |
| Subscription | 1,532 | 1,306 | 4,554 | 4,171 |
| License | 595 | 4,385 | 1,781 | 6,249 |
| Total revenue | 4,914 | 8,677 | 15,965 | 20,355 |
| Cost of revenue: | | | | |
| Service | 1,301 | 1,332 | 4,412 | 4,431 |
| Subscription | 480 | 611 | 1,470 | 1,701 |
| License | 154 | 129 | 443 | 369 |
| Total cost of revenue | 1,935 | 2,072 | 6,325 | 6,501 |
| Gross profit | 2,979 | 6,605 | 9,640 | 13,854 |
| Operating expenses: | | | | |
| Sales and marketing | 4,741 | 4,075 | 14,385 | 12,064 |
| Research, development and engineering | 4,069 | 4,108 | 12,074 | 11,503 |
| General and administrative | 2,447 | 2,442 | 7,495 | 7,066 |
| Intellectual property | 328 | 387 | 948 | 1,124 |
| Total operating expenses | 11,585 | 11,012 | 34,902 | 31,757 |
| Operating loss | (8,606) | (4,407) | (25,262) | (17,903) |
| Other income, net | 273 | 174 | 799 | 408 |
| Loss before income taxes | (8,333) | (4,233) | (24,463) | (17,495) |
| Benefit (provision) for income taxes | (9) | (7) | (29) | 94 |
| Net loss | \$ (8,342) | \$ (4,240) | \$ (24,492) | \$ (17,401) |
| Earnings (loss) per common share: | | | | |
| Loss per common share — basic | \$ (0.73) | \$ (0.39) | \$ (2.16) | \$ (1.67) |
| Loss per common share — diluted | \$ (0.73) | \$ (0.39) | \$ (2.16) | \$ (1.67) |
| Weighted average common shares outstanding — basic | 11,394 | 10,797 | 11,333 | 10,410 |
| Weighted average common shares outstanding — diluted | 11,394 | 10,797 | 11,333 | 10,410 |

The accompanying notes are an integral part of these consolidated financial statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands)

(UNAUDITED)

| | Preferred | | Common Stock | | Additional | Accumulated | Total |
|---|-----------|--------|--------------|--------|-----------------|--------------|----------------------|
| | Shares | Amount | Shares | Amount | Paid-in Capital | Deficit | Shareholders' Equity |
| BALANCE AT DECEMBER 31, 2016 | 10 | \$ 50 | 10,523 | \$ 11 | \$ 120,985 | \$ (47,712) | \$ 73,334 |
| Issuance of common stock, net of issuance costs | — | — | 500 | — | 17,698 | — | 17,698 |
| Exercise of stock options | — | — | 74 | — | 793 | — | 793 |
| Issuance of restricted common stock | — | — | 308 | — | — | — | — |
| Forfeiture of restricted common stock | — | — | (8) | — | — | — | — |
| Purchase and retirement of common stock | — | — | (73) | — | (2,063) | — | (2,063) |
| Stock-based compensation | — | — | — | — | 5,048 | (25) | 5,023 |
| Net loss | — | — | — | — | — | (17,401) | (17,401) |
| BALANCE AT SEPTEMBER 30, 2017 | 10 | \$ 50 | 11,324 | \$ 11 | \$ 142,461 | \$ (65,138) | \$ 77,384 |
| BALANCE AT DECEMBER 31, 2017 | 10 | \$ 50 | 11,651 | \$ 12 | \$ 155,793 | \$ (73,508) | \$ 82,347 |
| Exercise of stock options | — | — | 82 | — | 1,064 | — | 1,064 |
| Issuance of restricted common stock | — | — | 233 | — | — | — | — |
| Forfeiture of restricted common stock | — | — | (20) | — | — | — | — |
| Purchase and retirement of common stock | — | — | (58) | — | (1,689) | — | (1,689) |
| Stock-based compensation | — | — | — | — | 5,475 | — | 5,475 |
| Cumulative effect of the adoption of the new revenue standard, net of tax | — | — | — | — | — | 139 | 139 |
| Net loss | — | — | — | — | — | (24,492) | (24,492) |
| BALANCE AT SEPTEMBER 30, 2018 | 10 | \$ 50 | 11,888 | \$ 12 | \$ 160,643 | \$ (97,861) | \$ 62,844 |

The accompanying notes are an integral part of these consolidated financial statements.

DIGIMARC CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(UNAUDITED)

| | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|--|--|--|
| Cash flows from operating activities: | | |
| Net loss | \$ (24,492) | \$ (17,401) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation, amortization and write-off of property and equipment | 1,167 | 1,024 |
| Amortization and write-off of intangibles | 437 | 775 |
| Stock-based compensation | 5,345 | 4,872 |
| Changes in operating assets and liabilities: | | |
| Trade accounts receivable | 3,447 | (1,952) |
| Other current assets | (261) | (482) |
| Other assets | (148) | 20 |
| Accounts payable and other accrued liabilities | (374) | 373 |
| Deferred revenue | (1,225) | (1,247) |
| Net cash used in operating activities | (16,104) | (14,018) |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (1,023) | (1,424) |
| Capitalized patent costs | (571) | (625) |
| Maturity of marketable securities | 30,179 | 41,231 |
| Purchase of marketable securities | (18,904) | (27,631) |
| Net cash provided by investing activities | 9,681 | 11,551 |
| Cash flows from financing activities: | | |
| Issuance of common stock, net of issuance costs | — | 17,698 |
| Exercise of stock options | 1,064 | 793 |
| Purchase of common stock | (1,689) | (2,063) |
| Net cash provided by (used in) financing activities | (625) | 16,428 |
| Net increase (decrease) in cash and cash equivalents | (7,048) | 13,961 |
| Cash and cash equivalents at beginning of period | 40,823 | 11,638 |
| Cash and cash equivalents at end of period | \$ 33,775 | \$ 25,599 |
| Supplemental disclosure of cash flow information: | | |
| Cash received (paid) for income taxes, net | \$ 92 | \$ (29) |
| Supplemental schedule of non-cash investing activities: | | |
| Property and equipment and patent costs in accounts payable | \$ (39) | \$ 249 |
| Stock-based compensation capitalized to software and patent costs | \$ 130 | \$ 151 |

The accompanying notes are an integral part of these consolidated financial statements.

6

DIGIMARC CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data)

(UNAUDITED)

1. Description of Business and Significant Accounting Policies

Description of Business

Digimarc Corporation (“Digimarc” or the “Company”), an Oregon corporation, enables governments, banks and businesses around the world to automatically and reliably identify and interact with virtually any media. The Company has pioneered the Digimarc Intuitive Computing Platform (ICP), a comprehensive set of technologies for identifying, discovering and interacting with digitally-enhanced media. The platform includes Digimarc Barcode, a proprietary method for imperceptibly enhancing packaging, print, images, thermal labels, audio and other objects with data that is detected by enabled devices, such as smart phones, computers, barcode scanners and machine-vision equipment. Digimarc Discover software enables an ecosystem of connected devices to easily identify content or materials and deliver information.

Interim Consolidated Financial Statements

Our significant accounting policies are detailed in "Note 1: Description of Business and Summary of Significant Accounting Policies" of our Annual Report on Form 10-K for the year ended December 31, 2017. Significant changes to our accounting policies as a result of adopting Accounting Standards Codification (“ASC”) 606, “Revenue from Contracts with Customers,” effective January 1, 2018, are discussed in Note 3 below.

The accompanying interim consolidated financial statements have been prepared from the Company’s records without audit and, in management’s opinion, include all adjustments (consisting of only normal recurring adjustments) necessary to fairly reflect the financial condition and the results of operations for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) have been condensed or omitted in accordance with the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”).

These interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, which was filed with the SEC on February 22, 2018. The results of operations for the interim periods presented in these consolidated financial statements are not necessarily indicative of the results for the full year.

Reclassifications

Certain prior period amounts in the accompanying consolidated financial statements and notes thereto have been reclassified to conform to current period presentation. These reclassifications had no material effect on the results of operations or financial position for any period presented.

Contingencies

The Company evaluates all pending or threatened contingencies or commitments, if any, that are reasonably likely to have a material adverse effect on the Company's operations or financial position. The Company assesses the probability of an adverse outcome and determines if it is remote, reasonably possible or probable as defined in accordance with the provisions of ASC 450, "Contingencies." If information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then the loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to ASC 450 are not met, but the probability of an adverse outcome is at least reasonably possible, the Company will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

Goodwill

The Company tests goodwill for impairment annually in June and whenever events or changes in circumstances indicate that the carrying value may exceed the fair value. The Company operates as a single reporting unit. The Company estimated the fair value of its single reporting unit using a market approach, which takes into account the Company's market capitalization plus an estimated control premium.

Accounting Pronouncements Adopted

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” ASU No. 2014-09 provides specific guidance to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU replaces most existing revenue recognition guidance in U.S. GAAP. In August 2015, the FASB issued ASU No. 2015-14 to defer the effective date of the new revenue standard for public entities by one-year to annual reporting periods beginning after December 31, 2017, and interim periods beginning in the first interim period within the year of adoption. The guidance permits the use of either the retrospective or cumulative effect transition method. The Company adopted the new standard on January 1, 2018 and elected to use the cumulative effect transition method. Upon adoption, the Company recorded a \$139 increase to opening retained earnings to reflect the impact of adopting the new standard using the cumulative effect transition method. The adoption of the standard did not have a material impact on the Company’s financial condition, results of operations and cash flows.

Accounting Pronouncements Issued But Not Yet Adopted

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842),” which supersedes Topic 840, Leases. ASU No. 2016-02 increases the transparency and comparability of organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This guidance requires that operating leases recognize a right-of-use asset and a lease liability measured at the present value of the lease payments in the statement of financial position, recognize a single lease cost allocated over the lease term on a straight-line basis, and classify all cash payments within operating activities in the statement of cash flows. The amendments in this update are effective for fiscal years beginning after December 31, 2018, and interim periods beginning in the first interim period within the year of adoption. Early adoption is permitted. In July 2018, the FASB issued ASU No. 2018-11, “Leases (Topic 842) Targeted Improvements,” to provide a transition election to not restate comparative periods for the effects of applying the new standard. This transition election permits entities to change the date of initial application to the beginning of the year of adoption and to recognize the effects of applying the new standard as a cumulative-effect adjustment to the opening balance of retained earnings. The Company expects to elect this transition approach and recognize the cumulative impact of adoption in the opening balance of retained earnings as of January 1, 2019. The Company expects the adoption of this standard will have a material impact on its balance sheet as it records its minimum commitments under non-cancelable operating leases on its consolidated balance sheets, resulting in the recording of right of use assets and lease obligations. The Company’s minimum commitments under non-cancelable operating leases are disclosed in Note 7 in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

2. Fair Value of Financial Instruments

The estimated fair values of the Company’s financial instruments, which include cash equivalents, accounts receivable, accounts payable and other accrued liabilities approximate their carrying values due to the short-term nature of these instruments. The Company records marketable securities at amortized cost, which approximates fair value.

The Company’s fair value hierarchy for its cash equivalents and marketable securities as of September 30, 2018 and December 31, 2017, respectively, was as follows:

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| September 30, 2018 | Level | | Level | | Total |
|-------------------------|--------|----------|-------|--------|----------|
| | 1 | Level 2 | 3 | | |
| Money market securities | \$ 813 | \$— | \$ | — | \$813 |
| Commercial paper | — | 36,094 | — | 36,094 | |
| Corporate notes | — | 8,851 | — | 8,851 | |
| Federal agency notes | — | 2,010 | — | 2,010 | |
| U.S. treasuries | — | 1,004 | — | 1,004 | |
| Total | \$ 813 | \$47,959 | \$ | — | \$48,772 |

| December 31, 2017 | Level | | Level | | Total |
|-------------------------|---------|----------|-------|--------|----------|
| | 1 | Level 2 | 3 | | |
| Money market securities | \$2,197 | \$— | \$ | — | \$2,197 |
| Commercial paper | — | 49,834 | — | 49,834 | |
| Federal agency notes | — | 10,715 | — | 10,715 | |
| U.S. treasuries | — | 1,996 | — | 1,996 | |
| Corporate notes | — | 1,934 | — | 1,934 | |
| Total | \$2,197 | \$64,479 | \$ | — | \$66,676 |

The fair value maturities of the Company’s cash equivalents and marketable securities as of September 30, 2018 are as follows:

| | Maturities by Period | | | | |
|--|----------------------|------------------|-------------|--------------|--------------------|
| | Total | Less than 1 year | 1 - 5 years | 5 - 10 years | More than 10 years |
| Cash equivalents and marketable securities | \$48,772 | \$ 48,772 | \$ — | \$ — | \$ — |

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include commercial paper and money market funds totaling \$33,132 and \$39,761 at September 30, 2018 and December 31, 2017, respectively. Cash equivalents are carried at cost or amortized cost, which approximates fair value.

3. Revenue Recognition

The Company adopted ASC 606 “Revenue from Contracts with Customers” using the cumulative effect method with a date of initial application of January 1, 2018. Therefore, the comparative period information has not been adjusted and continues to be reported under ASC 605 “Revenue Recognition” and ASC 985 “Software.”

ASC 606

Effective January 1, 2018, revenue is recognized in accordance with ASC 606 by applying the following steps:

- Step 1: Identify the contract(s) with a customer.
- Step 2: Identify the performance obligations in the contract.
- Step 3: Determine the transaction price.
- Step 4: Allocate the transaction price to the performance obligations in the contract.
- Step 5: Recognize when (or as) the entity satisfies a performance obligation.

The Company derives its revenue primarily from professional services, subscriptions and licensing of its intellectual property. Applicable revenue recognition criteria are considered separately for each performance obligation as follows:

Service revenue consists primarily of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements. Revenue for development and consulting services is recognized as the services are performed. Billing for services rendered generally occurs within one month after the services are provided.

Subscription revenue includes revenue derived from the sale of Digimarc Discover, Digimarc Barcode and Digimarc Guardian products and services, is generally recurring, paid in advance and recognized over the term of the

subscription, which is generally one to three years.

License revenue originates primarily from licensing the Company's intellectual property where the Company receives license fees and/or royalties as its income stream. License fees are recognized when the customer has the right to the intellectual property and the license period has begun and royalties are recognized in the quarter in which the royalty was earned.

Some customer arrangements contain multiple performance obligations such as professional services, software licenses, and maintenance and support fees. The Company accounts for individual products and services separately if they are distinct. The consideration is allocated between distinct products and services based on their stand-alone selling prices. For items that are not sold separately, the Company estimates the standalone selling price based on reasonably available information, including market conditions, specific factors affecting the Company, and information about the customer.

ASC 605 and ASC 985

For the comparative periods, revenue was recognized under ASC 605 and ASC 985 when the following four criteria were met:

- (i) persuasive evidence of an arrangement exists,
- (ii) delivery has occurred,

9

- (iii) the fee is fixed or determinable, and
- (iv) collection is reasonably assured or probable.

All revenue recognized in the Consolidated Statements of Operations is considered to be revenue from contracts with customers.

The following table provides information about disaggregated revenue by major product line in the Company's single reporting segment:

| | Three Months Ended September 30, 2018 | Nine Months Ended September 30, 2018 |
|--|---|--|
| Service | \$ 2,787 | \$ 9,630 |
| Subscription | | |
| Digimarc Guardian | 904 | 2,781 |
| Digimarc Discover and Digimarc Barcode | 628 | 1,773 |
| License | 595 | 1,781 |
| Total | \$ 4,914 | \$ 15,965 |

The Company has contract assets from contracts with customers that are classified as "trade accounts receivable." Financial information about trade accounts receivable is included in Note 8.

The Company has contract liabilities from contracts with customers that are classified as "deferred revenue." Deferred revenue consists of billings in advance for professional services, subscriptions and licenses for which the performance obligation has not been satisfied.

The following table provides information about contract liabilities from contracts with customers:

| | September 30, 2018 | December 31, 2017 |
|-----------------------------|-----------------------|----------------------|
| Deferred revenue, current | \$ 1,846 | \$ 3,124 |
| Deferred revenue, long term | 19 | 42 |
| Total | \$ 1,865 | \$ 3,166 |

In addition to deferred revenue, the Company has backlog of \$30,468 representing the transaction price from contractual obligations that are unsatisfied or partially unsatisfied as of September 30, 2018.

4. Segment Information

Geographic Information

The Company derives its revenue from a single reporting segment: media management solutions. Revenue is generated in this segment through development services, subscriptions and licensing of intellectual property. The Company markets its products in the United States ("U.S.") and in non-U.S. countries through its sales and licensing personnel and channel partners.

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Revenue by geographic area, based upon the “bill-to” location, was as follows:

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|-------------------|---|---|--|--|
| Domestic | \$ 1,387 | \$ 1,153 | \$ 4,127 | \$ 3,907 |
| International (1) | 3,527 | 7,524 | 11,838 | 16,448 |
| Total | \$ 4,914 | \$ 8,677 | \$ 15,965 | \$ 20,355 |

(1) Revenue from the Central Banks, consisting of a consortium of central banks around the world, is classified as international revenue. Reporting revenue by country for this customer is not practicable.

10

Major Customers

The following customers accounted for 10% or more of revenue:

| | Three Months Ended September 30, 2018 | | Three Months Ended September 30, 2017 | | Nine Months Ended September 30, 2018 | | Nine Months Ended September 30, 2017 | |
|---------------|---|---|---|---|--|---|--|---|
| Central Banks | 62 | % | 38 | % | 65 | % | 52 | % |
| Customer B | 0 | % | 44 | % | 0 | % | 22 | % |

Long-lived assets by geographical area

The Company's long-lived assets are all domestic, domiciled in the U.S.

5. Stock-Based Compensation

Stock-based compensation includes expense charges for all stock-based awards to employees and directors. These awards include stock option grants and restricted stock awards.

Stock-based compensation expense related to internal labor is capitalized to software and patent costs based on direct labor hours charged to capitalized software and patent costs.

Determining Fair Value

Stock Options

Valuation and Amortization Method. The Company estimates the fair value of stock options on the date of grant (measurement date) using the Black-Scholes option valuation model. The Company amortizes the fair value of all awards on a straight-line basis over the requisite service periods, which are generally the vesting periods.

Expected Life. The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms and vesting schedules of the awards. Stock options granted generally vest over three years and have contractual terms of ten years.

Expected Volatility. The Company estimates the volatility of its common stock at the date of grant based on the historical volatility of its common stock based on historical prices over the most recent period commensurate with the expected life of the award.

Risk-Free Interest Rate. The Company determines the risk-free interest rate using current U.S. treasury yields for bonds with a maturity commensurate with the expected life of the award.

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Expected Dividend Yield. The expected dividend yield is derived by the Company's expected annual dividend rate over the expected term divided by the fair value of the Company's common stock at the grant date.

Stock options valuation assumptions:

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|-------------------------|---|---|--|--|
| Expected life (years) | 4.50 | 4.50 | 4.50 | 4.50 |
| Expected volatility | 57.11 | % 57.24 | % 57.11 | % 57.24 |
| Risk-free interest rate | 2.77 | % 1.77 | % 2.77 | % 1.77 |
| Expected dividend yield | 0 | % 0 | % 0 | % 0 |

Restricted Stock

The fair value of restricted stock awarded is based on the fair market value of the Company's common stock on the date of the grant (measurement date), and is recognized over the vesting period of the award using the straight-line method. Restricted stock awards granted generally vest over three to four years for employee grants and one to three years for director grants.

Stock-based Compensation

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|--|---|---|--|--|
| Stock-based compensation: | | | | |
| Cost of revenue | \$ 134 | \$ 170 | \$ 456 | \$ 521 |
| Sales and marketing | 442 | 364 | 1,198 | 1,074 |
| Research, development and engineering | 367 | 379 | 1,015 | 1,041 |
| General and administrative | 846 | 784 | 2,461 | 1,994 |
| Intellectual property | 76 | 82 | 215 | 242 |
| Stock-based compensation expense | 1,865 | 1,779 | 5,345 | 4,872 |
| Capitalized to software and patent costs | 37 | 53 | 130 | 151 |
| Total stock-based compensation | \$ 1,902 | \$ 1,832 | \$ 5,475 | \$ 5,023 |

The following table sets forth total unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans:

| | As of September 30, 2018 | As of December 31, 2017 |
|---------------------------------------|--------------------------------|-------------------------------|
| Total unrecognized compensation costs | \$ 16,034 | \$ 13,669 |

Total unrecognized compensation costs will be adjusted for any future forfeitures if and when they occur.

The Company expects to recognize the total unrecognized compensation costs as of September 30, 2018 for stock options and restricted stock over weighted average periods through September 2022 as follows:

| | Stock Options | Restricted Stock |
|-------------------------|------------------|---------------------|
| Weighted average period | 1.34 years | 1.45 years |

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As of September 30, 2018, under all of the Company's stock-based compensation plans, equity awards to purchase an additional 1,678 shares were authorized for future grants under the plans. The Company issues new shares upon option exercises.

Stock Option Activity

The following table reconciles the outstanding balance of stock options:

| Three months ended September 30, 2018: | Options | Weighted Average Exercise Price | Weighted Average Date Fair Value | Aggregate Grant Intrinsic Value |
|--|---------|--|---|--|
| Outstanding at June 30, 2018 | 443 | \$ 27.13 | \$ 12.37 | |
| Granted | 100 | 29.55 | 14.46 | |
| Exercised | (10) | 14.99 | 8.12 | |
| Forfeited or expired | — | — | — | |
| Outstanding at September 30, 2018 | 533 | \$ 27.81 | \$ 12.84 | \$ 1,938 |

12

| | Options | Weighted Average Exercise Price | Weighted Average Grant Date Fair Value | Aggregate Intrinsic Value |
|---------------------------------------|---------|--|--|---------------------------------|
| Nine months ended September 30, 2018: | | | | |
| Outstanding at December 31, 2017 | 515 | \$ 25.13 | \$ 11.64 | |
| Granted | 100 | 29.55 | 14.46 | |
| Exercised | (82) | 13.05 | 7.26 | |
| Forfeited or expired | — | — | — | |
| Outstanding at September 30, 2018 | 533 | \$ 27.81 | \$ 12.84 | \$ 1,938 |
| Exercisable at September 30, 2018 | 300 | \$ 26.04 | | \$ 1,621 |
| Unvested at September 30, 2018 | 233 | \$ 30.09 | | \$ 317 |

The aggregate intrinsic value is based on the closing price of \$31.45 per share of Digimarc common stock on September 30, 2018, which would have been received by the optionees had all of the options with exercise prices less than \$31.45 per share been exercised on that date.

Restricted Stock Activity

The following table reconciles the unvested balance of restricted stock:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|--|---------------------|---|
| Three months ended September 30, 2018: | | |
| Unvested balance, June 30, 2018 | 505 | \$ 29.02 |
| Granted | 23 | \$ 28.80 |
| Vested | (50) | \$ 28.86 |
| Forfeited | (1) | \$ 29.92 |
| Unvested balance, September 30, 2018 | 477 | \$ 29.03 |

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---------------------------------------|---------------------|---|
| Nine months ended September 30, 2018: | | |
| Unvested balance, December 31, 2017 | 426 | \$ 28.44 |
| Granted | 233 | \$ 29.97 |
| Vested | (162) | \$ 28.85 |
| Forfeited | (20) | \$ 28.92 |
| Unvested balance, September 30, 2018 | 477 | \$ 29.03 |

The following table indicates the fair value of all restricted stock awards that vested during the three and nine months ended September 30, 2018 and 2017:

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|--|---|---|--|--|
| Fair value of restricted stock awards vested | \$ 1,432 | \$ 1,669 | \$ 4,704 | \$ 5,160 |

6. Shareholders' Equity

In June 2017, the Company sold 500 shares of its common stock in a registered direct offering to a certain investor at a price of \$35.55 per share. The offering was made without an underwriter or placement agent. The Company received \$17,775 of cash proceeds from the offering, and paid \$72 in stock issuance costs.

In November 2017, the Company sold 331 shares of its common stock in a registered direct offering to a certain investor at a price of \$36.25 per share. The offering was made without an underwriter or placement agent. The Company received \$12,000 of cash proceeds from the offering, and paid \$21 in stock issuance costs.

7. Earnings Per Common Share

The Company calculates basic and diluted earnings per common share in accordance with ASC 260 "Earnings Per Share," using the two-class method because the Company's unvested restricted stock is a participating security since these awards contain non-forfeitable rights to receive dividends. Under the two-class method, earnings are allocated to each class of common stock and participating security as if all of the earnings for the period had been distributed.

Basic earnings per common share excludes dilution and is calculated by dividing earnings to common shares by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share is calculated by dividing earnings to common shares by the weighted-average number of common shares, as adjusted for the potentially dilutive effect of stock options.

The following table reconciles earnings (loss) per common share for the three and nine months ended September 30, 2018 and 2017:

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|--|---|---|--|--|
| Basic Earnings (Loss) per Common Share: | | | | |
| Numerator: | | | | |
| Net loss | \$ (8,342) | \$ (4,240) | \$ (24,492) | \$ (17,401) |
| Distributed earnings to common shares | — | — | — | — |
| Distributed earnings to participating securities | — | — | — | — |
| Total distributed earnings | — | — | — | — |
| Undistributed loss allocable to common shares | (8,342) | (4,240) | (24,492) | (17,401) |
| Undistributed earnings allocable to participating securities | — | — | — | — |
| Total undistributed loss | (8,342) | (4,240) | (24,492) | (17,401) |
| Loss to common shares — basic | \$ (8,342) | \$ (4,240) | \$ (24,492) | \$ (17,401) |
| Denominator | | | | |
| Weighted average common shares outstanding — basic | 11,394 | 10,797 | 11,333 | 10,410 |
| Basic earnings (loss) per common share | \$ (0.73) | \$ (0.39) | \$ (2.16) | \$ (1.67) |

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| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|--|---|---|--|--|
| Diluted Earnings (Loss) per Common Share: | | | | |
| Numerator: | | | | |
| Loss to common shares — basic | \$ (8,342) | \$ (4,240) | \$ (24,492) | \$ (17,401) |
| Undistributed earnings allocated to participating securities | — | — | — | — |
| Undistributed earnings reallocated to participating securities | — | — | — | — |
| Loss to common shares — diluted | \$ (8,342) | \$ (4,240) | \$ (24,492) | \$ (17,401) |
| Denominator | | | | |
| Weighted average common shares outstanding — basic | 11,394 | 10,797 | 11,333 | 10,410 |
| Dilutive effect of stock options | — | — | — | — |
| Weighted average common shares outstanding — diluted | 11,394 | 10,797 | 11,333 | 10,410 |
| Diluted earnings (loss) per common share | \$ (0.73) | \$ (0.39) | \$ (2.16) | \$ (1.67) |

14

There were 375 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share calculations for each of the three and nine months ended September 30, 2018, because their exercise prices were higher than the average market price of the underlying common stock for the periods.

There were 0 and 275 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share for the three and nine months ended September 30, 2017, respectively, because their exercise prices were higher than the average market price of the underlying common stock for the periods.

There were no common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share calculations for each of the three and nine months ended September 30, 2018, because the Company incurred a net loss for the periods.

There were 71 and 107 common stock equivalents related to stock options that were anti-dilutive and excluded from diluted earnings per common share calculations for the three and nine months ended September 30, 2017, respectively, because the Company incurred a net loss for the periods.

8. Trade Accounts Receivable

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount.

| | September 30, 2018 | December 31, 2017 |
|--|-----------------------|----------------------|
| Trade accounts receivable | \$ 2,972 | \$ 6,419 |
| Allowance for doubtful accounts | (15) | (15) |
| Trade accounts receivable, net | \$ 2,957 | \$ 6,404 |
| Unpaid deferred revenue included in trade accounts receivable | \$ 613 | \$ 2,217 |

Allowance for doubtful accounts

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing trade accounts receivable. The Company determines the allowance based on historical write-off experience and current information. The Company reviews its allowance for doubtful accounts each reporting period. Account balances are charged against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote.

Unpaid deferred revenue

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The unpaid deferred revenue that is included in trade accounts receivable is billed in accordance with the provisions of the contracts with the Company's customers. Unpaid deferred revenue from the Company's cash-basis customers is not included in trade accounts receivable nor deferred revenue.

Major customers

The following customers accounted for 10% or more of trade accounts receivable, net:

| | September 30, 2018 | | December 31, 2017 | |
|---------------|-----------------------|---|----------------------|---|
| Central Banks | 59 | % | 47 | % |
| Customer B | 0 | % | 27 | % |

9. Property and Equipment

Property and equipment are stated at cost. Repairs and maintenance are charged to expense when incurred.

Depreciation on property and equipment is calculated using the straight-line method over the estimated useful lives of the assets, generally two to ten years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life or the lease term.

| | September 30, 2018 | December 31, 2017 |
|--|-----------------------|----------------------|
| Office furniture and fixtures | \$ 1,569 | \$ 1,551 |
| Software | 3,562 | 3,068 |
| Equipment | 4,766 | 4,390 |
| Leasehold improvements | 1,721 | 1,720 |
| Gross property and equipment | 11,618 | 10,729 |
| Less accumulated depreciation and amortization | (7,522) | (6,493) |
| Property and equipment, net | \$ 4,096 | \$ 4,236 |

10. Intangibles

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. No impairment charges were recorded for the nine months ended September 30, 2018 and 2017.

Amortization of capitalized patent costs associated with the application and award of patents in the U.S. and various other countries are capitalized and amortized on a straight-line basis over the term of the patents as determined at the award date, which varies depending on the pendency period of the application, generally approximating seventeen years.

Amortization of intangible assets acquired is calculated using the straight-line method over the estimated useful lives of the assets.

| | Estimated Life (years) | September 30, 2018 | December 31, 2017 |
|---|---------------------------|-----------------------|----------------------|
| Capitalized patent costs | 17-20 | \$ 8,577 | \$ 7,978 |
| Intangible assets acquired: | | | |
| Purchased patents and intellectual property | 3-10 | 250 | 250 |
| Existing technology | 5 | 1,560 | 1,560 |
| Customer relationships | 7 | 290 | 290 |
| Backlog | 2 | 760 | 760 |
| Tradenames | 3 | 290 | 290 |
| Non-solicitation agreements | 1 | 120 | 120 |
| Gross intangible assets | | 11,847 | 11,248 |
| Accumulated amortization | | (5,245) | (4,867) |
| Intangibles, net | | \$ 6,602 | \$ 6,381 |

11. Income Taxes

The benefit (provision) for income taxes for the nine months ended September 30, 2018 and 2017 reflects current taxes, deferred taxes, and withholding taxes. The effective tax rates for the nine months ended September 30, 2018 and 2017 were 0% and 1%, respectively. The valuation allowance against net deferred tax assets as of September 30, 2018 was \$40,597, an increase of \$8,272 from \$32,325 as of December 31, 2017.

The Company adopted the provisions of ASU No. 2016-09, "Compensation – Stock Compensation (Topic 718)," effective January 1, 2017. Deferred tax assets of \$6,219 were recorded for previously unrecognized excess tax benefits as of December 31, 2016, which were offset by \$6,219 of valuation allowance. Excess tax benefits of \$51 and \$762 were recognized in the provision for income taxes for the three and nine months ended September 30, 2018, respectively, which were offset by \$51 and \$762 of valuation allowance, respectively. Excess tax benefits of \$296 and \$1,397 were recognized in the provision for income taxes for the three and nine months ended September 30, 2017, respectively, which were offset by \$296 and \$1,397 of valuation allowance, respectively.

The U.S. enacted tax reform legislation on December 22, 2017 commonly known as the Tax Cuts and Jobs Act, (“the Act”), resulting in significant modifications to existing U.S. tax law. The provisions of the Act effective in 2018 have been recorded as applicable as of September 30, 2018.

12. Commitments and Contingencies

Certain of the Company’s product license and services agreements include an indemnification provision for claims from third parties relating to the Company’s intellectual property. Such indemnification provisions are accounted for in accordance with ASC 450 “Contingencies.” To date, there have been no claims made under such indemnification provisions.

The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business. At this time, the Company does not believe that the resolution of any such matters will have a material adverse effect on its financial position, results of operations or cash flows.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements relating to future events or the future financial performance of Digimarc that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements. Please see the discussion regarding forward-looking statements included in this Quarterly Report on Form 10-Q under the caption "Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995."

The following discussion should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Quarterly Report on Form 10-Q. Readers are also urged to carefully review and consider the disclosures made in Part II, Item 1A (Risk Factors) of this Quarterly Report on Form 10-Q and in the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2017 filed on February 22, 2018 (our "2017 Annual Report"), and other reports and filings we have made with the U.S. Securities and Exchange Commission ("SEC").

Unless the context otherwise requires, references in this Quarterly Report on Form 10-Q to "Company," "Digimarc," "we," "our" and "us" refer to Digimarc Corporation.

All dollar amounts are in thousands except per share amounts or unless otherwise noted. Percentages within the following tables included in this section may not sum to 100% due to rounding.

Digimarc, Digimarc Barcode, Digimarc Discover and Guardian are registered trademarks of Digimarc Corporation.

Overview

Digimarc Corporation, an Oregon corporation incorporated in 2008, enables governments, banks and businesses around the world to automatically and reliably identify and interact with virtually any media. We have pioneered the Digimarc Intuitive Computing Platform (ICP), a comprehensive set of technologies for identifying, discovering and interacting with digitally-enhanced media. The platform includes Digimarc Barcode, a proprietary method for imperceptibly enhancing packaging, print, images, thermal labels, audio and other objects with data that is detected by enabled devices, such as smart phones, computers, barcode scanners and machine-vision equipment. Digimarc Discover software enables an ecosystem of connected devices to easily identify content or materials and deliver information.

Our media identification and discovery innovations enable our business partners to create numerous applications across a wide range of media content, including solutions that:

- Improve the speed of retail checkout;
- Provide simple and intuitive mobile customer engagement experiences in stores and at home;
- Provide efficient and reliable identification of consumer packaged goods by retail associates in stores for inventory management and restocking;
- Quickly and reliably identify and effectively manage music, movies, television programming, digital images, e-publications, documents and other printed materials, especially in light of non-linear distribution over the Internet;
- Deter counterfeiting of money, media and goods, and piracy of e-publications, movies and music;
- Support new digital media distribution models and methods to monetize media content;
- Leverage the power of ubiquitous computing to instantly link consumers to a wealth of information and/or interactive experiences related to the media and objects they encounter each day;
- Provide consumers with more choice and access to media content when, where and how they want it;
- Enhance imagery and video by associating metadata or authenticating media content for government and commercial uses; and

• Better secure identity documents to enhance national security and combat identity theft and fraud.

18

Our Intuitive Computing Platform has a proprietary foundation in signal processing innovation known as “digital watermarking,” which allows imperceptible digital information to be embedded in all forms of digitally designed, produced or distributed media content and many physical objects, including photographs, movies, music, television, personal identification documents, financial instruments, industrial parts and product packages. We refer to this embedded information as the Digimarc Barcode. This digital information can be detected and read by a wide range of computers, smartphones, tablets and other digital devices enabled with our proprietary reading software, which we refer to as Digimarc Discover.

Our inventions allow our business partners and customers to provide persistent digital identities for virtually any media content that is digitally processed at some point during its lifecycle. Our technology can be applied to images, video, and audio to supply a wide range of consumer engagement, media management and security solutions across multiple consumer and government industry sectors. Over the years our enabling software and business processes, and associated intellectual property portfolio have grown to encompass many related technologies.

We provide our solutions directly and through our business partners. Our inventions provide a powerful element of document security, giving rise to a long-term relationship with a consortium of central banks (the “Central Banks”), and many leading companies in the information technology industry. We and our business partners have successfully propagated the use of our technology in music, movies, television broadcasts, digital images, e-publications and printed materials. Digimarc Barcodes have been used in these applications to improve media rights and asset management, reduce piracy and counterfeiting losses, improve marketing programs, permit more efficient and effective distribution of valuable media content and enhance consumer entertainment and commercial experiences.

Digimarc Barcodes can be used to enhance all forms of media and are generally imperceptible to human senses, but quickly detected by computers, networks or other digital devices like smartphones and tablets. Unlike traditional barcodes and tags, our solution does not require content owners to give up valuable visual space on their media content; nor does it affect the overall layout or aesthetics of their media content. Digimarc Barcodes are generally imperceptible in normal use and do all that visible barcodes do, but perform better. Our Digimarc Discover platform delivers a range of rich media experiences to its readers on their smartphones or tablets across multiple media formats, including print, audio, video and packaging. Unique to the Digimarc Discover platform is its seamless multi-modal use of various content identification technologies as needed, including Digimarc Barcode when present.

Banknote counterfeit deterrence was the first commercially successful large scale use of our technologies. Innovations based on our existing digital watermarking technology and experience have been leveraged to create new products to deter counterfeiting and tampering of driver licenses and other government-issued secure credentials. In parallel, our business partners, under patent or technology licenses from us, are delivering digital watermarking solutions to track and monitor the distribution of music, images, television and movies to consumers.

In January 2014, we introduced Digimarc Barcodes for use in consumer product packaging. These Digimarc Barcodes can contain the same information found in traditional universal product codes (“UPC”). The UPC information is invisibly repeated multiple times over the entire package surface making checkout faster and easier for both customers and cashiers. We partnered with Datalogic, a global leader in automatic data capture and industrial automation markets and producer of barcode readers, in introducing the Digimarc Barcode to the consumer product packaging market. Since then, additional scanner vendors and other channel partners have announced support for the Digimarc Barcode platform. Digimarc Barcodes can also connect mobile-enabled consumers directly from packaging to engaging mobile experiences such as additional product information, special offers, recommendations, reviews, social networks and more.

In January 2016, Digimarc and GS1 US, the United States (“U.S.”) operation of the organization that maintains the global standards for barcodes, announced a broad collaboration to help the industries served by GS1 to make effective

use of Digimarc Barcode. GS1 US educates, trains and provides access to services to their 300,000 member businesses. Among other things, Digimarc and GS1 US are working to improve product identification for retailers and consumers with brand-certified, accurate product information via Digimarc Barcodes. In September 2016, Digimarc announced a similar collaboration with GS1 Germany.

In January 2018, we introduced Digimarc Barcode for use in thermal labels for fresh food products. These Digimarc Barcodes contain GS1 Application Identifiers for fresh foods, allowing retailers to dynamically adjust pricing on soon-to-be-expired fresh foods or sell items at a discount, instead of discarding them. Retail thermal labels with Digimarc Barcode scan even when ripped, creased, smudged or damaged, making checkout faster and easier for both customers and cashiers. We have partnered with multiple industry leading retail scale label manufacturers to introduce thermal labels enabled with Digimarc Barcode to the retail industry. Thermal labels enabled with Digimarc Barcode can also provide consumers an engaging mobile experience similar to Digimarc Barcode for consumer product packaging.

Our intellectual property contains many innovations in digital watermarking, content recognition (sometimes referred to as “fingerprinting”), digital rights management and related fields. To protect our inventions, we have implemented an extensive intellectual property protection program that relies on a combination of patent, copyright, trademark and trade secret laws, and nondisclosure agreements and other contracts. As a result, we believe we have one of the world’s most extensive patent portfolios in digital watermarking and related fields, with over 1,100 U.S. and foreign patents granted and applications pending as of September 30, 2018. We continue to develop and broaden our portfolio in the fields of media identification and management technology and related applications and systems. We devote significant resources to developing and protecting our inventions and continuously seek to identify and evaluate potential licensees for our patents. The patents in our portfolio each have a life of approximately 20 years from the effective filing date of the patent, and up to 17 years after the patent has been granted.

The market for patent licensing has become more challenging in recent years. As a result, we have shifted our focus from direct monetization through enforcement and licensing to facilitating progress toward the realization of our vision to enrich everyday living via pervasive, intuitive computing by:

- encouraging large scale adoption of our technologies by industry leaders;
- increasing the scale and rate of growth of our products and services business; and
- laying a foundation for continuing innovation.

For a discussion of activities and costs related to our research and development, see “Results of Operations –Summary – Research, development and engineering.”

Critical Accounting Policies and Estimates

Detailed information about our critical accounting policies and estimates is set forth in Part III, Item 15 of our 2017 Annual Report (“Exhibits and Financial Statement Schedules”), in “Note 1: Description of Business and Summary of Significant Accounting Policies,” which is incorporated by reference into this Quarterly Report on Form 10-Q.

Effective January 1, 2018, we adopted Accounting Standards Codification 606, Revenue from Contracts with Customers (Topic 606). Additional information is included in “Note 3: Revenue Recognition” of our Notes to Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

Results of Operations

The following table presents statements of operations data for the periods indicated as a percentage of total revenue. Unless otherwise indicated, all references in this Management's Discussion and Analysis of Financial Condition and Results of Operations relate to the three and nine months ended September 30, 2018 and all changes discussed with respect to such periods reflect changes compared to the three and nine months ended September 30, 2017.

| | Three Months Ended September 30, 2018 | | Three Months Ended September 30, 2017 | | Nine Months Ended September 30, 2018 | | Nine Months Ended September 30, 2017 | |
|--|---|----|---|----|--|----|--|----|
| | Percentages are percent of total revenue | | | | Percentages are percent of total revenue | | | |
| Revenue: | | | | | | | | |
| Service | 57 | % | 34 | % | 60 | % | 49 | % |
| Subscription | 31 | | 15 | | 29 | | 20 | |
| License | 12 | | 51 | | 11 | | 31 | |
| Total revenue | 100 | | 100 | | 100 | | 100 | |
| Cost of revenue: | | | | | | | | |
| Service | 26 | | 15 | | 28 | | 22 | |
| Subscription | 10 | | 7 | | 9 | | 8 | |
| License | 3 | | 1 | | 3 | | 2 | |
| Total cost of revenue | 39 | | 24 | | 40 | | 32 | |
| Gross profit | 61 | | 76 | | 60 | | 68 | |
| Operating expenses: | | | | | | | | |
| Sales and marketing | 96 | | 47 | | 90 | | 59 | |
| Research, development and engineering | 83 | | 47 | | 76 | | 57 | |
| General and administrative | 50 | | 28 | | 47 | | 35 | |
| Intellectual property | 7 | | 4 | | 6 | | 6 | |
| Total operating expenses | 236 | | 127 | | 219 | | 156 | |
| Operating loss | (175 |) | (51 |) | (158 |) | (88 |) |
| Other income, net | 6 | | 2 | | 5 | | 2 | |
| Loss before income taxes | (170 |) | (49 |) | (153 |) | (86 |) |
| Benefit (provision) for income taxes | (0 |) | (0 |) | (0 |) | 0 | |
| Net loss | (170 | %) | (49 | %) | (153 | %) | (85 | %) |

Summary

Total revenue for the three and nine month periods ended September 30, 2018 decreased 43% to \$4.9 million and 22% to \$16.0 million, respectively, compared to the corresponding three and nine month periods ended September 30, 2017, primarily as a result of lower license revenue.

Total operating expenses for the three and nine month periods ended September 30, 2018 increased 5% to \$11.6 million and 10% to \$34.9 million, respectively, compared to the corresponding three and nine month periods ended September 30, 2017, was due to higher investment in sales and marketing as we continue to address important opportunities in market development and delivery of Digimarc Discover and Digimarc Barcode.

Revenue

| | Three Months Ended September 30 2018 | Three Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30 2018 | Nine Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|--|--|----------------------------------|-----------------------------------|---|---|----------------------------------|-----------------------------------|
| Revenue: | | | | | | | | |
| Service | \$ 2,787 | \$ 2,986 | \$ (199) | (7)% | \$ 9,630 | \$ 9,935 | \$ (305) | (3)% |
| Subscription | 1,532 | 1,306 | 226 | 17 % | 4,554 | 4,171 | 383 | 9 % |
| License | 595 | 4,385 | (3,790) | (86)% | 1,781 | 6,249 | (4,468) | (71)% |
| Total | \$ 4,914 | \$ 8,677 | \$ (3,763) | (43)% | \$ 15,965 | \$ 20,355 | \$ (4,390) | (22)% |
| Revenue (as % of total revenue): | | | | | | | | |
| Service | 57 % | 34 % | | | 60 % | 49 % | | |
| Subscription | 31 % | 15 % | | | 29 % | 20 % | | |
| License | 12 % | 51 % | | | 11 % | 31 % | | |
| Total | 100 % | 100 % | | | 100 % | 100 % | | |

Service. Service revenue consists primarily of revenue derived from the sale of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements. Most of our service revenue is derived from contracts with the Central Banks and government agency contractors. The agreements range from several months to several years in length, and our longer term contracts are subject to work plans that are reviewed and agreed upon at least annually. These contracts generally provide for billing hours worked at predetermined rates and, to a lesser extent, reimbursement for third party costs and services. Increases or decreases in the services provided under these contracts are generally subject to both volume and price changes. The volume of work is generally negotiated at least annually and can be modified as the customer's needs change. We also have provisions in our longer term contracts that allow for specific hourly rate price increases on an annual basis to account for cost of living variables. Contracts with government agency contractors are generally shorter term in nature, less linear in billings and less predictable than our longer term contracts because the contracts with government agency contractors are subject to government budgets and funding.

The decreases in service revenue for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were primarily due to the timing of program work with the Central Banks.

Subscription. Subscription revenue includes revenue derived from the sale of Digimarc Discover, Digimarc Barcode and Digimarc Guardian products and services, and is generally recurring in nature, paid in advance and recognized over the term of the subscription.

The increases in subscription revenue for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were due to higher Digimarc Discover and Digimarc Barcode revenue, partially offset by lower Digimarc Guardian revenue.

License. License revenue originates primarily from licensing our intellectual property where we receive license fees and/or royalties as our income stream.

The decrease in license revenue for the three month period ended September 30, 2018, compared to the corresponding three month period ended September 30, 2017, was primarily due to lower license revenue reflecting the impact of the \$3.5 million upfront license fee and \$0.3 million of royalties realized in the third quarter of 2017 from an existing licensee. In exchange for the upfront license fee, the company waived any future royalty obligations from this licensee in one of the licensed fields of use.

The decrease in license revenue for the nine month period ended September 30, 2018, compared to the corresponding nine month period ended September 30, 2017, was primarily due to lower license revenue reflecting the impact of the \$3.5 million upfront license fee realized in the third quarter of 2017 and \$0.9 million of royalties realized in the first nine months of 2017 from an existing licensee.

Revenue by Geography

| | Three Months Ended September 30 2018 | Three Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30 2018 | Nine Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|--|--|----------------------------------|-----------------------------------|---|---|----------------------------------|-----------------------------------|
| Revenue by geography: | | | | | | | | |
| Domestic | \$ 1,387 | \$ 1,153 | \$ 234 | 20 % | \$ 4,127 | \$ 3,907 | \$ 220 | 6 % |
| International | 3,527 | 7,524 | (3,997) | (53)% | 11,838 | 16,448 | (4,610) | (28)% |
| Total | \$ 4,914 | \$ 8,677 | \$ (3,763) | (43)% | \$ 15,965 | \$ 20,355 | \$ (4,390) | (22)% |
| Revenue (as % of total revenue): | | | | | | | | |
| Domestic | 28 % | 13 % | | | 26 % | 19 % | | |
| International | 72 % | 87 % | | | 74 % | 81 % | | |
| Total | 100 % | 100 % | | | 100 % | 100 % | | |

The increases in domestic revenue for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were primarily due to higher Digimarc Discover and Digimarc Barcode revenue from our domestic customers.

The decrease in international revenue for the three month period ended September 30, 2018, compared to the corresponding three month period ended September 30, 2017, was primarily due to lower license revenue reflecting the impact of the \$3.5 million upfront license fee and \$0.3 million of royalties realized in the third quarter of 2017 from an existing licensee. In exchange for the upfront license fee, the company waived any future royalty obligations from this licensee in one of the licensed fields of use.

The decrease in international revenue for the nine month period ended September 30, 2018, compared to the corresponding nine month period ended September 30, 2017, was primarily due to lower license revenue reflecting the impact of the \$3.5 million upfront license fee realized in the third quarter of 2017 and \$0.9 million of royalties realized in the first nine months of 2017 from an existing licensee.

Cost of Revenue

Service. Cost of service revenue primarily includes costs that are allocated from research, development and engineering, sales and marketing and intellectual property that relate directly to performing services under our customer contracts and direct costs of program delivery. Costs include:

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of our software developers, quality assurance personnel, product managers, business development managers and other personnel where we bill our customers for time and materials costs;
- payments to outside contractors that are billed to customers;
- charges for equipment directly used by customers;
- depreciation for machinery, equipment and software directly used by customers;
- travel costs directly attributable to service and development contracts; and

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- charges for infrastructure and centralized costs of facilities and information technology.

Subscription. Cost of subscription revenue primarily includes:

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of operations personnel;
- cost of outside contractors that provide operational support;
- amortization of existing technology acquired in the acquisition of Contributor Corporation; and

23

Internet service provider connectivity charges and image search data fees to support the services offered to our subscription customers.

License. Cost of license revenue primarily includes:

- amortization of capitalized patent costs; and
- amortization of patent maintenance fees.

Gross Profit

| | Three Months Ended September 30 2018 | Three Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30 2018 | Nine Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|----------------------|--|--|----------------------------------|-----------------------------------|---|---|----------------------------------|-----------------------------------|
| Gross Profit: | | | | | | | | |
| Service | \$ 1,486 | \$ 1,654 | \$ (168) | (10)% | \$ 5,218 | \$ 5,504 | \$ (286) | (5)% |
| Subscription | 1,052 | 695 | 357 | 51 % | 3,084 | 2,470 | 614 | 25 % |
| License | 441 | 4,256 | (3,815) | (90)% | 1,338 | 5,880 | (4,542) | (77)% |
| Total | \$ 2,979 | \$ 6,605 | \$ (3,626) | (55)% | \$ 9,640 | \$ 13,854 | \$ (4,214) | (30)% |

Gross Profit (as %
of related

revenue
components):

| | | | | | | | | |
|--------------|-----------|----------|-----------|----------|-----------|----------|-----------|----------|
| Service | 53 | % | 55 | % | 54 | % | 55 | % |
| Subscription | 69 | % | 53 | % | 68 | % | 59 | % |
| License | 74 | % | 97 | % | 75 | % | 94 | % |
| Total | 61 | % | 76 | % | 60 | % | 68 | % |

The decreases in total gross profit for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were primarily due to lower license revenue.

The decreases in service gross profit as a percentage of service revenue for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were insignificant.

The increases in subscription gross profit as a percentage of subscription revenue for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were primarily due to higher subscription revenue and lower operational costs.

The decreases in license gross profit as a percentage of license revenue for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were primarily due to lower license revenue.

Operating Expenses

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We allocate certain costs of research, development and engineering, sales and marketing, and intellectual property to cost of revenue when they relate directly to our customer contracts. We record all remaining, or “residual,” costs as sales and marketing, research, development and engineering, general and administrative, and intellectual property expenses.

Sales and marketing

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|-------------------------|---|---|----------------------------------|-----------------------------------|--|--|----------------------------------|-----------------------------------|
| Sales and marketing | \$ 4,741 | \$ 4,075 | \$ 666 | 16 % | \$ 14,385 | \$ 12,064 | \$ 2,321 | 19 % |
| (as % of total revenue) | 96 | % 47 | % | | 90 | % 59 | % | |

24

Sales and marketing expenses consist primarily of:

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of sales and marketing employees and product managers;
- travel and market research costs, and costs associated with marketing programs, such as trade shows, public relations and new product launches;
- professional services and outside contractor costs for product and marketing initiatives; and
 - charges for infrastructure and centralized costs of facilities and information technology.

The increase in sales and marketing expenses for the three month period ended September 30, 2018, compared to the corresponding three month period ended September 30, 2017, was primarily due to:

- increased headcount and compensation-related expenses of \$0.5 million; and
- increased marketing and professional fees of \$0.1 million related to market development activities.

The increase in sales and marketing expenses for the nine month period ended September 30, 2018, compared to the corresponding nine month period ended September 30, 2017, was primarily due to:

- increased headcount and compensation-related expenses of \$1.9 million; and
- increased charges for infrastructure and centralized costs of \$0.4 million due to increased costs and headcount; partially offset by
- decreased recruiting costs of \$0.2 million.

Research, development and engineering

| | Three Months Ended September 30 2018 | Three Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30 2018 | Nine Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|--|--|----------------------------------|-----------------------------------|---|---|----------------------------------|-----------------------------------|
| Research, development and engineering | \$ 4,069 | \$ 4,108 | \$ (39) | (1)% | \$ 12,074 | \$ 11,503 | \$ 571 | 5 % |
| Research, development and engineering (as % of total revenue) | 83 | % 47 | % | | 76 | % 57 | % | |

Research, development and engineering expenses consist primarily of:

- compensation, benefits, incentive compensation in the form of stock-based compensation and related costs of software and hardware developers and quality assurance personnel;
- payments to outside contractors;
- the purchase of materials and services for product development; and

- charges for infrastructure and centralized costs of facilities and information technology.

25

The decrease in research, development and engineering expenses for the three month period ended September 30, 2018, compared to the corresponding three month period ended September 30, 2017, was insignificant.

The increase in research, development and engineering expenses for the nine month period ended September 30, 2018, compared to the corresponding nine month period ended September 30, 2017, was primarily due to:

- increased headcount and compensation-related expenses of \$0.5 million; and
- increased charges for infrastructure and centralized costs of \$0.2 million due to increased costs and headcount; partially offset by
- decreased recruiting costs of \$0.1 million.

General and administrative

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|--|---|---|----------------------------------|-----------------------------------|--|--|----------------------------------|-----------------------------------|
| General and administrative | \$ 2,447 | \$ 2,442 | \$ 5 | 0 % | \$ 7,495 | \$ 7,066 | \$ 429 | 6 % |
| General and administrative (as % of total revenue) | 50 | % 28 | % | | 47 | % 35 | % | |

We incur general and administrative costs in the functional areas of finance, legal, human resources, executive and board of directors. Costs for facilities and information technology are also managed as part of the general and administrative processes and are allocated to this area as well as each of the areas in cost of revenue, sales and marketing, research, development and engineering and intellectual property.

General and administrative expenses consist primarily of:

- compensation, benefits and incentive compensation in the form of stock-based compensation and related costs of general and administrative personnel;
- third party and professional fees associated with legal, accounting and human resources functions;
- costs associated with being a public company; and
 - charges for infrastructure and centralized costs of facilities and information technology.

The increase in general and administrative expenses for the three month period ended September 30, 2018, compared to the corresponding three month period ended September 30, 2017, was insignificant.

The increase in general and administrative expenses for the nine month period ended September 30, 2018, compared to the corresponding nine month period ended September 30, 2017, was primarily due to:

- increased headcount and compensation-related expenses of \$1.0 million; and
- increased depreciation and amortization expenses of \$0.3 million; partially offset by
- decreased charges for infrastructure and centralized costs of \$0.6 million, which were allocated to sales and marketing and research, development and engineering due to increased headcount in those areas; and
- decreased professional fees of \$0.2 million.

Intellectual property

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|---|---|----------------------------------|-----------------------------------|--|--|----------------------------------|-----------------------------------|
| Intellectual property | \$ 328 | \$ 387 | \$ (59) | (15)% | \$ 948 | \$ 1,124 | \$ (176) | (16)% |
| Intellectual property (as % of total revenue) | 7 % | 4 % | | | 6 % | 6 % | | |

We incur intellectual property expenses that arise primarily from costs associated with documenting, applying for, and maintaining domestic and international patents and trademarks.

Gross expenditures for intellectual property costs, before reflecting the effect of capitalized patent costs, primarily consist of:

- compensation, benefits and incentive compensation in the form of stock-based compensation and related costs of attorneys and legal assistants;
- third party costs, including filing and governmental regulatory fees and fees for outside legal counsel and translation costs, each incurred in the patent process;
- charges to write off previously capitalized patent costs for patent assets we abandon; and
 - charges for infrastructure and centralized costs of facilities and information technology.

Intellectual property expenses can vary from period to period based on the level of capitalized patent activity.

The decreases in intellectual property expenses for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were primarily due to lower write-offs of abandoned patent costs.

Stock-based compensation

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| | Three Months Ended September 30 2018 | Three Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | | Nine Months Ended September 30 2018 | Nine Months Ended September 30 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|--|--|--|----------------------------------|-----------------------------------|--|---|---|----------------------------------|-----------------------------------|
| Cost of revenue | \$ 134 | \$ 170 | \$ (36) | (21)% | | \$ 456 | \$ 521 | \$ (65) | (12)% |
| Sales and marketing | 442 | 364 | 78 | 21 % | | 1,198 | 1,074 | 124 | 12 % |
| Research, development and engineering | 367 | 379 | (12) | (3)% | | 1,015 | 1,041 | (26) | (2)% |
| General and administrative | 846 | 784 | 62 | 8 % | | 2,461 | 1,994 | 467 | 23 % |
| Intellectual property | 76 | 82 | (6) | (7)% | | 215 | 242 | (27) | (11)% |
| Total | \$ 1,865 | \$ 1,779 | \$ 86 | 5 % | | \$ 5,345 | \$ 4,872 | \$ 473 | 10 % |

27

The increases in stock-based compensation expense for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were primarily due to the timing and amount of stock awards.

We anticipate incurring an additional \$16,034 in stock-based compensation expense through September 2022 for awards outstanding as of September 30, 2018.

Other income, net

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|---|---|----------------------------------|-----------------------------------|--|--|----------------------------------|-----------------------------------|
| Other income, net | \$ 273 | \$ 174 | \$ 99 | 57 % | \$ 799 | \$ 408 | \$ 391 | 96 % |
| Other income, net (as % of total revenue) | 6 % | 2 % | | | 5 % | 2 % | | |

The increases in other income, net for the three and nine month periods ended September 30, 2018, compared to the corresponding three and nine month periods ended September 30, 2017, were primarily due to higher interest income as a result of higher interest rates on cash and investments.

Income Taxes

The benefit (provision) for income taxes for the nine month periods ended September 30, 2018 and 2017 reflects current taxes, deferred taxes, and withholding taxes. The effective tax rates for the nine month periods ended September 30, 2018 and 2017 were 0% and 1%, respectively, because we have a full valuation allowance recorded against our deferred tax assets.

The effective tax rate was not affected by our adoption of Accounting Standards Update (“ASU”) No. 2016-09, “Compensation – Stock Compensation (Topic 718),” because the excess tax benefit from stock-based compensation for the three and nine months ended September 30, 2018 of \$51 and \$762, respectively, were offset by \$51 and \$762 of valuation allowance, respectively. Excess tax benefits of \$296 and \$1,397 were recognized in the provision for income taxes for the three and nine months ended September 30, 2017, respectively, which were offset by \$296 and \$1,397 of valuation allowance, respectively. The valuation allowance against deferred tax assets as of September 30, 2018 was \$40,597, an increase of \$8,272 from \$32,325 as of December 31, 2017.

The U.S. enacted tax reform legislation on December 22, 2017 commonly known as the Tax Cuts and Jobs Act, (“the Act”), resulting in significant modifications to existing U.S. tax law. The provisions of the Act effective in 2018 have been recorded as applicable as of September 30, 2018. The Act is not expected to have a material impact on our financial condition, results of operations and cash flows in the foreseeable future.

We continually assess the applicability of valuation allowance against our deferred tax assets. Based upon the positive and negative evidence available as of September 30, 2018, and largely due to the cumulative loss incurred by us over the last several years, which is considered a significant piece of negative evidence when assessing the realizability of deferred tax assets, a full valuation allowance is recorded against our deferred tax assets. We will not record tax

benefits on any future losses until it is determined that those tax benefits will be realized. All future reversals of the valuation allowance would result in a tax benefit in the period recognized.

Liquidity and Capital Resources

| | September 30, 2018 | December 31, 2017 |
|---------------------------------------|-----------------------|----------------------|
| Working capital | \$ 51,403 | \$ 71,275 |
| Current ratio (1) | 16.0:1 | 15.1:1 |
| Cash, cash equivalents and short-term | | |
| marketable securities | \$ 49,415 | \$ 67,738 |
| Long-term marketable securities | \$ — | \$ — |
| Total cash, cash equivalents and | | |
| marketable securities | \$ 49,415 | \$ 67,738 |

- (1) The current (liquidity) ratio is calculated by dividing total current assets by total current liabilities.

The \$18.3 million decrease in cash, cash equivalents and marketable securities resulted primarily from:

- cash used in operations;
- purchases of common stock related to tax withholding in connection with the vesting of restricted stock; and
- purchases of property and equipment and capitalized patent costs; partially offset by proceeds from stock option exercises.

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities, and trade accounts receivable. We place our cash and cash equivalents with major banks and financial institutions and at times deposits may exceed insured limits. Marketable securities primarily include commercial paper, corporate notes, federal agency notes and U.S. treasuries. Our investment policy requires our portfolio to be invested to ensure that the greater of \$3 million or 7% of the invested funds will be available within 30 days' notice.

Other than cash used for operating needs, which may include short-term marketable securities, our investment policy limits our credit exposure to any one financial institution or type of financial instrument by limiting the maximum of 5% of our cash and cash equivalents and marketable securities or \$1 million, whichever is greater, to be invested in any one issuer except for the U.S. government, U.S. federal agencies and U.S. backed securities, which have no limits, at the time of purchase. Our investment policy also limits our credit exposure by limiting to a maximum of 40% of our cash and cash equivalents and marketable securities, or \$15 million, whichever is greater, to be invested in any one industry category (e.g., financial or energy industries) at the time of purchase. As a result, we believe our credit risk associated with cash and investments to be minimal. A decline in the market value of any security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. To determine whether an impairment is other-than-temporary, we consider whether we have the ability and intent to hold the investment until a market price recovery and evidence indicating that the cost of the investment is recoverable outweighs evidence to the contrary. There have been no other-than-temporary impairments identified or recorded by us in the three and nine months ended September 30, 2018 and 2017.

Operating Cash Flow

The components of operating cash flows were:

| | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 | Dollar Increase (Decrease) | Percent Increase (Decrease) |
|---|--|--|----------------------------------|-----------------------------------|
| Net loss | \$ (24,492) | \$ (17,401) | \$ (7,091) | (41)% |
| Non-cash items | 6,949 | 6,671 | 278 | 4 % |
| Changes in operating assets and liabilities | 1,439 | (3,288) | 4,727 | 144 % |
| Net cash used in operating activities | \$ (16,104) | \$ (14,018) | \$ (2,086) | (15)% |

Cash flows used in operating activities for the nine month period ended September 30, 2018 increased by \$2.1 million, compared to the corresponding nine month period ended September 30, 2017, primarily the result of a higher net loss, partially offset by changes in operating assets and liabilities. The higher net loss was primarily as a result of lower license revenue, and higher operating expenses in sales and marketing. The changes in operating assets and liabilities were primarily due to increased collections of accounts receivable.

Cash flows provided by investing activities for the nine month period ended September 30, 2018, compared to the corresponding nine month period ended September 30, 2017, decreased by \$1.9 million from \$11.6 million to \$9.7 million, primarily as a result of lower net maturities of marketable securities.

Cash flows from financing activities for the nine month period ended September 30, 2018, compared to the corresponding nine month period ended September 30, 2017, decreased by \$17.1 million from \$16.4 million provided to \$0.6 million used, primarily as a result of the sale of common stock in a registered direct public offering in June 2017.

Future Cash Expectations

We believe that our current cash, cash equivalents, and short-term marketable securities balances will satisfy our projected working capital and capital expenditure requirements for at least the next 12 months. We have a \$100 million shelf registration statement in place, of which \$17.8 million and \$12.0 million were allocated for sales of our common stock in connection with our registered direct public offerings in June 2017 and November 2017, respectively. This shelf registration statement has \$70.2 million remaining for future issuance and expires in June 2020.

We may use similar or other financing means to raise working capital in the future, if necessary, to support continued investment in our growth initiatives. We may also raise capital in the future to fund acquisitions and/or investments in complementary businesses, technologies or product lines. If it becomes necessary to obtain additional financing, we may not be able to do so, or if these funds are available, they may not be available on satisfactory terms.

Off-Balance Sheet Arrangements

Other than the contractual obligations disclosed in our 2017 Annual Report, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995

This Quarterly Report on Form 10-Q includes “forward-looking statements” within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Words such as “may,” “might,” “plan,” “should,” “could,” “expect,” “anticipate,” “intend,” “believe,” “project,” “forecast,” “estimate,” “continue,” and variations of similar expressions are intended to identify such forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements, or other statements made by us, are made based on our expectations and beliefs concerning future events impacting us, and are subject to uncertainties and factors (including those specified below), which are difficult to predict and, in many instances, are beyond our control. As a result, our actual results could differ materially from those expressed in or implied by any such forward-looking statements, and investors are cautioned not to place undue reliance on such statements. We believe that the following factors, among others (including those described in Item 1A. “Risk Factors” of our 2017 Annual Report), could affect our future performance and the liquidity and value of our securities and cause our actual results to differ materially from those expressed or implied by forward-looking statements made by us. Forward-looking statements include but are not limited to statements relating to:

- concentration of revenue with few customers comprising a large majority of the revenue;
- revenue trends and expectations;
- anticipated successful advocacy of our technology by our channel partners;
- our future level of investment in our business, including investment in research, development and engineering of products and technology, development of our intellectual property, sales growth initiatives and development of new market opportunities;
- anticipated expenses, costs, margins, provision for income taxes and investment activities in the foreseeable future;
- our assumptions and expectations related to stock awards;
- anticipated effect of our adoption of accounting pronouncements and the Tax Cuts and Jobs Act;
- anticipated revenue to be generated from current contracts, renewals, and as a result of new programs;
- our estimates, judgements and assumptions related to impairment testing;
- variability of contracted arrangements;

- business opportunities that could require that we seek additional financing and our ability to do so;
- the size and growth of our markets;
- the existence of international growth opportunities and our future investment in such opportunities;
- the sources of our future revenue;
- our expected short-term and long-term liquidity positions;

30

- our capital expenditure and working capital requirements and our ability to fund our capital expenditure and working capital needs through cash flow from operations or financing;
- capital market conditions, our expectations regarding credit risk exposure, interest rate volatility and other limitations on the availability of capital, which could have an impact on our cost of capital and our ability to access the capital markets;
- our use of cash, cash equivalents and marketable securities in upcoming quarters;
- the adoption of our technology and success of our products, including Digimarc Discover, Digimarc Barcode and Digimarc Guardian;
- our ability to innovate and enhance our competitive differentiation;
- protection, development and monetization of our intellectual property portfolio; and
- our beliefs related to legal proceedings and claims arising in the ordinary course of business.

We believe that the risk factors specified above and the risk factors contained in Part I, Item 1A. “Risk Factors” of our 2017 Annual Report, among others, could affect our future performance and the liquidity and value of our securities and cause our actual results to differ materially from those expressed or implied by forward-looking statements made by us or on our behalf. Investors should understand that it is not possible to predict or identify all risk factors and that there may be other factors that may cause our actual results to differ materially from the forward-looking statements. All forward-looking statements made by us or by persons acting on our behalf apply only as of the date of this Quarterly Report on Form 10-Q. We do not undertake any obligation to publicly update or revise any forward-looking statements to reflect future events, information or circumstances that arise after the date of the filing of this Quarterly Report on Form 10-Q.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We conducted an evaluation (pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934 (the “Exchange Act”)), under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company’s disclosure controls and procedures (as defined in Rule 13a-15(e)) as of the end of the period covered by this Quarterly Report on Form 10-Q. These disclosure controls and procedures are designed to ensure that information required to be disclosed in our reports that are filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Our disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that this information is accumulated and communicated to management, including the principal executive and principal financial officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

Based on the evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

Changes in Controls

There were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) that occurred during the three month period ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION.

Item 1. Legal Proceedings.

We are subject from time to time to other legal proceedings and claims arising in the ordinary course of business. At this time, we do not believe that the resolution of any such matters will have a material adverse effect on our financial position, results of operations or cash flows.

Item 1A. Risk Factors

Our business, financial condition, results of operations and cash flows may be affected by a number of factors. Detailed information about risk factors that may affect Digimarc's actual results are set forth in Part I, Item 1A. "Risk Factors" of our 2017 Annual Report. The risks and uncertainties described in our 2017 Annual Report are those risks of which we are aware and that we consider to be material to our business. If any of the following risks and uncertainties develops into actual events, our business, financial condition, results of operations or cash flows could be materially adversely affected. In that case, the trading price of our common stock could decline. As of September 30, 2018, there have been no material changes to the risk factors set forth in our 2017 Annual Report.

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

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchases

We repurchase shares of common stock in satisfaction of required withholding tax liability in connection with the vesting of restricted shares.

The following table sets forth information regarding purchases of our equity securities during the three month period ended September 30, 2018:

| Period | (a) Total number of shares purchased (1) | (b) Average price paid per share (1) | (c) Total number of shares purchased as part of publicly announced plans or programs | (d) Approximate dollar value of shares that may yet be purchased under the plans or programs |
|--|---|---|--|---|
| Month 1 July 1, 2018 to July 31, 2018 | — | \$ — | — | \$ — |

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| | | | | | |
|---|--------|----------|---|----|---|
| Month 2 | | | | | |
| August 1, 2018 to August 31, 2018 | 17,294 | \$ 28.80 | — | \$ | — |
| Month 3 | | | | | |
| September 1, 2018 to September 30, 2018 | 2,423 | \$ 29.55 | — | \$ | — |
| Total | 19,717 | \$ 28.89 | — | \$ | — |

(1) Fully vested shares of common stock withheld (purchased) by us in satisfaction of required withholding tax liability upon vesting of restricted stock.

32

Item 6. Exhibits.

Exhibit

Number Exhibit Description

- 10.1 Digimarc Corporation 2008 Incentive Plan (incorporated by reference to Appendix A to the Registrant's definitive proxy statement on Schedule 14A with respect to the 2014 annual meeting of shareholders filed with the SEC on March 21, 2014 (SEC File No. 001-34108))
- 10.2 Digimarc Corporation 2018 Incentive Plan (incorporated by reference to Appendix A to the Registrant's definitive proxy statement on Schedule 14A with respect to the 2018 annual meeting of shareholders filed with the SEC on March 21, 2018 (SEC File No. 001-34108))
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
- 32.1 Section 1350 Certification of Chief Executive Officer
- 32.2 Section 1350 Certification of Chief Financial Officer
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 1, 2018 DIGIMARC CORPORATION

By: /s/ CHARLES BECK
CHARLES BECK
Chief Financial Officer
(Duly Authorized Officer and Principal Financial and Accounting Officer)