

ZIX CORP
Form 10-Q
November 02, 2011

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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, 2011

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

For the transition period from _____ to _____

Commission File Number: 0-17995

ZIX CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Texas

(State of Incorporation)

75-2216818

(I.R.S. Employer Identification Number)

2711 North Haskell Avenue

Suite 2200, LB 36

Dallas, Texas 75204-2960

(Address of Principal Executive Offices)

(214) 370-2000

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting

(Do not check if a smaller reporting company)

company

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

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

Class

Outstanding at October 25, 2011

Common Stock, par value \$0.01 per share

65,998,747

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ZIX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2011 (unaudited)	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 19,738,000	\$ 24,619,000
Commercial paper	2,290,000	
Receivables, net	891,000	1,344,000
Prepaid and other current assets	1,026,000	1,115,000
Deferred tax assets	950,000	1,056,000
Total current assets	24,895,000	28,134,000
Property and equipment, net	2,196,000	2,209,000
Goodwill	2,161,000	2,161,000
Deferred tax assets	34,407,000	34,304,000
Other assets		44,000
Total assets	\$ 63,659,000	\$ 66,852,000
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 194,000	\$ 562,000
Accrued expenses	2,295,000	2,282,000
Deferred revenue	17,346,000	15,331,000
License subscription note payable		137,000
Total current liabilities	19,835,000	18,312,000
Long-term liabilities:		
Deferred revenue	745,000	1,439,000
License subscription note payable		49,000
Deferred rent	155,000	165,000
Total long-term liabilities	900,000	1,653,000
Total liabilities	20,735,000	19,965,000
Commitments and contingencies (see Note 8)		
Stockholders' equity:		
Preferred stock, \$1 par value, 10,000,000 shares authorized; none issued and outstanding		
Common stock, \$0.01 par value, 175,000,000 shares authorized; 71,019,223 issued and 64,383,642 outstanding at September 30, 2011 and 69,505,919 issued and 67,178,738 outstanding at December 31, 2010	710,000	695,000
Additional paid-in capital	348,416,000	344,981,000
Treasury stock, at cost; 6,635,581 common shares at September 30, 2011 and 2,327,181 common shares at December 31, 2010	(26,507,000)	(11,507,000)
Accumulated deficit	(279,695,000)	(287,282,000)

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Total stockholders' equity	42,924,000	46,887,000
Total liabilities and stockholders' equity	\$ 63,659,000	\$ 66,852,000

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues	\$ 9,558,000	\$ 8,548,000	\$ 28,260,000	\$ 24,221,000
Cost of revenues	1,789,000	1,662,000	5,362,000	4,734,000
Gross margin	7,769,000	6,886,000	22,898,000	19,487,000
Operating expenses:				
Research and development	1,343,000	1,261,000	3,948,000	3,817,000
Selling, general and administrative	3,754,000	4,026,000	11,310,000	12,242,000
Total operating expenses	5,097,000	5,287,000	15,258,000	16,059,000
Operating income	2,672,000	1,599,000	7,640,000	3,428,000
Other income, net	18,000	22,000	79,000	66,000
Income from continuing operations before income taxes	2,690,000	1,621,000	7,719,000	3,494,000
Income tax benefit (expense)	(119,000)	50,000	(132,000)	80,000
Income from continuing operations	2,571,000	1,671,000	7,587,000	3,574,000
Income from discontinued operations before income taxes		150,000		628,000
Income tax expense		(53,000)		(221,000)
Income from discontinued operations		97,000		407,000
Net income	\$ 2,571,000	\$ 1,768,000	\$ 7,587,000	\$ 3,981,000
Basic income per common share:				
Income from continuing operations	\$ 0.04	\$ 0.03	\$ 0.12	\$ 0.05
Income from discontinued operations		0.00		0.01
Net income	\$ 0.04	\$ 0.03	\$ 0.12	\$ 0.06
Diluted income per common share:				
Income from continuing operations	\$ 0.04	\$ 0.03	\$ 0.11	\$ 0.05
Income from discontinued operations		0.00		0.01

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Net income	\$	0.04	\$	0.03	\$	0.11	\$	0.06
Basic weighted average common shares outstanding		64,140,926		64,148,452		65,499,763		63,973,102
Diluted weighted average common shares outstanding		65,927,794		66,636,460		67,727,404		66,170,440

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(Unaudited)

	Stockholders' Equity					Total Stockholders Equity
	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Treasury Stock	Accumulated Deficit	
Balance, December 31, 2010	69,505,919	\$ 695,000	\$ 344,981,000	\$ (11,507,000)	\$ (287,282,000)	\$ 46,887,000
Issuance of common stock upon exercise of stock options	720,374	7,000	1,771,000			1,778,000
Issuance of common stock upon exercise of warrants	792,930	8,000	1,251,000			1,259,000
Employee stock-based compensation costs			369,000			369,000
Non-employee stock-based compensation costs			44,000			44,000
Repurchase of common stock				(15,000,000)		(15,000,000)
Net income					7,587,000	7,587,000
Balance, September 30, 2011	71,019,223	\$ 710,000	\$ 348,416,000	\$ (26,507,000)	\$ (279,695,000)	\$ 42,924,000

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September	
	30,	
	2011	2010
Operating activities:		
Net income	\$ 7,587,000	\$ 3,981,000
Non-cash items in net income:		
Depreciation and amortization	1,020,000	1,047,000
Employee stock-based compensation costs	369,000	1,506,000
Non-employee stock-based compensation costs	44,000	30,000
Changes in deferred taxes	3,000	6,000
Changes in operating assets and liabilities:		
Receivables	453,000	(57,000)
Prepaid and other assets	133,000	330,000
Accounts payable	(272,000)	(411,000)
Deferred revenue	1,321,000	795,000
Accrued and other liabilities	3,000	(756,000)
Net cash provided by operating activities	10,661,000	6,471,000
Investing activities:		
Purchases of property and equipment	(1,103,000)	(1,150,000)
Purchase of commercial paper	(2,290,000)	
Sales of marketable securities		25,000
Net cash used in investing activities	(3,393,000)	(1,125,000)
Financing activities:		
Proceeds from exercise of stock options	1,778,000	1,032,000
Proceeds from exercise of warrants	1,259,000	
Payment of license subscription note payable	(186,000)	(94,000)
Purchase of treasury shares	(15,000,000)	
Net cash (used in) provided by financing activities	(12,149,000)	938,000
(Decrease) increase in cash and cash equivalents	(4,881,000)	6,284,000
Cash and cash equivalents, beginning of period	24,619,000	13,287,000
Cash and cash equivalents, end of period	\$ 19,738,000	\$ 19,571,000

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Zix Corporation (ZixCorp, the Company, we, our, us) should be read in conjunction with the audited consolidated financial statements included in the Company's 2010 Annual Report on Form 10-K. These financial statements are unaudited, but have been prepared in the ordinary course of business for the purpose of providing information with respect to the interim periods covered thereby. Management of the Company believes that all adjustments necessary for a fair presentation of such periods have been included and are of a normal recurring nature. The results of operations for the nine-month period ended September 30, 2011, are not necessarily indicative of the results to be expected for any future interim periods or for the full fiscal year.

2. Recent Accounting Standards and Pronouncements*Testing for Goodwill Impairment*

In September 2011, the Financial Accounting Standards Board (FASB) amended guidance on testing goodwill for impairment. Under the new guidance, entities testing goodwill for impairment have the option of performing a qualitative assessment before calculating the fair value of a reporting unit in step 1 of the goodwill impairment test. If entities determine, on the basis of qualitative factors, that the fair value of a reporting unit is more likely than not less than the carrying value amount, the two-step impairment test would be required. Otherwise, further testing would not be needed. The new guidance does not change how goodwill is calculated, nor does it revise the requirement to test goodwill annually for impairment or between tests if events or circumstances warrant. The amended guidance is effective for us for fiscal year 2012, with earlier adoption permitted. We do not anticipate that this new guidance will have a material impact on our consolidated financial statements.

Presentation of Other Comprehensive Income

In June 2011, the FASB issued guidance that requires entities to report components of comprehensive income in either a continuous statement of comprehensive income or two separate but consecutive statements. The guidance removes the option to present the components of other comprehensive income (OCI) as part of the statement of equity. This guidance is effective for us for fiscal year 2012, and must be applied retrospectively for all periods presented in the financial statements. The new guidance does not apply to entities that have no items of OCI in any period presented. We do not anticipate that this new guidance will have a material impact on our consolidated financial statements.

Revenue Recognition

In October 2009, the FASB issued guidance on revenue recognition that became effective January 1, 2011. Under the new guidance tangible products that have software components that are essential to the functionality of the tangible product will no longer be within the scope of the software revenue recognition guidance; such software-enabled products will now be subject to other relevant revenue recognition guidance. Additionally, the FASB issued authoritative guidance on revenue arrangements with multiple deliverables that are outside the scope of the software revenue recognition guidance. Under the new guidance, when Vendor Specific Objective Evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. This new guidance did not have a material impact on our condensed consolidated financial statements.

3. Discontinued Operations

On December 31, 2010, we discontinued our e-Prescribing business. For information relating to discontinued operations, see the Company's 2010 Annual Report on Form 10-K.

Table of Contents**4. Stock Options and Stock-based Employee Compensation**

As of September 30, 2011, there were 7,174,647 options outstanding and 993,456 available for grant. Of the options available for grant, 771,932 options were available for grant to employees and 221,524 were available for grant to the Company's directors. For the three month and nine month periods ended September 30, 2011, the total stock-based employee compensation expense was recorded to the following line items of the Company's condensed consolidated statements of operations:

	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2011
Cost of revenues	\$ 21,000	\$ 45,000
Research and development	20,000	47,000
Selling, general and administrative	127,000	277,000
Stock-based compensation expense	\$ 168,000	\$ 369,000

There were 84,783 and 720,374 stock options exercised for the three and nine month periods ended September 30, 2011, respectively. There were 333,542 and 642,638 stock options exercised for the three and nine month periods ended September 30, 2010, respectively. The excess tax benefit recorded in the three month period ended September 30, 2011, related to the 84,783 options exercises was \$11,000. The excess tax benefit recorded in the nine month periods ended September 30, 2011, related to the 720,374 option exercises was \$113,000. A deferred tax asset totaling \$120,000 and \$477,000, resulting from stock-based compensation expense relating to the Company's U.S. operations, was recorded for the nine month periods ended September 30, 2011 and 2010, respectively. As of September 30, 2011, there was \$1,493,000 of total unrecognized stock-based compensation related to non-vested stock-based compensation awards granted under the stock option plans. This cost is expected to be recognized over a weighted average period of 1.31 years.

Stock Option Activity

The following is a summary of all stock option transactions during the three months ended September 30, 2011:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Yrs)	Aggregate Intrinsic Value
Outstanding at June 30, 2011	6,827,165	\$ 4.52		
Granted at market price	491,500	\$ 3.85		
Cancelled or expired	(59,235)	\$ 6.31		
Exercised	(84,783)	\$ 1.91		
Outstanding at September 30, 2011	7,174,647	\$ 4.48	4.69	\$ 1,761,000
Options exercisable at September 30, 2011	6,318,822	\$ 4.67	4.09	\$ 1,507,000

Of the above-described stock options outstanding at September 30, 2011, 1,858,511 of such stock options outstanding had an exercise price lower than the market price of the Company's common stock.

For additional information regarding the Company's Stock Options and Stock-based Employee Compensation, see Note 4 to the consolidated financial statements contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

5. Supplemental Cash Flow Information

Supplemental cash flow information relating to interest, taxes and non-cash activities:

	Nine Months Ended September	
	30,	
	2011	2010
Cash paid for interest	\$ 7,000	\$ 17,000
Cash income tax payments	\$ 172,000	\$ 217,000
Non-cash investing and financing activities:		
Assets sold to customers as part of their subscription service	\$	\$ 14,000
Payables related to purchases of fixed assets	\$ 96,000	\$ 56,000

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	September 30, 2011	December 31, 2010
Receivables	\$ 912,000	\$ 1,376,000
Allowance for returns and doubtful accounts	(21,000)	(32,000)
Note receivable	458,000	476,000
Allowance for note receivable	(458,000)	(476,000)
Receivables, net	\$ 891,000	\$ 1,344,000

The allowance for doubtful accounts includes all specific accounts receivable which we believe are likely not collectible based on known information. In addition, we record 2.5% of all accounts receivable greater than 90 days past due, net of those accounts specifically reserved, as a general allowance against accounts that could potentially become uncollectible.

The note receivable represents the remaining outstanding balance of an original note related to the sale of a product line in 2005 in the amount of \$540,000. The note receivable is fully reserved at September 30, 2011.

7. Earnings Per Share and Potential Dilution

Basic earnings per share are computed using the weighted average number of common shares outstanding for the period. The dilutive effect of common shares potentially outstanding is included in diluted earnings per share. The computations for basic and diluted earnings per share for the three and nine month periods ended September 30, 2011 and 2010, are as follows:

	Three Months ended September 30,		Nine Months ended September 30,	
	2011	2010	2011	2010
Basic weighted average shares	64,140,926	64,148,452	65,499,763	63,973,102
Effect of dilutive securities:				
Employee and director stock options	878,992	850,978	1,055,906	770,395
Warrants	907,876	1,637,030	1,171,735	1,426,943
Potential dilutive common shares	65,927,794	66,636,460	67,727,404	66,170,440

During the three and nine month periods ended September 30, 2011, weighted average shares of 4,831,146 and 4,341,573 respectively, related to stock options were excluded from the calculation of diluted earnings per share because the option exercise prices exceeded the market price of ZixCorp's common stock on that date, and the options were therefore anti-dilutive. During each of those periods, 145,853 of shares related to anti-dilutive warrants were excluded from that calculation. During the three and nine month periods ended September 30, 2010, weighted average shares of 6,982,729 and 7,263,978 respectively, related to anti-dilutive stock options were excluded from the calculation of diluted earnings per share. During those same periods, 145,853 and 2,797,441, respectively, of shares related to anti-dilutive warrants were excluded from that calculation.

8. Commitments and contingencies

A summary of our fixed contractual obligations and commitments at September 30, 2011, is as follows:

	Payments Due by Period			Beyond 3 Years
	Total	1 Year	Years 2 & 3	
Operating leases	\$ 3,688,000	\$ 1,327,000	\$ 2,072,000	\$ 289,000

We have not entered into any material, non-cancelable purchase commitments at September 30, 2011.

Claims and Proceedings

We are, from time to time, involved in various legal proceedings that arise in the ordinary course of business. We do not believe the outcome of these legal proceedings either individually or taken as a whole, will have a material adverse effect on our consolidated financial condition, results of operations or cash flows. However, we cannot predict with certainty any eventual loss or range of possible loss related to such matters.

9. Fair Value Measurements

FASB guidance regarding fair value measurement establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets for identical assets or liabilities; Level 2, defined as inputs other than quoted prices for similar assets and liabilities in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

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For certain of the Company's financial instruments, including cash and cash equivalents, commercial paper, trade receivables, and accounts payable, the fair values approximate carrying values due to the short-term maturities of these instruments. The carrying values of other current assets and accrued expenses are also not recorded at fair value, but approximate fair values primarily due to their short-term nature.

10. Commercial Paper

The investment in commercial paper is classified as a held-to-maturity debt security as the Company had the positive intent and ability to hold this investment until maturity. This short term investment was purchased on February 18, 2011, and matured on October 25, 2011. The carrying value of this security approximated fair market value due to the short-term maturity of the investment. At maturity, the Company received approximately \$10,000 of interest for the commercial paper, and the cash investment was moved to a money market fund.

11. Common Stock Repurchase Program

On March 7, 2011, the Company announced that its Board of Directors approved a share repurchase program that authorized the Company to purchase up to \$15,000,000 of its shares of common stock from time to time in the open market. During the six months ended June 30, 2011, the Company repurchased 4,285,600 shares at an aggregate cost of \$14,900,000. We completed the share repurchase program during the first week of July 2011 when the remaining 22,800 repurchased shares valued at approximately \$100,000 were transferred to the Company.

12. Income Taxes

At the end of 2010, the Company recorded a \$35,300,000 tax benefit by reducing the valuation allowance related to its deferred tax assets. This reduction was determined through an assessment of future deferred tax asset utilization following accounting guidance which relies largely on historical earnings. Using the same methodology, and updating