

ZIX CORP  
Form 10-Q  
August 07, 2017

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 June 30, 2017

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-17995

ZIX CORPORATION

(Exact Name of Registrant as Specified in its Charter)

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

2711 North Haskell Avenue

Suite 2200, LB 36

Dallas, Texas 75204-2960

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(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, smaller reporting company, or an emerging growth company. See the 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

(Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

If an emerging growth company, indicated 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

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

| Class                                    | Outstanding at August 3, 2017 |
|--|-------------------------------|
| Common Stock, par value \$0.01 per share | 55,222,192                    |



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## ZIX CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

|  | June 30,    | December 31, |
|--|-------------|--------------|
| (In thousands, except share and par value data)                                  | 2017        | 2016         |
|  | (unaudited) |              |
| <b>ASSETS</b>  |             |              |
| Current assets:  |             |              |
| Cash and cash equivalents  | \$ 29,508   | \$ 26,457    |
| Receivables, net   | 993         | 1,209        |
| Prepaid and other current assets   | 2,845       | 2,829        |
| Total current assets   | 33,346      | 30,495       |
| Property and equipment, net  | 4,308       | 3,976        |
| Intangible assets, net   | 4,934       | —            |
| Goodwill   | 6,488       | 2,161        |
| Deferred tax assets  | 41,886      | 45,726       |
| Total assets   | \$ 90,962   | \$ 82,358    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                      |             |              |
| Current liabilities:   |             |              |
| Accounts payable   | \$ 730      | \$ 355       |
| Accrued expenses   | 4,726       | 4,365        |
| Deferred revenue   | 25,738      | 25,773       |
| Total current liabilities  | 31,194      | 30,493       |
| Long-term liabilities:   |             |              |
| Deferred revenue   | 1,606       | 1,448        |
| Deferred rent  | 1,270       | 1,347        |
| Total long-term liabilities  | 2,876       | 2,795        |
| Total liabilities  | 34,070      | 33,288       |
| Commitments and contingencies (see Note 7)                                       |             |              |
| 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; 80,634,210 issued |             |              |
| and 55,267,157 outstanding in 2017 and 78,913,266 issued and 53,643,139          |             |              |
| outstanding in 2016  | 778         | 769          |
| Additional paid-in capital   | 379,784     | 374,386      |
| Treasury stock, at cost; 25,367,053 common shares in 2017 and 25,270,127 common  |             |              |
| shares in 2016   | (98,269 )   | (97,770 )    |
| Accumulated deficit  | (225,401 )  | (228,315 )   |
| Total stockholders' equity   | 56,892      | 49,070       |
| Total liabilities and stockholders' equity                                       | \$ 90,962   | \$ 82,358    |

See notes to condensed consolidated financial statements.

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## ZIX CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

| (In thousands, except share and per share data)    | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|--|-----------------------------|------------|---------------------------|------------|
|  | 2017                        | 2016       | 2017                      | 2016       |
| Revenues   | \$16,378                    | \$14,930   | \$32,271                  | \$29,258   |
| Cost of revenues                                   | 3,247                       | 2,635      | 6,070                     | 5,172      |
| Gross margin                                       | 13,131                      | 12,295     | 26,201                    | 24,086     |
| Operating expenses:                                |                             |            |                           |            |
| Research and development                           | 2,708                       | 2,321      | 5,131                     | 4,500      |
| Selling, general and administrative                | 7,783                       | 9,028      | 15,768                    | 16,172     |
| Total operating expenses                           | 10,491                      | 11,349     | 20,899                    | 20,672     |
| Operating income                                   | 2,640                       | 946        | 5,302                     | 3,414      |
| Other income, net                                  | 66                          | 50         | 145                       | 109        |
| Income before income taxes                         | 2,706                       | 996        | 5,447                     | 3,523      |
| Income tax expense                                 | (1,567 )                    | (437 )     | (2,533 )                  | (1,394 )   |
| Net income   | \$1,139                     | \$559      | \$2,914                   | \$2,129    |
| Basic income per common share                      | \$0.02                      | \$0.01     | \$0.05                    | \$0.04     |
| Diluted income per common share                    | \$0.02                      | \$0.01     | \$0.05                    | \$0.04     |
| Basic weighted average common shares outstanding   | 53,573,431                  | 53,766,979 | 53,268,005                | 54,884,713 |
| Diluted weighted average common shares outstanding | 54,479,963                  | 54,270,000 | 54,075,003                | 55,425,683 |

See notes to condensed consolidated financial statements.

## ZIX CORPORATION

## CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited)

| (In thousands, except shares)       | Stockholders' Equity   |        |                    |                   |                        | Total<br>Stockholders'<br>Equity |
|-------------------------------------|------------------------|--------|--------------------|-------------------|------------------------|----------------------------------|
|                                     | Common Stock<br>Shares | Amount | Paid-In<br>Capital | Treasury<br>Stock | Accumulated<br>Deficit |                                  |
| Balances, December 31, 2016         | 78,913,266             | \$ 769 | \$ 374,386         | \$(97,770)        | \$(228,315)            | \$ 49,070                        |
| Issuance of common stock upon       |                        |        |                    |                   |                        |                                  |
| exercise of stock options           | 915,543                | 9      | 4,119              | —                 | —                      | 4,128                            |
| Issuance of common stock upon       |                        |        |                    |                   |                        |                                  |
| vesting of restricted stock units   | 83,166                 | —      | —                  | —                 | —                      | —                                |
| Issuance of restricted common stock | 650,623                | —      | —                  | —                 | —                      | —                                |
| Issuance of restricted performance  |                        |        |                    |                   |                        |                                  |
| common stock                        | 71,612                 | —      | —                  | —                 | —                      | —                                |
| Employee stock-based                |                        |        |                    |                   |                        |                                  |
| compensation costs                  | —                      | —      | 1,279              | (499)             | —                      | 780                              |
| Net income                          | —                      | —      | —                  | —                 | 2,914                  | 2,914                            |
| Balances, June 30, 2017             | 80,634,210             | \$ 778 | \$ 379,784         | \$(98,269)        | \$(225,401)            | \$ 56,892                        |

See notes to condensed consolidated financial statements.

## ZIX CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| (In thousands)  | Six Months Ended June |           |
|---|-----------------------|-----------|
|   | 2017                  | 2016      |
| <b>Operating activities:</b>                                |                       |           |
| Net income  | \$ 2,914              | \$ 2,129  |
| <b>Non-cash items in net income:</b>                        |                       |           |
| Depreciation and amortization                               | 1,296                 | 1,098     |
| Employee stock-based compensation costs                     | 1,279                 | 1,083     |
| Changes in deferred taxes                                   | 2,231                 | 1,145     |
| <b>Changes in operating assets and liabilities:</b>         |                       |           |
| Receivables   | 460                   | (287 )    |
| Prepaid and other current assets                            | (9 )                  | 33        |
| Accounts payable  | 322                   | 336       |
| Deferred revenue  | (414 )                | 2,031     |
| Accrued and other liabilities                               | (797 )                | (26 )     |
| Net cash provided by operating activities                   | 7,282                 | 7,542     |
| <b>Investing activities:</b>                                |                       |           |
| Purchases of property and equipment                         | (1,266 )              | (1,238 )  |
| Acquisition of business, net of cash acquired               | (6,594 )              | —         |
| Net cash used in investing activities                       | (7,860 )              | (1,238 )  |
| <b>Net cash provided by (used in) financing activities:</b> |                       |           |
| Proceeds from exercise of stock options                     | 4,128                 | 50        |
| Purchase of treasury shares                                 | (499 )                | (14,290 ) |
| Net cash provided by (used in) financing activities         | 3,629                 | (14,240 ) |
| Increase (decrease) in cash and cash equivalents            | 3,051                 | (7,936 )  |
| Cash and cash equivalents, beginning of period              | 26,457                | 28,664    |
| Cash and cash equivalents, end of period                    | \$ 29,508             | \$ 20,728 |

See notes to condensed consolidated financial statements.

ZIX CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Zix Corporation (“Zix” the “Company,” “we,” “our,” “us”) should be read in conjunction with the audited consolidated financial statements included in the Company’s 2016 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 covered interim periods. Management of the Company believes that all adjustments necessary for a fair presentation for such periods have been included and are of a normal recurring nature. The results of operations for the three and six-month periods ended June 30, 2017, are not necessarily indicative of the results to be expected for any future periods or for the full fiscal year.

2. Recent Accounting Standards and Pronouncements

Revenue Recognition

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes most current revenue recognition guidance under U.S. Generally Accepted Accounting Principles (“GAAP”). The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP.

The standard is effective for us beginning 2018, and requires using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We have begun an assessment of the guidance and expect our revenue to remain primarily unchanged. We are additionally analyzing the effect of the new guidance on the timing of our recognition of the incremental costs of obtaining contracts. Accordingly, we are still evaluating the impact of our pending adoption of ASU 2014-09 on our consolidated financial statements and have not yet determined the method by which we will adopt the standard.

Leases

In February 2016, the FASB issued Accounting Standards Update No. 2016-02, Leases (Topic 842), which introduces a lessee model that brings most leases on the balance sheet. The new ASU eliminates the requirement in U.S. GAAP

that entities use bright-line tests in determining lease classifications and requires lessors to provide additional transparency into their exposure to the changes in value of their residual assets and how they manage that exposure.

The standard is effective for us beginning 2019. We expect the valuation of right to use assets and lease liabilities to be the present value of our forecasted future lease commitments and are assessing the discount rate to be applied in these valuations. We are currently evaluating the potential impact of this new guidance on our consolidated financial statements.

#### Accounting for Share-Based Payments

In March 2016, the FASB issued Accounting Standards Update No. 2016-09, Improvements to Employee Share-Based Payment Accounting (Topic 718), which simplifies several aspects of the accounting for employee share-based payment transactions including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows.

The standard became effective for us beginning 2017. We completed an evaluation of the impact of this new guidance in the first quarter 2017, which resulted in \$414 thousand in previously unrecognized excess tax benefits being recorded on a modified retrospective basis through a cumulative-effect adjustment to retained earnings. The balance was fully reserved, resulting in a net zero impact to our retained earnings.

### 3. Stock- Based Awards and Stock-Based Employee Compensation Expense

Our stock-based awards include (i) stock options, (ii) restricted stock awards, some of which are subject to time-based vesting (“Restricted Stock”) and some of which are subject to performance-based vesting (“Performance Stock”), and (iii) restricted stock units, some of which are subject to time-based vesting (“RSUs”) and some of which are subject to performance-based vesting (“Performance RSUs”). As of June 30, 2017, the Company had 1,075,486 stock options outstanding, 1,157,303 non-vested Restricted Stock awards; 193,110 non-vested Performance Stock awards; 129,420 non-vested RSUs; 60,663 non-vested Performance RSUs and 1,174,894 shares of common stock available for grant.

#### Stock Option Activity

The following is a summary of all stock option transactions during the three months ended June 30, 2017:

|                                      | Options    | Exercise Price | Weighted Average | Weighted | Remaining        |
|--------------------------------------|------------|----------------|------------------|----------|------------------|
|                                      |            |                |                  | Average  | Contractual Term |
|                                      |            |                | (Yrs)            |          |                  |
| Outstanding at March 31, 2017        | 1,902,521  | \$ 3.82        |                  |          |                  |
| Granted at market price              | —          | —              |                  |          |                  |
| Cancelled or expired                 | —          | —              |                  |          |                  |
| Exercised                            | (827,035 ) | 4.63           |                  |          |                  |
| Outstanding at June 30, 2017         | 1,075,486  | \$ 3.19        | 5.63             |          |                  |
| Options exercisable at June 30, 2017 | 833,672    | \$ 3.00        | 4.69             |          |                  |

At June 30, 2017, all 1,075,486 stock options outstanding and all 833,672 stock options exercisable had an exercise price lower than the market price of the Company’s common stock on that date. The aggregate intrinsic value of these stock options were \$2.7 million and \$2.2 million, respectively. The Company did not record an excess tax benefit for the three and six month periods ended June 30, 2017, related to the exercise of stock options. The Company did not record an excess tax benefit in the three month period ended June 30, 2016, but did record a \$2 thousand excess tax benefit for the six month period ended June 30, 2016, related to the exercise of 19,812 stock options.

#### Restricted Stock Activity

The following is a summary of Restricted Stock activity during the three months ended June 30, 2017:

|   | Restricted | Weighted   |
|---|------------|------------|
|   | Shares     | Average    |
|   |            | Fair Value |
| Non-vested restricted stock at March 31, 2017 | 1,140,125  | \$ 4.52    |

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|  |           |         |
|--|-----------|---------|
| Granted at market price                      | 50,000    | 5.46    |
| Vested                                       | (32,822 ) | 3.87    |
| Cancelled                                    | —         | —       |
| Non-vested restricted stock at June 30, 2017 | 1,157,303 | \$ 4.57 |

The Company did not record an excess tax benefit for the three and six month periods ended June 30, 2017, related to Restricted Stock awards that vested. The Company did not record an excess tax benefit for the three month period ended June 30, 2016, but did record a \$32 thousand excess tax benefit for the six month period ended June 30, 2016, related to 168,750 Restricted Stock awards that vested.

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## Restricted Stock Unit Activity

The following is a summary of all RSU activity during the three months ended June 30, 2017:

|   | Restricted  | Weighted<br>Average |
|---|-------------|---------------------|
|   | Stock Units | Fair Value          |
| Non-vested restricted stock units at March 31, 2017 | 129,420     | \$ 4.39             |
| Granted at market price                             | —           | —                   |
| Vested  | —           | —                   |
| Cancelled   | —           | —                   |
| Non-vested restricted stock units at June 30, 2017  | 129,420     | \$ 4.39             |

The Company did not record an excess tax benefit for the three and six month periods ended June 30, 2017, related to RSUs that vested. The Company did not record an excess tax benefit for the three month period ended June 30, 2016, but did record a \$5 thousand excess tax benefit for the six month period ended June 30, 2016, related to 133,664 RSUs that vested.

## Performance RSU Activity

The following is a summary of all Performance RSU activity during the three months ended June 30, 2017:

|   | Performance | Weighted<br>Average |
|---|-------------|---------------------|
|   | RSUs        | Fair Value          |
| Non-vested performance RSUs at March 31, 2017 | 60,663      | \$ 4.02             |
| Granted at market price                       | —           | —                   |
| Vested  | —           | —                   |
| Forfeited                                     | —           | —                   |
| Non-vested performance RSUs at June 30, 2017  | 60,663      | \$ 4.02             |

The Company did not record an excess tax benefit for the three and six month periods ended June 30, 2017. The Company did not record an excess tax benefit for the three month period ended June 30, 2016, but did record a \$12 thousand excess tax benefit for the six month period ended June 30, 2016, related to 77,428 Performance RSUs that vested.

## Performance Stock Activity

The following is a summary of all Performance Stock activity during the three months ended June 30, 2017:

|  | Performance Stock | Weighted Average Fair Value |
|--|-------------------|-----------------------------|
| Non-vested performance stock at March 31, 2017 | 193,110           | \$ 4.39                     |
| Granted at market price                        | —                 | —                           |
| Vested   | —                 | —                           |
| Forfeited                                      | —                 | —                           |
| Non-vested performance stock at June 30, 2017  | 193,110           | \$ 4.39                     |

The Company did not record an excess tax benefit for each of the three and six month periods ended June 30, 2017, and 2016.

The weighted average grant-date fair value of awards of Restricted Stock, RSUs, Performance RSUs and Performance Stock is based on the quoted market price of the Company's common stock on the date of grant.

## Stock-Based Compensation Expense

For the three and six month periods ended June 30, 2017, the total stock-based employee compensation expense resulting from stock options, Restricted Stock, RSUs, Performance RSUs and Performance Stock was recorded to the following line items of the Company's condensed consolidated statements of income:

|                                     | Three Months   | Six Months     |
|-------------------------------------|----------------|----------------|
|                                     | Ended June 30, | Ended June 30, |
| (In thousands)                      | 2017           | 2017           |
| Cost of revenues                    | \$ 77          | \$ 148         |
| Research and development            | 97             | 177            |
| Selling, general and administrative | 515            | 954            |
| Stock-based compensation expense    | \$ 689         | \$ 1,279       |

A deferred tax asset totaling \$374 thousand and \$303 thousand, resulting from stock-based compensation expense associated with awards relating to the Company's U.S. operations, was recorded for the six month periods ended June 30, 2017 and 2016, respectively. As of June 30, 2017, there was \$6.1 million of total unrecognized stock-based compensation expense related to non-vested stock-based compensation awards granted under the incentive plans. This expense is expected to be recognized over a weighted average period of 1.70 years.

For additional information regarding the Company's Equity Awards and Stock-based Employee Compensation, see Note 3 to the consolidated financial statements contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

## 4. Supplemental Cash Flow Information

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

|                          | Six Months Ended June |        |
|--------------------------|-----------------------|--------|
|                          | 30,                   |        |
| (In thousands)           | 2017                  | 2016   |
| Cash income tax payments | \$ 349                | \$ 354 |

## 5. Receivables, net

|   | December |          |
|---|----------|----------|
|   | June 30, | 31,      |
| (In thousands)                              | 2017     | 2016     |
| Gross accounts receivables                  | \$10,153 | \$ 8,417 |
| Allowance for returns and doubtful accounts | (243 )   | (91 )    |
| Unpaid portion of deferred revenue          | (8,917 ) | (7,117 ) |
| Note receivable                             | 458      | 458      |
| Allowance for note receivable               | (458 )   | (458 )   |
| Receivables, net                            | \$993    | \$ 1,209 |

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 reduction for the unpaid portion of deferred revenue represents future customer service or maintenance obligations which have been billed to customers, but remain unpaid as of the respective balance sheet dates. Deferred revenue on our consolidated balance sheets represents future customer service or maintenance obligations which have been billed and collected as of the respective balance sheet dates.

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 thousand. This was fully reserved at the time of the sale as the note's collectability was not assured. The note receivable is fully reserved at June 30, 2017.

## 6. Earnings Per Share and Potential Dilution

Basic earnings per share are computed using the weighted average number of common shares outstanding for the applicable period. The dilutive effect of potential common shares outstanding is included in diluted earnings per share. The computations for basic and diluted earnings per share for the three and six months ended June 30, 2017 and 2016, are as follows:

|                                     | Three Months ended June 30, |            | Six Months ended June 30, |            |
|-------------------------------------|-----------------------------|------------|---------------------------|------------|
|                                     | 2017                        | 2016       | 2017                      | 2016       |
| Basic weighted average shares       | 53,573,431                  | 53,766,979 | 53,268,005                | 54,884,713 |
| Effect of dilutive securities:      |                             |            |                           |            |
| Employee and director stock options | 457,714                     | 304,993    | 418,470                   | 320,346    |
| Restricted stock                    | 313,577                     | 119,264    | 270,569                   | 121,287    |
| RSUs                                | 42,283                      | 49,076     | 51,154                    | 64,664     |
| Performance RSUs                    | 29,054                      | 12,786     | 22,169                    | 23,204     |
| Performance Stock                   | 63,904                      | 16,902     | 44,636                    | 11,469     |
| Potential dilutive common shares    | 54,479,963                  | 54,270,000 | 54,075,003                | 55,425,683 |

During the three months ended June 30, 2017, no weighted average shares were excluded from the calculation of diluted earnings per share as anti-dilutive. During the six months ended June 30, 2017, weighted average shares related to 120,529 stock options, 127,856 shares of Restricted Stock, 9,487 RSUs, 3,003 Performance RSUs, and 29,274 shares of Performance Stock were excluded from the calculation of diluted earnings per share because these awards were anti-dilutive.

## 7. Commitments and contingencies

A summary of our fixed contractual obligations and commitments at June 30, 2017, is as follows:

| (In thousands)   | Payments Due by Period |         |             |             |                |
|------------------|------------------------|---------|-------------|-------------|----------------|
|                  | Total                  | 1 Year  | Years 2 & 3 | Years 4 & 5 | Beyond 5 Years |
| Operating leases | \$8,825                | \$1,496 | \$ 2,661    | \$ 2,144    | \$ 2,524       |

We have not entered into any material, non-cancelable purchase commitments at June 30, 2017.

### Claims and Proceedings

We are from time to time involved in legal claims, litigation, and other legal proceedings. Although we may incur significant expenses in those matters, we expect no material adverse effect on our operations or financial results from

current or concluded legal proceedings.

## 8. 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.

For certain of the Company's financial instruments, including cash and cash equivalents, trade receivables, and accounts payable, the fair values approximate the 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.

## 9. Common Stock Repurchase Program

On April 24, 2017, the Company's board of directors approved a share repurchase program that enables the Company to purchase up to \$10 million of its shares of common stock. The share repurchase program will expire May 31, 2018. No shares have been repurchased under this program or during the three and six month periods ended June 30, 2017.

During the three months ended June 30, 2016, the Company repurchased 2,269,588 shares of our common stock at an aggregate cost of \$8.8 million under a \$15.0 million share repurchase program authorized by our board of directors in January 2016. During the three months ended March 31, 2016, the Company repurchased 1,303,484 shares at an aggregate cost of \$5.2 million under the same program.

## 10. Income Taxes

The operating losses incurred by the Company's U.S. operations in past years and the resulting net operating losses for U.S. Federal tax purposes are subject to a \$46.4 million reserve. Any reduction to this \$46.4 million valuation allowance is based on an assessment of future utilization following accounting guidance, which relies largely on historical earnings. Using this methodology, and updating the future taxable earnings estimates based on first and second quarter 2017 actual earnings, the Company believes the deferred tax asset allowance as of December 31, 2016, will remain unchanged at December 31, 2017. For this reason, the Company has recognized its first and second quarter 2017 federal deferred tax provision in full. If in prospective periods we conclude our future U.S. federal taxable estimate established at the end of the year will exceed the prior year estimate, the Company will offset its federal deferred tax provision by reducing its valuation allowance by an equal amount, thereby eliminating from its deferred tax provision federal taxes in excess of the estimated Alternative Minimum Tax from the Company's financial statements. The Company will continue to reevaluate the need for its valuation allowance each quarter, following the same assessment methodology described above. Adjusting our valuation allowance could have a significant impact on operating results for each period that it becomes more likely than not that an additional portion of our deferred tax assets will or will not be realized.

Our deferred taxes at June 30, 2017, include the recognition of a \$494 thousand excess tax deficiency related to stock options exercised during this period. As required by our 2017 implementation of ASU 2016-09, all excess tax benefits and deficiencies are recognized in the period they become deductible on our income tax return. They are not anticipated when determining our annual estimated effective tax rate, but are instead discrete items in the reporting period in which they occur.

## 11. Acquisitions

On March 15, 2017, the Company acquired all of the outstanding capital stock of Greenview Data, Inc. ("Greenview"), a provider of antivirus, anti-spam, and archiving products for a total purchase price of \$7.7 million, including cash consideration of \$6.7 million, subject to a customary post-closing adjustment for working capital. Our acquisition of Greenview addresses increasing buyer demand for email security bundles by adding these capabilities to our existing portfolio of encryption services. Of the cash consideration paid, \$650 thousand was deposited into an escrow account for the satisfaction of certain indemnification claims of the Company, if any, during the two year period following the closing of the acquisition, after which the balance, if any, will be distributed to the selling shareholders. The Company may additionally be required to pay earnout consideration in cash of up to \$1.6 million based on achievement of certain sales milestones of Greenview products by December 31, 2018. Contingent consideration is considered a Level 3 fair value measurement. The Company is in the process of assessing the fair value for this contingent consideration, which was not complete as of June 30, 2017.

We accounted for the acquisition as the purchase of a business and have initially recorded the excess purchase price as goodwill. The goodwill from this transaction is not deductible for tax purposes. The results of operations and the provisional fair values of the acquired assets and liabilities assumed have been included in the accompanying condensed consolidated financial statements since our March 15, 2017, acquisition date.

The following table summarizes the provisional fair value of acquired assets and liabilities:

| (In thousands)            | Provisional<br>Fair<br>Value |
|---------------------------|------------------------------|
| <b>Assets:</b>            |                              |
| Current assets            | \$ 334                       |
| Property and equipment    | 255                          |
| Intangible assets         | 5,040                        |
| Goodwill                  | 4,327                        |
| Total assets              | 9,956                        |
| <b>Liabilities:</b>       |                              |
| Deferred revenue          | \$ 537                       |
| Other current liabilities | 114                          |
| Deferred tax liability    | 1,609                        |
| Total liabilities         | 2,260                        |
| Net assets recorded       | \$ 7,696                     |

The following unaudited pro forma financial information presents the combined results of operations for the three and six month periods ending June 30, 2017, and 2016, respectively, as though the Greenview acquisition that occurred during the reporting period had occurred as of the beginning of the comparable prior reporting period, with adjustments to give effect to pro forma events that are directly attributable to the acquisition, such as amortization expense of intangible assets and acquisition-related transaction costs. These unaudited pro forma results are presented for information purposes only and are not necessarily indicative of what the actual results of operations of the combined company would have been if the acquisition had occurred at the beginning of the period presented, nor are they indicative of future results of operations:

| (In thousands, except per share data) | Three Months Ended June 30, |           | Six Months Ended June 30, |           |
|---------------------------------------|-----------------------------|-----------|---------------------------|-----------|
|                                       | 2017                        | 2016      | 2017                      | 2016      |
| Revenues                              | \$ 16,378                   | \$ 15,600 | \$ 32,818                 | \$ 30,597 |
| Net income                            | 1,359                       | 417       | 3,116                     | 1,845     |
| Basic income per common share         | \$ 0.03                     | \$ 0.01   | \$ 0.06                   | \$ 0.03   |
| Diluted income per common share       | \$ 0.02                     | \$ 0.01   | \$ 0.06                   | \$ 0.03   |

The Company is in the process of determining the valuation of certain property, equipment and intangible assets and liabilities, which may result in further refinement of the allocation of the purchase price for Greenview.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

NOTE ON FORWARD-LOOKING STATEMENTS AND RISK FACTORS

Statements in this report which are not purely historical facts or which necessarily depend upon future events, including statements about trends, uncertainties, hopes, beliefs, anticipations, expectations, plans, intentions or strategies for the future, may be forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. Forward-looking statements involve risks and uncertainties that could cause actual events or results to differ materially from the events or results described in the forward-looking statements, including risks and uncertainties described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016. Any of these risk factors could have a material adverse effect on our business, financial condition or financial results and reduce the value of an investment in our securities. We may not succeed in addressing these and other risks associated with an investment in our securities, with our business and with our achieving any forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements. All forward-looking statements are based upon information available to us on the date the statements are made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## Overview

Zix® is a leader in email security. Trusted by the nation's most influential institutions in healthcare, finance and government, Zix delivers a superior experience and easy-to-use solutions for email encryption and data loss prevention ("DLP"), advanced threat protection, archiving, and bring your own device ("BYOD") mobile security. Focusing on the protection of business communication, Zix enables its customers to better secure data and meet compliance needs. We primarily serve organizations in the healthcare, financial services, insurance and government sectors, including U.S. federal financial regulators— such as members of the Federal Financial Institutions Examination Council (FFIEC), divisions of the U.S. Treasury, the U.S. Securities and Exchange Commission (SEC), 30% of U.S. banks, more than 30% of Blue Cross Blue Shield plans and more than 1,200 U.S. hospitals.

ZixEncrypt<sup>SM</sup> (formerly ZixGateway® and ZixQuarantine®) bundles email encryption and DLP capabilities to enable the secure exchange of email that includes sensitive information. Through a comprehensive secure messaging service, ZixEncrypt allows an enterprise to use policy-driven rules to determine which email messages should be sent securely or quarantined for review to comply with regulations or company-defined policies.

The main differentiation for ZixEncrypt in the marketplace is our exceptional ease of use. The best example of this is our ability to provide transparent delivery of encrypted email. Most email encryption solutions are focused on the sender. They typically introduce an added burden on recipients, often requiring additional user authentication with creation of a new user identity and password. We designed our solution to alleviate the recipient's burden by enabling the delivery of encrypted email automatically and transparently. Zix enables transparent delivery by (1) ZixDirectory®, the world's largest email encryption community which is designed to share identities of our tens of millions of members (growing by approximately 170,000 members per week), (2) Zix's patented Best Method of Delivery®, which is designed to deliver email in the most secure, most convenient method possible for the recipient, and (3) ZixEncrypt, which automatically encrypts and decrypts messages with sensitive content. The result is secure, transparent encrypted email, such that secure email can be exchanged without any impact to administrators or extra steps for both senders and recipients. Zix delivers more than 1,400,000 encrypted messages on a typical business day. Of those messages, approximately 70% are exchanged transparently between senders and recipients.

ZixEncrypt also addresses business's greatest source of data loss – corporate email– with an easy, straightforward DLP approach. By focusing strictly on the risks of email, ZixEncrypt simplifies DLP in comparison to other DLP solutions by decreasing complexity and cost, reducing deployment time from months to hours and minimizing impact on customer resources and workflow. In addition, Zix offers a convenient experience for both employees interacting with our solution and administrators managing the system.

ZixEncrypt enables DLP capabilities for email by combining proven policy and content scanning capabilities with quarantine functionality. The quarantine system and its intuitive interface allow administrators to (1) easily define policies and create custom lexicons for quarantining email messages, (2) conveniently manage quarantined messages using flexible searching and filtering options, (3) release or delete individual or multiple quarantined messages with one click, (4) review reports that monitor quarantine activities and trends and (5) automate custom notifications informing employees of quarantined messages.

ZixEncrypt also provides greater visibility into an organization's data risks in email by capturing data in outbound emails and highlighting violations that trigger policy filters to encrypt or quarantine. Through our interactive, real-time interface, companies can monitor their greatest vulnerabilities, generate reports for business executives and train employees about the sensitivity of their company's data.

ZixEncrypt is available as a physical or virtual on-premises appliance or as a hosted solution.

ZixOne® is a unique mobile email app that solves the key IT challenge created by the BYOD trend in the workplace. BYOD describes employee's use of personal devices to conduct work. ZixOne provides mobile access to corporate email while never allowing that data to be persistently stored on an employee's device where it is vulnerable to loss or theft. If the device is lost or stolen, an administrator can simply disable access to corporate email from that device through ZixOne.

Unlike other BYOD solutions, ZixOne meets employee demands of convenience, control and privacy while giving companies the ability to secure corporate data and meet compliance needs. With seamless access to work email in a secure, simple-to-use environment, employees can stay productive while preserving device independence. A BYOD solution that is acceptable to employees and yet provides strong data protection for corporate data solves one of today's greatest IT management challenges.

ZixOne is available as a standalone solution and easily integrates with ZixEncrypt as an add-on solution. A feature in ZixOne is the ability to encrypt an email from your mobile device with the simple slide of an "Encrypt" button, ensuring that sensitive information is secured either by the user or through automatic policies of ZixEncrypt.

In March 2017, Zix acquired Greenview Data Inc. (“Greenview”), an email security company. Zix’s acquisition of Greenview addresses increasing buyer demand for email security bundles by adding advanced threat protection, antivirus, anti-spam and archiving capabilities to its industry-leading email encryption. Greenview is a good fit for Zix’s business based on its employees’ expertise in email security and its emphasis on customer success, which align with Zix’s reputation for delivering industry-leading solutions and a superior experience.

Through the acquisition of Greenview, Zix launched two new solutions in April 2017 – ZixProtect and ZixArchive. ZixProtect defends organizations from zero-day malware, ransomware, phishing, CEO fraud, W-2 phishing attacks, spam and viruses in email with multi-layer filtering techniques. Accuracy in protecting organizations from email threats is increased further with automated traffic analysis, machine learning and real-time threat analysts.

ZixProtect is available as a cloud-based service in three bundles. ZixProtect Essentials includes email threat protection and business email continuity to enable access to emails during service disruption; ZixProtect Plus combines email threat protection and business email continuity with automatic email encryption; and ZixProtect Premium delivers a comprehensive email security solution with email threat protection, business email continuity, email encryption and data loss prevention.

ZixArchive is a low-cost, cloud-based email retention solution that easily enables user retrieval, compliance and eDiscovery. Available as a standalone or add-on solution for ZixEncrypt or ZixProtect bundles, ZixArchive includes policy-based retention, automatic indexing and flexible search capabilities for audit and legal requirements. With on-demand access through the cloud, organizations can conveniently share messages with employees, auditors and outside consultants or legal counsel, as well as revoke access when needed.

Our business operations and service offerings are supported by the ZixData Center™, a PCI DSS 3.2 certified, SOC2 accredited and SOC 3 certified facility. The operations of the ZixData Center are independently audited annually to maintain SOC3 certification in the areas of security, confidentiality, integrity and availability. Auditors also produce a SOC2 report on the effectiveness of operational controls used over the audit period. The ZixData Center is staffed 24 hours a day and has a track record that exceeds 99.99% availability.

#### Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in accordance with accounting principles generally accepted in the United States requires the Company’s management to make estimates and assumptions that affect the amounts reported in the Company’s condensed consolidated financial statements and accompanying notes. Actual results could differ from these estimates and assumptions. Critical accounting policies and estimates are defined as those that are both most important to the portrayal of the Company’s financial condition and results and require management’s most subjective judgments.

We describe our significant accounting policies in Note 2, Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2016. We discuss our Critical Accounting Policies and Estimates in Management’s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2016.

#### Results of Operations

##### Second Quarter 2017 Summary of Operations

##### Financial

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Revenue for the quarter ended June 30, 2017, was \$16.4 million compared with \$14.9 million for the same period in 2016, representing a 10% increase.

Gross margin for the quarter ended June 30, 2017, was \$13.1 million or 80% of revenues compared with \$12.3 million or 82% of revenues for the comparable period in 2016.

Net income for the quarter ended June 30, 2017, was \$1.1 million compared with net income of \$0.6 million in the comparable period in 2016, representing a 104% increase.

- Net income per diluted share was \$0.02 for the quarter ended June 30, 2017, compared with net income per diluted share of \$0.01 in the comparable period in 2016.

Ending cash and cash equivalents were \$29.5 million on June 30, 2017, compared with \$20.7 million on June 30, 2016, and \$26.5 million on December 31, 2016.

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## Operations

• New first year orders (“NFYOs”) for the quarter ended June 30, 2017, were \$2.6 million, compared with \$3.0 million for the same period in 2016, representing a 13% decrease.

• Total orders for the quarter ended June 30, 2017, were \$15.7 million, compared with \$20.4 million for the same period in 2016, representing a 23% decrease.

• The annual contract value of our customer subscriptions as of June 30, 2017, was \$65.2 million, compared to \$59.5 million for the same period in 2016, representing a 10% increase.

• Net cash provided by operations in the six months ended June 30, 2017, was \$7.3 million, compared to \$7.5 million for the same period in 2016, representing a 3% decrease.

• As of June 30, 2017, backlog was \$77.8 million, compared with \$80.9 million as of June 30, 2016, representing a 4% decrease.

## Revenues

Our Company provides subscription-based services. The following table sets forth the quarter-over-quarter comparison of the Company’s revenues:

| (in thousands) | 3-month Variance            |           |               |      | 6-month Variance          |           |               |      |
|----------------|-----------------------------|-----------|---------------|------|---------------------------|-----------|---------------|------|
|                | Three Months Ended June 30, |           | 2017 vs. 2016 |      | Six Months ended June 30, |           | 2017 vs. 2016 |      |
|                | 2017                        | 2016      | \$            | %    | 2017                      | 2016      | \$            | %    |
| Revenues       | \$ 16,378                   | \$ 14,930 | \$ 1,448      | 10 % | \$ 32,271                 | \$ 29,258 | \$ 3,013      | 10 % |

The increase in revenue was due to the growth inherent in a successful subscription-based business model with steady additions to the subscriber base coupled with a high rate of existing customer renewals and the realization of previously contracted revenue in our backlog. In the first six months of 2017, excluding our Greenview sales, we categorized our revenue in the following core industry verticals: 51% healthcare, 28% financial services, 7% government sector, and 14% as other. In the first six months of 2016, we categorized our revenue in the following core industry verticals: 52% healthcare, 28% financial services, 7% government sector, and 13% as other.

## Revenue Indicators — Backlog and Orders

**Backlog** — Our end-user order backlog is comprised of contractually binding agreements that we expect to amortize into revenue as the services are performed. The timing of revenue is affected by both the length of time required to deploy a service and the length of the service contract.

As of June 30, 2017, total backlog was \$77.8 million and we expect approximately 60% of the total backlog, or approximately \$46.4 million, to be recognized as revenue during the next twelve months. As of June 30, 2017, the backlog was comprised of the following elements: \$27.3 million of deferred revenue that has been billed and paid, \$8.9 million billed but unpaid, and approximately \$41.6 million of unbilled contracts. The backlog at June 30, 2017, was 4% lower than the \$80.9 million backlog at the end of the second quarter 2016, and 5% lower than the ending backlog of \$81.7 million at December 31, 2016. Our decrease in backlog reflects the shorter term contractual commitment generally associated with our new customer pricing as a component of a higher touch strategy, as well as the loss of a large customer in the first quarter 2017.

Orders — Total orders were \$15.7 million and \$20.4 million for the three-month periods ended June 30, 2017 and 2016, respectively, representing a 23% decrease year-over-year. Total orders include contract renewals, NFYOs, and in the case of new multi-year contracts, amounts attributable to the years beyond the first year of service. As noted above, our decrease in total orders is reflective of our move away from such multi-year contracts in our selling approach. NFYOs were \$2.6 million and \$3.0 million for the three-month periods ended June 30, 2017 and 2016, respectively, representing a 13% decrease year-over-year. Our 2017 decrease in NFYOs is the result of a single \$640 thousand order secured in April 2016.

## Cost of Revenues

The following table sets forth the quarter-over-quarter comparison of the cost of revenues:

| (in thousands)   | 3-month Variance                          |          |        |      | 6-month Variance                        |          |        |      |
|------------------|---|----------|--------|------|---|----------|--------|------|
|                  | Three Months Ended June 30, 2017 vs. 2016 |          |        |      | Six Months ended June 30, 2017 vs. 2016 |          |        |      |
|                  | 2017                                      | 2016     | \$     | %    | 2017                                    | 2016     | \$     | %    |
| Cost of revenues | \$ 3,247                                  | \$ 2,635 | \$ 612 | 23 % | \$ 6,070                                | \$ 5,172 | \$ 898 | 17 % |

Cost of revenues is comprised of costs related to operating and maintaining the ZixData Center, a field deployment team, customer service and support and the amortization of Company-owned, customer-based computer appliances. The increases in 2017 compared to 2016 reflected in the table above resulted primarily from increases in average headcount expense, which now include our ZixProtect support team gained in the Greenview acquisition in March 2017. We are also incurring costs associated with leased equipment currently supporting Greenview customers, and we are amortizing expense resulting from the acquisition of Greenview's internally developed software. Additional increases relate to standard software maintenance and license support, and depreciation and other expense relating to investments in networking equipment.

## Research and Development Expenses

The following table sets forth the quarter-over-quarter comparison of our research and development expenses:

| (in thousands)                    | 3-month Variance                          |          |        |      | 6-month Variance                        |          |        |      |
|-----------------------------------|---|----------|--------|------|---|----------|--------|------|
|                                   | Three Months Ended June 30, 2017 vs. 2016 |          |        |      | Six Months ended June 30, 2017 vs. 2016 |          |        |      |
|                                   | 2017                                      | 2016     | \$     | %    | 2017                                    | 2016     | \$     | %    |
| Research and development expenses | \$ 2,708                                  | \$ 2,321 | \$ 387 | 17 % | \$ 5,131                                | \$ 4,500 | \$ 631 | 14 % |

Research and development expenses consist primarily of salary, benefits, and stock-based compensation for our development staff, independent development contractor expenses, and other direct and indirect costs associated with enhancing our existing products and services and developing new products and services. The increase in 2017 compared to 2016 reflected in the table above resulted primarily from an increase in average headcount, which now includes ZixProtect R&D employees gained in the Greenview acquisition in March 2017.

## Selling and Marketing Expenses

The following table sets forth the quarter-over-quarter comparison of our selling and marketing expenses:

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| (in thousands)                 | 3-month Variance                          |          |        |     | 6-month Variance                        |          |        |      |
|--------------------------------|---|----------|--------|-----|---|----------|--------|------|
|                                | Three Months Ended June 30, 2017 vs. 2016 |          |        |     | Six Months ended June 30, 2017 vs. 2016 |          |        |      |
|                                | 2017                                      | 2016     | \$     | %   | 2017                                    | 2016     | \$     | %    |
| Selling and marketing expenses | \$ 5,222                                  | \$ 5,083 | \$ 139 | 3 % | \$ 10,395                               | \$ 9,492 | \$ 903 | 10 % |

Selling and marketing expenses consist primarily of salary, commissions, travel, stock-based compensation and employee benefits for selling and marketing personnel as well as costs associated with promotional activities and advertising. The increase in the three months ended June 30, 2017, compared to the same period in 2016, resulted primarily from higher payroll and stock-based compensation costs, including expense associated with enhancing our customer success teams, additional travel, and amortization expense resulting from the acquisition of Greenview's customer base and brand. These costs were offset by decreased advertising and promotional expense.

The six month variance in selling and marketing expense resulted primarily from higher payroll and stock-based compensation costs, including costs related to the enhancement of our product management team, travel, and the amortization expense resulting from the acquisition of Greenview intangible assets noted above. We additionally incurred a higher bad debt expense year over year.

## General and Administrative Expenses

The following table sets forth the quarter-over-quarter comparison of our general and administrative expenses:

| (in thousands)                      | 3-month Variance                          |          |            |        | 6-month Variance                        |          |            |        |
|-------------------------------------|---|----------|------------|--------|---|----------|------------|--------|
|                                     | Three Months Ended June 30, 2017 vs. 2016 |          |            |        | Six Months ended June 30, 2017 vs. 2016 |          |            |        |
|                                     | 2017                                      | 2016     | \$         | %      | 2017                                    | 2016     | \$         | %      |
| General and administrative expenses | \$ 2,561                                  | \$ 3,945 | \$(1,384 ) | (35 )% | \$ 5,373                                | \$ 6,680 | \$(1,307 ) | (20 )% |

General and administrative expenses consist primarily of salary and bonuses, travel, stock-based compensation and benefits for administrative and executive personnel as well as fees for professional services and other general corporate activities. The decrease in the three months ended June 30, 2017, compared to the same period in 2016 resulted primarily from a \$1.2 million reduction in legal fees specific to intellectual property litigation, decreased expenses related to 2016 CFO separation pay and related acceleration of equity, as well as decreases in broker and other professional fees. These decreases were offset by increased headcount expenses and the addition of the Greenview office.

The decrease in the six months ended June 30, 2017, compared to the same period 2016, resulted primarily from a \$1.7 million reduction in legal fees specific to intellectual property litigation, decreases in expenses related to 2016 CFO separation, as well as decreases in broker and other professional fees. These reductions were offset by Greenview acquisition costs, as well as increased headcount, and Greenview office expenses.

## Provision for Income Taxes

The provision for income taxes was \$1.6 million and \$437 thousand for the three-month periods ended June 30, 2017 and 2016, respectively, and \$2.5 million and \$1.4 million for each of the six months ended June 30, 2017 and 2016. The operating losses incurred by the Company's U.S. operations in past years and the resulting net operating losses for U.S. Federal income tax purposes are subject to a \$46.4 million reserve because of the uncertainty of future taxable income levels sufficient to utilize our net operating losses and credits. Our June 30, 2017, provision of \$2.5 million includes \$2.2 million in deferred taxes, \$151 thousand in state taxes currently payable based on gross revenues, \$89 thousand related to the federal Alternative Minimum Tax, and \$61 thousand in taxes related to our Canadian operations. Our June 30, 2016, provision of \$1.4 million included \$1.1 million in deferred taxes, \$98 thousand in state taxes then payable based on gross revenues, \$65 thousand related to the federal Alternative Minimum Tax, and \$86 thousand in taxes related to our Canadian operations.

Our deferred taxes at June 30, 2017, include the recognition of a \$494 thousand excess tax deficiency related to stock options exercised during this period. As required by our 2017 implementation of ASU 2016-09, all excess tax benefits and deficiencies are recognized in the period they become deductible on our income tax return. They are not anticipated when determining our annual estimated effective tax rate, but are instead discrete items in the reporting period in which they occur.

No tax penalty-related charges were accrued or recognized for the three month periods ended June 30, 2017 and 2016. Additionally, we have not taken a tax position that would have a material effect on our financial statements or our

effective tax rate for the three-month period ended June 30, 2017. We are currently subject to a three-year statute of limitations by major tax jurisdictions.

At June 30, 2017, the Company partially reserved its U.S. net deferred tax assets due to the uncertainty of future taxable income being sufficient to utilize net loss carryforwards prior to their expiration, as noted above. The Company did not reserve \$41.9 million of its U.S. net deferred tax assets. The majority of this unreserved portion related to \$37.0 million in U.S. net operating losses (“NOLs”) because we believe the Company will generate sufficient taxable income in future years to utilize these NOLs prior to their expiration. The remaining balance consists of \$1.8 million relating to temporary differences between GAAP and tax-related expense, \$1.7 million relating to U.S. state income tax credits and net operating loss carryovers, and \$1.4 million related to Alternative Minimum Tax credits.

Any reduction to the \$46.4 million valuation allowance related to our deferred tax asset would be based on an assessment of future utilization following accounting guidance, which relies largely on historical earnings. Using this methodology, and updating the future taxable earnings estimates based on first and second quarter 2017 actual earnings, the Company believes the deferred tax asset allowance as of December 31, 2016, will remain unchanged at December 31, 2017. For this reason, the Company has recognized its first and second quarter 2017 federal deferred tax provision in full. If in future periods we conclude our future U.S. federal taxable estimate established at the end of the year will exceed the prior year estimate, the Company will offset its federal deferred tax provision by reducing its valuation allowance by an equal amount, thereby eliminating from its deferred tax provision federal taxes in excess of the estimated Alternative Minimum Tax from the Company’s financial statements. Significant judgment is required in determining any valuation allowance recorded against the deferred tax asset. In assessing the need for such an allowance, we consider

all available evidence, including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies. The Company will continue to reevaluate the need for its valuation allowance each quarter, following the same assessment methodology described above. Adjusting our valuation allowance could have a significant impact on operating results for each period during which it becomes more likely than not that an additional portion of our deferred tax assets will or will not be realized.

We have determined that utilization of existing net operating losses against future taxable income is not currently subject to limitation by Section 382 of the Internal Revenue Code. Future ownership changes, however, may limit the Company's ability to fully utilize its existing net operating loss carryforwards against future taxable income.

## Net Income

Our net income for the three months ended June 30, 2017, of \$1.1 million was an increase of \$0.6 million compared to our net income of \$0.6 million for the same period last year, representing a 104% increase. The increase in our net income was due to our increase in revenue, offset by our higher operating expenses, as discussed above.

## Liquidity and Capital Resources

### Overview

Based on our performance over the last four quarters and current expectations, we believe our cash and cash equivalents and cash generated from operations will satisfy our working capital needs, capital expenditure requirements, investment requirements, contractual obligations, commitments, future customer financings, and other liquidity requirements associated with our operations through at least the next twelve months. We plan for and measure our liquidity and capital resources through an annual budgeting process. During the first six months of 2017, net cash provided by operations was \$7.3 million, a decrease of 3% compared to the \$7.5 million of net cash provided by operations in the first six months of 2016. At June 30, 2017, our cash and cash equivalents totaled \$29.5 million, an increase of \$3.1 million from the December 31, 2016 balance, and we had no debt. This \$3.1 million increase in our cash position included our expenditure of \$6.6 million, net of cash acquired, in the first three months of 2017 related to our Greenview acquisition, as discussed elsewhere herein.

### Sources and Uses of Cash Summary

| (In thousands)                           | Six<br>Months Ended June<br>30, |            |
|--|---------------------------------|------------|
|  | 2017                            | 2016       |
| Net cash provided by operations          | \$ 7,282                        | \$ 7,542   |
| Net cash used in investing activities    | \$(7,860)                       | \$(1,238)  |
| Net cash used in by financing activities | \$ 3,629                        | \$(14,240) |

Our primary source of liquidity from our operations is the collection of revenue in advance from our customers and collection of accounts receivable from our customers, net of the timing of payments to our vendors and service providers.

Our investing activities in the first six months of 2017 consisted of \$6.6 million, net of cash acquired, used in the acquisition of Greenview. We additionally purchased \$1.2 million of computer and networking equipment, including Greenview equipment with a provisional fair value of \$228 thousand. In the first six months of 2016, our spending was primarily computer and networking equipment purchases to improve our capacity to provide hosting services.

Financing activities in the first three months of 2017 include the receipt of \$4.1 million from the exercise of stock options offset by \$499 thousand used in the repurchase of common stock related to the tax impact of vesting restricted awards. Cash received from financing activities in the first three months of 2016 included the receipt of \$50 thousand from the exercise of stock options offset by \$14.0 million used in a \$15.0 million share repurchase program authorized by our board of directors in January 2016 and \$263 thousand used in the repurchase of common stock related to the tax impact of vesting restricted awards.

## Options of Zix Common Stock

We have significant stock options outstanding that are currently vested. There is no assurance that any of these options will be exercised; therefore, the extent of future cash inflow from additional option activity is not certain. The following table summarizes the options that were outstanding as of June 30, 2017. The vested shares are a subset of the outstanding shares. The value of the shares is the number of shares multiplied by the exercise price for each share.

| Exercise Price Range | Summary of Outstanding Options |                                    |                                   |                               |
|----------------------|--------------------------------|------------------------------------|-----------------------------------|-------------------------------|
|                      | Options                        | Total Value of Outstanding Options | (included in outstanding options) | Total Value of Vested Options |
| \$1.11 - \$1.99      | 76,724                         | \$ 117                             | 76,724                            | \$ 117                        |
| \$2.00 - \$3.49      | 441,813                        | 1,136                              | 441,813                           | 1,136                         |
| \$3.50 - \$4.99      | 556,949                        | 2,178                              | 315,135                           | 1,247                         |
| Total                | 1,075,486                      | \$ 3,431                           | 833,672                           | \$ 2,500                      |

## Off-Balance Sheet Arrangements

None.

## Contractual Obligations, Contingent Liabilities and Commitments

A summary of our fixed contractual obligations and commitments at June 30, 2017, is as follows:

| (In thousands)   | Payments Due by Period |         |             |                |
|------------------|------------------------|---------|-------------|----------------|
|                  | Total                  | 1 Year  | Years 2 & 3 | Beyond 3 Years |
| Operating leases | \$8,825                | \$1,496 | \$ 2,661    | \$ 4,668       |

We have not entered into any material, non-cancelable purchase commitments at June 30, 2017.

We have severance agreements with certain employees which would require the Company to pay approximately \$6.3 million if all such employees were separated from employment with our Company following a triggering event (e.g., change of control) as defined in the severance agreements.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have no material changes to the disclosure on this matter made in our Annual Report on Form 10-K for the year ended December 31, 2016.

#### ITEM 4. CONTROLS AND PROCEDURES

The Company, under the supervision and with the participation of its management, including the Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's "disclosure controls and procedures" (as defined in Rule 13a-15(e)) under the Exchange Act as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2017.

#### Changes in Internal Controls over Financial Reporting

During the six months ended June 30, 2017, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect internal control over financial reporting.

## PART II — OTHER INFORMATION

#### ITEM 1. Legal Proceedings

None.

ITEM 1A. Risk Factors

See Part I, Item 1A, “Risk Factors,” of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2016. There have been no material changes in our risk factors from those disclosed in such Annual Report on Form 10-K. The risk factors in our Form 10-K should be read in conjunction with the considerations set forth above in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) None.

(b) None.

(c) Purchases of Equity Securities by the Issuer

| Period                          | Total Number of Shares Purchased (1) | Average Price Paid per Share (1) | Announced Plans or Programs |                             | Total Number of Shares Purchased as part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares Yet Be Purchased |
|---------------------------------|--------------------------------------|----------------------------------|-----------------------------|-----------------------------|--|---|
|                                 |                                      |                                  | Under the Plans or Programs | Under the Plans or Programs |  |   |
| April 1, 2017 to April 30, 2017 | —                                    | \$ —                             | —                           | \$ —                        | —  | —   |
| May 1, 2017 to May 31, 2017     | 8,368                                | \$ 5.43                          | —                           | \$ —                        | —  | —   |
| June 1, 2017 to June 31, 2017   | —                                    | \$ —                             | —                           | \$ —                        | —  | —   |
| Total                           | 8,368                                | \$ 5.43                          | —                           | \$ —                        | —  | —   |

1 Of the total number of shares purchased for the one month period ended April 30, 2017; May 31, 2017; and June 30, 2017; 8,368 shares of Restricted Stock represent shares of Restricted Stock withheld by us upon the vesting of outstanding Restricted Stock. These shares were withheld by us to satisfy the minimum statutory tax withholding for the employees for whom Restricted Stock vested during the period, which is required once the Restricted Stock is vested.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.



ITEM 6. EXHIBITS

a. Exhibits

The following is a list of exhibits filed as part of this Quarterly Report on Form 10-Q:

Exhibit

| No.    | Description of Exhibits  |
|--------|--|
| 3.1    | Restated Articles of Incorporation of Zix Corporation, as filed with the Texas Secretary of State on November 10, 2005 (incorporated herein by reference to Exhibit 3.1 to Zix Corporation's Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission on March 14, 2006, and incorporated herein by reference). |
| 3.2    | Second Amended and Restated Bylaws of Zix Corporation, dated November 1, 2016 (incorporated herein by reference to Exhibit 3.2 to Zix Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016 filed with the Securities and Exchange Commission on November 3, 2016, and incorporated herein for reference).                                |
| 31.1*  | <u>Certification of David J. Wagner, President and Chief Executive Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>  |
| 31.2*  | <u>Certification of David E. Rockvam, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>  |
| 32.1** | <u>Certification of CEO and CFO, pursuant to 18 U.S.C. Section 1350, as adopted, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>  |
| 101.1* | 101. INS (XBRL Instance Document)  |
|        | 101. SCH (XBRL Taxonomy Extension Schema Document)   |
|        | 101. CAL (XBRL Calculation Linkbase Document)  |
|        | 101. LAB (XBRL Taxonomy Label Linkbase Document)   |
|        | 101. DEF (XBRL Taxonomy Linkbase Document)   |
|        | 101. PRE (XBRL Taxonomy Presentation Linkbase Document)  |

\* Filed herewith.

\*\* Furnished herewith.



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.

ZIX CORPORATION

Date: August 7, 2017 By: /s/ DAVID E. ROCKVAM  
David E. Rockvam  
Chief Financial Officer (Principal Financial  
Officer and Principal Accounting Officer)