

ZIX CORP
Form 10-Q
August 07, 2018

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, 2018

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, 2018
Common Stock, par value \$0.01 per share	54,164,608

INDEX

	Page
	Number
PART I — FINANCIAL INFORMATION	
Item 1. Financial Statements (Unaudited)	
<u>Condensed Consolidated Balance Sheets at June 30, 2018 (unaudited) and December 31, 2017</u>	3
<u>Condensed Consolidated Statements of Income (unaudited) for the three and six months ended June 30, 2018 and 2017</u>	4
<u>Condensed Consolidated Statement of Stockholders' Equity (unaudited) for the six months ended June 30, 2018</u>	5
<u>Condensed Consolidated Statements of Cash Flows (unaudited) for the six months ended June 30, 2018 and 2017</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	24
Item 4. <u>Controls and Procedures</u>	24
PART II — OTHER INFORMATION	
Item 1. <u>Legal Proceedings</u>	25
Item 1A. <u>Risk Factors</u>	25
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	25
Item 3. <u>Defaults Upon Senior Securities</u>	25
Item 4. <u>Mine Safety Disclosures</u>	25
Item 5. <u>Other Information</u>	25
Item 6. <u>Exhibits</u>	26

ZIX CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30,	December 31,
(In thousands, except share and par value data)	2018	2017
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 17,696	\$ 33,009
Receivables, net	2,296	1,389
Prepaid and other current assets	2,978	3,222
Total current assets	22,970	37,620
Property and equipment, net	4,212	4,048
Other assets and deferred costs	7,920	—
Intangible assets, net	14,467	5,524
Goodwill	13,494	8,469
Deferred tax assets	22,340	25,647
Total assets	\$ 85,403	\$ 81,308
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,201	\$ 1,053
Accrued expenses	7,742	6,101
Deferred revenue	24,082	28,362
Total current liabilities	33,025	35,516
Long-term liabilities:		
Deferred revenue	3,966	1,087
Deferred rent	1,095	1,185
Total long-term liabilities	5,061	2,272
Total liabilities	38,086	37,788
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; 81,688,734		
issued and 54,167,688 outstanding in 2018 and 80,709,970 issued and 54,542,612		
outstanding in 2017	778	778
Additional paid-in capital	382,962	381,457
Treasury stock, at cost; 27,521,046 common shares in 2018 and 26,167,358		
common shares in 2017	(108,347)	(102,343)
Accumulated deficit	(228,076)	(236,372)
Total stockholders' equity	47,317	43,520

Total liabilities and stockholders' equity	\$ 85,403	\$ 81,308
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See notes to condensed consolidated financial statements.

3

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,	
	2018	2017	2018	2017
Revenues	\$17,500	\$16,378	\$34,153	\$32,271
Cost of revenues	3,806	3,247	7,319	6,070
Gross margin	13,694	13,131	26,834	26,201
Operating expenses:				
Research and development	2,978	2,708	5,956	5,131
Selling, general and administrative	8,562	7,783	16,115	15,768
Total operating expenses	11,540	10,491	22,071	20,899
Operating income	2,154	2,640	4,763	5,302
Other income, net	360	66	479	145
Income before income taxes	2,514	2,706	5,242	5,447
Income tax expense	(674)	(1,567)	(1,510)	(2,533)
Net income	\$1,840	\$1,139	\$3,732	\$2,914
Basic income per common share	\$0.04	\$0.02	\$0.07	\$0.05
Diluted income per common share	\$0.03	\$0.02	\$0.07	\$0.05
Basic weighted average common shares outstanding	52,467,904	53,573,431	52,670,540	53,268,005
Diluted weighted average common shares outstanding	53,217,100	54,479,963	53,347,976	54,075,003

See notes to condensed consolidated financial statements.

ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited)

	Stockholders' Equity					Total
	Common Stock		Additional	Treasury	Accumulated	
(In thousands, except shares)	Shares	Amount	Capital	Stock	Deficit	Equity
Balances, January 1, 2018, as reported	80,709,970	\$ 778	\$ 381,457	\$(102,343)	\$(236,372)	\$ 43,520
Cumulative effect adjustment from						
changes in accounting standards, net						
of taxes (see Note 2)	—	—	—	—	4,564	4,564
Balances, January 1, 2018, as adjusted	80,709,970	778	381,457	(102,343)	(231,808)	48,084
Net issuance of common stock upon						
exercise of stock options	27,080		33			33
Net issuance of common stock upon						
vesting of restricted stock units	50,751	—	—	—	—	—
Net issuance of common stock upon						
vesting of performance stock units	32,665	—	—	—	—	—
Net issuance of restricted common						
stock	772,322	—	—	—	—	—
Net issuance of restricted						
performance common stock	95,946	—	—	—	—	—
Employee stock-based						
compensation costs	—	—	1,472	(611)	—	861
Treasury repurchase program	—	—	—	(5,393)	—	(5,393)
Net income	—	—	—	—	3,732	3,732
Balances, June 30, 2018	81,688,734	\$ 778	\$ 382,962	\$(108,347)	\$(228,076)	\$ 47,317

See notes to condensed consolidated financial statements.

ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	Six Months Ended June 30,	
	2018	2017
Operating activities:		
Net income	\$3,732	\$2,914
Non-cash items in net income:		
Depreciation and amortization	1,681	1,296
Employee stock-based compensation costs	1,472	1,279
Changes in deferred taxes	1,691	2,231
Changes in operating assets and liabilities:		
Receivables	(484)	460
Prepaid and other current assets	312	(9)
Other assets and deferred costs	(1,740)	—
Accounts payable	107	322
Deferred revenue	(2,222)	(414)
Earn-out payment	(195)	—
Accrued and other liabilities	49	(797)
Net cash provided by operating activities	4,403	7,282
Investing activities:		
Purchases of property, equipment and internal-use software	(1,367)	(1,266)
Acquisition of business, net of cash acquired	(11,773)	(6,594)
Net cash used in investing activities	(13,140)	(7,860)
Financing activities:		
Proceeds from exercise of stock options	33	4,128
Earn-out payment	(605)	—
Purchase of treasury shares	(6,004)	(499)
Net cash used in financing activities	(6,576)	3,629
(Decrease) Increase in cash and cash equivalents	(15,313)	3,051
Cash and cash equivalents, beginning of period	33,009	26,457
Cash and cash equivalents, end of period	\$17,696	\$29,508

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,” or “us”) should be read in conjunction with the audited consolidated financial statements included in the Company’s 2017 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.

Effective January 1, 2018, the Company adopted Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (“ASC 606”) using the modified retrospective transition method. The cumulative effect of applying the standard was a \$4.6 million increase to shareholder’s equity as of January 1, 2018. The Company’s condensed consolidated statement of income for the three and six month period ended June 30, 2018, and the Company’s condensed consolidated balance sheet at June 30, 2018, are presented under ASC 606, while the Company’s condensed consolidated statement of income for the three and six month period ended June 30, 2017, and the Company’s condensed consolidated balance sheet at December 31, 2017, are presented under ASC 605, Revenue Recognition (“ASC 605”). See note 2 for disclosure of the impact of the adoption of ASC 606 on the Company’s condensed consolidated statement of income for the three and six month periods ended June 30, 2018, and the Company’s condensed consolidated balance sheet at June 30, 2018, and the effect of changes made to the Company’s consolidated balance sheet as of January 1, 2018.

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, 2018, 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 ASC 606, which supersedes most prior revenue recognition guidance under U.S. Generally Accepted Accounting Principles (“GAAP”). The core principle of ASC 606 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. ASC 606 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 became effective for us beginning in 2018. Our Company provides primarily email encryption and advanced threat protection security solutions as subscription services in which we recognize revenue as our services are rendered. We determined our revenue was not materially impacted by the new guidance. However, the guidance did require us to increase the amortization period of our sales commission expense. We applied the guidance to commissions earned on all contracts that were not complete as of January 1, 2018. Prior period amounts have not been adjusted and continue to be reported in accordance with the previous guidance. Our Company elected to use a portfolio approach, applying 8 year, 4 year, and 18 month amortization periods to our new, add-on, and renewal sales commission expenses, respectively. Determination of the amortization period and the subsequent assessment for impairment of the deferred cost asset requires significant judgement.

We applied a modified retrospective approach to our implementation of ASC 606 in which we recognized a \$4.6 million cumulative effect adjustment to our 2018 retained earnings opening balance related to our increased amortization period. This adjustment includes a \$1.6 million impact to our deferred tax asset. The table below presents the cumulative effect of the changes made to our condensed consolidated balance sheet due to the adoption of ASC 606:

(In thousands)	January 1, 2018		
	Beginning Balance	Cumulative Effect Adjustment	Beginning Balance, as Adjusted
Assets:			
Prepaid and other current assets	\$3,222	\$ (415)	\$2,807
Other assets and deferred costs	—	6,595	6,595
Deferred tax assets	25,647	(1,616)	24,031
Stockholders' equity:			
Accumulated deficit	\$(236,372)	\$ 4,564	\$(231,808)

Financial statement results as reported under the new revenue standard as compared to the previous standard for the three and six months ended and as of June 30, 2018, are as follows:

	Three Months Ended June 30,			Six Months Ended June 30,		
	Under	Under		Under	Under	
	ASC	ASC	Variance ⁽¹⁾	ASC	ASC	Variance
(In thousands, except per share data)	605	606		605	606	
Revenues	\$17,500	\$17,500	\$ —	\$34,153	\$34,153	\$ —
Cost of revenues	3,806	3,806	—	7,319	7,319	—
Gross margin	13,694	13,694	—	26,834	26,834	—
Operating expenses:						
Research and development	2,978	2,978	—	5,956	5,956	—
Selling, general and administrative	9,298	8,562	(736)	17,389	16,115	(1,274)
Total operating expenses	12,276	11,540	(736)	23,345	22,071	(1,274)
Operating income	1,418	2,154	736	3,489	4,763	1,274
Other income, net	360	360	—	479	479	—
Income before income taxes	1,778	2,514	736	3,968	5,242	1,274
Income tax expense	(519)	(674)	(155)	(1,242)	(1,510)	(268)
Net income	\$1,259	\$1,840	\$ 581	\$2,726	\$3,732	\$1,006
Basic income per common share	\$0.02	\$0.04	\$ 0.01	\$0.05	\$0.07	\$0.02
Diluted income per common share	\$0.02	\$0.03	\$ 0.01	\$0.05	\$0.07	\$0.02

⁽¹⁾ Per share variance may not foot due to rounding.

(In thousands)	June 30, 2018		
	Under	Under	
	ASC 605	ASC 606	Variance
Assets:			
Prepaid and other current assets	\$3,444	\$2,978	\$(466)
Other assets and deferred costs	—	7,920	7,920
Deferred tax assets	23,956	22,340	(1,616)
Stockholders' equity:			
Accumulated deficit	\$(233,646)	\$(228,076)	\$5,570

Cash Flow Statement

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230), which amends guidance on the classification of certain cash receipts and payments in the statement of cash flows. This ASU was issued with the intent to reduce diversity in practice with respect to eight types of cash flows. The new guidance addressed debt prepayment or extinguishment of costs, settlement of zero-coupon bonds, contingent consideration made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of

corporate-owned life insurance policies and bank-owned life insurance policies, distributions received from equity method investees, beneficial interests in securitization transactions, and separately identifiable cash flows and application of the predominance principle.

The standard became effective for us beginning 2018. We applied the new guidance within our condensed consolidated statements of cash flows classification to an \$800 thousand earn-out payment associated with our Greenview Data acquisition. Because this consideration payment was not made soon after the consummation date, as required by the guidance, we classified \$605 thousand of the payment as a financing activity. This reflects the portion of the payment recognized a contingent liability as of the acquisition date. The \$195 thousand balance of the payment was in excess of the original contingent consideration liability and was classified as an operating activity. The standard had no other impact to our condensed consolidated financial statements.

Leases

In February 2016, the FASB issued ASU 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.

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, 2018 the Company had 987,234 stock options outstanding, 1,503,855 non-vested Restricted Stock awards; 211,182 non-vested Performance Stock awards; 72,168 non-vested RSUs; 12,499 non-vested Performance RSUs and 5,850,004 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, 2018:

	Options	Weighted Average Exercise Price	Weighted Average	Remaining Contractual Term (Yrs)
Outstanding at March 31, 2018	1,014,314	\$ 3.10		
Granted at market price	—	—		
Cancelled or expired	—	—		
Exercised	(27,080)	1.22		
Outstanding at June 30, 2018	987,234	\$ 3.16		5.06
Options exercisable at June 30, 2018	843,484	\$ 3.06		4.59

At June 30, 2018, all 987,234 stock options outstanding and all 843,484 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 \$2.2 million and \$2.0 million, respectively.

Restricted Stock Activity

The following is a summary of Restricted Stock activity during the three months ended June 30, 2018:

	Restricted	Weighted Average
	Shares	Fair Value
Non-vested restricted stock at March 31, 2018	1,162,143	\$ 4.33
Granted at market price	405,000	5.10
Vested	(60,288)	4.20
Cancelled	(3,000)	4.04
Non-vested restricted stock at June 30, 2018	1,503,855	\$ 4.54

Restricted Stock Unit Activity

The following is a summary of all RSU activity during the three months ended June 30, 2018:

	Restricted	Weighted Average
	Stock Units	Fair Value
Non-vested restricted stock units at March 31, 2018	52,168	\$ 4.42
Granted at market price	20,000	5.01
Vested	—	—
Cancelled	—	—
Non-vested restricted stock units at June 30, 2018	72,168	\$ 4.59

Performance RSU Activity

The following is a summary of all Performance RSU activity during the three months ended June 30, 2018:

	Performance	Weighted Average
	RSUs	Fair Value
Non-vested performance RSUs at March 31, 2018	12,499	\$ 4.20
Granted at market price	—	—
Vested	—	—
Forfeited	—	—
Non-vested performance RSUs at June 30, 2018	12,499	\$ 4.20

Performance Stock Activity

The following is a summary of all Performance Stock activity during the three months ended June 30, 2018:

	Performance	Weighted Average
	Stock	Fair Value
Non-vested performance stock at March 31, 2018	211,182	\$ 4.25
Granted at market price	—	—

Vested	—	—
Forfeited	—	—
Non-vested performance stock at June 30, 2018	211,182	\$ 4.25

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 month period ended June 30, 2018, 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	
	Ended June	Six Months
	30,	Ended June 30,
(In thousands)	2018	2018
Cost of revenues	\$ 80	\$ 148
Research and development	112	202
Selling, general and administrative	653	1,122
Stock-based compensation expense	\$ 845	\$ 1,472

A deferred tax asset totaling \$293 thousand and \$374 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, 2018 and 2017, respectively. As of June 30, 2018, there was \$7.2 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 1.62 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, 2017.

4. Supplemental Cash Flow Information

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

	Six Months Ended June 30,	
(In thousands)	2018	2017
Cash income tax payments	\$556	\$349

5. Receivables, net

	December	
(In thousands)	June 30,	31,
	2018	2017
Gross accounts receivables	\$15,400	\$9,307
Allowance for returns and doubtful accounts	(279)	(270)
Unpaid portion of deferred revenue	(12,825)	(7,648)
Note receivable	458	458
Allowance for note receivable	(458)	(458)
Receivables, net	\$2,296	\$1,389

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, 2018.

6. Revenue from Contracts with Customers

Accounting policies

Our Company provides message security solutions as subscription services in which we recognize revenue as our services are rendered. Our contracts are typically one to three year contracts billed annually. We exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by our company from a customer (e.g., sales, use, value added, and some excise taxes).

Disaggregation of Revenue

In the three months ended June 30, 2018, we recorded revenue for our services in the following core industry verticals: 49% healthcare, 29% financial services, 7% government sector, and 15% as other. In the six months ended June 30, 2018, we recorded revenue for our services in the following core industry verticals: 50% healthcare, 28% financial services, 7% government sector, and 15% as other.

We operate as a single operating segment. Revenue generated from our email protection services represented 100% of our revenues in the three and six months ended June 30, 2018 and 2017. Further, we sell our solutions as a bundle, applying significant judgement to allocate transaction prices of our services based on the standalone selling price of our component services.

Contract balances

Our contract assets include our accounts receivables, discussed in Footnote 5 above, and the deferred cost associated with commissions earned by our sales team on securing new, add-on, and renewal contract orders. Upon our adoption of ASU 606 we recorded a cumulative effect adjustment, establishing a \$6.6 million noncurrent deferred contract asset in recognition of the lengthened amortization period required by the new guidance. The Company simultaneously released the previously existing current deferred commission asset balance of \$415 thousand. During the three and six months ended June 30, 2018, we increased our noncurrent deferred contract asset \$1.3 million and \$ 2.3 million, respectively, resulting from commissions earned by our sales team during the three and six months ended June 30, 2018. We also amortized \$510 thousand and \$954 thousand of deferred cost, respectively, as a selling and marketing expense in the related periods. Our deferred cost asset is assessed for impairment on a periodic basis. There were no impairment losses recognized on deferred contract cost assets for the three or six months ended June 30, 2018.

Our contract liabilities consist of deferred revenue representing future customer services which have been billed and collected. The \$1.4 million decrease to our net deferred revenue in the six months ended June 30, 2018, is related to the timing of orders and payments.

Performance obligations

As of June 30, 2018, the aggregate amount of the transaction prices allocated to remaining service performance obligations, which represents the transaction price of firm orders less inception to date revenue, is \$73.2 million. We expect to recognize approximately \$27.9 million of revenue related to this backlog during the remainder of 2018, \$27.2 million in 2019, and \$18.1 million in periods thereafter.

Approximately \$15.0 million of our \$17.5 million revenue recognized in the three months ended June 30, 2018, was included in our performance obligation balance at the beginning of the period. Approximately \$28.2 million of our \$34.2 million revenue recognized in the six months ended June 30, 2018, was included in our performance obligation balance at the beginning of the period.

7. 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, 2018 and 2017, are as follows:

	Three Months ended June 30,		Six Months ended June 30,	
	2018	2017	2018	2017
Basic weighted average common shares	52,467,904	53,573,431	52,670,540	53,268,005
Effect of dilutive securities:				
Employee and director stock options	356,061	457,714	309,909	418,470
Restricted stock	306,909	313,577	272,549	270,569
RSUs	13,044	42,283	20,114	51,154
Performance RSUs	4,207	29,054	11,700	22,169

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Performance Stock	68,975	63,904	63,164	44,636
Dilutive weighted average common shares	53,217,100	54,479,963	53,347,976	54,075,003

During the three months ended June 30, 2018, weighted average shares related to 56,250 stock options, 74,986 shares of Restricted Stock were excluded from the calculation of diluted earnings per share as anti-dilutive. During the six months ended June 30, 2018, weighted average shares related to 124,750 stock options, 263,004 shares of Restricted Stock, 12,167 RSUs, 1,833 Performance RSUs, and 37,073 shares of Performance Stock were excluded from the calculation of diluted earnings per share because these awards were anti-dilutive.

8. Commitments and contingencies

A summary of our fixed contractual obligations and commitments at June 30, 2018, is as follows:

(In thousands)	Payments Due by Period				
	Total	1 Year	Years 2 & 3	Years 4 & 5	Beyond 5 Years
Operating leases	\$7,866	\$1,755	\$ 2,512	\$ 2,175	\$ 1,424

We have not entered into any material, non-cancelable purchase commitments at June 30, 2018.

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.

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.

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.

The Company recorded a contingent liability for the estimated fair value of earn-out consideration payments in our Greenview (as defined herein) acquisition. The Company determined the fair value of this earn-out liability based on the probability of attainment of certain sales milestones. Any changes to the variables and assumptions could significantly impact the estimated fair values recorded for the liability, resulting in significant changes to the Condensed Consolidated Statements of Operations. The fair value measurements are based on significant inputs not observable in the market and thus represent Level 3 measurements, which reflect the Company's own assumptions concerning the achievement of the sales milestones in measuring the fair value of the acquisition-related contingent earn-out liability.

The following table represents a reconciliation of our acquisition-related contingent earn-out liability measured at fair value on a recurring basis, using Level 3 inputs for the three month period ended June 30, 2018:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
(In thousands)		
Balance at December 31, 2017	\$	1,488
Payments during the period		(800)

Adjustments to fair value during the period recorded in General and Administrative expenses		406
Balance at June 30, 2018	\$	1,094

10. Goodwill

The following is a summary of the changes in the carrying amount of goodwill for the six month periods ended June 30, 2018 and 2017:

(In thousands)	Six Months ended June 30,	
	2018	2017
Opening balance	\$ 8,469	\$ 2,161
Additions	5,926	4,327
Acquisition adjustments	(901)	—
Goodwill	\$ 13,494	\$ 6,488

Our 2018 acquisition of Erado resulted in the addition to our goodwill in the six months ended June 30, 2018. Our acquisition adjustments to goodwill in the six month period ended June 30, 2018, reflect the appropriate reallocation of excess purchase price from goodwill to acquired assets and liabilities related to our 2017 Greenview and EMS purchases. Our 2017 acquisition of Greenview resulted in the increase to our goodwill in the six months ended June 30, 2017. We evaluate goodwill for impairment annually in the fourth quarter, or when there is a reason to believe that the value has been diminished or impaired. There were no impairments to goodwill during the periods presented above.

11. Common Stock Repurchase Program

On April 24, 2017, the Company's board of directors approved a share repurchase program that enabled the Company to purchase up to \$10 million of its shares of common stock. During the three months ended June 30, 2018, the Company repurchased 500,000 shares of our common stock under this program at an aggregate cost of \$2.3 million. During the three months ended March 31, 2018, the Company repurchased 706,994 shares of our common stock under the same program at an aggregate cost of \$3.1 million. The share repurchase program expired May 31, 2018.

No shares were repurchased during the three month and six month periods ended June 30, 2017.

12. 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 \$30.8 million reserve. Any reduction to this \$30.8 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 2018 actual earnings, the Company believes the deferred tax asset allowance as of December 31, 2017, will remain unchanged at December 31, 2018. For this reason, the Company has recognized its first and second quarter 2018 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 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.

13. Acquisitions

Greenview Data, Inc.

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. Because sales of Greenview products met certain sales milestones by December 31, 2017, the Company paid contractually required cash earn-out consideration of \$800 thousand in the three month period ended March 31, 2018. The Company may be

required to pay an additional \$800 thousand of earn-out consideration in cash should sales of the Greenview products achieve a separate target by December 31, 2018. Contingent consideration is considered a Level 3 fair value measurement.

We accounted for the acquisition as the purchase of a business and 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. Revenue from Greenview was \$892 thousand and \$1.7 million for the three and six months ended June 30, 2018, and due to the continued integration of the combined businesses, it was impracticable to determine the earnings.

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

(In thousands)	Estimated Fair Value
Assets:	
Current assets	\$ 334
Property and equipment	249
Trademark /names	170
Technology	1,990
Customer relationships	2,880
Goodwill	4,343
Total assets	9,966
Liabilities:	
Deferred revenue	\$ 537
Other current liabilities	124
Deferred tax liability	1,609
Total liabilities	2,270
Net assets recorded	\$ 7,696

Entelligence Messaging Server

On September 13, 2017, the Company acquired Entelligence Messaging Server (“EMS”) technology, an email encryption solution, and the related business from Entrust Datacard Corporation for a cash purchase price of \$1.7 million. Our acquisition of EMS strengthens our email encryption suite by offering enterprise-centric capabilities, such as advanced message tracking, PDF statement delivery, high availability on-premises architecture and standards-based end-to-end encryption.

We accounted for the acquisition as the purchase of a business and recorded the excess purchase price as goodwill. The goodwill from this transaction is 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 September 13, 2017, acquisition date. Revenue from EMS was not material for the three and six months ended June 30, 2018, and due to the continued integration of the combined businesses, it was impracticable to determine the earnings.

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

(In thousands)	Provisional Fair Value
----------------	------------------------------

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Assets:	
Trademark/names	\$ 140
Internally developed software	550
Customer relationships	230
Goodwill	1,063
Total assets	1,983
Liabilities:	
Deferred revenue	\$ 333
Total liabilities	333
Net assets recorded	\$ 1,650

Erado

On April 2, 2018, the Company acquired all the outstanding capital stock of CM2.COM, Inc., d/b/a Erado (“Erado”) for a total purchase price of \$14.4 million, including cash consideration of \$11.8 million, net of cash acquired. The purchase of Erado strengthens Zix’s comprehensive archiving solutions with unified archiving, supervision, security, and messaging solutions for customers that demand bundled services. Erado’s long standing focus on helping its customers comply with FINRA and SEC regulations will help further strengthen Zix’s offering for customers with compliance requirements. This acquisition also expands Zix’s cloud-based email archiving capabilities into more than 50 content channels, including social medial, instant message, mobile, web, audio, and video.

The purchase price includes a holdback of \$2.3 million for the satisfaction of certain indemnification claims by the Company, if any, during the two-year period following the closing of the acquisition. An amount equal to \$1.1 million of the holdback amount, less any amounts paid or otherwise subject to an outstanding claim for indemnification, will be released to the selling shareholders upon the one year anniversary of the closing of the acquisition, and the balance of the holdback amount, if any, will be distributed to the Selling Shareholders following the two year anniversary of the closing of the acquisition. The Company is currently in the process of determining the fair value of the contingent consideration associated with the indemnification liability.

The Company incurred \$56 thousand and \$375 thousand in acquisition-related costs which were recorded within operating expenses during the three and six months ended June 30, 2018, respectively.

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 deductible for tax purpose. The results of operations and the provisional fair values of the acquired assets and liabilities have been included in the accompanying condensed consolidated financial statements since our April 2, 2018 acquisition. Revenue from Erado was \$642 thousand for the three months ended June 30, 2018, and due to the continued integration of the combined businesses, it was impracticable to determine the earnings.

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

(In thousands)	Estimated Fair Value
Assets:	
Current assets	\$ 848
Property and equipment	458
Trademark /names	260
Technology	3,030
Customer relationships	4,760
Goodwill	5,926
Total assets	15,282
Liabilities:	
Deferred revenue	\$ 809
Other current liabilities	93
Total liabilities	902

Net assets recorded \$ 14,380

Pro Forma Financial Information (Unaudited)

The following unaudited pro forma financial information presents the combined results of operations for the three and six month periods ending June 30, 2018 and 2017, as though the Greenview, EMS and Erado acquisitions that occurred during the reporting period had occurred as of the beginning of the period presented, 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,	
	2018	2017	2018	2017
Revenues	\$ 17,731	\$ 17,241	\$ 35,191	\$ 34,436
Net income	2,320	1,684	5,013	3,989
Basic income per common share	\$ 0.04	\$ 0.03	\$ 0.10	\$ 0.07
Diluted income per common share	\$ 0.04	\$ 0.03	\$ 0.09	\$ 0.07

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

14. Subsequent Events

On July 31, 2018, we filed with the SEC a “shelf” registration statement on Form S-3 (the “Registration Statement”) to register 25 million shares of our common stock for offering and sale in one or more future offerings. Our goal is to position the Company to take advantage of favorable market conditions for raising equity capital that may be used to finance future acquisitions and for other general corporate purposes. The registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. A written copy of the registration statement may be obtained from our website at <http://investor.zixcorp.com>.

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, 2017. 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), more than 30% of U.S. banks, more than 30% of Blue Cross Blue Shield plans and more than 1,200 U.S. hospitals.

ZixEncryptSM (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 1.5 million 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 hosted solution, as a multi-tenant cloud solution, or as a physical or virtual on-premises appliance.

In March 2017, Zix acquired 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 adds attachment assurance and time-of-click link defense to provide enhanced protection against sophisticated, targeted threats; and ZixProtect Premium delivers a comprehensive email security solution by including its leading email encryption and data loss prevention with its threat protection capabilities.

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.

In April 2018, Zix acquired Erado, a unified archiving company. Erado strengthens Zix's comprehensive archiving solutions with unified archiving, supervision, security, and messaging solutions for customers that demand bundled services. Erado's long standing focus on helping its customers comply with FINRA and SEC regulations will help further strengthen Zix's offering for customers with compliance requirements. This acquisition also expands Zix's cloud-based email archiving capabilities into more than 50 content channels, including social medial, instant message, mobile, web, audio, and video.

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.

ZixOne is available as a standalone solution and easily integrates with ZixEncrypt as an add-on solution. One feature of 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. Our business operations and service offerings are supported by the ZixData Center™, which is PCI DSS 3.2 certified for applicable services, SOC2 accredited and SOC 3 certified. The operations of the ZixData Center are independently audited annually to maintain AICPA 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, 2017. 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, 2017.

Related to the adoption of ASC 606, the Company increased its amortization period associated with sales, commission expense, see Note 2 "Recent Accounting Standards and Pronouncements," and Note 6, "Revenue from Contracts with Customers," of Part I, Item 1 of this Quarterly Report on Form 10-Q for the critical accounting policies resulting from our adoption of ASC 606.

As we increasingly moved to a multi-tenant environment to keep up with the industry trend requiring transition to a cloud based solution for our existing services, certain research and development expenditures associated with hosting arrangements now meet the accounting guidance requirement for capitalizing development costs under ASC 350-40, Internal-Use Software, as it applies to hosting arrangements. These capitalized costs are classified as intangible assets in our condensed consolidated balance sheet. The Company expects our capitalization of these research and development expenditures to increase in the future.

With the exception of accounting policies related to the adoption of ASC 606 and the increased capitalization of research and development costs under ASC 350-40, there have been no material changes to our critical accounting policies as compared to those described in our Annual Report on Form 10-K for the year ended December 31, 2017.

Results of Operations

Second Quarter 2018 Summary of Operations

Financial

Revenue for the quarter ended June 30, 2018, was \$17.5 million, compared with \$16.4 million for the same period in 2017, representing a 7% increase.

- Gross margin for the quarter ended June 30, 2018, was \$13.7 million (or 78% of revenues), compared with \$13.1 million (or 80% of revenues) for the comparable period in 2017.

Net income for the quarter ended June 30, 2018, was \$1.8 million, compared with net income of \$1.1 million in the comparable period in 2017, representing a 62% increase.

- Net income per diluted share was \$0.03 for the quarter ended June 30, 2018, compared with net income per diluted share of \$0.02 in the comparable period in 2017.

Ending cash and cash equivalents were \$17.7 million on June 30, 2018, compared with \$29.5 million on June 30, 2017, and \$33.0 million on December 31, 2017.

Operations

New first year orders (“NFYOs”) for the quarter ended June 30, 2018, were \$3.3 million, compared with \$2.6 million for the same period in 2017, representing a 27% increase.

Total orders for the quarter ended June 30, 2018, were \$21.9 million, compared with \$15.7 million for the same period in 2017, representing a 39% increase.

The annual contract value of our customer subscriptions as of June 30, 2018, was \$74.0 million, compared with \$65.2 million for the same period in 2017, representing a 13% increase.

Net cash provided by operations in the six months ended June 30, 2018, was \$4.4 million, compared with \$7.3 million for the same period in 2017, representing a 40% decrease.

As of June 30, 2018, backlog was \$73.2 million, compared with \$77.8 million as of June 30, 2017, representing a 6% decrease.

Revenues

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

Three Months Ended	3-month Variance	Six Months ended	6-month Variance
June 30,	2018 vs. 2017	June 30,	2018 vs. 2017

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(in thousands)	2018	2017	\$	%	2018	2017	\$	%
Revenues	\$ 17,500	\$ 16,378	\$ 1,122	7 %	\$ 34,153	\$ 32,271	\$ 1,882	6 %

The increase in revenue was due to the growth inherent in a successful subscription-based business model with both steady additions to the subscriber base and new sales attributable to our Erado and Greenview acquisitions, 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 2018, excluding our Erado and Greenview sales, we categorized our revenue in the following core industry verticals: 50% healthcare, 28% financial services, 7% government sector, and 15% as other. In the first six months of 2017, we categorized our revenue in the following core industry verticals: 51% healthcare, 28% financial services, 7% government sector, and 14% 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, 2018, total backlog was \$73.2 million, and we expect approximately 62% of the total backlog, or approximately \$45.6 million, to be recognized as revenue during the next twelve months. As of June 30, 2018, the backlog was comprised of the following elements: \$28.1 million of deferred revenue that has been billed and paid, \$12.8 million billed but unpaid, and approximately \$32.3 million of unbilled contracts. The backlog at June 30, 2018, was 6% lower than the \$77.8 million backlog at the end of the second quarter 2017, and 1% higher than the ending backlog of \$72.6 million at December 31, 2017. Our decrease in backlog year over year reflects the shorter term contractual commitment generally associated with our new customer pricing as a component of a higher touch strategy.

Orders — Total orders were \$21.9 million and \$15.7 million for the three month periods ended June 30, 2018 and 2017, respectively, representing a 39% increase 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. NFYOs were \$3.3 million and \$2.6 million for the three-month periods ended June 30, 2018 and 2017, respectively, representing a 27% increase year-over-year.

Cost of Revenues

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

	Three Months Ended		3-month Variance		Six Months ended		6-month Variance	
(in thousands)	June 30, 2018	June 30, 2017	2018 vs. 2017 \$	2018 vs. 2017 %	June 30, 2018	June 30, 2017	2018 vs. 2017 \$	2018 vs. 2017 %
Cost of revenues	\$ 3,806	\$ 3,247	\$ 559	17 %	\$ 7,319	\$ 6,070	\$ 1,249	21 %

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 2018 compared to 2017 reflected in the table above resulted primarily from increases in average headcount, which include additional ZixArchive support gained in the Erado acquisition in April 2018 and the ZixProtect support team gained in the Greenview acquisition in March 2017. We are also incurring additional costs associated with leased equipment supporting Greenview customers, and we are amortizing expense resulting from the acquisition of 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:

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(in thousands)	Three Months Ended		3-month Variance		Six Months ended		6-month Variance	
	June 30,		2018 vs. 2017		June 30,		2018 vs. 2017	
	2018	2017	\$	%	2018	2017	\$	%
Research and development								
expenses	\$ 2,978	\$ 2,708	\$ 270	10 %	\$ 5,956	\$ 5,131	\$ 825	16 %

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 2018 compared to 2017 reflected in the table above resulted primarily from an increase in average headcount, including the ZixProtect and additional ZixArchive R&D employees gained in the Greenview acquisition and Erado acquisition in March 2017 and April 2018, respectively. These increases were partially offset by the capitalization of \$306 thousand of costs related to development of new features and functionality for our hosting service arrangements in the current year.

As we increasingly move to a multi-tenant environment to keep up with industry trends requiring a transition to cloud-based solutions for our existing services, the Company expects our capitalization of research and development expense to become increasingly material.

Selling and Marketing Expenses

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

(in thousands)	Three Months Ended		3-month Variance		Six Months ended		6-month Variance	
	June 30, 2018	2017	2018 vs. 2017 \$	%	June 30, 2018	2017	2018 vs. 2017 \$	%
Selling and marketing expenses	\$ 5,453	\$ 5,222	\$ 231	4 %	\$ 9,831	\$ 10,395	\$ (564)	(5)%

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 month period ended June 30, 2018, compared to the same period in 2017, was due primarily to additional headcount expenses, including the employees gain in the April 2018 Erado acquisition, travel, and amortization of acquisition related intangible assets. These costs were offset by lower commission expense associated with our implementation of GAAP accounting rule ASC 606, which became effective for our Company on January 1, 2018. We adopted a modified retrospective approach in applying this new guidance. The rule requires us to lengthen the amortization period of our commission expense, resulting in a decrease to our commission expense in three month period ended June 30, 2018, of approximately \$736 thousand.

The six month decrease in selling and marketing expense resulted primarily from a \$1.3 million reduction in commission expense associated with our 2018 implementation of ASC 606, offset by higher headcount, travel, and amortization of acquisition related intangible assets as noted above.

General and Administrative Expenses

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

Three Months Ended

June 31,