

MARCHEX INC  
Form 10QSB  
August 16, 2004  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

---

**FORM 10-QSB**

---

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended June 30, 2004

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

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

Commission File Number: 000-50658

---

**Marchex, Inc.**

(Exact name of small business issuer as specified in its charter)

---

Delaware  
(State or other jurisdiction of  
incorporation or organization)

35-2194038  
(IRS Employer  
Identification No.)

Edgar Filing: MARCHEX INC - Form 10QSB

413 Pine Street, Suite 500

Seattle, Washington 98101

(Address of principal executive offices)

Issuer's telephone number: (206) 331-3300

---

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

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

<u>Class</u>	<u>Outstanding at</u> <u>August 16, 2004</u>
Class A common stock, par value \$.01	11,987,500
Class B common stock, par value \$.01	12,941,746

Transitional Small Business Disclosure Format: Yes  No

---

**Table of Contents**

**Marchex, Inc.**

**Form 10-QSB**

**Table of Contents**

	<b>Page</b>
<b><u>Part I Financial Information</u></b>	
<b>Item 1.</b> <u>Financial Statements (unaudited).</u>	
<u>Condensed Consolidated Balance Sheets June 30, 2004 and December 31, 2003.</u>	3
<u>Condensed Consolidated Statements of Operations Period from January 1 to February 28, 2003 (Predecessor Period), period from January 17, 2003 (Inception) to June 30, 2003, six months ended June 30, 2004, and quarter ended June 30, 2004 and 2003 (Successor Periods).</u>	4
<u>Condensed Consolidated Statements of Cash Flows Period from January 1 to February 28, 2003 (Predecessor Period), period from January 17, 2003 (Inception) to June 30, 2003, six months ended June 30, 2004 and quarter ended June 30, 2004 and 2003 (Successor Periods).</u>	5
<b>Item 2.</b> <u>Management's Discussion and Analysis.</u>	11
<b>Item 3.</b> <u>Controls and Procedures.</u>	40
<b><u>Part II Other Information</u></b>	
<b>Item 1.</b> <u>Legal Proceedings.</u>	41
<b>Item 2.</b> <u>Changes in Securities and Small Business Issuer Purchases of Equity Securities.</u>	41
<b>Item 3.</b> <u>Defaults Upon Senior Securities.</u>	41
<b>Item 4.</b> <u>Submission of Matters to a Vote of Security Holders.</u>	41
<b>Item 5.</b> <u>Other Information.</u>	42
<b>Item 6.</b> <u>Exhibits and Reports on Form 8-K.</u>	42

**Table of Contents****Part I Financial Information****Item 1. Financial Statements (unaudited)****MARCHEX, INC. AND SUBSIDIARIES****Condensed Consolidated Balance Sheets****(unaudited)**

	<b>December 31, 2003</b>	<b>June 30, 2004</b>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 6,019,119	29,769,037
Accounts receivable, net	1,627,730	2,361,195
Other receivables	384	4,108
Prepaid expenses	117,596	412,943
Income tax receivable	290,939	14,642
Deferred tax assets	263,193	394,221
Other current assets	24,190	58,366
	<u>8,343,151</u>	<u>33,014,512</u>
<b>Total current assets</b>	<b>8,343,151</b>	<b>33,014,512</b>
Property and equipment, net	994,793	1,191,913
Other assets	409,878	152,037
Goodwill	17,252,999	17,279,035
Identifiable intangible assets, net	6,701,791	4,632,279
	<u>\$ 33,702,612</u>	<u>56,269,776</u>
<b>Total assets</b>	<b>\$ 33,702,612</b>	<b>56,269,776</b>
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 2,842,229	2,871,864
Accrued payroll and benefits	252,642	232,006
Accrued expenses and other current liabilities	1,031,850	672,647
Accrued facility relocation		121,071
Deferred revenue	848,958	1,055,586
Earn-out liability payable	3,525,995	258,328
	<u>8,501,674</u>	<u>5,211,502</u>
<b>Total current liabilities</b>	<b>8,501,674</b>	<b>5,211,502</b>
Deferred tax liabilities	1,829,687	1,068,559
Deferred revenue	38,993	35,897
Accrued facility relocation		45,199
Other non-current liabilities	2,274	39,849
Fair value of redemption obligation	55,250	
	<u>1,926,203</u>	<u>1,293,505</u>
<b>Total liabilities</b>	<b>1,926,203</b>	<b>1,293,505</b>

Edgar Filing: MARCHEX INC - Form 10QSB

Total liabilities	10,427,878	6,401,006
Series A redeemable convertible preferred stock	21,440,402	
Commitments, contingencies, and subsequent events		
Stockholders' equity:		
Class A common stock	122,500	122,500
Class B common stock	15,675	128,271
Class B restricted common stock		1,146
Additional paid-in capital	6,716,734	55,946,513
Deferred stock-based compensation	(1,532,340)	(936,342)
Accumulated deficit	(3,488,237)	(5,393,318)
	<u>                    </u>	<u>                    </u>
Total stockholders' equity	1,834,332	49,868,770
	<u>                    </u>	<u>                    </u>
Total liabilities and stockholders' equity	\$ 33,702,612	56,269,776
	<u>                    </u>	<u>                    </u>

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Condensed Consolidated Statement of Operations**

(unaudited)

	Predecessor Period	Successor Periods			
	Period from January 1 to February 28,  2003	Period from January 17, (inception) to June 30,  2003	Six months ended  June 30,  2004	Quarter ended  June 30,  2003	Quarter ended  June 30,  2004
Revenue	\$ 3,071,055	7,072,219	16,467,089	5,356,286	8,865,178
Expenses:					
Service costs (1)	1,732,813	3,838,815	10,523,390	2,955,535	5,743,815
Sales and marketing (1)	365,043	868,797	2,040,682	654,182	1,030,710
Product development (1)	144,479	459,874	1,033,841	354,927	528,306
General and administrative (1)	234,667	1,156,775	1,541,427	729,856	846,680
Acquisition-related retention consideration (2)			255,660		122,724
Facility relocation			230,459		
Stock-based compensation (3)	38,981	1,261,069	595,998	550,078	235,234
Amortization of intangible assets (4)		1,159,675	2,069,512	869,588	1,034,643
Total operating expenses	2,515,983	8,745,005	18,290,969	6,114,166	9,542,112
Income (loss) from operations	555,072	(1,672,786)	(1,823,880)	(757,880)	(676,934)
Other income (expense):					
Interest income	1,529	16,571	81,346	13,479	70,329
Interest expense			(1,813)		(1,488)
Adjustment to fair value of redemption obligation			55,250		
Other			3,643		
Total other income	1,529	16,571	138,426	13,479	68,841
Income (loss) before provision for income taxes	556,601	(1,656,215)	(1,685,454)	(744,401)	(608,093)
Income tax expense (benefit)	224,082	(586,863)	(200,803)	(263,771)	(147,103)
Net income (loss)	332,519	(1,069,352)	(1,484,651)	(480,630)	(460,990)
Accretion to redemption value of redeemable convertible preferred stock		504,355	420,430	385,274	17,751

Edgar Filing: MARCHEX INC - Form 10QSB

Net income (loss) applicable to common stockholders	\$ 332,519	(1,573,707)	(1,905,081)	(865,904)	(478,741)
Basic and diluted net loss per share applicable to common stockholders		\$ (0.12)	\$ (0.10)	\$ (0.07)	\$ (0.02)
Shares used to calculate basic and diluted net loss per share		13,174,451	18,810,413	13,255,000	24,174,284
(1) Excludes acquisition-related retention consideration, stock-based compensation and amortization of intangible assets					
(2) Components of acquisition-related retention consideration					
Service costs			30,423		14,604
Sales and marketing			86,924		41,726
Product development			94,083		45,162
General and administrative			44,230		21,232
(3) Components of stock-based compensation					
Service costs	190		6,300		2,250
Sales and marketing	715	228,854	116,588	99,861	49,042
Product development	37,710	164,877	34,577	95,108	12,675
General and administrative	366	867,338	438,533	355,109	171,267
(4) Components of amortization of intangible assets					
Service costs		859,675	1,469,512	644,588	734,643
Sales and marketing		116,667	325,000	87,500	162,500
Product development					
General and administrative		183,333	275,000	137,500	137,500

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****MARCHEX, INC. AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows****(unaudited)**

	Predecessor Period	Successor Periods	
	Period from January 1 to February 28,  2003	Period from January 17, (inception) to June 30,  2003	Six months ended  June 30, 2004
Cash flows from operating activities:			
Net income (loss)	\$ 332,519	(1,069,352)	(1,484,651)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Amortization and depreciation	43,584	1,271,041	2,351,678
Adjustment to fair value of redemption obligation			(55,250)
Facility relocation			193,931
Allowance for doubtful accounts and merchant advertiser credits	86,908	234,894	464,110
Stock-based compensation	38,981	1,261,069	595,998
Deferred income taxes	(6,956)	(909,359)	(918,192)
Income tax benefit related to stock options	231,038		101,092
Change in certain assets and liabilities, net of acquisition:			
Accounts receivable, net	(135,457)	(233,916)	(1,197,575)
Other receivables	(1,137)	(5,206)	(3,724)
Income tax receivable and payable		(257,504)	276,297
Prepaid expenses and other current assets	(26,549)	(45,803)	(329,523)
Accounts payable	(403,753)	343,578	28,271
Accrued expenses, payroll, benefits and other current liabilities	117,133	160,919	(209,044)
Deferred revenue	75,650	67,899	203,532
Acquisition-related retention consideration in earn-out liability			(24,941)
Other non current liabilities	1,092	875	(2,274)
<b>Net cash provided by (used in) operating activities</b>	<b>353,053</b>	<b>819,135</b>	<b>(10,265)</b>
Cash flows from investing activities:			
Purchases of property and equipment	(63,878)	(259,251)	(463,260)
Cash paid for acquisition, net of cash acquired		(13,295,931)	(3,242,726)
Proceeds from sale of equipment			3,710
Decrease (increase) in other non current assets		(17,204)	(30,739)
<b>Net cash used in investing activities</b>	<b>(63,878)</b>	<b>(13,572,386)</b>	<b>(3,733,015)</b>
Cash flows from financing activities:			
Capital lease obligation principal paid			(1,263)
Deferred offering costs paid			(1,068,814)
Proceeds from IPO, net of offering costs			28,405,100
Proceeds from exercises of stock options	37,288		58,525
Proceeds from employee stock purchase plan			99,650



Edgar Filing: MARCHEX INC - Form 10QSB

Proceeds from sale of stock		132,500	
Proceeds from sale of redeemable convertible preferred stock		20,122,162	
Net cash provided by financing activities	37,288	20,254,662	27,493,198
Net increase in cash and cash equivalents	326,463	7,501,411	23,749,918
Cash and cash equivalents at beginning of period	1,494,300		6,019,119
Cash and cash equivalents at end of period	\$ 1,820,763	7,501,411	29,769,037
Supplemental disclosure of cash flow information			
cash paid during the period			
for income taxes	\$	580,000	340,000
Supplemental disclosure of non-cash investing and financing activities:			
Accretion to redemption value of redeemable convertible preferred stock	\$	504,355	420,430
Deferred offering costs recorded in accrued expenses and accounts payable	\$		(175,485)
Property and equipment acquired with capital lease obligation	\$		47,167

See accompanying notes to condensed consolidated financial statements.

---

**Table of Contents**

**Marchex, Inc. and Subsidiaries**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**(1) Description of Business and Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of Marchex, Inc. and subsidiaries (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the instructions to the Quarterly Report under the Securities Exchange Act of 1934, as amended, on Form 10-QSB and Item 310(b) of Regulation S-B under the Securities Act of 1933, as amended. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for annual financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the quarter ended June 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004, or for any other period. The balance sheet at December 31, 2003 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These financial statements and notes should be read with the financial statements and notes thereto for the year ended December 31, 2003 included in the Company's final prospectus dated March 30, 2004 for its initial public offering filed with the Securities and Exchange Commission.

Prior to February 28, 2003 the Company was involved in business and product development activities, as well as financing and acquisition initiatives. Revenue commenced with the acquisition of eFamily.com, Inc. and its wholly-owned operating subsidiary ah-ha.com, Inc.

On February 28, 2003, the Company acquired 100% of the outstanding stock of eFamily.com, Inc. and ah-ha.com, Inc., the wholly-owned operating subsidiary, based in Provo, Utah. ah-ha.com, Inc. was renamed Enhance Interactive, Inc. in December 2003. The aggregate cash consideration, including acquisition costs to acquire Enhance Interactive was approximately \$15,117,000. The purchase price excludes performance-based contingent payments that depend on Enhance Interactive's achievement of minimum thresholds in calendar years 2003 and 2004 of income before tax, excluding stock-based compensation and amortization of intangible assets relating to the purchase (earnings before taxes). The payment of the earnings-based contingent amounts is based on the formula of 69.44% of the acquired businesses' 2003 and 2004 earnings before taxes up to an aggregate maximum payout cap of \$12,500,000 (earn-out consideration). In the event earnings before taxes do not exceed \$3,500,000 for 2003 or 2004, then no amount shall be payable for such period. The contingent earn-out consideration payments are being accounted for as additional goodwill, as all former Predecessor shareholders receive the consideration in proportion to their respective share holdings prior to the acquisition date and the amounts reflect the payment of additional purchase price to these shareholders. For the calendar year 2003, additional goodwill of \$3,243,000 was recorded for the earn-out consideration.

In addition, if the minimum earnings before taxes thresholds above are achieved, a payment of 5.56% of the acquired businesses' 2003 and 2004 earnings before taxes up to an aggregate maximum of \$1,000,000 will be paid to certain current employees of the acquired business (acquisition-related retention consideration). These amounts will be accounted for as compensation expense. The threshold determination is calculated separately for each of the calendar years 2003 and 2004. At June 30, 2003, in consideration of the assessed probability of payment, no amounts were accrued for the acquisition-related retention consideration. For the calendar year 2003, \$283,000 was recorded for the acquisition-related retention consideration including employer payroll-related taxes. For the quarter ended June 30, 2004, an additional \$123,000 acquisition-related retention consideration was recorded based on the quarterly portion of the annual estimated forecast. For the six months ended June 30, 2004, total acquisition-related consideration of \$256,000 was recorded.

Enhance Interactive provides performance-based advertising services to merchant advertisers, including pay-per-click listings. Through Enhance Interactive's pay-per-click service, merchant advertisers create keyword listings that describe their product or service, which are marketed to

## Edgar Filing: MARCHEX INC - Form 10QSB

consumers and businesses primarily through search engine or directory results when users search for information, products or services using the Internet.

The Company's condensed consolidated statements of operations, and cash flows have been presented for the period from January 17, 2003 (inception) through June 30, 2003. The assets, liabilities and operations of Enhance Interactive are included in the Company's condensed consolidated financial statements since the February 28, 2003 acquisition date. All significant inter-company transactions and balances have been eliminated in consolidation. The Company's purchase accounting resulted in all assets and liabilities being recorded at their estimated fair values on the acquisition date. Accordingly, the Company's condensed consolidated financial results for periods subsequent to the acquisition are not comparable to the condensed financial statements of Enhance Interactive presented for prior periods. The condensed consolidated statements of operations and cash flows representing Enhance Interactive's results prior to February 28, 2003 have been presented as the Predecessor for the period from January 1 to February 28, 2003. The Company, including the results of Enhance Interactive since the date of acquisition, is referred to as the Successor in the accompanying condensed consolidated financial statements.

---

## Table of Contents

The condensed consolidated financial statements of the Predecessor include the financial statements of eFamily.com, Inc. and its wholly-owned subsidiary, Enhance Interactive (formerly known as ah-ha.com, Inc.). All significant inter-company transactions and balances have been eliminated in consolidation.

On October 24, 2003, the Company acquired 100% of the outstanding stock of Sitewise Marketing, Inc. (d.b.a Traffic Leader) ( TrafficLeader ). In November 2003, Sitewise Marketing, Inc., based in Eugene, Oregon, was renamed TrafficLeader, Inc. The costs of acquisition included:

Cash and acquisition costs of approximately \$3,570,000;

425,000 shares of Class B common stock with a redemption right that required the Company to buy back the 425,000 shares for \$8 per share, but only at the election of the holders of 75% of such shares in the event the Company had not completed a firm commitment initial public offering with gross proceeds of at least \$20 million prior to October 24, 2005. This redemption right terminated with the closing of the Company's initial public offering on April 5, 2004;

137,500 shares of restricted Class B common stock that vest over a period of 3 years.

The above summary of the costs of acquisition excludes performance-based contingent payments that depend on TrafficLeader's achievement of revenue thresholds. The assets, liabilities and operations of TrafficLeader are included in the Company's condensed consolidated financial statements since the October 24, 2003 acquisition date.

TrafficLeader provides performance-based advertising and search marketing services to merchant advertisers, including paid inclusion, advertising campaign management, conversion tracking and analysis, and search engine optimization. Through TrafficLeader's primary service, paid inclusion, TrafficLeader manages search-based advertising campaigns and services for merchant advertisers. TrafficLeader's paid inclusion service helps merchant advertisers reach prospective customers by first creating relevant product listings and then placing these listings in front of potential customers, primarily through search engines. Merchant advertiser's product listings map directly to user search queries, which link to specific product or information pages when clicked. On behalf of merchant advertisers, TrafficLeader indexes these relevant listings through its distribution partners, including search engines, product shopping engines and directories.

### **(2) Initial Public Offering (IPO), Pro Forma Net Loss Per Share and the 2004 Employee Stock Purchase Plan**

The Securities and Exchange Commission declared the Company's registration statement on Form SB-2 (Registration No. 333-111096) under the Securities Act of 1933 effective on March 30, 2004. Under this registration statement, in an initial public offering, the Company registered 4,600,000 shares of its Class B common stock, including 600,000 shares subject to the underwriters' over-allotment option, with an aggregate public offering price of \$29,900,000.

On April 5, 2004 the Company completed its IPO in which it sold 4,600,000 shares of the Company's Class B common stock that resulted in aggregate gross proceeds of approximately \$29,900,000, of which the Company applied approximately \$1,500,000 to underwriting discounts and commissions and approximately \$1,200,000 to related IPO costs. As a result, the net cash amount of the offering proceeds was approximately \$27,200,000. In connection with the IPO, the underwriters were also granted warrants, exercisable for a four-year period commencing one year after the offering date, to purchase 120,000 shares of Class B common stock at an exercise price equal to \$8.45 per share. The \$579,000 fair value of the warrants is also an IPO related cost and was determined on the date of grant using the Black-Scholes option pricing model with the following assumptions: expected dividend yield of 0%, risk-free interest rate of 4.75%, volatility of 102%, and an

## Edgar Filing: MARCHEX INC - Form 10QSB

expected life equal to the warrant term of five years.

Upon the completion of the IPO on April 5, 2004, 6,724,063 outstanding shares of the Company's Series A redeemable convertible preferred stock automatically converted into 6,724,063 shares of Class B common stock and the Series A redeemable convertible preferred stock was automatically retired. Subsequent to the IPO, the authorized number of shares of preferred stock is 1,000,000 and the authorized number of shares of the Class B common stock is 125,000,000. The Board will have the authority to issue up to 1,000,000 shares of preferred stock, \$0.01 par value in one or more series and have the authority to designate rights, preferences, privileges and restrictions of each such series, including dividend rights, dividend rates, conversion rights, voting rights, terms of redemption, redemption prices, liquidation preferences and the number of shares constituting any series.

**Table of Contents**

On February 15, 2004, the Company's board of directors and shareholders approved the 2004 Employee Stock Purchase Plan, which became effective on March 30, 2004. The plan provides employees the opportunity to purchase the Company's Class B common stock at 85% of the lower of the fair value at the beginning or end of the three-month offering period. A total of 300,000 shares have been initially reserved under the plan.

**(3) (a) Significant Accounting Policies**

The Company's significant accounting policies are disclosed in the Company's final prospectus dated March 30, 2004 for its initial public offering filed with the Securities and Exchange Commission. The Company's significant accounting policies have not materially changed during the quarter ended June 30, 2004.

**(b) Stock-based Compensation**

The Company and the Predecessor apply the intrinsic value-based method of accounting prescribed by Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations including FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, an interpretation of APB Opinion No. 25 issued in March 2000, to account for its employee stock options and restricted stock grants. Under this method, employee compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. SFAS No. 123, *Accounting for Stock-Based Compensation*, established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company and the Predecessor have elected to apply the intrinsic value-based method of accounting described above for options granted to employees, and have adopted the disclosure requirements of SFAS No. 123.

The Company and the Predecessor recognize compensation expense over the vesting period utilizing the accelerated methodology described in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*.

The following table illustrates the effect on net loss if the fair-value-based method had been applied to all outstanding awards in each period.

	Predecessor Period	Successor Periods			
	Period from January 1 to February 28,  2003	Period from January 17, (inception) to June 30,  2003	Six months ended  June 30,  2004	Quarter ended  June 30, 2003	Quarter ended  June 30, 2004
Net income (loss) applicable to common stockholders:					
As reported	\$ 332,519	(1,573,707)	(1,905,081)	(865,904)	(478,741)
Add: stock-based employee compensation expense included in reported net income (loss), net of related tax effect	38,428	822,142	504,850	361,797	202,198

Edgar Filing: MARCHEX INC - Form 10QSB

Deduct: stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effect

	(42,375)	(962,680)	(2,050,922)	(374,717)	(1,029,660)
Pro forma	\$ 328,572	(1,714,245)	(3,451,153)	(878,824)	(1,306,203)
Net loss per share applicable to common stockholders:					
As reported (basic and diluted)		\$ (0.12)	\$ (0.10)	\$ (0.07)	\$ (0.02)
Pro forma (basic and diluted)		\$ (0.13)	\$ (0.18)	\$ (0.07)	\$ (0.05)

The Company and the Predecessor account for non-employee stock-based compensation in accordance with SFAS No. 123 and FASB Emerging Issues Task Force (EITF) Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

**Table of Contents****(4) Net Loss Per Share**

The Company's basic and diluted net loss per share is presented for the period from January 17, 2003 (inception) to June 30, 2003, for the six months ended June 30, 2004 and for the quarters ended June 30, 2003 and 2004. Basic net loss per share is computed by dividing net loss applicable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed by dividing net loss applicable to common stockholders by the weighted average number of common and dilutive common equivalent shares outstanding during the period. Net loss applicable to common stockholders consists of net loss as adjusted for the impact of accretion of redeemable convertible preferred stock to its redemption value. As the Company had a net loss during the period from January 17, 2003 (inception) to June 30, 2003, for the six months ended June 30, 2004 and for the quarters ended June 30, 2003 and 2004 basic and diluted net loss per share are the same.

The following table reconciles the Company's reported net loss applicable to common stockholders used to compute basic and diluted net loss per share for the period from January 17, 2003 (inception) to June 30, 2003, for the six months ended June 30, 2004 and for the quarter ended June 30, 2003 and 2004:

	<b>Successor Periods</b>			
	<b>Period from January 17, (inception) to June 30,</b>	<b>Six months ended</b>	<b>Quarter ended</b>	<b>Quarter ended</b>
			<b>June 30,</b>	<b>June 30,</b>
	<b>2003</b>	<b>June 30, 2004</b>	<b>2003</b>	<b>2004</b>
Net loss	(1,069,352)	(1,484,651)	(480,630)	(460,990)
Accretion to redemption value of Series A redeemable convertible preferred stock	504,355	420,430	385,274	17,751
Net loss applicable to common stockholders	(1,573,707)	(1,905,081)	(865,904)	(478,741)
Basic and diluted net loss per share applicable to common stockholders	\$ (0.12)	\$ (0.10)	\$ (0.07)	\$ (0.02)
Weighted average number of shares outstanding used to calculate basic and diluted net loss per share	13,174,451	18,810,413	13,255,000	24,174,284

The computation of diluted net loss per share excludes the following because their effect would be anti-dilutive:

6,724,063 shares issuable upon conversion of the Series A redeemable convertible preferred stock at June 30, 2003. On April 5, 2004, 6,724,063 shares of the Company's Series A redeemable convertible preferred stock automatically converted into 6,724,063 shares of Class B common stock;

Outstanding options at June 30, 2003 to acquire: (a) 2,421,500 shares of Class B common stock with a weighted average exercise price of \$1.67 per share; and (b) 100,000 options to acquire shares of Class B common stock with an exercise price equal to the initial public offering price; provided that in the event that twelve months from the option grant date the Company had not completed a firm commitment initial public offering with gross proceeds of at least \$20 million, these options were to have an exercise price equal to the then determined fair market value. Outstanding options at June 30, 2004 to acquire 3,506,350 shares of Class B common stock



## Edgar Filing: MARCHEX INC - Form 10QSB

with a weighted average exercise price of \$3.50 per share.

warrants to acquire 120,000 shares of Class B common stock at an exercise price equal to \$8.45 per share at June 30, 2004; and

90,385 Class B restricted common shares issued in connection with the October 2003 acquisition of TrafficLeader at June 30, 2004. These shares were for future services that vest over 3 years. Additionally, these shares were excluded from the computation of basic net loss per share.

### **(5) Concentrations**

The Company and the Predecessor maintain substantially all of their cash and cash equivalents with two financial institutions.

Primarily all of the Company's revenue earned from merchant advertisers is generated through arrangements with distribution partners. The Company may not be successful in renewing any of these agreements, or if they are renewed, they may not be on terms as favorable as current agreements. The Company may not be successful in entering into agreements with new distribution partners on commercially acceptable terms. In addition, several of these distribution partners may be considered potential competitors.

**Table of Contents**

The percentage of revenue earned from merchant advertisers supplied by distribution partners representing more than 10% of consolidated revenue is as follows:

	Predecessor Period	Successor Periods			
	Period from January 1 to February 28,  2003	Period from January 17, (inception) to June 30,  2003	Six months ended June 30,  2004	Quarter ended June 30,  2003	Quarter ended June 30,  2004
Distribution Partner A	12%	8%	3%	8%	2%
Distribution Partner B			23%		26%

**(6) Segment Reporting and Geographic Information**

Operating segments are revenue-producing components of the enterprise for which separate financial information is produced internally for the Company's or the Predecessor's management. For all periods presented the Company and the Predecessor operated as a single segment. The Company and the Predecessor operate in a single business segment principally in domestic markets providing internet merchant transaction services to enterprises.

Revenues from merchant advertisers by geographical areas are tracked on the basis of the location of the merchant advertiser. The vast majority of the Company's and its Predecessor's revenue and accounts receivable are derived from domestic sales to advertisers engaged in various activities involving the Internet.

Revenues by geographic region are as follows:

	Predecessor Period	Successor Periods			
	Period from January 1 to February 28,  2003	Period from January 17, (inception) to June 30,  2003	Six months ended June 30,  2004	Quarter ended June 30,  2003	Quarter ended June 30,  2004
United States	90%	91%	93%	91%	93%
Canada	5%	4%	3%	4%	3%
Other countries	5%	5%	4%	5%	4%
	100%	100%	100%	100%	100%

**(7) Facility Relocation**

As part of its anticipated expansion, in March 2004, the Company entered into a sublease agreement for new office facilities in Seattle, Washington and relocated from its original office facilities also located in Seattle, Washington. Future minimum payments related to these new facilities are as follows: \$138,000 in 2004, \$340,000 in 2005, \$422,000 in 2006, and \$455,000 in each of 2007, 2008 and 2009. The remaining lease obligation for the previous office facilities extends through June 30, 2006

and totaled \$251,000 as of June 30, 2004. In March 2004, the Company accrued for lease and related costs of \$230,000 for the estimated future obligations of non-cancelable lease and other payments for the original facilities.

The remaining lease accrual is based on estimates of vacancy period and sublease income. The actual vacancy periods may differ from these estimates, and sublease income, if any, may not materialize. Accordingly, these estimates may be adjusted in future periods. The remaining liability at June 30, 2004 was \$166,000, of which \$121,000 was the current portion.

#### **(8) Subsequent Event**

On July 27, 2004, we completed the acquisition of goClick.com, Inc. ( goClick ) a provider of marketing technology and services for small merchants. In accordance with the terms of the Agreement and Plan of Merger, dated as of July 21, 2004, by and among Marchex, Project TPS, Inc. ( Project TPS ), our wholly-owned acquisition subsidiary, goClick and the sole stockholder of goClick, Project TPS merged with and into goClick, and goClick, as the surviving corporation became a wholly-owned subsidiary of Marchex.

**Table of Contents**

In consideration for all of the outstanding shares of goClick stock, the sole stockholder of goClick received approximately \$12.5 million in a combination of cash and equity, subject to the escrow provisions of the acquisition agreement. The cash portion of the consideration was equal to \$8,229,750. The equity portion of the consideration was equal to 433,541 shares of Class B common stock of Marchex, which shares in the aggregate were valued at approximately \$4,250,000 for purposes of the transaction (based on the average of the last quoted sales price on the NASDAQ National Market for the 10 trading days immediately prior to the execution of the acquisition agreement).

The goClick operations have not been included in the consolidated results of the Company set forth in this Quarterly Report. The following Management's Discussion and Analysis is limited to the Company and its operating subsidiaries Enhance Interactive and TrafficLeader.

**Item 2. Management's Discussion and Analysis.**

*This Quarterly Report on Form 10-QSB contains forward-looking statements that involve substantial risks and uncertainties. All statements, other than statements of historical facts, included on this Quarterly Report regarding our strategy, future operations, future financial position, future revenue, projected costs, prospects, plans and objectives of management are forward-looking statements. We may not actually achieve the plans, intentions or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements we make. There are a number of important factors that could cause our actual results to differ materially from those indicated by forward-looking statements. Some, but not all, of these factors are described in the Risk Factors section and elsewhere in this Quarterly Report. We disclaim any intention or obligation to update any forward-looking statements.*

*The following discussion and analysis provides information that we believe is relevant to an assessment and understanding of our results of operation and financial condition. You should read this analysis in conjunction with the attached condensed financial statements and related notes thereto, and with the audited consolidated financial statements and the notes thereto of the Predecessor to Marchex, Inc. as of February 28, 2003 and for the period from January 1, 2003 through February 28, 2003 and of Marchex, Inc. as of December 31, 2003 and for the period from January 17, 2003 (inception) through December 31, 2003, included in our final prospectus dated March 30, 2004.*

## Table of Contents

### **Initial Public Offering**

On March 30, 2004 we commenced an initial public offering ( IPO ) of 4.6 million shares of our Class B common stock. The closing of the IPO took place on April 5, 2004. The proceeds of the IPO, net of cash offering expenses were approximately \$27.2 million. In connection with the IPO, the underwriters were also granted warrants, exercisable over a four year period commencing one year from the offering date and ending five years from the offering date, to purchase 120,000 shares of Class B common stock at an exercise price equal to \$8.45 per share. Net proceeds have been or are expected to be used to pay for product and business development, acquisitions and strategic relationships, capital expenditures, personnel, facilities, earn-out obligations and working capital and other general corporate purposes.

### **Overview**

We are an early stage company focused on providing technology-based services to merchants engaged in online transactions. Our current operating businesses are in the performance-based advertising and search marketing industries, primarily focused on helping merchants market and sell their products and services via the Internet.

For the quarter ended June 30, 2004, we provided our merchant advertisers with the following technology-based services through our wholly-owned operating subsidiaries Enhance Interactive and TrafficLeader:

**Performance-Based Advertising** primarily includes pay-per-click and paid inclusions services.

*Pay-per-click Services.* With pay-per-click services, merchant advertisers purchase keywords based on an amount they choose for a targeted placement, usually within search engine results.

*Paid Inclusion Services.* With paid inclusion services, merchant advertisers pay for their Web pages and product databases to be crawled, or searched, and indexed and included primarily within search engine and shopping engine results.

**Search Marketing** is designed for merchant advertisers who are focused on advertising campaign management, conversion tracking and analysis, and search engine optimization.

Enhance Interactive provides performance-based advertising services to merchant advertisers, including pay-per-click listings. Through Enhance Interactive, merchant advertisers market their products and services to millions of consumers and businesses through targeted pay-per-click listings that are primarily found in search engine or directory results when users search for information, products or services.

TrafficLeader provides performance-based advertising and search marketing services to merchant advertisers, including paid inclusion, advertising campaign management, conversion tracking and analysis, and search engine optimization. Through TrafficLeader's primary service, paid inclusion, TrafficLeader manages advertising campaigns and services for merchant advertisers that have hundreds or even thousands of products or content pages. TrafficLeader's paid inclusion service helps merchant advertisers reach prospective advertisers by placing their products or information, as well as associated detail and pricing, into many of the Internet's most-visited search engines, product shopping engines, and directories.

## Edgar Filing: MARCHEX INC - Form 10QSB

Following our acquisition of goClick on July 27, 2004, we began the integration of our most recently acquired wholly-owned operating subsidiary. goClick is a provider of marketing technology and services for small merchants.

We were incorporated in Delaware on January 17, 2003. On February 28, 2003, we acquired eFamily, together with its direct wholly-owned subsidiary Enhance Interactive. eFamily was incorporated in Utah on November 29, 1999, under the name FocusFilter.com, Inc. On October 24, 2003, we acquired TrafficLeader, which was incorporated in Oregon on January 24, 2000, under the name Sitewise Marketing, Inc. On July 27, 2004, we acquired goClick, which was incorporated in Connecticut on October 25, 2000.

From January 17, 2003 (inception) through February 28, 2003, we were involved in business and product development, as well as financing and acquisition initiatives.

We currently have offices in Seattle, Washington; Provo, Utah; Eugene, Oregon and Norwalk, Connecticut.

### ***Recent Development Acquisition of goClick***

On July 27, 2004, we completed the acquisition of goClick, a provider of marketing technology and services for small merchants. In accordance with the terms of the Agreement and Plan of Merger, dated as of July 21, 2004, by and among Marchex, Project TPS, our wholly-owned acquisition subsidiary, goClick and the sole stockholder of goClick, Project TPS merged with and into goClick, and goClick, as the surviving corporation became a wholly-owned subsidiary of Marchex.

## **Table of Contents**

In consideration for all of the outstanding shares of goClick stock, the sole stockholder of goClick received approximately \$12.5 million in a combination of cash and equity, subject to the escrow provisions of the acquisition agreement. The cash portion of the consideration was equal to \$8,229,750. The equity portion of the consideration was equal to 433,541 shares of Class B common stock of Marchex, which shares in the aggregate were valued at \$4,250,000 for purposes of the transaction (based on the average of the of the last quoted sales price on the NASDAQ National Market for the 10 trading days immediately prior to execution of the acquisition agreement).

The goClick operations have not been included in the consolidated results of Marchex set forth in this Quarterly Report. The following Management's Discussion and Analysis is limited to Marchex and its operating subsidiaries Enhance Interactive and TrafficLeader.

### ***Prior Acquisitions***

*Enhance Interactive.* In February 2003, we acquired eFamily together with its wholly-owned subsidiary Enhance Interactive, a Provo, Utah-based company, for the following consideration:

\$13.3 million in net cash and acquisition costs, plus

Additional consideration in the form of a contingent earnings-based cash incentive payment of up to \$13.5 million payable over two years.

The additional consideration consists of two components: (i) a contingent earnings-based payment to the original stockholders (earn-out consideration) and (ii) a contingent earnings-based payment to certain employees (retention consideration). These amounts are payable by us with respect to the years 2003 and 2004. We shall have no obligation with respect to a year, however, in the event that Enhance Interactive's earnings before taxes, excluding stock-based compensation and amortization of intangibles relating to the acquisition (earnings before taxes) do not exceed \$3.5 million for that calendar year. The threshold determination is calculated separately for each of the calendar years 2003 and 2004. At June 30, 2003, in consideration of the assessed probability, no amounts were accrued for the acquisition-related retention consideration. For the 2003 calendar year, the total Enhance Interactive earnings-based payment obligation was approximately \$3.5 million.

The contingent payment of earn-out consideration, payable to the original stockholders of Enhance Interactive, is calculated based on the formula of 69.44% of earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout cap of \$12.5 million in aggregate. This payment obligation for each year is conditioned on Enhance Interactive meeting the earnings threshold described above. To the extent we make any payments under this obligation, we have and will account for such amounts as additional goodwill. For the 2003 calendar year, the earn-out consideration was approximately \$3.2 million.

The contingent payment of retention consideration, payable to certain employees of Enhance Interactive, is calculated based on the formula of 5.56% of Enhance Interactive's earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout of \$1 million in aggregate. This payment obligation for each year is also conditioned on Enhance Interactive meeting the earnings threshold described above. To the extent we make any payments under this obligation, we have and will account for such amounts as compensation. For the six months ended June 30, 2004, we recorded an additional \$256,000 in retention-related consideration as compensation for such period, although the actual amount for the calendar year 2004 has not yet been determined. With respect to the quarter ended June 30, 2004, we recorded \$123,000 in retention-related consideration.

## Edgar Filing: MARCHEX INC - Form 10QSB

In connection with this acquisition, we also issued nonqualified stock options to certain employees of Enhance Interactive, subject to their continued employment, to purchase up to an aggregate of 1,250,000 shares of our Class B common stock with an exercise price per share of \$0.75.

The Enhance Interactive operations were consolidated in our results from the acquisition date of February 28, 2003 and have had a substantial impact on our results.

*TrafficLeader.* In October 2003, we acquired TrafficLeader, a Eugene, Oregon-based company, for the following consideration:

\$3.2 million in net cash and acquisition costs; plus

425,000 shares of Class B common stock with a redemption right that required us to buy back the 425,000 shares for \$8 per share, but only at the election of the holders of 75% of such shares in the event we had not completed a firm commitment initial public offering with gross proceeds of at least \$20 million prior to October 24, 2005. This redemption right terminated with the closing of our initial public offering on April 5, 2004; plus



**Table of Contents**

137,500 shares of restricted Class B common stock which will vest over a three-year period in installments of 16.67% after each six month period during that term; plus

Additional consideration in the form of a contingent revenue-based cash incentive payment of up to \$1 million.

With respect to the second and third components, the total value of the shares and the redemption right was recorded at \$3.9 million.

Of the 137,500 restricted shares, 108,432 were issued to employees of TrafficLeader valued at \$732,000, which amount will be recorded as compensation expense over the associated employment period in which these shares vest.

In the event on or prior to December 31, 2004, there were a change of control of TrafficLeader or of us, or both TrafficLeader's CEO and CTO were either to resign for good reason or were terminated without cause, or we were to take any action prior to the end of December 31, 2004, which would make it impractical to calculate or reconstruct the earn out obligation, we would be obligated to pay the full amount of the \$1 million contingent payment obligation.

## **Table of Contents**

### ***Consolidated Statements of Operations***

Our consolidated statements of operations and cash flows have been presented for the periods January 17, 2003 (inception) to June 30, 2003 and the quarter ended June 30, 2004. Business planning and other activities related to our business began in late 2002. We were organized and incorporated in Delaware in January 2003. Included in the results of operations subsequent to our incorporation in January 2003 are reimbursements to certain founding officers for approximately \$86,000 in general and administrative pre-incorporation costs. Included in property and equipment are purchases from certain of our founding officers of approximately \$62,000 for the carrying value of the assets.

The assets, liabilities and operation of Enhance Interactive and TrafficLeader are included in our consolidated financial statements since the date of their respective acquisitions in February and October 2003. Our wholly-owned operating subsidiary goClick is not included in our consolidated financial statements as of June 30, 2004. The goClick acquisition was completed on July 27, 2004.

All significant inter-company transactions and balances have been eliminated in consolidation. Our purchase accounting resulted in all assets and liabilities from our acquisitions of Enhance Interactive and TrafficLeader being recorded at their estimated fair values on their respective acquisition dates. For the period of February 28 through December 31, 2003 and October 24, 2003 through December 31, 2003, all goodwill, intangible assets and liabilities resulting from the respective Enhance Interactive and TrafficLeader acquisitions have been recorded in our financial statements. Accordingly, our consolidated financial results for periods subsequent to the acquisition of Enhance Interactive are not comparable to the financial statements of Enhance Interactive presented for prior periods. The consolidated statements of operations and cash flows reflecting Enhance Interactive's historical results have been presented for the period from January 1, 2003 through February 28, 2003.

eFamily and its wholly-owned subsidiary Enhance Interactive are described as Enhance Interactive in this Management's Discussion and Analysis. In the accompanying condensed consolidated financial statements, the statements of operations, stockholders' equity, and cash flows reflecting Enhance Interactive results have been presented as the Predecessor for the period of January 1, 2003 to February 28, 2003.

### ***Presentation of Financial Reporting Periods***

For purposes of our discussion, we have included the results of operations of the Predecessor, Enhance Interactive. The comparative periods presented are the quarter ended June 30, 2003 and 2004 and the combined periods of January 17, 2003 (inception) to June 30, 2003 and Enhance Interactive's results from January 1, 2003 to February 28, 2003 (2003 period) compared to the six months ended June 30, 2004 (2004 period). Included in the 2003 period are the overlapping operating activities of Enhance Interactive and our operating activities for the period of January 17, 2003 (inception) through February 28, 2003. During January 17, 2003 (inception) through February 28, 2003, we were involved in business and product development, as well as financing and acquisition initiatives and accordingly, our activities were different from the operating activities of Enhance Interactive.

### ***Revenue***

We currently generate revenue through our operating businesses. The primary revenue source, amounting to greater than 91% in all periods presented, is performance-based advertising services, which include pay-per-click listings and paid inclusion. The secondary sources of revenue, amounting to less than 9% in all periods presented, are the search marketing services, which include advertising campaign management, conversion tracking and analysis and search engine optimization. We generally recognize revenue upon completion of our performance

## Edgar Filing: MARCHEX INC - Form 10QSB

obligation, provided that: (i) evidence of an arrangement exists; (ii) the arrangement fee is fixed and determinable; and (iii) collection is reasonably assured. We have no barter transactions.

In providing pay-per-click advertising services primarily via Enhance Interactive, we generate revenue when we deliver qualified click-throughs to our merchant advertisers. These merchant advertisers pay us a designated transaction fee for each click-through, which occurs when an online user clicks on any of their advertisement listings after it has been placed by us or by our distribution partners. Each click-through on an advertisement listing represents a completed transaction. The advertisement listings are displayed within our distribution network, which includes search engines, directories, destination sites and other targeted Web-based content.

In our paid inclusion services delivered primarily via TrafficLeader, merchant advertisers pay for their Web pages and product databases to be crawled, or searched, and included within search engine and product shopping engine results. Generally, the paid inclusion results are presented separately on a Web page from the pay-per-click listings. For this service, revenue is generated when an online user clicks on a paid inclusion listing within search engine and product shopping engine results. The placement of a paid inclusion result within search engine results is largely determined by its relevancy, as determined by the search engine partner.

Merchant advertisers also pay us for our search marketing services and tools, primarily delivered by TrafficLeader. Merchant advertisers pay us additional fees for such services as advertising campaign management, conversion tracking and analysis, and search

## **Table of Contents**

engine optimization. Merchant advertisers generally pay us on a click-through basis, although in certain cases we receive a fixed fee for delivery of these services. In some cases we also deliver banner campaigns for select merchant advertisers, primarily through Enhance Interactive. We may also charge initial set-up or inclusion fees as part of our services. Revenue from these collective services accounted for less than 9% of total revenue in all periods presented.

Banner advertising revenue (generated by Enhance Interactive) is primarily based on a fixed fee-per-click and recognized on click-through activity. In limited cases, banner payment terms are volume-based with revenue recognized when impressions are delivered.

Non-refundable account set-up fees are paid by merchant advertisers and are recognized ratably over the longer of the term of the contract or the average expected merchant advertiser relationship period, which generally ranges between twelve months to more than two years.

Other inclusion fees are generally associated with monthly or annual subscription-based services where a merchant advertiser pays a fixed amount to be included in our index of listings, or our distribution partners' index of listings. These subscription arrangements are recognized ratably over the service period.

We enter into agreements with various distribution partners to provide distribution for the URL strings and advertisement listings of our merchant advertisers. We generally pay distribution partners based on a percentage of revenue or a fixed amount per click-through on these listings. The level of click-throughs contributed by our distribution partners has varied, and we expect it will continue to vary, from quarter to quarter and year to year, sometimes significantly. Our growth will be impacted by our ability to increase our distribution, which impacts the number of Internet users who have access to our merchant advertisers' listings and the rate at which our merchant advertisers are able to convert clicks from these Internet users into completed transactions, such as a purchase or sign up. Our growth also depends on our ability to continue to increase the number of merchant advertisers who use our services and the amount these merchant advertisers spend on our services.

We anticipate that these variables will fluctuate in the future, affecting our growth rate and our financial results. In particular it is difficult to project the number of click-throughs we will deliver to our merchant advertisers and how much merchant advertisers will spend with us, and even more difficult to anticipate the average revenue per click-through.

In addition, we believe we will experience seasonality. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of Internet usage. It is generally understood that during the spring and summer months, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and results.

## ***Service Costs***

Service costs include network operations and customer service costs that consist primarily of costs associated with serving our search results, maintaining our Web sites, credit card processing fees, network fees, fees paid to outside service providers, and customer services. Customer service and other costs associated with providing our performance-based advertising and search marketing services and maintaining our Web site include depreciation of Web site and network equipment, colocation charges of our Web site equipment, bandwidth, and software license fees, salaries of related personnel, stock-based compensation and amortization of intangible assets.

## Edgar Filing: MARCHEX INC - Form 10QSB

Service costs also include user acquisition costs that relate primarily to payments to our distribution partners for access to their user traffic. We enter into agreements of varying durations with distribution partners that integrate our services into their sites and indexes. The primary economic structure of the distribution partner agreements is a variable payment based on a specified percentage of revenue. These variable payments are often subject to minimum payment amounts per click-through. Other economic structures that to a lesser degree exist include:

fixed payments, based on a guaranteed minimum amount of usage delivered;

variable payments based on a specified metric, such as number of paid click-throughs; and

a combination arrangement with both fixed and variable amounts.

We expense user acquisition costs under two methods: agreements with fixed payments are generally expensed at the greater of pro-rata over the term the fixed payment covers; or usage delivered to date divided by the guaranteed minimum amount of usage delivered. Agreements with variable payment based on a percentage of revenue, number of paid click-throughs or other metric are generally expensed based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

## **Table of Contents**

### ***Sales and Marketing***

Sales and marketing expense consists primarily of payroll and related expenses for personnel engaged in marketing and sales functions; advertising and promotional expenditures; and cost of systems used to sell to and serve advertisers.

### ***Product Development***

Product development costs consist primarily of expenses incurred in the research and development, creation and enhancement of our Internet site and services. Research and development expenses include compensation and related expenses, costs of computer hardware and software, and costs incurred in developing features and functionality of the services. For the periods presented, substantially all of the product development expenses are research and development.

Product development costs are expensed as incurred or capitalized into property and equipment in accordance with the American Institute of Certified Public Accountants' Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." This statement requires that costs incurred in the preliminary project and post-implementation stages of an internal use software project be expensed as incurred and that certain costs incurred in the application development stage of a project be capitalized.

### ***General and Administrative***

General and administrative expenses consist primarily of payroll and related expenses for executive and administrative personnel, bad debt provision, facilities, professional services (including legal and insurance), and other general corporate expenses.

### ***Acquisition-Related Retention Consideration***

Acquisition-related retention consideration results from the contingent, earnings-based payment obligation to certain employees of Enhance Interactive for each of the calendar years 2003 and 2004, pursuant to the terms of the merger agreement. See subsection "Prior Acquisitions" above. We shall have no obligation with respect to a year in the event that Enhance Interactive's earnings before taxes do not exceed \$3.5 million for that calendar year. The threshold determination is calculated separately for each of the calendar years 2003 and 2004.

The contingent payment obligation is calculated based on the formula of 5.56% of Enhance Interactive's earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout of \$1 million in the aggregate. To the extent we make any payments under this obligation, we will account for such amounts as compensation. For the six months ended June 30, 2004, we recorded an additional \$256,000 in retention-related consideration as compensation for such period; although the actual amount for the calendar year 2004 has not yet been determined. With respect to the quarter ended June 30, 2004, we recorded \$123,000 in retention-related consideration.

*Stock-Based Compensation*

Stock-based compensation consists of the following:

the intrinsic value of employee option and restricted stock issuance where the fair market value of the underlying stock exceeded the exercise price on the date of the grant;

the fair value of non-employee option issuances; and

the amount by which the fair market value of our Class B common stock exceeded the exercise price at the end of the period for certain options. We used variable accounting for options to purchase 125,000 shares of our Class B common stock that are issued under our Stock Incentive Plan. These options were held in escrow as security for the indemnification obligations under the Enhance Interactive merger agreement, and were subject to forfeiture. We accounted for them as variable awards until the expiration of the agreed-upon escrow period on February 28, 2004.

## **Table of Contents**

### ***Amortization of Intangibles***

Amortization of identifiable intangible assets relates to intangible assets identified in connection with the purchase of Enhance Interactive and TrafficLeader. Intangible assets identified in connection with the purchase of Enhance Interactive were valued at \$8.4 million at the acquisition date of February 28, 2003. Intangible assets identified in connection with the purchase of TrafficLeader were valued at \$1.3 million at the acquisition date of October 24, 2003. The intangible assets have been identified as non-competition agreements, trade and domain names, distributor relationships, and merchant advertising customer base relationships and acquired technology. These assets are amortized over useful lives ranging from 12 to 42 months.

### ***Provision for Income Taxes***

For income tax purposes, we utilize the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in results of operations in the period that includes the enactment date. A valuation allowance is recorded for deferred tax assets when it is more likely than not that such deferred tax assets will not be realized.

As of June 30, 2004, we had net operating loss carryforwards (NOL s) of \$1.8 million, which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL s and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. We believe that such a change has occurred, and that the utilization of the approximately \$1.8 million of carryforwards is limited such that substantially all of these NOL carryforwards will never be utilized.

### ***Accretion to Redemption Value of Redeemable Convertible Preferred Stock***

Holders of Series A redeemable convertible preferred stock were entitled to receive annual cumulative dividends at the per annum rate of 8% of the original purchase price per share when and if declared by the board of directors. Upon the automatic conversion of the Series A redeemable convertible preferred stock in connection with the closing of our IPO in April 2004, all accumulated and unpaid dividends on the Series A redeemable convertible preferred stock, whether or not declared, since the date of issue up to and including the conversion date, were eliminated.

Prior to the conversion of the Series A redeemable preferred stock, we accounted for the difference between the carrying amount of the redeemable preferred stock and the redemption amount by increasing the carrying amount for periodic accretion using the interest method, so that the carrying amount was equal to the redemption amount at the earliest redemption date. All 6,724,063 shares of Series A redeemable convertible preferred stock were automatically converted into 6,724,063 shares of Class B common stock upon the closing of the IPO in April 2004.



**Table of Contents****Results of Operations**

The following table presents certain financial data, derived from our unaudited statements of operations, as a percentage of total revenue for the period indicated. The operating results for the period of January 17, 2003 (inception) to June 30, 2003 and the period of January 1, 2003 to February 28, 2003, for the six months ended June 30, 2004 and the quarters ended June 30, 2003 and 2004 are not necessarily indicative of the results that may be expected for the full year or any future period.

	Predecessor Period	Successor Periods			
	Period from January 1 to February 28,  2003	Period from January 17, (inception) to June 30, 2003	Six months ended June 30, 2004	Quarter ended June 30, 2003	Quarter ended June 30, 2004
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Expenses:					
Service costs	56.4%	54.3%	63.9%	55.2%	64.8%
Sales and marketing	11.9%	12.3%	12.4%	12.2%	11.6%
Product development	4.7%	6.5%	6.3%	6.6%	6.0%
General and administrative	7.6%	16.4%	9.4%	13.6%	9.6%
Acquisition-related retention consideration		0.0%	1.6%	0.0%	1.4%
Facility relocation		0.0%	1.4%	0.0%	0.0%
Stock-based compensation	1.3%	17.8%	3.6%	10.3%	2.7%
Amortization of intangible assets		16.4%	12.6%	16.2%	11.7%
Total operating expenses	81.9%	123.7%	111.2%	114.1%	107.8%
Income (loss) from operations	18.1%	-23.7%	-11.2%	-14.1%	-7.8%
Other income:					
Interest income		0.2%	0.8%	0.3%	0.8%
Interest expense		0.0%	0.0%	0.0%	0.0%
Adjustment to fair value of redemption obligation		0.0%	0.0%	0.0%	0.0%
Other		0.0%	0.0%	0.0%	0.0%
Total other income	0.0%	0.2%	0.8%	0.3%	0.8%
Income (loss) before provision for income taxes	18.1%	-23.5%	-10.4%	-13.8%	-7.0%
Income tax expense (benefit)	7.3%	-8.3%	-1.2%	-4.9%	-1.7%
Net income (loss)	10.8%	-15.2%	-9.2%	-8.9%	-5.3%
Accretion to redemption value of redeemable convertible preferred stock	0.0%	7.1%	2.6%	7.2%	0.2%
Net income (loss) applicable to common stockholders	10.8%	-22.3%	-11.8%	-16.1%	-5.5%

**Comparison of the Quarter ended June 30, 2003 to the Quarter ended June 30, 2004 and the combined periods of January 17, 2003 (inception) to June 30, 2003, and January 1, 2003 to February 28, 2003 (2003 period) to the six months ended June 30, 2004 (2004 period).**

**Revenue.** Revenue for the second quarter of 2004 increased by \$3.5 million or 66%, as compared to the same period in 2003. This increase was primarily attributable to a \$3.3 million increase for the quarter ended June 30, 2004 in performance-based advertising services which primarily related to an increase in the average revenue per merchant advertiser. Revenue for the 2004 period increased by \$6.3 million or 62% as compared to the 2003 period. This increase was primarily attributable to our performance-based advertising services, which increased by approximately \$6.0 million in the 2004 period.

We believe the increase in revenue is primarily a result of the growth of our existing distribution partners, the increased number of searches and the resulting click-throughs performed by users of our service, and merchant advertisers. The number of our distribution partners was approximately 460 for the 2003 period and the 2004 period. We also believe the foregoing factors, combined with our sales efforts and improved operational controls, have contributed to an increase in the number of merchant advertisers. The increase in revenue in the 2004 period is also attributable to the acquisition of TrafficLeader in October 2003, which added 11 unique distribution partners and more than 280 merchant advertisers as of such acquisition in October 2003. TrafficLeader's operating results were included as of the acquisition date of October 24, 2003.

Our growth rate will depend in part on our ability to increase the number of click-throughs performed by users of our service, primarily through our distribution partners. If we do not renew our distribution partner agreements or replace traffic lost from

---

**Table of Contents**

terminated distribution agreements with other sources or if our distribution partners' search businesses do not grow or are adversely affected, our revenue and results of operations may be materially and adversely affected. Our growth rate will also depend in part on our ability to increase the number and volume of transactions with merchant advertisers. We believe this is dependent in part on delivering high quality traffic that ultimately results in purchases or conversions for our merchant advertisers.

***Expenses***

*Service Costs.* Service costs for the second quarter of 2004 increased by \$2.8 million or 94%, as compared to the same period in 2003. The increase was mainly attributable to an increase in payments to distribution partners of \$2.4 million, an increase in agency commissions and referral fees of \$26,000, an increase in personnel costs of \$255,000, an increase in technology and licensing costs of \$37,000, and an increase in facility and other costs of \$109,000. Approximately \$1.9 million of the total increase in service costs for the quarter ended June 30, 2004 was attributable to the October 2003 acquisition of TrafficLeader, which was not included in the same period in 2003.

This total increase also resulted from a greater number of searches, an increase in database and hardware capacity requirements as a result of an increase in our distribution partner base and corresponding number of searches, an increase in the number of personnel required to support our services and increased fees paid to outside service providers. Service costs represented 65% of revenue in the second quarter of 2004 as compared to 55% in the same period in 2003. As a percentage of revenue, the increase in service costs for the second quarter of 2004 as compared to the same period in 2003 was primarily a result of increased additional fixed costs for network operations incurred in anticipation of additional expansion and the impact as a percentage of revenue from the service cost level from the October 2003 acquisition of TrafficLeader. TrafficLeader's service costs were 75% of TrafficLeader revenue for the quarter ended June 30, 2004. Since TrafficLeader's user acquisition costs are higher as a percentage of revenue than Enhance Interactive, to the extent that TrafficLeader's operations make up a larger percentage of future operations, we expect that service costs will increase as a percentage of revenue.

We also expect that service costs will continue to increase in absolute dollars, since we anticipate expanding our operations. Service costs increased by \$5.0 million or 89% for the 2004 period as compared to the 2003 period. This increase was primarily attributable to an increase of \$4.0 million in payments to distribution partners, an increase in agency commissions and referral fees of \$68,000, an increase in personnel costs of \$541,000, an increase in technology and licensing costs of \$83,000 and an increase in facility and other costs of \$218,000. Service costs as a percentage of revenue were 64% in the 2004 period as compared to 55% in the 2003 period.

*Sales and Marketing.* Sales and marketing expenses for the second quarter of 2004 increased by \$377,000 or 58%, as compared to the same period in 2003. As a percentage of revenue, sales and marketing expenses were 12% for the second quarter of 2004 and 2003. The increase in dollars was primarily related to an increase in personnel costs of \$250,000 primarily related to an increase in the number of employees. For the second quarter of 2004, \$113,000 in personnel costs related to TrafficLeader. The remaining increase is related to increases in outside marketing activities, rent, travel and other operating costs arising from operations in multiple jurisdictions. We expect that sales and marketing expenses will increase in absolute dollars in connection with any revenue increase, to the extent that we also increase our marketing activities. Sales and marketing expenses increased \$807,000 or 65% for the 2004 period as compared to the 2003 period. As a percentage of revenue, the sales and marketing expenses were 12% for both the 2004 and 2003 periods.

*Product Development.* Product development expenses for the second quarter of 2004 increased \$173,000 or 49%, as compared to the same period in 2003. As a percentage of revenue, product development expenses were 6% for second quarter of 2004 and 2003. The increase in dollars was primarily due to an increase in personnel costs of \$127,000, primarily due to an increase in the number of employees, including \$77,000 resulting from TrafficLeader for the quarter ended June 30, 2004. We expect that product development expenses will increase in absolute dollars as we increase the number of personnel and consultants to enhance our service offerings. Product development expenses for the 2004 period increased by \$429,000 or 71%, as compared to the 2003 period. The increase was primarily attributable to an increase in personnel

## Edgar Filing: MARCHEX INC - Form 10QSB

costs of \$344,000, an increase in travel of \$33,000 and an increase in other expenses of \$52,000.

*General and Administrative.* General and administrative expenses for the second quarter of 2004 increased by \$117,000 or 16%, as compared to the same period 2003. As of percentage of revenue, general and administrative expenses were 10% for the second quarter of 2004 and 14% for the same period in 2003. The net increase in the dollars was primarily due to an increase in personnel costs of \$191,000, a decrease in professional fees of \$152,000, a decrease in travel of \$18,000, an increase in insurance of \$20,000, an increase in bad debt expense of \$42,000 and an increase in other expenses of \$35,000. Many of these costs in the 2004 period result from operating in multiple jurisdictions commencing in 2003 and increased operating activity, including the acquisition of TrafficLeader in October 2003. We expect that our general and administrative expenses will increase in absolute dollars to the extent that we expand our operations and incur additional costs in connection with being a public company, including expenses related to professional fees and insurance. General and administrative expenses for the 2004 period increased by \$150,000 or 11%, as compared to the 2003 period. As a percentage of revenue, general and administrative expenses decreased to 9% in the 2004 period as compared to 14% in the 2003 period. As a percentage of revenue, the decrease in general and administrative expenses in the 2004 period as compared to the 2003 period was primarily a result of a decrease in professional fees and the allocation of the general and administrative expenses over a larger revenue base.

---

**Table of Contents**

*Acquisition-Related Retention Consideration.* Acquisition-related retention consideration increased to \$123,000 in the second quarter of 2004 as compared to \$0 during the same period in 2003. During the second quarter of 2004, the components of acquisition-related retention consideration were estimated based on forecasts of the Enhance Interactive earn-out calculations. Estimated allocations were made as follows: service costs of \$15,000, sales and marketing of \$42,000, product development of \$45,000, and general and administrative of \$21,000. The acquisition related retention consideration was calculated as part of the contingent, earnings-based payment obligation to certain employees of Enhance Interactive and is equal 5.56% of Enhance Interactive's earnings before taxes in excess of \$3.5 million for the 2004 period of which \$256,000 has been recorded as acquisition-related retention consideration including employer payroll-related taxes. A quarterly proportion of the annual estimated acquisition-related retention consideration was recorded in the second quarter of 2004. We will account for any payment amount as compensation. The acquisition-related retention consideration for the calendar years 2003 and 2004 is subject to an aggregate maximum of \$1 million. Acquisition-related consideration increased in the 2004 period by \$256,000 or 100%, as compared to \$0 in the 2003 period.

*Facility Relocation.* In March 2004, we entered into a sublease agreement for new and larger office facilities in Seattle, Washington, and we relocated from our original office facilities also located in Seattle, Washington. As of June 30, 2004, the net sublease income is estimated to be approximately \$84,000 over the life of the lease. The remaining lease obligations for the original facilities extend through June 30, 2006 and totaled \$251,000 as of June 30, 2004. In March 2004, we accrued lease and related costs of \$230,000 for the estimated future obligations of non-cancelable lease and other payments for the original facilities.

The remaining lease accrual is based on estimates of vacancy period and sublease income. The actual vacancy periods may differ from these estimates, and sublease income, if any, may not materialize. Accordingly, these estimates may be adjusted in future periods.

*Stock-Based Compensation.* The amortization of stock-based compensation in the second quarter of 2004 decreased by \$315,000 or 57%, as compared to the same period in 2003. In the second quarter of 2004, the components of stock-based compensation were service costs of \$2,000, sales and marketing of \$49,000, product development of \$13,000 and general and administrative of \$171,000. The second quarter of 2003 includes \$300,000 of stock-based compensation for 125,000 options issued that were held in escrow as security for the indemnification obligations under the Enhance Interactive merger agreement. These options were subject to forfeiture, until the expiration of the escrow period which was February 28, 2004. Accordingly, we have accounted for these options as variable awards during the escrow period. Under variable plan accounting, compensation expense is measured quarterly as the amount by which the fair market value of the shares of our Class B common stock covered by the option grant exceeds the exercise price and is recognized over the option's vesting period. Increases or decreases in the fair market value of our Class B common stock between the date of grant and the date of exercise result in a corresponding increase or decrease in the measure of compensation expense. The amortization of stock-based compensation in the 2004 period decreased by \$704,000 or 54%, as compared to the 2003 period. During the 2004 period, the components of stock-based compensation were service costs of \$2,000, sales and marketing of \$117,000, product development of \$39,000 and general and administrative of \$439,000. Amounts in the 2004 period related primarily to the vesting of stock options granted to employees in which the exercise price was less than the fair market value at the date of grant and \$253,000 related to restricted stock issued to employees for future services in connection with the acquisition of TrafficLeader.

*Amortization of Intangibles.* Intangible amortization expense increased in the second quarter of 2004 by \$165,000 or 19%, as compared to the same period in 2003. The increase is associated with the purchase of Enhance Interactive and TrafficLeader. During second quarter of 2004, the components of amortization of intangibles were service costs of \$735,000, sales and marketing of \$163,000 and general and administrative of \$138,000. Our purchase accounting resulted in all assets and liabilities from our acquisition of Enhance Interactive and TrafficLeader being recorded at their estimated fair values on the acquisition dates of February 28, 2003 and October 24, 2003, respectively. For the period from February 28, 2003, through June 30, 2004, all goodwill, identifiable intangible assets and liabilities resulting from the Enhance Interactive and TrafficLeader acquisitions have been recorded in our financial statements. The identified intangibles amounted to \$9.7 million and are being amortized over a range of useful lives of 12 to 42 months. Our consolidated financial results for periods subsequent to the acquisition of Enhance Interactive are not comparable to the financial statements of Enhance Interactive presented for prior periods. We may acquire identifiable intangible assets as part of future acquisitions and if so, we expect that our intangible amortization will increase in absolute dollars.

## Edgar Filing: MARCHEX INC - Form 10QSB

*Other Income.* Other income increased in the second quarter of 2004 by \$55,000 or 411%, as compared to the same period in 2003. Interest income increased by \$57,000 due to an increase in the average cash balance in the second quarter 2004 resulting from the Company's IPO which accounts for primarily all of the increase. Other income increased \$120,000 or 665% in the 2004 period as compared to the 2003 period. The increase was primarily attributable to an increase in interest income of \$63,000 and the adjustment to fair value of the TrafficLeader redemption obligation of \$55,000 in the 2004 period as compared to the 2003 period.

*Income Taxes.* The income tax benefit in the second quarter of 2004 decreased by 117,000 or 44%, as compared to the same period in 2003. In the second quarter of 2003, the effective tax rate benefit of 35% differed from the expected effective rate of 34% primarily

---

**Table of Contents**

due to state income taxes and non-deductible stock compensation amounts. The income tax effective rate was 12% in the 2004 period. This differed from the expected rate of 34% primarily due to state income taxes and non-deductible stock compensation amounts. The periods were also impacted by the following factors:

On February 28, 2003, and October 24, 2003 in connection with the purchase accounting for the respective acquisitions of Enhance Interactive and TrafficLeader, we recorded net deferred tax liabilities in the amount of approximately \$3.5 million, including \$479,000 associated with the acquisition of TrafficLeader, relating to the difference in the book basis and tax basis of its assets and liabilities.

Approximately \$3.6 million of these deferred tax liabilities, including \$479,000 associated with the acquisition of TrafficLeader, related to the book basis versus tax basis of the identifiable intangible assets in the acquisitions totaling approximately \$9.7 million.

During the period from January 1, 2003 through February 28, 2003 and in the second quarter of 2004, as a result of tax deductions from stock option exercises, Enhance Interactive and the Company recognized tax-effected benefits of approximately \$231,000 and \$101,000, respectively, which were recorded as credits to additional paid in capital. The income tax benefit decreased in the 2004 period by \$162,000 or 45%, as compared to the 2003 period.

*Accretion to Redemption Value of Redeemable Convertible Preferred Stock.* The accretion to redemption value of preferred stock in the second quarter of 2004 decreased by \$368,000 or 95%, as compared to the same period in 2003. The accretion to the redemption value recorded during the 2004 period is based upon 6,724,063 shares of Series A redeemable convertible preferred stock outstanding as of April 5, 2004 with a dividend rate of 8% per annum. All 6,724,063 shares of Series A redeemable convertible preferred stock automatically converted into 6,724,063 shares of Class B common stock upon the closing of the IPO on April 5, 2004. For the 2004 period, accretion to redemption value of preferred stock decreased by \$84,000 or 17%, as compared to the same period in 2003.

*Net Loss Applicable to Common Stockholders.* Net loss applicable to common stockholders in the second quarter of 2004 decreased by \$387,000 or 45%, as compared to the same period in 2003. The decrease was primarily attributable to the decrease in accretion to redemption value of the Series A redeemable convertible preferred stock of \$368,000 and the decrease in stock-based compensation of \$315,000. For the 2004 period, the net loss applicable to common stockholders increased \$664,000 or 53%, as compared to the 2003 period.

*Operating Income before Amortization.* Our management believes that certain non-GAAP measures, which are calculated and presented on the basis of methodologies other than in accordance with generally accepted accounting principles (GAAP), are helpful, when presented in conjunction with comparable GAAP measures. The non-GAAP measures are not meant to replace or supercede the GAAP measures, but rather to supplement the information to present to the readers of the financial statements the same information as management considers in assessing the results of operations and performance.

When presenting non-GAAP measures we will present a reconciliation of the most directly comparable GAAP measure. These non-GAAP measures are consistent with how management views the results of operations in assessing performance.

We report operating income before amortization (OIBA) that is a supplemental measure to GAAP. OIBA represents income (loss) from operations before (1) stock-based compensation expense and (2) amortization of intangible assets. It is one of the primary metrics by which we evaluate the performance of our business. Additionally, management uses adjusted OIBA which excludes both the acquisition-related retention consideration, as we view this as part of the earn-out incentives related to the Enhance transaction, and a facility relocation expense. Both of these items are viewed as non-recurring in nature with the facility relocation expense recognized in the six months ended June 30, 2004 and the

## Edgar Filing: MARCHEX INC - Form 10QSB

earn-out consideration relating to calendar year 2004. We refer to adjusted OIBA to facilitate accurate comparisons to our historical operating results, in making operating decisions, for internal budget planning, and in some cases to form the basis upon which management are evaluated. Management believes that investors should have access to, and we are obligated to provide, the same set of tools that we use in analyzing our results. These non-GAAP measures should be considered in addition to results prepared in accordance with GAAP, and should not be considered in isolation, as a substitute for or superior to GAAP results. We believe these measures are useful to investors because they represent our consolidated operating results, taking into account depreciation, which we believe is an ongoing cost of doing business, but excluding the effects of certain other non-cash and non-recurring expenses.

OIBA and adjusted OIBA have certain limitations in that they do not take into account the impact to our statement of operations of certain expenses, including non-cash stock-based compensation associated with our employees, acquisition-related accounting and facility relocation amounts. We endeavor to compensate for the limitations of these non-GAAP measures presented by providing the comparable GAAP measure with equal or greater prominence, GAAP financial statements and detailed descriptions of the reconciling items and adjustments, including quantifying such items, to derive the non-GAAP measure.



**Table of Contents**

The following are non-cash expenses that are excluded from our non-GAAP measures:

stock-based compensation consists of restricted stock and options expense, which relates mostly to restricted stock and options issued in connection with acquisitions. We view this expense as part of transaction costs which are not paid in cash. Stock-based compensation also includes the expense of associated with certain employee stock options where on the date of grant the fair value of the underlying stock exceeded the exercise price.

Amortization of intangible assets is a non-cash expense relating primarily to acquisitions. At the time of an acquisition, the intangible assets of the acquired company, such as distribution partner relationships and merchant advertiser customer relationships are valued and amortized over their estimated lives. While it is likely that we will have significant intangible amortization expense as we continue to acquire companies, we believe that since intangibles represent costs incurred by the acquired company to build value prior to the acquisition, they were part of the transaction costs and will not be replaced with cash costs when the intangibles are fully amortized.

The following is a reconciliation of income (loss) from operations and net income (loss) applicable to common stockholders to the non-GAAP measure of operating income before amortization for the period of January 1, 2003 to February 28, 2003, the period of January 17, 2003 (inception) to June 30, 2003, for the six months ended June 30, 2004 and for the quarters ended June 30, 2003 and 2004.

	Period from January 1 to February 28, 2003	Period from January 17, (inception) to June 30, 2003	Six months ended June 30, 2004	Quarter ended June 30, 2003	Quarter ended June 30, 2004
Operating income before amortization	\$ 594,053	747,958	841,630	661,786	592,943
Stock-based compensation	(38,981)	(1,261,069)	(595,998)	(550,078)	(235,234)
Amortization of intangible assets		(1,159,675)	(2,069,512)	(869,588)	(1,034,643)
Income (loss) from operations	555,072	(1,672,786)	(1,823,880)	(757,880)	(676,934)
Other income (expense):					
Interest income	1,529	16,571	81,346	13,479	70,329
Interest expense			(1,813)		(1,488)
Adjustment to fair value of redemption obligation			55,250		
Other			3,643		
Total other income	1,529	16,571	138,426	13,479	68,841
Income (loss) before provision for income taxes	556,601	(1,656,215)	(1,685,454)	(744,401)	(608,093)
Income tax expense (benefit)	224,082	(586,863)	(200,803)	(263,771)	(147,103)
Net income (loss)	332,519	(1,069,352)	(1,484,651)	(480,630)	(460,990)
Accretion to redemption value of redeemable convertible preferred stock		504,355	420,430	385,274	17,751
Net income (loss) applicable to common stockholders	\$ 332,519	(1,573,707)	(1,905,081)	(865,904)	(478,741)

## Edgar Filing: MARCHEX INC - Form 10QSB

Operating income before amortization decreased in the second quarter of 2004 by \$69,000 or 10%, as compared to the same period in 2003. The decrease in OIBA was primarily attributable to an increase in the acquisition-related retention consideration of \$123,000. Operating income before amortization decreased in the 2004 period by \$500,000 or 37%, as compared to the same period in 2003 primarily attributable to an increase in acquisition-related retention consideration of \$256,000 and an increase in facility relocation costs of \$230,000.

### **Liquidity and Capital Resources**

We initially financed our company through the private sales of Marchex securities in January through May of 2003, which resulted in total proceeds of approximately \$20.3 million. Primarily from such proceeds, we funded our early business operations and the acquisitions of Enhance Interactive and TrafficLeader. The acquisition of Enhance Interactive amounted to \$13.3 million in net cash consideration and the acquisition of TrafficLeader amounted to \$3.2 million in net cash consideration.

On April 5, 2004, we completed our IPO of 4.6 million shares of Class B common stock. The proceeds received in the second quarter of fiscal 2004 from the stock offering, net of cash offering expenses and underwriter discounts, were \$27.2 million. Net proceeds have

## Table of Contents

been or will be used to pay for product and business development, acquisitions and strategic relationships, capital expenditures, personnel, facilities, earn-out obligations and working capital and other general corporate purposes. On April 5, 2004, all of our outstanding shares of Series A redeemable convertible preferred stock, with a value of \$21.8 million, were automatically converted into Class B common stock and are now included as components of stockholders' equity.

As of June 30, 2004, we had cash and cash equivalents of \$29.8 million. As of June 30, 2004, we had operating lease contractual obligations of \$3.0 million of which \$2.7 million is for rent under our facility leases.

Cash provided by operating activities primarily consists of net loss adjusted for certain non-cash items such as depreciation and amortization, tax benefit from stock options, loss on facility relocation, deferred income taxes and changes in working capital. Cash used by operating activities for the quarter ended June 30, 2004 of approximately \$1.1 million consisted primarily of a net loss of \$461,000 adjusted for non-cash items of \$1.4 million, including depreciation and amortization of intangibles and stock-based compensation, offset by approximately \$2.1 million used in working capital and related activities, as well as payments for acquisition-related retention consideration. Cash provided by operating activities for the quarter ended June 30, 2003 of approximately \$176,000 consisted primarily of a net loss of \$481,000 adjusted for non-cash items of \$1.1 million, including depreciation and amortization of intangibles and stock-based compensation, offset by approximately \$479,000 used by working capital and other activities.

With respect to most of the Enhance Interactive merchant advertisers, we receive payments for pay-per-click advertising services prior to our delivery of click-through occurs. Our corresponding payments to the distribution partners who provide placement for the listings are generally made only after our delivery of a click-through. In most cases, the amount payable to the distribution partner will be calculated at the end of a calendar month, with a payment period following the delivery of the click-throughs. This payment structure results in a lag period between the earlier receipt of the cash from the merchant advertisers and the later payment to the distribution partners. These services constituted the majority of revenue in the 2003 and 2004 periods.

Nearly all of the TrafficLeader merchant advertisers are billed on a monthly basis following the month of our click-through delivery. This payment structure results in our advancement of monies to the distribution partners who have provided the corresponding placements of the listings. TrafficLeader merchant advertiser's payments are generally received one to three weeks following payment to the distribution partners. We expect that in the future periods, if the paid inclusion services provided by TrafficLeader accounts for a greater percentage of our operating activity, working capital requirements will increase as a result.

Cash used in investing activities for the quarter ended June 30, 2004 of approximately \$3.5 million was primarily attributable to the 2003 Enhance earn-out consideration payment of approximately \$3.2 million and purchases of property and equipment of \$288,000. Cash used in investing activities for the quarter ended June 30, 2003 of approximately \$120,000 was related to purchases of property and equipment.

As a result of the Enhance Interactive and TrafficLeader acquisitions, we increased our property and equipment purchases for items such as network equipment and software, furniture, software and equipment for our personnel, and systems used to sell to and serve merchant advertisers. Purchases of property, plant and equipment for the period following the Enhance Interactive acquisition date of February 28, 2003 through June 30, 2004 totaled \$670,000. As our operations increase, we expect property and equipment purchases will increase as we continue to invest in equipment and software for our systems and personnel.

Cash provided by financing activities for the quarter ended June 30, 2004 of approximately \$27.9 million was primarily attributable to net proceeds from our IPO. Cash provided by financing activities for the quarter ended June 30, 2003 of approximately \$2.7 million was attributable

## Edgar Filing: MARCHEX INC - Form 10QSB

to the proceeds from the sale of Series A redeemable convertible preferred stock.

For purposes of the calculations of the contingent earnings and revenue-based payment obligations for Enhance Interactive and TrafficLeader, we have allocated revenue based on the source of revenue. We attribute revenue from products and services originating with Enhance Interactive to Enhance Interactive, and likewise we attribute revenue from products and services originating with TrafficLeader to TrafficLeader. Consistent with that approach, we allocate revenues based on origination of merchant advertiser and distribution partner relationships and agreements.

Future contingent earnings-and revenue-based payment obligations related to Enhance Interactive and TrafficLeader acquisitions, which will be determined in early 2005 for the 2004 calendar year, could significantly impact our cash flows and could significantly reduce our available cash and cash equivalents balances. These payment obligations are still subject to the aggregate maximums of \$13.5 million for Enhance Interactive for the calendar years 2003 and 2004 and \$1 million for TrafficLeader for the calendar year 2004.

For the calendar year 2003, the total aggregate Enhance Interactive contingent, earnings-based payment obligation was approximately \$3.5 million. This payment obligation includes the earn-out consideration of approximately \$3.2 million and the retention-related consideration of approximately \$283,000. These amounts for the calendar year 2003 were paid in April 2004.

**Table of Contents**

The following table summarizes our contractual obligations as of June 30, 2004, and the effect these obligations are expected to have on our liquidity and cash flows in future periods

	<u>Total</u>	<u>less than 1 year</u>	<u>1-3 years</u>	<u>4-5 years</u>	<u>After 5 years</u>
<b>Contractual Obligations:</b>					
Operating leases	\$ 3,019,000	487,000	1,622,000	910,000	
Earn-out obligation associated with Enhance Interactive (A)	Up to 9,997,000	Up to 9,997,000			
Earn-out obligation associated with Acquisition of TrafficLeader (B)	Up to 1,000,000	Up to 1,000,000			
<b>Total Contractual Obligations</b>	<b>\$ Up to 14,016,000</b>	<b>Up to 11,484,000</b>	<b>1,622,000</b>	<b>910,000</b>	<b>0</b>

(A) A contingent, earnings-based payment obligation may be owed to the former shareholders of Enhance Interactive. The payment obligation has two components, which consist of earn-out consideration and retention consideration.

The earn-out consideration is calculated based on the formula of 69.44% of Enhance Interactive's earnings before taxes for each of the calendar years 2003 and 2004, up to an aggregate maximum payout cap of \$12.5 million. In the event income before taxes does not exceed \$3.5 million for 2003 or 2004, then no amount shall be payable for the related period. Any amounts payable will be accounted for as additional goodwill.

The retention consideration is calculated based on the formula of 5.56% of Enhance Interactive's earnings before taxes for each of the calendar years 2003 and 2004, up to an aggregate maximum payout cap of \$1 million. In the event earnings before taxes do not exceed \$3.5 million for 2003 and 2004, then no amount shall be payable for the related period. Any amounts payable will be accounted for as compensation.

Based upon the calculation for the calendar year 2003, a \$3.5 million payment liability was recorded for total 2003 earnings-based payment obligations and an estimate for the six months of 2004 of \$256,000 was recorded. These amounts will reduce the maximum aggregate obligation by the same amount.

(B) A contingent, revenue-based payment obligation may be owed under the TrafficLeader acquisition agreement. The contingent revenue-based payment is conditioned on TrafficLeader having revenue in excess of \$15 million for calendar year 2004. In the event that TrafficLeader meets the minimum revenue threshold, we will be obligated to pay an amount equal to 10% of each dollar in revenue above the \$15 million threshold, up to a maximum payout cap of \$1 million. Any amounts payable will be accounted for as additional goodwill.

In the event on or prior to December 31, 2004, there were a change of control of us or TrafficLeader, or TrafficLeader's CEO and CTO both were either to resign for good reason or were terminated without cause, or we were to take any action prior to the end of December 31, 2004, which would make it impractical to calculate or reconstruct the earn out, we will be obligated to pay the full amount of the \$1 million performance-based contingent payment.

On July 27, 2004, we acquired goClick for approximately \$12.5 million in a combination of cash and equity. The cash portion of the consideration was equal to \$8,229,750.

## Edgar Filing: MARCHEX INC - Form 10QSB

We anticipate that we will need to invest working capital towards the development and expansion of our overall operations. We may also make a significant number of acquisitions, which could result in the reduction of our cash balances or the incurrence of debt. We have allocated a portion of net proceeds from our offering to fund acquisitions. Furthermore, we expect that future capital expenditures may increase in future periods, particularly if our operating activity increases.

Based on our operating plans, we believe that the proceeds from our IPO, together with existing resources and cash flows provided by operations, will be sufficient to fund our operations for at least twelve months. Additional equity and debt financing may be needed to support our acquisition strategy, our long-term obligations and our company's needs. If additional financing is necessary, it may not

## **Table of Contents**

be available; and if it is available, it may not be possible for us to obtain financing on satisfactory terms. Failure to generate sufficient revenue or raise additional capital could have a material adverse effect on our ability to continue as a going concern and to achieve our intended business objectives.

### **Critical Accounting Policies**

The policies below are critical to our business operations and the understanding of our results of operations. In the ordinary course of business, we make a number of estimates and assumptions relating to the reporting of our results.

Our condensed consolidated financial statements have been prepared with accounting principles generally accepted in the United States. The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses and the related disclosures of contingent assets and liabilities. We base our estimates on historical experience and on various assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our critical accounting policies relate to the following matters and are described below:

Revenue;

Goodwill and intangible assets;

Stock-based compensation; and

Allowance for doubtful accounts and merchant advertiser credits.

### ***Revenue***

We currently generate revenue through our operating businesses by delivering performance-based and search marketing services to merchant advertisers. The primary revenue driver has been performance-based advertising, which includes pay-per-click listings, delivered primarily through Enhance Interactive; and beginning in October 2003, paid inclusion, delivered primarily through TrafficLeader. For these particular services, revenue is recognized upon a user's click-through of a merchant advertiser listing within our network. Each click-through represents a completed transaction.

We have entered into agreements with various distribution partners in order to expand our distribution network, which includes search engines, directories, product shopping engines and other Web sites on which we include our merchant advertisers' listings. We generally pay distribution partners based on a specified percentage of revenue or a fixed amount per click-through on these listings. We act as the primary obligor in these transactions, and we are responsible for providing customer and administrative services to the merchant advertiser. In accordance with EITF

## Edgar Filing: MARCHEX INC - Form 10QSB

Issue No. 99-19, Reporting Revenue Gross as a Principal Versus Net as an Agent, the revenue derived from merchant advertisers who receive paid introductions through us as supplied by distribution partners is reported gross based upon the amounts received from the merchant advertiser.

### *Goodwill and Intangible Assets*

Goodwill represents the excess of the purchase price over the fair value of identifiable assets acquired and liabilities assumed in business combinations accounted for under the purchase method.

We apply the provisions of the Financial Accounting Standards Board's (FASB) Statements of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets (SFAS 142). Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS 142. SFAS 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. (SFAS 144).

Goodwill not subject to amortization is tested annually for impairment, and is tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. To date, no impairment charge has been taken for the goodwill related to our acquisitions of Enhance Interactive or TrafficLeader. If the fair value is lower than the carrying value, a material impairment charge may be reported in our financial results.



## **Table of Contents**

We review our long-lived assets for impairment in accordance with SFAS 144 whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment is to be recognized by the amount by which the carrying amount of the assets exceeds fair value. Assets to be disposed of are separately presented on the balance sheet and reported at the lower of their carrying amount or fair value less costs to sell, and are no longer depreciated.

No impairment of our intangible assets has been indicated to date. To the extent such evaluation indicates that the useful lives of intangible assets are different than originally estimated, the amortization period is reduced or extended and, accordingly, the quarterly amortization expense is increased or decreased.

As a result of the significance of the goodwill and intangible asset carrying values, any impairment charges or changes to the estimated amortization periods could have a material adverse effect on our financial results.

## ***Stock-Based Compensation***

Our stock-based compensation plan is described more fully in Note 3(b) to the condensed consolidated financial statements. We account for the plan under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations including FASB Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25 issued in March 2000, to account for our employee stock options. Under this method, employee compensation expense is recorded on the date of grant only if the fair market value of the underlying stock exceeded the exercise price. SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS 123) established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans.

As allowed by SFAS 123, we have elected to continue to apply the intrinsic value-based method of accounting described above for options granted to employees, and have adopted the disclosure requirements of SFAS 123. We recognize compensation expense over the vesting period utilizing the accelerated methodology described in Financial Accounting Standards Board Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. We account for non-employee stock-based compensation in accordance with SFAS 123 and EITF No. 96-18.

We used variable plan accounting to account for options to purchase 125,000 shares of our Class B common stock issued under our Stock Incentive Plan that were held in escrow as security for the indemnification obligations under the Enhance Interactive merger agreement. These options were subject to forfeiture, until the expiration of the escrow period which was February 28, 2004, and, accordingly, we were required to record a compensation charge on a quarterly basis, which lowered our earnings. Under variable plan accounting, compensation expense is measured quarterly as the amount by which the fair market value of the shares of our Class B common stock covered by the option grant exceeds the exercise price and is recognized over the option's vesting period. Increases or decreases in the fair market value of our Class B common stock between the date of grant and the date of exercise result in a corresponding increase or decrease in the measure of compensation expense.

The amount of stock-based compensation to be recognized is derived based upon our determination of the fair value of our Class B common stock. We determine the fair value of our Class B common stock based upon factors, including our operating performance, issuance of our convertible preferred stock, liquidation preferences of our preferred stock, and valuations of other publicly-traded companies.

The amount of compensation expense actually recognized in future periods could be lower than currently anticipated if unvested stock options for which deferred compensation has been recorded are forfeited. In addition, if we used different assumptions to determine the deemed fair value of our common stock, we could have reported materially different amounts of stock-based compensation. We currently are not required to record stock-based compensation charges if the employee stock option exercise price or restricted stock purchase price equals or exceeds the deemed fair value of our common stock at the date of grant. Several companies have recently elected to change their accounting policies and begun to record the fair value of options as an expense. In addition, we understand that discussions of potential changes to applicable accounting standards are ongoing. If we had estimated the fair value of options on the date of grant using a Black-Scholes pricing model, and then amortized this estimated fair value over the vesting period of the options, our net income (loss) would have been adversely affected. See Note 3(b) to our condensed consolidated financial statements for a discussion of how our net income (loss) would have been adversely affected.

*Allowance for Doubtful Accounts and Merchant Advertiser Credits*

Accounts receivable balances are presented net of allowance for doubtful accounts and merchant advertiser credits. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our accounts receivable. We determine our allowance based on analysis of historical bad debts, advertiser concentrations, advertiser creditworthiness and current economic trends. We

**Table of Contents**

review the allowance for collectibility on a quarterly basis. Account balances are written off against the allowance after all reasonable means of collection have been exhausted and the potential recovery is considered remote. If the financial condition of our advertisers were to deteriorate, resulting in an impairment of their ability to make payments, or if we underestimated the allowances required, additional allowances may be required which would result in increased general and administrative expenses in the period such determination was made.

We determine our allowance for merchant advertiser credits and adjustments based upon our analysis of historical credits. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments and estimates.

## **Table of Contents**

### **Risk Factors**

#### **Risks Relating to Our Company**

*Our limited operating history makes evaluation of our business difficult.*

We were formally incorporated in January 2003. We acquired Enhance Interactive in February 2003, TrafficLeader in October 2003 and goClick in July 2004. As a result, we have limited historical financial data upon which to base planned operating expenses or forecast accurately our future operating results. Further, our limited operating history will make it difficult for investors and securities analysts to evaluate our business and prospects. Our failure to address these risks and difficulties successfully could seriously harm us.

*We will need additional funding to support our operations and capital expenditures and to pursue our business strategy, which may not be available to us and which lack of availability could adversely affect our financial condition.*

We have no committed sources of additional capital. We intend to fund our current operations and capital expenditures from cash flow from operations and our cash on hand, which includes the net proceeds of our IPO, which closed in April 2004. If our capital resources are insufficient to continue our operations and fund current capital expenditures, we will have to raise additional funds. We will also need additional funds to, pursue business opportunities (such as expansion, acquisitions of complementary businesses or the development of new products or services), to react to unforeseen difficulties or to respond to competitive pressures. There can be no assurance that any financing arrangements will be available in amounts or on terms acceptable to us, if at all. Furthermore, the sale of additional equity or convertible debt securities will result in additional dilution to existing stockholders. If adequate additional funds are not available, we will be required to delay, reduce the scope of or eliminate material parts of the implementation of our business strategy, including the possibility of additional acquisitions or internally developed businesses.

*We may need additional funding to make payments to the former shareholders of Enhance Interactive and TrafficLeader, which may not be available to us and our failure to raise such funding could adversely affect our financial condition.*

We are obligated to make earnings-based performance payments to the original shareholders and certain employees of eFamily which we acquired in February 2003, together with its direct wholly-owned subsidiary, Enhance Interactive. These payment obligations are calculated based on a percentage of Enhance Interactive's earnings before taxes excluding stock-based compensation and amortization of intangibles relating to the acquisition for the calendar years 2003 and 2004, according to the terms of the merger agreement, with a maximum aggregate obligation of \$13.5 million. For the 2003 calendar year, the total Enhance Interactive earnings-based payment obligation was approximately \$3.5 million. We may also be obligated to make revenue-based performance payments to the original shareholders of TrafficLeader, which we acquired in October 2003. If TrafficLeader has revenues in excess of \$15 million for 2004, we will be obligated to pay an amount equal to 10% of each dollar in revenue above the \$15 million threshold, with a maximum obligation of \$1 million. We may need additional funding to meet our payment obligations under our acquisition agreements for Enhance Interactive and TrafficLeader, and our failure to raise such funding could have a material adverse effect upon our financial condition.

*We have incurred losses since our inception, and we expect our losses to continue for the foreseeable future, which will adversely affect our ability to achieve profitability.*

We have incurred net losses since inception and had an accumulated deficit of \$5.4 million as of June 30, 2004.

Our net losses are likely to continue for the foreseeable future. Also, our net losses may increase to the extent we increase our sales and marketing activities and acquire additional businesses. These efforts may prove to be more expensive than we currently anticipate which could further increase our net losses. We cannot predict if we will become profitable in the future. Even if we were to achieve profitability, we may not be able to sustain it.

*We have made a recent acquisition and may make future acquisitions, which could divert management's attention, cause ownership dilution to our stockholders, and be difficult to integrate.*

Our business strategy depends heavily upon our ability to identify structure and integrate acquisitions. Acquisitions, strategic relationships and investments in the technology and Internet sectors involve a high degree of risk. We may also be unable to find a sufficient number of attractive opportunities, if any, to meet our objectives. Although many technology and Internet companies have grown in terms of revenue, few companies are profitable or have competitive market share. Our acquired companies and potential strategic acquisition, strategic relationship or investment targets and partners may have histories of net losses and may expect net losses for the foreseeable future.

## **Table of Contents**

Acquisition transactions are accompanied by a number of risks that could harm us and our business, operating results and financial condition:

we could experience a substantial strain on our resources, including time and money, and we may not be successful;

our management's attention may be diverted from our ongoing business concerns;

while integrating new companies, we may lose key executives or other employees of these companies;

we could experience customer dissatisfaction or performance problems with an acquired company or technology;

we may become subject to unknown or underestimated liabilities of an acquired entity or incur unexpected expenses or losses from such acquisitions; and

we may incur possible impairment charges related to goodwill or other intangible assets or other unanticipated events or circumstances, any of which could harm our business.

Consequently, we might not be successful in integrating any acquired businesses, products or technologies, and might not achieve anticipated revenue and cost benefits.

***The loss of our senior management, including our founding officers, could harm our current and future operations and prospects.***

We are heavily dependent upon the continued services of Russell C. Horowitz and John Keister and the other members of our senior management team. We do not have long-term employment agreements with any of the members of our senior management team. Each of these individuals may voluntarily terminate his employment with Marchex at any time upon short notice. Following any termination of employment, each of these employees would only be subject to a twelve-month period of non-competition under our standard confidentiality agreement.

Further, as of June 30, 2004 our founding officers together control ninety-seven percent (97%) of the voting power of our issued and outstanding capital stock. Their collective voting control is not tied to their continued employment with Marchex. The loss of the services of any member of our senior management, including our founding officers, for any reason, or any conflict among our founding officers, could harm our current and future operations and prospects.

***We may have difficulty attracting and retaining qualified, experienced, highly skilled personnel, which could adversely affect the implementation of our business plan.***

In order to fully implement our business plan, we will need to attract and retain additional qualified personnel. Thus, our success will in significant part depend upon the efforts of personnel not yet identified and upon our ability to attract and retain highly skilled managerial, engineering, sales and marketing personnel. We are also dependent on managerial and technical personnel to the extent they may have knowledge or information about our businesses and technical systems that may not be known by other personnel in our company. There can be

## Edgar Filing: MARCHEX INC - Form 10QSB

no assurance that we will be able to attract and retain necessary personnel. The failure to hire and retain such personnel could adversely affect the implementation of our business plan.

*If we are unable to obtain and maintain adequate insurance, our financial condition could be adversely affected in the event of uninsured or inadequately insured loss or damage. Our ability to effectively recruit and retain qualified officers and directors may also be adversely affected if we experience difficulty in maintaining adequate directors and officers liability insurance*

We may not be able to obtain and maintain insurance policies on terms affordable to us that would adequately insure our business and property against damage, loss or claims by third parties. To the extent our business or property suffers any damages, losses or claims by third parties, which are not covered or adequately covered by insurance, our financial condition may be materially adversely affected.

We currently have directors and officers liability insurance, but we may be unable to maintain sufficient insurance as a public company to cover liability claims made against our officers and directors. If we are unable to adequately insure our officers and directors, we may not be able to retain or recruit qualified officers and directors to manage our company, which could have a material adverse effect on our operations.

---

## **Table of Contents**

*New rules, including those contained in and issued under the Sarbanes-Oxley Act of 2002, may make it difficult for us to retain or attract qualified officers and directors which could adversely affect our business and the possible listing of our Class B common stock on NASDAQ.*

We may be unable to attract and retain qualified officers, directors and members of board committees required to provide for our effective management as a result of the recent and currently proposed changes in the rules and regulations which govern publicly-held companies, including, but not limited to, certifications from executive officers and requirements for financial experts on the board of directors. The perceived increased personal risk associated with these recent changes may deter qualified individuals from accepting these roles. The enactment of the Sarbanes-Oxley Act of 2002 has resulted in the issuance of a series of new rules and regulations and the strengthening of existing rules and regulations by the Securities and Exchange Commission, as well as the adoption of new and more stringent rules by the NASDAQ National Market.

Further, certain of these recent and proposed changes heighten the requirements for board or committee membership, particularly with respect to an individual's independence from the corporation and level of experience in finance and accounting matters. We may have difficulty attracting and retaining directors with the requisite qualifications. If we are unable to attract and retain qualified officers and directors, our business and our ability to maintain the NASDAQ National Market System listing of our shares of Class B common stock could be adversely affected.

### **Risks Relating to Our Business**

*We are dependent on our distribution partners for a significant portion of our total revenue. A loss of a larger distribution partner or decrease in revenue from a larger distribution partner could adversely affect our business.*

We rely primarily on distribution partners to provide us with access to users and consumers. This sector has experienced, and will likely continue to experience, consolidation among the larger distribution partners. This consolidation has reduced the number of partners that control the online advertising outlets with the most user traffic. For example, Yahoo! owns or controls multiple distribution networks and destinations. According to *U.S. Bancorp Piper Jaffray* in a March 2003 report, Yahoo! Search accounted for twenty-one percent (21%) of the online searches in the United States and Google accounted for thirty-four percent (34%). Certain Yahoo! subsidiaries are among our current distribution partners, and we purchase advertising on Google.

As a result, the larger distribution partners have greater control over determining the market terms of distribution, including placement of merchant advertisements and cost of placement. Our agreements with large distribution partners contain short-term termination clauses in their favor. We cannot be assured that we will maintain our current agreements with any of these distribution partners. In addition, we cannot be assured that any of these distribution partners will continue to generate current levels of revenue for us. A loss of any of these distribution partners or a decrease in revenue from any one of these distribution relationships could have an adverse effect on our revenue, and the loss of any one large distribution partner could have a material adverse effect on our business, financial condition and results of operations.

*We currently have a reliance on certain distribution partners, including Yahoo! and its subsidiaries, to distribute our services. The termination of any of these distribution relationships could have a material adverse effect on our operating results.*

We currently have certain distribution partners that deliver a significant percentage of traffic to our merchant listings, in terms of click-throughs. Yahoo!, primarily through its subsidiaries, such as Inktomi and Overture, is the largest distribution partner of our paid inclusion services, and



## Edgar Filing: MARCHEX INC - Form 10QSB

these distribution relationships collectively represented more than 20% of our total revenue for the six months ended June 30, 2004. Prior to this period, for the year ended December 31, 2003, distribution through Yahoo! and its subsidiaries collectively represented less than 10% of our total revenue. Existing agreements with certain Yahoo! subsidiaries contain mutual termination clauses and are primarily structured on a variable-payment basis, under which we make payments based on a specified percentage of revenue or based on the number of paid click-throughs. We intend to continue devoting resources in support of our Yahoo! relationship, although there are no guarantees that this relationship will remain in place over the short- or long-term.

Currently, many participants in the performance-based advertising and search marketing industries own significant portions of the traffic that they deliver to advertisers. We do not believe, for example, that Yahoo! and Google are as reliant as we are on a distribution network to deliver their services. This gives these companies a significant advantage in delivering their services, and with a lesser degree of risk.

***If we do not maintain and grow a critical mass of merchant advertisers and distribution partners, the value of our services could be adversely affected.***

Our success depends, in part, on the maintenance and growth of a critical mass of merchant advertisers and distribution partners and a continued interest in our performance-based advertising and search marketing services. If our business is unable to achieve a growing base of merchant advertisers, our current distribution partners may be discouraged from continuing to work with us, and this may create obstacles for us to enter into agreements with new distribution partners. Similarly, if our distribution network does not grow and improve over time, current and prospective merchant advertisers may reduce or terminate their business with us. Any decline in the number of merchant advertisers and distribution partners could adversely affect the value of our services.

## **Table of Contents**

***We are dependent upon our distribution partners to continue to provide us traffic that our merchant advertisers deem to be of value, and if they do not, it may have a material adverse effect on the value of our services.***

We are dependent upon our distribution partners to provide us traffic that our merchant advertisers deem to be of value. We monitor the traffic of our distribution partners in an attempt to optimize the quality of traffic we deliver to our merchant advertisers. We review factors such as non-human processes, including robots, spiders, scripts (or other software), mechanical automation of clicking and other sources and causes of low-quality traffic, including, but not limited to, other non-human clicking agents. Even with such monitoring in place, there is a risk that a certain amount of low-quality traffic will be provided to our merchant advertisers, which, if not contained, may be detrimental to those relationships. Low-quality traffic (or traffic that is deemed to be less valuable by our merchant advertisers) that is provided by our distribution partners may prevent us from growing our base of merchant advertisers and cause us to lose relationships with existing merchant advertisers.

***We may be subject to intellectual property claims, which could adversely affect our financial condition and ability to use certain critical technologies, divert our resources and management attention from our business operations and create uncertainty about ownership of technology essential to our business.***

Our success depends, in part, on our ability to protect our intellectual property and to operate without infringing on the intellectual property rights of others in the process. There can be no guarantee that any of our intellectual property will be adequately safeguarded, or that it will not be challenged by third parties. We may be subject to patent infringement claims or other intellectual property infringement claims that would be costly to defend and could limit our ability to use certain critical technologies.

For example, Overture Services, a subsidiary of Yahoo!, which operates in certain competitive areas with us, owns a patent (U.S. Patent No. 6,269,361), which purports to give Overture rights to certain bid-for-placement products and pay-per-performance search technologies. Overture is currently involved in litigation with FindWhat relating to this patent. FindWhat is vigorously contesting Overture's patent. If we were to acquire or develop a related product or business model that Overture construes as infringing upon the above-referenced patent, then we could be asked to license, re-engineer our product(s) or revise our business model according to terms that may be extremely expensive and/or unreasonable. Additionally, if Overture construes any of our current products or business models as infringing upon the above-referenced patent, then we could be asked to license, re-engineer our product(s) or revise our business model according to terms that could be extremely expensive and/or unreasonable.

Any patent litigation could negatively impact our business by diverting resources and management attention from other aspects of the business and adding uncertainty as to the ownership of technology and services that we view as proprietary and essential to our business. In addition, a successful claim of patent infringement against us and our failure or inability to license the infringed or similar technology on reasonable terms, or at all, could have a material adverse effect on our business.

***We have grown quickly and if we fail to manage our growth, our business will suffer.***

We have rapidly expanded our operations and anticipate that further significant expansion, including the possible acquisition of third-party assets, technologies or businesses, will be required to address potential growth in our customer base and market opportunities. This expansion has placed, and is expected to continue to place, a significant strain on our management, operational and financial resources. If we are unable to manage our growth effectively or if we are unable to successfully integrate any assets, technologies or businesses that we may acquire, our business, financial condition and results of operations could be affected adversely.

**Risks Relating to Our Industry**

*If we are unable to compete in the highly competitive performance-based advertising and search marketing industries, we may experience reduced demand for our products and services.*

We operate in a highly competitive and changing environment. We principally compete with other companies in five main areas:

sales to merchant advertisers of performance-based advertising;

sales to merchant advertisers of paid inclusion services;

aggregation or optimization of advertising inventory for distribution through search engines, product shopping engines, directories, Web sites or other outlets;

delivery of products and services to end users or customers of merchants at destination Web sites or other distribution outlets; and

services that allow merchants to manage their advertising campaigns across multiple networks and track the success of these campaigns.

## Table of Contents

Although we currently pursue a strategy that allows us to potentially partner with all relevant companies in the industry, there are certain companies in the industry that may not wish to partner with us. Despite the fact that we currently work with several of our potential competitors, there are no guarantees that these companies will continue to work with us in the future.

We currently or potentially compete with a variety of companies, including Decide Interactive, DoubleClick, FindWhat, Google, LookSmart, Microsoft, ValueClick and Yahoo!. We currently have some form of relationship with a majority of these companies. Going forward, however, these companies may terminate their relationships with us. Furthermore, our competitors may be able to secure agreements with more favorable terms, which could reduce the usage of our services, increase the amount payable to our distribution partners, reduce total revenue and thereby have a material adverse effect on our business, operating results and financial condition. Increased competition is likely to result in a loss of market share, which could seriously harm our revenue and results of operations.

We expect competition to intensify in the future because current and new competitors can enter our market with little difficulty. The barriers to entering our market are relatively low. In fact, many current Internet and media companies presently have the technical capabilities and advertiser bases to enter the search marketing services industry. Further, if the consolidation trend continues among the larger media and search engine companies with greater brand recognition, the share of the market remaining for smaller search marketing services providers could decrease, even though the number of smaller providers could continue to increase. These factors could adversely affect our competitive position in the search marketing services industry.

Some of our competitors, as well as potential entrants into our market, may be better positioned to succeed in this market. They may have:

longer operating histories;

more management experience;

an employee base with more extensive experience;

a better ability to service customers in multiple cities in the United States and internationally by virtue of the location of sales offices;

larger customer bases;

greater brand recognition; and

significantly greater financial, marketing and other resources.

In addition, many current and potential competitors can devote substantially greater resources than we can to promotion, Web site development and systems development. Furthermore, currently and in the future as the use of the Internet and other online services increases, there will likely be larger, more well-established and well-financed entities that acquire companies and/or invest in or form joint ventures in categories or countries of interest to us, all of which could adversely impact our business. Any of these trends could increase competition and reduce the demand for any of our services.

*If we are not able to respond to the rapid technological change characteristic of our industry, our products and services may not be competitive.*

The market for our products and services is characterized by rapid change in business models and technological infrastructure, and we will need to constantly adapt to changing markets and technologies to provide competitive products and services. We believe that our future success will depend, in part, upon our ability to develop our products and services for both our target market and for applications in new markets. We may not, however, be able to successfully do so, and our competitors may develop innovations that render our products and services obsolete or uncompetitive.

*Our technical systems are vulnerable to interruption and damage that may be costly and time-consuming to resolve and may harm our business and reputation.*

A disaster could interrupt our services for an indeterminate length of time and severely damage our business, prospects, financial condition and results of operations. Our systems and operations are vulnerable to damage or interruption from:

fire;

floods;

network failure;

**Table of Contents**

hardware failure;

software failure;

power loss;

telecommunications failures;

break-ins;

terrorism, war or sabotage;

computer viruses;

denial of service attacks;

penetration of our network by unauthorized computer users and hackers and other similar events;

natural disaster; and

other unanticipated problems.

We may not have developed or implemented adequate protections or safeguards to overcome any of these events. We also may not have anticipated or addressed many of the potential events that could threaten or undermine our technology network. Any of these occurrences could cause material interruptions or delays in our business, result in the loss of data or render us unable to provide services to our customers. In addition, if a person is able to circumvent our security measures, he or she could destroy or misappropriate valuable information or disrupt our operations. We have deployed firewall hardware intended to thwart hacker attacks. Although we maintain property insurance and business interruption insurance, our insurance may not be adequate to compensate us for all losses that may occur as a result of a catastrophic system failure or other loss, and our insurers may not be able or may decline to do so for a variety of reasons.

If we fail to address these issues in a timely manner, we may lose the confidence of our merchant advertisers and distribution partners, our revenue may decline and our business could suffer. In addition, as we expand our service offerings and enter into new business areas, we may be required to significantly modify and expand our software and technology platform. If we fail to accomplish these tasks in a timely manner, our business and reputation will likely suffer.

*We rely on third party technology, server and hardware providers, and a failure of service by these providers could adversely affect our business and reputation.*

## Edgar Filing: MARCHEX INC - Form 10QSB

We rely upon third party colocation providers to host our main servers. In the event that these providers experience any interruption in operations or cease operations for any reason or if we are unable to agree on satisfactory terms for continued hosting relationships, we would be forced to enter into a relationship with other service providers or assume hosting responsibilities ourselves. If we are forced to switch hosting facilities, we may not be successful in finding an alternative service provider on acceptable terms or in hosting the computer servers ourselves. We may also be limited in our remedies against these providers in the event of a failure of service. In the past, we have experienced short term outages in the service maintained by one of our current colocation providers. We also rely on third party providers for components of our technology platform, such as hardware and software providers, credit card processors and domain name registrars. A failure or limitation of service or available capacity by any of these third party providers could adversely affect our business and reputation.

***We may not be able to protect our intellectual property rights, which could result in our competitors marketing competing products and services utilizing our intellectual property and could adversely affect our competitive position.***

Our success and ability to compete effectively are substantially dependent upon our internally developed and acquired technology and data resources, which we protect through a combination of copyright, trade secret, and patent and trademark law. To date, we have filed two provisional patent applications with the United States Patent and Trademark Office and may in the future file additional patents with respect to internally developed or acquired technologies. Our industry is highly competitive and many individuals and companies have sought to patent processes in the industry. In addition, the patent process takes several years and involves considerable expense. Further, patent applications and patent positions in our industry are highly uncertain and involve complex legal and factual questions due in part to the number of competing technologies. As a result, we may not be able to successfully prosecute these patents, in whole or in part, or any additional patent filings that we may make in the future. We also depend on our trade name and domain names. We may not be able to adequately protect our technology and data resources. In addition, intellectual property laws vary from country to country, and it may be more difficult to protect our intellectual property in some foreign jurisdictions in which we may plan to enter. If we fail to obtain and maintain patent or other intellectual property protection for our technology, our competitors could market competing products and services utilizing our technology. Any such failure could have a material adverse effect on our business.

## **Table of Contents**

Despite our efforts to protect our proprietary rights, unauthorized parties domestically and internationally may attempt to copy or otherwise obtain and use our services, technology and other intellectual property. We cannot be certain that the steps we have taken will prevent any misappropriation or confusion among consumers and merchant advertisers.

*We may be involved in lawsuits to protect or enforce our patents, which could be expensive and time consuming.*

We may initiate patent litigation against third parties to protect or enforce our patent rights, and we may be similarly sued by others. We may also become subject to interference proceedings conducted in the patent and trademark offices of various countries to determine the priority of inventions. The defense and prosecution, if necessary, of intellectual property suits, interference proceedings and related legal and administrative proceedings is costly and may divert our technical and management personnel from their normal responsibilities. We may not prevail in any of these suits. An adverse determination of any litigation or defense proceedings could put our patents at risk of being invalidated or interpreted narrowly and could put our patent applications at risk of not being issued.

Furthermore, because of the substantial amount of discovery required in connection with intellectual property litigation, there is a risk that some of our confidential information could be compromised by disclosure during this type of litigation. In addition, during the course of this kind of litigation, there could be public announcements of the results of hearings, motions or other interim proceedings or developments in the litigation. If securities analysts or investors perceive these results to be negative, it could have an adverse effect on the trading price of our Class B common stock.

*We may incur liabilities for the activities of users of our service and our merchant advertisers, which could adversely affect our business.*

Many of our advertisement generation processes are automated, and we do not conduct a manual editorial review of a substantial number of our merchant listings. State, federal as well as applicable international law relating to the liability of providers of online services including merchant listings and other third party content is currently unsettled and could damage our business. We may not successfully avoid liability for unlawful activities carried out by consumers of our services, or unpermitted uses of our merchant listings by distribution partners.

Our potential liability for unlawful activities of users of our services or unpermitted uses of our merchant listings by distribution partners could require us to implement measures to reduce our exposure to such liability, which may require us, among other things, to spend substantial resources or to discontinue certain service offerings. Furthermore, under agreements with certain of our largest distribution partners, we are required to indemnify these partners against any liabilities or losses resulting from the content of our merchant listings. Although our merchant advertisers indemnify us with respect to claims arising from these listings, we may not be able to recover all or any of the liability or losses incurred by us as a result of the activities of our merchant advertisers.

Our insurance policies may not provide coverage for liability arising out of activities of users of our services. Furthermore, we may not be able to obtain or maintain adequate insurance coverage to reduce or limit the liabilities associated with our businesses. Any costs incurred as a result of such liability or asserted liability could have a material adverse effect on our business, operating results and financial condition.

*Our quarterly results of operations might fluctuate due to seasonality, which could adversely affect our growth rate and in turn the market price of our Class B common stock.*



Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in the level of Internet usage. As is typical in our industry, the second and third quarters of the calendar year generally experience relatively lower usage than the first and fourth quarters. It is generally understood that during the spring and summer months of the year, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and in turn the market price of our Class B common stock.

*We are susceptible to general economic conditions, and a down-turn in advertising and marketing spending by merchants could adversely affect our operating results.*

Our operating results will be subject to fluctuations based on general economic conditions, in particular those conditions that impact merchant-consumer transactions. If there were to be a general economic downturn that affected consumer activity in particular, however slight, then we would expect that business entities, including our merchant advertisers and potential merchant advertisers, could substantially and immediately reduce their advertising and marketing budgets. We believe that during periods of lower consumer activity, merchant spending on advertising and marketing is more likely to be reduced, and more quickly, than many other types of business expenses. These factors could cause a material adverse effect on our operating results.

**Table of Contents**

*We depend on the growth of the Internet and Internet infrastructure for our future growth and any decrease or less than anticipated growth in Internet usage could adversely affect our business prospects.*

Our future revenue and profits, if any, depend upon the continued widespread use of the Internet as an effective commercial and business medium. Factors which could reduce the widespread use of the Internet include:

possible disruptions or other damage to the Internet or telecommunications infrastructure;

failure of the individual networking infrastructures of our merchant advertisers and distribution partners to alleviate potential overloading and delayed response times;

a decision by merchant advertisers to spend more of their marketing dollars in offline areas;

increased governmental regulation and taxation; and

actual or perceived lack of security or privacy protection.

In particular, concerns over the security of transactions conducted on the Internet and the privacy of users may inhibit the growth of the Internet and other online services, especially online commerce. In order for the online commerce market to develop successfully, we and other market participants must be able to transmit confidential information, including credit card information, securely over public networks. Any decrease or less than anticipated growth in Internet usage could have a material adverse effect on our business prospects.

*We are exposed to risks associated with credit card fraud and credit payment, and we may continue to suffer losses as a result of fraudulent data or payment failure by merchant advertisers.*

We have suffered losses and may continue to suffer losses as a result of payments made with fraudulent credit card data. Our failure to control fraudulent credit card transactions adequately could reduce our net revenue and gross margin. In addition, under limited circumstances, we extend credit to merchant advertisers who may default on their accounts payable to us or fraudulently charge-back amounts on their credit cards for services that have already been delivered by us.

*Government regulation of the Internet may adversely affect our business and operating results.*

Companies engaging in online search, commerce and related businesses face uncertainty related to future government regulation of the Internet. Due to the rapid growth and widespread use of the Internet, legislatures at the federal and state levels have enacted and are considering various laws and regulations relating to the Internet. Individual states may also enact stricter consumer legislation that affects the conduct of our business.

## Edgar Filing: MARCHEX INC - Form 10QSB

Furthermore, the application of existing laws and regulations to Internet companies remains somewhat unclear. For example, as a result of the actions of merchant advertisers in our network we may be subject to the application of existing laws and regulations relating to a wide variety of issues such as privacy, gambling, sweepstakes, promotions, financial market regulation, and intellectual property ownership and infringement. In addition, existing laws that regulate or require licenses or permits for certain businesses of merchant advertisers may be unclear in their application to our business, including those related to the insurance and securities brokerage, law offices and pharmacies. Our business may be negatively affected by a variety of new or existing laws and regulations, which may expose us to substantial compliance costs and liabilities and may impede the growth in use of the Internet.

The application of these statutes and others to the Internet search industry is not entirely settled. Further, several existing and proposed federal laws could have an impact on our business. The existing federal laws include, among others:

The Digital Millennium Copyright Act and its related safe harbors are intended to reduce the liability of online service providers for listing or linking to third-party Web sites that include materials that infringe copyrights or other rights of others.

The Children's Online Protection Act and the Children's Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children, and they impose additional restrictions on the ability of online services to collect user information from minors.

The Protection of Children from Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances.

The CAN-SPAM Act of 2003 and certain state laws are intended to regulate interstate commerce by imposing limitations and penalties on the transmission of unsolicited commercial electronic mail via the Internet.

## **Table of Contents**

With respect to the subject matter of each of these laws, courts may apply these laws in unintended and unexpected ways. As a company that provides services over the Internet, we may be subject to an action brought under any of these or future laws governing online services. Many of the services of the Internet are automated and companies, such as ours, may be unknowing conduits for illegal or prohibited materials. It is not known how courts will rule in many circumstances; for example, it is possible that some courts could find strict liability or impose know your customer standards of conduct in certain circumstances.

We may also be subject to costs and liabilities with respect to privacy issues. Several Internet companies have incurred costs and paid penalties for violating their privacy policies. Further, it is anticipated that new legislation will be adopted by federal and state governments with respect to user privacy. Such legislation could negatively affect our business.

Additionally, foreign governments may pass laws which could negatively impact our business and/or may prosecute us for our products and services based upon existing laws. Any such prosecution or costs incurred in addressing foreign laws could negatively affect our business.

The restrictions imposed by, and cost of complying with, current and possible future laws and regulations related to our business could harm our business and operating results.

*Future regulation of search engines may adversely affect the commercial utility of our search marketing services.*

The Federal Trade Commission, or FTC, has recently reviewed the way in which search engines disclose paid placements or paid inclusion practices to Internet users. In 2002, the FTC issued guidance recommending that all search engine companies ensure that all paid search results are clearly distinguished from non-paid results, that the use of paid inclusion is clearly and conspicuously explained and disclosed and that other disclosures are made to avoid misleading users about the possible effects of paid placement or paid inclusion listings on search results. Such disclosures if ultimately mandated by the FTC or voluntarily made by us may reduce the desirability of our paid placement and paid inclusion services. We believe that some users will conclude that paid search results are not subject to the same relevancy requirements as non-paid search results, and will view paid search results less favorably. If such FTC disclosure reduces the desirability of our paid placement and paid inclusion services, and click-throughs of our paid search results decrease, our business could be adversely affected.

*State and local governments may in the future be permitted to levy additional taxes on Internet access and electronic commerce transactions, which could result in a decrease in the level of usage of our services.*

In 1998, the federal government imposed a three-year moratorium on state and local governments' imposition of new taxes on Internet access or electronic commerce transactions. This moratorium was extended until November 1, 2003, and has now expired. Unless the moratorium is extended by Congress, state and local governments may levy additional taxes on Internet access and electronic commerce transactions. An increase in applicable taxes may make electronic commerce transactions less attractive for merchants and businesses, which could result in a decrease in the level of usage of our services.

## **Risks Relating To Our Class B Common Stock**

*Our stock price has been and is likely to continue to be highly volatile.*

The trading price of our Class B common stock has been and is likely to continue to be highly volatile and could be subject to wide fluctuations in price in response to various factors, which may be the result of our business strategy or events beyond our control, including:

developments concerning proprietary rights, including patents, by us or a competitor;

announcements by us or our competitors of significant contracts, acquisitions, financings, commercial relationships, joint ventures or capital commitments;

registration of additional shares of Class B common stock in connection with a strategic transaction;

the release of shares of Class B common stock from contractual lock-up restrictions implemented in connection with our IPO;

actual or anticipated fluctuations in our operating results;

developments concerning our various strategic collaborations;

## Table of Contents

lawsuits initiated against us or lawsuits initiated by us;

changes in the market valuations of similar companies; and

changes in our industry and the overall economic environment.

In addition, the stock market in general, and the NASDAQ National Market and the market for online commerce companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of the listed companies. These broad market and industry factors may seriously harm the market price of our Class B common stock, regardless of our operating performance. In the past, following periods of volatility in the market, securities class action litigation has often been instituted against these companies. Litigation against us, whether or not judgment is entered against us, could result in substantial costs and potentially economic loss, and a diversion of our management's attention and resources, any of which could seriously harm our financial condition. Additionally, there can be no assurance that an active trading market of our Class B common stock will be sustained.

***Our founding officers control the outcome of stockholder voting, and there may be an adverse effect on the price of our Class B common stock due to the disparate voting rights of our Class A common stock and our Class B common stock.***

Our founding officers beneficially own all of our outstanding shares of Class A common stock, representing 96% of the voting power of all issued and outstanding shares of our capital stock as of June 30, 2004. The holders of our Class A common stock and Class B common stock have identical rights except that the holders of our Class B common stock are entitled to one vote per share, while holders of our Class A common stock are entitled to twenty-five votes per share on all matters to be voted on by stockholders. This concentration of control could be disadvantageous to our other stockholders with interests different from those of our founding officers. This difference in the voting rights of our Class A common stock and Class B common stock could adversely affect the price of our Class B common stock to the extent that investors or any potential future purchaser of our shares of Class B common stock give greater value to the superior voting rights of our Class A common stock.

Further, as long as our founding officers have a controlling interest, they will continue to be able to elect our entire board of directors and generally be able to determine the outcome of all corporate actions requiring stockholder approval. As a result, our founding officers will be in a position to continue to control all fundamental matters affecting the Company, including any merger involving, sale of substantially all of the assets of, or change in control of, the Company.

Our founding officers' ability to control the Company may result in our Class B common stock trading at a price lower than the price at which it would trade if our founding officers did not have a controlling interest in us. This control may deter or prevent a third party from acquiring us which could adversely affect the market price of our Class B common stock.

***Anti-takeover provisions may limit the ability of another party to acquire us, which could cause our stock price to decline.***

Our certificate of incorporation, as amended, our by-laws and Delaware law contain provisions that could discourage, delay or prevent a third party from acquiring us, even if doing so may be beneficial to our stockholders. In addition, these provisions could limit the price investors would be willing to pay in the future for shares of our Class B common stock. The following are examples of such provisions in our certificate of incorporation, as amended or our by-laws:

## Edgar Filing: MARCHEX INC - Form 10QSB

the authorized number of our directors can be changed only by a resolution of our board of directors;

advance notice is required for proposals that can be acted upon at stockholder meetings;

there are limitations on who may call stockholder meetings; and

our board of directors is authorized, without prior stockholder approval, to create and issue blank check preferred stock.

We are also subject to Section 203 of the Delaware General Corporation Law, which provides, subject to enumerated exceptions, that if a person acquires 15% or more of our voting stock, the person is an interested stockholder and may not engage in business combinations with us for a period of three years from the time the person acquired 15% or more of our voting stock.

**Table of Contents**

*We anticipate that we will retain our future earnings, and as a result holders of Class B common stock are not likely to receive dividends.*

We anticipate that we will retain all of our future earnings, if any, for use in the operation and expansion of our business. Therefore, holders of Class B common stock are not likely to receive dividends in the foreseeable future. In addition, dividends, if and when paid, may be subject to income tax withholding.



**Table of Contents**

**Item 3. Controls and Procedures.**

An evaluation was performed under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-QSB. Based on that evaluation, our management, including our principal executive officer and principal financial officer, concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

There was no significant change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-QSB that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Our management has concluded that our disclosure controls and procedures and internal controls provide reasonable assurance that the objectives of our control system are met. However, our management (including our principal executive officer and principal financial officer) does not expect that the disclosure controls and procedures or internal controls will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Due to the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, errors and instances of fraud, if any, within the company have been or will be detected.

**Table of Contents**

**Part II Other Information**

**Item 1. Legal proceedings.**

Not applicable with respect to the current reporting period.

**Item 2. Changes in Securities and Small Business Issuer Purchases of Equity Securities.**

- (a) Not applicable.
- (b) Not applicable.
- (c) During the period ended June 30, 2004, the Company issued and sold an aggregate of 37,850 shares of Class B common stock that were not registered under the Securities Act of 1933 upon the exercise of stock options previously issued to two employees and one independent contractor under the Company's 2003 stock incentive plan, with an average weighted exercise price of \$1.55. The Company received an aggregate of \$58,525 as payment upon exercise thereof.

The issuance of stock options and the Class B common stock issuable upon the exercise of such options as described above were issued pursuant to written compensatory plans or arrangements with our employees, directors and consultants, in reliance on the exemption provided by Rule 701 promulgated under the Securities Act. All recipients either received adequate information about us or had access, through employment or other relationships, to such information. None of the foregoing transactions involved any underwriters, underwriting discounts or commissions, or any public offering.

All of the securities issued in connection with the foregoing option exercises are deemed restricted securities for the purposes of the Securities Act. All certificates representing the issued shares of Class B common stock described above included appropriate legends setting forth that the securities had not been registered and the applicable restrictions on transfer.

- (d) On March 30, 2004, our registration statement on Form SB-2 (No. 333-111096) was declared effective by the Securities and Exchange Commission, pursuant to which we registered 4,000,000 shares of our Class B common stock, and another 600,000 shares subject to the underwriters' over-allotment option. The shares of Class B common stock registered under the registration statement, including the 600,000 shares of Class B common stock covered by the over-allotment option, were sold at a price of \$6.50 per share. The IPO generated gross offering proceeds of approximately \$29.9 million. The closing of the IPO and the exercise in full of the underwriter's over-allotment option, took place on April 5, 2004. The managing underwriters were Sander Morris Harris, Inc. and National Securities Corporation. In connection with the IPO, we incurred \$1.5 million in underwriting discounts and commissions, and approximately \$1.2 million in other cash related expenses. The net proceeds from the IPO, after deducting the foregoing expenses, were approximately \$27.2 million. Pending application of the funds, as described in our registration statement on Form SB-2, we have invested the net proceeds in short-term, investment grade, interest-bearing securities.

Effective upon the closing of our IPO, all previously outstanding shares of Series A redeemable convertible preferred stock were automatically converted into Class B common stock and in connection therewith, we filed an amended and restated certificate of incorporation, a copy of

## Edgar Filing: MARCHEX INC - Form 10QSB

which was filed as an exhibit to Amendment No. 2 to our registration statement on Form SB-2 as filed with the Securities and Exchange Commission on March 19, 2004. This amendment and restatement, among other things, increased the authorized shares of Class B common stock and authorized undesignated shares of preferred stock.

### **Item 3. Defaults Upon Senior Securities.**

Not applicable with respect to the current reporting period.

### **Item 4. Submission of Matters to a Vote of Security Holders.**

Not applicable with respect to the current reporting period.

**Table of Contents**

**Item 5. Other Information.**

Not applicable with respect to the current reporting period.

**Item 6. Exhibits and Reports on Form 8-K.**

**(a) Exhibits:**

- 31.1 Certification of CEO pursuant to Rule 13a-14(a) /15d-14(a).
- 31.2 Certification of CFO pursuant to Rule 13a-14(a) /15d-14(a).
- 32.1 Certification of CEO pursuant to Section 1350.
- 32.2 Certification of CFO pursuant to Section 1350.

**(b) Reports on Form 8-K:**

- (i) Current Report on Form 8-K dated May 13, 2004, furnished to the SEC on May 13, 2004, with respect to the announcement of Marchex's financial results for the quarter ended March 31, 2004.

