

MARCHEX INC
Form 10QSB
August 15, 2005
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended June 30, 2005

.. **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

35-2194038

Edgar Filing: MARCHEX INC - Form 10QSB

(State or other jurisdiction of
incorporation or organization)

(IRS Employer
Identification No.)

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 August 9, 2005</u>
Class A common stock, par value \$.01	11,987,500
Class B common stock, par value \$.01	24,701,868

Transitional Small Business Disclosure Format: Yes No

Table of Contents

Marchex, Inc.

Form 10-QSB

Table of Contents

	Page
Part I Financial Information	
Item 1. <u>Financial Statements (unaudited)</u>	
<u>Condensed Consolidated Balance Sheets June 30, 2005 and December 31, 2004</u>	3
<u>Condensed Consolidated Statements of Operations Three and Six Months Ended June 30, 2005 and 2004</u>	4
<u>Condensed Consolidated Statements of Cash Flows Six Months Ended June 30, 2005 and 2004</u>	5
Item 2. <u>Management's Discussion and Analysis</u>	18
Item 3. <u>Controls and Procedures</u>	59
Part II Other Information	
Item 1. <u>Legal Proceedings</u>	59
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	59
Item 3. <u>Defaults Upon Senior Securities</u>	60
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	60
Item 5. <u>Other Information</u>	60
Item 6. <u>Exhibits</u>	60

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

Condensed Consolidated Balance Sheets

(unaudited)

	December 31, 2004	June 30, 2005
	<u> </u>	<u> </u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 24,933,066	\$ 71,292,532
Accounts receivable, net	4,773,646	7,771,592
Prepaid expenses and other current assets	513,427	1,176,603
Refundable income taxes	902,246	2,509,483
Deferred tax assets	522,754	401,087
	<u> </u>	<u> </u>
Total current assets	31,645,139	83,151,297
Property and equipment, net	1,508,446	1,797,194
Deferred tax assets		1,351,690
Intangible and other assets, net	1,067,896	15,159,314
Goodwill	32,375,966	154,250,051
Intangible assets from acquisitions, net	4,996,289	55,899,422
	<u> </u>	<u> </u>
Total assets	<u>\$ 71,593,736</u>	<u>\$ 311,608,968</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 6,227,274	\$ 7,671,270
Accrued expenses and other current liabilities	1,170,039	1,723,923
Deferred revenue	1,947,617	2,015,469
Earn-out liability payable	6,237,578	
	<u> </u>	<u> </u>
Total current liabilities	15,582,508	11,410,662
Deferred tax liabilities	245,657	
Other non-current liabilities	93,539	50,942
	<u> </u>	<u> </u>
Total liabilities	15,921,704	11,461,604
Commitments, contingencies, and subsequent events		
Stockholders' equity:		
Convertible preferred stock		55,205,369
Class A common stock	122,500	122,500
Class B common stock	135,115	237,291
Additional paid-in capital	60,577,997	251,843,392
Deferred stock-based compensation	(521,820)	(3,457,120)

Edgar Filing: MARCHEX INC - Form 10QSB

Accumulated deficit	(4,641,760)	(3,804,068)
Total stockholders' equity	55,672,032	300,147,364
Total liabilities and stockholders' equity	\$ 71,593,736	\$ 311,608,968

See accompanying notes to condensed consolidated financial statements.

Table of Contents**MARCHEX, INC. AND SUBSIDIARIES**

Condensed Consolidated Statements of Operations

(unaudited)

	Six months ended June 30, 2004	Six months ended June 30, 2005	Three months ended June 30, 2004	Three months ended June 30, 2005
Revenue	\$ 16,467,089	\$ 39,564,005	\$ 8,865,178	\$ 21,168,022
Expenses:				
Service costs (1)	10,523,390	21,407,535	5,743,815	10,738,628
Sales and marketing (1)	2,040,682	2,868,881	1,030,710	1,543,895
Product development (1)	1,033,841	2,065,094	528,306	1,290,545
General and administrative (1)	1,541,428	2,925,595	846,680	1,473,561
Acquisition-related retention consideration (2)	255,660		122,724	
Facility relocation	230,459			
Stock-based compensation (3)	595,998	643,707	235,234	497,169
Amortization of intangible assets from acquisitions (4)	2,069,511	8,032,808	1,034,643	4,949,651
Total operating expenses	18,290,969	37,943,620	9,542,112	20,493,449
Income (loss) from operations	(1,823,880)	1,620,385	(676,934)	674,573
Other income (expense):				
Interest income	81,346	856,356	70,329	587,973
Interest expense	(1,813)	(3,460)	(1,488)	(1,600)
Adjustment to fair value of redemption obligation	55,250			
Other	3,643	4,000		
Total other income	138,426	856,896	68,841	586,373
Income (loss) before provision for income taxes	(1,685,454)	2,477,281	(608,093)	1,260,946
Income tax expense (benefit)	(200,803)	949,589	(147,103)	470,656
Net income (loss)	(1,484,651)	1,527,692	(460,990)	790,290
Convertible preferred stock dividends		1,031,806		682,813
Accretion to redemption value of redeemable convertible preferred stock	420,430		17,751	
Net income (loss) applicable to common stockholders	\$ (1,905,081)	\$ 495,886	\$ (478,741)	\$ 107,477
Basic net income (loss) per share applicable to common stockholders	\$ (0.10)	\$ 0.02	\$ (0.02)	\$ 0.00
Diluted net income (loss) per share applicable to common stockholders	\$ (0.10)	\$ 0.01	\$ (0.02)	\$ 0.00
Shares used to calculate basic net income (loss) per share applicable to common stockholders	18,810,413	32,790,977	24,174,284	35,308,306
Shares used to calculate diluted net income (loss) per share applicable to common stockholders	18,810,413	35,149,062	24,174,284	37,459,860
(1) Excludes acquisition-related retention consideration, stock-based compensation and amortization of intangible assets from acquisitions				
(2) Components of acquisition-related retention consideration:				
Service costs	30,430		14,604	

Edgar Filing: MARCHEX INC - Form 10QSB

Sales and marketing	86,901		41,726	
Product development	94,078		45,162	
General and administrative	44,251		21,232	
(3) Components of stock-based compensation:				
Service costs	6,300	134,634	2,250	132,834
Sales and marketing	116,588	315,431	49,042	285,924
Product development	34,577	148,650	12,675	137,985
General and administrative	438,533	44,992	171,267	(59,574)
(4) Components of amortization of intangible assets from acquisitions:				
Service costs	1,469,511	6,283,724	734,643	3,890,299
Sales and marketing	325,000	325,555	162,500	204,722
General and administrative	275,000	1,423,529	137,500	854,630

See accompanying notes to condensed consolidated financial statements.

Table of Contents**MARCHEX, INC. AND SUBSIDIARIES**

Condensed Consolidated Statements of Cash Flows

(unaudited)

	Six months ended June 30, 2004	Six months ended June 30, 2005
Cash flows from operating activities:		
Net income (loss)	\$ (1,484,651)	\$ 1,527,692
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Amortization and depreciation	2,351,678	9,678,664
Adjustment to fair value of redemption obligation	(55,250)	
Facility relocation costs	193,931	(18,710)
Gain on sales of fixed assets		(4,000)
Allowance for doubtful accounts and merchant advertiser credits	464,110	1,021,612
Stock-based compensation	595,998	643,707
Deferred income taxes	(918,192)	(1,475,680)
Income tax benefit related to stock options	101,092	328,093
Change in certain assets and liabilities, net of acquisition:		
Trade accounts receivable, net	(1,197,575)	(4,020,058)
Refundable income taxes and income tax payable	276,297	(1,607,237)
Prepaid expenses and other current assets	(333,247)	(610,490)
Accounts payable	28,271	877,998
Accrued expenses and other current liabilities	(209,044)	499,103
Deferred revenue	203,532	59,200
Acquisition-related retention consideration in earn-out liability	(24,941)	(501,769)
Other non current liabilities	(2,274)	2,909
Net cash provided by (used in) operating activities	(10,265)	6,401,034
Cash flows from investing activities:		
Purchases of property and equipment	(463,260)	(654,166)
Cash paid for acquisitions and earn-outs	(3,242,726)	(173,711,646)
Proceeds from sale of equipment	3,710	4,000
Proceeds from sale of intangible assets		330,180
Increase in other non current assets	(30,739)	(15,513,998)
Net cash used in investing activities	(3,733,015)	(189,545,630)
Cash flows from financing activities:		
Capital lease obligation principal paid	(1,263)	(3,830)
Offering costs paid	(1,068,814)	(517,706)
Proceeds from public offering, net of underwriter discounts	28,405,100	230,287,500
Preferred stock dividends cash paid		(690,000)
Proceeds from exercises of stock options	58,525	309,250
Proceeds from employee stock purchase plan	99,650	118,848
Net cash provided by financing activities	27,493,198	229,504,062
Net increase in cash and cash equivalents	23,749,918	46,359,466
Cash and cash equivalents at beginning of period	6,019,119	24,933,066
Cash and cash equivalents at end of period	\$ 29,769,037	\$ 71,292,532

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 of 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 notes 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 three and six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ended December 31, 2005, or for any other period. The balance sheet at December 31, 2004 has been derived from the audited consolidated financial statements at that date but does not include all of the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. These financial statements and notes should be read in conjunction with the Company's audited financial statements and accompanying notes included in the Annual Report on Form 10-KSB for the year ended December 31, 2004 filed with the Securities and Exchange Commission.

The Company's condensed consolidated financial statements presented include the balance sheets as of December 31, 2004 and June 30, 2005, the consolidated statements of operations for the three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005, and the consolidated statements of cash flows for the six months ended June 30, 2004 and 2005. Acquisitions are included in the Company's consolidated financial statements as of the date of acquisition. The Company's purchase accounting resulted in all assets and liabilities of acquired businesses being recorded at their estimated fair values on the acquisition dates. All significant inter-company transactions and balances have been eliminated in consolidation.

On February 28, 2003, the Company acquired 100% of the outstanding stock of eFamily.com, Inc. and ah-ha.com, Inc., its wholly-owned operating subsidiary, based in Provo, Utah. ah-ha.com, Inc. was renamed Enhance Interactive, Inc. in December 2003. Enhance Interactive provides performance-based advertising services to merchant advertisers, including pay-per-click listings. The aggregate cash consideration, including acquisition costs to acquire Enhance Interactive was approximately \$15,117,000. The purchase price excludes earnings-based contingent payments that depended upon the achievement of minimum income before taxes, excluding stock-based compensation and amortization of intangible assets relating to the acquisition (earnings before taxes) thresholds in calendar years 2003 and 2004 of the acquired business. As of December 31, 2003 and 2004, the thresholds had been achieved for the calendar years 2003 and 2004 and the contingent earn-out consideration payments have been accounted for as additional goodwill, as all original shareholders of Enhance Interactive received the consideration in proportion to their former share interests and the amounts reflect additional purchase price. Additional goodwill of \$3.2 million and \$5.7 million was recorded for the calendar years 2003 and 2004, respectively, for the earn-out consideration. Subsequent to December 31, 2004, no additional obligations exist related to the shareholder earn-out consideration.

In addition, if the minimum thresholds above were achieved, a payment of 5.56% of the acquired businesses' earnings before taxes for calendar years 2003 and 2004, up to an aggregate maximum of \$1,000,000 was to be paid to certain current employees of the acquired business (acquisition-related retention consideration). As of December 31, 2003 and 2004, the thresholds had been achieved for the calendar years 2003 and 2004, and \$283,000 and \$499,000, respectively, was recorded for the acquisition-related retention consideration including employer payroll-related taxes. These amounts have been accounted for as compensation expense. For the three and six months ended June 30, 2004, \$123,000 and \$256,000, respectively, of acquisition-related retention consideration was recorded. Subsequent to December 31, 2004, no

additional obligations exist related to the acquisition-related retention consideration.

Table of Contents

Marchex, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

On October 24, 2003, the Company acquired 100% of the outstanding stock of Sitewise Marketing, Inc. (d.b.a TrafficLeader) (TrafficLeader). In November 2003, Sitewise Marketing, Inc., based in Eugene, Oregon, was renamed TrafficLeader, Inc. TrafficLeader provides performance-based advertising and search marketing services to merchant advertisers, including feed management, advertising campaign management, conversion tracking and analysis, and search engine optimization. The purchase consideration consisted of:

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

425,000 shares of Class B common stock, which were subject to a redemption right; plus

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

The above summary of the costs of acquisition excludes performance-based contingent payments that depended on TrafficLeader's achievement of revenue thresholds. As of December 31, 2004, the performance-based conditions had not been achieved therefore no further contingent payment obligation remains.

On July 27, 2004, the Company acquired 100% of the outstanding stock of goClick.com, Inc. (goClick), a Norwalk, Connecticut-based company and a provider of marketing technology and services for small merchants, for the following consideration:

\$7.5 million in net cash and acquisition costs; plus

433,541 shares of Class B common stock.

The shares of Class B common stock were valued (for accounting purposes) at an aggregate amount of approximately \$4.14 million.

On February 14, 2005, the Company acquired substantially all of the assets of Name Development Ltd. (Name Development) for the following consideration:

\$155.6 million in cash and estimated acquisition costs; plus

Edgar Filing: MARCHEX INC - Form 10QSB

419,659 shares of Class B common stock.

The shares of Class B common stock were valued at \$20.99 per share (for accounting purposes) for an aggregate amount of approximately \$8.8 million.

The Company acquired certain assets of Name Development, including its portfolio of Internet domains and Web properties, revenue-generating contracts, technology and systems, for the operation of the Name Development direct navigation business. The Company did not assume any other obligations with respect to Name Development as part of this asset acquisition. The assets, liabilities and operations of Name Development are included in the Company's condensed consolidated financial statements as of the February 14, 2005 acquisition date.

On April 26, 2005, the Company acquired certain assets of Pike Street Industries, Inc. (Pike Street), an online yellow pages and lead generation provider for local merchants, for the following consideration:

\$12.8 million in cash and estimated acquisition costs; plus

242,748 shares of Class B common stock; plus

212,404 shares of restricted Class B common stock that vest over a period of 3 years from the closing date.

Table of Contents

Marchex, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately \$4.1 million.

The shares of restricted Class B common stock were valued at \$16.85 per share (the last reported sales price on the closing date) for an aggregate amount of approximately \$3.6 million. The shares of restricted Class B common stock were issued to the former stockholders of Pike Street who became employees of the Company.

The Company did not assume any other obligations with respect to Pike Street as part of the asset acquisition. The assets, liabilities, and operations of Pike Street are included in the Company's condensed consolidated financial statements as of the April 26, 2005 acquisition date.

(2) (a) Significant Accounting Policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These judgments are difficult as matters that are inherently uncertain directly impact their valuation and accounting. Actual results may vary from management's estimates and assumptions.

The Company's significant accounting policies are disclosed in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2004 filed with the Securities and Exchange Commission.

In certain cases, the Company records revenue based on available and reported preliminary information from third parties. Collection of the related receivables may vary from reported information based upon third party refinement of the estimated and reported amounts owing that occurs subsequent to period ends.

(b) Stock-based Compensation

The Company applies 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 Financial Accounting Standards Board (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

Edgar Filing: MARCHEX INC - Form 10QSB

of grant only if the current market price of the underlying stock exceeded the exercise price. Statement of Financial Accounting Standards (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 has 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.

In December 2004, the FASB issued Statement No. 123-R, which replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. As originally issued, SFAS No. 123 established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that pronouncement permitted entities to apply the intrinsic-value-based model of APB Opinion No. 25, provided that the financial statements disclosed the pro forma net income or loss based on the preferable fair-value method. The Company is required to apply SFAS No. 123-R as of the interim reporting period that begins after December 15, 2005. Thus, the Company's consolidated financial statements will reflect an expense for (a) all share-based compensation arrangements granted after January 1, 2006 and for any such arrangements that are modified, cancelled, or repurchased after that date, and (b) the portion of previous share-based awards for which the requisite service has not been rendered as of that date, based on the grant-date estimated fair value of those awards.

Table of Contents**Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

The Company recognizes 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 income (loss) if the fair-value-based method had been applied to all outstanding awards in each period.

	Six months ended June 30, 2004	Six months ended June 30, 2005	Three months ended June 30, 2004	Three months ended June 30, 2005
Net income (loss) applicable to common stockholders:				
As reported	\$ (1,905,081)	\$ 495,886	\$ (478,741)	\$ 107,477
Add: stock based employee compensation expense included in reported net income (loss), net of related tax effect	504,850	415,327	202,198	291,151
Deduct: stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effect	(1,922,760)	(4,264,343)	(941,816)	(2,290,663)
Pro forma	\$ (3,322,991)	\$ (3,353,130)	\$ (1,218,359)	\$ (1,892,035)
Net income (loss) per share applicable to common stockholders:				
As reported basic	\$ (0.10)	\$ 0.02	\$ (0.02)	\$ 0.00
As reported diluted	\$ (0.10)	\$ 0.01	\$ (0.02)	\$ 0.00
Pro forma basic	\$ (0.18)	\$ (0.10)	\$ (0.05)	\$ (0.05)
Pro forma diluted	\$ (0.18)	\$ (0.10)	\$ (0.05)	\$ (0.05)

The Company accounts 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*.

(3) Net Income (Loss) Per Share

The Company's basic and diluted net income (loss) per share is presented for the three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005. Basic net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) applicable to common stockholders by the weighted average number of common and dilutive common equivalent shares outstanding during the period. Net income (loss) applicable to common stockholders consists of net income (loss) as adjusted for the impact in

Edgar Filing: MARCHEX INC - Form 10QSB

2004 of accretion of redeemable convertible preferred stock to its redemption value and in 2005 for convertible preferred stock dividends. Diluted net income (loss) per share excludes the convertible preferred stock dividends and includes the shares that the preferred stock is convertible into if the result is dilutive. As the Company had a net loss for the three and six months ended June 30, 2004, basic and diluted net loss per share are the same for that period.

Table of Contents**Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

The following table reconciles the Company's reported net income (loss) applicable to common stockholders used to compute basic and diluted net income (loss) per share for the three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005:

	Six months ended June 30, 2004	Six months ended June 30, 2005	Three months ended June 30, 2004	Three months ended June 30, 2005
Numerator:				
Net income (loss)	\$ (1,484,651)	\$ 1,527,692	\$ (460,990)	\$ 790,290
Convertible preferred stock dividends		1,031,806		682,813
Accretion to redemption value of Series A redeemable convertible preferred stock	420,430		17,751	
Net income (loss) applicable to common stockholders	\$ (1,905,081)	\$ 495,886	\$ (478,741)	\$ 107,477
Denominator:				
Weighted average common shares outstanding excluding unvested common shares subject to repurchase or cancellation	18,810,413	32,790,977	24,174,284	35,308,306
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	18,810,413	32,790,977	24,174,284	35,308,306
Effect of dilutive securities:				
Weighted average stock options and warrants and common shares subject to repurchase or cancellation		2,358,085		2,151,554
Weighted average number of shares outstanding used to calculate diluted net income (loss) per share	18,810,413	35,149,062	24,174,284	37,459,860
Basic net income per share applicable to common stockholders	\$ (0.10)	\$ 0.02	\$ (0.02)	\$ 0.00
Diluted net income per share applicable to common stockholders	\$ (0.10)	\$ 0.01	\$ (0.02)	\$ 0.00

The computation of diluted net income (loss) per share for the three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005, excludes the following because their effect would be anti-dilutive:

For the three and six months ended June 30, 2004, 6,724,063 shares issuable upon conversion of the Series A redeemable convertible preferred stock. 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 in connection with the Company's initial public offering;

Edgar Filing: MARCHEX INC - Form 10QSB

For the three and six months ended June 30, 2005, 2,346,939 shares issuable upon conversion of the 4.75% convertible preferred stock issued in connection with the February 2005 follow-on public offering;

For the three and six months ended June 30, 2004, outstanding options to acquire 3,506,350 shares of Class B common stock with a weighted average exercise price of \$3.50 per share at June 30, 2004 and for the three and six months ended June 30, 2005, outstanding options to acquire 672,300 and 438,100 shares of Class B common stock with a weighted average exercise price of \$18.48 per share and 19.60 per share, respectively, have been excluded in the computation of diluted net income per share;

Table of Contents**Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

For the three and six months ended June 30, 2004, warrants to acquire up to an aggregate of 120,000 shares of Class B common stock at an exercise price equal to \$8.45 per share; and

For the three and six months ended June 30, 2004, 90,385 of unvested Class B restricted common shares at June 30, 2004, related to the 108,432 Class B restricted common shares issued in connection with the October 2003 acquisition of TrafficLeader. These shares were for future services that vest over 3 years. Additionally, unvested shares were excluded from the computation of basic net income (loss) per share in both periods.

(4) Concentrations

The Company maintains substantially all of their cash and cash equivalents with two financial institutions.

A substantial majority of the Company's revenue earned from merchant advertisers was generated through arrangements with distribution partners for the three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005. 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.

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

	Six months ended June 30, 2004	Six months ended June 30, 2005	Three months ended June 30, 2004	Three months ended June 30, 2005
Distribution Partner A	24%	12%	26%	11%

There was one merchant advertiser who represented approximately 25% and 20% of revenue for the three and six months ended June 30, 2005, respectively. This same merchant advertiser represented approximately 45% of the outstanding accounts receivable balance at June 30, 2005. There was one other merchant advertiser representing 14% of the outstanding receivable balance at June 30, 2005.

(5) Segment Reporting and Geographic Information

Edgar Filing: MARCHEX INC - Form 10QSB

Operating segments are revenue-producing components of the enterprise for which separate financial information is produced internally for the Company's management. For all periods presented, the Company operated as a single segment. The Company operates 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 revenue and accounts receivable are derived from domestic sales to advertisers engaged in various activities involving the Internet.

Table of Contents**Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

Revenues by geographic region are as follows:

	Six months ended June 30, 2004	Six months ended June 30, 2005	Three months ended June 30, 2004	Three months ended June 30, 2005
United States	93%	90%	93%	90%
Canada	3%	3%	3%	3%
Other countries	4%	7%	4%	7%
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

(6) 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 as of June 30, 2005 are as follows: \$181,000 in the remainder of 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 \$100,000 as of June 30, 2005. 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. For the quarter ended September 30, 2004, the Company reduced the lease and related costs accrual by \$30,000 based on a revised estimate for subtenant income.

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 may not materialize. Accordingly, these estimates may be adjusted in future periods. The remaining liability at June 30, 2005 was \$72,000, all of which was classified as a current liability.

(7) Name Development Asset Acquisition

On February 14, 2005, the Company acquired substantially all of the assets of Name Development, a corporation operating in the direct navigation market, for purchase consideration of \$164.4 million in a combination of cash and equity. The Company accounted for the Name Development asset acquisition as a business combination. Under the terms of the agreement, the Company acquired certain assets of Name Development, including its portfolio of Internet domains and Web properties, revenue-generating contracts, technology and systems, for the operation of the Name Development direct navigation business. The Company did not assume any other obligations with respect to Name Development as part of this asset acquisition. As a result of the acquisition, the Company obtained a proprietary source of targeted traffic.

Edgar Filing: MARCHEX INC - Form 10QSB

The following summarizes the preliminary estimated fair value of the assets acquired and the liabilities assumed at the date of acquisition:

Current assets	\$ 45,808
Intangible assets	54,261,242
Goodwill	110,083,905
	<hr/>
Total assets acquired	\$ 164,390,955
	<hr/>

Table of Contents

Marchex, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

To date the Company has conducted a preliminary analysis of the estimated fair value of the assets acquired from Name Development. The foregoing estimates may be subject to adjustment upon the completion of the Company's final review and assessment of the fair value of each of the more than 100,000 Internet domain and Web properties and other assets included in the acquisition.

In connection with the acquisition, \$24.6 million of the cash consideration was placed in escrow to secure indemnification obligations for a period of 18 months from the closing date. The escrow amounts are included as part of the purchase price consideration and will ultimately be released in the event no indemnification obligations are identified.

The acquired intangible assets in the amount of \$54,261,242 have a weighted average useful life of approximately 4.5 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of a non-compete agreement with a value of approximately \$5,700,000 (2-year weighted-average useful life), domain names with a value of approximately \$47,761,242 (4.9-year weighted average useful life), and acquired technology with a value of approximately \$800,000 (3-year weighted average useful life). The goodwill of \$110,083,905 and the acquired intangible assets with a value of \$54,261,242 are deductible over 15 years for federal tax purposes.

(8) Pike Street Industries Asset Acquisition

On April 26, 2005, the Company acquired certain assets of Pike Street, an online yellow pages and lead generation provider for local merchants. The purchase price consideration consisted of:

\$12.8 million in cash and estimated acquisition costs; plus

242,748 shares of Class B common stock; plus

212,404 shares of restricted Class B common stock that vest over a period of 3 years.

The Company accounted for the Pike Street asset acquisition as a business combination.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately \$4.1 million.

Edgar Filing: MARCHEX INC - Form 10QSB

The shares of restricted Class B common stock were valued at \$16.85 per share (the last reported sales price on the closing date) for an aggregate amount of approximately \$3.6 million. The shares of restricted Class B common stock were issued to the former stockholders of Pike Street who became employees of the Company. The shares vest over a period of three years, with the first 16.67% vesting after six months and each additional 16.67% vesting each successive 6-month period over the next thirty months. As part of employment agreements entered into with these former stockholders of Pike Street, a deferred stock-based compensation charge of approximately \$3.6 million was recorded in connection with the 212,404 shares of restricted Class B common stock. The deferred stock-based compensation is being amortized using the accelerated vesting method, in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 28, as compensation costs over the associated three-year employment periods over which those shares vest. The Company recorded stock-based compensation cost of approximately \$527,000 from the acquisition date through June 30, 2005.

The Company did not assume any other obligations with respect to Pike Street as part of this asset acquisition.

Table of Contents**Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

The following summarizes the preliminary estimated fair value of the assets acquired and the liabilities assumed at the date of acquisition:

Property and equipment	\$ 6,874
Intangible assets	5,025,000
Goodwill	11,810,180
	<hr/>
Total assets acquired	\$ 16,842,054
	<hr/>

To date the Company has conducted a preliminary analysis of the estimated fair value of the assets acquired from Pike Street. The foregoing estimates may be subject to adjustment upon the completion of the Company's final review and assessment of the fair value of the assets included in the acquisition.

In connection with the acquisition, \$1.3 million of the cash consideration, 24,275 shares of Class B common stock, and 81,927 shares of restricted Class B common stock were placed in escrow to secure indemnification obligations for a period of 12 months from the closing date. The escrow amounts are included as part of the purchase price consideration and will ultimately be released in the event no indemnification obligations are identified.

The acquired intangible assets in the amount of \$5,025,000 have a weighted average useful life of approximately 3.4 years and are being amortized using the straight-line method. The identifiable intangible assets are comprised of non-compete agreements with a value of approximately \$500,000 (3-year weighted-average useful life), domain names with a value of approximately \$1,025,000 (5-year weighted average useful life), merchant advertiser customer base with a value of approximately \$2,400,000 (3-year weighted-average useful life) and acquired technology with a value of approximately \$1,100,000 (3-year weighted average useful life). The goodwill of \$11,810,180 and the acquired intangible assets with a value of \$5,025,000 are deductible over 15 years for federal tax purposes.

Table of Contents**Marchex, Inc. and Subsidiaries****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****(9) Pro Forma Results of Operations goClick, Name Development and Pike Street**

The following table presents pro forma results of operations for the three and six months ended June 30, 2005 as if the asset acquisitions of Name Development and Pike Street occurred as of January 1, 2005. The pro forma results of operations for the three months ended June 30, 2005 combine (1) the historical results of operations of the Company for the three months ended June 30, 2005; and (2) Pike Street's historical results of operations for the pre-acquisition period from April 1, 2005 to April 25, 2005. The pro forma results of operations for the six months ended June 30, 2005 combine (1) the historical results of operations of the Company for the six months ended June 30, 2005; (2) Name Development's historical results of operations for the pre-acquisition period from January 1, 2005 to February 13, 2005; (3) an offering of only that number of shares of Class B common stock and preferred stock as necessary to consummate the Name Development asset acquisition for the period January 1, 2005 through February 13, 2005; and (4) Pike Street's historical results of operations for the pre-acquisition period from January 1, 2005 to April 25, 2005. The following table also presents pro forma results of operations for the three months and six months ended June 30, 2004 as if the acquisition of goClick and the Name Development and Pike Street asset acquisitions had occurred as of January 1, 2004. The pro forma results of operations for the three and six months ended June 30, 2004 are based on the historical results of operations of the Company, goClick, Name Development and Pike Street for the three and six months ended June 30, 2004 and an offering of only that number of shares of Class B common stock and preferred stock as necessary to consummate the Name Development asset acquisition. The Company has used statutory tax rates in effect during the three and six months ended June 30, 2004 and 2005 to calculate the tax effects of the pro forma adjustments in determining the pro forma results of operations for each of the periods presented.

	Six months ended June 30, 2004	Six months ended June 30, 2005	Three months ended June 30, 2004	Three months ended June 30, 2005
Revenue	\$ 30,710,867	\$ 43,338,958	\$ 16,156,961	\$ 21,435,318
Net income	(43,929)	1,554,292	407,154	704,182
Net income (loss) applicable to common stockholders	(1,651,859)	225,611	(204,347)	21,369
Net income (loss) per share applicable to common stockholders:				
Basic and diluted net income (loss) per share	\$ (0.06)	\$ 0.01	\$ (0.01)	\$ 0.00

The pro forma information is not necessarily indicative of the combined results that would have occurred had the acquisitions taken place at January 1, 2004 or at January 1, 2005, nor is it necessarily indicative of results that may occur in the future.

(10) Intangible Assets from Acquisitions

Intangible assets from acquisitions at June 30, 2005 consist of the following:

Merchant advertiser customer base	\$ 3,900,000
-----------------------------------	--------------

Edgar Filing: MARCHEX INC - Form 10QSB

Distribution partner base	2,200,000
Non-compete agreements	8,200,000
Trademarks/domains	48,987,395
Acquired technology	8,600,000
	<hr/>
	\$ 71,887,395
Less: accumulated amortization	15,987,974
	<hr/>
Total	\$ 55,899,422
	<hr/>

Table of Contents

Marchex, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Amortizable intangible assets are amortized on a straight-line basis over their useful lives. Aggregate amortization expense incurred by the Company was approximately \$1,035,000 and \$4,950,000 for the three months ended June 30, 2004 and 2005, respectively, and approximately \$2,070,000 and \$8,033,000 for the six months ended June 30, 2004 and 2005, respectively. Based upon the current amount of intangible assets subject to amortization, the estimated amortization expense for the next five years is as follows: \$8,800,000 for the remainder of 2005, \$15,900,000 in 2006, \$12,600,000 in 2007, \$10,400,000 in 2008 and \$8,200,000 in 2009 and thereafter.

(11) February 2005 Follow-on Public Offering

In February 2005, the Company closed its offering of 9,200,000 shares of Class B common stock at a public offering price of \$20.00 per share and 230,000 shares of 4.75% convertible exchangeable preferred stock at a public offering price of \$250 per share and with a liquidation preference of \$250 per share. These amounts include the exercise by the Company's underwriters of their over-allotment option to purchase 1,200,000 additional shares of Class B common stock and 30,000 additional shares of preferred stock. The common stock and preferred stock proceeds, net of total offering costs of \$12.2 million, were approximately \$174.1 million and \$55.3 million, respectively, for an aggregate amount of \$229.4 million.

Dividends on the preferred stock are cumulative from the date of original issue at the annual rate of 4.75% of the liquidation preference of the preferred stock, payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005. Any dividends must be declared by the Company's board of directors and must come from funds which are legally available for dividend payments.

In April 2005, the Company's board of directors declared a quarterly dividend in the amount of \$3.00 per share on its 4.75% convertible exchangeable preferred stock in accordance with the terms thereof which was paid on May 16, 2005 to the holders of record as of the close of business on May 4, 2005. This quarterly dividend totaled \$690,000. In July 2005, the Company's board of directors declared a quarterly dividend in the amount of \$2.97 per share on its 4.75% convertible exchangeable preferred stock which was paid on August 15, 2005 to the holders of record as of the close of business on August 4, 2005. This quarterly dividend totaled approximately \$683,000.

The preferred stock is convertible at the option of the holder at any time into shares of the Company's Class B common stock at a conversion rate of approximately 10.2041 shares of Class B common stock for each share of preferred stock, based on an initial conversion price of \$24.50. The initial conversion price is subject to adjustment in certain events, including a non-stock fundamental change or a common stock fundamental change.

The Company may automatically convert the preferred stock into shares of Class B common stock if the closing price of the Company's Class B common stock has exceeded \$36.75, which is 150% of the conversion price, for at least 20 of the 30 consecutive trading days ending within 5 trading days prior to the notice of automatic conversion.

Edgar Filing: MARCHEX INC - Form 10QSB

If the Company elects to automatically convert some or all of the preferred stock into shares of Class B common stock prior to February 15, 2008, the Company will make an additional payment on the preferred stock equal to the aggregate amount of cumulative dividends that would have accrued and become payable on the preferred stock from February 14, 2005 through and including February 15, 2008, less any dividends already paid on the preferred stock. This additional payment is payable in cash or, at the Company's option, in shares of the Company's Class B common stock, or a combination of cash and shares of Class B common stock.

The Company may elect to redeem the preferred stock, in whole or in part, at declining redemption prices on or after February 20, 2008.

Table of Contents

Marchex, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The preferred stock is exchangeable, in whole but not in part, at the option of the Company on any dividend payment date beginning on February 15, 2006 for the Company's 4.75% convertible subordinated debentures (Debentures) at the rate of \$250 principal amount of Debentures for each share of preferred stock. This embedded derivative will be reflected as an asset, if there is any value ascribed to it, and is subject to variable accounting. The right will be marked to market at each reporting date until such time as the right is exercised or expires. Based on a variety of factors including the assessed probability of exercise, no value has been ascribed to this right at June 30, 2005. The Debentures, if issued, will mature 25 years after the exchange date.

The preferred stock has no maturity date and no voting rights prior to conversion into shares of Class B common stock, except under limited circumstances.

(12) Licensing Agreement and Taxes

(a) Licensing Agreement

In connection with the closing of the Name Development asset acquisition, the Company entered into (i) a new master agreement with an advertising partner with respect to the Company's direct navigation business, and (ii) a license agreement with the same partner with respect to certain of the partner's patents, pursuant to which the Company paid \$4.5 million in an upfront payment (and an additional \$674,000 in certain circumstances) and a contingent royalty based upon a discounted rate of 3% (3.75% under certain circumstances) of certain of the Company's gross revenues payable on a quarterly basis through December 2016.

The upfront license fee has been capitalized and is being amortized ratably over 42 months. The royalty payment is recognized as incurred in service costs.

(b) Taxes

From time to time, various state, federal and other jurisdictional tax authorities undertake reviews of the Company and its filings. In evaluating the exposure associated with various tax filing positions, the Company on occasion accrues charges for probable exposures. The Company believes any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

(13) Subsequent Events

Edgar Filing: MARCHEX INC - Form 10QSB

On July 27, 2005, the Company acquired IndustryBrains, Inc. (IndustryBrains), a company focused on monetizing vertical and brand-name Web sites through contextual advertising solutions, for the following consideration, exclusive of acquisition costs:

\$15.6 million in cash; plus

788,046 shares of Class B common stock; plus

176,909 shares of restricted Class B common stock issued to the employee shareholders of IndustryBrains which will vest over a two-and-one half year period in installments of 33.34% after each ten month period during that term and will result in compensation expense.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued at (for accounting purposes) an aggregate amount of approximately \$13.4 million.

The shares of restricted Class B common stock were issued to employee shareholders of IndustryBrains and valued at approximately \$3.0 million, which will be recorded as compensation expense over the associated employment period during which these shares vest.

Table of Contents

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 Marchex, Inc, included in our Annual Report on Form 10-KSB for the year ended December 31, 2004 which was filed with the Securities and Exchange Commission.

Overview

We are an online technology company that helps merchants sell through search. We are focused on search engine and contextual marketing, local search, and direct navigation. Our platform of integrated performance-based advertising and search marketing services enables merchants to efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories and selected Web properties.

We currently provide our merchant advertisers with the following technology-based services:

Pay-Per-Click Services. We deliver pay-per-click advertising listings that are reflective of our merchant advertisers' products and services to online users in response to their keyword search queries. These pay-per-click listings are generally ordered in the search results based on the amount our merchant advertisers choose to pay for a targeted placement. These targeted listings are displayed to consumers and businesses through our distribution network of leading search engines, product shopping engines, directories and other Web properties. We also generate revenue from cost-per-action services, which occurs when the online user is redirected from the Company websites to a merchant advertiser website and completes the specified action.

Feed Management Services. We leverage our proprietary technology to crawl and extract relevant product content from merchant advertisers' databases and Web sites to create highly-targeted product and service listings, which we deliver into our distribution network. These feed management listings are ordered in the results based on relevance to user search queries. Our trusted feed relationships with our distribution partners enable merchant advertisers to deliver comprehensive and up-to-date product and service listings to some of the Web's largest search engines, product shopping engines and directories.

Advertising Campaign Management Services. We enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of online advertising campaigns using our conversion tracking and detailed reporting services.

Edgar Filing: MARCHEX INC - Form 10QSB

Search Engine Optimization Services. We optimize key attributes of merchant advertiser Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.

Outsourced Search Marketing Services Platform. We provide large aggregators of advertisers, such as yellow page companies, with an outsourced, integrated platform to enable them to market performance-

Table of Contents

based advertising and search marketing services directly to their customers. We distribute performance-based advertisements through our broad network of distribution partners comprising many of the leading search engines, product shopping engines, directories and other Web properties. Our sources of distribution include industry leaders such as Yahoo!, Google, Shopping.com and many others.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date. We have completed the following acquisitions since our inception:

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.

On February 14, 2005, we acquired certain assets of Name Development which was incorporated in the British Virgin Islands in July 2000.

On April 26, 2005, we acquired certain assets of Pike Street Industries, which was incorporated in Washington on March 6, 2002.

On July 27, 2005, we acquired IndustryBrains, which was incorporated in New York on January 31, 2002.

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; Las Vegas, Nevada; and New York City, New York.

Acquisitions

Since our inception, we have completed the following acquisitions which have been accounted for as business combinations.

Enhance Interactive

In February 2003, we acquired eFamily together with its wholly-owned subsidiary Enhance Interactive for the following consideration:

Edgar Filing: MARCHEX INC - Form 10QSB

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

Additional consideration in the form of a contingent earnings-based cash payment of up to \$13.5 million payable over two years, of which \$3.5 million and \$6.2 million have been paid for the calendar years 2003 and 2004, respectively, which such payments were made in April 2004 and March 2005, respectively.

The additional consideration consisted of two components:

A contingent earnings-based payment to the original stockholders (earn-out consideration); and

A contingent earnings-based payment to certain employees (retention consideration).

These amounts were payable by us with respect to the years 2003 and 2004. For the 2003 and 2004 calendar years, the total Enhance Interactive earnings-based payment obligation was approximately \$3.5 million and \$6.2 million, respectively.

The contingent payment of earn-out consideration, payable to the original stockholders of Enhance Interactive, was calculated based on the formula of 69.44% of earnings before taxes for each of the calendar

Table of Contents

years 2003 and 2004, up to a maximum payout cap of \$12.5 million in aggregate. This payment obligation for each calendar year was conditioned on Enhance Interactive meeting the earnings threshold described above. We have accounted for all such amounts paid as additional goodwill. For the 2003 and 2004 calendar years, the earn-out consideration paid was approximately \$3.2 million and \$5.7 million, respectively. Subsequent to December 31, 2004, no additional obligations exist related to the shareholder earn-out consideration.

The contingent payment of retention consideration, payable to certain employees of Enhance Interactive, was 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 cap of \$1 million in aggregate. This payment obligation for each calendar year was also conditioned on Enhance Interactive meeting the earnings threshold described above. We have accounted for all such amounts paid as compensation. For the 2003 and 2004 calendar years, the retention consideration paid was approximately \$283,000 and \$499,000, respectively. Subsequent to December 31, 2004, no additional obligations exist related to the acquisition-related retention consideration.

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.

TrafficLeader

In October 2003, we acquired TrafficLeader for the following consideration:

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

425,000 shares of Class B common stock, which had a redemption right that terminated upon the closing of our initial public offering in April 2004; plus

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 \$1.0 million. For the 2004 calendar year, no additional consideration was due under this provision.

With respect to the second and third components, the total value of the shares and the redemption right was recorded at \$3.9 million. Prior to its expiration, the redemption right required us to buy back the 425,000 shares for \$8.00 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 \$20.0 million prior to October 24, 2005.

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

goClick

In July 2004, we acquired goClick for the following consideration:

\$7.5 million in net cash and acquisition costs; plus

433,541 shares of Class B common stock.

The shares of Class B common stock were valued (for accounting purposes) at an aggregate amount of approximately \$4.14 million.

Table of Contents

Name Development

In February 2005, we acquired substantially all of the assets of Name Development for the following consideration:

\$155.6 million in cash and estimated acquisition costs; plus

419,659 shares of Class B common stock.

The shares of Class B common stock were valued at \$20.99 per share (for accounting purposes) for an aggregate amount of approximately \$8.8 million.

Under the terms of the agreement, we acquired certain assets of Name Development, including its portfolio of Internet domains and Web properties, revenue-generating contracts, technology and systems, for the operation of the Name Development direct navigation business. We did not assume any other obligations with respect to Name Development as part of this asset acquisition.

Pike Street Industries

In April 2005, we acquired certain assets of Pike Street Industries for the following consideration:

\$12.8 million in cash and estimated acquisition costs; plus

242,748 shares of Class B common stock; plus

212,404 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.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued (for accounting purposes) at an aggregate amount of approximately \$4.1 million.

The shares of restricted Class B common stock were issued to employees of Pike Street Industries and valued at approximately \$3.6 million, which will be recorded as compensation expense over the associated employment period during which these shares vest.

IndustryBrains

Edgar Filing: MARCHEX INC - Form 10QSB

In July 2005, the Company acquired IndustryBrains for the following consideration, exclusive of acquisition costs:

\$15.6 million in cash; plus

788,046 shares of Class B common stock; plus

176,909 shares of restricted Class B common stock issued which will vest over a two-and-one half year period in installments of 33.34% after each ten month period during that term.

The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued at (for accounting purposes) an aggregate amount of approximately \$13.4 million.

The shares of restricted Class B common stock were issued to employee shareholders of IndustryBrains and valued at approximately \$3.0 million, which will be recorded as compensation expense over the associated employment period during which these shares vest.

Consolidated Statements of Operations

The assets, liabilities and operations of our acquisitions are included in our consolidated financial statements as of the date of the respective acquisitions.

All significant inter-company transactions and balances within Marchex have been eliminated in consolidation. Our purchase accounting resulted in all assets and liabilities from our acquisitions being recorded at their estimated fair values on the respective acquisition dates. All goodwill, intangible assets and liabilities resulting from the acquisitions have been recorded in our financial statements.

Table of Contents

Presentation of Financial Reporting Periods

The comparative periods presented are for the three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005.

Revenue

We currently generate revenue through our suite of services, including our pay-per-click services, feed management services, advertising campaign management services, search optimization services and outsourced search marketing services platform.

Our primary sources of revenue are the performance-based advertising services, which include pay-per-click services, cost-per-action services and feed management services. These primary sources amounted to greater than 93% of our revenues in all periods presented. Our secondary sources of revenue are our advertising campaign management services, search optimization services and outsourced search marketing services platform. These secondary sources amounted to less than 7% of our revenues in all periods presented. We have no barter transactions.

We recognize revenue upon the completion of our performance obligation, provided that: (1) evidence of an arrangement exists; (2) the arrangement fee is fixed and determinable; and (3) collection is reasonably assured.

Performance-Based Advertising Services

In providing pay-per-click advertising services, we generate revenue upon our delivery of qualified and reported click-throughs to our merchant advertisers or advertising service providers listings. These merchant advertisers and advertising service providers 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, Internet domains or Web properties, and other targeted Web-based content. We also generate revenue from cost-per-action services, which occurs when the online user is redirected from the Company websites to a merchant advertiser website and completes the specified action.

In providing feed management services, merchant advertisers pay for their Web pages and product databases to be crawled, or searched, and included in search engine, directory and product shopping engine results within our distribution network. Generally, the feed management listings are presented in a different section of the Web page than the pay-per-click listings. For this service, revenue is generated when an online user clicks on a feed management listing from search engine, directory or product shopping engine results. Each click-through on an advertisement listing represents a completed transaction for which the merchant advertiser pays for on a per-click basis. The placement of a feed management result is largely determined by its relevancy, as determined by the distribution partner.

Search Marketing Services

Edgar Filing: MARCHEX INC - Form 10QSB

Merchant advertisers pay us additional fees for services such as advertising campaign management services and search optimization services. 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. We may also charge initial set-up or inclusion fees as part of our services. Total revenue from these services accounted for less than 7% of total revenue in all periods presented.

Banner advertising revenue is primarily based on a fixed fee per click and is generated and recognized on click-through activity. In limited cases, banner payment terms are volume-based with revenue generated and 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 from twelve months to more than two years.

Table of Contents

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' indexes of listings. Revenues from these subscription arrangements are recognized ratably over the service period.

Industry and Market Factors

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 current 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 current 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 it is 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 and seasonal purchasing cycles of many merchant advertisers. 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

Our service costs represent the cost of providing our performance-based advertising services and our search marketing services. The service costs that we have incurred in the periods presented primarily include:

user acquisition costs;

amortization and impairment of intangible assets;

license fees;

credit card processing fees;

network operations;

serving our search results;

maintaining our Web sites;

domain name registration renewal fees;

network fees;

fees paid to outside service providers;

delivering customer service;

depreciation of our Web site and network equipment;

colocation service charges of our Web site equipment;

bandwidth and software license fees;

salaries of related personnel; and

stock-based compensation of related personnel.

Table of Contents

User Acquisition Costs

For the periods presented the largest component of our service costs consist of user acquisition costs that relate primarily to payments to our distribution partners for access to their online 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 our 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 we may use to a lesser degree 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.

Our method of expensing user acquisition costs is based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments are generally expensed at the greater of: (1) pro-rata over the term the fixed payment covers; or (2) usage delivered to date divided by the guaranteed minimum amount of usage delivered. Agreements with variable payments based on a percentage of revenue, number of paid click-throughs or other metrics are generally expensed based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

Sales and Marketing

Sales and marketing expenses consist 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 merchant advertisers.

Product Development

Product development costs consist primarily of expenses incurred in the research and development, creation and enhancement of our Internet sites and services.

Edgar Filing: MARCHEX INC - Form 10QSB

Our 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 we offer.

For the periods presented, substantially all of our 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;

professional services, including accounting, legal and insurance;

Table of Contents

bad debt provisions;

facilities costs; and

other general corporate expenses.

Acquisition-Related Retention Consideration

Acquisition-related retention consideration results from our 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 "Acquisitions" above.

The contingent payment obligation was 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 cap of \$1.0 million in the aggregate. All payments made under this obligation have been accounted for as compensation. For the three and six months ended June 30, 2004, we recorded \$123,000 and \$256,000, respectively, in acquisition-related retention consideration. Subsequent to December 31, 2004, no additional obligations exist related to the acquisition-related retention consideration.

Stock-Based Compensation

Stock-based compensation consists of the following components:

the intrinsic value of employee option and restricted stock issuances in cases where the fair value of the underlying stock was greater than the exercise price on the date of the grant;

the fair value of non-employee option issuances; and

the amount by which the fair value of our Class B common stock exceeds the exercise price at the end of the period for certain options.

We used variable accounting for the options to purchase 125,000 shares of our Class B common stock that were issued under our stock incentive plan pursuant to the Enhance Interactive merger agreement. These options were held in escrow until February 28, 2004 as security for the indemnification obligations under the Enhance Interactive merger agreement, and these options were subject to forfeiture during the escrow period. We accounted for these options as variable awards until February 28, 2004.

Amortization of Intangibles from Acquisitions

Edgar Filing: MARCHEX INC - Form 10QSB

Amortization of intangible assets excluding goodwill relates to intangible assets identified in connection with our acquisitions.

The intangible assets have been identified as:

non-competition agreements;

trade and Internet domain names;

distributor relationships;

merchant advertising customer base relationships; and

acquired technology.

These assets are amortized over useful lives ranging from 12 to 84 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

Table of Contents

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. Although realization is not assured, the Company believes it is more likely than not, based on its operating performance and projections of future taxable income, that the Company's net deferred tax assets will be realized. In determining that it was more likely than not that the Company would realize the deferred tax assets, factors considered included: historical taxable income, historical trends related to merchant advertiser usage rates and projected revenues and expenses. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if the Company's projections of future taxable income are reduced or if the Company does not perform at the levels it is projecting. This could result in increases to the valuation allowance for deferred tax assets and a corresponding increase to income tax expense of up to the entire net amount of deferred tax assets. From time to time, various state, federal, and other jurisdictional tax authorities undertake reviews of the Company and its filings. The Company believes any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

As of June 30, 2005, we had net operating loss, or NOL, carryforwards of \$1.7 million, which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL 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 \$1.7 million of carryforwards is limited such that substantially all of these NOL carryforwards will never be utilized.

Initial Public Offering

On March 30, 2004, we commenced an initial public offering of 4.6 million shares of our Class B common stock. The closing of our initial public offering took place on April 5, 2004. The proceeds of our initial public offering, net of cash offering expenses, were approximately \$27.2 million. In connection with our initial public offering, the underwriters were also granted warrants, exercisable over a four-year period commencing April 5, 2005 and ending April 5, 2009, to purchase 120,000 shares of Class B common stock at an exercise price equal to \$8.45 per share. Net proceeds have been used to pay for product and business development, acquisitions and strategic relationships, capital expenditures, personnel, facilities, earn-out obligations, working capital and other general corporate purposes.

Accretion to Redemption Value of Redeemable Convertible Preferred Stock

All 6,724,063 shares of our outstanding Series A redeemable convertible preferred stock were automatically converted into 6,724,063 shares of Class B common stock upon the closing of our initial public offering in April 2004. Prior to this conversion, holders of our 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 our board of directors. Upon the conversion of the Series A redeemable convertible preferred stock, dividend rights were automatically terminated and any rights to past dividends were forgiven.

Prior to the automatic conversion, 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 redemption amount at the earliest redemption date.

Follow-on Public Offering

Edgar Filing: MARCHEX INC - Form 10QSB

In February 2005, we closed a follow-on public offering of 9,200,000 shares of Class B common stock at a public offering price of \$20.00 per share and 230,000 shares of 4.75% convertible exchangeable preferred stock

Table of Contents

at a public offering price of \$250 per share and with a liquidation preference of \$250 per share. These amounts include the exercise by our underwriters of their over-allotment option to purchase 1,200,000 additional shares of Class B common stock and 30,000 additional shares of preferred stock. The common stock and preferred stock proceeds, net of total offering costs of \$12.2 million, were estimated to be approximately \$174.1 million and \$55.3 million, respectively, for an aggregate amount of \$229.4 million. In addition to funding the acquisition of certain assets from Name Development, we intend to use the proceeds from the offering for working capital and other general corporate purposes, including most recently for our recent acquisition of certain assets from Pike Street Industries and the IndustryBrains acquisition and for future acquisitions.

Holders of the preferred stock are entitled to receive cumulative dividends from the date of original issue at the annual rate of 4.75% of the liquidation preference of the preferred stock, payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005. Any dividends must be declared by our board of directors and must come from funds which are legally available for dividend payments.

In April 2005, the Company's board of directors declared a quarterly dividend in the amount of \$3.00 per share on its 4.75% convertible exchangeable preferred stock in accordance with the terms thereof which was paid on May 16, 2005 to the holders of record as of the close of business on May 4, 2005. This quarterly dividend distribution totaled \$690,000. In July 2005, the Company's board of directors declared a quarterly dividend in the amount of \$2.97 per share on its 4.75% convertible exchangeable preferred stock which was paid on August 15, 2005 to the holders of record as of the close of business on August 4, 2005. This quarterly dividend totaled approximately \$683,000.

The preferred stock is convertible at the option of the holder at any time into shares of our Class B common stock at a conversion rate of approximately 10.2041 shares of Class B common stock for each share of preferred stock, based on an initial conversion price of \$24.50. The initial conversion price is subject to adjustment in certain events, including a non-stock fundamental change or a common stock fundamental change.

We may elect to automatically convert some or all of the preferred stock into shares of Class B common stock if the closing price of our Class B common stock has exceeded \$36.75, which is 150% of the conversion price for at least 20 of the 30 consecutive trading days ending within 5 trading days prior to the notice of automatic conversion.

If we elect to automatically convert some or all of the preferred stock into shares of Class B common stock prior to February 15, 2008, we will make an additional payment on the preferred stock equal to the aggregate amount of cumulative dividends that would have accrued and become payable on the preferred stock from February 14, 2005 through and including February 15, 2008, less any dividends already paid on the preferred stock. This additional payment is payable in cash or, at our option, in shares of our Class B common stock, or a combination of cash and shares of Class B common stock.

We may elect to redeem the preferred stock, in whole or in part, at declining redemption prices on or after February 20, 2008.

The terms of the preferred stock contain an exchange right, at our option, to convert the preferred stock, in whole but not in part, on any dividend payment date beginning on February 15, 2006 into our 4.75% convertible subordinated debentures (Debentures) at the rate of \$250 principal amount of Debentures for each share of preferred stock. This embedded derivative will be reflected as an asset, if there is any value ascribed to it, and is subject to variable accounting. The right will be marked to market at each reporting date until such time as the right is exercised or expires. Based on a variety of factors including the assessed probability of exercise, no value has been ascribed to this right as of June 30, 2005. The Debentures, if issued, will mature 25 years after the exchange date.

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 three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005 are not necessarily indicative of the results that may be expected for the full year or any future period.

	<u>Six months ended June 30, 2004</u>	<u>Six months ended June 30, 2005</u>	<u>Three months ended June 30, 2004</u>	<u>Three months ended June 30, 2005</u>
Revenue	100.0%	100.0%	100.0%	100.0%
Expenses:				
Service costs	63.9%	54.1%	64.8%	50.7%
Sales and marketing	12.4%	7.3%	11.6%	7.3%
Product development	6.3%	5.2%	6.0%	6.1%
General and administrative	9.4%	7.4%	9.6%	7.0%
Acquisition-related retention consideration	1.6%	0.0%	1.4%	0.0%
Facility relocation	1.4%	0.0%	0.0%	0.0%
Stock-based compensation	3.6%	1.6%	2.7%	2.4%
Amortization of acquired intangible assets	12.6%	20.3%	11.7%	23.4%
Total operating expenses	111.1%	95.9%	107.6%	96.8%
Income (loss) from operations	-11.1%	4.1%	-7.6%	3.2%
Other income (expense):				
Interest income	0.5%	2.2%	0.8%	2.8%
Interest expense	0.0%	0.0%	0.0%	0.0%
Adjustment to fair value of redemption obligation	0.3%	0.0%	0.0%	0.0%
Other	0.0%	0.0%	0.0%	0.0%
Total other income	0.8%	2.2%	0.8%	2.8%
Income (loss) before provision for income taxes	-10.3%	6.3%	-6.8%	6.0%
Income tax expense (benefit)	-1.2%	2.4%	-1.7%	2.2%
Net income (loss)	-9.1%	3.9%	-5.1%	3.8%
Convertible preferred stock dividend	0.0%	2.6%	0.0%	3.2%
Accretion to redemption value of redeemable convertible preferred stock	2.6%	0.0%	0.2%	0.0%
Net income (loss) applicable to common stockholders	-11.7%	1.3%	-5.3%	0.6%

Comparison of the Three Months ended June 30, 2004 to the Three Months ended June 30, 2005 and the Six Months ended June 30, 2004 to the Six Months ended June 30, 2005.

Edgar Filing: MARCHEX INC - Form 10QSB

Revenue. Revenue increased 139%, from \$8.9 million in the three months ended June 30, 2004 to \$21.2 million in the same period in 2005. This increase was attributable to a \$12.1 million increase in performance-based advertising services. Of this increase approximately 49% related to an increase in the average revenue per merchant advertiser, while approximately 51% related to an increase in the number of merchant advertisers. Approximately 88%, or \$5.3 million, of the increase in the average revenue per merchant advertiser was due to an advertising services provider relationship initiated in 2005. Of the total revenue increase, \$6.3 million is derived from 43 advertiser and advertising service provider relationships including the previously mentioned advertising services provider relationship and indirectly attributable to the acquisition of certain assets of Name Development and Pike Street, including their portfolios of more than 100,000 Internet domain names. Of the \$6.3 million increase, \$701,000 was indirectly attributable to the acquisition of certain assets of Pike Street.

Table of Contents

We believe the increase in revenue is primarily a result of the growth of our existing distribution partners, the increased number of searches and resulting click-throughs performed by users of our services, and new merchant advertisers and advertising services provider relationships. We had over 400 distribution partners in June 2004 and 2005. We also believe the foregoing factors, combined with our sales efforts and improved operational controls, have contributed to an increase in the average revenue per merchant advertiser. The increase in revenue in the 2005 period is also attributable to the acquisition of goClick in July 2004 which added more than 40 unique distribution partners and more than 5,000 unique merchant advertisers as of such acquisition in July 2004.

Revenue increased 140%, from \$16.5 million in the six months ended June 30, 2004 to \$40.0 million in the same period in 2005. This increase was primarily attributable to a \$22.8 million increase in performance-based advertising services of which \$8.7 million was due to the addition of Name Development and Pike Street advertiser and advertising services provider relationships and indirectly attributable to the acquisition of certain assets of Name Development and Pike Street, including their portfolios of more than 100,000 Internet domain names.

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 and growth in our proprietary traffic sources. If we do not renew our distribution partner agreements or replace traffic lost from 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 increased 87% from \$5.7 million in the three months ended June 30, 2004 to \$10.7 million in the same period in 2005. The increase was mainly attributable to an increase in payments to distribution partners of \$3.5 million, an increase in personnel costs of \$72,000, an increase in payment processing fees of \$128,000, an increase in facility and other costs of \$44,000, an increase in licenses and royalties of \$655,000 and an increase in registration fees and Internet domain amortization of \$553,000.

Approximately \$3.0 million of the total increase in service costs for the three months ended June 30, 2005 was attributable to the July 2004 acquisition of goClick which was not included in the same period in 2004.

This total increase also resulted from a greater number of searches, an increase in database and hardware capacity requirements, an increase in the number of personnel required to support our services and an increase in fees paid to outside service providers.

Service costs represented 65% of revenue in the three months ended June 30, 2004 as compared to 51% in 2005. The 2005 decrease in service costs as compared to the same period in 2004 was primarily a result of the impact as a percentage of revenue of a larger proportion of revenue attributable to our proprietary traffic sources for which there are no corresponding distribution partner payments. Payments to feed management and pay-per-click services distribution partners account for higher user acquisition costs as a percentage of revenue relative to our overall service cost percentage. To the extent that payments to feed management and pay-per-click services distribution partners make up a larger percentage of future operations, we expect that service costs will increase as a percentage of revenue. Our proprietary traffic sources have a lower service cost as a percentage of revenue relative to our overall service cost percentage. To the extent our proprietary traffic sources make up a larger percentage of our future operations, we expect that service costs will decrease as a percentage of revenue. We also expect that service costs will continue to increase in absolute dollars, since we anticipate expanding our operations.

Table of Contents

Service costs increased by \$10.9 million or 103%, from \$10.5 million in the six months ended June 30, 2004 to \$21.4 million in the same period in 2005. This increase was primarily attributable to an increase of \$8.4 million in payments to distribution partners, an increase in personnel costs of \$260,000, an increase in payment processing fees of \$271,000, an increase in facility and other costs of \$69,000, an increase in licenses and royalties of \$1.0 million and an increase in registration fees and Internet domain amortization of \$850,000. Service costs as a percentage of revenue were 64% for the six months ended June 30, 2004 as compared to 54% in the same period in 2005. The 2005 decrease in service costs as compared to the same period in 2004 was primarily a result of the impact as a percentage of revenue of a larger proportion of revenue attributable to our proprietary traffic sources for which there are no corresponding distribution partner payments.

Sales and Marketing. Sales and marketing expenses increased 50%, from \$1.0 million in the three months ended June 30, 2004 to \$1.5 million in the same period in 2005. As a percentage of revenue, sales and marketing expenses were 12% and 7% for the three months ended June 30, 2004 and 2005, respectively. The increase in dollars was primarily related to an increase in personnel costs of \$212,000 related primarily to an increase in the number of employees and an increase in online and outside marketing activities of \$259,000. The remaining increase is related to increases in 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 \$828,000 or 41%, from \$2.0 million in the six months ended June 30, 2004 to \$2.9 million in the same period in 2005. As a percentage of revenue, the sales and marketing expenses were 12% in the six months ended June 30, 2004 as compared to 7% in the same period in 2005.

Product Development. Product development expenses increased 144%, from \$528,000 in the three months ended June 30, 2004 to \$1.3 million in the same period in 2005. As a percentage of revenue, product development expenses were 6% for both the three months ended June 30, 2004 and 2005, respectively. The increase in dollars was primarily due to an increase in personnel costs of \$567,000, primarily related to an increase in the number of employees. 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 increased 100%, from \$1.0 million in the six months ended June 30, 2004 to \$2.0 million in the same period in 2005. The increase in dollars was primarily due to an increase in personnel costs of \$816,000. As a percentage of revenue, the product development expenses were 6% in the six months ended June 30, 2004 as compared to 5% in the same period in 2005.

General and Administrative. General and administrative expenses increased 74%, from \$847,000 in the three months ended June 30, 2004 to \$1.5 million in the same period in 2005. The increase in dollars was primarily due to an increase in personnel costs of \$312,000, an increase in professional services of \$59,000, an increase in facilities related costs of \$189,000, and an increase in travel, bad debt and other costs of \$67,000. As a percentage of revenue, general and administrative expenses were 10% for the three months ended June 30, 2004 and 7% in the same period in 2005. As a percentage of revenue, the decrease in general and administrative expenses in 2005 as compared to 2004 was primarily a result of general and administrative expenses being compared to a larger revenue base. 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 increased 90%, from \$1.5 million in the six months ended June 30, 2004 to \$2.9 million in the same period in 2005. As a percentage of revenue, general and administrative expenses in 2005 decreased to 7% as compared to 9% in 2004. As a percentage of revenue, the decrease in general and administrative expenses in 2005 as compared to 2004 was primarily a result of the allocation of the general and administrative expenses over a larger revenue base.

Table of Contents

Acquisition-Related Retention Consideration. Acquisition-related retention consideration was \$123,000 for the three months ended June 30, 2004 and zero in the same period in 2005. The acquisition related retention consideration was calculated as part of the contingent, earnings-based payment obligation to certain employees of Enhance Interactive and was equal to 5.56% of Enhance Interactive's earnings before taxes in excess of \$3.5 million. A quarterly proportion of the annual estimated acquisition-related retention consideration was recorded in the 2004. We have accounted for any payment amounts as compensation. Subsequent to December, 2004, no additional obligations exist related to the acquisition-related retention consideration. Acquisition-retention consideration was \$256,000 for the six months ended June 30, 2004 compared to zero in the same period in 2005.

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. 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 obligations for the original facilities extend through June 30, 2006 and totaled \$100,000 as of June 30, 2005. As of June 30, 2005, we estimate the net sublease income to be approximately \$41,000 over the remaining life of the lease.

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 increased 111%, from \$235,000 in the three months ended June 30, 2004 to \$497,000 in the same period in 2005. In the three months ended June 30, 2005, the components of stock-based compensation were service costs of \$133,000, sales and marketing of \$286,000, product development of \$138,000 and general and administrative of (\$60,000). Amounts in the three months ended June 30, 2004 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 \$104,000 related to restricted stock issued to employees for future services in connection with the acquisition of TrafficLeader. The three months ended June 30, 2005 includes primarily the effect of \$443,000 of stock-based compensation related to restricted stock issued to employees for future services in connection with the acquisition of TrafficLeader and the Pike Street asset acquisition.

The amortization of stock-based compensation increased 8%, from \$596,000 in the six months ended June 30, 2004 to \$644,000 in the same period in 2005. In the six months ended June 30, 2005, the components of stock-based compensation were service costs of \$135,000, sales and marketing of \$315,000, product development of \$149,000 and general and administrative of \$45,000. Amounts in the six months ended June 30, 2004 related primarily to the vesting of stock options granted to employees in which the exercise price was less than the fair 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. Amounts in 2005 related primarily to the restricted stock issued to employees for future services in connection with the acquisition of Trafficleader and the Pike Street asset acquisition.

Amortization of Intangible Assets From Acquisitions. Intangible amortization expense increased 378%, from \$1.0 million in the three months ended June 30, 2004 to \$5.0 million in the same period in 2005. The increase was associated with the July 2004 acquisition of goClick, the February 2005 Name Development asset acquisition and the April 2005 Pike Street asset acquisition. During the three months ended June 30, 2005 the components of amortization of intangibles were service costs of \$3.9 million, sales and marketing of \$205,000 and general and administrative of \$855,000.

Intangible amortization expense increased 288%, from \$2.1 million in the six months ended June 30, 2004 to \$8.0 million in the same period in 2005. The increase was associated with the July 2004 acquisition of goClick, the February 2005 Name Development asset acquisition and the April 2005 Pike Street asset acquisition. During the six months ended June 30, 2005, the components of amortization of intangibles were service costs of \$6.3 million, sales and marketing of \$326,000 and general and administrative of \$1.4 million.

Table of Contents

Our purchase accounting resulted in all assets and liabilities from our acquisitions being recorded at their estimated fair values on their respective acquisition dates. All goodwill, identifiable intangible assets and liabilities resulting from our acquisitions have been recorded in our financial statements. The identified intangibles amounted to \$71.9 million and are being amortized over a range of useful lives of 12 to 84 months. We may acquire identifiable intangible assets as part of future acquisitions including the acquisition of IndustryBrains, and if so, we expect that our intangible amortization will increase in absolute dollars.

Other Income. Other income increased 752%, from \$69,000 in the three months ended June 30, 2004 to \$586,000 in the same period in 2005. The increase was primarily attributable to an increase in interest income of \$518,000 which was primarily a result of the impact of our follow-on public offering in February 2005 on the average cash balances in the 2005 period as well as an increase in rates realized on invested funds. Other income increased 519%, from \$138,000 in the six months ended June 30, 2004 to \$857,000 in the same period in 2005. The increase was primarily attributable to an increase in interest income of \$775,000.

Income Taxes. The income tax benefit in the three months ended June 30, 2004 was \$147,000 as compared to an income tax expense of \$471,000 in the same period in 2005. The increase in income taxes was primarily a result of a pretax income of \$1.3 million in the three months ended June 30, 2005 compared to a pretax loss of \$608,000 in the same period in 2004.

In the six months ended June 30, 2004, the income tax benefit was \$201,000 as compared to an income tax expense of \$950,000 in the same period in 2005. In the three and six months ended June 30, 2004, the effective tax benefit of 24% and 12%, respectively, differed from the expected effective rate of 34% primarily due to state income taxes and non-deductible stock compensation amounts. The effective rate was 37% and 38% in the three and six months ended June 30, 2005, respectively. This differed from the expected rate of 35% due to state income taxes and non-deductible stock compensation and other amounts.

During the three months ended June 30, 2004 and 2005, as a result of tax deductions from stock option exercises, we recognized tax-effected benefits of approximately \$101,000 and \$198,000, respectively, which were recorded as credits to additional paid in capital. During the six months ended June 30, 2004 and 2005, we recognized tax-effected benefits of approximately \$101,000 and \$328,000, respectively.

Convertible Preferred Stock Dividends. The convertible preferred stock dividends during the three and six months ended June 30, 2005 of \$683,000 and \$1.0 million, respectively, are based upon the 230,000 convertible preferred shares with a dividend rate of 4.75% that were issued in February 2005.

Accretion to Redemption Value of Redeemable Convertible Preferred Stock. The accretion to redemption value of preferred stock decreased from \$18,000 and \$420,000 in the three and six months ended June 30, 2004, respectively, to zero in the same periods in 2005. 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 initial public offering on April 5, 2004.

Net Income (Loss) Applicable to Common Stockholders. Net income (loss) applicable to common stockholders increased from a net loss of \$479,000 in the three months ended June 30, 2004 to net income of \$107,000 in the same period in 2005. The increase was primarily attributable to revenue increasing at a faster rate than service costs, sales and marketing, product development and general and administration expenses offset by convertible preferred dividends of \$683,000. There was also a decrease in acquisition-related retention consideration of \$123,000.

Edgar Filing: MARCHEX INC - Form 10QSB

The net income (loss) applicable to common stockholders increased from a net loss of \$1.9 million in the six months ended June 30, 2004 to a net income of \$496,000 in the same period in 2005.

Table of Contents

Non-GAAP Financial Measures

To supplement our consolidated financial statements presented in accordance with GAAP and to provide clarity internally and externally, management uses certain non-GAAP measures of financial performance and liquidity, including but not limited to OIBA, Adjusted OIBA and EBITDA.

OIBA represents income (loss) from operations plus (1) stock-based compensation expense and (2) amortization of acquired intangible assets. This measure, among other things, is one of the primary metrics by which we evaluate the performance of our business. Additionally, management uses Adjusted OIBA which excludes both acquisition-related retention consideration, as we view this as part of the earn-out incentives related to the Enhance Interactive acquisition transaction, and a facility relocation expense. Both of these considerations are viewed as non-recurring in nature with the facility relocation expense recognized in calendar year 2004 and the earn-out consideration related 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 is evaluated. These measures are useful to investors because they represent our consolidated operating results, taking into account depreciation and other license and intangible amortization, which we believe is an ongoing cost of doing business, but excluding the effects of certain other non-cash and non-recurring expenses. EBITDA represents income before interest, income taxes, depreciation, amortization, and stock compensation expense. Management believes that EBITDA is another alternative measure of liquidity to GAAP net cash provided by operating activities that provides meaningful supplemental information regarding liquidity and is used by management to measure our ability to fund operations and our financing obligations.

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. These non-GAAP terms, as defined by management, may not be comparable to similarly titled measures used by other companies. We endeavor to compensate for the limitations of the non-GAAP measures used herein 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.

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 that are not paid in cash. Stock-based compensation also includes the expense 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 acquired 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.

Table of Contents

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 three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005.

	Six months ended June 30, 2004	Six months ended June 30, 2005	Three months ended June 30, 2004	Three months ended June 30, 2005
Net income (loss) applicable to common stockholders	\$ (1,905,081)	\$ 495,886	\$ (478,741)	\$ 107,477
Convertible preferred stock dividends		1,031,806		682,813
Accretion to redemption value of redeemable convertible preferred stock	420,430		17,751	
Net income (loss)	(1,484,651)	1,527,692	(460,990)	790,290
Income tax expense (benefit)	(200,803)	949,589	(147,103)	470,656
Income (loss) before provision for income taxes	(1,685,454)	2,477,281	(608,093)	1,260,946
Interest income and other, net	(138,426)	(856,896)	(68,841)	(586,373)
Income (loss) from operations	(1,823,880)	1,620,385	(676,934)	674,573
Stock-based compensation	595,998	643,707	235,234	497,169
Amortization of acquired intangible assets	2,069,511	8,032,808	1,034,643	4,949,651
Operating income before amortization (OIBA)	\$ 841,629	\$ 10,296,900	\$ 592,943	\$ 6,121,393

Operating income before amortization increased 932%, from \$593,000 in the three months ended June 30, 2004 to \$6.1 million in the same period in 2005. The net increase in OIBA was primarily attributable to revenue increasing at a faster rate than service costs, sales and marketing, product development, and general and administrative expenses as a percentage of revenue, acquisition initiatives, and no similar cost in the 2005 related to acquisition-related retention consideration.

Operating income before amortization increased 1123%, from \$842,000 in the six months ended June 30, 2004 to \$10.3 million in the same period in 2005. This net increase in OIBA was primarily attributable to revenue increasing at a faster rate than service costs, sales and marketing, product development and general and administrative expenses as a percentage of revenue, acquisition initiatives, and no similar costs in the 2005 related to acquisition-related retention consideration and facility relocation costs.

The following is reconciliation from net cash provided by operating activities to the non-GAAP measure of EBITDA for the three months ended June 30, 2004 and 2005 and the six months ended June 30, 2004 and 2005.

	Six months ended June 30, 2004	Six months ended June 30, 2005	Three months ended June 30, 2004	Three months ended June 30, 2005
Net cash provided by operating activities	\$ (10,265)	\$ 6,401,034	\$ (1,072,359)	\$ 4,642,208
Changes in asset and liabilities, net of effects of acquisitions	1,768,313	5,754,412	2,094,325	2,868,681

Edgar Filing: MARCHEX INC - Form 10QSB

Provision for income taxes	(200,803)	949,589	(147,103)	470,656
Other items facility relocation	(193,931)	18,710	36,528	9,972
Interest income and other, net	(83,176)	(852,896)	(68,841)	(586,373)
Tax benefits from exercise of stock options	(101,092)	(328,093)	(101,092)	(198,319)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
EBITDA	\$ 1,179,046	\$ 11,942,756	\$ 741,458	\$ 7,206,825
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

EBITDA increased 872% from \$741,000 in the three months ended June 30, 2004 to \$7.2 million in the same period in 2005 and increased 913% from \$1.2 million in the six months ended June 30, 2004 to \$11.9 million in the same period in 2005.

Table of Contents

Liquidity and Capital Resources

On April 5, 2004, we completed our initial public offering of 4.6 million shares of Class B common stock. The proceeds received in the second quarter of fiscal year 2004 from the stock offering, net of cash offering expenses and underwriter discounts, were \$27.2 million. Net proceeds have been used to pay for product and business development, acquisitions and strategic relationships, capital expenditures, personnel, facilities, earn-out obligations, working capital and other general corporate purposes. From the effective date of our initial public offering through June 30, 2005, we have used the entire net proceeds as follows: approximately \$7.3 million of these proceeds to fund a portion of the Pike Street asset acquisition, approximately \$7.5 million to fund the acquisition of goClick, approximately \$3.5 million for the 2003 earn-out obligation relating to our acquisition of Enhance Interactive, and \$8.9 million for capital expenditures, personnel, facilities, 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 in connection with the closing of our initial public offering and are now included as components of stockholders' equity.

In February 2005, we closed a follow-on offering of 9,200,000 shares of Class B common stock at a public offering price of \$20.00 per share and 230,000 shares of 4.75% convertible exchangeable preferred stock at a public offering price of \$250 per share and with a liquidation preference of \$250 per share. These amounts include the exercise by our underwriters of their over-allotment option to purchase 1,200,000 additional shares of Class B common stock and 30,000 additional shares of preferred stock. The common stock and preferred stock proceeds, net of total offering costs of \$12.2 million, were estimated to be approximately \$174.1 million and \$55.3 million, respectively, for an aggregate amount of \$229.4 million. In addition to funding the acquisition of certain assets from Name Development, we used these proceeds to fund a portion of the Pike Street asset acquisition and intend to use the proceeds from the offering for working capital and other general corporate purposes, including for our recent acquisition of IndustryBrains and for future acquisitions.

Concurrent with the close of our offerings, we completed the acquisition of certain assets of Name Development, a corporation operating in the direct navigation market, for purchase consideration of \$164.4 million, including approximately \$155.6 million in cash and estimated acquisition costs and approximately 419,659 shares of our Class B common stock valued at \$20.99 per share (for accounting purposes) for an aggregate amount of approximately \$8.8 million.

As of June 30, 2005, we had cash and cash equivalents of \$71.3 million. As of June 30, 2005, we had operating lease contractual obligations of \$3.1 million of which \$2.3 million is for rent under our facility leases.

Cash provided by operating activities primarily consists of net income (loss) adjusted for certain non-cash items such as depreciation and amortization, tax benefit from stock options, facility relocation amounts, deferred income taxes and changes in working capital. Cash provided by operating activities for the six months ended June 30, 2005 of approximately \$6.4 million consisted primarily of net income of \$1.5 million adjusted for non-cash items of \$10.2 million, including depreciation, amortization of intangible assets, allowance for doubtful accounts and merchant advertiser credits, stock-based compensation, deferred income taxes and income tax benefit related to stock options, and approximately \$5.3 million used in working capital and other activities. Cash used by operating activities for the six months ended June 30, 2004 of approximately \$10,000 consisted primarily of a net loss of \$1.5 million adjusted for non-cash items of \$2.6 million, including depreciation and amortization of intangible assets, allowance for doubtful accounts and merchant advertiser credits, stock-based compensation, deferred income taxes, and income tax benefit related to stock options and approximately \$1.1 million used by working capital and other activities.

With respect to most of our pay-per-click advertising services, we receive payment prior to our delivery of related click-throughs. 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

Table of Contents

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 2004 and 2005 periods.

Nearly all of the feed management services and advertising services provider arrangements 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. For these services, 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 feed management services account for a greater percentage of our operating activity, working capital requirements will increase as a result.

Cash used in investing activities for the six months ended June 30, 2005, of approximately \$189.5 million was primarily attributable to the payment of the Name Development asset acquisition for approximately \$155.5 million, the payment of the Pike Street asset acquisition for approximately \$12.5 million, the 2004 Enhance Interactive earn-out consideration payment of \$5.7 million, purchases for Internet domain names or Web properties of approximately \$11.0 million, payment for a prepaid license of \$4.5 million and net purchases for property and equipment of \$650,000 offset by proceeds of \$330,000 from the sale of intangible assets. Cash used in investing activities for the six months ended June 30, 2004 of approximately \$3.7 million was primarily attributable to the 2003 Enhance earn-out consideration payment of approximately \$3.2 million and purchases of property and equipment of \$463,000.

As a result of our 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. 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 six months ended June 30, 2005 of approximately \$229.5 million was primarily attributable to net proceeds from the follow-on offering in February 2005 of approximately \$229.8 million, net proceeds of approximately \$428,000 from the sale of stock through employee stock options and employee stock purchase plan offset by preferred dividend payments of \$690,000. Cash provided by financing activities for the six months ended June 30, 2004 of approximately \$27.5 million was primarily attributable to net proceeds from our initial public offering.

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

For calendar years 2003 and 2004, the total aggregate Enhance Interactive contingent, earnings-based payment obligation was approximately \$3.5 million and \$6.2 million, respectively. These payment obligations include the earn-out consideration of approximately \$3.2 million and \$5.7 million and the retention-related consideration of approximately \$283,000 and \$499,000 for calendar years 2003 and 2004, respectively. The amounts for the calendar year 2003 were paid in April 2004. The amounts for the calendar year 2004 were paid in March 2005. Subsequent to December 31, 2004, no further obligation exists related to the Enhance Interactive earn-out and retention-related consideration.

For calendar year 2004, TrafficLeader did not achieve the performance-based conditions therefore no further contingent payment obligation remains.

Table of Contents

The following table summarizes our contractual obligations as of June 30, 2005, 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>
Contractual Obligations:				
Operating leases	\$ 2,345,857	\$ 411,070	\$ 1,050,795	\$ 883,992
Capital leases	70,805	8,166	32,664	29,976
Other contractual obligations	677,332	232,560	412,773	32,000
Total contractual obligations (1), (2), (3)	\$ 3,093,995	\$ 651,795	\$ 1,496,231	\$ 945,968

- (1) In February 2005 we entered into (i) a new master agreement with Overture with respect to our direct navigation business, and (ii) a license agreement with Overture with respect to certain of Overture's patents, including but not limited to U.S. Patent No. 6,269,361, pursuant to which we paid \$4.5 million (and an additional \$674,000 in certain circumstances), in an upfront payment and a contingent royalty based on a discounted rate of 3% (3.75% under certain circumstances) of certain of our gross revenues payable on a quarterly basis through December 2016. The upfront license fee has been capitalized and is being amortized ratably over 42 months. The royalty payment is recognized as incurred in service costs.
- (2) Under the terms of the preferred stock offering in February 2005, we have a quarterly dividend payment obligation. Dividends are cumulative and payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005 at an annual rate of \$11.875 per preferred share. Any dividends must be declared by our board of directors and must come from funds which are legally available for dividend payments. In April 2005, our board of directors declared a quarterly dividend in the amount of \$3.00 per share on our 4.75% convertible exchangeable preferred stock in accordance with the terms thereof was paid on May 16, 2005 to the holders of record as of the close of business on May 4, 2005. This quarterly dividend distribution totaled \$690,000. In July 2005, the our board of directors declared a quarterly dividend in the amount of \$2.97 per share on our 4.75% convertible exchangeable preferred stock which was paid on August 15, 2005 to the holders of record as of the close of business on August 4, 2005. This quarterly dividend totaled approximately \$683,000.
- (3) In connection with the acquisition of IndustryBrains, we assumed their office lease commitment that extends through 2010 for approximately \$1.0 million. This amount is not included in the above schedule as the acquisition closed on July 27, 2005.

In April 2005, we acquired certain assets of Pike Street Industries, an online yellow pages and lead generation provider for local merchants, for approximately \$12.8 million in cash and estimated acquisition costs, 242,748 shares of our Class B common stock and 212,404 shares of our restricted Class B common stock. The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued at (for accounting purposes) at an aggregate amount of approximately \$4.1 million. The shares of restricted Class B will vest over a three-year period in installments of 16.67% after each six month period. The shares of restricted Class B common stock were issued to employees of Pike Street Industries and valued at approximately \$3.6 million, which will be recorded as compensation expense over the associated employment period during which these shares vest.

In July 2005, we acquired IndustryBrains, a company focused on monetizing vertical and brand-name Web sites through contextual advertising solutions, for approximately \$15.6 million in cash, 788,046 shares of our Class B common stock and 176,909 shares of our restricted Class B common stock. The shares of Class B common stock, excluding the shares of restricted Class B common stock, were valued at (for accounting purposes) an aggregate amount of approximately \$13.4 million. The shares of restricted Class B will vest over a two-and-one half year period in installments of 33.34% after each ten month period during that term. The shares of restricted Class B common stock were issued to employee shareholders of IndustryBrains and valued at approximately \$3.0 million, which will be recorded as compensation expense over the associated employment period during which these shares vest. These amounts exclude estimated transaction costs.

From January through June 2005, we paid approximately \$11.0 million for the purchase of additional Internet domains or Web properties. We expect to continue acquiring Internet domains or Web properties in the normal course of business as we grow our presence in the field of direct navigation.

Table of Contents

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 offerings to fund acquisitions. Furthermore, we expect that capital expenditures may increase in future periods, particularly if our operating activity increases.

We will have an annual dividend payment obligation under the terms of the preferred stock of \$2.7 million. Dividends are cumulative and payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005 at an annual rate of \$11.875 per preferred share. Under Delaware law, dividends to stockholders may be made only from the surplus of a company, or, in certain situations, from the net profits for the current fiscal year before the dividend is declared by the board of directors. If we were to exchange the preferred stock for debentures, we would assume the principal and interest payment obligations under the terms of the debentures. Our ability to pay dividends under the preferred stock or to make payments of principal and interest under the debentures in the future will depend on our financial results, liquidity and financial condition.

On July 7, 2005, a Registration Statement on Form S-3 (File No. 333-125372) relating to the resale of 1,382,093 shares of our Class B common stock by certain selling shareholders with S-3 or piggyback registration rights granted principally in connection with our prior acquisitions was declared effective by the Securities and Exchange Commission. We are contractually required to use best efforts to keep this Registration Statement effective for approximately one year. We will not receive any proceeds in connection with these sales by selling stockholders.

Based on our operating plans we believe that the proceeds from our follow-on public offering, together with existing resources and cash flow provided by ongoing 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 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 consolidated financial statements have been prepared using 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, merchant advertiser and incentive program credits.

Table of Contents

Revenue

We currently generate revenue through our operating businesses by delivering performance-based and search marketing services to merchant advertisers and advertising service providers. The primary revenue driver has been performance-based advertising, which includes pay-per-click listings, feed management services, and cost-per-action services. For pay-per-click listing and feed management services, revenue is recognized upon our delivery of qualified and reported click-throughs to our merchant advertisers or advertising service providers' listing which occurs when an online user clicks on any of their advertisements after it has been placed by us or by our distribution partners. Each click-through on an advertisement listing represents a completed transaction. For cost-per-action services, revenue is recognized when the online user is redirected from the Company websites to an advertiser website and completes the specified action.

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 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. We also recognize revenue for certain agency contracts with merchant advertisers under the net revenue recognition method. Under these specific agreements, we purchase listings on behalf of merchant advertisers from search engines and directories. We are paid an agency fee based on the total amount of the purchase made on behalf of these merchant advertisers. Under these agreements, our merchant advertisers are primarily responsible for choosing the publisher and determining pricing, and the Company, in certain instances, is only financially liable to the publisher for the amount collected from our merchant advertisers. This creates a sequential liability for media purchases made on behalf of merchant advertisers.

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 Asset* (SFAS 144).

Goodwill 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. If the fair value is lower than the carrying value, a material impairment charge may be reported in our financial results. We exercise judgment in the assessment of the related useful lives of intangible assets, the fair values and the recoverability. In certain instances, the fair value is determined in part based on cash flow forecasts and discount rate estimates. 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 group may not be recoverable. Recoverability of assets held and used is measured by a comparison of the carrying amount of an asset group to estimated undiscounted future cash flows expected to be generated by the asset group. If such asset group is considered to be impaired, the impairment is to be recognized by the amount by

Table of Contents

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 2(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 recognized was derived based upon our determination of the fair value of our Class B common stock. We determined the fair value of our Class B common stock based upon factors, including our operating performance, issuance of our convertible preferred stock, liquidation preference 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. Recent changes to applicable accounting standards will require us to record the fair

Edgar Filing: MARCHEX INC - Form 10QSB

value of options as an expense for periods beginning after December 15, 2005. If we had estimated the fair value of options on the date of grant using a Black-Scholes

Table of Contents

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 2(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 and Incentive Program 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 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. Under the merchant advertiser incentive program, we grant merchant advertisers credits depending upon the individual amounts of prepayments made. The incentive program allowance is determined based on the historical rate of incentives earned and used by merchant advertisers compared to the related revenues recognized by us. Material differences may result in the amount and timing of our revenue for any period if our management made different judgments and estimates.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123-R, which replaces SFAS No. 123 and supersedes APB Opinion No. 25. As originally issued, SFAS No. 123 established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that pronouncement permitted entities to continue applying the intrinsic-value-based model of APB Opinion No. 25, provided that the financial statements disclosed the pro forma net income or loss based on the preferable fair-value method.

We are required to apply SFAS No. 123-R as of the interim reporting period that begins after December 15, 2005. Thus, our consolidated financial statements will reflect an expense for (a) all share-based compensation arrangements granted after January 1, 2006 and for any such arrangements that are modified, cancelled, or repurchased after that date, and (b) the portion of previous share-based awards for which the requisite service has not been rendered as of that date, based on the grant-date estimated fair value of those awards.

In May 2005, the FASB issued Statement No. 154, *Accounting Changes and Error Corrections*, a replacement of Accounting Principles Board Opinion No. 20, *Accounting Changes*, and Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements* (SFAS 154). The new statement changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, voluntary changes in accounting principles were generally required to be recognized by way of a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the statement does not change the transition provisions of any existing accounting pronouncements.

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. In February 2005 and April 2005, we completed the acquisitions of certain assets of Name Development and Pike Street Industries, respectively, and in July 2005 we completed the acquisition of IndustryBrains.

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 have largely incurred net losses since our inception, and we may incur net losses in the foreseeable future.

We had an accumulated deficit of \$3.8 million as of June 30, 2005. While we recently achieved profitability, we may not be able to sustain it. Our net expenses may increase based on the initiatives we undertake which for instance, may include increasing our sales and marketing activities, hiring additional personnel, additional costs of being a public company, and acquiring additional businesses. In addition, we will be required to expense the fair value of stock options granted and incur expense in connection with our employee stock purchase plans commencing January 1, 2006.

We are dependent on certain distribution partners, including Yahoo! and its subsidiaries, for distribution of our services, and we derive a significant portion of our total revenue through these distribution partners. A loss of distribution partners or a decrease in revenue from certain distribution partners could adversely affect our business. Yahoo! is also a significant customer.

A relatively small number of distribution partners currently deliver a significant percentage of traffic to our merchant listings. Yahoo! Search Marketing is our largest distribution partner and delivers traffic to our merchant listings which collectively represents approximately 12% of our total revenue for the six months ended June 30, 2005. Separately, Yahoo! Search Marketing was responsible for 20% of our total revenue during the same period principally in respect of the revenues associated with our portfolio of domains.

Our existing agreements with many of our larger distribution partners permit either company to terminate without penalty on short notice 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 larger distribution partners, but there are no guarantees that these relationships will remain in place over the short- or long-term. 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

Edgar Filing: MARCHEX INC - Form 10QSB

partner could have a material adverse effect on our business, financial condition and results of operations.

Companies distributing advertising on the Internet have experienced, and will likely continue to experience, consolidation. This consolidation has reduced the number of partners that control the online advertising outlets with the most user traffic. According to the comScore Media Metrix qSearch report for December 2004, Yahoo! Search accounted for 32% of the online searches in the United States and Google accounted for 35%. 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. In addition, many participants in the performance-

Table of Contents

based advertising and search marketing industries control 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 third-party distribution network to deliver their services. This gives these companies a significant advantage over us in delivering their services, and with a lesser degree of risk.

We may incur liabilities for the activities of our merchant advertisers, distribution partners and other users of our services, which could adversely affect our business.

Many of our advertisement generation and distribution processes are automated. In most cases, merchant advertisers use our online tools and account management systems to create and submit merchant listings. These merchant listings are submitted in a bulk data feed to our distribution partners. Although we monitor our distribution partners on an ongoing basis primarily for traffic quality, these partners control the distribution of the merchant listings provided in the data feed.

As a result, we do not conduct a manual editorial review of a substantial number of our merchant listings, nor do we manually review the display of the vast majority of the merchant listings by our distribution partners. We may not successfully avoid liability for unlawful activities carried out by our merchant advertisers and other users of our services or unpermitted uses of our merchant listings by distribution partners and their affiliates.

Our potential liability for unlawful activities of our merchant advertisers and other 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. For example, as a result of the actions of merchant advertisers in our network, we may be subject to civil claims relating to a wide variety of issues, such as privacy, gambling, promotions, and intellectual property ownership and infringement. Under agreements with certain of our larger distribution partners, we may be required to indemnify these distribution 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.

We have a large number of distribution partners who display our merchant listings on their networks. Our merchant listings are predominantly delivered to our distribution partners in an automated fashion through an XML data feed or data dump. Our distribution partners are required contractually to use the merchant listings that we provide in accordance with applicable law and regulation and in conformity with our publication restrictions included in our agreements, which are intended to promote the quality and validity of the traffic provided to our merchant advertisers. Nonetheless, we do not operationally control or manage these distribution partners and any breach of these agreements on the part of any distribution partner or its affiliates could result in liability for our business. These agreements include indemnification obligations on the part of our distribution partners, but there is no assurance that we would be able to collect against offending distribution partners or their affiliates in the event of a claim under these indemnification provisions.

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.

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

Table of Contents

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 does not continue to 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.

We are dependent upon the quality of traffic in our network to provide value to our merchant advertisers, and any failure in our quality control could have a material adverse effect on the value of our services to our merchant advertisers.

We utilize certain monitoring processes with respect to the quality of the traffic that we deliver to our merchant advertisers. Among the factors we seek to review are 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. Additionally, we also seek to identify other indicators which may suggest that a user may not be targeted by or desirable to our merchant advertisers. Even with such monitoring in place, there is a risk that a certain amount of low-quality traffic or traffic that is deemed to be less valuable by our merchant advertisers will be delivered to such merchant advertisers, which, if not contained, may be detrimental to those relationships. Low-quality traffic 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, including claims of trademark infringement in connection with an acquisition of previously-owned Internet domain names, that would be costly to defend and could limit our ability to use certain critical technologies.

Any patent or other intellectual property 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, services and property 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 may need additional funding to meet our obligations and to pursue our business strategy. Additional funding may not be available to us and our financial condition could therefore be adversely affected.

We may require additional funding to meet our ongoing obligations and to pursue our business strategy, which may include the selective acquisition of businesses and technologies. In addition, we have incurred and we may incur certain obligations in the future, including:

We were required to make performance payments of approximately \$6.2 million based on 2004 earnings to the original shareholders and certain employees of eFamily and its wholly-owned subsidiary, Enhance Interactive, which we acquired in February 2003.

Edgar Filing: MARCHEX INC - Form 10QSB

We recently entered into agreements with Overture, pursuant to which we paid \$4.5 million in an upfront payment (and an additional \$674,000 in certain circumstances) and a contingent royalty based on 3.0% (3.75% under certain circumstances) of certain of our gross revenues payable on a quarterly basis through December 2016.

Table of Contents

We are obligated to pay quarterly dividends to the holders of preferred stock at an annual rate of \$11.875 per preferred share. Based on 230,000 outstanding shares of preferred stock issued as part of the preferred stock offering in February 2005, the annual dividend obligation would be \$2.7 million.

If debentures are issued upon exchange of the preferred stock, we will become obligated to make interest payments to the holders of the debentures.

There can be no assurance that if we were to need additional funds to meet these obligations that additional financing arrangements would be available in amounts or on terms acceptable to us, if at all. Furthermore, 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 potential additional acquisitions or internally-developed businesses.

Our acquisitions could divert management's attention, cause ownership dilution to our stockholders, cause our earnings to decrease and be difficult to integrate.

Our business strategy includes identifying, structuring, completing and integrating acquisitions. Acquisitions 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 to meet our objectives which include revenue growth, profitability and competitive market share. Our acquired companies may have histories of net losses and may expect net losses for the foreseeable future.

Acquisitions are accompanied by a number of risks that could harm 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 could be diverted from our ongoing business concerns;

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

We may issue shares of our Class B common stock as consideration for acquisitions which may result in ownership dilution to our stockholders;

We could fail to successfully integrate our financial and management controls, technology, reporting systems and procedures, or adequately expand, train and manage our workforce;

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

We could become subject to unknown or underestimated liabilities of an acquired entity or incur unexpected expenses or losses from such acquisitions;

Edgar Filing: MARCHEX INC - Form 10QSB

We could incur possible impairment charges related to goodwill or other intangible assets or other unanticipated events or circumstances, any of which could harm our business; and

We may be exposed to investigations and/or audits by federal, state or other taxing authorities.

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 executive officers, could harm our current and future operations and prospects.

We are heavily dependent upon the continued services of Russell C. Horowitz, our chairman and chief executive officer, and John Keister, our president and chief operating officer, and the other members of our

Table of Contents

senior management team. Each member of our senior management team is an at-will employee and may voluntarily terminate his employment with us at any time with minimal notice. Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founding executive officers, each own shares of fully vested Class A common stock. Following any termination of employment, each of these employees would only be subject to a twelve-month non-competition and non-solicitation obligation with respect to our clients and customers under our standard confidentiality agreement.

Further, as of June 30, 2005, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister together controlled 90% of the combined voting power of our outstanding capital stock excluding shares of Class B common stock issuable upon conversion of preferred 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 executive officers, for any reason, or any conflict among our founding executive 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 our other personnel. There can be 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 that 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.

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 our ability to maintain the listing of our Class B common stock and preferred stock on the Nasdaq National Market.

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,

Edgar Filing: MARCHEX INC - Form 10QSB

including, but not limited to, certifications from executive officers and requirements for financial experts on boards 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 Stock Market.

Table of Contents

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 listing of our shares of Class B common stock and preferred stock on the Nasdaq National Market could be adversely affected.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud, which could harm our brand and operating results.

Effective internal controls are necessary for us to provide reliable and accurate financial reports and effectively prevent fraud. We have devoted significant resources and time to comply with the new internal control over financial reporting requirements of the Sarbanes-Oxley Act of 2002. In addition, Section 404 under the Sarbanes-Oxley Act of 2002 requires that we assess and our auditors attest to the design and operating effectiveness of our controls over financial reporting. Our compliance with the annual internal control report requirement for our first fiscal year ending on or after July 15, 2006, the requisite SEC compliance date, will depend on the effectiveness of our financial reporting and data systems and controls across our operating subsidiaries. We expect these systems and controls to become increasingly complex to the extent that we integrate acquisitions and our business grows. To effectively manage this growth, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. We cannot be certain that these measures will ensure that we design, implement and maintain adequate controls over our financial processes and reporting in the future. Any failure to implement required new or improved controls, or difficulties encountered in their implementation or operation, could harm our operating results or cause us to fail to meet our financial reporting obligations. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock and our access to capital.

Recently adopted changes in accounting rules and regulations, such as expensing of stock options and shares issued through employee stock purchase plans, will result in unfavorable accounting charges and may require us to change our compensation policies.

Accounting methods and policies regarding expensing stock options are subject to review, interpretation and guidance from relevant accounting authorities, including the Financial Accounting Standards Board, or FASB. For example, while we currently are not required to record stock-based compensation charges if an employee's stock option exercise price equals or exceeds the fair value of our common stock at the date of grant, recently adopted FASB and SEC standards will require us to expense the fair value of stock options granted commencing January 1, 2006. In addition, under such rules, we will also incur an expense in connection with our employee stock purchase plans commencing January 1, 2006. We rely heavily on stock options to compensate existing employees and attract new employees. In light of these new requirements to expense stock options and shares issued under employee stock purchase plans, we may choose to reduce our reliance on these as compensation tools. If we reduce our use of stock options and the employee stock purchase plan, it may be more difficult for us to attract and retain qualified employees and we may need to compensate our employees with greater amounts of cash or other incentives. If we do not reduce our reliance on stock options and the employee stock purchase plan, our reported losses will increase. Further changes to interpretations of accounting methods or policies in the future may require us to adversely revise how our financial statements are prepared.

Impairment of goodwill and other intangible assets would result in a decrease in earnings.

Current accounting rules require that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. These rules also require that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment whenever events or changes in circumstances indicate

Table of Contents

that the carrying amount of an asset may not be recoverable. 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.

We have substantial goodwill and other intangible assets, and we may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined. Any impairment charges or changes to the estimated amortization periods could have a material adverse effect on our financial results.

We may not be able to realize the intended and anticipated benefits from our acquisitions of Internet domain names, which could affect the value of these acquisitions to our business and our ability to meet our financial obligations and targets.

We may not be able to realize the intended and anticipated benefits that we currently expect from our acquisitions of Internet domain names. These intended and anticipated benefits include increasing our cash flow from operations, broadening our distribution offerings and delivering services that strengthen our merchant relationships.

Factors that could affect our ability to achieve these benefits include:

A significant amount of revenue attributed to our domain name assets comes through our agreement with Yahoo! and its subsidiaries. Under our agreement, Yahoo! has certain limited exclusive and preferential rights with respect to the commercialization of these domain names and Web properties through paid listings. Yahoo! controls the delivery of a portion of the paid listings to these domain names and Web properties. As a result, the monetization of these properties will initially be largely dependent on the revenue from the paid listings allocated by Yahoo! and its subsidiaries to these properties. This allocation may depend on Yahoo!'s advertiser base, internal policies in effect from time to time, perceived quality of traffic, origin of traffic, history of performance and conversion, technical and network changes made by Yahoo!, among many factors and determinations which may or may not be controlled by us or known to us.

We will need to continue to acquire commercially valuable Internet domain names to grow our presence in the field of direct navigation. We will need to continuously improve our technologies to acquire valuable Internet domain names as competition in the marketplace for appropriate Internet domain names intensifies. Our domain name acquisition efforts are subject to rules and guidelines established by registries which maintain Internet domain name registrations and the registrars which process and facilitate Internet domain name registrations. The registries and registrars may change the rules and guidelines for acquiring Internet domains in ways that may prove detrimental to our domain acquisition efforts.

The business of direct navigation is dependent on current technologies and user practices. If browser or search technologies were to change significantly, the practice of direct navigation may be altered to our disadvantage.

Some of our existing distribution partners may perceive direct navigation as a competitive threat and therefore may decide to terminate their agreements with us because of our recent acquisitions of a substantial number of Internet domain names.

We intend to apply our technology and expertise to geography-specific Web properties that we believe are under-commercialized and not yet mature from a monetization perspective. However, if the current disparities in traffic and monetization of such search terms do not narrow in a favorable way, we may expend significant company resources on business efforts that do not realize the results we

anticipate.

If the acquired assets are not integrated into our business as we anticipate, we may not be able to achieve these benefits or realize the value paid for the asset acquisitions, which could materially harm our business, financial condition and results of operations.

Table of Contents

We may experience unforeseen liabilities in connection with our acquisitions of Internet domain names, which could negatively impact our financial results.

The Name Development and Pike Street asset acquisitions involve the acquisition of a large number of previously-owned Internet domain names. Furthermore, we have separately acquired and intend to continue to acquire in the future additional previously-owned Internet domain names. In some cases, these acquired names may have trademark significance that is not readily apparent to us or is not identified by us in the bulk purchasing process. As a result we may face demands by third party trademark owners asserting infringement or dilution of their rights and seeking transfer of acquired Internet domain names under the Uniform Domain Name Dispute Resolution Policy administered by ICANN or actions under the U.S. Anti-Cybersquatting Consumer Protection Act.

We intend to review each claim or demand which may arise from time to time on its merits on a case-by-case basis with the assistance of counsel and we intend to transfer any rights acquired by us to any party that has demonstrated a valid prior right or claim. We cannot, however, guarantee that we will be able to resolve these disputes without litigation. The potential violation of third party intellectual property rights and potential causes of action under consumer protection laws may subject us to unforeseen liabilities including injunctions and judgments for money damages.

Regulation could reduce the value of the Internet domain names acquired or negatively impact the Internet domain acquisition process, which could significantly impair the value attributable to our acquisitions of Internet domain names.

The Name Development business includes the registrations of thousands of Internet domain names both in the United States and internationally. Name Development acquired previously-owned Internet domain names that have expired and have been offered for sale by Internet domain name registrars following the period of permitted reclamation by their prior owners. Furthermore, we have separately acquired and intend to continue to acquire in the future additional previously-owned Internet domain names, including in connection with the Pike Street asset acquisition.

The acquisition of Internet domain names generally is governed by regulatory bodies. The regulation of Internet domain names in the United States and in foreign countries is subject to change. Regulatory bodies could establish additional requirements for previously-owned Internet domain names or modify the requirements for holding Internet domain names. As a result, we might not acquire or maintain names that contribute to our financial results in the same manner as reflected in the historical financial results of Name Development and Pike Street. Because certain Internet domain names are important assets, a failure to acquire or maintain such Internet domain names could adversely affect our financial results and our growth. Any impairment in the value of these important assets could cause our stock price to decline.

Risks Relating to Our Business and 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 which offer services in five main areas:

Edgar Filing: MARCHEX INC - Form 10QSB

sales to merchant advertisers of pay-per-click services;

sales to merchant advertisers of feed management services;

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

Table of Contents

delivery of online advertising to end users or customers of merchants through 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.

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 Miva (formerly known as FindWhat.com), Google, Microsoft and Yahoo! Many of these actual or perceived competitors also currently or may in the future have business relationships with us, particularly in distribution. Going forward, however, these companies may terminate their relationships with us. Furthermore, our competitors may be able to secure agreements with us on 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.

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;

better geographic coverage;

larger customer bases;

greater brand recognition; and

significantly greater financial, marketing and other resources.

Edgar Filing: MARCHEX INC - Form 10QSB

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.

Table of Contents

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;

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.

Edgar Filing: MARCHEX INC - Form 10QSB

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.

We rely upon third party colocation providers to host our main servers. If 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

Table of Contents

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 two non-provisional patent applications based on the two filed provisional applications in the United States and via the Patent Cooperation Treaty designating all member countries. In the future, additional patents may be filed 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.

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 and the trading price of our preferred stock.

Table of Contents

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 securities.

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 securities.

We are susceptible to general economic conditions, and a downturn 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.

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.

Edgar Filing: MARCHEX INC - Form 10QSB

In particular, concerns over the security of transactions conducted on the Internet and the privacy of users, including the risk of identity theft, 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 and negatively impact our standing with applicable credit card authorization agencies. 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.

Table of Contents

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.

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 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 impose limitations and penalties on the transmission of unsolicited commercial electronic mail via the Internet.

The Electronic Communications Privacy Act is intended to protect the privacy of e-mail and other electronic communications.

Courts may apply each of 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. Among the types of legislation currently being considered at the federal and state levels are consumer laws regulating the practices for software applications or downloads and the use of cookies and these laws may introduce requirements for user consent and other restrictions. These proposed laws are intended to target applications often referred to as spyware, invasiveware or adware, although the scope may also include some software applications currently used in the online advertising industry to serve and distribute advertisements.

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 courts could find strict liability or impose "know your customer" standards of conduct in some circumstances. Although we may not be directly involved in any of these practices, under current and future regulation we may ultimately be held responsible for the actions of our merchant advertisers or distribution partners.

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.

Table of Contents

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 addition, we may be required to pay additional income, sales, or other taxes.

On November 19, 2004, the federal government passed legislation placing a three-year ban on state and local governments' imposition of new taxes on Internet access or electronic commerce transactions. Unless the ban is extended, state and local governments may begin to levy additional taxes on Internet access and electronic commerce transactions upon the legislation's expiration in November 2007. An increase in 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. Additionally, from time to time, various state, federal and other jurisdictional tax authorities undertake reviews of the Company and the Company's filings. In evaluating the exposure associated with various tax filing positions, the Company on occasion accrues charges for probable exposures. We cannot predict the outcome of any of these reviews.

Risks Relating to our Common Stock and Preferred Stock

Our Class B common stock and preferred stock prices have been and are likely to continue to be highly volatile.

The trading prices of our Class B common stock and preferred stock have been and are likely to continue to be highly volatile and subject to wide fluctuations. Since our initial public offering, the closing sale price of our Class B common stock on the Nasdaq National Market ranged from \$8.56 to \$24.71 per share through June 30, 2005. Since our February 2005 follow-on offering, the closing price of our preferred stock on the Nasdaq National Market ranged from \$164.00 to \$267.00 per share through June 30, 2005. Our stock prices may fluctuate in response to a number of events and factors, which may be the result of our business strategy or events beyond our control, including:

Edgar Filing: MARCHEX INC - Form 10QSB

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;

Table of Contents

actual or anticipated fluctuations in our operating results;

developments concerning our various strategic collaborations;

lawsuits initiated against us or lawsuits initiated by us;

announcements of acquisitions or technical innovations;

potential loss or reduced contributions from distribution partners or merchant advertisers;

changes in earnings estimates or recommendations by analysts;

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 and preferred 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 and preferred stock will be sustained.

Because our shares of the preferred stock are convertible into shares of Class B common stock, volatility or depressed prices for our Class B common stock could have a similar effect on the value of the preferred stock. Holders who receive Class B common stock upon conversion also will be subject to the risk of volatility and depressed prices of our Class B common stock.

If we, or our existing stockholders, sell additional shares of our Class B common stock, the market price of our Class B common stock and therefore our preferred stock could decline.

We have a substantial number of shares of Class B common stock that are eligible for resale, including:

Upon completion of our recent common stock and preferred stock offerings, we had 22,711,461 shares of Class B common stock outstanding.

Edgar Filing: MARCHEX INC - Form 10QSB

As of June 30, 2005, we had issued options for 4,879,570 shares of Class B common stock. We have also issued shares in connection with our initial financing and our prior acquisitions, of which 20,279,063 are eligible for resale under Rule 144.

As of June 30, 2005, we had 101,270,904 shares of authorized but unissued shares of our Class B common stock that are available for future sale.

Approximately 11,987,500 of our shares of Class A common stock and 8,171,563 of our shares of Class B common stock are subject to piggyback registration rights. 964,955 shares of our Class B common stock issued as part of the consideration for the Industry Brains acquisition are subject to future registration on Form S-3 on a best efforts basis. We also may enter into additional registration rights agreements in the future in connection with any subsequent acquisitions we may undertake. Any sales of our common stock under these registration rights arrangements with these stockholders could be negatively perceived in the trading markets and negatively affect the price of our common stock.

On July 7, 2005, a Registration Statement on Form S-3 (File No. 333-125372) relating to the resale of 1,382,093 shares of our Class B common stock by certain selling shareholders with S-3 or piggyback registration rights granted principally in connection with our prior acquisitions was declared effective by the Securities and Exchange Commission. We are contractually required to use best efforts to keep this Registration Statement effective for approximately one year.

The market price of our Class B common stock and our preferred stock as well could decline as a result of sales of a large number of shares of our Class B common stock in the market, or the perception that such sales could occur. These sales, or the possibility that these sales may occur, could make it more difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate.

Table of Contents

Our founding executive 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.

As of June 30, 2005, Russell C. Horowitz, Ethan A. Caldwell, Peter Christothoulou and John Keister, our founding executive officers, beneficially owned 96% of the outstanding shares of our Class A common stock, which shares represented 89% of the combined voting power of all outstanding shares of our capital stock. These founding executive officers together control 90% of the combined voting power of all outstanding shares of our capital stock excluding shares of Class B common stock issuable upon conversion of the preferred stock. 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 these founding executive 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 these founding executive officers have a controlling interest, they will continue to be able to elect all or a majority of our board of directors and generally be able to determine the outcome of all corporate actions requiring stockholder approval. As a result, these founding executive officers will be in a position to continue to control all fundamental matters affecting our company, including any merger involving, sale of substantially all of the assets of, or change in control of, our company. The ability of these founding executive officers to control our company may result in our Class B common stock trading at a price lower than the price at which it would trade if these founding executive 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:

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. The application of Section 203 of the Delaware General Corporation Law could have the effect of delaying or preventing a change of control of our company.

Conversion of our convertible preferred stock will dilute the interests of our existing Class B common stockholders.

The conversion of some or all of the preferred stock will dilute the interests of our existing Class B common stockholders. Sales in the public market of shares of Class B common stock issued upon conversion would apply

Table of Contents

downward pressure on the prevailing market price. In addition, the mere issuance of the preferred stock represents a future issuance, and perhaps a future sale, of our Class B common stock to be acquired upon conversion, which could depress trading prices for our Class B common stock.

We anticipate that we will retain our future earnings except for the payment of dividends on the preferred stock, 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 and to make periodic installments of the dividend on the preferred stock. 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.

We may not be able to pay dividends on the preferred stock, which could impair its value.

Under Delaware law, dividends to stockholders may be made only from the surplus of a company, or, in certain situations, from the net profits for the current fiscal year or the fiscal year before which the dividend is declared. Our ability to pay dividends in the future will depend on our financial results, liquidity and financial condition. We can not be sure that we will have the surplus or profits to make periodic dividend payments, and we can not be sure that we will be able to pay the periodic installments of the dividend on the preferred stock.

The market price of the preferred stock may decline.

If an active trading market does not develop, the market price and liquidity of the preferred stock will be adversely affected. Even if an active trading market for the preferred stock were to develop, the preferred stock could trade for less than the public offering price, depending on many factors, including prevailing interest rates, our operating results and the markets for similar securities, and such active trading market could cease to continue at any time. In addition, if the preferred stock is exchanged for debentures, we are not obligated to list the debentures and cannot assure you that a market for the debentures will develop.

There may be tax consequences to the holders if we exchange preferred stock for debentures.

An exchange of the preferred stock for debentures will be a taxable event for federal income tax purposes which may result in tax liability to the holders without any corresponding receipt of cash by the holder. Such an exchange may be taxable as a dividend distribution to the extent of our current and accumulated earnings and profits, and may be subject to withholding tax if the exchanging stockholder is a Non-U.S. Holder.

Our current and future payment obligations or indebtedness will have priority over a preferred stock liquidation preference and accrued dividend payment obligation in the event of our liquidation, dissolution or winding-up.

Edgar Filing: MARCHEX INC - Form 10QSB

The terms of the preferred stock do not contain any financial or operating covenants that would prohibit or limit us or our subsidiaries from incurring indebtedness or other liabilities, pledging assets to secure such indebtedness and liabilities, paying dividends, or issuing securities or repurchasing securities issued by us or any of our subsidiaries. The incurrence of indebtedness by us or our subsidiaries and, in particular, the granting of a security interest to secure the indebtedness could adversely affect our ability to pay accrued dividends under the terms of the preferred stock.

If we incur indebtedness, the holders of that debt will have prior rights with respect to any proceeds distributed in connection with any insolvency, liquidation, reorganization, dissolution or other winding-up of us. This may have the effect of reducing the amount of proceeds in connection with any insolvency, liquidation, reorganization or other winding-up of us paid to holders of the preferred stock.

Table of Contents

The rights of holders of the Class B common stock will be junior to the rights of holders of the preferred stock in the event of our liquidation, dissolution or winding-up.

The terms of the preferred stock provide that holders will receive a preference over the other equity securities of the company upon its liquidation, dissolution or winding-up. This liquidation preference is equal to \$250 per share of preferred stock plus all accrued and unpaid dividends through the distribution date. These rights of payment are senior to the liquidation rights of the holders of the Class B common stock. This may have the effect of reducing the amount of proceeds in connection with any insolvency, liquidation, reorganization or other winding-up of us paid to holders of the Class B common stock.

Item 3. Controls and Procedures.

(a) Evaluation of Disclosure 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.

(b) Changes in Internal Controls. There was no significant change in our internal controls 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 controls over financial reporting.

(c) Limitations on Effectiveness of Controls. 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.

Part II Other Information

Item 1. Legal Proceedings.

Not applicable with respect to the current reporting period.

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

Edgar Filing: MARCHEX INC - Form 10QSB

We issued the following securities, none of which have been registered under the Securities Act of 1933, as amended (the Act) during the second quarter of 2005:

1. Certain warrants issued to the underwriters or their designees as compensation in connection with our initial public offering in April of 2004 were exercised for shares of stock via cashless exercise resulting in the issuance of an aggregate of 43,841 shares of our Class B common stock. No underwriters were involved in these warrant exercises. Such sales and issuances of stock were made in reliance upon an exemption from the registration provisions of the Act set forth in Section 4(2) and Rule 506 of Regulation D thereof relative to the sale by an issuer not involving a public offering or the rules and regulations thereunder.

All other unregistered sales of shares of our Class B common stock during the second quarter of 2005 were disclosed in previous current reports on Form 8-K. In addition, we did not repurchase any of our equity securities during the second quarter of 2005.

Table of Contents

On March 30, 2004, our registration statement on Form SB-2 (No. 333-111096) was declared effective by the SEC, 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 offering generated gross offering proceeds of approximately \$29.9 million. The closing of the offering and the exercise in full of the underwriters' 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 offering, 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 initial public offering, after deducting the foregoing expenses, were approximately \$27.2 million. From the effective date of our initial public offering through June 30, 2005, we have used the entire net proceeds as follows: approximately \$7.3 to fund a portion of the Pike Street asset acquisition, approximately \$7.5 million to fund the goClick acquisition, approximately \$3.5 million for the 2003 earn-out obligation relating to the Enhance Interactive acquisition, and \$8.9 million for capital expenditures, personnel, facilities, working capital and other general corporate purposes.

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.

On May 19, 2005, the Company held its Annual Meeting of Stockholders. At the meeting, the stockholders elected as directors Russell C. Horowitz (with shares representing 319,071,338 votes voting for and 97,301 votes withheld), John Keister (with shares representing 319,070,019 votes voting for and 98,620 votes withheld), Dennis Cline (with shares representing 318,625,477 votes voting for and 543,162 votes withheld), Jonathan Fram (with shares representing 316,899,688 votes voting for and 2,268,951 votes withheld) and Rick Thompson (with shares representing 318,627,477 votes voting for and 541,162 votes withheld).

The stockholders also ratified the appointment of KPMG LLP as the independent registered public accounting firm for the Company for the fiscal year ending December 31, 2005 (with shares representing 319,030,278 votes voting for, 96,477 votes against and 41,884 votes abstaining).

Item 5. Other Information.

Not applicable with respect to the current reporting period.

Item 6. Exhibits.

Exhibits:

- 2.5(1) Asset Purchase Agreement, dated as of April 26, 2005, by and among Marchex, Inc., Pike Street Industries, Inc. and the stockholders of Pike Street Industries, Inc.
- 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).

Edgar Filing: MARCHEX INC - Form 10QSB

- 32.1 Certification of CEO pursuant to Section 1350.
 - 32.2 Certification of CFO pursuant to Section 1350.
-

- (1) Incorporated by reference to the Registrant's Current Report on Form 8-K dated April 26, 2005 and filed with the Securities and Exchange Commission on May 2, 2005.

Table of Contents

SIGNATURE

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MARCHEX, INC.

By: /s/ MICHAEL A. ARENDS
Name: **Michael A. Arends**
Title: **Chief Financial Officer**

(principal accounting officer)

August 15, 2005