

MARCHEX INC
Form 10-Q
November 09, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

or

.. **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 Registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

413 Pine Street, Suite 500

Seattle, Washington 98101

35-2194038
(I.R.S. Employer

Identification No.)

Edgar Filing: MARCHEX INC - Form 10-Q

(Address of principal executive offices)

Registrant's telephone number, including area code: (206) 331-3300

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

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

Class	Outstanding at November 7, 2006
Class A common stock, par value \$.01	11,659,216
Class B common stock, par value \$.01	27,469,825

Table of Contents

Marchex, Inc.

Form 10-Q

Table of Contents

	Page
<u>Part I Financial Information</u>	
Item 1. <u>Financial Statements (unaudited)</u>	
<u>Condensed Consolidated Balance Sheets December 31, 2005 and September 30, 2006</u>	3
<u>Condensed Consolidated Statements of Operations Three and Nine Months Ended September 30, 2005 and 2006</u>	4
<u>Condensed Consolidated Statements of Cash Flows Nine Months Ended September 30, 2005 and 2006</u>	5
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	48
Item 4. <u>Controls and Procedures</u>	49
<u>Part II Other Information</u>	
Item 1. <u>Legal Proceedings</u>	50
Item 1A. <u>Risk Factors</u>	50
Item 6. <u>Exhibits</u>	50
<u>SIGNATURES</u>	51

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

Condensed Consolidated Balance Sheets

(unaudited)

	December 31, 2005	September 30, 2006
Assets		
Current assets:		
Cash and cash equivalents	\$ 63,090,941	\$ 69,334,818
Accounts receivable, net	14,401,814	14,539,441
Prepaid expenses and other current assets	1,818,211	2,400,316
Refundable taxes	3,835,542	3,146,204
Deferred income tax assets	428,855	358,081
Total current assets	83,575,363	89,778,860
Property and equipment, net	3,402,262	7,331,859
Deferred income tax assets		2,121,944
Intangible and other assets, net	15,447,504	12,984,003
Goodwill	180,637,076	200,742,308
Intangible assets from acquisitions, net	51,346,944	42,127,241
Total assets	\$ 334,409,149	\$ 355,086,215
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 9,258,423	\$ 9,052,542
Accrued expenses and other current liabilities	1,755,970	2,149,649
Deferred revenue	2,291,374	2,491,013
Total current liabilities	13,305,767	13,693,204
Deferred income tax liabilities	397,481	
Other non-current liabilities	92,309	98,076
Total liabilities	13,795,557	13,791,280
Commitments and contingencies		
Stockholders equity:		
Convertible preferred stock	54,121,678	34,116,491
Class A common stock	119,282	119,217
Class B common stock	254,839	274,651
Additional paid-in capital	271,949,963	311,932,041
Deferred stock-based compensation	(3,042,016)	
Accumulated deficit	(2,790,154)	(5,147,465)
Total stockholders equity	320,613,592	341,294,935

Edgar Filing: MARCHEX INC - Form 10-Q

Total liabilities and stockholders equity	\$ 334,409,149	\$ 355,086,215
---	----------------	----------------

See accompanying notes to condensed consolidated financial statements.

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

Condensed Consolidated Statements of Operations

(unaudited)

	Nine months ended	September 30, 2006	Three months ended	September 30, 2006
	September 30, 2005	September 30, 2006	September 30, 2005	September 30, 2006
Revenue	\$ 65,191,682	\$ 95,153,161	\$ 25,627,677	\$ 32,326,116
Expenses:				
Service costs (1), (2)	34,822,513	45,056,393	13,280,344	15,184,125
Sales and marketing (1), (2)	6,382,121	17,236,349	3,197,809	5,962,465
Product development (1), (2)	3,252,001	7,470,331	1,038,257	2,689,912
General and administrative (1), (2)	4,841,571	10,364,929	1,870,984	3,109,209
Amortization of intangible assets from acquisitions (3)	13,224,507	15,343,966	5,191,699	5,309,102
Total operating expenses	62,522,713	95,471,968	24,579,093	32,254,813
Gain (loss) on sales and disposals of intangible assets, net		284,766		(68,513)
Income (loss) from operations	2,668,969	(34,041)	1,048,584	2,790
Other income (expense):				
Interest income	1,390,332	2,323,415	533,976	831,005
Interest expense	(5,393)	(6,280)	(1,933)	(1,841)
Other	4,000	(9,764)		(7,901)
Total other income	1,388,939	2,307,371	532,043	821,263
Income before provision for income taxes	4,057,908	2,273,330	1,580,627	824,053
Income tax expense	1,820,866	2,305,247	871,277	812,795
Income (loss) before cumulative effect of change in accounting principle	2,237,042	(31,917)	709,350	11,258
Cumulative effect of a change in accounting principle, net of tax		151,341		
Net income	2,237,042	119,424	709,350	11,258
Convertible preferred stock dividends and conversion payment	1,714,619	2,338,229	682,813	422,147
Net income (loss) applicable to common stockholders	\$ 522,423	\$ (2,218,805)	\$ 26,537	\$ (410,889)
Basic net income (loss) applicable to common stockholders	\$ 0.02	\$ (0.06)	\$ 0.00	\$ (0.01)
Diluted net income (loss) applicable to common stockholders	\$ 0.01	\$ (0.06)	\$ 0.00	\$ (0.01)
Shares used to calculate basic net income (loss) per share applicable to common stockholders	33,886,928	38,065,347	36,043,092	38,720,191
Shares used to calculate diluted net income (loss) per share applicable to common stockholders	36,188,819	38,065,347	38,144,506	38,720,191

Edgar Filing: MARCHEX INC - Form 10-Q

(1) Excludes amortization of intangible assets from acquisitions

(2) Includes stock-based compensation as follows:

Service costs	\$ 3,600	\$ 760,607	\$ (131,034)	\$ 268,654
Sales and marketing	753,414	2,836,843	437,983	845,594
Product development	22,755	2,446,530	(125,895)	884,156
General and administrative	421,896	4,113,376	376,904	1,210,301
 Total stock-based compensation	 \$ 1,201,665	 \$ 10,157,356	 \$ 557,958	 \$ 3,208,705

(3) Components of amortization of intangible assets from acquisitions:

Service costs	\$ 10,079,097	\$ 10,441,008	\$ 3,795,373	\$ 3,595,177
Sales and marketing	774,166	1,921,057	448,611	732,473
General and administrative	2,371,244	2,981,901	947,715	981,452
 Total amortization of intangible assets form acquisitions	 \$ 13,224,507	 \$ 15,343,966	 \$ 5,191,699	 \$ 5,309,102

See accompanying notes to condensed consolidated financial statements.

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

Condensed Consolidated Statements of Cash Flows

(unaudited)

	Nine months ended September 30, 2005	Nine months ended September 30, 2006
Cash flows from operating activities:		
Net income	\$ 2,237,042	\$ 119,424
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of a change in accounting principle		(151,341)
Amortization and depreciation	16,167,325	19,677,510
Facility relocation recoveries	(36,690)	(43,431)
Gain (loss) on sales of fixed assets	(4,000)	9,764
Gain on sales and disposals of intangible assets, net		(284,766)
Allowance for doubtful accounts and merchant advertiser credits	1,441,503	1,280,645
Stock-based compensation	1,201,665	10,157,356
Deferred income taxes	(2,238,696)	(2,473,582)
Income tax benefit related to stock options	798,162	
Excess tax benefit related to stock options		(2,025,351)
Change in certain assets and liabilities, net of acquisitions:		
Trade accounts receivable, net	(5,655,212)	(1,418,272)
Refundable taxes	(1,966,356)	2,798,658
Prepaid expenses, other current assets, and restricted cash	(1,400,541)	(916,447)
Accounts payable	(742,932)	(397,390)
Accrued expenses and other current liabilities	707,967	290,394
Deferred revenue	29,496	197,859
Acquisition-related retention consideration in earn-out liability	(501,769)	
Other non current liabilities	31,666	12,789
Net cash provided by operating activities	10,068,630	26,833,819
Cash flows from investing activities:		
Purchases of property and equipment	(1,456,883)	(5,010,864)
Cash paid, net of recoveries, for acquisitions and earn-outs	(189,282,667)	(17,875,318)
Proceeds from sales of property and equipment	4,000	2,170
Proceeds from sales of intangible assets	687,036	1,570,445
Increase in other non current assets	(16,591,145)	(674,238)
Net cash used in investing activities	(206,639,659)	(21,987,805)
Cash flows from financing activities:		
Capital lease obligation principal paid	(5,980)	(8,811)
Excess tax benefit related to stock options		2,025,351
Offering costs paid	(907,058)	
Preferred stock dividends and conversion payment	(1,373,100)	(2,476,735)
Proceeds from public offering, net of underwriter discounts	230,287,500	
Proceeds from exercises of stock options	630,778	1,802,168
Proceeds from employee stock purchase plan	175,744	55,890
Net cash provided by financing activities	228,807,884	1,397,863
Net increase in cash and cash equivalents	32,236,855	6,243,877

Edgar Filing: MARCHEX INC - Form 10-Q

Cash and cash equivalents at beginning of period	24,933,066	63,090,941
Cash and cash equivalents at end of period	\$ 57,169,921	\$ 69,334,818

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

Marchex, Inc. (the Company) was incorporated in the state of Delaware on January 17, 2003. The Company offers a platform of performance-based advertising and search marketing services which enable merchants to market and sell their products across multiple distribution channels, including search engines, product shopping engines, directories and selected Web sites. The Company also offers super-aggregators and publishers outsourced search marketing platforms, which are a combination of several of the Company's advertiser technology services, to allow them to sell search marketing packages directly to their customers.

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 rules and regulations of the Securities and Exchange Commission (SEC). 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 nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006, or for any other period. The balance sheet at December 31, 2005 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 condensed consolidated financial statements and notes should be read in conjunction with the Company's audited consolidated financial statements and accompanying notes included in the Annual Report on Form 10-KSB for the year ended December 31, 2005 filed with the SEC.

The condensed consolidated financial statements include the accounts of Marchex and its wholly-owned subsidiaries. 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.

The Company's condensed consolidated financial statements presented include the balance sheets as of December 31, 2005 and September 30, 2006, the consolidated statements of operations for the three and nine months ended September 30, 2005 and 2006, and the consolidated statements of cash flows for the nine months ended September 30, 2005 and 2006.

Certain reclassifications have been made to the prior year condensed consolidated financial statements to conform to the current year presentation.

Acquisitions

The Company has completed the following acquisitions since January 1, 2004 and has accounted for them as business combinations:

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

On February 14, 2005, the Company acquired substantially all of the assets of Name Development Ltd. (Name Development) including its portfolio of Internet domains and Web sites, revenue-generating contracts, technology and systems, for the operation of the Name Development direct navigation business.

Table of Contents

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.

On July 27, 2005, the Company acquired 100% of the outstanding stock of IndustryBrains, Inc. (IndustryBrains), a company focused on monetizing Web sites through contextual advertising solutions.

On May 1, 2006, the Company acquired certain assets of AreaConnect LLC (AreaConnect), a provider of local online traffic to Yellow and White Pages publishers.

On May 26, 2006, the Company acquired certain assets of Open List, Inc. (Open List), including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform.

(2) Significant Accounting Policies

The preparation of financial statements in conformity with generally accepted accounting principles (GAAP) in the United States 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, 2005 filed with the SEC.

Stock-based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123-R (SFAS 123R), *Share-Based Payment*, which replaced Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock issued to Employees*. The adoption of SFAS 123R had a material impact on the Company's consolidated financial statements. See Note 3 Stock-based Compensation Plans for further information regarding the Company's adoption of SFAS 123R, including pro forma disclosure for the prior period as if the Company recorded stock-based compensation expense on a fair value basis estimated in accordance with the pro forma provisions of SFAS 123.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to application of SFAS 123R. In accordance with SAB 107, the Company will no longer present stock-based compensation separately on the consolidated statements of operations but will present stock-based compensation in the same lines as compensation paid to the same individuals.

Recently Issued Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This pronouncement prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in the Company's tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning January 1, 2007. The Company is in the process of evaluating the effect of the adoption of FIN 48 will have on its financial statements.

Table of Contents

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 will be effective for the Company for the fiscal year ended December 31, 2006. The Company does not believe that the adoption of SAB 108 will have a material impact on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, which clarifies the definition of fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is in the process of evaluating the effect that SFAS 157 will have on its financial statements.

Revenues

The following table presents our revenues, by revenue source, for the periods presented:

	Nine months		Three months	
	ended	ended	ended	ended
	September 30, 2005	September 30, 2006	September 30, 2005	September 30, 2006
Proprietary Traffic Sources	\$ 16,789,402	\$ 34,637,969	\$ 7,762,225	\$ 12,261,956
Partner and Other Revenue Sources	48,402,280	60,515,192	17,865,452	20,064,160
Total Revenue	\$ 65,191,682	\$ 95,153,161	\$ 25,627,677	\$ 32,326,116

The Company's proprietary traffic revenues are generated from the Company's portfolio of owned Web sites which are monetized with pay-per-click and cost-per-action listings and graphical ad units that are relevant to the Web sites. When an online user navigates to one of the Company's owned and operated Web sites and clicks on a particular listing or completes the specified action, the Company receives a fee.

The Company's partner network revenues are primarily generated using third-party distribution networks to deliver the merchant advertisers listings. The distribution network includes search engines, shopping engines, directories, destination sites, Internet domains or Web sites, and other targeted Web-based content. The Company generates revenue upon delivery of qualified and reported click-throughs to the Company's merchant advertisers or to advertising services providers' listings. The Company pays a revenue share to the distribution partners to access their online user traffic. Other revenues include the Company's bid management services, natural search optimization services and outsourced search marketing platforms.

(3) Stock-based Compensation Plans**(a) Stock Option Plan and Issuance of Restricted Class B Common Stock**

In January 2003, the Company adopted a stock incentive plan (the Plan) pursuant to which the Plan's Administrative Committee, appointed by the Company's Board of Directors, may grant both stock options and restricted stock awards to employees, officers, non-employee directors, and consultants and such options may be designated as incentive or non-qualified stock options at the discretion of the Administrative Committee. The Plan authorizes grants of options to purchase up to 4,000,000 shares of authorized but unissued Class B common stock and provides for the total number of shares of Class B common stock for which options designated as incentive stock options may be granted shall not exceed 8,000,000 shares. Annual increases are to be added on the first day of each fiscal year beginning on January 1, 2004 equal to 5% of the outstanding common stock (including for this purpose any shares of common stock issuable upon conversion of any outstanding capital stock of the Company). As a result of this provision, the authorized number of shares available under this Plan

Table of Contents

was increased by 1,013,953 to 5,013,953 on January 1, 2004 and by 1,274,948 to 6,288,901 on January 1, 2005 and by 1,972,526 to 8,261,427 on January 1, 2006. The Company issues new shares and shares from treasury for shares delivered under the Plan and restricted stock grants. Generally, stock options have 10-year terms and vest 25% each year either annually or quarterly, over a 4 year period.

SFAS 123 established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. As originally issued, SFAS 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 25, provided that the financial statements disclosed the pro forma net income or loss based on the preferable fair-value method. Through December 31, 2005, the Company applied the intrinsic value-based method of accounting prescribed by APB 25 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 was recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price.

Through December 31, 2005, the Company recognized 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*.

In December 2004, the FASB issued SFAS 123R, which replaces SFAS 123 and supersedes APB 25. The Company began applying SFAS 123R as of January 1, 2006, using the modified prospective application method. As a result, the Company's consolidated financial statements 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 estimated in accordance with the pro forma provisions of SFAS 123. Under the modified prospective application method, our condensed consolidated financial statements for periods prior to the first quarter of 2006 have not been restated. Upon adoption of SFAS 123R, the Company recognized a one-time gain from the cumulative effect of a change in accounting principle, net of tax, of \$151,000 based on SFAS 123R's requirement to apply an estimated forfeiture rate to unvested awards. Previously, the Company had recorded forfeitures as incurred.

The Company will recognize stock-based compensation expense after adoption of SFAS 123R using the straight-line method for all stock awards issued after January 1, 2006, which results in the recognition of less stock-based compensation expense over at least the next several years compared to that which would have been recognized had the Company continued to use the accelerated method.

SFAS 123R requires that the deferred stock-based compensation on the Company's balance sheet on the date of adoption be netted against paid-in capital. The Company netted approximately \$3.0 million of deferred stock-based compensation against paid-in capital on the balance sheet upon adoption of SFAS 123R.

Prior to adoption of SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating inflows in the consolidated statements of cash flows, in accordance with the provisions of the Emerging Task Force (EITF) issue No. 00-15, *Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option*. SFAS 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis. This amount is shown as Excess tax benefit related to stock options on the consolidated statement of cash flows.

Table of Contents

The per share fair value of stock options granted during the three and nine months ended September 30, 2005 and 2006 was determined on the date of grant using the Black Scholes option-pricing model with the following assumptions:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Expected life (in years)	4.0	4.0	4.0	4.0
Risk-free interest rate	3.70%-4.18%	4.60%-5.12%	4.18%	4.60%
Expected volatility	58%-61%	54%-58%	58%	54%
Weighted average expected volatility	60%	57%	58%	54%
Expected dividend yield	0%	0%	0%	0%

For the three and nine months ended September 30, 2005 and 2006, the expected life of each award granted was determined based on historical experience with similar awards, giving consideration to contractual terms, vesting schedules and forfeitures. Expected volatility is based on historical volatility levels of the Company's Class B common stock and the expected volatility of companies in similar industries that have similar vesting and contractual terms. The risk free interest rate is based on the implied yield currently available on U.S. Treasury issues with terms approximately equal to the expected life. Since the Company has never paid any cash dividends on the Company's Class B common stock and does not anticipate paying any material cash dividends in the foreseeable future, the Company has used an expected dividend yield of zero.

Stock option activity during the period indicated is as follows:

	Options available for grant	Number of options outstanding	Weighted average exercise price of options outstanding	Weighted average remaining contractual term (in years)	Aggregate intrinsic value
Balance at December 31, 2005	96,009	5,414,932	\$ 9.79		
Increase to option pool January 1, 2006	1,972,526				
Granted equal to or above fair value	(1,052,927)	1,052,927	21.06		
Options exercised		(476,051)	3.79		
Options cancelled	668,271	(668,271)	14.03		
Options forfeited	19,677	(19,677)	9.64		
Balance at September 30, 2006	1,703,556	5,303,860	\$ 12.03	8.04	\$ 44,187,000
Options exercisable at September 30, 2006		1,923,574	\$ 6.22	7.10	\$ 26,554,000

Information related to stock option activity during the period indicated is as follows:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three Months ended September 30, 2005	Three Months ended September 30, 2006
Weighted average fair value of options granted	\$ 8.29	\$ 10.24	\$ 7.62	\$ 7.22
Intrinsic value of options exercised	\$ 1,467,000	\$ 7,636,000	\$ 320,000	\$ 693,000
Total fair value of options vested	\$ 2,275,000	\$ 4,468,000	\$ 586,000	\$ 1,545,000

At September 30, 2006, there was \$13.8 million of stock option compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted average period of 1.38 years.

Table of Contents

During the three and nine months ended September 30, 2006, gross proceeds recognized from the exercise of stock options was approximately \$250,000 and \$1,802,000, respectively. The tax benefit realized from the exercise of options during the three and nine months ended September 30, 2006 was approximately \$193,000 and \$2,173,000, respectively.

Restricted stock activity for the nine months ended September 30, 2006 is summarized as follows:

	Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2005	265,410	\$ 16.95
Granted	192,631	19.13
Vested	(76,671)	16.97
Unvested at September 30, 2006	381,370	\$ 18.05

Prior to 2006, the Company had issued restricted stock to employees for future services in connection with acquisitions. Through December 31, 2005, in accordance with the accelerated vesting methodology under FIN 28, the Company amortized the stock-based compensation related to the restricted stock awards as compensation expense over the associated employment periods over which the shares vest. The graded vesting schedules generally range from 2.5 to 3 years. For all awards granted prior to January 1, 2006, the Company will continue amortizing the stock-based compensation related to the unvested stock awards as compensation expense over the associated employment periods over which the shares vest in accordance with the accelerated vesting methodology under FIN 28. The Company issued 192,631 shares of restricted shares to employees for future services in connection with the acquisitions completed in 2006. The restricted shares issued in 2006 will be accounted for under SFAS 123R using the straight-line method net of estimated forfeitures.

As of September 30, 2006, there was \$3.8 million of total restricted stock compensation expense related to non-vested awards not yet recognized, which is expected to be recognized over a weighted average period of 1.17 years. There were no shares of restricted stock vested during the three months ended September 30, 2005 and 2006. The total fair value of restricted stock awards vested during the nine months ended September 30, 2005 and 2006 was \$122,000 and \$1.3 million, respectively. The Company realized a tax benefit during the three and nine months ended September 30, 2006 related to the vesting of restricted shares of approximately \$107,000. In October 2006, the compensation committee of the Company's board of directors resolved to approve effective January 1, 2007 grants to certain executives of 2.3 million shares of restricted Class B common stock which vest over a six year period. Stock-based compensation expense will be recognized over the vesting period when these grants are effected.

The following table summarizes stock-based compensation expense related to all stock-based awards under SFAS 123R:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three Months ended September 30, 2005	Three Months ended September 30, 2006
Stock-based compensation:				
Total stock-based compensation included in net income (loss)	\$ 1,202,000	\$ 10,154,000	\$ 558,000	\$ 3,205,000
Income tax benefit related to stock-based compensation included in net income (loss)	\$ 277,000	\$ 1,361,000	\$ 49,000	\$ 451,000

In accordance with the methodology described in SFAS 123R, \$63,000 and \$140,000 of stock-based compensation expense related to stock options was capitalized as part of internally developed software during the three and nine months ended September 30, 2006, respectively.

Table of Contents

The following table presents the impact of our adoption of SFAS 123R on selected line items from our condensed consolidated financial statements for the three and nine months ended September 30, 2006:

	Nine months		Three Months	
	ended	ended	ended	ended
	September 30, 2006 As reported	September 30, 2006 If reported	September 30, 2006 As reported	September 30, 2006 If reported
	under SFAS 123R	under APB 25	under SFAS 123R	under APB 25
Condensed consolidated statement of operations:				
Income (loss) from operations	\$ (34,041)	\$ 7,040,694	\$ 2,790	\$ 2,042,598
Income before provision for income taxes	\$ 2,273,330	\$ 9,348,065	\$ 824,053	\$ 2,863,861
Income (loss) before cumulative effect of a change in accounting principle	\$ (31,917)	\$ 6,145,826	\$ 11,258	\$ 1,810,879
Net income (loss) applicable to common shareholders	\$ (2,218,805)	\$ 3,807,597	\$ (410,889)	\$ 1,388,732
Net income (loss) per share applicable to common shareholders				
Basic	\$ (0.06)	\$ 0.10	\$ (0.01)	\$ 0.04
Diluted	\$ (0.06)	\$ 0.10	\$ (0.01)	\$ 0.03
Condensed consolidated statement of cash flows:				
Net cash provided by operating activities	\$ 26,833,818	\$ 28,859,169	\$ 11,152,292	\$ 11,344,943
Net cash provided (used) by financing activities	\$ 1,397,863	\$ (627,488)	\$ 170,381	\$ (22,270)

Prior to the adoption of SFAS 123R, the Company followed the intrinsic value method in accordance with APB 25 to account for stock-based compensation. The following table illustrates the effect on net income for the three and nine months ended September 30, 2005, if the fair-value-based method of SFAS 123 had been applied to all outstanding awards in the prior period.

	Nine months	
	ended September 30, 2005	Three months ended September 30, 2005
Net income applicable to common stockholders:		
As reported	\$ 522,423	\$ 26,537
Add: stock based employee compensation expense included in reported net income, net of related tax effect	924,597	509,270
Deduct: stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effect	(6,914,945)	(2,650,602)
Pro forma net loss applicable to common stockholders	\$ (5,467,925)	\$ (2,114,795)
Net income (loss) per share applicable to common stockholders:		
As reported basic	\$ 0.02	\$ 0.00
As reported diluted	\$ 0.01	\$ 0.00
Pro forma basic	\$ (0.16)	\$ (0.06)
Pro forma diluted	\$ (0.16)	\$ (0.06)

(b) Employee Stock Purchase Plan

On February 15, 2004, the Company's board of directors and shareholders approved the 2004 Employee Stock Purchase Plan, which became effective on March 30, 2004. The Company has authorized an aggregate of 300,000 shares of Class B common stock for issuance under the plan

to participating employees.

Table of Contents

The original plan provided eligible employees the opportunity to purchase the Company's Class B common stock for amounts up to 15% of their compensation during offering periods. Under the plan, no employee was permitted to purchase stock worth more than \$25,000 in any calendar year, valued as of the first day of each offering period.

The original purchase plan provided for offering periods which were determined by the board of directors. Eligible participants could purchase Class B common stock under the purchase plan at a price equal to the lesser of 85% of the fair value on the first day of an offering period or 85% of the fair value on the last day of an offering period. During 2005, 17,280 shares were purchased at prices ranging from \$12.75 to \$15.84 per share. As of December 31, 2005, approximately 256,000 shares were available under the purchase plan for future issuance.

In December 2005, the compensation committee of the Company's board of directors amended the 2004 Employee Stock Purchase Plan to provide that effective January 1, 2006 eligible participants may purchase Class B common stock under the purchase plan at a price equal to 95% of the fair value on the last day of an offering period. During the nine months ended September 30, 2006, 3,425 shares were purchased at prices ranging from \$14.57 to \$18.28 per share. At September 30, 2006, approximately 253,000 shares were available under the purchase plan for future issuance.

(4) Net Income (Loss) Per Share

The Company's basic and diluted net income (loss) per share is presented for the three months ended September 30, 2005 and 2006 and nine months ended September 30, 2005 and 2006. 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 year. 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 cumulative effect of change in accounting principle, net of tax and the impact of convertible preferred stock dividends and conversion payment. Diluted net income (loss) per share includes the cumulative effect of change in accounting principle, net of tax and excludes the convertible preferred stock dividends and conversion payment 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 nine months ended September 30, 2006, basic and diluted net loss per share are the same.

Table of Contents

The following table reconciles the Company's reported net income (loss) to net income (loss) applicable to common stockholders used to compute basic and diluted net income (loss) per share for the three months ended September 30, 2005 and 2006 and the nine months ended September 30, 2005 and 2006:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Numerator:				
Net income (loss) before cumulative effect of change in accounting principle	\$ 2,237,042	\$ (31,917)	\$ 709,350	\$ 11,258
Cumulative effect of change in accounting principle, net of taxes		151,341		
Convertible preferred stock dividends	(1,714,619)	(2,338,229)	(682,813)	(422,147)
Net income (loss) applicable to common stockholders	\$ 522,423	\$ (2,218,805)	\$ 26,537	\$ (410,889)
Denominator:				
Weighted average common shares outstanding excluding unvested common shares subject to repurchase or cancellation	33,886,928	38,065,347	36,043,092	38,720,191
Weighted average number of shares outstanding used to calculate basic net income (loss) per share	33,886,928	38,065,347	36,043,092	38,720,191
Effect of dilutive securities:				
Weighted average stock options and warrants and common shares subject to repurchase or cancellation	2,301,891		2,101,414	
Weighted average number of shares outstanding use to calculate diluted net income (loss) per share	36,188,819	38,065,347	38,144,506	38,720,191
Basic net income (loss) per share applicable to common stockholders	\$ 0.02	\$ (0.06)	\$ 0.00	\$ (0.01)
Diluted net income (loss) per share applicable to common stockholders	\$ 0.01	\$ (0.06)	\$ 0.00	\$ (0.01)
The computation of diluted net income (loss) per share excludes the following because their effect would be anti-dilutive:				

For the three and nine months ended September 30, 2005 and for the three and nine months ended September 30, 2006, 2,346,939 shares and 1,450,377 shares, respectively, 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 nine months ended September 30, 2005, outstanding options to acquire 889,400 and 608,300 shares of Class B common stock with a weighted average exercise price of \$18.00 per share and \$18.78 per share, respectively, and for the three months and nine months ended September 30, 2006, outstanding options to acquire 5,303,860 shares of Class B common stock with a weighted average exercise price of \$12.03 per share.

Edgar Filing: MARCHEX INC - Form 10-Q

For the three and nine months ended September 30, 2006, warrants to acquire 6,500 shares of Class B common stock at an exercise price of \$8.45.

For the three and nine months ended September 30, 2006, 381,370 shares of unvested Class B restricted common shares at September 30, 2006 issued to employees in connection with acquisitions. These shares were for future services that vest over periods ranging from two and one-half to three years. Unvested shares were excluded from the computation of basic net income (loss) per share.

Table of Contents

(5) Concentrations

The Company maintains substantially all of their cash and cash equivalents with one financial institution.

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

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

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Distribution Partner A	11%	7%	10%	6%

Distribution Partner A was a new merchant advertiser in 2005 who represented approximately 23% and 28% of revenue for the three months ended September 30, 2005 and 2006, and approximately 21% and 27% of revenue for the nine months ended September 30, 2005 and 2006, respectively. This same merchant advertiser represented approximately 37% and 44% of the outstanding accounts receivable balance at December 31, 2005 and September 30, 2006, respectively.

(6) Segment Reporting and Geographic Information

Operating segments are revenue-producing components of the enterprise for which separate financial information is produced internally for the Company's management. For all periods presented the Company operated as a single segment. The Company operates in a single operating 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.

Revenues by geographic region are as follows (in percentages):

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
United States	90%	91%	91%	89%
Canada	3%	2%	2%	2%
Other countries	7%	7%	7%	9%
	100%	100%	100%	100%

Table of Contents**(7) Property and Equipment**

Property and equipment consisted of the following:

	As of December 31, 2005	As of September 30, 2006 (unaudited)
Computer and other related equipment	\$ 2,828,726	\$ 4,124,759
Purchased and internally developed software	2,142,710	5,832,149
Furniture and fixtures	107,829	280,719
Leasehold improvements	94,561	128,512
	\$ 5,173,826	\$ 10,366,139
Less accumulated depreciation and amortization	(1,771,564)	(3,034,280)
Property and equipment, net	\$ 3,402,262	\$ 7,331,859

The Company has capitalized certain costs of internally developed software for internal use. The estimated useful life of costs capitalized is evaluated for each specific project. Amortization begins in the period in which the software is ready for its intended use. The Company had \$1.3 million and \$1.6 million of internally developed software costs that had not commenced amortization as of December 31, 2005 and September 30, 2006, respectively.

(8) Commitments

The Company has commitments for future payments related to office facilities leases, equipment and furniture leases, and other contractual obligations. The Company leases its office facilities under operating lease agreements expiring through 2010. The equipment and furniture leases are financed through capital lease arrangements and are included in property and equipment and the related depreciation is recorded as depreciation expense. The Company also has other contractual obligations expiring over varying time periods through 2009. Other contractual obligations primarily relate to minimum contractual payments due to distribution partners and other service providers. Future minimum payments are as follows:

	Equipment and furniture capital leases	Facilities operating leases	Other contractual obligations	Total
2006	\$ 5,135	\$ 293,225	\$ 604,856	\$ 903,216
2007	20,539	976,494	576,782	1,573,815
2008	20,539	758,018	130,168	908,725
2009	17,851	629,259	82,598	729,708
2010		169,294		169,294
Total minimum payments	\$ 64,064	\$ 2,826,290	\$ 1,394,404	\$ 4,284,758
Less: amounts representing interest	(13,004)			
Present value of lease obligation	51,060			
Less current portion	(13,889)			
Long-term portion	\$ 37,171			

Edgar Filing: MARCHEX INC - Form 10-Q

Rent expense incurred by the Company was approximately \$254,000 and \$257,000 for the three months ended September 30, 2005 and 2006, respectively, and \$599,000 and \$774,000 for the nine months ended September 30, 2005 and 2006.

In October 2006, the Company entered into a lease agreement for additional office space in Seattle, Washington commencing in 2007 and expiring in 2009 totaling approximately \$1.4 million. This amount is not included in the above table.

Table of Contents

In connection with the closing of the Name Development asset acquisition in 2005, 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 royalty payment is recognized as incurred in service costs.

(9) Contingencies and Taxes**(a) Contingencies**

The Company is involved in legal and administrative proceedings and claims of various types from time to time. While any litigation contains an element of uncertainty, the Company is not aware of any legal proceedings or claims which are pending that the Company believes, based on current knowledge, will have, individually or taken together, a material adverse effect on the Company's financial condition or results of operations.

(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.

(10) 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 price 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 sites, 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.

The following summarizes the estimated fair value of the assets acquired at the date of acquisition:

Current assets	\$ 45,808
Intangible assets	52,948,941
Goodwill	111,061,747
 Total assets acquired	 \$ 164,056,496

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. The escrow agent is holding the balance of the escrow amount pending a determination related to potential indemnification obligations. In the event any indemnification obligations are so determined, the purchase price will be reduced accordingly. A net amount of \$357,000 was released from escrow in March 2006 in satisfaction of certain intangible asset indemnification obligations. This amount was reflected as an adjustment to goodwill.

The acquired intangible assets in the amount of \$52.9 million have a weighted average useful life of approximately 4.4 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 \$5.7 million (2-year weighted-average

Table of Contents

useful life), domain names with a value of approximately \$46.4 million (4.7-year weighted average useful life), and acquired technology with a value of approximately \$800,000 (3-year weighted average useful life). The goodwill of \$111.1 million and the acquired intangible assets with a value of \$52.9 million are deductible over 15 years for federal tax purposes.

(11) 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 and as a result of the acquisition, acquired additional sources of proprietary targeted traffic.

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 shares vest over a period of three years from the closing date, 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, net of forfeitures, is being amortized using the accelerated vesting method as compensation costs over the associated three-year employment periods over which those shares vest. See Note 3 for the amortization of deferred stock-based compensation during the three and nine months ended September 30, 2006.

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

The following summarizes the estimated fair value of the assets acquired at the date of acquisition:

Property and equipment	\$ 6,874
Intangible assets	5,025,000
Goodwill	11,827,967
Total assets acquired	\$ 16,859,841

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 have been included as part of the purchase price consideration and were released upon termination of the escrow period.

The acquired intangible assets in the amount of \$5.0 million 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 \$1.0 million (5-year weighted average useful life), merchant advertiser customer base with a value of approximately \$2.4 million (3-year weighted-average useful

Table of Contents

life) and acquired technology with a value of approximately \$1.1 million (3-year weighted average useful life). The goodwill of \$11.8 million and the acquired intangible assets with a value of \$5.0 million are deductible over 15 years for federal tax purposes.

(12) IndustryBrains Acquisition

On July 27, 2005, the Company acquired IndustryBrains, a company focused on monetizing Web sites through contextual advertising solutions, for the following purchase price consideration:

\$16.1 million in net cash and estimated acquisition costs; plus

788,046 shares of Class B common stock; plus

176,909 shares of restricted Class B common stock that vest over a period of two and one-half years.

The Company accounted for the IndustryBrains acquisition as a business combination. As a result of the acquisition, the Company obtained technologies focused on contextual advertising solutions and a broader base of merchant advertisers and distribution partners.

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 \$13.4 million.

The shares of restricted Class B common stock were valued at \$17.00 per share (the last reported sales price on the closing date) for an aggregate amount of approximately \$3.0 million. The shares of restricted Class B common stock were issued to employee stockholders of IndustryBrains who became employees of the Company. The shares vest over a period of two and one-half years from the closing date, with the first 33.34% vesting after ten months and each additional 33.33% vesting each successive ten month period over the next twenty months. As part of employment agreements entered into with these former stockholders of IndustryBrains, a deferred stock-based compensation charge of approximately \$3.0 million was recorded in connection with the 176,909 shares of restricted Class B common stock. The deferred stock-based compensation, net of estimated forfeitures, is being amortized using the accelerated vesting method as compensation costs over the associated three-year employment periods over which those shares vest. See Note 3 for the amortization of deferred stock-based compensation during the three and nine months ended September 30, 2006.

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

Current assets, including acquired cash and cash equivalents of \$1,147,154	\$ 2,074,787
Property and equipment	81,008
Other non-current assets	55,805
Intangible assets	8,100,000
Goodwill	25,018,206
Total assets acquired	35,329,806
Current liabilities	1,718,714
Non-current deferred tax liabilities	2,957,799
Total liabilities assumed	4,676,513
Net assets acquired	\$ 30,653,293

Edgar Filing: MARCHEX INC - Form 10-Q

In connection with the acquisition, \$2.5 million of the cash consideration, 118,207 shares of Class B common stock, and 26,536 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 have been included as part of the purchase price consideration and were released upon termination of the escrow period.

Table of Contents

The acquired estimated intangible assets in the amount of \$8.1 million have a weighted average useful life of approximately 2.8 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 \$900,000 (2-year weighted-average useful life), domain names with a value of approximately \$400,000 (1.5-year weighted average useful life), merchant advertiser customer base with a value of approximately \$3.1 million (3-year weighted-average useful life), distribution partner base of approximately \$900,000 (3-year weighted-average useful life), and acquired technology with a value of approximately \$2.8 million (3-year weighted average useful life). The goodwill of \$25.0 million and the acquired intangible assets with a value of \$8.1 million are not deductible for federal tax purposes.

(13) AreaConnect Asset Acquisition

On May 1, 2006, the Company acquired certain assets of AreaConnect, a provider of local online traffic to Yellow and White Pages publishers. The purchase price consideration consisted of:

\$12.2 million in cash and estimated acquisition costs; plus

183,832 shares of Class B common stock; plus

78,129 shares of restricted Class B common stock that vest over a period of 3 years.

The Company accounted for the AreaConnect asset acquisition as a business combination and as a result of the acquisition, acquired additional sources of proprietary targeted traffic.

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 \$3.9 million. The shares of restricted Class B common stock were valued at \$21.39 per share (the last reported sales price on the closing date) for an aggregate amount of approximately \$1.7 million. The shares of restricted Class B common stock were issued to the former equityholder of AreaConnect who became an employee of the Company. The shares vest over a period of three years from the closing date, 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 the employment agreement entered into with the former equityholder of AreaConnect, a deferred stock-based compensation charge of approximately \$1.7 million was recorded in connection with the 78,129 shares of restricted Class B common stock. The deferred stock-based compensation, net of estimated forfeitures, is being amortized on a straight-line basis as compensation costs over the associated three-year employment period over which those shares vest. See Note 3 for the amortization of deferred stock-based compensation during the three and nine months ended September 30, 2006.

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

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

Intangible assets	\$ 3,520,000
Goodwill	12,652,666
Total assets acquired	\$ 16,172,666

To date the Company has conducted a preliminary analysis of the estimated fair value of the assets acquired from AreaConnect. 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 intangible assets included in the acquisition.

In connection with the acquisition, \$1.2 million of the cash consideration, 55,609 shares of Class B common stock, and 11,719 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

Table of Contents

purchase price consideration. In the event any indemnification obligations are identified, the purchase price will be reduced accordingly. The escrow amounts, less any indemnification obligations identified, will be released upon termination of the escrow period.

The acquired intangible assets in the amount of \$3.5 million have a weighted average useful life of approximately 2.6 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 \$400,000 (3-year weighted-average useful life), domain names with a value of approximately \$20,000 (3-year weighted average useful life), merchant advertiser customer base with a value of approximately \$1.0 million (1.5-year weighted-average useful life) and acquired technology with a value of approximately \$2.1 million (3-year weighted average useful life). The goodwill of \$12.7 million and the acquired intangible assets with a value of \$3.5 million are deductible over 15 years for federal tax purposes.

(14) Open List Asset Acquisition

On May 26, 2006, the Company acquired certain assets of Open List, including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform. The purchase price consideration consisted of:

\$6.3 million in cash and estimated acquisition costs; plus

286,254 shares of Class B common stock; plus

114,502 shares of restricted Class B common stock that vest over a period of two and one-half years.

The Company accounted for the Open List asset acquisition as a business combination and as a result of the acquisition, acquired additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform.

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 \$5.0 million. The shares of restricted Class B common stock were valued at \$17.58 per share (the last reported sales price on the closing date) for an aggregate amount of approximately \$2.0 million. The shares of restricted Class B common stock were issued to certain former equityholders of Open List who became employees of the Company. The shares vest over a period of two and one-half years from the closing date, with the first 20.0% vesting after six months and each additional 20.0% vesting each successive 6-month period over the next twenty-four months. As part of the employment agreements entered into with certain former equityholders of Open List, a deferred stock-based compensation charge of approximately \$2.0 million was recorded in connection with the 114,502 shares of restricted Class B common stock. The deferred stock-based compensation, net of estimated forfeitures, is being amortized on a straight-line basis as compensation costs over the associated two and one-half year employment periods over which those shares vest. See Note 3 for the amortization of deferred stock-based compensation during the three and nine months ended September 30, 2006.

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

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

Property and equipment	\$ 10,000
Intangible assets	3,520,000
Goodwill	7,829,845
 Total assets acquired	 \$ 11,359,845

To date the Company has conducted a preliminary analysis of the estimated fair value of the assets acquired from Open List. 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.

Table of Contents

In connection with the acquisition, \$600,000 of the cash consideration and 40,076 shares of 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. In the event any indemnification obligations are identified, the purchase price will be reduced accordingly. The escrow amounts, less any indemnification obligations identified, will be released upon termination of the escrow period.

The acquired intangible assets in the amount of \$3.5 million have a weighted average useful life of approximately 3.1 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 \$400,000 (2-year weighted-average useful life), domain names with a value of approximately \$20,000 (3-year weighted average useful life), merchant advertiser customer base with a value of approximately \$900,000 (2.5-year weighted-average useful life) and acquired technology with a value of approximately \$2.2 million (3.5-year weighted average useful life). The goodwill of \$7.8 million and the acquired intangible assets with a value of \$3.5 million are deductible over 15 years for federal tax purposes.

(15) Pro Forma Results of Operations Name Development, Pike Street, IndustryBrains, AreaConnect and Open List (Unaudited)

The following table presents pro forma results of operations for the three and nine months ended September 30, 2006 as if the AreaConnect and Open List asset acquisitions occurred as of January 1, 2006. The pro forma results of operations for the three months ended September 30, 2006 combine: (1) the historical results of operations of the Company for the three months ended September 30, 2006; and (2) the pro forma effect of shares issued in connection with the AreaConnect and Open List asset acquisitions. The pro forma results of operations for the nine months ended September 30, 2006 combine: (1) the historical results of operations of the Company for the nine months ended September 30, 2006; (2) AreaConnect's historical results of operations for the pre-acquisition period from January 1, 2006 to April 30, 2006; and (3) Open List's historical results of operations for the pre-acquisition period from January 1, 2006 to May 25, 2006. The following table presents pro forma results of operations for the three and nine months ended September 30, 2005 as if the IndustryBrains acquisition and the Name Development, Pike Street, AreaConnect and Open List asset acquisitions occurred as of January 1, 2005. The pro forma results of operations for the three months ended September 30, 2005 combine: (1) the historical results of operations of the Company for the three months ended September 30, 2005; (2) IndustryBrains' historical results of operations for the pre-acquisition period from July 1, 2005 to July 26, 2005; and (3) AreaConnect's and Open List's pre-acquisition historical results of operations for the three months ended September 30, 2005. The pro forma results of operations for the nine months ended September 30, 2005 combine: (1) the historical results of operations of the Company for the nine months ended September 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; (4) Pike Street's historical results of operations for the pre-acquisition period from January 1, 2005 to April 25, 2005; and (5) IndustryBrains' historical results of operations for the pre-acquisition period from January 1, 2005 to July 26, 2005; and (6) AreaConnect's and Open List's pre-acquisition historical results of operations for the nine months ended September 30, 2005. A forfeiture by an employee of restricted stock related to the Pike Street acquisition occurred in the three months ended September 30, 2005 resulted in a pro forma reversing adjustment in the three and nine months ended September 30, 2005. The Company has used statutory rates in effect during the three and nine months ended September 30, 2005 and 2006 to calculate the tax effects of the pro forma adjustments in determining the pro forma results of operations for each of the periods presented.

Table of Contents

	Nine months		Three months	
	ended September 30, 2005	ended September 30, 2006	ended September 30, 2005	ended September 30, 2006
Revenue	\$ 76,071,045	\$ 95,937,088	\$ 26,766,190	\$ 32,326,116
Net income (loss)	(2,047,110)	(1,342,759)	(135,975)	11,258
Net loss applicable to common stockholders	(4,058,604)	(3,680,988)	(818,788)	(410,889)
Net loss per share applicable to common stockholders:				
Basic and diluted net loss per share	\$ (0.11)	\$ (0.10)	\$ (0.02)	\$ (0.01)

The pro forma information is not necessarily indicative of the combined results that would have occurred had the acquisitions taken place at January 1, 2005 or at January 1, 2006, nor is it necessarily indicative of results that may occur in the future.

(16) Intangible Assets from Acquisitions

Intangible assets from acquisitions consist of the following:

	As of December 31, 2005	As of September 30, 2006 (unaudited)
Merchant advertiser customer base	\$ 7,000,000	\$ 8,900,000
Distribution partner base	3,100,000	3,100,000
Non-compete agreements	9,100,000	9,900,000
Trademarks/domains	46,979,732	45,604,885
Acquired technology	11,400,000	15,700,000
	\$ 77,579,732	\$ 83,204,885
Less accumulated amortization	(26,232,788)	(41,077,644)
Total	\$ 51,346,944	\$ 42,127,241

Amortizable intangible assets are amortized on a straight-line basis over their useful lives. Aggregate amortization expense incurred by the Company was approximately \$5.2 million and \$5.3 million for the three months ended September 30, 2005 and 2006, respectively, and approximately \$13.2 million and \$15.3 million for the nine months ended September 30, 2005 and 2006, respectively. Based upon the current amount of intangible assets subject to amortization, the estimated amortization expense for the next five years is as follows: \$5.1 million for the remainder of 2006, \$16.5 million in 2007, \$12.3 million in 2008, \$4.2 million in 2009, and \$4.0 million in 2010 and thereafter.

Table of Contents**(17) Intangible and other assets, net**

Intangible and other assets, net consisted of the following:

	As of December 31, 2005	As of September 30, 2006 (unaudited)
Internet domain names	\$ 13,407,166	\$ 13,935,989
Less accumulated amortization	(2,327,978)	(4,356,638)
Other intangible assets, net	11,079,188	9,579,351
Other assets:		
License fee	4,500,000	4,500,000
Less accumulated amortization	(1,128,826)	(2,093,112)
License fee, net	3,371,174	2,406,888
Restricted cash	800,000	800,000
Other	197,142	197,764
Total intangibles and other assets, net	\$ 15,447,504	\$ 12,984,004

The Company capitalizes costs incurred to acquire domain names or URLs, which include the initial registration fees, to other intangible assets which excludes intangible assets acquired through business combinations. The capitalized costs are amortized over the expected useful life of the domain names on a straight-line basis. Based upon the current amount of domains subject to amortization, the estimated expense for the next five years is as follows: \$691,000 for the remainder of 2006, \$2.7 million in 2007, \$2.2 million in 2008, \$1.6 million in 2009, and \$2.4 million in 2010 and thereafter. There were domains held for sale valued at approximately \$300,000 and \$5,500 under prepaid expenses and other current assets as of December 31, 2005 and September 30, 2006, respectively, which are no longer being amortized.

In 2005, the Company entered into a license agreement with an advertising 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 was capitalized and is being amortized ratably over 42 months.

(18) Convertible Preferred Stock Dividends

In March 2006, the Company entered into privately negotiated and unsolicited transactions with certain holders of the preferred stock in which such holders converted approximately 80,848 shares of the Company's preferred stock into approximately 824,980 shares of the Company's Class B common stock at a conversion rate of \$24.50 per share and received a cash payment from the Company of \$12.00 per share of preferred stock for an aggregate amount of approximately \$970,000 in order to induce conversions. The \$970,000 was reflected as preferred stock dividends and conversion payment in the Company's financial statements. Approximately 142,137 shares of preferred stock remain outstanding as of September 30, 2006.

In April 2006, 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 May 15, 2006 to the holders of record as of the close of business on May 4, 2006. This quarterly dividend obligation totaled approximately \$422,000.

In July 2006, 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 will be paid on August 15, 2006 to the holders of record as of the close of business on August 4, 2006. This quarterly dividend obligation totaled approximately \$422,000.

In October 2006, 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 will be paid on November 15, 2006 to the holders of record as of the close of business on November 4, 2006. This quarterly dividend obligation totals approximately \$422,000.

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We use words such as believes, intends, expects, anticipates, plans, may, will and similar expressions to identify forward-looking statements. All forward-looking statements, including, but not limited to, statements regarding our future operating results, financial position, and business strategy, expectations regarding our growth and the growth of the industry in which we operate, and plans and objectives of management for future operations, are inherently uncertain as they are based on our expectations and assumptions concerning future events. Any or all of our forward-looking statements in this report may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including but not limited to the risks, uncertainties and assumptions described in this report, in Part II, Item 1A. Risk Factors and elsewhere in our Annual Report on Form 10-KSB for the year ended December 31, 2005 and in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006, and those described from time to time in our future reports filed with the Securities and Exchange Commission. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements. All forward-looking statements in this report are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement.

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 consolidated financial statements and related notes thereto, and with our audited consolidated financial statements and the notes thereto, included in our Annual Report on Form 10-KSB for the year ended December 31, 2005.

Overview

We are a technology driven search and media company focused on vertical and local online traffic. Specifically, we are focused on direct navigation, local search and search marketing. Our network of vertical and local Web sites provide online users with: (1) information relating to specific products or services; and (2) relevant advertisers who sell such products or services. Our platform of 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 sites.

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

Local and Vertical Web Sites. We have more than 200,000 vertical and local Web sites. Our Web sites are designed to help online users find information for specific products or services, and also find relevant advertisers who sell such products or services. We refer to this as direct navigation.

Contextual Targeting. We sell advertising placement on specialized vertical and branded Web sites and on specific sections of a Web site on a bid-for-click basis. We refer to this as site-specific contextual advertising. We believe this site-specific approach to contextual advertising allows publishers an opportunity to monetize the value of their own brand and traffic, and gives advertisers greater transparency and relevancy.

Pay-Per-Click Targeting. 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, and in response to their typing of specific Web sites into their browser (direct navigation). 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

Table of Contents

and businesses through our distribution network of search engines, product shopping engines, directories and other Web sites. We also generate revenue from cost-per-action services. Cost-per-action revenue occurs when the online user is redirected from the Company web sites to a merchant advertiser web site and completes a specified action.

Natural Search Engine Optimization. We optimize 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 Platforms. We support online marketing efforts of local businesses and SMEs (small and medium-sized enterprises) by providing super-aggregator partners, such as yellow page publishers and newspaper companies, with an outsourced platform of our performance-based advertising and search marketing technology services. Our outsourced platform allows super-aggregator partners to directly sell search marketing packages to their customers, such as yellow page or classified advertisers. Our outsourced platform for publishers, which is separate and distinct from the local platform, allows publishers to monetize their Web site(s) with their advertiser relationships. Our outsourced platforms are provided to super-aggregator partners and publishers allowing the partners and publishers to sell under their brand.

Feed Management. 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. Our trusted feed relationships with certain of 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.

Bid Management. 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.

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.

Edgar Filing: MARCHEX INC - Form 10-Q

On May 1, 2006, we acquired certain assets of AreaConnect, which was formed in Delaware on June 5, 2002.

On May 26, 2006, we acquired certain assets of Open List, which was incorporated in Delaware on November 18, 2003. We currently have offices in Seattle, Washington; Orem, Utah; Eugene, Oregon; Las Vegas, Nevada; and New York, New York.

Table of Contents

Acquisitions

We have completed the following acquisitions during 2005 and 2006 which have been accounted for as business combinations.

Name Development

In February 2005, we acquired substantially all of the assets of Name Development, a corporation operating in the direct navigation market, 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 (for accounting purposes) at 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 sites, 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, 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 which will vest over a three year period from the closing date 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.

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

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

IndustryBrains

In July 2005, we acquired IndustryBrains, a company focused on monetizing Web sites through contextual advertising solutions, for the following consideration:

\$16.1 million in net cash and estimated acquisition costs; plus

Edgar Filing: MARCHEX INC - Form 10-Q

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 from the closing date 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 (for accounting purposes) at an aggregate amount of approximately \$13.4 million.

Table of Contents

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

AreaConnect

In May 2006, we acquired certain assets of AreaConnect, a provider of local online traffic to Yellow and White Pages publishers, for the following consideration:

\$12.2 million in cash and estimated acquisition costs; plus

183,832 shares of Class B common stock; plus

78,129 shares of restricted Class B common stock issued which will vest over a three year period from the closing date 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 \$3.9 million.

We did not assume any other obligations with respect to AreaConnect as part of this asset acquisition.

The shares of restricted Class B common stock were issued to the former equityholder of AreaConnect who became an employee of the Company and were valued at approximately \$1.7 million, which will be recorded as compensation expense over the associated employment period during which these shares vest.

Open List

In May 2006, we acquired certain assets of Open List, including additional sources of proprietary targeted-traffic and its content aggregation, search technology, and user-generated content platform, for the following consideration:

\$6.3 million in cash and estimated acquisition costs; plus

286,254 shares of Class B common stock; plus

114,502 shares of restricted Class B common stock issued which will vest over a two and one-half year period from the closing date in installments of 20% 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 \$5.0 million.

We did not assume any other obligations with respect to Open List as part of this asset acquisition.

The shares of restricted Class B common stock were issued to certain former equityholders of Open List who became employees of the Company and were valued at approximately \$2.0 million, which will be recorded as compensation expense over the associated employment period during which these shares vest.

Consolidated Statements of Operations

Edgar Filing: MARCHEX INC - Form 10-Q

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 September 30, 2005 and 2006 and the nine months ended September 30, 2005 and 2006.

Revenue

We currently generate revenue through our suite of services, including our pay-per-click targeting, feed management, bid management, contextual targeting, natural search optimization and outsourced search marketing services platforms.

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 92% of our revenues in all periods presented. Our secondary sources of revenue are our bid management services, natural search optimization services and outsourced search marketing platforms. These secondary sources amounted to less than 8% 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.

In certain cases, we record revenue based on available and reported preliminary information from third parties. Collection on 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.

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 sites, 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 Web sites to a merchant advertiser Web site and completes the specified action.

In providing contextual targeting services, merchant advertisers purchase keywords or keyword strings, based on an amount they choose for a targeted placement on vertically-focused Web sites or specific pages of a Web site that are specific to their products or services and their marketing objectives. The contextual results distributed by our services are prioritized for users by the amount the merchant advertiser is willing to pay each time a user clicks on the merchant's advertisement and the relevance of the merchant's advertisement, which is dictated by historical click-through rates. Merchant advertisers pay us when a click-through occurs on their advertisement.

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 on a per-click basis. The placement of a feed management result is largely determined by its relevancy, as determined by the distribution partner.

Table of Contents

Search Marketing Services

Merchant advertisers pay us additional fees for services such as bid management and natural search engine optimization. Merchant advertisers generally pay us on a click-through basis, although in certain cases we receive a fixed fee for delivery of these services. In some cases we also deliver banner campaigns for select merchant advertisers. We may also charge initial set-up, account or inclusion fees as part of our services.

Banner advertising revenue may be based on a fixed fee per click and is generated and recognized on click-through activity. In other 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. Other account and service fees are recognized in the month or period the account fee or services relate to.

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.

Outsourced Search Marketing Platforms

We generate revenue from super-aggregator partners and publishers utilizing our web-based technologies. We are paid a management or agency fee based on the total amount of the purchase made by the merchant advertiser. The partners or publishers engage the merchant advertisers and are the primary obligor, and we, in certain instances, are only financially liable to the publishers in our capacity as a collection agency for the amount collected from the merchant advertisers. We recognize revenue for these fees under the net revenue recognition method.

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.

Table of Contents

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 and content 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 sites 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.

User Acquisition Costs

For the periods presented the largest component of our service costs consists 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;

Table of Contents

advertising and promotional expenditures including online and outside marketing activities;

cost of systems used to sell to and serve merchant advertisers; and

stock-based compensation of related personnel.

Product Development

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

Our research and development expenses include:

compensation and related expenses;

costs of computer hardware and software;

costs incurred in developing features and functionality of the services we offer; and

stock-based compensation of related personnel.

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;

bad debt provisions;

facilities costs;

other general corporate expenses; and

stock-based compensation of related personnel.

Stock-Based Compensation

Prior to January 1, 2006, we accounted for stock-based compensation under APB 25 and used the intrinsic value method. In accordance with APB 25, stock-based compensation consisted of the following:

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; and

the fair value of non-employee option issuances.

As of January 1, 2006, we adopted SFAS 123R and account for stock-based compensation under the fair value method. As a result, stock-based compensation consists of the following:

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

Table of Contents

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 estimated in accordance with the pro forma provisions of SFAS 123. As we adopted SFAS 123R using the modified prospective method, the results for the prior year have not been restated under the fair value method for GAAP purposes.

Stock-based compensation expense has been included in the same lines as compensation paid to the same individuals in the consolidated statement of operations in accordance with SAB 107. Stock-based compensation expense recognized in the prior period has been reclassified to conform to the presentation in the current period.

Amortization of Intangibles from Acquisitions

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 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 Company's financial statements.

As of September 30, 2006, 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

Table of Contents

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 NOL carryforwards is limited such that substantially all of these NOL carryforwards will never be utilized.

Follow-on Public Offering

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 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. All of the net proceeds have been used to fund the Name Development and Pike Street asset acquisitions and the IndustryBrains acquisition in 2005, the AreaConnect and Open List asset acquisitions in May 2006, and for working capital and other general corporate purposes.

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.

The Company's board of directors has declared and paid the following quarterly dividends on the Company's 4.75% convertible exchangeable preferred stock:

Approval Date	Per share dividend	Date of record	Total amount (in thousands)	Payment date
April 2005	\$ 3.00	May 4, 2005	\$ 690	May 16, 2005
July 2005	2.97	August 4, 2005	683	August 15, 2005
October 2005	2.97	November 4, 2005	683	November 15, 2005
January 2006	2.97	February 4, 2006	662	February 15, 2006
April 2006	2.97	May 4, 2006	422	May 15, 2006
July 2006	2.97	August 4, 2006	422	August 15, 2006

In October 2006, 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 will be paid on November 15, 2006 to the holders of record as of the close of business on November 4, 2006. This quarterly dividend obligation totals approximately \$422,000.

The preferred stock is convertible at the option of the holder at any time into shares of 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. During 2005, approximately 4,515 shares of preferred stock were converted at the option of the holders into approximately 46,071 shares of the Company's Class B common stock at a conversion price of \$24.50 per share. In January 2006, approximately 2,500 shares of preferred stock were converted at the option of the holders into approximately 25,510 shares of the Company's Class B common stock at a conversion price of \$24.50 per share. In March 2006, the Company entered into privately negotiated and unsolicited transactions with certain holders of the preferred stock in which such holders converted approximately 80,848 shares of the Company's preferred stock into approximately 824,980 shares of the Company's Class B common stock at a conversion rate of \$24.50 per share and received a cash payment from the Company of \$12.00 per share of preferred stock for an aggregate

Table of Contents

amount of approximately \$970,000 in order to induce conversions. The \$970,000 was reflected as preferred stock dividends and conversion payment in the Company's financial statements. Approximately 142,137 shares of preferred stock remain outstanding as of September 30, 2006.

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 September 30, 2006. 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 periods indicated. The operating results for the three and nine months ended September 30, 2005 and 2006 and are not necessarily indicative of the results that may be expected for the full year or any future period.

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Revenue	100.0%	100.0%	100.0%	100.0%
Expenses:				
Service costs	53.4%	47.4%	51.8%	47.0%
Sales and marketing	9.8%	18.1%	12.5%	18.4%
Product development	5.0%	7.9%	4.1%	8.3%
General and administrative	7.4%	10.9%	7.3%	9.6%
Amortization of acquired intangible assets	20.3%	16.1%	20.3%	16.4%
Total operating expenses	95.9%	100.4%	96.0%	99.7%
Gain (loss) on sales and disposals of intangible assets, net	0.0%	0.3%	0.0%	-0.2%
Income (loss) from operations	4.1%	(0.0%)	4.0%	0.1%
Other income (expense):				
Interest income	2.1%	2.4%	2.1%	2.6%
Interest expense	0.0%	0.0%	0.0%	0.0%
Other	0.0%	0.0%	0.0%	0.0%
Total other income	2.1%	2.4%	2.1%	2.6%
Income before provision for income taxes	6.2%	2.4%	6.1%	2.7%
Income tax expense	2.8%	2.4%	3.4%	2.5%
Income (loss) before cumulative effect of a change in accounting change	3.4%	(0.0%)	2.7%	0.2%
Cumulative effect of change in accounting principle	0.0%	0.2%	0.0%	0.0%
Net income	3.4%	0.2%	2.7%	0.2%
Convertible preferred stock dividend and conversion payment	2.6%	2.5%	2.7%	1.3%
Net income (loss) applicable to common stockholders	0.8%	(2.3%)	0.0%	(1.1%)

Comparison of the Three Months ended September 30, 2005 to the Three Months ended September 30, 2006 and the Nine Months ended September 30, 2005 to the Nine Months ended September 30, 2006

Edgar Filing: MARCHEX INC - Form 10-Q

Revenues. The following table presents our revenues, by revenue source, for the periods presented:

	Nine months ended September 30, 2005	Nine months ended September 30, 2006	Three months ended September 30, 2005	Three months ended September 30, 2006
Proprietary Traffic Sources	\$ 16,789,402	\$ 34,637,969	\$ 7,762,225	\$ 12,261,956
Partner and Other Revenue Sources	48,402,279	60,515,192	17,865,451	20,064,160
Total Revenue	\$ 65,191,681	\$ 95,153,161	\$ 25,627,676	\$ 32,326,116

Table of Contents

Our proprietary traffic revenues are generated from our portfolio of owned and operated Web sites which are monetized with pay-per-click and cost-per-action listings and graphical ad units that are relevant to the Web sites. When an online user navigates to one of our owned Web sites and clicks on a particular listing or completes the specified action, we receive a fee.

Our partner network revenues are primarily generated using third-party distribution networks to deliver the merchant advertisers listings. The distribution network includes search engines, shopping engines, directories, destination sites, Internet domains or Web sites, and other targeted Web-based content. We generate revenue upon delivery of qualified and reported click-throughs to our merchant advertisers or to advertising services providers listings. We pay a revenue share to the distribution partners to access their online user traffic. Other revenues include our bid management services, natural search optimization services and outsourced search marketing platforms.

Revenue increased 26%, from \$25.6 million for the three months ended September 30, 2005 to \$32.3 million in the same period in 2006. This increase was attributable to a \$6.0 million increase in performance-based advertising services. Of this increase, a substantial majority related to an increase in the average revenue per merchant advertiser, while the remaining related to an increase in the number of merchant advertisers. Of the total revenue increase, \$4.5 million is derived from our proprietary traffic revenues which are attributable to our portfolio of more than 200,000 Web sites. The majority of the revenues from our proprietary traffic are attributable to the Name Development and Pike Street asset acquisitions in 2005 and the AreaConnect and Open List asset acquisitions in 2006 including their respective portfolios of Web sites.

We believe the increase in revenue is primarily a result of the growth of our existing distribution partners and proprietary traffic sources, 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 also believe the foregoing factors, combined with our sales efforts have contributed to an increase in the average revenue per merchant advertiser. The increase in revenue in the 2006 period is also attributable to the acquisition of IndustryBrains in July 2005 which added more than 100 unique distribution partners and more than 1,000 unique merchant advertisers and the May 2006 AreaConnect asset acquisition.

Revenue increased 46%, from \$65.2 million for the nine months ended September 30, 2005 to \$95.2 million in the same period in 2006. This increase was attributable to a \$26.6 million increase in performance-based advertising services. Of the total revenue increase, \$17.8 million is derived from our proprietary traffic revenues which are attributable to our portfolio of more than 200,000 Web sites. Of this increase, a substantial majority related to an increase in the average revenue per merchant advertiser, while the remaining related to an increase in the number of merchant advertisers. The majority of the revenues from our proprietary traffic are attributable to the Name Development and Pike Street asset acquisitions in 2005 and the AreaConnect and Open List asset acquisitions in 2006 including their respective portfolios of Web sites.

Our ability to maintain and grow our revenues will depend in part on maintaining and increasing the number of click-throughs performed by users of our service, primarily through our distribution partners. If we do not add new distribution partners, renew our current 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 ability to maintain and grow our revenues will also depend in part on maintaining and growing our proprietary traffic sources and also maintaining and increasing the number and volume of transactions and favorable variable payment terms with merchant advertisers and advertising services providers, which we believe is dependent in part on delivering high quality traffic that ultimately results in purchases or conversions for our merchant advertisers and advertising services providers.

Table of Contents**Expenses**

Expenses were as follows:

	Nine months ended September 30,				Three months ended September 30,			
	2005	% of revenue	2006	% of revenue	2005	% of revenue	2006	% of revenue
Service costs	34,822,513	53%	45,056,393	47%	13,280,344	52%	15,184,125	47%
Sales and marketing	6,382,121	10%	17,236,349	18%	3,197,809	12%	5,962,465	18%
Product development	3,252,001	5%	7,470,331	8%	1,038,257	4%	2,689,912	8%
General and administrative	4,841,571	7%	10,364,929	11%	1,870,984	7%	3,109,209	10%
Amortization of acquired intangible assets	13,224,507	20%	15,343,966	16%	5,191,699	20%	5,309,102	16%

Effective January 1, 2006, we adopted SFAS 123R and record stock-based compensation expense under the fair value method. Prior to January 1, 2006, we accounted for stock-based compensation under APB 25 and used the intrinsic value method. In the three months ended September 30, 2006, we recorded \$3.2 million of stock-based compensation expense compared to \$558,000 for the same period in 2005. In the nine months ended September 30, 2006, we recorded \$10.2 million of stock-based compensation expense compared to \$1.2 million for the same period in 2005. This stock-based compensation expense has been included in the same lines as compensation paid to the same individuals in the consolidated statement of operations in accordance with SAB 107. Stock-based compensation recognized in the prior period has been reclassified to conform to the presentation in the current period.

Stock-based compensation expense was included in the following operating expense categories as follows:

	Nine months ended September 30,		Three months ended September 30,	
	2005	2006	2005	2006
Service costs	\$ 3,600	\$ 760,607	\$ (131,034)	\$ 268,654
Sales and marketing	753,414	2,836,843	437,983	845,594
Product development	22,755	2,446,530	(125,895)	884,156
General and administrative	421,896	4,113,376	376,904	1,210,301
Total stock-based compensation	\$ 1,201,665	\$ 10,157,356	\$ 557,958	\$ 3,208,705

See Note 3 Stock-based Compensation Plans of the condensed consolidated statements as well as our Critical Accounting Policies for additional information about stock-based compensation.

Service Costs. Service costs increased 14% from \$13.3 million in the three months ended September 30, 2005 to \$15.2 million in the same period in 2006. The increase was mainly attributable to an increase in payments to distribution partners of \$662,000 which in part was attributable to the acquisition of IndustryBrains in July 2005. The increase was also attributable to an increase in personnel costs of \$675,000 of which \$400,000 was related to stock-based compensation expense, an increase in payment processing fees of \$53,000, an increase in facility and other costs of \$231,000, and an increase in registration fees and Internet domain amortization of \$283,000. The increase in stock-based compensation expense was due to our adoption of SFAS 123R in 2006.

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 52% of revenue in the three months ended September 30, 2005 as compared to 47% in 2006. The 2006 decrease as a percentage of revenue in service costs as compared to the same period in 2005 was primarily a result 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

Table of Contents

distribution partners account for higher user acquisition costs as a percentage of revenue relative to our overall service cost percentage. We expect that user acquisition costs and revenue shares to distribution partners are likely to increase prospectively given the competitive landscape for distribution partners. To the extent that payments to feed management and pay-per-click services distribution partners make up a larger percentage of future operations, or the addition or renewal of existing distribution partner agreements are on terms less favorable to us, 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 as a result of additional stock-based compensation expense due to our adoption of SFAS 123R in 2006 and costs associated with the expansion of our operations.

Service costs increased by \$10.2 million or 29% in the nine months ended September 30, 2005 to \$45.1 million in the same period in 2006. This increase was primarily attributable to an increase in payments to distribution partners of \$5.6 million which in part was attributable to the acquisition of IndustryBrains in July 2005. The increase was also attributable to an increase in personnel costs of \$2.0 million of which \$757,000 was related to stock-based compensation expense, an increase in payment processing fees of \$247,000 an increase in facility and other costs of \$793,000, an increase in license fees and royalties of \$154,000 and an increase in registration fees and Internet domain amortization of \$1.5 million. The increase in stock-based compensation expense was due to our adoption of SFAS 123R in 2006. Service costs as a percentage of revenue were 53% for the nine months ended September 30, 2005 as compared to 47% in the same period in 2006. The 2006 decrease in service costs as compared to the same period in 2005 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 86%, from \$3.2 million for the three months ended September 30, 2005 to \$6.0 million in the same period in 2006. As a percentage of revenue, sales and marketing expenses were 12% and 18% for the three months ended September 30, 2005 and 2006, respectively. The increase in dollars was related primarily to an increase in personnel costs of \$342,000 of which a majority was related to stock-based compensation and the remaining amount was primarily related to an increase in the number of employees and an increase in online and outside marketing activities of \$2.4 million. The increase in stock-based compensation expense was due to our adoption of SFAS 123R in 2006. The remaining increase was 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 as a result of additional stock-based compensation expense due to our adoption of SFAS 123R and in connection with any revenue increase, to the extent that we also increase our marketing activities and correspondingly could increase as a percentage of revenue.

Sales and marketing expenses increased \$10.9 million or 170%, from \$6.4 million in the nine months ended September 30, 2005 to \$17.2 million in the same period in 2006 primarily due to an increase in personnel costs and an increase in online and outside marketing activities. As a percentage of revenue, the sales and marketing expenses were 10% in the nine months ended September 30, 2005 as compared to 18% in the same period in 2006.

Product Development. Product development expenses increased 159%, from \$1.0 million in the three months ended September 30, 2005 to \$2.7 million in the same period in 2006. As a percentage of revenue, product development expenses were 4% and 8% for the three months ended September 30, 2005 and 2006, respectively. The increase in dollars was primarily due to an increase in personnel costs of \$1.5 million of which \$1.0 million was related to stock-based compensation expense and the remaining amount was primarily related to an increase in the number of employees, and an increase in travel, depreciation expense, and other operating costs of \$125,000. The increase in stock-based compensation expense was due to our adoption of SFAS 123R in 2006. 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 and as a result of additional stock-based compensation expense due to our adoption of SFAS 123R.

Table of Contents

Product development expenses increased 130%, from \$3.3 million in the nine months ended September 30, 2005 to \$7.5 million in the same period in 2006. The increase in dollars was primarily due to an increase in personnel costs of \$3.8 million of which \$2.4 million was related to stock-based compensation expense and the remaining amount was primarily related to an increase in the number of employees. As a percentage of revenue, the product development expenses were 5% in the nine months ended September 30, 2005 compared to 8% in the same period in 2006.

General and Administrative. General and administrative expenses increased 66%, from \$1.9 million in the three months ended September 30, 2005 to \$3.1 million in the same period in 2006. The increase in dollars was primarily due to an increase in personnel costs of \$1.0 million of which \$833,000 was related to stock-based compensation, an increase in professional services of \$179,000, an increase in facilities related costs of \$10,000, and by a net increase in travel, bad debt, and other costs of \$13,000. As a percentage of revenue, general and administrative expenses were 7% and 10% for the three months ended September 30, 2005 and 2006, respectively. As a percentage of revenue, the increase in general and administrative expenses in 2006 as compared to 2005 was primarily a result of additional stock-based compensation expense due to our adoption of SFAS 123R in 2006. We expect that our general and administrative expenses will increase in absolute dollars as a result of additional stock-based compensation expense due to our adoption of SFAS 123R in 2006 and 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 114%, from \$4.8 million in the nine months ended September 30, 2005 to \$10.4 million in the same period in 2006. As a percentage of revenue, the general administrative expenses were 7% in the nine months ended September 30, 2005 compared to 11% in the same period in 2006.

Amortization of Intangible Assets From Acquisitions. Intangible amortization expense increased 2%, from \$5.2 million in the three months ended September 30, 2005 to \$5.3 million in the same period in 2006. The increase was associated with the July 2005 acquisition of IndustryBrains and the May 2006 AreaConnect and Open List asset acquisitions. During the 2006 period, the components of amortization of intangibles were service costs of \$3.6 million, sales and marketing of \$732,000 and general and administrative of \$981,000 million.

Intangible amortization expense increased 16%, from \$13.2 million in the nine months ended September 30, 2005 to \$15.3 million in the same period in 2006. The increase was associated with the Name Development and Pike Street asset acquisitions and the IndustryBrains acquisition during 2005 and the AreaConnect and Open List asset acquisitions in May 2006. During the nine months ended September 30, 2006, the components of amortization of intangibles were service costs of \$10.4 million, sales and marketing of \$1.9 million and general and administrative of \$3.0 million.

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 \$83.2 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, and if so, we expect that our intangible amortization will increase in absolute dollars.

Gain (loss) on sales and disposals of intangible assets, net. The gain (loss) on sales and disposals of intangible assets, net was (\$69,000) and \$285,000 for the three and nine months ended September 30, 2006 and was attributable to the sales and disposals of Internet domain name intangible assets. There was no comparable gain (loss) during the same period in 2005.

Other Income. Other income increased 54%, from \$532,000 in the three months ended September 30, 2005 to \$821,000 in the same period in 2006. The increase was primarily attributable to an increase in interest income

Table of Contents

of \$297,000 which was primarily a result of an increase in rates realized on invested funds. Other income increased 66%, from \$1.4 million in the nine months ended September 30, 2005 to \$2.3 million in the same period in 2006. The increase was primarily attributable to an increase in interest income of \$933,000.

Income Taxes. The income tax expense in the three months ended September 30, 2005 was \$871,000 as compared to \$813,000 in the same period in 2006. In the nine months ended September 30, 2005, the income tax expense was \$1.8 million as compared to \$2.3 million in the same period in 2006.

In the three and nine months ended September 30, 2005, the effective tax rate of 55% and 45%, respectively, differed from the expected effective tax rate of 35% primarily due to state income taxes and non-deductible stock compensation amounts recorded under the intrinsic-value based accounting prescribed by APB 25 in which stock-based compensation was recorded only if, on the date of grant, the current market price of our Class B common stock exceeded the exercise price. The effective tax rate of 99% and 101% in the three and nine months ended September 30, 2006, respectively, differed from the expected tax rate of 35% due to non-deductible stock-based compensation related to restricted stock and incentive stock options recorded under the fair-value method as prescribed by SFAS 123R, state income taxes, and other amounts.

During the three months ended September 30, 2005 and 2006, as a result of tax deductions from stock option exercises, we recognized tax-effected benefits of approximately \$470,000 and \$193,000, respectively, which were recorded as credits to additional paid in capital. During the nine months ended September 30, 2005 and 2006, we recognized tax-effected benefits of approximately \$798,000 and \$2.1 million, respectively.

Cumulative effect of Change in Accounting Principle. For the nine months ended September 30, 2006, a one-time gain of \$151,000, net of tax, was recognized as an cumulative effect of a change in accounting principle based on SFAS 123R's requirement to apply an estimated forfeiture rate to unvested awards. Previously, forfeitures had been recorded as incurred.

Convertible Preferred Stock Dividends and Conversion Payment. The convertible preferred stock dividends decreased 38%, from \$683,000 in the three months ended September 30, 2005 to \$422,000 in the same period in 2006. The decrease was primarily attributable to the reduction of outstanding preferred stock at September 30, 2006 due to the voluntary conversion of approximately 80,848 shares in March 2006. Convertible preferred stock dividends increased 36%, from \$1.7 million in the nine months ended September 30, 2005 to \$2.3 million in the same period in 2006. The increase was primarily attributable to a one time payment of \$970,000 associated with the voluntary conversion of approximately 80,848 shares of our preferred stock into approximately 824,980 shares of our Class B common stock in March 2006. Preferred stock dividends are based upon a dividend rate of 4.75%.

Net Income (Loss) Applicable to Common Stockholders. Net income (loss) applicable to common stockholders decreased from a net income of \$27,000 for the three months ended September 30, 2005 to a net loss of \$411,000 in the same period in 2006. The decrease was primarily attributable to an increase in stock-based compensation expense of \$2.7 million due to our adoption of SFAS 123R in 2006 and an increase in amortization of intangible assets from acquisitions of \$117,000 due primarily to the May 2006 AreaConnect and Open List asset acquisitions, offset by revenue increasing at a faster rate than service costs, sales and marketing, product development and general administration expenses excluding stock-based compensation expense, a decrease in preferred stock dividends of \$261,000, and an increase in interest income of \$297,000.

The net income (loss) applicable to common stockholders decreased from a net income of \$522,000 for the nine months ended September 30, 2005 to a net loss of \$2.2 million in the same period in 2006. The decrease was primarily attributable to an increase in stock-based compensation expense of \$9.0 million due to our adoption of SFAS 123R in 2006, a net increase in preferred stock dividends of \$624,000 which included a one-time payment of \$970,000 offset by a decrease in convertible preferred stock dividends on the outstanding preferred shares due to the voluntary conversion of 80,848 shares in March 2006, an increase in income tax expense of \$484,000, and an increase of amortization of intangible assets from acquisitions of \$2.1 million, offset by revenue increasing at a faster rate than service costs, sales and marketing, product development and general administration expenses

Table of Contents

excluding stock-based compensation expense, a one-time gain of \$151,000 as a cumulative effect of a change in accounting principle, an increase in interest income of \$933,000, and gain (loss) on sales and disposals of intangible assets, net of \$285,000.

Liquidity and Capital Resources

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. 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 price 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 (for accounting purposes) at an aggregate amount of approximately \$8.8 million. All of the net proceeds have been used to fund the Name Development and Pike Street asset acquisitions and the IndustryBrains acquisition in 2005, the AreaConnect and Open List asset acquisitions in May 2006 and for working capital and other general corporate purposes.

As of September 30, 2006, we had cash and cash equivalents of \$69.3 million. As of September 30, 2006, we had contractual obligations of \$4.3 million of which \$2.8 million is for rent under our facility leases.

Upon adoption of SFAS 123R on January 1, 2006, we are reporting the excess tax benefit from stock options as financing cash inflows rather than as an operating cash inflows as prescribed under the prior accounting rules in accordance with the modified prospective method of SFAS 123R. The tax benefit from stock options for the prior year has not been restated to conform to the current presentation.

Cash provided by operating activities primarily consists of net income adjusted for certain non-cash items such as depreciation and amortization, facility relocation amounts, deferred income taxes, cumulative effect of a change in accounting principle, excess tax benefit related to stock options, and changes in working capital. Cash provided by operating activities for the nine months ended September 30, 2006 of approximately \$26.8 million consisted primarily of net income of \$119,000 adjusted for non-cash items of \$26.5 million, including depreciation, amortization of intangible assets, allowance for doubtful accounts and merchant advertiser credits, stock-based compensation, deferred income taxes, cumulative effect of a change in accounting principle, and excess tax benefit related to stock options and approximately \$249,000 provided by working capital and other activities. Cash provided by operating activities for the nine months ended September 30, 2005 of approximately \$10.1 million consisted primarily of a net income of \$2.2 million adjusted for non-cash items of \$17.4 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 \$9.5 million used by working capital and other activities.

With respect to a significant portion 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 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 nine months ended September 30, 2005 and 2006. In certain cases, payments to distribution partners are paid in advance or are fixed in advance based on a guaranteed minimum amount of usage delivered.

Table of Contents

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 nine months ended September 30, 2006 of approximately \$22.0 million was primarily attributable to the payments for the AreaConnect and Open List asset acquisitions totaling approximately \$18.2 million, purchases for Internet domain names or Web sites of approximately \$603,000 and net purchases for property and equipment of \$5.0 million, offset by proceeds from the sales of intangible assets of approximately \$1.6 million, and proceeds, net of legal fees, from the settlement of certain intangible asset indemnification obligations in connection with our 2005 acquisitions of approximately \$347,000. Cash used in investing activities for the nine months ended September 30, 2005 of approximately \$206.6 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 of approximately \$12.6 million, the payment of the IndustryBrains acquisition for approximately \$15.4 million which is net of cash acquired of \$1.1 million, the Enhance Interactive earn-out consideration payment of \$5.7 million, purchases for Internet domain names or Web sites of approximately \$12.0 million, payment for a prepaid license of \$4.5 million and net purchases for property and equipment of \$1.5 million offset by proceeds from the sales of intangible assets of \$687,000.

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. Additionally, we have expended amounts for product development initiatives as well as amounts recorded as part of property and equipment for internally developed software. We expect our expenditures for product development initiatives and internally developed software will increase in absolute dollars as our development activities accelerate and we increase the number of personnel and consultants to enhance our service offerings.

Cash provided by financing activities for the nine months ended September 30, 2006 of approximately \$1.4 million was primarily attributable to net proceeds of approximately \$1.9 million from the sale of stock through employee stock options and employee stock purchases and \$2.0 million of excess tax benefit related to stock options offset by preferred dividend payments of \$2.5 million which included the one-time payment of \$970,000 associated with the voluntary conversion of approximately 80,848 shares of our preferred stock into approximately 824,980 shares of our Class B common stock. Cash provided by financing activities for the nine months ended September 30, 2005 of approximately \$228.8 million was primarily attributable to net proceeds from our follow-on offering in February 2005 of \$229.4 million, net proceeds of approximately \$807,000 from the sale of stock through employee stock options and employee stock purchase plan offset by preferred dividend payments of \$1.4 million.

The following table summarizes our contractual obligations as of September 30, 2006, and the effect these obligations are expected to have on our liquidity and cash flows in future periods.

	Total	Less than 1 year	1-3 years	4-5 years
Contractual Obligations:				
Operating leases (3)	\$ 2,826,290	\$ 293,225	\$ 1,734,512	\$ 798,553
Capital leases	64,064	5,135	41,078	17,851
Other contractual obligations	1,394,404	604,856	706,950	82,598
Total contractual obligations (1), (2)	\$ 4,284,758	\$ 903,216	\$ 2,482,540	\$ 899,002

- (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,

Table of Contents

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. The royalty payments are not included in the above schedule.

- (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.
- (3) In October 2006, the Company entered into a lease agreement for additional office space in Seattle, Washington commencing in 2007 and expiring in 2009 totaling approximately \$1.4 million. This amount is not included in the above table.

During the nine months ended September 30, 2006, we paid approximately \$603,000 for the purchase of additional Web sites. We expect to continue acquiring Internet domains or Web sites in the normal course of business as we grow our presence in the field of direct navigation.

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 \$1.7 million based upon approximately 142,137 convertible preferred shares outstanding as of September 30, 2006. 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 stockholders 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 were contractually required to use best efforts to keep this Registration Statement effective until April 26, 2006. We will not receive any proceeds in connection with these sales by selling stockholders.

On September 29, 2005, a Registration Statement on Form S-3 (File No. 333-128317) relating to the resale of 964,955 shares of our Class B common stock by certain selling stockholders with S-3 registration rights granted in connection with the IndustryBrains acquisition was declared effective by the Securities and Exchange Commission. We were contractually required to use best efforts to keep this Registration Statement effective until September 29, 2006. We will not receive any proceeds in connection with these sales by selling stockholders.

On June 21, 2006, a Registration Statement on Form S-3 (File No. 333-134851) relating to the resale of 662,717 shares of our Class B common stock by certain selling stockholders with S-3 registration rights granted

Table of Contents

in connection with the AreaConnect and Open List asset acquisitions was declared effective by the Securities and Exchange Commission. We are contractually required to use best efforts to keep this Registration Statement effective until May 26, 2007 (plus the period of time, if any, during which sales may be suspended while the suspension right is in effect). 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.

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 Web sites to an advertiser Web site and completes the specified action. In certain cases, we record revenue based on available and reported preliminary information from third parties. Collection on 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.

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

Table of Contents

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 Emerging Issues Task Force 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. In certain instances, the web publishers engage the merchant advertisers directly and we are paid an agency fee based on the total amount of the purchase made by the merchant advertiser.

Goodwill and Intangible Assets

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

We apply the provisions of the Financial Accounting Standards Board's (FASB) Statements of Financial Accounting Standards (SFAS) No. 142,

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

Table of Contents

Stock-Based Compensation

On January 1, 2006, we adopted SFAS 123R using the modified prospective method and therefore have not restated prior periods' results. SFAS 123R requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and restricted stock issuances based on estimated fair values. Under the fair value recognition provisions of SFAS 123R, we recognize stock-based compensation net of an estimated forfeiture rate and therefore only recognize compensation cost for those shares expected to vest over the service period of the award. Prior to SFAS 123R, we accounted for share-based payments under APB 25 and accordingly, generally recognized compensation expense related to restricted stock awards and stock options with intrinsic value and accounted for forfeitures as they occurred.

Under FAS 123R, we use the Black-Scholes option pricing model as our method of valuation for stock-based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the expected life of the award, our expected stock price, volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with FAS 123R, the assumptions used in calculating fair value of stock-based awards and the Black-Scholes option pricing model are highly subjective, and other reasonable assumptions could provide differing results. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. We estimate the forfeiture rate based on historical experience of our stock-based awards that are granted, exercised and cancelled. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period. See Note 3 *Stock-based Compensation Plans* in the condensed consolidated financial statements for additional information.

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 (SFAS 123R), *Share-Based Payment*, which replaces SFAS No. 123 (SFAS 123) and supersedes APB Opinion No. 25 (APB 25). We adopted the provisions of SFAS 123R on January 1, 2006. Thus, our consolidated financial statements 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

Table of Contents

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. See Note 3 **Stock-based Compensation Plans** for further information regarding our adoption of SFAS 123R and the impact on our financial position and results of operations.

In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107. In accordance with this Bulletin, effective January 1, 2006 we will no longer present stock-based compensation separately on our statements of income. Instead we will present stock-based compensation in the same lines as cash compensation paid to the same individuals.

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.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This pronouncement prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in the Company's tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning January 1, 2007. The Company is in the process of evaluating the effect of the adoption of FIN 48 will have on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The provisions of SAB 108 will be effective for the Company for the fiscal year ended December 31, 2006. The Company does not believe that the adoption of SAB 108 will have a material impact on its financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, which clarifies the definition of fair value, establishes a framework for measuring fair value and expands the related disclosure requirements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is in the process of evaluating the effect that SFAS 157 will have on its financial statements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our exposure to market risk is limited to interest income sensitivity, which is affected by changes in the general level of U.S. interest rates, particularly because the majority of our investments are in short-term, money market funds. We place our investments with high-quality financial institutions and limit the amount of credit exposure to any one financial institution. Due to the nature of our short-term investments, we believe that we are not subject to any material market risk exposure. We do not have any material foreign currency or other derivative financial instruments.

Table of Contents

Item 4. 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-Q. 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 control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q 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.

Table of Contents

Part II Other Information

Item 1. Legal Proceedings

We are not a party to any material legal proceedings. From time to time, however, we may be subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of intellectual property rights, and a variety of claims arising in connection with our services.

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report including the updated risk factor included below, you should also carefully review the risk factors discussed in Part II, Item 6 of our Annual Report on Form 10-KSB for the year ended December 31, 2005 and in Part II, Item 1A. of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006. Such risks could materially affect our business, financial condition or future results. Other than with respect to the risk factor included below, there have been no material changes from the risk factors previously disclosed in Part II, Item 6 of our Annual Report on Form 10-KSB and in Part II, Item 1A. of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 and such risks are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may adversely affect our business, financial condition and/or future results.

We anticipate that we will retain all or substantially all of our future earnings except for the payment of dividends on the preferred stock, and as a result holders of common stock are not likely to receive material dividends.

We anticipate that we will retain all or substantially 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 common stock are not likely to receive material dividends. The payment of any dividend by us to the holders of common stock will be at the discretion of our board of directors and will depend on, among other things, our cash flows, capital requirements and financial condition. In addition, dividends, if and when paid, may be subject to income tax withholding.

Item 6. Exhibits

Exhibits:

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

Table of Contents

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MARCHEX, INC.

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

(Principal Accounting Officer)

November 9, 2006