

Net Element, Inc.
Form 10-K
April 01, 2019
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2018

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: **001-34887**

Net Element, Inc.

(Exact name of registrant as specified in its charter)

Delaware **90-1025599**
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

3363 NE 163rd Street, Suite 705 **33160**
North Miami Beach, FL
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (305) 507-8808

Securities registered under Section 12(b) of the Exchange Act:

Title of each class	Name of each exchange on which registered
Common Stock, par value \$0.0001 per share	NASDAQ Capital Market

Securities registered under Section 12(g) of the Exchange Act:

Title of each class
Warrants, each exercisable for one share of Common Stock

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES NO

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 232.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Table of Contents

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The aggregate market value of the registrant's common equity, other than shares held by persons who may be deemed affiliates of the registrant, as of June 30, 2018 was approximately \$22,904,233.

The registrant had 3,865,467 shares of common stock outstanding as of March 29, 2019.

DOCUMENTS INCORPORATED BY REFERENCE

None.

Table of Contents

TABLE OF CONTENTS

	Page
<u>PART I</u>	
Item 1. <u>Business.</u>	5
Item 1A. <u>Risk Factors.</u>	26
Item 1B. <u>Unresolved Staff Comments.</u>	34
Item 2. <u>Properties.</u>	34
Item 3. <u>Legal Proceedings.</u>	35
Item 4. <u>Mine Safety Disclosures.</u>	35
<u>PART II</u>	
Item 5. <u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.</u>	35
Item 6. <u>Selected Financial Data.</u>	35
Item 7. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations.</u>	36
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk.</u>	45
Item 8. <u>Financial Statements and Supplementary Data.</u>	45
Item 9. <u>Changes In and Disagreements With Accountants on Accounting and Financial Disclosure.</u>	45
Item 9A. <u>Controls and Procedures.</u>	45
Item 9B. <u>Other Information.</u>	46
<u>PART III</u>	
Item 10. <u>Directors, Executive Officers and Corporate Governance.</u>	47
Item 11. <u>Executive Compensation.</u>	50
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.</u>	51
Item 13. <u>Certain Relationships and Related Transactions, and Director Independence.</u>	52

Item 14. Principal Accountant Fees and Services. 53

PART IV

Item 15. Exhibits and Financial Statement Schedules. 54

Item 16. Form 10-K Summary. 63

Signatures 64

Table of Contents

NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K (this "Report") includes statements that express our opinions, expectations, beliefs, plans, objectives, assumptions or projections regarding future events or future results and therefore are, or may be deemed to be, "forward-looking statements" within the meaning of the federal securities laws. All statements other than statements of historical facts contained in this Report may be forward-looking statements, including, statements regarding our future results of operations and financial position, our business strategy and plans, our objectives for future operations and any statements of a general economic or industry specific nature. These forward-looking statements can generally be identified by the use of forward-looking terminology, including the terms "believes," "estimates," "continues," "anticipates," "expects," "seeks," "projects," "intends," "plans," "may," "will," "would" or "should" or, in each case, their negative or other variations or comparable terminology.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. These factors include, but are not limited to, the following:

- *the impact of any new or changes made to laws, regulations, card network rules or other industry standards affecting our business;*
- *the impact of any significant chargeback liability and liability for merchant or customer fraud, which we may not be able to accurately anticipate and/or collect;*
- *our ability to secure or successfully migrate merchant portfolios to new bank sponsors if current sponsorships are terminated;*
- *our and our bank sponsors' ability to adhere to the standards of Visa and MasterCard payment card brand;*
- *our reliance on third-party processors and service providers;*
- *our dependence on independent sales groups ("ISGs") that do not serve us exclusively to introduce us to new merchant accounts;*
- *our ability to retain clients, many of which are small- and medium-sized businesses ("SMBs"), which can be difficult and costly to retain;*
- *our ability to pass along increases in interchange costs and other costs to our merchants;*
- *our ability to protect against unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems or otherwise;*
- *the effect of the loss of key personnel on our relationships with ISGs, card brands, bank sponsors and our other service providers;*
- *the effects of increased competition, which could adversely impact our financial performance;*
- *the impact of any increase in attrition due to an increase in closed merchant accounts and/or a decrease in merchant charge volume that we cannot anticipate or offset with new accounts;*
- *the effect of adverse business conditions on our merchants;*
- *our ability to adopt technology to meet changing industry and customer needs or trends;*
- *the impact of any decline in the use of credit cards as a payment mechanism for consumers or adverse developments with respect to the credit card industry in general;*
- *the impact of any adverse conditions in industries in which we obtain a substantial amount of our bankcard processing volume;*

Edgar Filing: Net Element, Inc. - Form 10-K

- *the impact of seasonality on our operating results;*
- *the impact of any failure in our systems due to factors beyond our control;*
- *the impact of any material breaches in the security of third-party processing systems we use;*
- *the impact of any new and potential governmental regulations designed to protect or limit access to consumer information;*
- *the impact on our profitability if we are required to pay federal, state or local taxes on transaction processing;*
- *the impact on our growth and profitability if the markets for the services that we offer fail to expand or if such markets contract;*
- *significant losses we have incurred and may continue to experience in the future;*
- *foreign laws and regulations, which are subject to change and uncertain interpretation;*
- *geopolitical instability and other conditions that may adversely affect trends in consumer, business and government spending;*
- *the Company's ability (or inability) to obtain additional financing in sufficient amounts or on acceptable terms when needed;*
- *the impact on our operating results as a result of impairment of our goodwill and intangible assets;*
- *our material weaknesses in internal control over financial reporting and our ability to maintain effective controls over financial reporting in the future; and*
- *the risk factors included in Part I, Item 1A of this Annual Report on Form 10-K*

Although we base these forward-looking statements on assumptions that we believe are reasonable when made, we caution you that forward-looking statements are not guarantees of future performance and that our actual results of operations, financial condition and liquidity, and industry developments may differ materially from statements made in or suggested by the forward-looking statements contained in this Annual Report on Form 10-K. If these or other risks and uncertainties (including those described in Part I, Item 1A of this Report and our subsequent filings with the U.S. Securities and Exchange Commission (the "SEC" or the "Commission")) materialize, or if the assumptions underlying any of these statements prove incorrect, our actual results may be materially different from those expressed or implied by such statements. In addition, even if our results of operations, financial condition and liquidity, and industry developments are consistent with the forward-looking statements contained in this filing, those results or developments may not be indicative of results or developments in subsequent periods.

In light of these risks and uncertainties, we caution you not to place undue reliance on these forward-looking statements. Any forward-looking statement that we make in this filing speaks only as of the date of such statement, and we undertake no obligation to update any forward-looking statement or to publicly announce the results of any revision to any of those statements to reflect future events or developments, except as required by applicable law. Comparisons of results for current and any prior periods are not intended to express any future trends or indications of future performance, unless specifically expressed as such, and should only be viewed as historical data.

Table of Contents

PART I

Item 1. Business.

Net Element, Inc., (“Net Element”) a Delaware corporation, is a holding company that conducts its operations through its subsidiaries. Net Element and its subsidiaries are referred to collectively as the “Company,” “Net Element,” “we,” “us,” or “our,” unless the context requires otherwise.

Company Overview

Net Element is a global technology and value-added solutions group that supports electronic payments acceptance in a multi-channel environment including point-of-sale (POS), ecommerce and mobile devices. The Company operates two business segments as a provider of *North American Transaction Solutions* and *International Transaction Solutions*.

We offer a broad range of payment acceptance and transaction processing services that enable merchants of all sizes to accept and process over 100 different payment options in more than 120 currencies, including credit, debit, prepaid and alternative payments. We also provide merchants with value-added services and technologies including integrated payment technologies, POS solutions, fraud management, information solutions and analytical tools.

We are differentiated by our technology-centered value-added service offerings built around our payments ecosystem and our diversified business model, which enables us to provide our varied customer base with a broad range of transaction-processing services from a single source across numerous channels and geographic markets. We believe these capabilities provide several competitive advantages that will enable us to continue to penetrate our existing customer base with complementary new services, win new customers, develop new sales channels and enter new markets. We believe these competitive advantages include:

- Our ability to provide competitive products through use of proprietary technologies;
- Our ability to provide in one package a range of services that traditionally had to be sourced from different vendors;
- Our ability to provide a single agnostic on-boarding and merchant management platform to our indirect non-bank sales force ("Sales Partners");
- Our ability to provide management and optimization tools to our Sales Partners amongst multiple networks and platforms;

Our ability to serve customers with disparate operations in several geographies with technology solutions that enable them to manage their business as one enterprise; and

Our ability to capture and analyze data across the transaction processing value chain and use that data to provide value-added services that are differentiated from those offered by pure-play vendors that serve only one portion of the transaction processing value chain (such as only merchant acquiring or POS).

We have operations and offices located within the United States (“U.S.”) (domestic) and outside of the U.S. (international) where sales, customer service and/or administrative personnel are based. Through U.S. based subsidiaries, we generate revenues from transactional services, value-added payment services and technologies that we provide to SMBs. Through wholly owned subsidiaries, we focus on transactional services, mobile payment transactions, online payment transactions, value-added payment services and technologies in selected international markets.

Our business is characterized by transaction related fees, multi-year contracts, and a diverse client base, which allows us to grow alongside our clients. Our multi-year contracts allow us to achieve a high level of recurring revenues with the same clients. While the contracts typically do not specify fixed revenues to be realized thereunder, they do provide a framework for revenues to be generated based on volume of services provided during such contracts’ term.

Table of Contents

Products and Services Information

Our broad suite of services spans the entire transaction processing value chain of commerce enabling services and technologies and includes a range of front-end customer-facing solutions, as well as back-end support services and account reconciliation. We deliver our value-added solutions from a suite of proprietary technology products, software, cloud-based applications, processing services, fraud management offerings, and customer support programs that we configure to meet our client's individual needs.

Many of our payment solutions are technology-enabled in that they incorporate or are incorporated into innovative, technology-driven solutions, including enterprise software solutions, designed to enable merchants to better manage their businesses.

Integrated and Vertical Markets. Our integrated and vertical market solutions provide advanced payments technology that is deeply integrated into business enterprise software solutions either owned by us or by our partners. We grow our business when new merchants implement our enterprise software solutions and when new or existing merchants enable payments services through enterprise software solutions sold by us or by our partners. Our primary technology-enabled solutions include integrated and vertical markets, ecommerce and multi-channel solutions, each as described below:

Unified Payments – doing business as Unified Payments, we provide businesses of all sizes and types throughout the United States with a wide range of fully-integrated payment acceptance solutions, value-added POS and business process management services;

PayOnline – through our subsidiary, PayOnline Systems (“PayOnline”), we provide a wide range of value-added online solutions in the selected international markets utilizing our fully-integrated, agnostic electronic commerce platform that simplifies complex enterprise online transaction processing challenges from payment acceptance and processing through risk prevention and payment security via point-to-point encryption and tokenization solutions;

Pay-Travel – integrated payment processing solutions to the travel industry, which includes integrations with various Global Distribution Systems (“GDS”) such as Amadeus®, Galileo®, Sabre®, additional geo filters and passenger name record (PNR) through Pay-Travel service offered by PayOnline;

Aptito POS Platform – an integrated POS platform developed on Apple's® iOS and Android® mobile operating systems for the hospitality, retail, service and on the go industries. Our goal with Aptito is to create an easy to use POS and business management solution, which incorporates everything a small business needs to help streamline every-day management, operations and payment acceptance;

Restoactive – utilizing Aptito POS Platform architecture, we have developed and launched Restoactive, which seamlessly plugs into a current restaurant environment through integrations with some of the biggest POS and restaurant management platforms available on the market today;

Unified m-POS – mobile POS application makes accepting payments on the go easy and secure. Mobile application is EMV-compliant, accepts traditional and contactless transactions such as Apple Pay®. Unified m-POS application is available for download in Apple’s App Store and Google Play;

Zero Pay – zero-fee payment acceptance program for SMB merchants in the United States. Zero Pay program saves merchants costs involved in accepting credit and debit cards using mobile POS;

Netevia – our internally developed future-ready multi-channel payments and merchant management platform. Connecting and simplifying payments across sales channels through a single integration point, Netevia delivers end-to-end payment processing through easy-to-use APIs. The Netevia platform is the core of the company’s technology stack.

Table of Contents

Recent Developments

During 2018 and through the filing of this Report, we completed a number of transactions and other accomplishments in pursuit of our strategy of enhancing financial results, creating a strong operational foundation and competitive advantage. We believe the following transactions and actions have focused and strengthened our company and improved our capital structure and cash flow.

Our primary actions and achievements during 2018, and through the filing of this Form 10K, were as follows:

- Acquired recurring cash flow portfolio from Argus Merchant Services, projected to add over \$4 million in gross profits over the next 4 years
- Acquired recurring cash flow portfolio from Universal Payment Systems, projected to add over \$5 million in gross profits over the next 4 years
- Ranked as one of the fastest growing companies in North America on Deloitte's 2018 Technology Fast 500™
- Jon Najarian of CNBC "Halftime Report" and "Fast Money", and Jonathan Fichman, a fin-tech and startup executive, joined our Company's Board of Directors

Recent Partnership and Achievements:

- Entered into a partnership with Payment Club for subscription-based payment processing services for small businesses projected to add over \$1.5 million in gross profits over the next 4 years
- Partnered with VIP Systems to launch seamless payments for the multi-billion-dollar hospitality industry
- Net Element was named one of the top 10 retail payment consulting/services companies of 2018 by Retail CIO Outlook magazine
- Our subsidiary, Unified Payments, is among the first companies to achieve self-regulatory certification from the Electronics Transactions Association

Recently Completed Product Launches:

- Launched multi-channel payments platform, Netevia, connecting and simplifying payments across sales channels through a single integration point, delivering end-to-end payment processing through easy-to-use APIs. This model complements our ability to perform in a multi-channel environment, including point-of-sale (POS), e-commerce, and mobile devices
- Launched multi-channel Blockchain-powered payments acceptance application as part of its Netevia platform
- Launched subscription-based payment processing services for small businesses which targets the multi-billion dollar subscription economy

Edgar Filing: Net Element, Inc. - Form 10-K

Launched Netevia Light POS, a seamless and secure mobile payments acceptance software available on smart terminals by PAX Technology

Launched Aptito on the world's first smart payment terminal. This comprehensive POS solution is now available for restaurants on the Poynt Smart Payment terminal

Launched Netevia Smart Vendor payment solutions for B2B sales which will allow our Company access to the \$7.7 trillion B2B sales market

Launched an intelligent payments solution that addresses the needs of North America's annual \$845 billion events industry

Launched "Fast Pass Funding", a same-day funding service available through our Netevia platform.

Table of Contents

Outlook

Our strategy is to ensure that our business remains successful in a rapidly changing market, creating sustainable value for all our stakeholders, including our clients, distribution partners and shareholders. We aim to achieve superior results for our clients by having a deep understanding of their payment acceptance needs, extensive market reach, strong product development and technology enablement.

Planned for 2019:

We will continue to focus on understanding our clients and addressing their payment acceptance needs in core market segments.

- Continue growth in all key segments and expand our network of referral partners
- Drive and improve client retention
- Expand our client base in selected markets
- Deliver value-added products to our clients to increase efficiencies and payment acceptance
- Launch new tools to reach our clients, such as digital channels, and deepening partner relations

The global payments industry continued to deliver healthy growth during 2018, with underlying transaction volumes demonstrating even greater strength. We believe that new and disruptive technologies will provide us the opportunity to differentiate ourselves from our competition, continue developing and delivering innovative payment solutions in 2019 and beyond.

- Continue to enhance Netevia, our future-ready multi-channel payments platform, enabling intelligent routing of payments for the application development community
- Continue to scale and enhance new product launches that will add value to our clients
- Extend our capabilities in next-generation POS hardware and software, and deepening our partner proposition
- Commence trials of advanced technologies around business intelligence and mobile based payments acceptance
- Continue the further development of disruptive emerging technologies such as blockchain technologies, payments enablement for Internet of Things (“IoT”), biometrics payment acceptance and artificial intelligence
- Continue research and investments in future emerging payment technologies

Realize the full potential of our business model.

Deliver stronger organic growth

Develop additional payment network relationships to integrate with our technologies

Monetize acquisitions completed in 2018

Seek acquisition or investment opportunities to deepen our technological and distribution capabilities

We continue to believe that disruptive technologies such as blockchain, IoT, biometrics payments and artificial intelligence will play key roles in future commerce. These technologies will encourage innovation through development of value-added services and cater to both merchants and their customers.

We believe Netevia, our future-ready payments and merchant management platform will act as a framework and core for a number of value-added services that can connect merchants and consumers directly utilizing these disruptive technologies while increasing the economic efficiency of all transactions being made within the ecosystem. Specifically, Netevia delivers end-to-end payment processing through easy-to-use APIs and complements the Company's ability to perform in a multi-channel environment, including point-of-sale (POS), e-commerce and mobile devices and will enable the Company to