

ZIX CORP
Form 10-Q
November 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2014

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

For the transition period from _____ to _____

Commission File Number: 0-17995

ZIX CORPORATION
(Exact Name of Registrant as Specified in its Charter)

Texas
(State of Incorporation)

75-2216818
(I.R.S. Employer

Identification Number)

2711 North Haskell Avenue

Suite 2200, LB 36

Dallas, Texas 75204-2960

(Address of Principal Executive Offices)

(214) 370-2000

(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

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 4, 2014
Common Stock, par value \$0.01 per share	56,819,201

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ZIX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2014 (unaudited)	December 31, 2013
(In thousands, except share and par value data)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 20,262	\$ 27,518
Receivables, net	2,313	2,324
Prepaid and other current assets	1,748	2,038
Deferred tax assets	1,361	1,814
Total current assets	25,684	33,694
Property and equipment, net	3,823	2,608
Goodwill	2,161	2,161
Deferred tax assets	51,023	52,239
Total assets	\$ 82,691	\$ 90,702
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 641	\$ 495
Accrued expenses	3,069	1,992
Deferred revenue	21,733	19,080
Total current liabilities	25,443	21,567
Long-term liabilities:		
Deferred revenue	959	1,278
Deferred rent	1,561	1,623
Total long-term liabilities	2,520	2,901
Total liabilities	27,963	24,468
Commitments and contingencies (see Note 7)		
Stockholders' equity:		
Preferred stock, \$1 par value, 10,000,000 shares authorized; none issued and outstanding		
Common stock, \$0.01 par value, 175,000,000 shares authorized; 74,851,387 issued and 56,814,401 outstanding in 2014 and 74,417,946 issued and 60,513,287 outstanding in 2013	739	737
Additional paid-in capital	360,943	359,154
Treasury stock, at cost; 18,036,986 common shares in 2014 and 13,904,659 common shares in 2013	(66,882)	(50,386)
Accumulated deficit	(240,072)	(243,271)

Total stockholders' equity	54,728	66,234
Total liabilities and stockholders' equity	\$ 82,691	\$ 90,702

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

Three Months Ended September 30, Nine Months Ended September 30,

(In thousands, except share and per share data)

	2014		2013		2014		2013	
Revenues	\$	12,705	\$	12,225	\$	37,482	\$	35,827
Cost of revenues		2,062		1,904		6,119		5,743
Gross margin		10,643		10,321		31,363		30,084
Operating expenses:								
Research and development		2,234		2,345		6,653		7,444
Selling, general and administrative		6,544		4,659		19,611		16,807
Total operating expenses		8,778		7,004		26,264		24,251
Operating income		1,865		3,317		5,099		5,833
Other income, net		66		17		140		141
Income before income taxes		1,931		3,334		5,239		5,974
Income tax expense		(768)		(159)		(2,040)		(361)
Net Income	\$	1,163	\$	3,175	\$	3,199	\$	5,613
Basic income per common share	\$	0.02	\$	0.05	\$	0.05	\$	0.09
Diluted income per common share	\$	0.02	\$	0.05	\$	0.05	\$	0.09
Basic weighted average common shares outstanding		57,610,386		61,378,131		58,510,426		61,172,708
Diluted weighted average common shares outstanding		58,501,937		63,065,762		59,613,658		62,517,989

See notes to condensed consolidated financial statements.

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(Unaudited)

	Stockholders' Equity					Total
	Common Stock		Additional	Treasury	Accumulated	Stockholders
(In thousands, except shares)	Shares	Amount	Capital	Stock	Deficit	Equity
Balance, December 31, 2013	74,417,946	\$ 737	\$ 359,154	\$ (50,386)	\$ (243,271)	\$ 66,234
Issuance of common stock upon exercise of stock options	241,441	2	455			457
Issuance of restricted common stock	140,000					
Issuance of common stock upon vesting of restricted stock units	52,000					
Employee stock-based compensation costs			1,334	(257)		1,077
Treasury repurchase program				(16,239)		(16,239)
Net income					3,199	3,199
Balance, September 30, 2014	74,851,387	\$ 739	\$ 360,943	\$ (66,882)	\$ (240,072)	\$ 54,728

See notes to condensed consolidated financial statements.

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ZIX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	Nine Months Ended September 30,	
	2014	2013
Operating activities:		
Net income	\$ 3,199	\$ 5,613
Non-cash items in net income:		
Depreciation and amortization	1,210	1,078
Employee stock-based compensation costs	1,334	1,298
Changes in deferred taxes	1,669	89
Changes in operating assets and liabilities:		
Receivables	11	(1,798)
Prepaid and other current assets	290	(58)
Accounts payable	(482)	(72)
Deferred revenue	2,334	2,520
Accrued and other liabilities	1,015	1,106
Net cash provided by operating activities	10,580	9,776
Investing activities:		
Purchases of property and equipment	(1,797)	(1,262)
Net cash used in investing activities	(1,797)	(1,262)
Financing activities:		
Proceeds from exercise of stock options	457	1,494
Purchase of treasury shares	(16,496)	(120)
Net cash provided by (used in) financing activities	(16,039)	1,374
Increase (decrease) in cash and cash equivalents	(7,256)	9,888
Cash and cash equivalents, beginning of period	27,518	22,988
Cash and cash equivalents, end of period	\$ 20,262	\$ 32,876

See notes to condensed consolidated financial statements.

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ZIX CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Zix Corporation (ZixCorp, the Company, we, us) should be read in conjunction with the audited consolidated financial statements included in the Company's 2013 Annual Report on Form 10-K. These financial statements are unaudited, but have been prepared in the ordinary course of business for the purpose of providing information with respect to the covered interim periods. Management of the Company believes that all adjustments necessary for a fair presentation for such periods have been included and are of a normal recurring nature. The results of operations for the nine-month period ended September 30, 2014, are not necessarily indicative of the results to be expected for any future periods or for the full fiscal year.

2. Recent Accounting Standards and Pronouncements

Unrecognized Tax Benefit

In July 2013, the FASB issued guidance that requires entities to present unrecognized tax benefits (UTB) in the financial statements as a reduction to a deferred tax asset (DTA) for a net operating loss (NOL) carry-forward when NOLs exist. Entities whose NOL carry-forwards are not available to settle taxes that would result from the disallowance of the tax position, or who do not intend to use their DTA for that purpose, should present their UTB as a liability and should not net the UTB with the DTA. The guidance became effective for us at the beginning of 2014. This new guidance did not have an impact on our condensed consolidated financial statements.

Revenue Recognition

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes most current revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP.

The standard is effective for us beginning 2017, and requires using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We are currently evaluating the impact of our pending adoption of ASU 2014-09 on our consolidated financial statements and have not yet determined the method by which we will adopt the standard in 2017.

3. Stock- Based Awards and Stock-Based Employee Compensation Expense

Our stock-based awards include stock options, restricted stock awards (RSA s), restricted stock units (RSU s), and performance units (PU s). As of September 30, 2014, the Company had 5,147,997 stock options outstanding and 284,804 shares available for grant.

Stock Option Activity

There were 217,468 and 241,441 stock options exercised for the three and nine month period ended September 30, 2014, respectively. There were 435,066 and 759,186 stock options exercised for the three and nine month period ended September 30, 2013, respectively. A \$61 thousand excess tax benefit was recorded in the three month period ended September 30, 2014, related to the 217,468 option exercises. The excess tax benefit in the nine month period ended September 30, 2014, related to the 241,441 option exercises was \$70 thousand.

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The following is a summary of all stock option transactions during the three months ended September 30, 2014:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Yrs)
Outstanding at June 30, 2014	5,759,945	\$ 3.60	
Granted at market price			
Cancelled or expired	(394,480)	\$ 4.75	
Exercised	(217,468)	\$ 1.83	
Outstanding at September 30, 2014	5,147,997	\$ 3.58	3.85
Options exercisable at September 30, 2014	4,710,157	\$ 3.66	3.48

At September 30, 2014, we had 2,273,589 stock options outstanding and 1,898,249 options exercisable in which the exercise price was lower than the market price of the Company's common stock. The aggregate intrinsic value of these options was \$2.3 million and \$2.0 million, respectively.

Restricted Stock Activity

The following is a summary of all RSA activity during the three months ended September 30, 2014:

	Restricted Shares	Weighted Average Fair Value
Unvested at June 30, 2014	692,000	\$ 3.33
Granted at market price		
Vested	(87,750)	\$ 2.49
Cancelled		
Unvested restricted stock at September 30, 2014	604,250	\$ 3.45

A \$28 thousand excess tax benefit was recorded in the three month period ended September 30, 2014. A \$69 thousand excess tax benefit was recorded in the nine month period ended September 30, 2014, related to vesting RSA's.

Restricted Stock Unit Activity

The following is a summary of all RSU activity during the three months ended September 30, 2014:

	Restricted Stock Units	Weighted Average Fair Value
Unvested at June 30, 2014	211,000	\$ 3.38
Granted at market price		
Vested	(28,250)	\$ 2.49
Cancelled		
Unvested restricted stock units at September 30, 2014	182,750	\$ 3.52

Performance Unit Activity

The following is a summary of all PU activity during the three months ended September 30, 2014:

	Performance Units	Weighted Average Fair Value
Unvested at June 30, 2014	100,000	\$ 4.66
Granted at market price		
Vested		
Cancelled		
Unvested restricted stock units at September 30, 2014	100,000	\$ 4.66

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The weighted average grant-date fair value of awards of restricted stock, RSU's (collectively restricted stock), and PU's is based on the quoted market price of the Company's common stock on the date of grant.

Stock-Based Compensation Expense

For the three and nine month period ended September 30, 2014, the total stock-based employee compensation expense resulting from stock options, restricted stock, RSU's, and PU's was recorded to the following line items of the Company's condensed consolidated statements of income:

(In thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014		2014	
Cost of revenues	\$	45	\$	145
Research and development		61		185
Selling, general and administrative		312		1,004
Stock-based compensation expense	\$	418	\$	1,334

A deferred tax asset totaling \$368 thousand and \$243 thousand, resulting from stock-based compensation expense associated with awards relating to the Company's U.S. operations, was recorded for the nine month periods ended September 30, 2014 and 2013, respectively. As of September 30, 2014, there was \$2.8 million of total unrecognized stock-based compensation related to non-vested stock-based compensation awards granted under the incentive plans. This cost is expected to be recognized over a weighted average period of 1.56 years.

For additional information regarding the Company's Equity Awards and Stock-based Employee Compensation, see Note 3 to the consolidated financial statements contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

4. Supplemental Cash Flow Information

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

(In thousands)	Nine Months Ended September 30,	
	2014	2013
Cash income tax payments	\$ 399	\$ 188
Non-cash investing and financing activities:		
Payables related to purchases of capitalized assets	\$ (628)	\$ 20
Excess tax benefit on exercise of employee stock options	\$ 70	\$
Excess tax benefit on vesting of restricted awards	\$ 69	\$

5. Receivables, net

(In thousands)	September 30, 2014	December 31, 2013
Gross Accounts Receivables	\$ 8,983	\$ 8,359
Allowance for returns and doubtful accounts	(104)	(46)
Unpaid portion of deferred revenue	(6,566)	(5,989)
Note receivable	458	458
Allowance for note receivable	(458)	(458)
Receivables, net	\$ 2,313	\$ 2,324

Our gross receivables as of September 30, 2014, include \$775 thousand associated with a tenant improvement allowance received as an incentive when we renewed the lease for our Dallas headquarters in 2013.

The allowance for doubtful accounts includes all specific accounts receivable which we believe are likely not collectible based on known information. In addition, we record 2.5% of all accounts receivable greater than 90 days past due, net of those accounts specifically reserved, as a general allowance against accounts that could potentially become uncollectible.

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The reduction for deferred revenue represents future customer service or maintenance obligations which have been billed to customers, but remain unpaid as of the respective balance sheet dates. Deferred revenue on our consolidated balance sheets represents future customer service or maintenance obligations which have been billed and collected as of the respective balance sheet dates.

The note receivable represents the remaining outstanding balance of an original note related to the sale of a product line in 2005 in the amount of \$540 thousand. This was fully reserved at the time of the sale as the note's collectability was not assured. The note receivable is fully reserved at September 30, 2014.

6. Earnings Per Share and Potential Dilution

Basic earnings per share are computed using the weighted average number of common shares outstanding for the period. The dilutive effect of potential common shares outstanding is included in diluted earnings per share. The computations for basic and diluted earnings per share for the three and nine months ended September 30, 2014 and 2013, are as follows:

	Three Months ended September 30,		Nine Months ended September 30,	
	2014	2013	2014	2013
Basic weighted average shares	57,610,386	61,378,131	58,510,426	61,172,708
Effect of dilutive securities:				
Employee and director stock options	701,111	1,342,060	858,876	1,073,873
Restricted stock	146,556	268,504	188,412	208,805
RSU's	43,884	77,067	55,876	62,603
PU's			68	
Potential dilutive common shares	58,501,937	63,065,762	59,613,658	62,517,989

During the three months ended September 30, 2014, weighted average shares related to 3,467,745 stock options, 105,000 shares of restricted stock, and 41,250 RSU's were excluded from the calculation of diluted earnings per share because they were anti-dilutive. During the nine months ended September 30, 2014, weighted average shares related to 3,270,853 stock options, 97,222 shares of restricted stock, 38,194 RSU's and 44,444 PU's were excluded from the calculation of diluted earnings per share because the awards were similarly anti-dilutive.

7. Commitments and contingencies

A summary of our fixed contractual obligations and commitments at September 30, 2014, is as follows:

(In thousands)	Payments Due by Period				
	Total	1 Year	Years 2 & 3	Years 4 & 5	Beyond 5 Years
Operating leases	\$ 11,179	\$ 1,441	\$ 2,282	\$ 2,038	\$ 5,418

We have not entered into any material, non-cancelable purchase commitments at September 30, 2014.

Claims and Proceedings

We are from time to time involved in legal claims, litigation, and other legal proceedings. Although we may incur significant expenses in those matters, we expect no material adverse effect on our operations or financial results from current or concluded legal proceedings.

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8. Fair Value Measurements

FASB guidance regarding fair value measurement establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets for identical assets or liabilities; Level 2, defined as inputs other than quoted prices for similar assets and liabilities in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

For certain of the Company's financial instruments, including cash and cash equivalents, trade receivables, and accounts payable, the fair values approximate carrying values due to the short-term maturities of these instruments. The carrying values of other current assets and accrued expenses are also not recorded at fair value, but approximate fair values primarily due to their short-term nature.

9. Common Stock Repurchase Program

During the three months ended September 30, 2014, the Company repurchased 2,663,066 shares at an aggregate cost of \$10.0 million, completing a \$10 million share repurchase program authorized by our board of directors which was announced July 30, 2014. During the three months ended March 31, 2014, the Company repurchased 1,407,129 shares at an aggregate cost of \$6.2 million, completing a \$15 million share repurchase program authorized by our board of directors which was announced November 6, 2013. The Company previously repurchased 1,976,900 shares at an aggregate cost of \$8.8 million under this program.

10. Income Taxes

At the end of 2013, the Company recorded a \$1.4 million tax benefit by reducing the valuation allowance related to its deferred tax assets. This reduction was determined through an assessment of future deferred tax asset utilization following accounting guidance which relies largely on historical earnings. Using the same methodology, and updating the future taxable earnings estimates based on first, second, and third quarter 2014 actual earnings, the Company believes its future U.S. federal taxable earnings estimate to be established at the end of 2014 may not exceed the estimate used at the end of 2013. For this reason, the Company recognized its first, second, and third quarter 2014 federal deferred tax provision in full. In contrast, in the first, second, and third quarter 2013, the Company believed that its future U.S. federal taxable estimate established at the end of 2013 would exceed the prior year estimate. Accordingly, the Company offset its federal deferred tax provision by reducing its valuation allowance by an equal amount, thereby eliminating from its deferred tax provision federal taxes in excess of the estimated Alternative Minimum Tax from the Company's first, second, and third quarter 2013 financial statements. The Company will continue to reevaluate its valuation allowance each quarter, following the same assessment methodology described above.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

NOTE ON FORWARD-LOOKING STATEMENTS AND RISK FACTORS

Statements in this report which are not purely historical facts or which necessarily depend upon future events, including statements about trends, uncertainties, hopes, beliefs, anticipations, expectations, plans, intentions or strategies for the future, may be forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. Forward-looking statements involve risks and uncertainties that could cause actual events or

results to differ materially from the events or results described in the forward-looking statements, including risks and uncertainties described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013. Any of these risk factors could have a material adverse effect on our business, financial condition or financial results and reduce the value of an investment in our securities. We may not succeed in addressing these and other risks associated with an investment in our securities, with our business and with our achieving any forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking statements. All forward-looking statements are based upon information available to us on the date the statements are made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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Overview

ZixCorp® offers email encryption, data loss prevention (DLP), and Bring-Your-Own-Device (BYOD) security to meet business data protection and compliance needs. We primarily serve organizations in the healthcare, financial services, insurance and government sectors, including significant federal financial regulators such as those on the Federal Financial Institutions Examination Council (FFIEC), divisions of the U.S. Treasury, the U.S. Securities and Exchange Commission (SEC), the Financial Industry Regulatory Agency (FINRA) one in every five U.S. banks, more than 30 Blue Cross Blue Shield organizations and one in every five U.S. hospitals.

Zix® Email Encryption enables the secure exchange of email that includes sensitive information through a comprehensive secure messaging service, which allows an enterprise to use policy-driven rules to determine which email messages should be sent securely to comply with regulations or company-defined policies. It is a Software-as-a-Service (SAAS) solution, for which customers pay an annual service subscription fee.

ZixCorp's main differentiation in the marketplace is our exceptional ease of use. The best example of this is our ability to provide transparent delivery of secure, encrypted email. Most email encryption solutions are focused on the sender. They typically introduce an added burden on receivers, often requiring additional user authentication with creation of a new user identity and password. We designed our solution to alleviate the receiver's burden by enabling the delivery of encrypted email automatically and transparently. ZixCorp enables transparent delivery by (1) ZixDirectory®, the world's largest email encryption community which is designed to share identities of our tens of millions of members (growing by approximately 100,000 members per week), (2) ZixCorp's Best Method of Delivery®, which is designed to deliver email according to the sender's encryption policy, and (3) ZixGateway®, which is an enterprise gateway that automatically decrypts the message. The result is the industry's only transparent encrypted email, such that secure email can be exchanged without extra steps or passwords for both sender and receiver.

In March 2013 the Company launched ZixDLP®, an email-specific data loss prevention (DLP) solution. By focusing strictly on email, ZixDLP addresses business's greatest source of data loss corporate email. The straightforward DLP approach that decreases the complexity and cost often associated with other DLP solutions. ZixDLP is designed to reduce deployment time from months to hours and to minimize impact on customer resources and workflow. In addition, ZixDLP offers a convenient experience for both employees interacting with the solution and administrators managing the system.

Leveraging the Company's leadership and expertise in email encryption, ZixDLP uses ZixCorp's proven policy and content scanning capabilities with new quarantine functionality. The quarantine system and its intuitive interface allow administrators to (1) easily define policies and create custom lexicons for quarantining email messages, (2) conveniently manage quarantined messages using flexible searching and filtering options, (3) release or delete individual or multiple quarantined messages with one click, (4) review reports that monitor quarantine activities and trends and (5) automate custom notifications informing employees of quarantined messages.

ZixDLP is available as an add-on for existing ZixCorp customers or as a bundle with ZixCorp Email Encryption for new customers. ZixDLP is also available as a standalone solution that can easily integrate with most email systems and email encryption solutions.

In April 2014, we introduced a subset of our DLP solution, ZixDLP Insight, that provides visibility into the content of all outbound email and related attachments but does not block or quarantine any email. ZixDLP Insight gives customers a better understanding of what data is leaving their organization in their outbound email, and it enables customers to assess the data risks in their email and how quarantine capabilities could be implemented to mitigate these risks, prior to deploying the full DLP solution. ZixDLP Insight can be used as a standalone solution or as an

ideal add-on for Zix Email Encryption customers who need increased visibility into the policies that are triggering encrypted email.

On September 3, 2013, ZixCorp launched ZixOne®, a unique mobile email app that solves the key IT challenge created by the BYOD trend in the workplace. BYOD describes the increasing trend of employees using their personal devices to conduct work. ZixOne provides access to corporate email while never allowing that data to be persistently stored on the device where it is vulnerable to loss or theft. If the device is lost or stolen, an administrator can simply disable access to corporate email from that device through ZixOne.

Unlike other BYOD solutions, ZixOne meets employee demands of convenience, control and privacy while giving companies the ability to secure corporate data and meet compliance needs. With seamless access to work email in a secure, simple-to-use environment, employees can stay productive while preserving device independence. A BYOD solution that is acceptable to employees and yet provides strong data protection for corporate data solves one of today's greatest IT management challenges.

Our business operations and service offerings are supported by the ZixData Center, a SysTrust/SOC3 certified, SOC2 accredited, PCI, DSS V2.0 certified facility. The operations of the ZixData Center are independently audited annually to maintain AICPA SysTrust/SOC3 certification in the areas of security, confidentiality, integrity and availability. Auditors also produce a SOC2 (formerly SAS70 Type II) report on the effectiveness of operational controls used over the audit period. The ZixData Center is staffed 24 hours a day with a track record that exceeds 99.99% availability.

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Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in accordance with accounting principles generally accepted in the United States requires the Company's management to make estimates and assumptions that affect the amounts reported in the Company's condensed consolidated financial statements and accompanying notes. Actual results could differ from these estimates and assumptions. Critical accounting policies and estimates are defined as those that are both most important to the portrayal of the Company's financial condition and results and require management's most subjective judgments.

We describe our significant accounting policies in Note 2, *Summary of Significant Accounting Policies*, of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2013. We discuss our *Critical Accounting Policies and Estimates* in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2013.

Results of Operations

Third Quarter 2014 Summary of Operations

Financial

Revenue for the quarter ended September 30, 2014, was \$12.7 million compared with \$12.2 million for the same period in 2013, representing a 4% increase.

Gross margin for the quarter ended September 30, 2014, was \$10.6 million or 84% of revenues compared with \$10.3 million or 84% of revenues for the comparable period in 2013.

Net income for the quarter ended September 30, 2014, was \$1.2 million compared with net income of \$3.2 million in the comparable period in 2013.

Ending cash and cash equivalents were \$20.3 million on September 30, 2014, compared with \$27.5 million on December 31, 2013.

Operations

New first year orders (NFYOs) for the quarter ended September 30, 2014, were \$1.6 million. As of September 30, 2014, backlog was \$68.8 million.

Revenues

Our Company provides subscription-based services. The following table sets forth the quarter-over-quarter and nine month comparisons of the Company's revenues:

(in thousands)	3-month Variance				9-month Variance			
	2014 vs.				2014 vs. 2013			
	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013		Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2014	2013	\$	%	2014	2013	\$	%
Revenues	\$ 12,705	\$ 12,225	\$ 480	4%	\$ 37,482	\$ 35,827	\$ 1,655	5%

The increase in revenue was due to the growth inherent in a successful subscription model with steady additions to the subscriber base coupled with a high rate of existing customer renewals.

Revenue Indicators Backlog, Orders and Deployments

Backlog Our end-user order backlog is comprised of contractually bound agreements that we expect to amortize into revenue as the services are performed. The timing of revenue is affected by both the length of time required to deploy a service and the length of the service contract.

As of September 30, 2014, total backlog was \$68.8 million and we expect approximately 56% of the total backlog to be recognized as revenue during the next twelve months. As of September 30, 2014, the backlog was comprised of the following elements: \$22.7 million of deferred revenue that has been billed and paid, \$6.6 million billed but unpaid, and approximately \$39.5 million of unbilled contracts. The third quarter ending backlog was a 7% increase over the \$64.2 million backlog at the end of the third quarter 2013 and 5% above the ending backlog of \$65.7 million at December 31, 2013.

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Orders Total orders were \$13.4 million and \$13.0 million for the three-month periods ended September 30, 2014 and 2013, respectively. Total orders include contract renewals, NFYOs, and in the case of new multi-year contracts, the years beyond the first year of service. NFYOs were \$1.6 million and \$2.2 million for the three-month period ended September 30, 2014 and 2013, respectively.

Cost of Revenues

The following table sets forth the quarter-over-quarter and nine month comparisons of the cost of revenues:

(in thousands)	3-month Variance				9-month Variance			
	2014 vs.		2014 vs.		2014 vs.		2014 vs.	
	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013		Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2014	2013	\$	%	2014	2013	\$	%
Cost of revenues	\$ 2,062	\$ 1,904	\$ 158	8%	\$ 6,119	\$ 5,743	\$ 376	7%

Cost of revenues is comprised of costs related to operating and maintaining the ZixData Center, a field deployment team, customer service and support and the amortization of Company-owned, customer-based computer appliances. A significant portion of the total cost of revenues relates to the ZixData Center, which currently has excess capacity. Accordingly, cost of revenues is relatively fixed and is therefore expected to grow at a slower pace than revenue. The three and nine month variances reflected in the table above resulted primarily from increases in average headcount and depreciation expense relating to investments in ZixOne networking equipment.

Research and Development Expenses

The following table sets forth the quarter-over-quarter and nine month comparisons of our research and development expenses:

(in thousands)	3-month Variance				9-month Variance			
	2014 vs.		2014 vs.		2014 vs.		2014 vs.	
	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013		Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	2014	2013	\$	%	2014	2013	\$	%
Research and development expenses	\$ 2,234	\$ 2,345	\$ (111)	(5)%	\$ 6,653	\$ 7,444	\$ (791)	(11)%

Research and development expenses consist primarily of salary, benefits, and stock-based compensation for our development staff, independent development contractor expenses, and other direct and indirect costs associated with enhancing our existing products and services and developing new products and services. The three and nine month decreases reflected in the table above resulted primarily from reduction in contractor headcount, partially offset by increases related to hiring research and development personnel.

Selling and Marketing Expenses

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

(in thousands)	3-month Variance				9-month Variance			
	Three Months Ended September 2014		vs. 2013		Nine Months Ended September 2014		vs. 2013	
	2014	2013	\$	%	2014	2013	\$	%
Selling and marketing expenses	\$ 4,543	\$ 3,088	\$ 1,455	47%	\$ 13,473	\$ 10,338	\$ 3,135	30%

Selling and marketing expenses consist primarily of salary, commissions, travel, stock-based compensation and employee benefits for selling and marketing personnel as well as costs associated with promotional activities and advertising. The \$1.5 million increase in the third quarter of 2014 compared to the same period in 2013 and the \$3.1 million nine-month variance resulted primarily from an increase in average headcount for selling and marketing personnel and advertising and promotional expense related to lead generation and brand awareness.

Table of Contents***General and Administrative Expenses***

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

(in thousands)	3-month Variance				9-month Variance			
	Three Months Ended September 2014	Three Months Ended September 2013	2014 vs. 2013		Nine Months Ended September 2014	Nine Months Ended September 2013	2014 vs. 2013	
	2014	2013	\$	%	2014	2013	\$	%
General and administrative expenses	\$ 2,001	\$ 1,571	\$ 430	27%	\$ 6,138	\$ 6,469	\$ (331)	(5)%

General and administrative expenses consist primarily of salary and bonuses, travel, stock-based compensation and benefits for administrative and executive personnel as well as fees for professional services and other general corporate activities. The \$0.4 million increase in the third quarter of 2014 compared to the same period in 2013 resulted primarily from a year-over-year increase in average headcount and consulting expense. The \$0.3 million decrease in the nine month comparison resulted primarily from lower outside legal counsel fees associated with litigation partially offset by higher average headcount costs.

Provision for Income Taxes

The provision for income taxes was \$768 thousand and \$159 thousand for the three-month periods ended September 30, 2014 and 2013, respectively, and \$2.0 million and \$361 thousand for the nine-month periods ended September 30, 2014 and 2013. The operating losses incurred by the Company's U.S. operations in past years and the resulting net operating losses for U.S. Federal tax purposes are subject to a \$46 million reserve because of the uncertainty of future taxable income levels sufficient to utilize our net operating losses and credits. Our September 30, 2014, provision of \$2.0 million includes \$1.7 million in deferred taxes, \$171 thousand in state taxes currently payable based on gross revenues, \$95 thousand related to the federal Alternative Minimum Tax, and \$103 thousand in taxes related to our Canadian operations. Our September 30, 2013, provision of \$361 thousand includes \$102 thousand in state taxes currently payable based on gross revenues, \$88 thousand related to deferred state taxes, \$82 thousand related to the federal Alternative Minimum Tax, and \$89 thousand in taxes related to our Canadian operations.

There were no penalty-related charges to selling, general and administrative expenses accrued or recognized for the three month periods ended September 30, 2014 and 2013. Additionally, we have not taken a tax position that would have a material effect on the financial statements or the effective tax rate for the three-month period ended September 30, 2014. We are currently subject to a three-year statute of limitations by major tax jurisdictions.

At September 30, 2014, the Company partially reserved its U.S. net deferred tax assets due to the uncertainty of future taxable income sufficient to utilize net loss carryforwards prior to their expiration. The Company did not reserve a portion, \$52.4 million, of its U.S. net deferred tax assets. The majority of this unreserved portion related to \$43.9 million in U.S. net operating losses (NOLs) because we believe the Company will generate sufficient taxable income in future years to utilize these NOLs prior to their expiration. The remaining balance consists of \$5.4 million relating to temporary differences between GAAP and tax-related expense, \$1.9 million relating to U.S. state income tax credits and net operating loss carryovers, and \$1.2 million related to Alternative Minimum Tax credits.

At the end of 2013, the Company recorded a \$1.4 million tax benefit by reducing the valuation allowance related to its deferred tax assets. This reduction was determined through an assessment of future deferred tax asset utilization following accounting guidance which relies largely on historical earnings. Using the same methodology, and updating

the future taxable earnings estimates based on first, second and third quarter 2014 actual earnings, the Company believes its future U.S. federal taxable earnings estimate to be established at the end of 2014 may not exceed the estimate used at the end of 2013. For this reason, the Company has recognized its first, second, and third quarter 2014 federal deferred tax provision in full. In contrast, in the first, second, and third quarter 2013, the Company believed that its future U.S. federal taxable estimate established at the end of 2013 would exceed the prior year estimate. Accordingly, the Company offset its federal deferred tax provision by reducing its valuation allowance by an equal amount, thereby eliminating from its deferred tax provision federal taxes in excess of the estimated Alternative Minimum Tax from the Company's first, second, and third quarter 2013 financial statements. The Company will continue to reevaluate the need for its valuation

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allowance each quarter, following the same assessment methodology described above. Adjusting our valuation allowance could have a significant impact on operating results for each period that it becomes more likely than not that an additional portion of our deferred tax assets will or will not be realized.

We have determined that utilization of existing net operating losses against future taxable income is not currently subject to limitation by Section 382 of the Internal Revenue Code. Future ownership changes, however, may limit the company's ability to fully utilize its existing net operating loss carryforwards against future taxable income.

As indicated earlier, the operating losses incurred by our U.S. operations and the resulting net operating losses for U.S. Federal tax purposes are subject to a partial reserve. Significant judgment is required in determining any reserve recorded against the deferred tax asset. In assessing the need for a reserve, we consider all available evidence, including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies.

Net Income

The net income for the three months ended September 30, 2014, of \$1.2 million is a decrease of \$2.0 million compared to the net income of \$3.2 million for the same period last year. Our increased revenue was offset primarily by higher selling and marketing and tax expense, as discussed above.

Liquidity and Capital Resources***Overview***

Based on our performance over the last four quarters and current expectations, we believe our cash and cash equivalents and cash generated from operations, will satisfy our working capital needs, capital expenditures, investment requirements, contractual obligations, commitments, future customer financings, and other liquidity requirements associated with our operations through at least the next twelve months. We plan for and measure our liquidity and capital resources through an annual budgeting process. At September 30, 2014, our cash and cash equivalents totaled \$20.3 million, a decrease of \$7.3 million from the December 31, 2013 balance, and we had no debt.

Sources and Uses of Cash Summary

(In thousands)	Nine Months Ended September 30,	
	2014	2013
Net cash provided by operations	\$ 10,580	\$ 9,776
Net cash used in investing activities	\$ (1,797)	\$ (1,262)
Net cash provided by (used in) financing activities	\$ (16,039)	\$ 1,374

Our primary source of liquidity from our operations is the collection of revenue in advance from our customers and accounts receivable from our customers, net of the timing of payments to our vendors and service providers.

Our investing activities consist of \$1.2 million in computer and networking equipment purchases and \$536 thousand in leasehold improvements associated with the lease renewal for our Dallas headquarters in 2013.

Cash used in financing activities in the first three quarters of 2014 include \$16.2 million used in completion of both the \$15 million share repurchase program authorized by our board of directors in November 2013 and \$10 million

share repurchase program authorized by our board of directors in July 2014, and \$257 thousand used in the repurchase of common stock related to the tax impact of vesting restricted awards. These usages were partially offset by \$457 thousand received from the exercise of stock options. Financing activities include the receipt of \$1.5 million from the exercise of stock options in the first three quarters 2013, offset by \$120 used in the repurchase of common stock related to the tax impact of vesting restricted awards.

Table of Contents***Options of ZixCorp Common Stock***

We have significant options outstanding that are currently vested. There is no assurance that any of these options will be exercised; therefore, the extent of future cash inflow from additional option activity is not certain. The following table summarizes the options that were outstanding as of September 30, 2014. The vested shares are a subset of the outstanding shares. The value of the shares is the number of shares multiplied by the exercise price for each share.

Exercise Price Range	Outstanding Options	Summary of Outstanding Options		
		Total Value of Outstanding Options (In thousands)	Vested Options (included in outstanding options)	Total Value of Vested Options (In thousands)
\$1.11 - \$1.99	533,391	\$ 796	533,391	\$ 796
\$2.00 - \$3.49	1,840,198	5,016	1,402,358	3,828
\$3.50 - \$4.99	2,337,908	10,098	2,337,908	10,098
\$5.00 - \$5.99	86,500	433	86,500	433
\$6.00 - \$8.99	350,000	2,100	350,000	2,100
Total	5,147,997	\$ 18,443	4,710,157	\$ 17,255

Off-Balance Sheet Arrangements

None.

Contractual Obligations, Contingent Liabilities and Commitments

A summary of our fixed contractual obligations and commitments at September 30, 2014, is as follows:

(In thousands)	Total	Payments Due by Period		
		1 Year	Years 2 & 3	Beyond 3 Years
Operating leases	\$ 11,179	\$ 1,441	\$ 2,282	\$ 7,456

We have not entered into any material, non-cancelable purchase commitments at September 30, 2014.

We have severance agreements with certain employees which would require the Company to pay approximately \$3.0 million if all such employees separated from employment with our Company following a change of control, as defined in the severance agreements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have no material changes to the disclosure on this matter made in our Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 4. CONTROLS AND PROCEDURES

The Company, under the supervision and with the participation of its management, including the Chief Executive Officer and the Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e)) under the Exchange Act as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of September 30, 2014.

Changes in Internal Controls over Financial Reporting

During the nine months ended September 30, 2014, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

None.

ITEM 1A. Risk Factors

See Part I, Item 1A, Risk Factors, of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2013. There have been no material changes in our risk factors from those disclosed in such Annual Report on Form 10-K. The risk factors in our Form 10-K should be read in conjunction with the considerations set forth above in Management's Discussion and Analysis of Financial Condition and Results of Operations and in Management's Discussion and Analysis of Financial Condition and Results of Operations set forth in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) None.

(b) None.

(c) Purchases of Equity Securities by the Issuer

Period	Total	Maximum Number
Table of Contents		31

	Total Number of Shares Purchased	Average Price Paid per Share	Number of Shares Purchased as part of Publicly Announced Plans or Programs¹	(or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
July 1, 2014 to July 31, 2014				\$ 10,000,000
August 1, 2014 to August 31, 2014	1,866,700	\$ 3.72	1,866,700	\$ 3,049,076
September 1, 2014 to September 30, 2014	796,366	\$ 3.83	796,366	\$
Total	2,663,066	\$ 3.75	2,663,066	\$

- ¹ The shares were repurchased under the \$10 million stock repurchase program announced July 30, 2014 and expiring March 31, 2015. No shares were purchased other than through publicly announced programs during the periods shown.

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ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

a. Exhibits

The following is a list of exhibits filed as part of this Quarterly Report on Form 10-Q:

Exhibit No.	Description of Exhibits
3.1	Restated Articles of Incorporation of Zix Corporation, as filed with the Texas Secretary of State on November 10, 2005. Filed as Exhibit 3.1 to Zix Corporation's Annual Report on Form 10-K for the year ended December 31, 2005, and incorporated herein by reference.
3.2	Amended and Restated Bylaws of Zix Corporation, dated March 12, 2014. Filed as Exhibit 3.2 to Zix Corporation's Annual Report on Form 10-K, for the year ended December 31, 2013, and incorporated herein by reference.
31.1*	Certification of Richard D. Spurr, President and Chief Executive Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Michael W. English, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of CEO and CFO, pursuant to 18 U.S.C. Section 1350, as adopted, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.1*	101. INS (XBRL Instance Document)
	101. SCH (XBRL Taxonomy Extension Schema Document)
	101. CAL (XBRL Calculation Linkbase Document)
	101. LAB (XBRL Taxonomy Label Linkbase Document)
	101. DEF (XBRL Taxonomy Linkbase Document)
	101. PRE (XBRL Taxonomy Presentation Linkbase Document)

* Filed herewith.

** Furnished herewith.

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SIGNATURES

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.

ZIX CORPORATION

Date: November 6, 2014

By: /s/ MICHAEL W. ENGLISH
Michael W. English
*Chief Financial Officer (Principal Financial
Officer and Principal Accounting Officer)*