ZIX CORP
Form 10-Q
November 07, 2018

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, 2018

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	75-2216818
(State of Incorporation)	(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 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 Emerging growth company	Smaller reporting company

If an emerging growth company, indicated 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 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 5, 2018
Common Stock, par value $0.01 per share	54,197,628

INDEX

ZIX CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and par value data)	September 30, 2018 (unaudited)	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$ 23,977	$ 33,009
Receivables, net	3,222	1,389
Prepaid and other current assets	2,826	3,222
Total current assets	30,025	37,620
Property and equipment, net	4,058	4,048
Other assets and deferred costs	8,647	—
Intangible assets, net	14,640	5,524
Goodwill	13,494	8,469
Deferred tax assets	21,371	25,647
Total assets	$ 92,235	$ 81,308
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$ 584	$ 1,053
Accrued expenses	8,016	6,101
Deferred revenue	29,425	28,362
Total current liabilities	38,025	35,516
Long-term liabilities:		
Deferred revenue	2,392	1,087
Deferred rent	1,054	1,185
Total long-term liabilities	3,446	2,272
Total liabilities	41,471	37,788
Commitments and contingencies (see Note 8)		
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; 81,722,748 issued and 54,194,512 outstanding in 2018 and 80,709,970 issued and 54,542,612 outstanding in 2017	779	778
Additional paid-in capital	383,990	381,457
Treasury stock, at cost; 27,528,236 common shares in 2018 and 26,167,358 common shares in 2017	(108,385)	(102,343)
Accumulated deficit	(225,620)	(236,372)
Total stockholders’ equity	50,764	43,520

Total liabilities and stockholders' equity	$ 92,235	$ 81,308

See notes to condensed consolidated financial statements.

ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except share and per share data)	Three Months Ended September 30, 2018	2017	Nine Months Ended September 30, 2018	2017
Revenues	$ 17,876	$ 16,592	$ 52,029	$ 48,863
Cost of revenues	3,870	3,272	11,189	9,342
Gross margin	14,006	13,320	40,840	39,521
Operating expenses:				
Research and development	2,764	2,916	8,720	8,047
Selling, general and administrative	8,025	7,514	24,139	23,282
Total operating expenses	10,789	10,430	32,859	31,329
Operating income	3,217	2,890	7,981	8,192
Other income, net	183	86	662	230
Income before income taxes	3,400	2,976	8,643	8,422
Income tax expense	(945)	(1,070)	(2,455)	(3,603)
Net income	$ 2,455	$ 1,906	$ 6,188	$ 4,819
Basic income per common share	$ 0.05	$ 0.04	$ 0.12	$ 0.09
Diluted income per common share	$ 0.05	$ 0.03	$ 0.12	$ 0.09
Basic weighted average common shares outstanding	52,494,340	53,786,876	52,611,161	53,443,749
Diluted weighted average common shares outstanding	53,474,849	54,631,407	53,389,622	54,263,258

See notes to condensed consolidated financial statements.

ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited)

	Stockholders' Equity					
			Additional			Total
	Common Stock		Paid-In	Treasury	Accumulated	Stockholders'
(In thousands, except shares)	Shares	Amount	Capital	Stock	Deficit	Equity
Balances, January 1, 2018, as reported	80,709,970	$ 778	$ 381,457	$ (102,343)	$ (236,372)	$ 43,520
Cumulative effect adjustment from changes in accounting standards, net of taxes (see Note 2)	—	—	—	—	4,564	$ 4,564
Balances, January 1, 2018, as adjusted	80,709,970	778	381,457	(102,343)	(231,808)	48,084
Net issuance of common stock upon exercise of stock options	85,095	1	160	—	—	161
Net issuance of common stock upon vesting of restricted stock units	50,751	—	—	—	—	—
Net issuance of common stock upon vesting of performance stock units	32,665	—	—	—	—	—
Net issuance of restricted common stock	748,321	—	—	—	—	—
Net issuance of restricted performance common stock	95,946	—	—	—	—	—
Employee stock-based compensation costs	—	—	2,373	(649)	—	1,724
Treasury repurchase program	—	—	—	(5,393)	—	(5,393)
Net income	—	—	—	—	6,188	6,188
Balances, September 30, 2018	81,722,748	$ 779	$ 383,990	$ (108,385)	$ (225,620)	$ 50,764

See notes to condensed consolidated financial statements.

ZIX CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	Nine Months Ended September 30, 2018	2017
Operating activities:		
Net income	$ 6,188	$ 4,819
Non-cash items in net income:		
Depreciation and amortization	2,635	2,023
Employee stock-based compensation costs	2,373	2,023
Changes in deferred taxes	2,660	3,216
Changes in operating assets and liabilities:		
Receivables	(1,410)	218
Prepaid and other current assets	464	(203)
Other assets and deferred costs	(2,272)	—
Accounts payable	(510)	472
Deferred revenue	1,547	2,416
Earn-out payment	(195)	—
Accrued and other liabilities	282	(1,000)
Net cash provided by operating activities	11,762	13,984
Investing activities:		
Purchases of property, equipment and internal-use software	(2,340)	(1,754)
Acquisition of business, net of cash acquired	(11,773)	(8,245)
Net cash used in investing activities	(14,113)	(9,999)
Financing activities:		
Proceeds from exercise of stock options	161	4,198
Stock issuance costs	(195)	—
Earn-out payment	(605)	—
Purchase of treasury shares	(6,042)	(1,880)
Net cash (used in) provided by financing activities	(6,681)	2,318
(Decrease) Increase in cash and cash equivalents	(9,032)	6,303
Cash and cash equivalents, beginning of period	33,009	26,457
Cash and cash equivalents, end of period	$ 23,977	$ 32,760

See notes to condensed consolidated financial statements.

ZIX CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated financial statements of Zix Corporation (“Zix” the “Company,” “we,” “our,” or “us should be read in conjunction with the audited consolidated financial statements included in the Company’s 2017 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.

Effective January 1, 2018, the Company adopted Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (“ASC 606”) using the modified retrospective transition method. The cumulative effect of applying the standard was a $4.6 million increase to shareholder’s equity as of January 1, 2018. The Company’s condensed consolidated statement of income for the three and nine month periods ended September 30, 2018, and the Company’s condensed consolidated balance sheet at September 30, 2018, are presented under ASC 606, while the Company’s condensed consolidated statement of income for the three and nine month periods ended September 30, 2017, and the Company’s condensed consolidated balance sheet at December 31, 2017, are presented under ASC 605, Revenue Recognition (“ASC 605”). See note 2 for disclosure of the impact of the adoption of ASC 606 on the Company’s condensed consolidated statement of income for the three and nine month periods ended September 30, 2018, and the Company’s condensed consolidated balance sheet at September 30, 2018, and the effect of changes made to the Company’s consolidated balance sheet as of January 1, 2018.

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 three and nine month periods ended September 30, 2018, 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

Revenue Recognition

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASC 606, which supersedes most prior revenue recognition guidance under U.S. Generally Accepted Accounting Principles (“GAAP”). The core principle of ASC 606 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. ASC 606 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 were required under prior U.S. GAAP.

The standard became effective for us beginning in 2018. Our Company provides primarily email encryption and advanced threat protection security solutions as subscription services in which we recognize revenue as our services are rendered. We determined our revenue was not materially impacted by the new guidance. However, the guidance did require us to increase the amortization period of our sales commission expense. We applied the guidance to commissions earned on all contracts that were not complete as of January 1, 2018. Prior period amounts have not been adjusted and continue to be reported in accordance with the previous guidance. Our Company elected to use a portfolio approach, applying 8 year, 4 year, and 18 month amortization periods to our new, add-on, and renewal sales commission expenses, respectively. Determination of the amortization period and the subsequent assessment for impairment of the deferred cost asset requires significant judgement.

We applied a modified retrospective approach to our implementation of ASC 606 in which we recognized a $4.6 million cumulative effect adjustment to our 2018 retained earnings opening balance related to our increased amortization period. This adjustment includes a $1.6 million impact to our deferred tax asset. The table below presents the cumulative effect of the changes made to our condensed consolidated balance sheet due to the adoption of ASC 606:

(In thousands)	January 1, 2018		
	Beginning Balance	Cumulative Effect Adjustment	Beginning Balance, as Adjusted
Assets:			
Prepaid and other current assets	$3,222	$ (415)	$2,807
Other assets and deferred costs	—	6,595	6,595
Deferred tax assets	25,647	(1,616)	24,031
Stockholders' equity:			
Accumulated deficit	$(236,372)	$ 4,564	$(231,808)

Financial statement results as reported under the new revenue standard as compared to the previous standard for the three and nine months ended and as of September 30, 2018, are as follows:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	Under	Under		Under	Under	
(In thousands, except per share data)	ASC 605	ASC 606	Variance	ASC 605	ASC 606	Variance
Revenues	$ 17,876	$ 17,876	$ —	$ 52,029	$ 52,029	$ —
Cost of revenues	3,870	3,870	—	11,189	11,189	—
Gross margin	14,006	14,006	—	40,840	40,840	—
Operating expenses:						
Research and development	2,764	2,764	—	8,720	8,720	—
Selling, general and administrative	8,650	8,025	(625)	26,038	24,139	(1,899)
Total operating expenses	11,414	10,789	(625)	34,758	32,859	(1,899)
Operating income	2,592	3,217	625	6,082	7,981	1,899
Other income, net	183	183	—	662	662	—
Income before income taxes	2,775	3,400	625	6,744	8,643	1,899
Income tax expense	(814)	(945)	(131)	(2,056)	(2,455)	(399)
Net income	$ 1,961	$ 2,455	$ 494	$ 4,688	$ 6,188	$ 1,500
Basic income per common share	$ 0.04	$ 0.05	$ 0.01	$ 0.09	$ 0.12	$ 0.03
Diluted income per common share	$ 0.04	$ 0.05	$ 0.01	$ 0.09	$ 0.12	$ 0.03

(In thousands)	September 30, 2018		
	Under	Under	
	ASC 605	ASC 606	Variance
Assets:			
Prepaid and other current assets	$ 3,198	$ 2,826	$ (372)
Other assets and deferred costs	—	8,647	8,647
Deferred tax assets	22,987	21,371	(1,616)
Stockholders' equity:			
Accumulated deficit	$ (231,684)	$ (225,620)	$ 6,064

Cash Flow Statement

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230), which amends guidance on the classification of certain cash receipts and payments in the statement of cash flows. This ASU was issued with the intent to reduce diversity in practice with respect to eight types of cash flows. The new guidance addressed debt prepayment or extinguishment of costs, settlement of zero-coupon bonds, contingent consideration made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies and bank-owned life insurance policies, distributions received from equity method investees, beneficial interests in securitization transactions, and separately identifiable cash flows and application of the predominance principle.

The standard became effective for us beginning 2018. We applied the new guidance within our condensed consolidated statements of cash flows classification to an $800 thousand earn-out payment associated with our Greenview(as defined herein) acquisition. Because this consideration payment was not made soon after the consummation date, as required by the guidance, we classified $605 thousand of the payment as a financing activity. This reflects the portion of the payment recognized a contingent liability as of the acquisition date. The $195 thousand balance of the payment was in excess of the original contingent consideration liability and was classified as an operating activity. The standard had no other impact on our condensed consolidated financial statements.

Leases

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which introduces a lessee model that brings most leases on the balance sheet. The new ASU eliminates the requirement in U.S. GAAP that entities use bright-line tests in determining lease classifications and requires lessors to provide additional transparency into their exposure to the changes in value of their residual assets and how they manage that exposure.

The standard is effective for us beginning 2019. We expect the valuation of right to use assets and lease liabilities to be the present value of our forecasted future lease commitments and are assessing the discount rate to be applied in these valuations. We are currently evaluating the potential impact of this new guidance on our consolidated financial statements.

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

Our stock-based awards include (i) stock options, (ii) restricted stock awards, some of which are subject to time-based vesting ("Restricted Stock") and some of which are subject to performance-based vesting ("Performance Stock"), and (iii) restricted stock units, some of which are subject to time-based vesting ("RSUs") and some of which are subject to performance-based vesting ("Performance RSUs"). As of September 30, 2018, the Company had 929,219 stock options outstanding; 1,433,316 non-vested Restricted Stock awards; 211,182 non-vested Performance Stock awards; 72,168 non-vested RSUs; 12,499 non-vested Performance RSUs and 5,886,005 shares of common stock available for grant.

Stock Option Activity

The following is a summary of all stock option transactions during the three months ended September 30, 2018:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Yrs)
Outstanding at June 30, 2018	987,234	$ 3.16	
Granted at market price	—	—	
Cancelled or expired	—	—	
Exercised	(58,015)	2.18	
Outstanding at September 30, 2018	929,219	$ 3.22	4.98
Options exercisable at September 30, 2018	804,219	$ 3.13	4.58

At September 30, 2018, all 929,219 stock options outstanding and all 804,219 stock options exercisable had an exercise price lower than the market price of the Company's common stock on that date. The aggregate intrinsic value of these stock options were $2.2 million and $1.9 million, respectively.

Restricted Stock Activity

The following is a summary of Restricted Stock activity during the three months ended September 30, 2018:

	Restricted Shares	Weighted Average Fair Value
Non-vested restricted stock at June 30, 2018	1,503,855	$ 4.54
Granted at market price	5,000	5.77
Vested	(46,538)	4.08
Cancelled	(29,001)	4.80
Non-vested restricted stock at September 30, 2018	1,433,316	$ 4.56

Restricted Stock Unit Activity

The following is a summary of all RSU activity during the three months ended September 30, 2018:

	Restricted Stock Units	Weighted Average Fair Value
Non-vested restricted stock units at June 30, 2018	72,168	$ 4.59
Granted at market price	—	—
Vested	—	—
Cancelled	—	—
Non-vested restricted stock units at September 30, 2018	72,168	$ 4.59

Performance RSU Activity

The following is a summary of all Performance RSU activity during the three months ended September 30, 2018:

	Performance RSUs	Weighted Average Fair Value
Non-vested performance RSUs at June 30, 2018	12,499	$ 4.20
Granted at market price	—	—
Vested	—	—
Forfeited	—	—
Non-vested performance RSUs at September 30, 2018	12,499	$ 4.20

Performance Stock Activity

The following is a summary of all Performance Stock activity during the three months ended September 30, 2018:

	Performance Stock	Weighted Average Fair Value
Non-vested performance stock at June 30, 2018	211,182	$ 4.25
Granted at market price	—	—

Vested	—	—
Forfeited	—	—
Non-vested performance stock at September 30, 2018	211,182	$ 4.25

The weighted average grant-date fair value of awards of Restricted Stock, RSUs, Performance RSUs and Performance Stock 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 month period ended September 30, 2018, the total stock-based employee compensation expense resulting from stock options, Restricted Stock, RSUs, Performance RSUs and Performance Stock was recorded to the following line items of the Company’s condensed consolidated statements of income:

	Three Months Ended September 30,	Nine Months Ended September 30,
(In thousands)	2018	2018
Cost of revenues	$ 91	$ 238
Research and development	130	333
Selling, general and administrative	680	1,802
Stock-based compensation expense	$ 901	$ 2,373

A deferred tax asset totaling $473 thousand and $603 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, 2018 and 2017, respectively. As of September 30, 2018, there was $6.2 million of total unrecognized stock-based compensation expense related to non-vested stock-based compensation awards granted under the incentive plans. This expense is expected to be recognized over a weighted average period of 1.52 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, 2017.

4. Supplemental Cash Flow Information

Supplemental cash flow information relating to taxes activities:

	Nine Months Ended September 30,	
(In thousands)	2018	2017
Cash income tax payments	$655	$465

5. Receivables, net

	September 30,	December 31,
(In thousands)	2018	2017
Gross accounts receivables	$ 15,433	$ 9,307
Allowance for returns and doubtful accounts	(296)	(270)
Unpaid portion of deferred revenue	(11,915)	(7,648)
Note receivable	458	458
Allowance for note receivable	(458)	(458)
Receivables, net	$ 3,222	$ 1,389

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.

The reduction for the unpaid portion of 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, 2018.

6. Revenue from Contracts with Customers

Accounting policies

Our Company provides message security solutions as subscription services in which we recognize revenue as our services are rendered. Our customer contracts are typically one to three year contracts billed annually. We exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction and collected by our company from a customer (e.g., sales, use, value added, and some excise taxes).

Disaggregation of Revenue

In the three months ended September 30, 2018, we recorded revenue for our services in the following core industry verticals: 48% healthcare, 29% financial services, 7% government sector, and 16% as other. In the nine months ended September 30, 2018, we recorded revenue for our services in the following core industry verticals: 49% healthcare, 29% financial services, 7% government sector, and 15% as other. The disaggregation of revenue by industry verticals does not include our Greenview and Erado (as defined herein) revenue.

We operate as a single operating segment. Revenue generated from our email protection services represented 100% of our revenue in the three and nine months ended September 30, 2018 and 2017. Further, we sell our solutions as a bundle, applying significant judgement to allocate transaction prices of our services based on the standalone selling price of our component services.

Contract balances

Our contract assets include our accounts receivable, discussed in Footnote 5 above, and the deferred cost associated with commissions earned by our sales team on securing new, add-on, and renewal contract orders. Upon our adoption of ASC 606 we recorded a cumulative effect adjustment, establishing a $6.6 million noncurrent deferred contract asset in recognition of the lengthened amortization period required by the new guidance, The Company simultaneously released the previously existing current deferred commission asset balance of $415 thousand. During the three and nine months ended September 30, 2018, we increased our noncurrent deferred contract asset by $1.1 million and $ 3.4 million, respectively, resulting from commissions earned by our sales team during the three and nine months ended September 30, 2018. We also amortized $577 thousand and $1.5 million of deferred cost, respectively, as a selling and marketing expense in the related periods. Our deferred cost asset is assessed for impairment on a periodic basis. There were no impairment losses recognized on deferred contract cost assets for the three or nine months ended September 30, 2018.

Our contract liabilities consist of deferred revenue representing future customer services which have been billed and collected. The $2.4 million increase to our net deferred revenue in the nine months ended September 30, 2018, is related to the timing of orders and payments.

Performance obligations

As of September 30, 2018, the aggregate amount of the transaction prices allocated to remaining service performance obligations, which represents the transaction price of firm orders less inception to date revenue, was $74.0 million. We expect to recognize approximately $15.8 million of revenue related to this backlog during the remainder of 2018, $35.9 million in 2019, and $22.3 million in periods thereafter.

Approximately $15.3 million of our $17.9 million revenue recognized in the three months ended September 30, 2018, was included in our performance obligation balance at the beginning of the period. Approximately $37.9 million of our $52.0 million revenue recognized in the nine months ended September 30, 2018, was included in our performance obligation balance at the beginning of the period.

7. Earnings Per Share and Potential Dilution

Basic earnings per share are computed using the weighted average number of common shares outstanding for the applicable 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, 2018 and 2017, are as follows:

	Three Months ended September 30,		Nine Months ended September 30,	
	2018	2017	2018	2017
Basic weighted average common shares	52,494,340	53,786,876	52,611,161	53,443,749
Effect of dilutive securities:				
Employee and director stock options	370,466	368,079	330,095	401,673
Restricted stock	475,912	317,476	340,337	286,205
RSUs	23,895	52,228	21,374	51,512

Performance RSUs	6,174	35,503	9,858	26,614
Performance Stock	104,062	71,245	76,797	53,505
Dilutive weighted average common shares	53,474,849	54,631,407	53,389,622	54,263,258

During the three months ended September 30, 2018, weighted average shares related to 43,750 stock options and 1,087 shares of Restricted Stock were excluded from the calculation of diluted earnings per share because these awards were anti-dilutive. During the nine months ended September 30, 2018, weighted average shares related to 97,750 stock options, 175,698 shares of Restricted Stock, 8,111 RSUs, 1,222 Performance RSUs, and 24,715 shares of Performance Stock were excluded from the calculation of diluted earnings per share because these awards were anti-dilutive.

8. Commitments and contingencies

A summary of our fixed contractual obligations and commitments at September 30, 2018, is as follows:

	Payments Due by Period				
(In thousands)	Total	1 Year	Years 2 & 3	Years 4 & 5	Beyond 5 Years
Operating leases	$7,434	$1,727	$ 2,371	$ 2,188	$ 1,148

We have not entered into any material, non-cancelable purchase commitments at September 30, 2018.

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.

9. 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 the 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.

The Company recorded a contingent liability for the estimated fair value of earn-out consideration payments in our Greenview acquisition. The Company determined the fair value of this earn-out liability based on the probability of attainment of certain sales milestones. Any changes to the variables and assumptions could significantly impact the estimated fair values recorded for the liability, resulting in significant changes to the Condensed Consolidated Statements of Operations. The fair value measurements are based on significant inputs not observable in the market and thus represent Level 3 measurements, which reflect the Company's own assumptions concerning the achievement of the sales milestones in measuring the fair value of the acquisition-related contingent earn-out liability.

The following table represents a reconciliation of our acquisition-related contingent earn-out liability measured at fair value on a recurring basis, using Level 3 inputs for the nine month period ended September 30, 2018:

(In thousands)	Fair Value Measurements Using Significant Unobservable

	Inputs (Level 3)
Balance at December 31, 2017	$ 1,488
Payments during the period	(800)
Adjustments to fair value during the period recorded in Selling, general and administrative expenses	459
Balance at September 30, 2018	$ 1,147

10. Goodwill

The following is a summary of the changes in the carrying amount of goodwill for the nine month periods ended September 30, 2018 and 2017:

	Nine Months ended September 30,	
(In thousands)	2018	2017
Opening balance	$ 8,469	$ 2,161
Additions	5,926	6,259
Acquisition adjustments	(901)	—
Goodwill	$ 13,494	$ 8,420

Our 2018 acquisition of Erado resulted in the addition to our goodwill in the nine months ended September 30, 2018. Our acquisition adjustments to goodwill in the nine month period ended September 30, 2018, reflect the appropriate reallocation of excess purchase price from goodwill to acquired assets and liabilities related to our 2017 Greenview and EMS (as define herein) purchases. Our 2017 acquisitions of Greenview and EMS resulted in the increase to our goodwill in the nine months ended September 30, 2017. We evaluate goodwill for impairment annually in the fourth quarter, or when there is a reason to believe that the value has been diminished or impaired. There were no impairments to goodwill during the periods presented above.

11. Common Stock Repurchase Program

On April 24, 2017, the Company's board of directors approved a share repurchase program that enabled the Company to purchase up to $10 million of its shares of common stock. During the three months ended September 30, 2018, the Company did not repurchase shares. The share repurchase program expired on May 31, 2018. During the nine months ended September 30, 2018, the Company repurchased 1,206,994 shares of our common stock under this program at an aggregate cost of $5.4 million.

During the three month and nine month periods ended September 30, 2017, the Company repurchased 250,000 shares of our common stock under the same program at an aggregate cost of $1.3 million.

12. Income Taxes

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 $30.8 million reserve. Any reduction to this $30.8 million valuation allowance is based on an assessment of future utilization following accounting guidance, which relies largely on historical earnings. Using this methodology, and updating the future taxable earnings estimates based on first, second, and third quarter 2018 actual earnings, the Company believes the deferred tax asset allowance as of December 31, 2017, will remain unchanged at December 31, 2018. For this reason, the Company has recognized its first, second, and third quarter 2018 federal deferred tax provision in full. If in prospective periods we conclude our future U.S. federal taxable estimate established at the end of the year will exceed the prior year estimate, the Company will offset its federal deferred tax provision by reducing its valuation allowance by an equal amount, thereby eliminating federal taxes from its deferred tax provision within the Company's financial statements. The Company will continue to reevaluate the need for its valuation 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.

13. Acquisitions

Greenview Data, Inc.

On March 15, 2017, the Company acquired all of the outstanding capital stock of Greenview Data, Inc. ("Greenview"), a provider of antivirus, anti-spam, and archiving products, for a total purchase price of $7.7 million, including cash consideration of $6.7 million, subject to a customary post-closing adjustment for working capital. Our acquisition of Greenview addresses increasing buyer demand for email security bundles by adding these capabilities to our existing portfolio of encryption services. Of the cash consideration paid, $650 thousand was deposited into an escrow account for the satisfaction of certain indemnification claims of the Company, if any, during the two year period following the closing of the acquisition, after which the balance, if any, will be distributed to the selling shareholders. Because sales of Greenview products met certain sales milestones by December 31, 2017, the Company paid contractually required cash earn-out consideration of $800 thousand in the three month period ended March 31, 2018. The Company may be required to pay an additional $800 thousand of earn-out consideration in cash should sales of the Greenview products achieve a separate target by December 31, 2018. Contingent consideration is considered a Level 3 fair value measurement.

We accounted for the acquisition as the purchase of a business and recorded the excess purchase price as goodwill. The goodwill from this transaction is not deductible for tax purposes. The results of operations and the provisional fair values of the acquired assets and liabilities assumed have been included in the accompanying condensed consolidated financial statements since our March 15, 2017, acquisition date. Revenue from Greenview was $838 thousand and $2.5 million for the three and nine months ended September 30, 2018, and due to the continued integration of the combined businesses, it was impracticable to determine the earnings.

The following table summarizes the estimated fair value of acquired assets and liabilities:

(In thousands)	Estimated Fair Value
Assets:	
Current assets	$ 334
Property and equipment	249
Trademark /names	170
Technology	1,990
Customer relationships	2,880
Goodwill	4,343
Total assets	9,966
Liabilities:	
Deferred revenue	$ 537
Other current liabilities	124
Deferred tax liability	1,609
Total liabilities	2,270
Net assets recorded	$ 7,696

Entelligence Messaging Server

On September 13, 2017, the Company acquired Entelligence Messaging Server ("EMS") technology, an email encryption solution, and the related business from Entrust Datacard Corporation for a cash purchase price of $1.7 million. Our acquisition of EMS strengthens our email encryption suite by offering enterprise-centric capabilities, such as advanced message tracking, PDF statement delivery, high availability on-premises architecture and standards-based end-to-end encryption.

We accounted for the acquisition as the purchase of a business and recorded the excess purchase price as goodwill. The goodwill from this transaction is deductible for tax purposes. The results of operations and the provisional fair values of the acquired assets and liabilities assumed have been included in the accompanying condensed consolidated financial statements since our September 13, 2017, acquisition date. Revenue from EMS was not material for the three and nine months ended September 30, 2018, and due to the continued integration of the combined businesses, it was impracticable to determine the earnings.

The following table summarizes the provisional fair value of acquired assets and liabilities:

(In thousands)	Estimated Fair Value

Assets:	
Trademark/names	$ 140
Technology	550
Customer relationships	230
Goodwill	1,063
Total assets	1,983
Liabilities:	
Deferred revenue	$ 333
Total liabilities	333
Net assets recorded	$ 1,650

Erado

On April 2, 2018, the Company acquired all the outstanding capital stock of CM2.COM, Inc., d/b/a Erado ("Erado") for a total purchase price of $14.4 million, including cash consideration of $11.8 million, net of cash acquired. The purchase of Erado strengthens Zix's comprehensive archiving solutions with unified archiving, supervision, security, and messaging solutions for customers that demand bundled services. Erado's long standing focus on helping its customers comply with FINRA and SEC regulations will help further strengthen Zix's offering for customers with compliance requirements. This acquisition also expands Zix's cloud-based email archiving capabilities into more than 50 content channels, including social medial, instant message, mobile, web, audio, and video.

The purchase price includes a holdback of $2.3 million for the satisfaction of certain indemnification claims by the Company, if any, during the two-year period following the closing of the acquisition. An amount equal to $1.1 million of the holdback amount, less any amounts paid or otherwise subject to an outstanding claim for indemnification, will be released to the selling shareholders upon the one year anniversary of the closing of the acquisition, and the balance of the holdback amount, if any, will be distributed to the Selling Shareholders following the two year anniversary of the closing of the acquisition. The Company is currently in the process of determining the fair value of the contingent consideration associated with the indemnification liability.

The Company incurred $16 thousand and $391 thousand in acquisition-related costs which were recorded within operating expenses during the three and nine months ended September 30, 2018, respectively.

We accounted for the acquisition as the purchase of a business and have initially recorded the excess purchase price as goodwill. The goodwill from this transaction is deductible for tax purpose. The results of operations and the provisional fair values of the acquired assets and liabilities have been included in the accompanying condensed consolidated financial statements since our April 2, 2018 acquisition date. Revenue from Erado was $679 thousand and $1.3 million for the three and nine months ended September 30, 2018 since the acquisition date. Due to the continued integration of the combined businesses, it was impracticable to determine the earnings.

The following table summarizes the provisional fair value of acquired assets and liabilities.

(In thousands)	Provisional Fair Value
Assets:	
Current assets	$ 848
Property and equipment	458
Trademark /names	260
Technology	3,030
Customer relationships	4,760
Goodwill	5,926
Total assets	15,282
Liabilities:	
Deferred revenue	$ 809
Other current liabilities	93
Total liabilities	902

Net assets recorded	$ 14,380

16

Pro Forma Financial Information (Unaudited)

The following unaudited pro forma financial information presents the combined results of operations for the three and nine month periods ending September 30, 2018 and 2017, as though the Greenview, EMS and Erado acquisitions that occurred during the reporting period had occurred as of the beginning of the period presented, with adjustments to give effect to pro forma events that are directly attributable to the acquisitions, such as amortization expense of intangible assets and acquisition-related transaction costs. These unaudited pro forma results are presented for information purposes only and are not necessarily indicative of what the actual results of operations of the combined company would have been if the acquisitions had occurred at the beginning of the period presented, nor are they indicative of future results of operations:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands, except per share data)	2018	2017	2018	2017
Revenues	$ 18,027	$ 17,469	$ 53,210	$ 51,979
Net income	2,862	2,082	7,698	5,301
Basic income per common share	$ 0.05	$ 0.04	$ 0.15	$ 0.10
Diluted income per common share	$ 0.05	$ 0.04	$ 0.14	$ 0.10

The Company is in the process of determining the valuation of certain Erado property, equipment, and intangible assets and liabilities, which may result in further refinement of the allocation of the purchase price for these acquisitions.

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 within Part II, Item 1A. Risk Factors of this Quarterly Report on Form 10-Q. 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.

Overview

Zix® is a leader in email security. Trusted by the nation's most influential institutions in healthcare, finance and government, Zix delivers a superior experience and easy-to-use solutions for email encryption and data loss prevention ("DLP"), advanced threat protection, archiving, and bring your own device ("BYOD") mobile security. Focusing on the protection of business communication, Zix enables its customers to better secure data and meet compliance needs. We primarily serve organizations in the healthcare, financial services, insurance and government sectors, including U.S. federal financial regulators— such as members of the Federal Financial Institutions Examination Council (FFIEC), divisions of the U.S. Treasury, the U.S. Securities and Exchange Commission (SEC), more than 30% of U.S. banks, more than 30% of Blue Cross Blue Shield plans and more than 1,200 U.S. hospitals.

ZixEncrypt℠ (formerly ZixGateway® and ZixQuarantine®) bundles email encryption and DLP capabilities to enable the secure exchange of email that includes sensitive information. Through a comprehensive secure messaging service, ZixEncrypt allows an enterprise to use policy-driven rules to determine which email messages should be sent securely or quarantined for review to comply with regulations or company-defined policies.

The main differentiation for ZixEncrypt in the marketplace is our exceptional ease of use. The best example of this is our ability to provide transparent delivery of encrypted email. Most email encryption solutions are focused on the sender. They typically introduce an added burden on recipients, often requiring additional user authentication with creation of a new user identity and password. We designed our solution to alleviate the recipient's burden by enabling the delivery of encrypted email automatically and transparently. Zix 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 170,000 members per week), (2) Zix's patented Best Method of Delivery®, which is designed to deliver email in the most secure, most convenient method possible for the recipient, and (3) ZixEncrypt, which automatically encrypts and decrypts messages with sensitive content. The result is secure, transparent encrypted email, such that secure email can be exchanged without any impact to administrators or extra steps for both senders and recipients. Zix delivers more than 1.5 million encrypted messages on a typical business day. Of those messages, approximately 70% are exchanged transparently between senders and recipients.

ZixEncrypt also addresses business's greatest source of data loss – corporate email– with an easy, straightforward DLP approach. By focusing strictly on the risks of email, ZixEncrypt simplifies DLP in comparison to other DLP solutions by decreasing complexity and cost, reducing deployment time from months to hours and minimizing impact on customer resources and workflow. In addition, Zix offers a convenient experience for both employees interacting with our solution and administrators managing the system.

ZixEncrypt enables DLP capabilities for email by combining proven policy and content scanning capabilities with 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.

ZixEncrypt also provides greater visibility into an organization’s data risks in email by capturing data in outbound emails and highlighting violations that trigger policy filters to encrypt or quarantine. Through our interactive, real-time interface, companies can monitor their greatest vulnerabilities, generate reports for business executives and train employees about the sensitivity of their company’s data.

ZixEncrypt is available as a hosted solution, as a multi-tenant cloud solution, or as a physical or virtual on-premises appliance.

In March 2017, Zix acquired Greenview, an email security company. Zix's acquisition of Greenview addresses increasing buyer demand for email security bundles by adding advanced threat protection, antivirus, anti-spam and archiving capabilities to its industry-leading email encryption. Greenview is a good fit for Zix's business based on its employees' expertise in email security and its emphasis on customer success, which align with Zix's reputation for delivering industry-leading solutions and a superior experience.

Through the acquisition of Greenview, Zix launched two new solutions in April 2017 – ZixProtect and ZixArchive. ZixProtect defends organizations from zero-day malware, ransomware, phishing, CEO fraud, W-2 phishing attacks, spam and viruses in email with multi-layer filtering techniques. Accuracy in protecting organizations from email threats is increased further with automated traffic analysis, machine learning and real-time threat analysts.

ZixProtect is available as a cloud-based service in three bundles. ZixProtect Essentials includes email threat protection and business email continuity to enable access to emails during service disruption; ZixProtect Plus adds attachment assurance and time-of-click link defense to provide enhanced protection against sophisticated, targeted threats; and ZixProtect Premium delivers a comprehensive email security solution by including its leading email encryption and data loss prevention with its threat protection capabilities.

ZixArchive is a low-cost, cloud-based email retention solution that easily enables user retrieval, compliance and eDiscovery. Available as a standalone or add-on solution for ZixEncrypt or ZixProtect bundles, ZixArchive includes policy-based retention, automatic indexing and flexible search capabilities for audit and legal requirements. With on-demand access through the cloud, organizations can conveniently share messages with employees, auditors and outside consultants or legal counsel, as well as revoke access when needed.

In April 2018, Zix acquired Erado, a unified archiving company. Erado strengthens Zix's comprehensive archiving solutions with unified archiving, supervision, security, and messaging solutions for customers that demand bundled services. Erado's long standing focus on helping its customers comply with FINRA and SEC regulations helps further strengthen Zix's offerings for customers with compliance requirements. This acquisition also expands Zix's cloud-based email archiving capabilities into more than 50 content channels, including social medial, instant message, mobile, web, audio, and video.

ZixOne® is a unique mobile email app that solves the key IT challenge created by the BYOD trend in the workplace. BYOD describes employee's use of personal devices to conduct work. ZixOne provides mobile access to corporate email while never allowing that data to be persistently stored on an employee's 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.

ZixOne is available as a standalone solution and easily integrates with ZixEncrypt as an add-on solution. One feature of ZixOne is the ability to encrypt an email from your mobile device with the simple slide of an "Encrypt" button, ensuring that sensitive information is secured either by the user or through automatic policies of ZixEncrypt.

Our business operations and service offerings are supported by the ZixData Center™, which is PCI DSS 3.2 certified for applicable services, SOC2 accredited and SOC 3 certified. The operations of the ZixData Center are independently audited annually to maintain AICPA SOC3 certification in the areas of security, confidentiality, integrity and availability. Auditors also produce a SOC2 report on the effectiveness of operational controls used over the audit period. The ZixData Center is staffed 24 hours a day and has a track record that exceeds 99.99% availability.

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, 2017. 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, 2017.

Related to the adoption of ASC 606, the Company increased its amortization period associated with sales, commission expense, see Note 2 “Recent Accounting Standards and Pronouncements,” and Note 6, “Revenue from Contracts with Customers,” of Part I, Item 1 of this Quarterly Report on Form 10-Q for more information concerning our adoption of ASC 606.

As we increasingly moved to a multi-tenant environment to keep up with the industry trend requiring transition to a cloud based solution for our existing services, certain research and development expenditures associated with hosting arrangements now meet the accounting guidance requirement for capitalizing development costs under ASC 350-40, Internal-Use Software, as it applies to hosting arrangements. These capitalized costs are classified as intangible assets in our condensed consolidated balance sheet. The Company expects our capitalization of these research and development expenditures to increase in the future.

With the exception of accounting policies related to the adoption of ASC 606 and the increased capitalization of research and development costs under ASC 350-40, there have been no material changes to our critical accounting policies as compared to those described in our Annual Report on Form 10-K for the year ended December 31, 2017.

Results of Operations

Third Quarter 2018 Summary of Operations

Financial

- Revenue for the quarter ended September 30, 2018, was $17.9 million, compared with $16.6 million for the same period in 2017, representing an 8% increase.
- Gross margin for the quarter ended September 30, 2018, was $14.0 million (or 78% of revenues), compared with $13.3 million (or 80% of revenues) for the comparable period in 2017.
- Net income for the quarter ended September 30, 2018, was $2.5 million, compared with net income of $1.9 million in the comparable period in 2017, representing a 29% increase.
- Net income per diluted share was $0.05 for the quarter ended September 30, 2018, compared with net income per diluted share of $0.03 in the comparable period in 2017.
- Ending cash and cash equivalents were $24.0 million on September 30, 2018, compared with $32.8 million on September 30, 2017, and $33.0 million on December 31, 2017.

Operations

- New first year orders (“NFYOs”) for the quarter ended September 30, 2018, were $2.6 million, compared with $2.1 million for the same period in 2017, representing a 24% increase.
- Total orders for the quarter ended September 30, 2018, were $19.0 million, compared with $14.3 million for the same period in 2017, representing a 33% increase.
- The annual contract value of our customer subscriptions as of September 30, 2018, was $74.9 million, compared with $66.1 million for the same period in 2017, representing a 13% increase.
- Net cash provided by operations in the nine months ended September 30, 2018, was $11.8 million, compared with $14.0 million for the same period in 2017, representing a 16% decrease.
- As of September 30, 2018, backlog was $74.0 million, compared with $75.0 million as of September 30, 2017, representing a 1% decrease.

Revenues

Our Company provides subscription-based services. The following table sets forth the quarter-over-quarter comparison of the Company’s revenues:

	Three Months Ended		3-month Variance		Nine Months ended		9-month Variance	
	September 30,		2018 vs. 2017		September 30,		2018 vs. 2017	
(in thousands)	2018	2017	$	%	2018	2017	$	%
Revenues	$ 17,876	$ 16,592	$ 1,284	8 %	$ 52,029	$ 48,863	$ 3,166	6 %

20

The increase in revenue was due to the growth inherent in a successful subscription-based business model with both steady additions to the subscriber base and new sales attributable to our Erado and Greenview acquisitions, coupled with a high rate of existing customer renewals and the realization of previously contracted revenue in our backlog. In the first nine months of 2018, excluding our Erado and Greenview revenue, we categorized our revenue in the following core industry verticals: 49% healthcare, 29% financial services, 7% government sector, and 15% as other. In the first nine months of 2017, we categorized our revenue in the following core industry verticals: 50% healthcare, 28% financial services, 7% government sector, and 15% as other.

Revenue Indicators — Backlog and Orders

Backlog — Our end-user order backlog is comprised of contractually binding 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, 2018, total backlog was $74.0 million, and we expect approximately 63% of the total backlog, or approximately $46.6 million, to be recognized as revenue during the next twelve months. As of September 30, 2018, the backlog was comprised of the following elements: $31.8 million of deferred revenue that has been billed and paid, $11.9 million billed but unpaid, and approximately $30.3 million of unbilled contracts. The backlog at September 30, 2018, was 1% lower than the $75.0 million backlog at the end of the third quarter 2017, and 2% higher than the ending backlog of $72.6 million at December 31, 2017. Our decrease in backlog year over year reflects the shorter term contractual commitment generally associated with our new customer pricing as a component of a higher touch strategy.

Orders — Total orders were $19.0 million and $14.3 million for the three month periods ended September 30, 2018 and 2017, respectively, representing a 33% increase year-over-year. Total orders include contract renewals, NFYOs, and in the case of new multi-year contracts, amounts attributable to the years beyond the first year of service. NFYOs were $2.6 million and $2.1 million for the three-month periods ended September 30, 2018 and 2017, respectively, representing a 24% increase year-over-year.

Cost of Revenues

The following table sets forth the quarter-over-quarter comparison of the cost of revenues:

	Three Months Ended		3-month Variance		Nine Months ended		9-month Variance	
	September 30,		2018 vs. 2017		September 30,		2018 vs. 2017	
(in thousands)	2018	2017	$	%	2018	2017	$	%
Cost of revenues	$ 3,870	$ 3,272	$ 598	18 %	$ 11,189	$ 9,342	$ 1,847	20 %

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. The increases in 2018 compared to 2017 reflected in the table above resulted primarily from increases in average headcount, which include additional ZixArchive support gained in the Erado acquisition in April 2018 and the ZixProtect support team gained in the Greenview acquisition in March 2017. We are also incurring additional costs associated with leased equipment supporting Greenview customers, and we are amortizing expense resulting from the acquisition of technology. Additional increases relate to standard software maintenance and license support, and depreciation and other expense relating to investments in networking equipment.

Research and Development Expenses

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

	Three Months Ended		3-month Variance		Nine Months ended		9-month Variance	
	September 30,		2018 vs. 2017		September 30,		2018 vs. 2017	
(in thousands)	2018	2017	$	%	2018	2017	$	%
Research and development expenses	$ 2,764	$ 2,916	$ (152)	(5)%	$ 8,720	$ 8,047	$ 673	8 %

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 decrease in the three month period ended September 30, 2018, compared to the same period 2017 reflected in the table above resulted primarily from capitalization of $454 thousand of costs related to development of new features and functionality for our hosting service arrangements partially offset by an increase in travel and average headcount, including the ZixProtect and additional ZixArchive R&D employees gained in the Greenview acquisition and Erado acquisition in March 2017 and April 2018, respectively.

The increase in research and development costs in the nine month period ended September 30, 2018, compared to the same period 2017 relates primarily to increased travel and average headcount as noted above, partially offset by $760 thousand of capitalized development costs.

As we increasingly move to a multi-tenant environment to keep up with industry trends requiring a transition to cloud-based solutions for our existing services, the Company expects our capitalization of research and development expense to become increasingly material.

Selling and Marketing Expenses

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

	Three Months Ended		3-month Variance		Nine Months ended		9-month Variance	
	September 30,		2018 vs. 2017		September 30,		2018 vs. 2017	
(in thousands)	2018	2017	$	%	2018	2017	$	%
Selling and marketing expenses	$ 5,223	$ 4,852	$ 371	8 %	$ 15,054	$ 15,247	$ (193)	(1)%

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 increase in the three month period ended September 30, 2018, compared to the same period in 2017, was due primarily to additional headcount expenses, including the employees gained in the April 2018 Erado acquisition, travel, increased bad debt expense, and the amortization of acquisition related intangible assets. These costs were partially offset by lower commission expense associated with our implementation of GAAP accounting rule ASC 606, which became effective for our Company on January 1, 2018. We adopted a modified retrospective approach in applying this new guidance. The rule requires us to lengthen the amortization period of our commission expense, resulting in a decrease to our commission expense in the three month period ended September 30, 2018, of approximately $625 thousand.

The nine month decrease in selling and marketing expense resulted primarily from a $1.9 million reduction in commission expense associated with our 2018 implementation of ASC 606, and decreased advertising and market research costs. These items were partially offset by higher headcount, travel, and amortization of acquisition related intangible assets as noted above.

General and Administrative Expenses

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

	Three Months Ended	3-month Variance	Nine Months ended	9-month Variance

(in thousands)	September 30, 2018	2017	2018 vs. 2017 $	%	September 30, 2018	2017	2018 vs. 2017 $	%
General and administrative expenses	$ 2,802	$ 2,662	$ 140	5 %	$ 9,085	$ 8,035	$ 1,050	13 %

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 increase in the three month period ended September 30, 2018, compared with the same period in 2017 resulted primarily from an increase in stock-based compensation expense, the addition of our Erado office, and amortization expense of internal use software, partially offset by a decrease in acquisition-related costs and consulting fees.

The increase in the nine month period ended September 30, 2018, compared to the same period 2017, resulted primarily from a $459 thousand revaluation in earn-out costs associated with our Greenview acquisition, an increase in stock-based compensation expense, and the addition of our Erado office.

Provision for Income Taxes

The provision for income taxes was $945 thousand and $1.1 million for the three month periods ended September 30, 2018 and 2017, respectively, and $2.5 million and $3.6 million for the nine months ended September 30, 2018 and 2017, respectively. The operating losses incurred by the Company's U.S. operations in past years and the resulting net operating losses for U.S. Federal income tax purposes are subject to a $30.8 million reserve because of the uncertainty of future taxable income levels sufficient to utilize our net operating losses and credits. Our September 30 2018, income tax provision of $2.5 million includes $2.7 million in deferred taxes, $416 thousand in state taxes currently payable based on gross revenues, and $61 thousand in taxes related to our Canadian operations, all of which are offset by a $690 thousand benefit related to the return of federal Alternative Minimum Tax credits. Our September 30, 2017, income tax provision of $3.6 million included $3.2 million in deferred taxes, $150 thousand in state taxes then payable based on gross revenues, $141 thousand related to the federal Alternative Minimum Tax, and $95 thousand in taxes related to our Canadian operations.

No tax penalty-related charges were accrued or recognized for the three month periods ended September 30, 2018 and 2017. Additionally, we have not taken a tax position that would have a material effect on our financial statements or our effective tax rate for the three month period ended September 30, 2018. We are currently subject to a three year statute of limitations by major tax jurisdictions.

At September 30, 2018, the Company partially reserved its U.S. net deferred tax assets due to the uncertainty of future taxable income being sufficient to utilize net loss carryforwards prior to their expiration, as noted above. The Company did not reserve $21.4 million of its U.S. net deferred tax assets. The majority of this unreserved portion related to $21.6 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 $843 thousand related to Alternative Minimum Tax credits and $359 thousand relating to U.S. state income tax credits and net operating loss carryovers. These items are offset by a $1.4 million liability relating to temporary differences between GAAP and tax-related expense.

Any reduction to the $30.8 million valuation allowance related to our deferred tax asset would be based on an assessment of future utilization following accounting guidance, which relies largely on historical earnings. Using this methodology, and updating the future taxable earnings estimates based on first, second, and third quarter 2018 actual earnings, the Company believes the deferred tax asset allowance as of December 31, 2017, will remain unchanged at December 31, 2018. For this reason, the Company has recognized its first, second, and third quarter 2018 federal deferred tax provision in full. If in future periods we conclude our future U.S. federal taxable estimate established at the end of the year will exceed the prior year estimate, the Company will offset its federal deferred tax provision by reducing its valuation allowance by an equal amount, thereby eliminating federal taxes from its deferred tax provision federal taxes within the Company's financial statements. Significant judgment is required in determining any valuation allowance recorded against the deferred tax asset. In assessing the need for such an allowance, we consider all available evidence, including past operating results, estimates of future taxable income, and the feasibility of tax planning strategies. The Company will continue to reevaluate the need for its valuation 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 during which 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.

Net Income

Our net income for the three months ended September 30, 2018, of $2.5 million was an increase of $0.5 million compared to our net income of $1.9 million for the same period last year, representing a 29% increase. The increase in our net income was due to our increase in revenue and decreased research and development expenses, offset by corresponding increases in cost of sales and higher selling and marketing, and general and administrative expenses, 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 expenditure requirements, 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. During the first nine months of 2018, net cash provided by operations was $11.8 million, a decrease of 16% compared with the $14.0 million of net cash provided by operations in the first nine months of 2017. This decrease is attributable to a reduction in our deferred revenue associated with shorter-term contracts. At September 30, 2018, our cash and cash equivalents totaled $24.0 million, a decrease of $9.0 million from the December 31, 2017 balance, and we had no debt. This $9.0 million decrease in our cash position included our expenditure of $11.8 million, net of cash acquired, related to our Erado purchase in April 2018 and $6.0 million related to our share repurchase activity, as discussed elsewhere herein.

Sources and Uses of Cash Summary

	Nine Months Ended September 30,	
(In thousands)	2018	2017
Net cash provided by operations	$ 11,762	$ 13,984
Net cash used in investing activities	$ (14,113)	$ (9,999)
Net cash (used in) provided by financing activities	$ (6,681)	$ 2,318

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

Our investing activities in the first nine months of 2018 consisted of $11.8 million, net of cash acquired, used in the acquisition of Erado and $2.3 million capital expenditure for computer and networking equipment, including internal-use software. In the first nine months of 2017, our spending consisted of $8.2 million, net of cash acquired, used in the acquisition of Greenview and EMS technology, and $1.8 million capital expenditure for computer and networking equipment.

Financing activities in the first nine months of 2018 include $5.4 million used in a $10.0 million share repurchase program authorized by our board of directors in April 2017, $650 thousand used in the repurchase of common stock related to the tax impact of vesting restricted stock awards, a $605 thousand earn-out payment associated with our acquisition of Greenview and $195 thousand used to pay costs associated with a shelf registration filed with the SEC on July 31, 2018, offset by $161 thousand cash received from the exercise of stock options. Cash received from financing activities in the first nine months of 2017 included the receipt of $4.2 million from the exercise of stock options offset by $1.3 million used in the same share repurchase program and a $543 thousand used in the repurchase of common stock related to the tax impact of vesting restricted stock awards.

Options of Zix Common Stock

We have significant stock 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, 2018. 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.

	Summary of Outstanding Options			
Exercise Price Range	Outstanding Options	Total Value of Outstanding	Vested Options (included in	Total Value of Vested Options

		Options (In thousands)	outstanding options)	(In thousands)
$1.11 - $1.99	5,396	$ 6	5,396	$ 6
$2.00 - $3.49	431,813	1,112	431,813	1,112
$3.50 - $4.99	492,010	1,871	367,010	1,403
Total	929,219	$ 2,989	804,219	$ 2,521

Off-Balance Sheet Arrangements

None.

Contractual Obligations, Contingent Liabilities and Commitments

A summary of our fixed contractual obligations and commitments at September 30, 2018, is as follows:

	Payments Due by Period			
(In thousands)	Total	1 Year	Years 2 & 3	Beyond 3 Years
Operating leases	$7,434	$1,727	$ 2,371	$ 3,336

We have not entered into any material, non-cancelable purchase commitments at September 30, 2018.

We have severance agreements with certain employees which would require the Company to pay approximately $5.8 million if all such employees were terminated from employment with our Company following a triggering event (e.g., change of control) as defined in the severance agreements.

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, 2017.

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, 2018.

Changes in Internal Controls over Financial Reporting

During the nine months ended September 30, 2018, 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

The Company has recently undertaken a comprehensive review of its risk factor disclosures in light of recent acquisitions and other changes to its business. The following description of risk factors includes any material changes to, and supersedes the description of, risk factors associated with the Company's business previously disclosed in Part I, Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2017, under the heading "Risk Factors." These risk factors 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 year ended December 31, 2017.

Our business depends upon customers using email and certain social media platforms to exchange confidential information, and a significant shift of those messages to other communication channels could impair our growth prospects and negatively affect our business, financial condition and financial results.

Our customers deploy and use our products and services to easily, securely and confidentially send and receive electronic messages, by way of internet communications channels including email and certain social media platforms. Our business and revenue substantially depend on our current and potential customers using email and social media to exchange sensitive information electronically. New technologies, products, or business models that could support migration to alternative means of secure communications could be disruptive to our business. If prospective or current customers were to send and receive sensitive information using technology or communication channels other than email or the social media platforms that we support, our growth prospects and our business, financial condition and financial results could be materially adversely affected.

Our business depends on market acceptance of our products and services, and our failure to achieve and maintain influential customers could negatively affect our business, financial condition and financial results.

In order to continue to operate profitably and grow, we must achieve and maintain broad market acceptance of our products and services at a price that provides us with an acceptable rate of return relative to our costs. We have been successful in selling our Email Encryption products and services to high-profile customers in the healthcare, financial services and government segments of the market. The acceptance and use of our products and services by those significant customers facilitates our sales to other potential customers, and an expanding base of users in the Zix Directory aids in our market penetration and expansion. The loss of an influential customer of our existing products and services, or the failure to achieve sufficient market adoption of new products including ZixProtect and ZixArchive, could impair our ability to expand the market penetration of our products and services, or cause us to reduce or increase prices, which could reduce our revenues and net income and materially adversely affect our business, financial condition and financial results.

Our business relies on securing new customer subscriptions and subscription renewals from existing customers.

A large portion of our revenue is derived from customer subscriptions, and existing customers have no contractual obligations to purchase beyond the initial subscription or contract period. Our ability to grow our business is dependent in part on customers renewing their existing subscriptions and purchasing additional solutions or services after the initial term of their agreement. Though we maintain and analyze historical data with respect to rates of customer renewals, upgrades and expansions, those rates may not accurately predict future trends in renewal of certain products and services offered by us. If our customers cancel or amend their agreements with us during their term, do not renew their agreements, renew on less favorable terms or do not purchase additional solutions or products during renewal periods, our revenue may grow more slowly than expected or decline and our profitability may be harmed.

Additionally, we have experienced, and expect to continue to experience, some level of attrition with existing customers and we may not maintain historical subscription rates, and we may be unable to accurately predict our customer renewal rates. Although we have historically retained approximately 90% of our recurring revenue on an annual basis, there has been some recent decline in such retention and our customers' renewal rates may further decline or fluctuate as a result of a number of factors, including the level of their satisfaction with our products and technical support services, customer merger or acquisition activity, customer budgets, the pricing of our products compared with those offered by our competitors, technology trends, the prevailing regulatory regime and general market conditions. If new subscriptions or subscription renewals decline from their current levels, our revenue or revenue growth may decline, and our business may suffer which could have a materially adverse effect on our financial performance.

The security of our networks and data centers is critical to our business and an actual or perceived breach of security through a cyber-attack or otherwise could cause us to lose customers and could negatively affect our reputation, business, financial condition and financial results.

We are dependent on our networks and data centers to provide our products and services. Due to the nature of the products and services we provide and the sensitive nature of the information we collect, process, store, use and transmit, we may face cyber-attacks, data protection breaches, computer viruses and other similar disruptions from unauthorized tampering or human error that attempt to penetrate and could harm our networks and data centers. Our business depends on customers having and maintaining confidence that we provide effective network and security protection. To reduce the risk of a successful cyber-attack or similar event, we have implemented significant physical and logical security measures to detect, identify and mitigate threats as well as to monitor for and respond to potential breaches and incidents. Despite these security measures, our networks and data centers may remain vulnerable. We may not be able to correct a security flaw or particular vulnerability promptly, or at all. Further efforts to limit the ability of malicious third parties to disrupt or undermine our security efforts may be costly to implement and may not be successful. If a cyber-attack or other breach of security occurs, or is perceived to have occurred, in our internal systems or at our data centers and networks, it could cause negative publicity, interruption of our services, damage to our reputation, unauthorized disclosure of our customers' confidential or proprietary information (including personally identifiable information), disclosure of our intellectual property, disclosure, modification or removal of our confidential or sensitive information, theft or unauthorized use or publication of our trade secrets, loss of customers, lost revenue and increased expense (including potentially indemnification or warranty costs), any of which could have a material adverse effect on our business, financial condition and financial results.

Public key cryptography technology used in our businesses is subject to technology integrity risks that could reduce demand for our products and services and could negatively affect our business, financial condition and financial results.

Our business employs public key cryptography technology and other encryption technologies to encrypt and decrypt sensitive data. The security afforded by encryption depends on the integrity of the private key, which is predicated on the assumption that it is very difficult to mathematically derive the private key from the related public key. Successful decryption of intercepted encrypted email, or public reports of successful decryption, whether or not true, could reduce demand for our products and services. If new methods or technologies, such as quantum computing, make it easier to derive the private key from the related public key, the security of encryption services using public key cryptography technology could be impaired and our products and services could become less marketable. That could require us to make significant changes to our products and services, which could increase our costs, damage our reputation, or otherwise harm our business. Any of these events could reduce our revenues, increase our expenses and materially adversely affect our business, financial condition and financial results.

Our business depends substantially on our data center facilities and other systems and infrastructure provided by third parties, and their unreliability or unavailability for a significant period could cause us to lose customers and could negatively affect our business, financial condition and financial results.

Our business relies on third-party suppliers of computer, cloud and telecommunications infrastructure to provide our products and services through the global Internet and to provide network access between our data centers, our customers and end-users of our products and services. Much of the computer and communications hardware upon which our businesses depend is located in our data center facilities in North America and in the United Kingdom. Our data centers might be damaged or interrupted as a result of numerous factors, many of which are beyond our control, including fire, flood, power loss, mechanical failure, telecommunications failure, break-ins, cyber-attacks, sabotage, vandalism, earthquakes, terrorist attacks, hostilities or war or other events. Computer viruses, equipment failure, denial of service attacks, and similar disruptions affecting the internet, infrastructure supplied by third parties or our systems might cause service interruptions, delays and loss of critical data, and could prevent us from providing our services. Problems affecting our data center operations or the networks on which we rely, whether or not in our control, could result in loss of revenues, increased expenses, failure to achieve market acceptance, diversion of resources, injury to our reputation, liability and increased costs, and may cause our customers to terminate or elect not to renew their agreements. We do not carry sufficient insurance to compensate us for all losses that may occur as a result of any of these events. Though our products generally tolerate isolated supplier failures, the occurrence of any of these events, including multiple supplier outages or problems, could materially adversely affect our business, financial condition and financial results.

Outages or problems with systems and infrastructure supplied by third parties could negatively affect our business, financial condition and financial results.

Our business relies on third-party suppliers of the telecommunications infrastructure. We use various communications service suppliers and the global internet to provide network access between our data centers, our customers and end-users of our products and services. If those suppliers do not enable us to provide our customers with reliable, real-time access to our systems, we may be unable to gain or retain customers. These suppliers periodically experience outages or other operational problems as a result of internal system failures or external third-party actions. Though our products generally tolerate isolated supplier failures, multiple supplier outages or problems could materially adversely affect our business, financial condition and financial results.

The infrastructure supporting our business may suffer capacity constraints and business interruptions that could cause us to lose customers, increase our operating costs and could negatively affect our business, financial condition and financial results.

Our business depends on our providing our customers reliable, real-time access to our data centers and networks. Customers will not tolerate a service hampered by slow delivery times, unreliable service levels, service outages, or insufficient capacity. System capacity limits or constraints arising from unexpected increases in our volume of business or network traffic could cause interruptions, outages or delays in our services, or deterioration in their performance, or could impair our ability to process transactions. We may not be able to accurately project the rate of increase in usage of our systems or to timely increase capacity to accommodate increased traffic on our systems. System delays or interruptions may prevent us from efficiently providing services to our customers or other third parties, which could result in our losing customers and revenues, or incurring liabilities that could have a material adverse effect on our business, financial condition and financial results.

The growth of our business may require significant investment in systems and infrastructure and these investments may achieve delayed, or lower than expected benefits, which could impair our profitability and negatively affect our business, financial condition and financial results.

As our operations grow in size and scope, we continually need to improve and upgrade our technology offerings, systems and infrastructure to offer an increasing number of customers enhanced products, services, features and functionality, while maintaining the reliability and integrity of our systems and infrastructure and pursuing reduced costs per transaction. Expanding our technology offerings, systems and infrastructure may require us to commit substantial financial, operational and technical resources, with no assurance that the volume of our business will increase, which could reduce our net income, deplete our cash, and materially adversely affect our business, financial condition and financial results. Developing and launching new product offerings adjacent to or outside of our core service offerings can be particularly costly in terms of capital investments for both product development and marketing. At the same time, these new offerings involve greater uncertainty concerning both market acceptance and our ability to successfully execute a sales and marketing strategy that justifies our investments. Our failure to properly manage and execute new product initiatives could materially adversely affect our business, financial condition and financial results.

Because we recognize subscription revenue over the term of the applicable customer agreement, a decline in subscription renewals or new service agreements may not be reflected immediately in our operating results.

We generally recognize revenue from customers ratably over the terms of their customer agreements, which are typically one year or two years. As a result, much of the revenue we report in each quarter is deferred revenue from customer agreements entered into during previous quarters. Consequently, a decline in new or renewed client agreements in any one quarter will not be fully reflected in our revenue or our results of operations until future periods. Accordingly, this revenue recognition model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new clients must be recognized over the applicable subscription term.

Our failure to keep pace with rapid technology changes could have a negative impact on our business, financial condition and financial results.

The markets for our products and services are characterized by rapid technological developments and frequent changes in customer requirements. We must continually improve the performance, features and reliability of our products and services, particularly in response to competitive offerings, to keep pace with these developments. We must ensure that our products and services address evolving operating environments, devices, industry trends, certifications and standards. For example, we have been required to expand our offerings for virtual computer environments and mobile environments to support a broader range of mobile devices. We also may need to develop products that are compatible with new operating systems while remaining compatible with existing, popular operating systems. Our business could be harmed by our competitors announcing or introducing new products and services that could be perceived by customers as superior to ours. We spend considerable resources on technology research and development, but our research and development resources are more limited than many of our competitors.

In addition, we are also focused on addressing new and accelerating market trends, such as the continued decline of on premise email security and advance threat protection solution and the continued transition towards cloud-based solutions, which requires us to continue to improve our product and service offerings. We may experience delays in the anticipated timing of activities related to our efforts to address these challenges and higher than expected or unanticipated execution costs. Our failure to introduce new or enhanced products on a timely basis, to keep pace with rapid industry, technological or market changes or to gain customer acceptance for our new and existing products and services, such as mobile device data protection, could have a material adverse effect on our business, financial condition and financial results.

We face strong competition, which could negatively affect our business, financial condition and financial results.

The markets in which we compete are characterized by rapid change and converging technologies and are very competitive. With rising demand for private and secure email communications, there is strong competition for email encryption products and services. Our Email Encryption Threat Protection, Archive, and Data Loss Prevention business competes with products and services offered by companies such as Microsoft, Barracuda Networks, Inc., Proofpoint, MIMECast, Virtru, and Micro Focus (Voltage). Our ZixOne business competes with products and services offered by companies such as AirWatch/VMWare, Citrix (with XenMobile), Blackberry, IBM/Fiberlink (with MaaS360), Microsoft (with ActiveSync), and MobileIron. Strong competition requires us to develop new technology solutions and service offerings to expand the functionality and value that we offer to our customers. Our competitors may develop products and services that are perceived by customers as equivalent to, or having advantages over, our products and services. Competitors could capture a significant share in our markets, causing our sales and revenue to decline or grow more slowly. Barriers to entry are relatively low, and new ventures are often formed that create products competitive with our products. Competitive pressures could lead to price discounting or to increases in expenses such as advertising and marketing costs. Increased competition could also decrease demand for our products and services. Competition could reduce our revenues and net income and materially adversely affect our business, financial condition and financial results.

Industry consolidation may lead to increased competition and may harm our operating results.

There has been a trend toward industry consolidation in our industry for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry and as companies are acquired or are unable to continue operations. For example, some of our current and potential competitors have made acquisitions, or announced new strategic alliances. Companies that are strategic alliance partners in some areas of our business may acquire or form alliances with our competitors, thereby reducing their business with us. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. This could have a material adverse effect on our business, financial condition and financial results.

Some competitors have advantages that may allow them to compete more effectively than us, which could negatively affect our business, financial condition and financial results.

Some of our competitors have longer operating histories, more extensive operations, greater name recognition, larger technical staffs, bigger product development and acquisition budgets, established relationships with more distributors and hardware vendors, and greater financial and marketing resources than we do. These advantages might enable them (independently or through alliances) to develop and expand functionality of products and services faster than we can, to spend more money to market and distribute products and services than we can, or to offer their products and services at prices lower than ours. These advantages could reduce our revenues and net income and materially adversely affect our business, financial condition and financial results.

If we do not effectively expand and train our sales force, we may be unable to add new customers or increase sales to our existing customers and our business may be harmed.

We continue to be substantially dependent on our sales force to obtain new customers and to sell additional solutions to our existing customers. We believe that there is significant competition for sales personnel with the skills and technical knowledge that we require. Our ability to achieve significant revenue growth will depend, in large part, on our success in recruiting, training and retaining sufficient numbers of sales personnel to support our growth. New hires require significant training and, in most cases, take significant time before they achieve full productivity. Our recent hires and planned hires may not become as productive as we expect, and we may be unable to hire or retain sufficient numbers of qualified individuals in the markets where we do business or plan to do business. If we are unable to hire and train sufficient numbers of effective sales personnel, or the sales personnel are not successful in obtaining new clients or increasing sales to our existing client base, our business will be harmed.

If we do not successfully manage our strategic alliances, we may not realize the expected benefits from such alliances and we may experience increased competition or delays in product development.

We have entered into several strategic alliances with other companies to offer complementary products and services. These arrangements are generally limited to specific projects or series of projects, and their main goal is generally to facilitate product compatibility and adoption of industry standards. There can be no assurance that we will realize the expected benefits from these strategic alliances. If successful, these relationships may be mutually beneficial and result in industry growth. However, alliances carry an element of risk because, in most cases, we must compete in some business areas with a company with which we have a strategic alliance and, at the same time, cooperate with that company in other business areas. Also, if these partner companies fail to perform or if these relationships fail to materialize as expected, we could suffer delays in product development or other operational difficulties.

We enlist third-party distributors to market our products and services, and our failure to succeed in those relationships could negatively affect our business, financial condition and financial results.

We distribute a significant percentage of our products and services by entering into alliances with third parties who can offer our products and services along with their own or our competitors' products and services. Increased reliance on third parties to market and distribute our products and services exposes us to a variety of risks. For example, we have limited control over and visibility into the sales cycles of third-party distributors, which could increase the length of our sales cycle, cause our revenue to fluctuate unpredictably and make it difficult to accurately forecast our revenue. In addition, we may not succeed in developing or maintaining marketing alliances. Companies with which we have marketing alliances may in the future discontinue their relationships with us, form marketing alliances with our competitors, or develop and market their own products and services that compete with ours. If a significant distributor were to discontinue its relationship with us, we could experience an interruption in the distribution of our products and services and our revenues could decline. Our failure to develop, maintain and expand strategic distribution relationships could reduce our revenues and net income and materially adversely affect our business, financial condition and financial results.

Our future growth and success may be affected by acquisitions. If we are not able to successfully identify, negotiate, complete and integrate acquisitions, our operating results and prospects could be harmed.

We have acquired and expect to continue to acquire new products and technology, as well as customers, through acquisitions. The success of our future acquisition strategy will depend on our ability to identify, negotiate, complete and integrate acquisitions. Acquisitions are inherently risky, and any acquisition we complete may not be successful. Acquisitions we pursue involve numerous risks, including the following:

- difficulties in integrating and managing the operations and technologies of the companies and assets we acquire;
- diversion of our management's attention from normal daily operations of our business;
- our inability to maintain the customers, the key employees, the key business relationships and the reputations of the businesses and products we acquire;
- our inability to generate sufficient revenue from acquisitions to offset increased expenses generally associated with acquisitions;
- difficulties in predicting or achieving synergies and cost savings between our existing businesses and acquired businesses;
- our responsibility for the liabilities of the businesses we acquire, including liabilities arising out of their failure to operate correctly, maintain effective data security, data integrity, disaster recovery and privacy controls prior to acquisition, or their infringement or alleged infringement of third-party intellectual property, contract or data access rights prior to acquisition;
- difficulties in complying with new markets or regulatory standards to which we were not previously subject;

- difficulties or unanticipated expenses associated with development work that is necessary to achieve interoperability between our products and solutions and the products and solutions we acquire;
- difficulties or unanticipated expenses associated with migrating customers from products and solutions developed by our acquisition targets to our own products and solutions;
- delays in our ability to implement internal standards, controls, procedures and policies in the businesses we acquire; and
- adverse effects of acquisition activity on the key performance indicators we use to monitor our performance as a business.

Unanticipated events and circumstances occurring in future periods may affect the realizability of intangible assets that we are required to record on our balance sheet as a result of acquisitions. These events and circumstances could include significant under-performance relative to projected future operating results and significant changes in our overall business or product strategies. Such events and circumstances may cause us to revise our estimates and assumptions used in analyzing the value of our intangible assets, and any such revision could result in a non-cash impairment charge that could have a material impact on our financial results.

Unfavorable economic environments, particularly in the U.S., could negatively affect our business, financial condition and financial results.

Challenging economic conditions worldwide have from time to time contributed, and may continue to contribute, to slowdowns in the technology and networking industries at large, as well as in the email/data security market and in specific geographic markets in which we operate. If economic growth in those markets, particularly in the U.S., which accounts for a substantial majority of our revenue, slows, or credit is unavailable at a reasonable cost, current and potential customers may delay or reduce technology purchases, including the deployment or expansion of our products and services. Additionally, as we continue our corporate strategy of exploring additional international markets, we may become more susceptible to unfavorable economic environments outside the U.S. and that could compound the negative effects of unfavorable economic environments in markets in which we currently operate. This could result in reduced sales of our products and services, longer sales cycles, slower adoption of new technologies and increased price competition. In addition, adverse economic conditions could negatively affect the cash flow of our customers and distributors, which might result in failures or delays in payments to us. This could increase our credit risk exposure and delay our recognition of revenue. Specific economic trends, such as declines in the demand for cloud computing services and computing devices, or softness in corporate information technology spending, could have a more direct impact on our business. If these conditions persist, spread or deteriorate further, our business, financial condition and financial results could be materially adversely affected.

If our products do not work properly or have security vulnerabilities, our reputation, business, financial condition and financial results could be negatively affected and we could experience negative publicity, declining sales and legal liability.

The threats facing our customers are constantly evolving and the techniques used by experienced hackers to access or sabotage data change frequently, often are not recognized until launched against a target, and may originate from less regulated or remote areas around the world. As a result, we must constantly update our product solutions to respond to these threats. We produce complex solutions that incorporate leading-edge technology, including both hardware and software, that must operate in a wide variety of technology environments. Software may contain defects or “bugs” that can interfere with expected operations or introduce security vulnerabilities that can lead to unauthorized use or data loss. There can be no assurance that our testing programs will be adequate to detect all defects prior to the product being introduced, which might decrease customer satisfaction with our products and services. The product reengineering cost to remedy a product defect or mitigate vulnerabilities could be material to our operating results. Our inability to cure a product defect could result in the temporary or permanent withdrawal of a product or service from the market, a security breach, negative publicity, damage to our reputation, failure to achieve market acceptance, lost revenue and increased expense, any of which could have a material adverse effect on our reputation, business, financial condition and financial results.

Our transmission and storage of personally identifiable information, including the personal data of European data subjects and other confidential information, and the potential for inadvertent exposure of PII or CI, could cause us to violate data privacy laws or lose customers and could negatively affect our business, financial condition and financial results.

We transmit and store large amounts of personally identifiable information ("PII") about individuals, which may include healthcare or financial information, and other confidential information ("CI"). Although we have established, and continue to develop and enhance, security measures and controls to help protect against unauthorized disclosure of such PII and other CI, an inadvertent disclosure of, or unauthorized third-party access to, PII or CI, could disrupt our operations, damage our reputation and subject us to claims or other liabilities.

In addition, our processing and storage of certain types of data is subject to confidentiality agreements with our clients and handling PII is increasingly subject to a variety of changing privacy and data security regulations around the world. For example, the collection and use of personal data in the European Union, previously governed by the provisions of the Data Protection Directive, were replaced with the General Data Protection Regulation, or GDPR, in May 2018. GDPR imposes several requirements relating to the collection, use, processing and transfer of personal data, such as requirements for using consent or other legal grounds to process personal data, providing information to individuals about how their personal data is used, maintaining adequate security and data protection measures, giving data breach notifications, complying with individuals' requests to access, correct or delete their personal data and using third-party processors of personal data. GDPR also maintains the European Union's strict rules limiting the transfer of personal data out of the European Economic Area. Failure to comply with the requirements of GDPR and the applicable national data protection laws of the European Union Member States may result in fines and other administrative penalties. GDPR will introduce substantial potential fines for violations and increase our responsibility and liability in relation to personal data that we process. To comply with the GDPR, we may be required to put in place additional technical and administrative measures and controls mechanisms. This may be onerous and adversely affect our business, financial condition, results of operations and prospects. Such laws and regulations are subject to new and differing interpretations and may be inconsistent among jurisdictions. For example, in October 2015, the European Court of Justice invalidated the U.S.-EU Safe Harbor framework that had been in place since 2000, which allowed companies including us to meet certain European legal requirements for the transfer of personal data from the European Economic Area to the United States. In the wake of that decision, we decided to participate in the new EU-U.S. Privacy Shield framework established by the U.S. Department of Commerce and the European Commission and opened for participation on August 1, 2016. We applied for and were approved for certification and are now an Active Participant in the Privacy Shield program. Our Privacy Shield self-certification was finalized by the Department of Commerce and became effective as of November 9, 2016 and was renewed in November 2017. This allows us to transfer personal data of European data subjects that we receive from customers to the United States, in compliance with the Privacy Shield principles. While our Privacy Shield certification and other mechanisms (such as Model Clauses) to lawfully transfer such data remain in place, those mechanisms are also subject to pending legal challenges and these legal challenges may result in different European data protection regulators applying differing standards for the transfer of personal data. Future changes in requirements under these regulations may be inconsistent with our existing data management practices. If so, we could be required to fundamentally change our business activities and practices or modify our software, which could have an adverse effect on our business, including increased cost of compliance and limitations on data transfer for us and our customers.

Any inability to adequately address privacy concerns, even if unfounded, or to comply with applicable privacy or data protection laws, regulations and policies, could result in additional costs and liability to us, damage our reputation, inhibit sales, and harm our business. Furthermore, any inadvertent disclosure of, or unauthorized access (including due to a cyber-attack) to, PII or other CI or other failure by us to comply with data privacy requirements could subject us to significant penalties, damages, remediation and other expenses, and damage our reputation, any of which could have a material adverse effect on our business, financial condition and financial results.

Problems with protecting and enforcing our intellectual property rights could negatively affect our business, financial condition and financial results.

We rely on a combination of contractual rights, trademarks, trade secrets, patents and copyrights to establish and protect intellectual property rights and other proprietary rights in our products and services. These intellectual property rights or other proprietary rights might be challenged, invalidated or circumvented. The steps we have taken to protect our proprietary information may not prevent its misuse, theft or misappropriation. Competitors may independently develop technologies or products that are substantially equivalent or superior to our products or that inappropriately incorporate our intellectual property rights or other proprietary technology into their products. Competitors may hire our former employees who may misappropriate our intellectual property rights or other proprietary technology. Some jurisdictions may not provide adequate legal protection of our intellectual property rights or other proprietary technology.

We may have to defend or assert our rights in intellectual property that we use in our products and services, and we could be found to infringe the intellectual property rights of others, which could be disruptive and expensive to our business.

We may have to defend against claims that we or our customers are infringing the rights of third parties in patents, copyrights, trademarks and other intellectual property. If we acquire technology to include in our products and services from third parties, our exposure to infringement actions may increase because we must rely upon these third parties to verify the origin and ownership of such technology. Also, we may be required to spend significant resources to monitor and protect our intellectual property rights, including initiating claims or litigation against third parties for infringement or misappropriation. Intellectual property litigation and controversies are disruptive and expensive, whether or not resolved in our favor. Even unmeritorious claims brought against us or our customers may harm our reputation and customer relationships, may cause us to incur significant legal and other fees to defend, and may have to be settled for significant amounts. Infringement claims against us could require us to develop non-infringing products and services or enter into expensive royalty or licensing arrangements. Our business, financial condition and financial results could be materially adversely affected if we are not able to develop non-infringing technology or license technology on commercially reasonable terms.

We may face risks from using “open source” software that could negatively affect our business, financial condition and financial results.

Like many other software companies, we use “open source” software in order to take advantage of common industry building blocks and to add functionality to our products quickly and inexpensively. Open source software license terms could adversely affect our intellectual property rights in our products that include open source software. Depending upon how the open source software is deployed, we could be required to offer products that use the open source software for no cost, or make available the source code for modifications or derivative works. Any of these obligations could have an adverse impact on our intellectual property rights and revenue from products incorporating the open source software. Using open source code could also cause us to inadvertently infringe third-party intellectual property rights or require us to publicly disclose proprietary information. We have processes and controls in place that are designed to address these risks and concerns, but we cannot be sure that our process or controls will be sufficient to mitigate all risk in this regard. Open source software might also introduce security vulnerabilities or defective functionality. The open source community may not always respond with adequate urgency to mitigate the impacts of such defects.

We rely on the availability of third-party intellectual property, which may not be accessible to us on reasonable terms or at all.

Some of our products include third-party intellectual property, which may require licenses for our use. For example, a significant portion of the revenue generated by our recently acquired business, Erado, relies on the licensing of certain electronic message API’s, such as those made available by LinkedIn Corporation, SMS providers, Facebook, and other social media channels. Based on past experience and industry practice, we believe that such licenses can be obtained on reasonable terms; however, there can be no assurance that we will be able to obtain or maintain the necessary licenses for new or current products on acceptable terms or at all. Failure to obtain or maintain such licenses may limit our ability to sell our products, which could have a material adverse effect on our business, financial condition and financial results.

We may fail to recruit and retain key personnel, which could impair our ability to meet key objectives.

Our success depends on our ability to attract and retain highly-skilled technical, managerial, sales, and marketing personnel. Changes in key personnel may be disruptive to our business. It could be difficult, time consuming and expensive to replace key personnel. Integrating new key personnel may be difficult and costly. Volatility, lack of positive performance in our stock price or changes to our overall compensation program including our stock incentive program may adversely affect our ability to retain key employees, many of whom are compensated, in part, based on the performance of our stock price. The loss of services of any of our key personnel, the inability to retain and attract qualified personnel in the future or delays in hiring required personnel could make it difficult to meet key objectives. Any of these impairments related to our key personnel could negatively affect our business, financial condition and financial results.

Governmental restrictions on the sale of our products and services in non-U.S. markets could negatively affect our business, financial condition and financial results.

Exports of software solutions and services using encryption technology such as ours are generally restricted by the U.S. government. Although we have obtained U.S. government approval to export our service to almost all countries, the list of countries to which we (and our distributors) cannot export our products and services could be expanded in the future. In addition, some countries impose restrictions on the importation and use of encryption solutions and services such as ours. The cost of compliance with U.S. and other export laws, or our failure to obtain governmental approvals to offer our products and services in non-U.S. markets, could affect our ability to sell our products and services and could impair our international expansion. We face a variety of other legal and compliance risks. If we or our distributors fail to comply with applicable law and regulations, we may become subject to penalties, fines or restrictions that could materially adversely affect our business, financial condition and financial results.

Our sales to government entities are subject to a number of challenges and risks.

Sales to U.S. federal, state and local governmental agency customers have accounted for a significant portion of our revenue in past periods, and we may in the future increase sales to government agencies. Sales to government entities are subject to a number of challenges and risks. Selling to government entities can be highly competitive, expensive and time consuming, often requiring significant upfront time and expense without any assurance that these efforts will generate a sale. Government contractual requirements often carry a high compliance risk. Government certification requirements for solutions like ours may change and in doing so restrict our ability to sell into the federal government sector until we have attained the revised certification. Government demand and payment for our solutions may be impacted by public sector budgetary cycles and funding authorizations, with funding reductions or delays adversely affecting public sector demand for our solutions. Government entities also may have statutory, contractual or other legal rights to terminate contracts for convenience or due to a default, and any such termination may adversely impact our future operating results.

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 Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
July 1, 2018 to July 31, 2018	6,088	$ 5.27	—	$ —
August 1, 2018 to August 31, 2018	1,102	$ 5.61	—	$ —
September 1, 2018 to September 30, 2018	—	$ —	—	$ —
Total	7,190	$ 5.32	—	$ —

1 Of the total number of shares purchased for the one month periods ended July 31, 2018, August 31, 2018, and September 30, 2018, 7,190 shares of Restricted Stock were withheld by us upon the vesting of outstanding Restricted Stock. These shares were withheld by us to satisfy the minimum statutory tax withholding for the employees for whom Restricted Stock vested during the periods, which is required once the Restricted Stock is vested.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

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
2.1	Stock Purchase Agreement, dated as of April 2, 2018, by and among Craig Brauff, Julie Lomax Brauff, Shari Wood-Richardson, as Trustee of the Alexandra Brauff Gift Trust U/A 12/21/12, Shari Wood-Richardson, as Trustee of the Courtney Brauff Gift Trust U/A 12/21/12, Julie A. Lomax, as Trustee of the Julie Lomax Gift Trust U/A 12/21/12, and Zix Corporation (incorporated herein by reference to Exhibit 2.1 to Zix Corporation's Current Report on Form 8-K filed with the Securities and Exchange Commission on April 2, 2018, and incorporated herein by reference).
3.1	Restated Articles of Incorporation of Zix Corporation, as filed with the Texas Secretary of State on November 10, 2005 (incorporated herein by reference to Exhibit 3.1 to Zix Corporation's Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission on March 14, 2006, and incorporated herein by reference).
3.2	Second Amended and Restated Bylaws of Zix Corporation, dated November 1, 2016 (incorporated herein by reference to Exhibit 3.2 to Zix Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016 filed with the Securities and Exchange Commission on November 3, 2016, and incorporated herein by reference).
31.1*	Certification of David J. Wagner, President and Chief Executive Officer of the Company, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of David E. Rockvam, 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.