Five9, Inc.
Form 10-Q
November 01, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number: 001-36383

Five9, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	94- 3394123
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

Bishop Ranch 8
4000 Executive Parkway, Suite 400
San Ramon, CA 94583
(Address of Principal Executive Offices) (Zip Code)
(925) 201-2000
(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: x No: o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes: x No: o

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

Large Accelerated Filer	o	Accelerated Filer	x
Non-accelerated filer	o (Do not check if a smaller reporting Company)	Smaller Reporting Company	o

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

As of October 25, 2016, there were 52,968,430 shares of the Registrant's common stock, par value $0.001 per share, outstanding.

Table of Contents

FIVE9, INC.
FORM 10-Q
TABLE OF CONTENTS

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which involve substantial risks and uncertainties. These statements reflect the current views of our senior management with respect to future events and our financial performance. These forward-looking statements include statements with respect to our business, expenses, strategies, losses, growth plans, product and client initiatives, market growth projections, and our industry. Statements that include the words “expect,” “intend,” “plan,” “believe,” “project,” “forecast,” “estimate,” “may,” “should,” “ar similar statements of a future or forward-looking nature identify forward-looking statements for purposes of the federal securities laws or otherwise.

Forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause our actual results to differ materially from those indicated in these statements. These factors include the information set forth under the caption “Risk Factors” and elsewhere in this report, including the following:

- our quarterly and annual results may fluctuate significantly, may not fully reflect the underlying performance of our business and may result in decreases in the price of our common stock;
- if we are unable to attract new clients or sell additional services and functionality to our existing clients, our revenue and revenue growth will be harmed;
- our recent rapid growth may not be indicative of our future growth, and even if we continue to grow rapidly, we may fail to manage our growth effectively;
- failure to adequately expand our sales force could impede our growth;
- security breaches and improper access to or disclosure of our data or our clients’ data, or other cyber attacks on our systems, could result in litigation and regulatory risk, harm our reputation and adversely affect our business;
- the markets in which we participate are highly competitive, and if we do not compete effectively, our operating results could be harmed;
- if we fail to manage our technical operations infrastructure, our existing clients may experience service outages, our new clients may experience delays in the deployment of our solution and we could be subject to, among other things, claims for credits or damages;
- if our existing clients terminate their subscriptions or reduce their subscriptions and related usage, our revenues and gross margins will be harmed and we will be required to spend more money to grow our client base;
- we sell our solution to larger organizations that require longer sales and implementation cycles and often demand more configuration and integration services or customized features and functions that we may not offer, any of which could delay or prevent these sales and harm our growth rates, business and operating results;
- because a significant percentage of our revenue is derived from existing clients, downturns or upturns in new sales will not be immediately reflected in our operating results and may be difficult to discern;
- we rely on third-party telecommunications and internet service providers to provide our clients and their customers with telecommunication services and connectivity to our cloud contact center software and any failure by these service providers to provide reliable services could subject us to, among other things, claims for credits or damages;
- we have a history of losses and we may be unable to achieve or sustain profitability;
- we may not be able to secure additional financing on favorable terms, or at all, to meet our future capital needs; and
- failure to comply with laws and regulations could harm our business and our reputation.

The foregoing factors should not be construed as exhaustive and should be read together with the other cautionary statements included in this report. If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, our actual results may differ materially from what we anticipate. You should not place undue reliance on our forward-looking statements. Any forward-looking statements you read in this report reflect our views only as of the date of this report with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. We undertake no obligation to update any forward-looking statements made in this report to reflect events or circumstances after the date of this report or to reflect new information or the occurrence of unanticipated events, except as required by law.

Table of Contents

PART I. FINANCIAL INFORMATION
ITEM 1. Financial Statements
FIVE9, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	September 30, 2016 (Unaudited)	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 57,333	$ 58,484
Accounts receivable, net	12,899	10,567
Prepaid expenses and other current assets	4,097	2,184
Total current assets	74,329	71,235
Property and equipment, net	13,690	13,225
Intangible assets, net	1,657	2,041
Goodwill	11,798	11,798
Other assets	1,225	934
Total assets	$ 102,699	$ 99,233
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,609	$ 2,569
Accrued and other current liabilities	10,500	7,911
Accrued federal fees	5,873	5,684
Sales tax liability	1,307	1,262
Revolving line of credit	—	12,500
Notes payable	1,070	7,212
Capital leases	5,634	4,972
Deferred revenue	8,838	6,413
Total current liabilities	36,831	48,523
Revolving line of credit — less current portion	32,594	—
Sales tax liability — less current portion	1,591	1,915
Notes payable — less current portion	470	17,327
Capital leases — less current portion	4,902	4,606
Other long-term liabilities	532	582
Total liabilities	76,920	72,953
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 5,000 shares authorized, no shares issued and outstanding at September 30, 2016 and December 31, 2015	—	—
Common stock, $0.001 par value; 450,000 shares authorized, 52,967 shares and 51,165 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	53	51
Additional paid-in capital	192,415	180,649
Accumulated deficit	(166,689)	(154,420)
Total stockholders' equity	25,779	26,280
Total liabilities and stockholders' equity	$ 102,699	$ 99,233

See accompanying notes to condensed consolidated financial statements.

3

Table of Contents

FIVE9, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(Unaudited, in thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Revenue	$40,982	$ 32,287	$117,883	$ 92,835
Cost of revenue	17,790	14,812	51,164	43,860
Gross profit	23,192	17,475	66,719	48,975
Operating expenses:				
Research and development	6,041	5,473	17,642	17,079
Sales and marketing	12,925	10,797	38,268	31,322
General and administrative	6,143	6,087	18,561	19,389
Total operating expenses	25,109	22,357	74,471	67,790
Loss from operations	(1,917)	(4,882)	(7,752)	(18,815)
Other income (expense), net:				
Interest expense	(961)	(1,235)	(3,357)	(3,529)
Extinguishment of debt	(1,026)	—	(1,026)	—
Interest income and other	12	119	(66)	72
Total other income (expense), net	(1,975)	(1,116)	(4,449)	(3,457)
Loss before income taxes	(3,892)	(5,998)	(12,201)	(22,272)
Provision for (benefit from) income taxes	(2)	50	68	48
Net loss	$(3,890)	$ (6,048)	$(12,269)	$ (22,320)
Net loss per share:				
Basic and diluted	$(0.07)	$ (0.12)	$(0.24)	$ (0.45)
Shares used in computing net loss per share:				
Basic and diluted	52,708	50,369	52,078	49,931
Comprehensive Loss:				
Net loss and comprehensive loss	$(3,890)	$ (6,048)	$(12,269)	$ (22,320)

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FIVE9, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in thousands)

	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Cash flows from operating activities:		
Net loss	$(12,269)	$ (22,320)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	6,302	5,525
Provision for doubtful accounts	58	157
Stock-based compensation	6,927	6,010
Loss on disposal of property and equipment	1	10
Loss on extinguishment of debt	1,026	—
Amortization of debt discount and issuance costs	221	260
Accretion of interest	11	—
Others	(10)	40
Changes in operating assets and liabilities:		
Accounts receivable	(2,383)	(1,149)
Prepaid expenses and other current assets	(1,927)	(957)
Other assets	(25)	(178)
Accounts payable	1,039	(1,329)
Accrued and other current liabilities	2,749	788
Accrued federal fees and sales tax liability	(90)	161
Deferred revenue	2,449	192
Other liabilities	(75)	(83)
Net cash provided by (used in) operating activities	4,004	(12,873)
Cash flows from investing activities:		
Purchases of property and equipment	(973)	(689)
(Increase) Decrease in restricted cash	(60)	806
Purchase of short-term investments	—	(20,000)
Proceeds from maturity of short-term investments	—	40,000
Net cash (used in) provided by investing activities	(1,033)	20,117
Cash flows from financing activities:		
Proceeds from exercise of common stock options	4,050	419
Proceeds from sale of common stock under ESPP	792	680
Repayments of notes payable	(23,866)	(2,622)
Proceeds from revolving line of credit	32,594	—
Payment of prepayment penalty and related fees	(368)	—
Payments for debt issuance costs	(206)	—
Payments of capital leases	(4,618)	(4,509)
Repayments on revolving line of credit	(12,500)	—
Net cash used in financing activities	(4,122)	(6,032)
Net (decrease) increase in cash and cash equivalents	(1,151)	1,212
Cash and cash equivalents:		
Beginning of period	58,484	58,289
End of period	$57,333	$ 59,501
Non-cash investing and financing activities:		
Equipment obtained under capital lease	$5,548	$ 4,193

Equipment purchased and unpaid at period-end	13	84

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

FIVE9, INC.

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Description of Business and Summary of Significant Accounting Policies

Five9, Inc. and its wholly-owned subsidiaries (the “Company”) is a provider of cloud software for contact centers. The Company was incorporated in Delaware in 2001 and is headquartered in San Ramon, California. The Company has offices in Europe and Asia, which primarily provide research, development, sales, marketing, and client support services.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) and applicable rules and regulations of the Securities and Exchange Commission (“SEC”) regarding interim financial reporting. Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Therefore, these condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015. All intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of condensed consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. The significant estimates made by management affect revenue, the allowance for doubtful accounts, intangible assets, goodwill, loss contingencies, including the Company’s accrual for federal fees and sales tax liability, accrued liabilities, stock-based compensation, provision for income taxes and uncertain tax positions. Management periodically evaluates such estimates and they are adjusted prospectively based upon such periodic evaluation. Actual results could differ from those estimates.

Significant Accounting Policies

The Company’s significant accounting policies are disclosed in its Annual Report on Form 10-K for the year ended December 31, 2015. During the nine months ended September 30, 2016, there were no changes to the Company's significant accounting policies.

Recently Adopted Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-15, Classification of Certain Cash Receipts and Cash Payments (Topic 230), which addresses eight classification issues related to the statement of cash flows, including those for debt prepayment or debt extinguishment costs. ASU 2016-15 is effective for the Company in its first quarter of 2018, with early adoption permitted. As permitted by ASU 2016-15, the Company early-adopted this new guidance at the beginning of the third quarter of 2016 and applied it prospectively. No prior periods were retrospectively adjusted.

In November 2015, the FASB issued ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes. This ASU eliminates the requirement for companies to present deferred tax assets and liabilities as current and noncurrent on the balance sheet and, instead, requires companies to classify all deferred tax assets and liabilities as noncurrent. As permitted by ASU 2015-17, the Company early-adopted this new guidance at the beginning of the fourth quarter of 2015 and applied it prospectively. No prior periods were retrospectively adjusted.

In April 2015, the FASB issued ASU No. 2015-05, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement. The ASU provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The ASU does not change the accounting for a customer's accounting for service contracts. A company can elect to adopt the ASU either prospectively or retrospectively. The Company adopted this guidance prospectively beginning in the first quarter of 2016 and the adoption did not have a material effect on its condensed consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. The ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by this ASU. In August 2015, the FASB issued ASU No. 2015-15, Interest—Imputation of Interest (Subtopic 835-30): Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements, which clarifies that the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The Company adopted this guidance retrospectively beginning in the first quarter of 2016 and the adoption did not have a material effect on its condensed consolidated financial statements for the prior periods or the current period reported.

Recent Accounting Pronouncements Not Yet Effective

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which requires measurement and recognition of expected credit losses for certain types of financial assets held. ASU 2016-13 is effective for the Company in its first quarter of 2020, and earlier adoption is permitted beginning in the first quarter of 2019. The Company is currently evaluating the impact of ASU 2016-13 on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This ASU simplifies several aspects of the accounting for share-based payment transactions, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The guidance is effective for the Company beginning in the first quarter of 2017, with early application permitted. The Company is currently assessing the effect the guidance will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). Under the new guidance, a lessee will be required to recognize assets and liabilities for both finance, or capital, and operating leases with lease terms of more than 12 months. The ASU also will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. Lessor accounting will remain largely unchanged from current GAAP. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach that includes a number of optional practical expedients that entities may elect to apply. This guidance is effective for the Company beginning in the first quarter of 2019. Early adoption is permitted. The Company is currently assessing the effect the guidance will have on its consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. The new guidance requires management of public and private companies to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern and, if so, disclose that fact. Management will also be required to evaluate and disclose whether its plans alleviate that doubt. The standard will be effective for the Company's annual period ending December 31, 2016 and interim and annual periods thereafter. Early adoption is permitted. The Company does not expect that the requirement will have an impact on its financial position, results of operations or cash flows.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers: Topic 606 and issued subsequent amendments to the initial guidance in August 2015, March 2016, April 2016 and May 2016 within ASU 2015-04, ASU 2016-08, ASU 2016-10 and ASU 2016-12, respectively (ASU 2014-09, ASU 2015-04, ASU 2016-08, ASU 2016-10 and ASU 2016-12 collectively, Topic 606). Topic 606 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers and will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. Topic 606 defines a five-step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than are required under existing GAAP. Topic 606 is effective for the Company's annual and interim reporting periods beginning January 1, 2018 using either a retrospective or a

Table of Contents

cumulative effect transition method. The Company has not yet selected a transition method or determined the effect of these ASUs on its ongoing financial reporting.

2. Fair Value Measurements

The Company carries cash equivalents consisting of money market funds at fair value on a recurring basis. Fair value is based on the price that would be received from selling an asset in an orderly transaction between market participants at the measurement date. Fair value is estimated by applying the following hierarchy, which prioritizes the inputs used to measure fair value into three levels and bases the categorization within the hierarchy upon the lowest level of input that is available and significant to the fair value measurement:

Level 1 — Observable inputs which include unadjusted quoted prices in active markets for identical assets.

Level 2 — Observable inputs other than Level 1 inputs, such as quoted prices for similar assets, quoted prices for identical or similar assets in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset.

Level 3 — Unobservable inputs that are supported by little or no market activity and that are based on management's assumptions, including fair value measurements determined by using pricing models, discounted cash flow methodologies or similar techniques.

The fair value of assets carried at fair value was determined using the following inputs (in thousands):

	September 30, 2016	
	Total	Level 1
Assets		
Cash equivalents		
Money market funds	$20,061	$20,061

	December 31, 2015	
	Total	Level 1
Assets		
Cash equivalents		
Money market funds	$20,010	$20,010

3. Financial Statement Components

Cash and cash equivalents consisted of the following (in thousands):

	September 30, 2016	December 31, 2015
Cash	$ 37,272	$ 38,474
Money market funds	20,061	20,010
Cash and cash equivalents	$ 57,333	$ 58,484

Accounts receivable, net consisted of the following (in thousands):

	September 30, 2016	December 31, 2015
Trade accounts receivable	$ 12,057	$ 9,554
Unbilled trade accounts receivable, net of advance client deposits	853	1,028
Allowance for doubtful accounts	(11)	(15)
Accounts receivable, net	$ 12,899	$ 10,567

Table of Contents

Prepaid expenses and other current assets consisted of the following (in thousands):

	September 30, 2016	December 31, 2015
Prepaid expenses	$ 3,494	$ 1,800
Other current assets	603	384
Prepaid expenses and other current assets	$ 4,097	$ 2,184

Property and equipment, net consisted of the following (in thousands):

	September 30, 2016	December 31, 2015
Computer and network equipment	$ 35,136	$ 30,277
Computer software	4,693	3,566
Internal-use software development costs	500	128
Furniture and fixtures	1,130	1,113
Leasehold improvements	624	619
Property and equipment	42,083	35,703
Accumulated depreciation and amortization	(28,393)	(22,478)
Property and equipment, net	$ 13,690	$ 13,225

Depreciation and amortization expense associated with property and equipment was $2.0 million and $5.9 million for the three and nine months ended September 30, 2016, respectively, and $1.7 million and $5.1 million for the three and nine months ended September 30, 2015, respectively.

Property and equipment capitalized under capital lease obligations consist primarily of computer and network equipment and were as follows (in thousands):

	September 30, 2016	December 31, 2015
Gross	$ 32,844	$ 27,302
Less: accumulated depreciation and amortization	(21,531)	(16,429)
Total	$ 11,313	$ 10,873

Accrued and other current liabilities consisted of the following (in thousands):

	September 30, 2016	December 31, 2015
Accrued compensation and benefits	$ 7,463	$ 5,718
Accrued expenses	3,037	2,193
Accrued and other current liabilities	$ 10,500	$ 7,911

4. Intangible Assets

The components of intangible assets were as follows (in thousands):

	September 30, 2016			December 31, 2015		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Developed technology	$ 2,460	$ (1,038)	$ 1,422	$ 2,460	$ (775)	$ 1,685
Customer relationships	520	(307)	213	520	(229)	291
Domain names	50	(30)	20	50	(22)	28
Non-compete agreements	140	(138)	2	140	(103)	37
Total	$ 3,170	$ (1,513)	$ 1,657	$ 3,170	$ (1,129)	$ 2,041

Table of Contents

Amortization expense related to intangible assets was $0.1 million and $0.4 million for the three and nine months ended September 30, 2016, respectively, and $0.1 million and $0.4 million for the three and nine months ended September 30, 2015, respectively.
As of September 30, 2016, the expected future amortization expense for intangible assets was as follows (in thousands):

Period	Expected Future Amortization Expense
Remainder of 2016	$ 119
2017	465
2018	442
2019	351
2020	280
Total	$ 1,657

5. Debt
2016 Loan and Security Agreement
On August 1, 2016 (the “Effective Date”), the Company entered into a loan and security agreement (the “2016 Loan and Security Agreement”) with the lenders party thereto and City National Bank, as agent for such lenders. The 2016 Loan and Security Agreement provides for a revolving line of credit (the “New Revolving Credit Facility”) of up to $50.0 million and matures on August 1, 2019. On the Effective Date, the Company borrowed $32.6 million under the 2016 Loan and Security Agreement. The proceeds were used to extinguish existing indebtedness under all prior Loan and Security Agreements and will be used for working capital and other general corporate purposes
Loans under the 2016 Loan and Security Agreement bear a variable annual interest rate of the prime rate plus 0.50%, subject to a 0.25% increase if our adjusted EBITDA is negative at the end of any fiscal quarter. The Company has agreed to pay a fee of 0.25% per annum on the unused portion of the revolving credit facility as well as an anniversary fee of $31,250 on each of the first and second anniversaries of the Effective Date. The Company is accreting the total estimation of unused fees and anniversary fees evenly over the full term of the 2016 Loan and Security Agreement. Under the terms of the 2016 Loan and Security Agreement, the outstanding balance cannot exceed the Company’s trailing four months of MRR (monthly recurring revenue including subscription and usage) multiplied by the average trailing 12 month dollar based retention rate (calculated on the same basis as in the Company’s periodic reports filed with the Securities and Exchange Commission). As of September 30, 2016, the outstanding principal balance under the 2016 Loan and Security Agreement was $32.6 million, which is included in 'Revolving line of credit — less current portion' in the condensed consolidated balance sheets. As of September 30, 2016, the amount available for additional borrowings was $17.4 million.
The Company incurred approximately $0.2 million in fees that were directly attributable to the issuance of this credit facility. These costs are deferred and included within 'Prepaid expenses and other current assets' and 'Other assets' in the Company's condensed consolidated balance sheets and being amortized to interest expense on a straight-line basis over three years starting from the Effective Date of the New Revolving Credit Facility.
The obligations of the Company under the 2016 Loan and Security Agreement are guaranteed by the Company’s subsidiary, Five9 Acquisition. The Company’s obligations under the 2016 Loan and Security Agreement and Five9 Acquisition’s obligations under its guaranty are secured by a first priority perfected security interest in and lien on substantially all of the Company’s and Five9 Acquisitions’ assets. The 2016 Loan and Security Agreement contains certain customary covenants, including the requirement that the Company maintain $25.0 million of unrestricted cash deposited with the lenders for the term of the agreement, a minimum liquidity ratio of unrestricted cash and accounts receivable to the outstanding amounts under the 2016 Loan and Security Agreement, as well as customary events of default. The Company was in compliance with these covenants as of September 30, 2016.
The Company recorded a $1.0 million loss on extinguishment of debt under the 2013 Loan and Security Agreement and the 2014 Loan and Security Agreement. The loss was comprised of $0.4 million in prepayment penalties, a $0.4

million write-off of unamortized debt discounts, and a $0.2 million write-off of unamortized debt issuance costs.

Table of Contents

2013 Loan and Security Agreement

Prior to entering into the 2016 Loan and Security Agreement on August 1, 2016, the Company had a revolving line of credit of up to $20.0 million ("Prior Revolving Credit Facility") under a loan and security agreement with a lender, which was entered into in March 2013 and last amended in December 2014 ("2013 Loan and Security Agreement"). The Prior Revolving Credit Facility carried a variable annual interest rate of the prime rate plus 0.50% and would mature on December 1, 2016.

The 2013 Loan and Security Agreement was collateralized by substantially all the assets of the Company. The balance outstanding could not exceed the lesser of (i) $20.0 million or (ii) an amount equal to the Company's monthly recurring revenue for the three months prior multiplied by the average Dollar-Based Retention Rate over the prior twelve months, less the amount accrued for the Company's Universal Service Fund ("USF") obligation (accrued federal fees). As of December 31, 2015, the outstanding principal balance under the Prior Revolving Credit Facility was $12.5 million, which is disclosed as a current liability, and the amount available for additional borrowings was $7.5 million. As of September 30, 2016, the Company had canceled and paid back all amounts due under the Prior Revolving Credit Facility.

In connection with its acquisition of SoCoCare in October 2013, the Company also borrowed $5.0 million under a term loan (the "Term Loan") under the 2013 Loan and Security Agreement in October 2013. Monthly interest-only payments were due on the advance at the prime rate plus 1.50% through September 2014. Principal and interest payments were due in equal monthly installments from October 2014 through the maturity of the Term Loan in March 2017. As December 31, 2015, $2.5 million in principal amount of this Term Loan was outstanding and is included as notes payable in the condensed consolidated balance sheets. As of September 30, 2016, the Company had canceled and paid back all amounts due under the Term Loan.

The 2013 Loan and Security Agreement contained certain covenants, including the requirement that the Company maintain $7.5 million of cash deposited with the lender for the term of the 2013 Loan and Security Agreement. The Company was in compliance with these covenants through the cancellation date of August 1, 2016. The 2013 Loan and Security Agreement remained senior to other debt, including the debt issued under the 2014 Loan and Security Agreement discussed below.

2014 Loan and Security Agreement

Prior to entering into the 2016 Loan and Security Agreement on August 1, 2016, the Company had a term loan facility of $30.0 million with a syndicate of two lenders ("Lenders"), which was entered into in February 2014 and amended in December 2014 and February 2015 (the "2014 Loan and Security Agreement"). The term loan facility was available to the Company in tranches. The first tranche for $20.0 million was advanced upon entering into the agreement. The remaining $10.0 million was available for drawdown by the Company until February 20, 2016 in $1.0 million increments, which expired on February 20, 2016. The Company incurred $0.4 million in debt costs in connection with borrowing the first tranche in February 2014. The term loan bore interest at a variable per annum rate equal to the greater of 10% or LIBOR plus 9%. Interest was due and payable on the last business day of each month during the term of the loan commencing in February 2014. Monthly principal payments were due beginning in February 2016 based on 1/60th of the outstanding balance at that time and would continue until all remaining principal outstanding under the term loan becomes due and payable in February 2019. As of December 31, 2015, $20.0 million of this loan facility was outstanding and is included as notes payable in the condensed consolidated balance sheets. As of September 30, 2016, the Company had canceled and paid back all borrowings under the 2014 Loan and Security Agreement.

The term loan was secured by substantially all the assets of the Company and was subordinate to the 2013 Loan and Security Agreement. The 2014 Loan and Security Agreement contained certain covenants and included the occurrence of a material adverse event, as defined in the agreement and determined by the Lenders, as an event of default. The Company was in compliance with these covenants through the effective cancellation date of August 1, 2016.

In connection with entering into the 2014 Loan and Security Agreement, the Company issued to the Lenders warrants to purchase 177,865 shares of common stock at $10.12 per share, which vest and become exercisable over a ten year term from the date of issuance, based on amounts drawn under the $30.0 million term loan facility. Based on the drawdown of $20.0 million in February 2014, 118,577 shares of common stock issuable under the warrants vested and are exercisable by the Lenders. The fair value of these vested warrants of $1.0 million was recorded as a discount against the debt proceeds and was being recognized as additional interest expense over the term of the loan. The remaining 59,288 shares of common stock issuable under the warrants pertaining to the undrawn $10.0

Table of Contents

million did not vest and were no longer exercisable on February 20, 2016 when the $10.0 million was no longer available for borrowing.

Promissory Note

In July 2013, the Company issued a promissory note to the Universal Service Administrative Company ("USAC") for $4.1 million as a financing arrangement for that amount of accrued federal fees. The promissory note carried a fixed annual interest rate of 12.75% and was repayable in 42 equal monthly installments of principal and interest beginning in August 2013. As of September 30, 2016 and December 31, 2015, approximately $0.5 million and $1.5 million, respectively, of this promissory note was outstanding and is included as notes payable in the accompanying condensed consolidated balance sheets.

FCC Civil Penalty

In June 2015, the Company entered into a consent decree with the Federal Communications Commission ("FCC") Enforcement Bureau (Note 9), in which the Company agreed to pay a civil penalty of $2.0 million to the U.S. Treasury in twelve equal quarterly installments starting in July 2015 without interest. As a result, the Company discounted the $2.0 million liability, which was accrued in the third quarter of 2014 for the then tentative civil penalty, to its present value of $1.7 million at an annual interest rate of 12.75% to reflect the imputed interest and reclassified this discounted liability from 'Accrued federal fees' to 'Notes payable.' The $0.3 million discount was recorded as a reduction to general and administrative expense in the three months ended June 30, 2015 and is being recognized as interest expense over the payment term of the civil penalty. As of September 30, 2016 and December 31, 2015, the outstanding civil penalty payable was $1.2 million and $1.7 million, respectively, of which the net carrying value was $1.1 million and $1.4 million, respectively, and is included as 'Notes payable' in the accompanying condensed consolidated balance sheets.

As of September 30, 2016 and December 31, 2015, the Company’s outstanding debt is summarized as follows (in thousands):

	September 30, 2016	December 31, 2015
Term loan under 2014 Loan and Security Agreement	$ —	$ 20,000
Term loan under 2013 Loan and Security Agreement	—	2,500
Promissory note to USAC	470	1,459
FCC civil penalty	1,167	1,667
Total notes payable, gross	1,637	25,626
Less: discount	(108)	(1,087)
Total notes payable, net carrying value	1,529	24,539
Revolving line of credit	32,594	12,500
Interest accretion under 2016 line of credit	$ 11	$ —
Total debt, net carrying value	$ 34,134	$ 37,039
Less: current portion of debt *	(1,070)	(19,712)
Total debt, less current portion **	33,064	17,327

* Included in ‘Notes payable’ in the condensed consolidated balance sheets.
** Included in ‘Notes payable - less current portion’ and 'Revolving line of credit — less current portion' in the condensed consolidated balance sheets.

Table of Contents

Future principal payments of the Company's outstanding debt as of September 30, 2016 are as follows (in thousands):

Period	Amount to Mature
Remainder of 2016	$517
2017	786
2018	334
2019	32,594
Total	$34,231

6. Stockholders' Equity

Capital Structure

The Company is authorized to issue 450,000,000 shares of common stock with a par value of $0.001 per share. As of September 30, 2016 and December 31, 2015, the Company had 52,967,421 shares and 51,164,621 shares of common stock issued and outstanding, respectively.

The Company is also authorized to designate and issue up to 5,000,000 shares of preferred stock with a par value of $0.001 per share in one or more series without stockholder approval and to fix the rights, preferences, privileges and restrictions thereof. As of September 30, 2016 and December 31, 2015, the Company had no shares of preferred stock issued and outstanding.

Warrants

As of September 30, 2016 and December 31, 2015, the Company had outstanding warrants to purchase 131,597 and 190,885 shares of common stock, respectively, with a weighted-average exercise price of $9.89 per share and $9.96 per share, respectively. These warrants expire primarily in October 2023 and February 2024.

Common Stock Reserved for Future Issuance

Shares of common stock reserved for future issuance related to outstanding equity awards, common stock warrants, and employee equity incentive plans were as follows (in thousands):

	September 30, 2016
Stock options outstanding	5,626
Restricted stock units outstanding	2,096
Shares available for future grant under 2014 Plan	6,188
Shares available for future issuance under ESPP	1,258
Common stock warrants outstanding	132
Total shares of common stock reserved	15,300

Equity Incentive Plans

Prior to its initial public offering ("IPO"), the Company granted stock options under its Amended and Restated 2004 Equity Incentive Plan, as amended (the "2004 Plan").

In March 2014, the Company's board of directors and stockholders approved the 2014 Equity Incentive Plan ("2014 Plan") and 5,300,000 shares of common stock were reserved for issuance under the 2014 Plan. In addition, on the first day of each year beginning in 2015 and ending in 2024, the 2014 Plan provides for an annual automatic increase to the shares reserved for issuance in an amount equal to 5% of the total number of shares outstanding on December 31st of the preceding calendar year or a lesser number as determined by the Company's board of directors. Pursuant to the automatic annual increase, 2,558,231 and 2,466,124 additional shares were reserved under the 2014 Plan on January 1, 2016 and 2015, respectively.

No further grants were made under the 2004 Plan once the 2014 Plan became effective on April 3, 2014. Upon the effectiveness of the 2014 Plan, all shares reserved for future issuance under the 2004 Plan became available for issuance under the 2014 Plan. After the IPO, any forfeited or expired shares that would have otherwise returned to

Table of Contents

the 2004 Plan instead return to the 2014 Plan. As of September 30, 2016, 6,188,160 shares of common stock were available for future grant under the 2014 Plan.

The 2004 Plan and the 2014 Plan are described in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015.

Stock Options

A summary of the Company’s stock option activity during the nine months ended September 30, 2016 is as follows (in thousands, except years and per share data):

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding as of December 31, 2015	6,092	$ 4.58		
Options granted (weighted average grant date fair value of $4.07 per share)	742	8.66		
Options exercised	(920)	4.40		
Options forfeited or expired	(288)	6.83		
Outstanding as of September 30, 2016	5,626	$ 5.03	6.2	$ 60,000

The Company has computed the aggregate intrinsic value amounts disclosed in the above table based on the difference between the exercise price of the options and the closing market price of the Company’s common stock of $15.68 per share as of September 30, 2016 for all in-the-money options outstanding.

Restricted Stock Units

A summary of the Company's restricted stock unit ("RSU") activity during the nine months ended September 30, 2016 is as follows (in thousands, except per share data):

	Number of Shares	Weighted Average Grant Date Fair Value Per Share
Outstanding as of December 31, 2015	1,818	$ 5.01
RSUs granted	1,120	8.97
RSUs vested and released	(718)	5.44
RSUs forfeited	(124)	6.05
Outstanding as of September 30, 2016	2,096	$ 6.91

Employee Stock Purchase Plan

The Company's 2014 Employee Stock Purchase Plan ("ESPP") became effective on April 3, 2014 and is described in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015. The number of shares of common stock originally reserved for issuance under the ESPP was 880,000 shares, which will increase automatically each year, beginning on January 1, 2015 and continuing through January 1, 2024, by the lesser of (i) 1% of the total number of shares of the Company’s common stock outstanding on December 31 of the preceding calendar year; (ii) 1,000,000 shares of common stock (subject to adjustment to reflect any split or combination of the Company’s common stock); or (iii) such lesser number as determined by the Company’s board of directors. Pursuant to the automatic annual increase, 511,646 additional shares were reserved under the ESPP on January 1, 2016. As of September 30, 2016, 1,258,442 shares of common stock were available for future grants under the ESPP.

During the three months ended September 30, 2016, no shares were purchased under the ESPP. During the nine months ended September 30, 2016, 164,310 shares were purchased on May 13, 2016 at a price of $4.82 per share under the ESPP.

Table of Contents

Stock-Based Compensation

Stock-based compensation expenses for the three and nine months ended September 30, 2016 and 2015 were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Cost of revenue	$357	$ 233	$951	$ 639
Research and development	547	475	1,510	1,389
Sales and marketing	626	448	1,604	1,430
General and administrative	989	789	2,862	2,552
Total stock-based compensation	$2,519	$ 1,945	$6,927	$ 6,010

As of September 30, 2016, unrecognized stock-based compensation expenses by award type, net of estimated forfeitures, and their expected weighted-average recognition periods are summarized in the following table (in thousands, except years).

	Stock Option	RSU	ESPP
Unrecognized stock-based compensation expense	$6,154	$12,124	$109
Weighted-average amortization period	2.3 years	2.9 years	0.1 years

The Company recognizes stock-based compensation expense that is calculated based upon awards ultimately expected to vest and, thus, stock-based compensation expense is reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. All stock-based compensation for equity awards granted to employees and non-employee directors is measured based on the grant date fair value of the award.

The Company values RSUs at the closing market price of its common stock on the date of grant. The Company estimates the fair value of each stock option and purchase right under the ESPP granted to employees on the date of grant using the Black-Scholes option-pricing model and using the assumptions noted in the below table. The weighted-average assumptions used to value stock options granted during the three and nine months ended September 30, 2016 and 2015 were as follows:

Stock Options	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Expected term (years)	6.1	6.1	6.0	6.1
Volatility	48%	48%	48%	49%
Risk-free interest rate	1.2%	1.6%	1.5%	1.5%
Dividend yield	—	—	—	—

7. Net Loss Per Share

Basic net loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the period, and excludes any dilutive effects of employee stock-based awards and warrants. Diluted net income per share is computed giving effect to all potentially dilutive common shares, including common stock issuable upon exercise of stock options and warrants and vesting of restricted stock. As the Company had net losses for the three and nine months ended September 30, 2016 and 2015, all potentially issuable common shares were determined to be anti-dilutive.

Table of Contents

The following table presents the calculation of basic and diluted net loss per share (in thousands, except per share data).

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net loss	$(3,890)	$ (6,048)	$(12,269)	$ (22,320)
Weighted-average shares used in computing basic and diluted net loss per share	52,708	50,369	52,078	49,931
Basic and diluted net loss per share	$(0.07)	$ (0.12)	$(0.24)	$ (0.45)

The following securities were excluded from the calculation of diluted net loss per share attributable to common stockholders because their effect would have been anti-dilutive for the periods presented (in thousands).

	September 30, 2016	September 30, 2015
Stock options	5,626	6,553
Restricted stock units	2,096	1,606
ESPP	—	189
Common stock warrants	132	360
Total	7,854	8,708

8. Income Taxes

The provision for income taxes for the three and nine months ended September 30, 2016 was approximately $(2) thousand and $68 thousand, respectively. The provision for income taxes for the three and nine months ended September 30, 2015 was approximately $50 thousand and $48 thousand, respectively. The provision for or benefit from income taxes consisted primarily of foreign income taxes.

For the three and nine months ended September 30, 2016 and 2015, the provision for or benefit from income taxes differed from the statutory amount primarily due to the Company realizing no benefit for current year losses due to maintaining a full valuation allowance against its domestic and U.K. net deferred tax assets.

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are expected to be deductible or taxable. Based on the available objective evidence, the Company does not believe it is more likely than not that the net deferred tax assets will be realizable. Accordingly, the Company has provided a full valuation allowance against the domestic and U.K. net deferred tax assets as of September 30, 2016 and December 31, 2015. There were no U.K. deferred tax assets as of December 31, 2015. The Company intends to maintain the remaining valuation allowance until sufficient positive evidence exists to support a reversal of, or decrease in, the valuation allowance. During the three and nine months ended September 30, 2016, there were no material changes to the total amount of unrecognized tax benefits.

9. Commitments and Contingencies

Commitments

The Company’s principal commitments consist of future payment obligations under capital leases to finance data centers and other computer and networking equipment purchases, operating lease agreements for office space, research and development, and sales and marketing facilities, and agreements with third parties to provide co-location hosting, telecommunication usage and equipment maintenance services. These commitments as of December 31, 2015 are disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, and did not change materially during the nine months ended September 30, 2016 except for the acquisition of certain additional data center and network equipment and software under multiple capital leases. As of September 30, 2016, the total minimum future payment commitments under these capital leases added during the nine months ended September 30, 2016 were approximately $6.2 million, of which $0.6 million is due in 2016, with the remainder of $5.6 million due over approximately 35 months.

Universal Services Fund Liability

During the third quarter of 2012, the Company determined that based on its business activities, it is classified as a telecommunications service provider for regulatory purposes and it should make direct contributions to the federal USF and related funds based on revenues it receives from the resale of interstate and international telecommunications services. Previously, the Company had believed that the telecommunications services were an integral part of an information service that the Company provides via its software and had instead made indirect USF contributions via payments to its wholesale telecommunications service providers. In order to comply with the obligation to make direct contributions, the Company made a voluntary self-disclosure to the FCC Enforcement Bureau and registered with the USAC, which is charged by the FCC with administering the USF. The Company filed exemption certificates with its wholesale telecommunications service providers in order to eliminate its obligation to reimburse such wholesale telecommunications service providers for their USF contributions calculated on services sold to the Company.

The Company’s registration with USAC subjects it to assessments for unpaid USF contributions, as well as interest thereon and civil penalties, due to its late registration and past failure to recognize its obligation as a USF contributor and as an international carrier. The Company will be required to pay assessments for periods prior to the Company’s registration. As of December 31, 2012, the total past due USF contribution being imposed by USAC and accrued by the Company for the period from 2003 through 2012 was $8.1 million, of which $4.7 million was undisputed and $3.4 million, including $0.8 million that pertains to 2003 through 2007, was disputed. While the Company is in administrative proceedings before the FCC to limit such back assessments to the period 2008 through 2012, it is possible that it will be required to pay back assessments for the period from 2003 through 2007. In 2013, the Company began remitting required contributions on a prospective basis directly to USAC.

In July 2013, the Company and USAC agreed to a financing arrangement for $4.1 million of the undisputed $4.7 million of the unpaid USF contributions whereby the Company issued to USAC a promissory note payable in the principal amount of the $4.1 million and paid off the remaining undisputed $0.6 million. The repayment terms of the promissory note payable are disclosed in Note 5. As of September 30, 2016 and December 31, 2015, the principal balance of the promissory note payable was $0.5 million and $1.5 million, respectively, and is included in the notes payable amounts on the condensed consolidated balance sheets. In addition to the promissory note payable, as of September 30, 2016 and December 31, 2015, the Company had an accrued liability for the disputed portion of the unpaid USF contributions and estimated interest and penalties of $5.2 million and $4.9 million, respectively, included in accrued federal fees on the condensed consolidated balance sheets. For the three and nine months ended September 30, 2016, the Company recorded interest and penalty expenses of $0.1 million and $0.3 million as a charge to general and administrative expense, which were related to its disputed unpaid USF obligations.

On June 12, 2015, in connection with the Company’s disclosure to the FCC, the Company entered into a consent decree with the FCC Enforcement Bureau. In the consent decree, the Company agreed to pay a civil penalty of $2.0 million to the U.S. Treasury in twelve equal quarterly installments starting in July 2015 without interest (Note 5). In the third quarter of 2014, the Company accrued a $2.0 million liability for the then tentative civil penalty. The consent decree also requires the Company to adopt certain internal regulatory compliance monitoring and training requirements, and to report on the status of those compliance efforts to the FCC’s Enforcement Bureau for three years. The Company’s implementation of the internal regulatory compliance monitoring and training requirements were completed in August 2015, and its annual compliance reporting to the FCC will continue until June 2018.

State and Local Taxes and Surcharges

In April 2012, the Company commenced collecting and remitting sales taxes on sales of subscription services in all the U.S. states in which it determined it was obligated to do so. During the first quarter of 2015, the Company conducted an updated sales tax review of the taxability of sales of its subscription services. As a result, the Company determined that it may be obligated to collect and remit sales taxes on such sales in four additional states. Based on its best estimate of the probable sales tax liability in those four states relating to its sales of subscription services during the period 2011 through 2014, during the three months ended March 31, 2015, the Company recorded a general and administrative expense of $0.6 million as an immaterial out of period adjustment to accrue for such taxes.

During 2013, the Company analyzed its activities and determined it may be obligated to collect and remit various state and local taxes and surcharges on its usage-based fees. The Company had not remitted state and local taxes on usage-based fees in any of the periods prior to 2014 and therefore accrued a sales tax liability for this contingency. In January 2014, the Company commenced paying such taxes and surcharges to certain state authorities. In June 2014, the Company commenced collecting state and local taxes or surcharges on usage-based fees from its clients on a current basis and remitting such taxes to the applicable U.S. state taxing authorities.

16

Table of Contents

During the three months ended September 30, 2016 and 2015, respectively, the Company remitted $0.5 thousand and $0.1 million for its contingent sales taxes on both usage-based fees and sales of subscription services. During the nine months ended September 30, 2016 and 2015, the Company has remitted $0.3 million and $1.0 million, respectively, for its contingent sales taxes on both usage-based fees and sales of subscription services.

The Company recognized a $0.1 million gain and a $0.3 million gain for the three and nine months ended September 30, 2016, respectively, and $17 thousand expense and $1.0 million expense for the three and nine months ended September 30, 2015, respectively, as general and administrative expense related to its estimated sales tax liability on both usage-based fees and sales of subscription services in the U.S. and Canada, which was not being collected from its clients.

As of September 30, 2016 and December 31, 2015, the Company had total accrued liabilities of $2.2 million and $2.7 million, respectively, for such contingent sales taxes and surcharges that were not being collected from its clients but may be imposed by various taxing authorities, of which $0.1 million and $0.8 million were included in current “Sales tax liability” on the condensed consolidated balance sheets, respectively, and the remaining were included in non-current “Sales tax liability” on the condensed consolidated balance sheets. The Company’s estimate of the probable loss incurred under this contingency is based on its analysis of the source location of its usage-based fees and the regulations and rules in each tax jurisdiction.

Legal Matters

The Company is involved in various legal and regulatory matters arising in the normal course of business. In management’s opinion, resolution of these matters is not expected to have a material impact on the Company’s consolidated results of operations, cash flows, or its financial position. However, due to the uncertain nature of legal matters, an unfavorable resolution of a matter could materially affect the Company’s future consolidated results of operations, cash flows or financial position in a particular period.

The Company is currently involved in the following lawsuits as a defendant.

Melcher Litigation

On September 28, 2016, a complaint was filed in the United States District Court for the Southern District of California against Five9, Inc. (“Five9”), as the successor in interest to Face It, Corp. (“Face It”), and Lance Fried, a former Five9 employee who was the former Chief Executive Officer of Face It. The action, captioned Melcher, et al. v. Five9, Inc., et al., No. 16-cv-02440, was filed as a direct action by Carl Melcher, a purported former stockholder of Face It, and his related investment entity.

In the complaint, the plaintiffs allege that Face It repurchased the plaintiffs’ stock in September 2013 before Five9 acquired Face It, and that in connection with the repurchase, Fried made material misstatements or omissions to Melcher, by failing to disclose that Face It allegedly was in concurrent discussions about a potential sale of the company to Five9. The complaint alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, as well as various claims under state law and common law. The complaint seeks to set aside Face It’s September 2013 stock repurchase from the plaintiffs, as well as an unspecified amount of damages and an award of attorney’s fees and costs, in addition to other relief.

While the Company does not believe that it is probable that a loss has been incurred, the ultimate resolution of the matter could potentially result in a loss. Management’s best estimate of the low end of the range of the potential loss is zero. At this time, it is not possible to reasonably estimate the high end of the range of the potential loss, which could be material to the Company’s results of operations. Accordingly, the Company has not accrued a loss related to this matter.

NobelBiz Litigation

On August 5, 2011, NobelBiz sent a letter to the Company asserting infringement of a patent related to virtual call centers. On April 3, 2012, NobelBiz filed a patent infringement lawsuit against the Company in the United States District Court for the Eastern District of Texas. The patent asserted in the complaint is different, but related, to the patent asserted in the original letter. The lawsuit, NobelBiz Inc. v. Five9, Inc., Case No. 6:12-cv-00243-LED, alleges that the Company’s local caller ID management service infringes United States Patent No. 8,135,122, or the ‘122 patent. The ‘122 patent, titled “System and Method for Modifying Communication Information (MCI),” issued on March 13, 2012, and according to the complaint is alleged to relate to “a system for processing a telephone call from a call originator (also referred to as a calling party) to a call target (also referred to as a receiving party), where the system accesses a database storing outgoing telephone numbers, selects a replacement telephone number from

17

Table of Contents

the outgoing telephone numbers based on the telephone number of the call target, and originates an outbound call to the call target with a modified outgoing caller identification ('caller ID')." NobelBiz seeks damages in the form of lost profits as well as injunctive relief. The lawsuit is one of several lawsuits filed by NobelBiz against various companies including TCN Inc., LiveVox, Inc. and Global Connect LLC. On March 28, 2013, the court granted the Company's motion to transfer the case to the United States District Court for the Northern District of California. Subsequently, NobelBiz amended its complaint to add claims related to U.S. Patent No. 8,565,399, or the '399 patent, which is a continuation in the same family as the '122 patent and addresses the same technology. The Company responded to the complaint and amended complaint by asserting noninfringement and invalidity of the '122 and '399 patents. On January 16, 2015, the court issued an order regarding claim construction of the two patents-in-suit. On March 7, 2016, the court stayed the case pending an appeal in lawsuits involving NobelBiz, Global Connect and TCN that also involve the '122 and '399 patents. The appeal for those cases is likely to last until late 2016 or into 2017, after which time the lawsuit between NobelBiz and Five9 will resume and a new schedule will be entered by the Court.

The Company has investigated the claims alleged in the complaint and believes that it has good defenses to the claims. While the Company does not believe that it is probable that a loss has been incurred, the ultimate resolution of the matter could potentially result in a loss. Management's best estimate of the low end of the range of the potential loss is zero. At this time, it is not possible to reasonably estimate the high end of the range of the potential loss, which could be material to the Company's results of operations. Accordingly, the Company has not accrued a loss related to this matter.

Indemnification Agreements

In the ordinary course of business, the Company may provide indemnification of varying scope and terms to clients, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of breach of such agreements, services to be provided by the Company or from intellectual property infringement claims made by third parties. In addition, the Company has entered into indemnification agreements with its directors, officers and certain employees that require the Company, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors, officers or employees. No demands have been made upon the Company to provide indemnification under such agreements and thus there are no claims that the Company is aware of that would have a material effect on the Company's condensed consolidated balance sheets, condensed consolidated statements of operations and comprehensive loss, or condensed consolidated statements of cash flows.

10. Geographical Information

The following table is a summary of revenues by geographic region based on client billing address and has been estimated based on the amounts billed to clients during the periods (in thousands).

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
United States	$38,251	$ 29,987	$109,948	$ 86,353
International	2,731	2,300	7,935	6,482
Total revenue	$40,982	$ 32,287	$117,883	$ 92,835

The following table summarizes total property and equipment, net in the respective locations (in thousands).

	September 30, 2016	December 31, 2015
United States	$ 11,846	$ 10,939
International	1,844	2,286
Property and equipment, net	$ 13,690	$ 13,225

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion in conjunction with the condensed consolidated financial statements and notes thereto included elsewhere in this report and in our Annual Report on Form 10-K for the year ended December 31, 2015.

Overview

We are a pioneer and leading provider of cloud software for contact centers, facilitating approximately three billion interactions between our more than 2,000 clients and their customers per year. We believe we achieved this leadership position through our expertise and technology, which has empowered us to help organizations of all sizes transition from legacy on-premise contact center systems to our cloud solution. Our solution, which is comprised of our Virtual Contact Center, or VCC, cloud platform and applications, allows simultaneous management and optimization of customer interactions across voice, chat, email, web, social media and mobile channels, either directly or through our application programming interfaces, or APIs. Our VCC cloud platform routes each customer interaction to an appropriate agent resource, and delivers relevant customer data to the agent in real-time to optimize the customer experience. Unlike legacy on-premise contact center systems, our solution requires minimal up-front investment and can be rapidly deployed and adjusted depending on our client's requirements.

Table of Contents

Since founding our business in 2001, we have focused exclusively on delivering cloud contact center software. We initially targeted smaller contact center opportunities with our telesales team and, over time, invested in expanding the breadth and depth of the functionality of our cloud platform to meet the evolving requirements of our clients. In 2009, we made a strategic decision to expand our market opportunity to include larger contact centers. This decision drove further investments in research and development and the establishment of our field sales team to meet the requirements of these larger contact centers. We believe this shift has helped us diversify our client base while significantly enhancing our opportunity for future revenue growth. To complement these efforts, we have also focused on building client awareness and driving adoption of our solution through marketing activities, which include internet advertising, digital marketing campaigns, social marketing, trade shows, industry events and telemarketing.

We provide our solution through a SaaS business model with recurring subscriptions. We offer a comprehensive suite of applications delivered on our VCC cloud platform that are designed to enable our clients to manage and optimize both inbound and outbound interactions. We primarily generate revenue by selling subscriptions and related usage of our VCC cloud platform. We charge our clients monthly subscription fees for access to our solution, primarily based on the number of agent seats, as well as the specific functionalities and applications our clients deploy. We define agent seats as the maximum number of named agents allowed to concurrently access our solution. Our clients typically have more named agents than agent seats, and multiple named agents may use an agent seat, though not simultaneously. Substantially all of our clients purchase both subscriptions and related telephony usage from us. A small percentage of our clients subscribe to our platform but purchase telephony usage directly from wholesale telecommunications service providers. We do not sell telephony usage on a stand-alone basis to any client. The related usage fees are based on the volume of minutes for inbound and outbound interactions. We also offer bundled plans, generally for smaller deployments, where the client is charged a single monthly fixed fee per agent seat that includes both subscription and unlimited usage in the contiguous 48 states and, in some cases, Canada. We offer monthly, annual and multiple-year contracts to our clients, generally with 30 days’ notice required for changes in the number of agent seats. Our clients can use this notice period to rapidly adjust the number of agent seats used to meet their changing contact center volume needs, including to reduce the number of agent seats to zero. As a general matter, this means that a client can effectively terminate its agreement with us upon 30 days’ notice. Our larger clients typically choose annual contracts, which generally include an implementation and ramp period of several months. Fixed subscription fees, including bundled plans, are generally billed monthly in advance, while related usage fees are billed in arrears. For the three and nine months ended September 30, 2016, subscription and related usage fees accounted for 96% and 95% of our revenue, respectively. For the three and nine months ended September 30, 2015, subscription and related usage fees accounted for 96% and 97% of our revenue, respectively. The remainder was comprised of professional services revenue from the implementation and optimization of our solution.

Our revenue increased to $41.0 million and $117.9 million for the three and nine months ended September 30, 2016 from $32.3 million and $92.8 million for the three and nine months ended September 30, 2015. Revenue growth has primarily been driven by our larger clients. For each of the three and nine months ended September 30, 2016 and 2015, no single client accounted for more than 10% of our total revenue. As of September 30, 2016, we had over 2,000 clients across multiple industries. Our clients' subscriptions generally range in size from fewer than 10 agent seats to approximately 1,000 agent seats.

We have continued to make significant expenditures and investments, including in sales and marketing, research and development and infrastructure. We primarily evaluate the success of our business based on revenue growth, adjusted EBITDA and the efficiency and effectiveness of our investments. The growth of our business and our future success depend on many factors, including our ability to continue to expand our client base, particularly in larger opportunities, grow revenue from our existing client base, develop innovative products and features, and expand internationally. While these areas represent significant opportunities for us, they also pose risks and challenges that we must successfully address in order to sustain the growth of our business and improve our operating results. In order to pursue these opportunities, we anticipate that we will continue to expand our operations and headcount in the near term.

Due to our continuing investments to grow our business, increase our sales and marketing efforts, pursue new opportunities, enhance our solution and build our technology, we expect our cost of revenue and operating expenses to increase in absolute dollars in future periods. However, we expect these expenses to decrease as a percentage of revenue as we grow our revenue and gain economies of scale by increasing our client base without direct incremental development costs and by utilizing more of the capacity of our data centers.

Table of Contents

Key Operating and Financial Performance Metrics

In addition to measures of financial performance presented in our condensed consolidated financial statements, we monitor the key metrics set forth below to help us evaluate growth trends, establish budgets, measure the effectiveness of our sales and marketing efforts and assess operational efficiencies.

Annual Dollar-Based Retention Rate

We believe that our Annual Dollar-Based Retention Rate provides insight into our ability to retain and grow revenue from our clients, and is a measure of the long-term value of our client relationships. Our Annual Dollar-Based Retention Rate is calculated by dividing our Retained Net Invoicing by our Retention Base Net Invoicing on a monthly basis, which we then average using the rates for the trailing twelve months for the period being presented. We define Retention Base Net Invoicing as recurring net invoicing from all clients in the comparable prior year period, and we define Retained Net Invoicing as recurring net invoicing from that same group of clients in the current period. We define recurring net invoicing as subscription and related usage revenue excluding the impact of service credits, reserves and deferrals. Historically, the difference between recurring net invoicing and our subscription and related usage revenue has been within 10%.

The following table shows our Annual Dollar-Based Retention Rate for the periods presented:

	Twelve Months Ended	
	September 30, 2016	September 30, 2015
Annual Dollar-Based Retention Rate	100%	95%

The increase in our Annual Dollar-Based Retention Rate from September 30, 2015 to September 30, 2016 was primarily due to our larger clients both increasing the number of agent seats and increasing the revenue per agent seat.

Adjusted EBITDA

We monitor adjusted EBITDA, a non-GAAP financial measure, to analyze our financial results and believe that it is useful to investors, as a supplement to U.S. GAAP measures, in evaluating our ongoing operational performance and enhancing an overall understanding of our past financial performance. We believe that adjusted EBITDA helps illustrate underlying trends in our business that could otherwise be masked by the effect of the income or expenses that we exclude from adjusted EBITDA. Furthermore, we use this measure to establish budgets and operational goals for managing our business and evaluating our performance. We also believe that adjusted EBITDA provides an additional tool for investors to use in comparing our recurring core business operating results over multiple periods with other companies in our industry.

Adjusted EBITDA should not be considered in isolation from, or as a substitute for, financial information prepared in accordance with U.S. GAAP and our calculation of adjusted EBITDA may differ from that of other companies in our industry. We compensate for the inherent limitations associated with using adjusted EBITDA through disclosure of these limitations, presentation of our financial statements in accordance with U.S. GAAP and reconciliation of adjusted EBITDA to the most directly comparable U.S. GAAP measure, net loss. We calculate adjusted EBITDA as net loss before (1) depreciation and amortization, (2) stock-based compensation, (3) interest income, expense and other, (4) provision for income taxes, and (5) other unusual items that do not directly affect what we consider to be our core operating performance.

Table of Contents

The following table shows a reconciliation from net loss to Adjusted EBITDA for the periods presented (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net loss	$(3,890)	$ (6,048)	$(12,269)	$ (22,320)
Non-GAAP adjustments:				
Depreciation and amortization [1]	2,140	1,840	6,302	5,525
Stock-based compensation [2]	2,519	1,945	6,927	6,010
Interest expense	961	1,235	3,357	3,529
Extinguishment of debt	1,026	—	1,026	—
Interest income and other	(12)	(119)	66	(72)
Provision for (benefit from) income taxes	(2)	50	68	48
Out of period adjustment for sales tax liability [3]	—	—	—	765
Adjusted EBITDA	$2,742	$ (1,097)	$5,477	$ (6,515)

(1) Depreciation and amortization expenses included in our results of operations are as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Cost of revenue	$1,668	$ 1,470	$4,964	$ 4,467
Research and development	204	126	513	315
Sales and marketing	56	52	163	152
General and administrative	212	192	662	591
Total depreciation and amortization	$2,140	$ 1,840	$6,302	$ 5,525

(2) See Note 6 of the notes to the condensed consolidated financial statements for stock-based compensation expense included in our results of operations for the periods presented.

(3) Included in general and administrative expense. The 2015 amounts represent immaterial out of period adjustments recorded in the first two quarters of 2015 for 2011 through 2014.

Key Components of Our Results of Operations

Revenue

Our revenue consists of subscription and related usage as well as professional services. We consider our subscription and related usage to be recurring revenue. This recurring revenue includes fixed subscription fees for the delivery and support of our VCC cloud platform, as well as related usage fees. The related usage fees are based on the volume of minutes for inbound and outbound client interactions. We also offer bundled plans, generally for smaller deployments, where the client is charged a single monthly fixed fee per agent seat that includes both subscription and unlimited usage in the contiguous 48 states and, in some cases, Canada. We offer monthly, annual and multiple-year contracts for our clients, generally with 30 days' notice required for changes in the number of agent seats. Our clients can use this notice period to rapidly adjust the number of agent seats used to meet their changing contact center volume needs, including to reduce the number of agent seats to zero. As a general matter, this means that a client can effectively terminate its agreement with us upon 30 days' notice.

Fixed subscription fees, including plans with bundled usage, are generally billed monthly in advance, while variable usage fees are billed in arrears. Fixed subscription fees are recognized on a straight-line basis over the applicable term, predominantly the monthly contractual billing period. Support activities include technical assistance for our solution and upgrades and enhancements on a when and if available basis, which are not billed separately. Variable subscription related usage fees for non-bundled plans are billed in arrears based on client-specific per minute rate plans and are recognized as actual usage occurs. We generally require advance deposits from clients based on estimated usage. All fees, except usage deposits, are non-refundable.

Table of Contents

In addition, we generate professional services revenue from assisting clients in implementing our solution and optimizing its use. These services include application configuration, system integration and education and training services. Professional services are primarily billed on a fixed-fee basis and are typically performed by us directly. In limited cases, our clients choose to perform these services themselves or engage their own third-party service providers to perform such services. Professional services are recognized as the services are performed using the proportional performance method, with performance measured based on labor hours, provided all other criteria for revenue recognition are met.

Cost of Revenue

Our cost of revenue consists primarily of personnel costs (including stock-based compensation), fees that we pay to telecommunications providers for usage, USF contributions and other regulatory costs, depreciation and related expenses of our servers and equipment, costs to build out and maintain co-location data centers, allocated office and facility costs and amortization of acquired technology. Cost of revenue can fluctuate based on a number of factors, including the fees we pay to telecommunications providers, which vary depending on our clients' usage of our VCC cloud platform, the timing of capital expenditures and related depreciation charges and changes in headcount. We expect to continue investing in our network infrastructure and operations and client support function to maintain high quality and availability of service. Therefore, we expect our cost of revenue to increase in absolute dollars, although these expenses are expected to generally trend down as a percentage of our revenue over the next few years. As our business grows, we expect to continue to realize economies of scale in network infrastructure, personnel and client support.

Operating Expenses

We classify our operating expenses as research and development, sales and marketing, and general and administrative expenses.

Research and Development. Research and development expenses consist primarily of salary and related expenses (including stock-based compensation) for personnel related to the development of improvements and expanded features for our services, as well as quality assurance, testing, product management and allocated overhead. We expense research and development expenses as they are incurred except for internal-use software development costs that qualify for capitalization. We believe that continued investment in our solution is important for our future growth, and we expect research and development expenses to increase in absolute dollars in the foreseeable future, although these expenses are expected to generally trend down as a percentage of our revenue over the next few years.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries and related expenses (including stock-based compensation) for employees in sales and marketing, sales commissions, as well as advertising, marketing, corporate communications, travel costs and allocated overhead. We expense the costs of sales commissions associated with the acquisition or renewal of client contracts as incurred in the period the contract is acquired or the renewal occurs. We believe it is important to continue investing in sales and marketing to continue to generate revenue growth. Accordingly, we expect sales and marketing expenses to increase in absolute dollars as we continue to support our growth initiatives, although these expenses are expected to generally trend down as a percentage of our revenue over the next few years.

General and Administrative. General and administrative expenses consist primarily of salary and related expenses (including stock-based compensation) for management, finance and accounting, legal, information systems and human resources personnel, professional fees, compliance costs, other corporate expenses and allocated overhead. We expect that general and administrative expenses will fluctuate in absolute dollars from period to period, although these expenses are expected to generally trend down as a percentage of our revenue over the next few years.

Other Expense, Net

Other expense, net consists primarily of interest expense associated with our debt and capital leases. We expect interest expense for our outstanding debt to decrease due to a lower interest rate for our New Revolving Credit Facility compared to the 2014 Loan and Security Agreement and the 2013 Loan and Security Agreement (see Note 5 of the notes to condensed consolidated financial statements included in this Form 10-Q). We expect interest expense for our capital leases to increase as a result of our continued capital spending funded by capital leases.

22

Table of Contents

Provision for Income Taxes

Our provision for income taxes consists primarily of corporate income taxes resulting from profits generated in foreign jurisdictions by our wholly-owned subsidiaries, along with state income taxes payable in the United States.

Results of Operations for the Three and Nine Months Ended September 30, 2016 and 2015

Based on the condensed consolidated statements of operations and comprehensive loss set forth in this quarterly report, the following table sets forth our operating results as a percentage of revenue for the periods indicated:

	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Revenue	100 %	100 %	100 %	100 %
Cost of revenue	43 %	46 %	43 %	47 %
Gross profit	57 %	54 %	57 %	53 %
Operating expenses:				
Research and development	15 %	17 %	15 %	18 %
Sales and marketing	32 %	33 %	32 %	34 %
General and administrative	15 %	19 %	17 %	21 %
Total operating expenses	62 %	69 %	64 %	73 %
Loss from operations	(5)%	(15)%	(7)%	(20)%
Other income (expense), net:				
Interest expense	(2)%	(4)%	(3)%	(4)%
Extinguishment of debt	(3)%	— %	(1)%	— %
Interest income and other	1 %	— %	1 %	— %
Total other income (expense), net	(4)%	(4)%	(3)%	(4)%
Loss before income taxes	(9)%			