Mattersight Corp
Form 10-Q
November 09, 2016

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, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM TO

Commission File Number 0-27975

Mattersight Corporation

(Exact Name of Registrant as Specified in Its Charter)

Delaware	36-4304577
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

200 W. Madison Street

Suite 3100

Chicago, Illinois 60606

(Address of Principal Executive Offices) (Zip Code)

(877) 235-6925

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 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 No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company

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

The number of shares of the registrant's common stock outstanding as of October 28, 2016 was 26,524,866.

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Part I. Financial Information

Forward-Looking Statements

Statements in this Quarterly Report on Form 10-Q that are not historical facts are “forward-looking statements” and are made pursuant to the safe harbor provisions of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements, which may be identified by use of words such as “plan,” “may,” “might,” “believe,” “expect,” “intend,” “could,” “would,” “should,” and other words and terms of similar meaning, in connection with any discussion of our prospects, financial statements, business, financial condition, revenues, results of operations, or liquidity, involve risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. In addition to other factors and matters contained or incorporated in this document, important factors that could cause actual results or events to differ materially from those indicated by such forward-looking statements include, without limitation, those noted under “Risk Factors” included in Part I Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2015, as well as the following:

- Uncertainties associated with the attraction of, and the ability to execute contracts with, new clients, the continuation of existing, and execution of new, engagements with existing clients, the conversion of free pilots to paid subscription contracts, and the timing of related client commitments;
- Reliance on a relatively small number of clients for a significant percentage of our revenue;
- Risks involving the variability and predictability of the number, size, scope, cost, and duration of, and revenue from, client engagements;
- Management of the other risks associated with complex client projects and new service offerings, including execution risk; and
- Management of growth and development of, and introduction of, new service offerings.

We cannot guarantee any future results, levels of activity, performance, or achievements. The statements made in this Quarterly Report on Form 10-Q represent our views as of the date of this report, and it should not be assumed that the statements made in this report remain accurate as of any future date. Moreover, we assume no obligation to update forward-looking statements, except as may be required by law. In light of Regulation FD, it is our policy not to comment on earnings, financial guidance, or operations other than through press releases, publicly announced conference calls, or other means that will constitute public disclosure for purposes of Regulation FD.

Item 1. Financial Statements

MATTERSIGHT CORPORATION

CONSOLIDATED BALANCE SHEETS

(Unaudited and in thousands, except share and per share data)

	September 30, 2016	December 31, 2015
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 14,652	$ 15,407
Receivables net of allowances of $28 and $24, respectively	5,447	4,863
Prepaid expenses	5,985	4,582
Other current assets	718	235
Total current assets	26,802	25,087
Equipment and leasehold improvements, net of accumulated depreciation and amortization of $18,263 and $14,805, respectively	9,743	8,523
Goodwill	972	972
Intangible assets, net of amortization of $3,699 and $3,351, respectively	3,262	3,353
Other long-term assets (includes $4,789 of restricted cash at September 30, 2016)	6,287	2,467
Total assets	$ 47,066	$ 40,402
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Short-term debt	$ 80	$ —
Accounts payable	1,583	1,223
Accrued compensation and related costs	2,915	2,761
Unearned revenue	2,331	6,378
Capital leases	2,034	1,819
Other current liabilities	4,662	1,796
Total current liabilities	13,605	13,977
Long-term debt	21,339	—
Long-term unearned revenue	857	1,597
Long-term capital leases	1,885	1,614
Other long-term liabilities	5,792	5,689
Total liabilities	43,478	22,877
7% Series B convertible preferred stock, $0.01 par value; 5,000,000 shares authorized and designated; 1,641,960 and 1,644,768 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively, with a liquidation preference of $10,865 and $10,443, at September 30, 2016 and December 31, 2015, respectively	8,374	8,388

Stockholders' Equity:		
Preferred stock, $0.01 par value; 35,000,000 shares authorized; none issued	—	—
Common stock, $0.01 par value; 50,000,000 shares authorized; 27,497,604 and 27,636,853 shares issued at September 30, 2016 and December 31, 2015, respectively; 26,520,854 and 25,849,876 shares outstanding at September 30, 2016 and December 31, 2015, respectively	275	276
Additional paid-in capital	263,906	264,212
Accumulated deficit	(259,944)	(242,085)
Treasury stock, at cost, 976,750 and 1,786,977 shares at September 30, 2016 and December 31, 2015, respectively	(4,979)	(9,239)
Accumulated other comprehensive loss	(4,044)	(4,027)
Total stockholders' (deficit) equity	(4,786)	9,137
Total liabilities and stockholders' equity	$ 47,066	$ 40,402

See accompanying notes to the Unaudited Consolidated Financial Statements.

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MATTERSIGHT CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited and in thousands, except per share data)

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Revenue:				
Subscription revenue	$ 9,574	$ 9,313	$ 27,297	$ 26,519
Other revenue	838	1,169	2,242	3,021
Total revenue	10,412	10,482	29,539	29,540
Operating expenses:				
Cost of subscription revenue	2,781	1,930	7,840	5,853
Cost of other revenue	662	609	2,044	1,930
Total cost of revenue, exclusive of depreciation and amortization	3,443	2,539	9,884	7,783
Research and development	2,988	3,397	9,588	10,185
Sales and marketing	4,625	3,773	13,452	10,016
General and administrative	2,912	3,108	8,950	8,811
Depreciation and amortization	1,477	1,396	4,295	3,607
Total operating expenses	15,445	14,213	46,169	40,402
Operating loss	(5,033)	(3,731)	(16,630)	(10,862)
Non-operating income (expense):				
Interest and other borrowing costs	(860)	(173)	(1,291)	(434)
Change in fair value of warrant liability	58	(22)	58	3
Other non-operating income	8	2	31	4
Total non-operating income (expense)	(794)	(193)	(1,202)	(427)
Loss before income taxes	(5,827)	(3,924)	(17,832)	(11,289)
Income tax provision	(11)	(15)	(27)	(31)
Net loss	(5,838)	(3,939)	(17,859)	(11,320)
Dividends related to 7% Series B convertible preferred stock	(147)	(147)	(440)	(441)
Net loss available to common stock holders	$ (5,985)	$ (4,086)	$ (18,299)	$ (11,761)
Per share of common stock:				
Basic net loss available to common stock holders	$ (0.24)	$ (0.17)	$ (0.73)	$ (0.52)
Diluted net loss available to common stock holders	$ (0.24)	$ (0.17)	$ (0.73)	$ (0.52)
Shares used to calculate basic net loss per share	25,244	24,185	25,156	22,698
Shares used to calculate diluted net loss per share	25,244	24,185	25,156	22,698
Stock-based compensation expense is included in individual line items above:				
Total cost of revenue	$ 112	$ 63	$ 298	$ 187
Research and development	194	294	863	813
Sales and marketing	482	391	1,415	1,112

General and administrative	463	728	1,718	2,146

See accompanying notes to the Unaudited Consolidated Financial Statements.

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MATTERSIGHT CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(Unaudited and in thousands)

	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net loss	$(5,838)	$ (3,939)	$(17,859)	$(11,320)
Other comprehensive loss:				
Effect of foreign currency translation	(10)	(2)	(17)	—
Comprehensive net loss	$(5,848)	$ (3,941)	$(17,876)	$(11,320)

See accompanying notes to the Unaudited Consolidated Financial Statements.

MATTERSIGHT CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited and in thousands)

	For the Nine Months Ended September 30, 2016	September 30, 2015
Cash Flows from Operating Activities:		
Net loss	$ (17,859)	$ (11,320)
Adjustments to reconcile net loss to net cash used in operating activities:		
Discount accretion and other debt related costs	173	—
Depreciation and amortization	4,295	3,607
Stock-based compensation	4,294	4,258
Provision for uncollectible accounts	25	—
Change in fair value of warrant liability	(58)	(3)
Changes in assets and liabilities:		
Receivables	(609)	(366)
Prepaid expenses	(1,448)	(957)
Other current assets	(484)	(240)
Other long-term assets	(3,820)	707
Accounts payable	287	75
Accrued compensation and related costs	154	210
Unearned revenue	(4,787)	(452)
Other current liabilities	1,375	(2,410)
Other long-term liabilities	374	4,066
Total adjustments	(229)	8,495
	(18,088)	(2,825)

Net cash used in operating activities		
Cash Flows from Investing Activities:		
Capital expenditures	(2,364)	(3,654)
Investment in intangible assets	(857)	(660)
Net cash used in investing activities	(3,221)	(4,314)
Cash Flows from Financing Activities:		
Proceeds from line of credit	16,246	15,000
Repayments of line of credit	(16,246)	(15,000)
Proceeds from other borrowings	28,880	—
Repayments of other borrowings	(6,030)	—
Debt issuance costs	(680)	—
Principal payments on capital lease obligations	(1,727)	(1,552)
Proceeds from issuance of common stock, net	—	15,942
7% Series B convertible preferred stock dividend	(3)	—
Cash paid to satisfy tax withholding upon vesting of employee stock awards	(328)	(753)
Proceeds from exercise of stock options	236	220
Proceeds from employee stock purchase plan	223	163
Net cash provided by financing activities	20,571	14,020
Effect of exchange rate changes on cash and cash equivalents	(17)	1
(Decrease) increase in cash and cash equivalents	(755)	6,882
Cash and cash equivalents,	15,407	14,238

beginning of period				
Cash and cash equivalents, end of period	$	14,652	$	21,120
Non-Cash Investing and Financing Activities:				
Capital lease obligations incurred	$	2,213	$	2,002
Equipment purchased under capital leases		2,213		2,002
Financing of intellectual property purchase, at fair value	—			2,605
Issuance of warrant, at fair value		924	—	
Supplemental Disclosures of Cash Flow Information:				
Interest paid	$	758	$	155

See accompanying notes to the Unaudited Consolidated Financial Statements.

MATTERSIGHT CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note One — Basis of Presentation

The accompanying interim consolidated financial statements include Mattersight Corporation and its subsidiaries (collectively, Mattersight or the company). The accompanying interim consolidated financial statements have been prepared without audit. Certain notes and other information normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. In the opinion of management, the accompanying consolidated financial statements include all normal recurring adjustments considered necessary to present fairly the financial position of the company at September 30, 2016 and December 31, 2015 and the results of operations and cash flows for the periods indicated. Quarterly results are not necessarily indicative of results for any subsequent period.

A prior year amount has been reclassified from non-operating income (expense) to depreciation and amortization to conform to the current year presentation of the statement of operations. On January 1, 2016, the company adopted Accounting Standards Update (ASU) 2015-03, Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. ASU 2015-03 simplifies the presentation of debt issuance costs by conforming the presentation of those costs to that of debt discounts and premiums. The standard requires that unamortized debt issuance costs related to a recognized debt liability be presented on the balance sheet as a direct deduction from the carrying amount of the debt liability. Long-term debt is shown net of unamortized debt issuance costs in the company's consolidated balance sheets.

The accompanying unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in Mattersight's Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission (SEC) on March 11, 2016.

Note Two — Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board (FASB) issued ASU No 2016-15, "Statement of Cash Flows (Topic 230) Classification of Certain Cash Receipts and Cash Payments", which applies to all entities that are required to present a statement of cash flows under Topic 230. ASU 2016-15 addresses the presentation and classification of cash flows related to (i) debt prepayment or debt extinguishment costs, (ii) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, (iii) contingent consideration payments made after a business combination, (iv) proceeds from the settlement of insurance claims, (v) proceeds from the settlement of corporate-owned life insurance policies (including bank-owned life insurance policies), (vi) distributions received from equity method investees, (vii) beneficial interests in securitization transactions, and (viii) separately identifiable cash flows and application of the predominance principle. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017. The company is currently evaluating the impact of this update on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments — Credit Losses: Measurement of Credit Losses on Financial Instruments. This update broadens the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The update is effective for annual periods beginning after December 15, 2019. The company is currently evaluating the impact of this update on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting (Topic 718). This update is intended to simplify the accounting for share-based payment transactions, including the income tax impacts, classification of awards as either equity or liabilities, and presentation on the statement of cash flows. The guidance also allows employers to repurchase more of an employee’s shares for tax withholding purposes without triggering liability accounting. In addition, the guidance allows for a policy election to account for forfeitures as they occur rather than on an estimated basis. The update is effective for annual periods beginning after December 15, 2016. The company is currently evaluating the impact of this update on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This update is intended to improve financial reporting of leasing transactions. The ASU will require organizations that lease assets to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. This update is effective for fiscal years beginning after December 15, 2018. The company is currently evaluating the impact of this update on its consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, Income Taxes (Topic 740). This update simplifies the presentation of deferred income taxes and requires that deferred income tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The update is effective for reporting periods beginning after December 15, 2016 and interim periods within those annual periods. The adoption of ASU 2015-17 is not expected to have a material impact on the company's consolidated financial statements.

In May 2014, FASB issued ASU 2014-09: Revenue from Contracts with Customers (Topic 606). This update sets forth a new five-step revenue recognition model that replaces the prior revenue recognition guidance in its entirety and is intended to eliminate numerous industry-specific pieces of revenue recognition guidance that have historically existed. The underlying principle of the new standard is that an organization will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. ASU 2014-09 provides alternative methods of initial adoption and is effective for annual periods beginning after December 15, 2017 and interim periods within those annual periods. Early adoption is not permitted prior to December 15, 2016. The company is currently evaluating the impact of this standard on its consolidated financial statements.

Note Three — Current Prepaid Expenses

Current prepaid expenses include the current portion of deferred costs and prepaid commissions related to client contracts for the company's predictive behavioral routing, performance management, quality assurance, and predictive analytics applications (collectively, Behavioral Analytics). These costs are recognized over the subscription periods of the respective contracts, generally three to five years after the go-live date. When the company contracts with a client for a short-term pilot, the pilot period generally ranges from three to twelve months after the go-live date.

Current prepaid expenses consisted of the following:

	As of September 30,	December 31,
(In millions)	2016	2015
Deferred costs	$ 2.0	$ 1.6
Prepaid commissions	1.8	1.4
Other	2.2	1.6
Total	$ 6.0	$ 4.6

Note Four — Other Long-Term Assets

Other long-term assets includes the long-term portion of deferred costs, prepaid commissions related to Behavioral Analytics, and restricted cash. Restricted cash represents cash used to collateralize certain letters of credit issued to support the company's equipment leasing activities. Other long-term assets consisted of the following:

(In millions)	As of September 30, 2016	December 31, 2015
Restricted cash	$4.8	$ —
Deferred costs	0.7	0.9
Prepaid commissions	0.1	1.2
Deferred tax asset	0.1	0.1
Other prepaid expenses	0.6	0.3
Total	$6.3	$ 2.5

Note Five — Other Current Liabilities

Other current liabilities consisted of the following:

(In millions)	As of September 30, 2016	December 31, 2015
Accrued vendor payable	$ 1.6	$ 0.7
Warrant liability	0.9	—
Deferred rent liability	0.4	0.3
Other	1.8	0.8
Total	$ 4.7	$ 1.8

On August 1, 2016, the company entered into a secured loan agreement with Hercules Capital, Inc., as agent and lender (Hercules). See Note Seven – Debt. Concurrent with the loan agreement, the company issued a warrant to Hercules that gives Hercules the right to purchase shares of the company's common stock at $3.50 per share. Initially, the warrant is exercisable for 357,142 shares of common stock. If the company borrows the entire third tranche of $5.0 million available under the loan agreement, the warrant will be exercisable for 428,570 shares of common stock. The warrant expires on August 1, 2023. The warrant is accounted for as a liability and carried at fair market value using the Black-Scholes model. Upon issuance, the Black-Scholes fair value was determined using a risk-free rate of 1.33%, expected volatility of 53% and an expected term of 7 years. The warrant liability is revalued on a quarterly basis. Changes in the warrant's fair market value are recognized in non-operating income (expense) in the consolidated statements of operations.

Note Six — Leases

Capital Leases

Assets under capital leases consist primarily of computer hardware and related equipment. The gross amount of assets recorded under capital leases was $7.2 million and $5.4 million at September 30, 2016 and December 31, 2015, respectively. Depreciation expense related to assets under capital leases is included in depreciation and amortization expense on the consolidated statements of operations.

As of September 30, 2016, the future minimum lease payments due under capital leases are expected to be as follows:

(In millions) Year	Amount
Remainder of 2016	$ 0.6
2017	2.1

2018	1.3
2019	0.2
Total minimum lease payments	$ 4.2
Less: estimated executory costs	—
Net minimum lease payments	$ 4.2
Other Less: amount representing interest	(0.3)
Present value of minimum lease payments	$ 3.9

Note Seven — Debt

On August 1, 2016, the company entered into a secured loan agreement with Hercules. The agreement, which matures on February 1, 2020, allows the company to borrow up to $30.0 million in three tranches. On August 1, 2016, the company borrowed $22.5 million. The second tranche of up to $2.5 million will become available starting July 1, 2017 and continuing until September 15, 2017, contingent on the company meeting certain financial milestones. The third tranche of up to $5.0 million will become available starting September 15, 2017 and continuing until September 15, 2018, contingent on meeting certain financial milestones, a portion of which will be mutually determined by the company and Hercules and will be subject to approval by Hercules.

The annual interest rate is equal to the greater of (i) 9.75% plus the prime rate minus 3.50% or (ii) 9.75%. Additionally, the principal balance will bear compounding payment-in-kind interest at an annual rate of 2.15%. Monthly payments are interest only until December 1, 2017, subject to extension until March 1, 2018 or June 1, 2018 depending on whether certain financial milestones are met. After the interest-only period, principal and interest will be due in equal monthly payments. The company may prepay all, but not a portion, of the loan. A prepayment charge of 3.0%, 2.0% or 1.0% of the outstanding balance would be due in year one, in year two, or after year two, respectively.

Initially, the agreement's covenants require the company (i) to achieve at least 80% of its trailing 6 month projected subscription revenues and (ii) to maintain at least $7.5 million in unrestricted cash. After the company achieves two consecutive quarters of earnings before interest, taxes, and depreciation and amortization of at least $1.0 million, the minimum requirement for unrestricted cash will decrease to $6.0 million. The agreement is secured by substantially all of the company's assets, including its intellectual property.

Prior to entering into the secured loan agreement with Hercules, the company was party to a credit facility and term loan with Silicon Valley Bank. The credit facility and term loan were terminated on August 1, 2016. The company used a portion of the proceeds from the Hercules secured loan agreement to repay its $6.0 million term loan with Silicon Valley Bank and to pay borrowing-related fees and expenses. The company expects to use the remaining proceeds and any future borrowings under the Hercules secured loan agreement for general corporate purposes.

In the third quarter of 2016, the company also entered into financing agreements to furnish its new facility in Austin, Texas.

Debt consisted of the following at September 30, 2016:

(In millions)	Amount
Hercules loan due February 1, 2020, effective rate of 14.50%	$ 22.5
Furniture loan due May 2021, effective rate of 9.10%	0.1
Furniture loan due May 2021, effective rate of 9.55%	0.1
Furniture loan due July 2019, effective rate of 13.98%	