

MARCHEX INC
Form 10KSB
March 31, 2005
Table of Contents

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

FORM 10-KSB

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

For the fiscal year ended December 31, 2004

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 000-50658

Marchex, Inc.

(Name of small business issuer in its charter)

Edgar Filing: MARCHEX INC - Form 10KSB

Delaware
(State or other jurisdiction of
incorporation or organization)

35-2194038
(I.R.S Employer
Identification No.)

413 Pine Street, Suite 500, Seattle, Washington 98101

Telephone: (206) 331-3300

(Address, including zip code and telephone number, including area code of Registrant's principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Class B Common Stock, \$0.01 par value per share

4.75% Convertible Exchangeable Preferred Stock \$0.01 par value per share

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. x

Registrant's revenues for its fiscal year ended December 31, 2004 were \$43,804,272.

Aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant as of February 15, 2005 was approximately \$409,604,683. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Number of shares outstanding of Registrant's Class A common stock as of March 25, 2005: 11,987,500 shares. Number of shares outstanding of Registrant's Class B common stock as of March 25, 2005: 23,157,670 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Edgar Filing: MARCHEX INC - Form 10KSB

Certain of the information required by Part III of this Form 10-KSB is incorporated by reference to the definitive proxy statement for the annual meeting of stockholders of the Company which will be filed no later than 120 days after December 31, 2004.

Transitional Small Business Disclosure Format (check one): Yes No

Table of Contents

TABLE OF CONTENTS

	Page

Part I	
ITEM 1. <u>DESCRIPTION OF BUSINESS</u>	1
ITEM 2. <u>DESCRIPTION OF PROPERTY</u>	18
ITEM 3. <u>LEGAL PROCEEDINGS</u>	19
ITEM 4. <u>SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u>	19
Part II	
ITEM 5. <u>MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS</u>	20
ITEM 6. <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION</u>	22
ITEM 7. <u>FINANCIAL STATEMENTS</u>	65
ITEM 8. <u>CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE</u>	98
ITEM 8A. <u>CONTROLS AND PROCEDURES</u>	98
ITEM 8B. <u>OTHER INFORMATION</u>	98
Part III	
ITEM 9. <u>DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT</u>	99
ITEM 10. <u>EXECUTIVE COMPENSATION</u>	99
ITEM 11. <u>SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS</u>	99
ITEM 12. <u>CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS</u>	99
ITEM 13. <u>EXHIBITS</u>	99
ITEM 14. <u>PRINCIPAL ACCOUNTANT FEES AND SERVICES</u>	99
<u>SIGNATURES</u>	
<u>EXHIBIT INDEX</u>	

Table of Contents

PART 1

This Annual Report on Form 10-KSB contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We use words such as believes, intends, expects, anticipates, plans, may, will and similar expressions to identify forward-looking statements. Discussions containing forward-looking statements may be found in the material set forth under Business, Management's Discussion and Analysis of Financial Condition and Results of Operations and in other sections of the report. All forward-looking statements, including, but not limited to, statements regarding the benefits and risks associated with our recent Name Development asset acquisition, our future operating results, financial position, and business strategy, expectations regarding our growth and the growth of the industry in which we operate, and plans and objectives of management for future operations, are inherently uncertain as they are based on our expectations and assumptions concerning future events. Any or all of our forward-looking statements in this report may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including the risks, uncertainties and assumptions described in Risk Factors and elsewhere in this report. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements. All forward-looking statements in this report are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement.

ITEM 1. DESCRIPTION OF BUSINESS.

Overview

References herein to we, us or our refer to Marchex, Inc. and its wholly-owned subsidiaries unless the context specifically states or implies otherwise.

We provide technology-based merchant services that facilitate and drive growth in online transactions. We connect merchants with consumers who are searching for information, products and services on the Internet. Our platform of integrated performance-based advertising and search marketing services enables merchants to more efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories and other selected Web properties.

With the completion of the Name Development asset acquisition, we believe we are among the leaders in the direct navigation market. We own a proprietary base of online user traffic that represented more than 17 million unique visitors in November 2004, searching for information, products and services. This user traffic is generated from a portfolio of Web properties that are generally reflective of commercially-relevant search terms in many of the Internet's most popular and dynamic vertical commerce categories and may include geographically-targeted elements. The total number of Web properties in the portfolio, including Marchex's existing Web properties, is more than 200,000. Key vertical commerce categories include: travel, financial services, insurance, real estate, auto, health, technology and electronics, personals, jobs, professional services, home and garden, Web and telecom services, education, and entertainment. The online user traffic is primarily monetized with pay-per-click listings that are relevant to the Web properties. As such, the Web properties connect online users searching for specific information with relevant advertisements.

Edgar Filing: MARCHEX INC - Form 10KSB

With the Name Development asset acquisition, we believe we are one of the few companies that owns both proprietary search engine marketing services and a critical mass of proprietary online user traffic.

Table of Contents

We intend to continue introducing products and services that will enable merchants to successfully acquire customers and transact online. While we currently provide performance-based advertising and search marketing services, in the future we may provide additional, complementary services. We also intend to grow proprietary traffic sources, consistent with our Name Development asset acquisition, that can drive potential customers to our merchants.

Merchants transacting online is a large and growing trend. Our services facilitate and support the efficient and cost-effective marketing and selling of goods and services online through the most rapidly-developing forms of search-based marketing methods. We accomplish this by providing multiple services:

Pay-Per-Click Services. We deliver pay-per-click advertising listings that are reflective of our merchant advertisers' products and services to online users in response to their keyword search queries. These pay-per-click listings are generally ordered in the search results based on the amount our merchant advertisers choose to pay for a targeted placement. These targeted listings are displayed to consumers and businesses through our distribution network of leading search engines, product shopping engines, directories and other Web properties.

Feed Management Services. We leverage our proprietary technology to crawl and extract relevant product content from merchant advertisers' databases and Web sites to create highly-targeted product and service listings, which we deliver into our distribution network. These feed management listings are ordered in the results based on relevance to user search queries. Our trusted feed relationships with our distribution partners enable merchant advertisers to deliver comprehensive and up-to-date product and service listings to some of the Web's largest search engines, product shopping engines and directories.

Advertising Campaign Management Services. We enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of online advertising campaigns using our conversion tracking and detailed reporting services.

Search Engine Optimization Services. We optimize key attributes of merchant advertiser Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.

Table of Contents

Outsourced Search Marketing Services Platform. We provide large aggregators of advertisers, such as yellow page companies, with an outsourced, integrated platform to enable them to market performance-based advertising and search marketing services directly to their customers. We distribute performance-based advertisements through our broad network of distribution partners comprising many of the leading search engines, product shopping engines, directories and other Web properties. Our sources of distribution include industry leaders such as Yahoo!, Google, Shopping.com and many others.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date and are a component of our overall strategy. We have completed four acquisitions since our inception including:

On February 28, 2003, we acquired eFamily together with its direct wholly-owned subsidiary Enhance Interactive.

On October 24, 2003, we acquired TrafficLeader.

On July 27, 2004, we acquired goClick.

On February 14, 2005, we acquired certain assets of Name Development.

Recent Name Development Asset Acquisition

Description of the Asset Acquisition

On February 14, 2005, we completed the acquisition of certain assets of Name Development, a corporation operating in the direct navigation market. Direct navigation is one of the methods that online consumers use to search for information, products or services online. Direct navigation is primarily characterized by online users directly accessing a Web site by: (1) typing descriptive keywords or keyword strings into the uniform resource locator, or URL, address box of an Internet browser; or (2) accessing bookmarked Web sites. It can also include navigating through referring or partner traffic sources. As a result of the completion of the asset acquisition we now own and maintain a portfolio of Web properties, that are generally reflective of online user search terms, descriptive keywords and keyword strings.

With the completion of the Name Development asset acquisition, we believe we are among the leaders in the direct navigation market due to our proprietary ownership of online user traffic totaling more than 17 million unique visitors in November 2004. This user traffic is generated from a portfolio of Web properties that are generally reflective of commercially-relevant search terms in many of the Internet's most popular and dynamic vertical commerce categories and may include geographically-targeted elements. The total number of Web properties in the portfolio, including Marchex's existing Web properties, is more than 200,000. Key vertical commerce categories include: travel, financial services, insurance, real estate, auto, health, technology and electronics, personals, jobs, professional services, home and garden, Web and telecom services, education, and entertainment. The online user traffic is primarily monetized with pay-per-click listings that are relevant to the Web property. As such, the Web properties facilitate the introduction of online users searching for specific information to targeted advertisements.

Anticipated Benefits of the Asset Acquisition

Edgar Filing: MARCHEX INC - Form 10KSB

We believe that the Name Development asset acquisition will provide us with several benefits, including:

A Defensible, Proprietary Source of Targeted Traffic. We believe that we will have an exclusive position due to the nature of Internet domains registration, which is similar to owning real-estate in that each Internet domain name is unique. The asset acquisition will provide us with Web properties that collectively generated more than 17 million monthly unique visitors in November 2004. The total number of Web properties in the portfolio, including Marchex's existing Web properties, is more than 200,000.

Table of Contents

Synergies with our Existing Search Engine Marketing Services Platform. We believe that our technology platform, combined with the Name Development asset acquisition, gives us an advantage in extending market share within the direct navigation market, expanding our participation in the search advertising market and in key commerce verticals. For example, we believe that: (1) there may be opportunities to work with monetization providers to improve the categorization and revenue generation of individual Web properties; (2) there may be opportunities to leverage our database of current search-related information to improve and automate selection and acquisition of complementary Web properties; (3) there may be opportunities to generate incremental user traffic to selected Web properties through leveraging our existing distribution network; (4) there may be opportunities to leverage our experience in working with a variety of online providers to add dynamic content and relevant advertiser listings, including product shopping listings and classified listings, to increase the user utility of the Web properties; and (5) there may be opportunities, over time, to supplement existing listings on certain Web properties with our performance-based advertisements.

Platform to Extend Expansion Initiatives. We intend to use the Name Development asset acquisition to supplement our planned expansion, both domestically and internationally.

Industry Overview

Performance-Based Advertising

As technology and the Internet continue to evolve, consumers are becoming increasingly confident that they can find comprehensive product information and securely transact online. As consumers spend more time and money online, advertisers are turning to the Internet to market their products and services. Businesses of all sizes can benefit from the Internet's potential to efficiently and cost-effectively reach consumers. With the U.S. Census Bureau reporting more than 23 million small businesses alone, we believe there is a large opportunity to sell online performance-based advertising services to businesses of all sizes. As a reflection of the potential impact of the Internet as an advertising medium, PricewaterhouseCoopers estimates that global Internet advertising will grow from \$12.2 billion in 2004 to \$18.9 billion in 2008. Internet advertising enables merchant advertisers to measure the effectiveness of their advertising campaigns and to revise them in response to real-time feedback and market factors. Traditional forms of advertising are not as targeted and do not permit evaluation of results in as timely and accurate a manner.

Within the Internet advertising market, paid search has become one of the fastest growing sectors. First Albany Capital estimates that paid search will grow 191% from \$4.5 billion in 2004 to \$13.1 billion in 2008. According to the Kelsey Group, only 17% of small and medium businesses in the United States currently utilize search marketing methods, but that number is expected to grow as more merchants experience the benefits. In addition, according to PricewaterhouseCoopers, 40% of Internet advertising in the second quarter of 2004 was performance-based, as opposed to 31% in the second quarter of 2003. Merchant advertisers are increasingly turning to performance-based online advertising for the following reasons:

Competitive Return-On-Investment. Merchant advertisers have experienced competitive returns on their online advertising campaigns. As advertisers have analyzed their marketing programs, they have determined that they are able to pay more for their programs while still generating an acceptable return-on-investment. As a result, First Albany Capital estimates that the average price-per-click will increase at a compound annual growth rate, or CAGR, of 7% from 2003 to 2008.

Consumers Increasing Receptiveness to Performance-Based Advertising. Due to the relevancy and appropriate placement of advertisements, First Albany Capital estimates that the rate at which consumers click through performance-based advertisements will grow at a CAGR of 21% from 2003 to 2008.

Table of Contents

Direct Navigation

Navigating and searching for information online has continued to evolve as users have become increasingly sophisticated. This continuing evolution has translated into a need for information providers to more efficiently provide highly-targeted, relevant information. Currently, there are three primary means through which online users access and search for information, products and services: search engines, commerce portals and direct navigation Web properties. Direct navigation is primarily characterized by online users directly accessing a Web site by: (1) typing descriptive keywords or keyword strings into the uniform resource locator, or URL, address box of an Internet browser; or (2) accessing bookmarked Web sites. It can also include navigating through referring or partner traffic sources.

First Albany Capital estimates that the paid search market will reach \$4.5 billion in revenue in 2004, and we believe the direct navigation market currently represents more than 10% of the global search market and is growing at comparable annual rates. According to WebSideStory, Inc.'s StatMarket division, in September 2004 more than 67% of daily global Internet users arrived at Web sites by direct navigation defined as typing a URL into a browser address bar or using a bookmark rather than through search engines and Web links, compared to approximately 53% in February 2002. The growth of the direct navigation market is a result of consumers' increasing sophistication in utilizing the Internet as a resource tool, coupled with their desire to quickly find targeted information, and their trust and experience that the depth and breadth of available and relevant online information extends to Web sites named by descriptive keywords. Direct navigation and the use of search engines, however, are not mutually exclusive. We believe that many of the commercially relevant Web properties which we own as part of the Name Development asset acquisition may be beneficiaries of search engine and directory traffic.

Strategy

We intend to leverage our senior management's experience, our financial and human resources and our existing operations to provide technology-based merchant services that facilitate and drive growth in online transactions. Key elements of our strategy include the following initiatives:

Provide Quality Services in Support of Merchants and Partners. We believe providing high quality services will make us more valuable to our merchants and partners. We are building proprietary products and services that we believe are innovative and provide a high degree of utility. We intend to continue investing our resources to create or develop new products, technologies and business models. We intend to expand our services by providing systems and information that help merchant advertisers maximize the performance of online marketing budgets and by working with partners to develop and market new products. For example, the services we have developed include:

a search engine inclusion and optimization platform for merchant advertisers who want the greatest opportunity for proper indexing, listing and inclusion of their product and services in the editorial results of algorithmic search engines;

an advertising campaign management platform for merchant advertisers who want to continuously track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks; and

an outsourced search marketing services platform for large aggregators of advertisers, such as yellow page companies, who want an integrated platform to market performance-based advertising and search marketing services directly to their customers.

Edgar Filing: MARCHEX INC - Form 10KSB

Increase the Number of Merchants Served. We believe we will continue to grow our base of merchant advertisers and strive to build merchant loyalty by providing merchants with a consistently high level of service and support as well as the ability to achieve their target return-on-investment thresholds. We intend to increase the number of merchants served through:

direct sales efforts, including strategic sales and telesales initiatives;

Table of Contents

referral arrangements with entities that can promote our services to potential merchants, such as advertising agencies; and

partnerships with large aggregators of advertisers, such as regional yellow page companies.

Develop New Markets. We intend to analyze opportunities and may seek to expand our technology-based services into new categories or new geographies where our services can be replicated on a cost effective basis, or where the creation or development of a service may be appropriate. We anticipate utilizing various strategies to enter new markets, including: developing strategic relationships; acquiring products that address a new category or opportunity; acquiring country-specific properties; and creating joint venture relationships and internal initiatives where existing services can be extended internationally. For example, the Name Development asset acquisition will diversify our business and will allow us to enter the direct navigation market.

Extend Presence in the Direct Navigation Market. We are in the process of implementing numerous initiatives to increase the traffic and monetization of the acquired network of Web properties, including enhancing the utility of the Web properties, broadening our geographic presence and making selective purchases of complementary Web properties.

Pursue Selective Acquisition and Consolidation Opportunities. We plan to selectively pursue strategic acquisitions. We apply rigorous evaluation criteria to acquisitions that are intended to enhance our strategic position, strengthen our financial profile, augment our points of defensibility and increase shareholder value. We do this through focusing on acquisition opportunities that represent a combination of the following characteristics:

under-leveraged and under-commercialized assets;

opportunities for business model, product or service innovation and evolution;

critical mass of transactions volume, merchants, traffic, revenue and profits;

business defensibility;

revenue growth and expanding margins and operating profitability or the characteristics to achieve significant scale and profitability; and

an opportunity to enhance efficiencies and provide incremental growth opportunities for our operating businesses.

Table of Contents

Our Services

Through our suite of search marketing services, we have partnered with a diverse set of Internet traffic partners in order to provide our merchant advertisers with access to a large base of potential, targeted customers. Our distribution strategy has been focused on building a broad footprint with primary online traffic sources, including search engines, directory sites and commerce portals, and with the recent Name Development asset acquisition, direct navigation Web properties. Additionally, we have focused on developing services and technologies to expand the suite of search-based marketing products we provide to online merchant advertisers. We believe that offering a holistic approach of search engine marketing services enables us to extend our reach to a broad base of customers and offer solutions that can generally address all the needs of a customer interested in search marketing.

Table of Contents

Our services are used to support and build the businesses of our merchant advertisers. We enable merchants to market and sell their products and services online through the following technology-based services:

Service	Description
Performance-Based Advertising Services	<p>Performance-based advertising services enable merchants to reach their target audience through search, product shopping and directory results.</p> <p>Pay-per-click services. With pay-per-click services, the amount that a merchant advertiser pays for the click-through influences the rank of its listings within the applicable results set.</p>
Search Marketing Services	<p>Feed management services. With feed management services, the ranking of a merchant's listing is influenced by the relevance of the product or service in relation to the user search query.</p> <p>Search marketing services are designed to assist merchant advertisers who want to acquire customers through search-based marketing methods, optimize the performance of their online advertising campaigns by tracking and analyzing historical results and refine their Web sites for increased relevance in algorithmic search engine indexes.</p>
Outsourced Search Marketing Services Platform	<p>Advertising campaign management services. Advertising campaign management services enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of their online advertising campaigns using our conversion tracking and detailed reporting services.</p> <p>Search engine optimization services. Search engine optimization services enable merchant advertisers to optimize key attributes of their Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.</p> <p>Outsourced search marketing services are designed to enable large advertiser aggregator partners with an outsourced, integrated search management platform to market performance-based advertising and search marketing services to their customers.</p>

In the twelve month period ended December 31, 2004, performance-based advertising services comprised more than 95% of our total revenue while search marketing services and outsourced search marketing services accounted for less than 5% of total revenue.

We currently provide these services through our operating subsidiaries Enhance Interactive, goClick and TrafficLeader. Enhance Interactive and goClick primarily manage our pay-per-click services while TrafficLeader primarily manages our feed management services, search marketing services and outsourced search marketing services. All of our services currently run on, or are being migrated to run on, a common technology architecture. As we continue to develop our services and implement new technologies and services, we believe the breadth of our marketing solutions will lead to cross leverage through technical integration.

Performance-Based Advertising Services

Edgar Filing: MARCHEX INC - Form 10KSB

Merchant advertisers utilize our performance-based advertising services to reach millions of individuals and businesses who search online for information on products and services. According to a Pricewaterhouse Coopers April 2004 report, performance-based advertising is one of the most rapidly growing segments of Internet

Table of Contents

advertising, as it is one of the most efficient and effective means to generate competitive returns-on-investment for advertisers. Accordingly, we are building appropriate services to leverage this trend.

On any given search engine results page, the listings that appear can either be categorized as sponsored listings or editorial listings. By leveraging the combination of our pay-per-click and feed management performance-based advertising services, merchant advertisers can ensure the broadest coverage within a given results page in response to a user search query, since our pay-per-click management service ensures merchant advertisement appearance within sponsored listings, and our feed management service ensures merchant advertisement appearance within editorial listings. The following is a description of our performance-based advertising services:

Pay-Per-Click Services. Our pay-per-click services enable merchant advertisers to market their products and services through targeted pay-per-click listings that we distribute through search engine or directory results when a user searches for information, products or services. We provide our services to thousands of merchant advertisers who want to drive customer leads to their Web sites. Our services enable merchants to purchase keywords or keyword strings, based on an amount they choose for a targeted placement, that are specific to their products and services and their marketing objectives.

Merchant advertisers find us directly through our Web site and through contact with our internal telesales force, and we reach out to find merchant advertisers through direct sales efforts, through third-party referral programs and through a variety of marketing activities that include trade shows, targeted mailings, online advertisements, e-mails and other promotional materials sent directly to merchant advertisers, advertising agencies and search engine marketers.

We believe that pay-per-click services are an important complement to algorithmic search and feed management technologies as they enable merchants to place relevant listings on a search engine results page related to a specific user information request. This process has the dual benefit of: (1) enhancing the user experience by placing relevant targeted listings at the portion of a search page dedicated to sponsored listings; and (2) connecting merchant advertisers with targeted customer leads.

When merchant advertisers submit advertisement listings to our service, we review them for relevance and for conformity with our editorial guidelines. We may also assist merchant advertisers in optimizing their advertisement campaigns by recommending relevant keywords or keyword strings based on their Web sites and product or service offerings.

The pay-per-click results distributed by our services are prioritized for users by the amount the merchant advertiser is willing to pay each time a user clicks on the merchant's advertisement. Merchant advertisers pay us when a click-through occurs on their advertisement.

Feed Management Services. Our feed management services deliver targeted advertiser listings into some of the Internet's most visited search engines and product shopping engines. Feed management leverages our proprietary technology to crawl and extract relevant product data and content from a merchant advertiser database and Web site, and to create highly relevant, optimized URL strings and advertisement listings. Increased listing relevancy frequently translates into a better search experience for users, allowing them to find targeted results in response to their search queries, and a competitive return-on-investment for merchant advertisers, as higher relevance typically leads to increased click-through and conversion rates, or customer acquisitions.

Edgar Filing: MARCHEX INC - Form 10KSB

Once our technology has crawled, extracted, optimized and refined the merchant advertiser URL strings and advertisement listings, such strings and listings are automatically tagged and placed into partner search and directory indexes. These URL strings and listings map directly to user search queries that link back to specific product pages when clicked, which we believe typically leads to competitive advertiser conversion rates.

Table of Contents

We believe that most algorithmic search engines crawl the Web approximately every seven days. When a merchant's Web site is crawled by algorithmic technology, many product and service listings tend to be excluded due to the nature of most merchant advertisers' product databases, which contain complex structures and are dynamically-updated. Our trusted feed relationships with our distribution partners allow us to deliver every merchant advertiser's product and to provide updated content in frequent intervals, as we regularly refresh the listings with the most up-to-date information. This is a significant benefit for our merchant advertisers as we maximize the number of selling opportunities and for our distribution partners as we increase the relevance of a user search experience.

We believe that feed management is an important complement to algorithmic search technologies since merchant advertisers provide us with direct access to their internal product databases. Often, only once a feed management service has crawled, replicated and optimized hundreds or thousands of individual product and informational Web pages for a merchant advertiser do links to these pages appear within search engine results. We believe the indexing and subsequent listing of these Web pages made possible by feed management enhances the overall relevancy of the search engines with which the company partners. We also believe feed management is complementary to pay-per-click services as merchants: (1) can leverage our technology to create detailed listings for each of their products; and (2) can leverage our extensive keyword query string database to identify many relevant keyword listings often overlooked in the manual pay-per-click listing creation process.

Merchant advertiser URL strings and advertisement listings are typically ordered based on relevance to the user search query. Merchant advertisers generally pay us a fixed price for each click received on each URL string and advertisement listing.

Additionally, by leveraging proprietary technology, we can analyze an advertiser's database as well as thousands to millions of actual, relevant user search queries to create additional, unique merchant advertiser listings that drive targeted traffic resulting in highly competitive conversion, or customer acquisition, rates. These additional unique listings are generally included as part of our basic feed management service.

Search Marketing Services

Our search marketing services are designed to assist merchant advertisers who want to acquire customers through search-based marketing methods, optimize the performance of their online advertising campaigns through tracking and analyzing historical results and refine their Web sites for increased relevance in algorithmic search engine indexes. The following is a description of our search marketing services:

Advertising Campaign Management Services. Through our advertising campaign management services, merchant advertisers continuously track, monitor and optimize the placement of performance-based search advertising campaigns across a number of search engines and pay-per-click networks and track the effectiveness of their online advertising campaigns through the use of the following services:

Bid management services. Our bid management services allow our merchant advertisers to consolidate the purchasing, management, optimization and reporting aspects of performance based search advertising campaigns. We have partnerships with leading search and product shopping engines that allow us to place and manage our clients' paid listings directly within their account management systems.

Conversion tracking and detailed reporting services. Our detailed reporting services enable merchants to track the effectiveness of their online advertising campaigns through conversion tracking and detailed reporting tools. By developing a common technology architecture underneath our platform of search marketing services, we are able to analyze the effectiveness of our merchant partners' advertising campaigns across a wide array of services and provide detailed reporting, such as: revenue per month statistics, number

Edgar Filing: MARCHEX INC - Form 10KSB

of orders, average order size and conversion rate and revenue by keyword and revenue by distribution source.

Table of Contents

Our advertising campaign management services broaden the potential reach of a merchant's advertising campaign by including multiple distribution partners as options for bid placement. Merchant advertisers pay us a pre-negotiated rate when a click through occurs on their advertisement. Also, with our analytic tool set, merchants are effectively able to track the effectiveness of their online advertising campaigns through the use of conversion tracking and analytic services.

Search Engine Optimization Services. Our search engine optimization technology optimizes key attributes of merchant advertisers' Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines. By leveraging our experience in the search industry and relationships with search engine distribution partners, we have architected a flexible technology platform that is designed to enable us to efficiently optimize our merchant partner Web sites in order to meet the ever changing technical standards of our distribution partners.

We primarily attract merchant advertisers with product databases who want to increase their online sales and achieve targeted return-on-investment metrics. Potential merchant advertisers find our services and we find them through a variety of means, including contact by our direct sales staff, through marketing efforts such as trade shows or advertising, and through third-party referral programs. Merchant advertisers pay us fees to optimize their site for inclusion in algorithmic search results.

Outsourced Search Marketing Services Platform

Our ability to build and integrate all of our marketing services on a common technology platform provides us with the opportunity to create an outsourced solution for strategic partners who have several hundred to several thousand direct merchant relationships. As part of our search management service we can enable a strategic partner or aggregator of merchant partner relationships with all or any part of our suite of search marketing services. For example, we currently enable a major regional yellow page company with our advertising campaign management and feed management technology platform which it can market to its local online yellow page merchants.

Partners can leverage this service in one of two ways, including: (1) as a fully outsourced solution, in which we manage and fulfill search marketing campaigns, and also delivers reporting on behalf of our partners; or (2) a partner-hosted solution that allows aggregators, such as yellow page companies, to easily manage campaigns internally and service their customers more directly. We principally receive payment for our outsourced search marketing services through a combination of variable licensing fees associated with total revenue generated using our technology platform, flat rate licensing fees for the use of our technology platform and per-click payments for clicks delivered from our pay-per-click and feed management network.

Our Distribution Network

We have built a broad distribution network for our marketing services comprised of many of the leading search engines, product shopping engines, directories and selected Web properties. With the completion of the recent Name Development asset acquisition, we acquired a proprietary source of direct navigation traffic.

Table of Contents

Performance-Based Advertising Distribution

We distribute merchant advertisement listings and advertiser URL strings through hundreds of traffic sources, including search and product shopping engines, directories and Web properties. Distribution sources for our marketing services platform include:

Selected Search Engines and Directories

Google
 LookSmart
 Switchboard
 Valueclick s Search123
 24/7 Search
 Yahoo!

Selected Product Shopping Engines

CNet s MySimon
 Google s Froogle.com
 NexTag
 PriceGrabber.com
 Shopping.com
 Yahoo!Shopping

Yahoo!, primarily through its subsidiaries, such as Overture and Yahoo!Shopping, is our largest distribution partner, accounting for approximately 18% of our total revenue for the twelve months ended December 31, 2004. Prior to this period, distribution through Yahoo! and its subsidiaries collectively represented less than 10% of our total revenue. Over the past year, we have enhanced and grown this relationship with additional agreements with Yahoo! and its subsidiaries. Additionally, we have enhanced existing relationships with various other partners, including LookSmart and Switchboard, and created several new relationships, including CNet s MySimon and Shopping.com. We intend to continue enhancing our existing partner relationships and create new ones, where appropriate.

Payment arrangements with our distribution partners are often subject to minimum payment amounts per click-through. Other economic structures that we may use to a lesser degree include:

- fixed payments, based on a guaranteed minimum amount of usage delivered;
- variable payments based on a specified metric, such as number of paid click-throughs; and
- a combination arrangement with both fixed and variable amounts.

Direct Navigation Distribution

With the completion of the recent Name Development asset acquisition, we believe we are among the leaders in the direct navigation market due to our proprietary ownership of online user traffic, which totaled more than 17 million unique visitors in November 2004. This user traffic is generated from a portfolio of Web properties that are generally reflective of commercially-relevant search terms in many of the Internet s most popular and dynamic vertical commerce categories and may include geographically-targeted elements. The total number of Web properties in the portfolio, including Marchex s existing Web properties, is more than 200,000. These vertical commerce categories include: travel, financial services, insurance, real estate, auto, health, technology and electronics, personals, jobs, professional services, home and garden, Web and telecom services, education and entertainment. The online user traffic is primarily monetized with pay-per-click listings that are relevant to the Web properties. As such, the Web properties connect online users searching for specific information with relevant advertisements.

Edgar Filing: MARCHEX INC - Form 10KSB

Online users can navigate the Web properties through a number of ways. For example, an online user who is specifically interested in going to Las Vegas for a vacation may enter *www.lasvegasvacations.com* directly into the Web address or URL box of their Internet browser. Once the user has arrived at the Web property they will find relevant product listings and information. As the user finds relevant information and clicks on a particular listing, Name Development receives a pay-per-click fee.

Table of Contents

The following represents a sampling of the Web properties we acquired as part of the Name Development asset acquisition and their corresponding vertical commerce category:

Vertical Commerce Category	Active Web Property Examples
Travel	FranceVacation.com LasVegasVacations.com
Financial Services	TravelAustralia.com AutoLender.com Debts.com
Insurance	LoanConsolidation.com AffordableInsurance.com InsuranceOnline.com
Real Estate	UnemploymentInsurance.com ApartmentFind.com HouseLoans.com
Auto	LAProperties.com AffordableCars.com CarSeller.com
Health	LeaseCars.com HealthAdvisor.com MedicalSearch.com
Technology and Electronics	NaturalDiets.com 3g.com NetworkServers.com
Personals	VideoCamera.com FriendsOnline.com LoveFinder.com
Jobs	SingleMatch.com CareerInfo.com BayAreaJobs.com
Professional Services	SoftwareJob.com PhysicianOnline.com TaxesOnline.com

Edgar Filing: MARCHEX INC - Form 10KSB

Home and Garden	TortLawyers.com BathroomHardware.com
	CarpetCleaners.com
Web and Telecom Services	HomeDecoration.com ComputerNetworking.com
	TelecomConsultants.com
Education	WirelessDevelopers.com USColleges.com
	VirtualEducation.com
Entertainment	LearningVideos.com ActionMovies.com
	HollywoodMovies.com
	TicketsUnlimited.com

Table of Contents

Sales, Marketing & Business Development

As of December 31, 2004, we had 53 full-time employee equivalents in our sales department, 11 full-time employee equivalents in our business development department and 5 full-time employee equivalents in our marketing department. Our sales department focuses on adding new merchant advertisers to our operating businesses, while our business development department focuses on servicing existing distribution partnerships and selectively adding new distribution partners. Our marketing department focuses on promoting our services through affiliate relationships, press coverage, and industry exposure. Advertising and promotion of our services is broken into five main categories: direct sales, agency sales, super aggregator sales, online promotion, and referral agreements.

Direct Sales. Our sales staff targets new merchant advertiser relationships through telesales efforts, direct marketing, and attendance at industry events.

Agency Sales. Our agency program includes a group within the sales team that targets interactive agencies and other entities that service merchant advertisers. This sales group focuses on in-person and remote presentations of our services to agencies, and is also periodically engaged in various marketing initiatives at industry trade shows and conferences. Our agency agreements may include a combination of revenue sharing, performance-based fees and other costs.

Super Aggregator Sales. Our super aggregator program includes a group within the sales team that targets large aggregators of merchant advertisers. An example of a large aggregator relationship would be our partnership with a large regional yellow page company whereupon we supply a comprehensive, outsourced search marketing platform that integrates our advertising campaign management and feed management platforms for their merchant advertisers. Our super aggregator agreements include a combination of revenue sharing, licensing revenue and per-click fees.

Online Promotion. We engage in certain advertising and direct marketing focused on acquiring new merchant advertisers and new distribution partners.

Referral Agreements. We seek to build referral arrangements with entities that can promote our services to large numbers of potential advertisers. Our referral partner agreements are based on a combination of revenue sharing and performance-based fees.

We intend to continue our strategy of growing our merchant advertiser base through sales and marketing programs while being as efficient as possible in terms of our marketing and advertising costs. We continually evaluate our marketing and advertising strategies to maximize the effectiveness of our programs and their return on investment.

Information Technology and Systems

We have a proprietary technology platform for the purposes of managing and delivering advertisements to our partners. We also combine third party licenses and hardware to create an operating environment that focuses on quality products and services, with such features as automated online customer purchasing, real-time customer support and interactive reporting for customers and partners. We employ commercially available technologies and products distributed by various companies, including Cisco, Dell, Intel, Microsoft, Sun Microsystems and Veritas. We also utilize public domain software such as Apache, Linux, MySQL, Sun Microsystems Java and Tomcat.

Edgar Filing: MARCHEX INC - Form 10KSB

Our technology platform is compatible with the systems used by our distribution partners, enabling us to deliver advertisement listings in rapid response to user queries made through such partners. We continue to build and innovate additional functionality to attempt to meet the quickly evolving demands of the marketplace. We devote significant financial and human resources to improving our merchant and partner experiences by continuing to develop our technology infrastructure. The cost of developing our technology solutions is included in the overall cost structure of our services and is not separately funded by any individual merchants or partners.

Table of Contents

In order to maintain a professional level of service and availability, we primarily rely upon third parties to provide hosting services, including hardware support and service, and network monitoring. Our servers are configured for high availability and large volumes of Internet traffic and are located in leased third-party facilities. Back-end databases make use of redundant servers and data storage arrays. We also have standby servers that provide for additional capacity as necessary. The facilities housing our servers provide redundant HVAC, power and Internet connectivity.

We continuously review ways to improve major aspects of our technology support and maintenance, including improving, upgrading and implementing business continuity plans, data retention initiatives, and backup and recovery processes.

Competition

Performance-Based Advertising

Many of our potential competitors, as well as potential entrants into our target markets, have longer operating histories, larger customer or user bases, greater brand recognition and greater financial, marketing and other resources than we have. Many current and potential competitors can devote substantially greater resources than we can to promotion, Web site and systems development. In addition, as the use of the Internet and other online services increases, there will likely be larger, more well-established and well-financed entities that acquire companies relevant to our business strategy; and invest in or form joint ventures in categories or countries relevant to our business strategy; all of which could adversely impact our business. Any of these trends could increase competition, reduce the demand for any of our services and could have a material adverse effect on our business, operating results and financial condition.

We pursue a strategy that we believe allows us to work with all relevant companies in the industry, even those companies that may be perceived as our competitors. We intend to continue with a strategy that allows us to consider and pursue business arrangements with all companies in our industry.

We provide our services to: (1) merchant advertisers who advertise online; (2) partners who provide a distribution network for online advertising; and (3) other intermediaries who may provide purchasing and/or sales opportunities, including advertising agencies, search engine marketing companies and search engine optimization companies. We depend on maintaining and continually expanding our network of partners and merchants to generate transactions online. As a result, we may work with, and compete with, those who:

sell performance-based advertising or search marketing services to merchants;

aggregate or optimize advertising inventory for distribution through search engines, product shopping engines, directories, Web sites or other outlets; or

provide destination Web sites or other distribution outlets that reach end users or customers of the merchants.

Edgar Filing: MARCHEX INC - Form 10KSB

The online advertising and marketing services industry is highly competitive. Although overall Internet advertising expenditures have increased in the last few years, the advertising industry has suffered as many online businesses have ceased operations and many traditional businesses have scaled back their advertising budgets. In addition, we believe that today's typical Internet advertiser is becoming more sophisticated in utilizing the different forms of Internet advertising, purchasing Internet advertising in a cost-effective manner, and measuring return-on-investment. The competition for this pool of advertising dollars has also put downward pressure on pricing points and online advertisers have demanded more effective means of reaching customers. We believe that these factors have contributed to the growth in performance-based advertising relative to certain other forms of online advertising and marketing, and as a result this sector has attracted many competitors.

Due to the long-term growth trends in online advertising, these competitors, real and potential, range in size and focus. Our competitors may include such diverse participants as small referral companies, established

Table of Contents

advertising agencies, inventory resellers, search engines, and destination Web sites. To some extent, we may compete with our business partners, as we do with all other types of advertising sales companies and agencies. To a more limited extent, we may also compete with traditional offline media such as television, radio and print and direct marketing companies, for a share of merchant advertisers' total advertising budgets. Although we pursue a strategy that enables us to work with most, if not all, of our competitors, there are no guarantees that all companies will view us as a potential partner.

We are also affected by the competition among destination Web sites that reach users or customers of search services. While thousands of smaller outlets are available to customers, several large media and search engine companies, such as AOL, Google, Microsoft through MSN Search and Yahoo!, through its subsidiaries, dominate online user traffic. The online search industry continues to experience consolidation of major Web sites and search engines, which has the effect of increasing the negotiating power of these parties in relation to smaller providers. The major destination Web sites and distribution providers may have leverage to demand more favorable contract terms, such as pricing, renewal and termination provisions.

Direct Navigation

The direct navigation market is primarily categorized into two parts: (1) Web property owners, which are the entities that own the Internet domain and potentially monetize it through performance-based integrations with third parties, including pay-per-click integrations; and (2) Web property monetization providers, which are companies that provide the monetization engine for Web property owners, including pay-per-click providers. We believe that the segment of the direct navigation market that directly owns and monetizes Internet domains with performance-based advertising is highly fragmented, and that, as a result of the Name Development asset acquisition, we are among the leaders in this segment.

While the availability of a high quality portfolio of multiple Internet domain names is limited and difficult to attain, the barriers to entry in the direct navigation market are also low as the cost of registering an individual Internet domain name is not significant. We expect competition to intensify as more analysis is conducted on, and more companies enter, the direct navigation market. This could adversely affect our competitive position and relatively small market share in the direct navigation industry.

Intellectual Property and Proprietary Rights

We seek to protect our intellectual property through existing laws and regulations and by contractual restrictions. We rely upon trademark, patent and copyright law, trade secret protection and confidentiality or license agreements with our employees, customers, partners and others to help us protect our intellectual property.

Our technologies involve a combination of proprietary rights, owned and developed by us, commercially available software and hardware elements that are licensed or purchased by us from various providers, including Cisco, Dell, Intel, Microsoft, Sun Microsystems and Veritas, and public domain software, such as Apache, Linux, MySQL, Sun Microsystems Java and Tomcat. We continue to develop additional technologies to update, supplement and replace existing components of the platform. We intend to protect these additional intellectual property rights through patent applications and trade secret enforcement.

Edgar Filing: MARCHEX INC - Form 10KSB

Our policy is to apply for patents or for other appropriate statutory protection when we develop valuable new or improved technology. We currently do not have any registered patents. We have filed two patent applications with the U.S. Patent and Trademark Office for various aspects of our transaction technologies and services, with the following titles, numbers and descriptions:

US Provisional Patent Application Serial Number 60/504,963, of Horowitz et al., entitled Performance-Based Online Advertising System and Method, was filed on September 23, 2003, with subsequent

Table of Contents

non-provisional US and PCT patent applications filed on September 23, 2004, and which are currently pending. These patent applications describe a system, method, and computer program product for implementing a performance-based online service for advertisers that provide the ability for advertisers to purchase various advertising products.

US Provisional Patent Application Serial Number 60/523,688, of Horowitz et al., entitled Online Advertising System and Method, was filed on November 21, 2003, with subsequent non-provisional US and PCT patent applications filed on November 19, 2004, and which are currently pending. This patent application describes an online advertising system, method, and computer program product configured to present an advertiser with keyword-driven pricing for advertisements.

The status of any patent involves complex legal and factual questions. The scope of allowable claims is often uncertain. As a result, we cannot be sure that any patent application filed by us will result in a patent being issued, nor that any patents issued in the future will afford adequate protection against competitors with similar technology; nor can we provide assurance that patents issued to us will not be infringed upon or designed around by others. Furthermore, the performance-based search advertising industry has been the subject of numerous patents and patent applications, which in turn has resulted in litigation. The outcome of this ongoing litigation or any future claims in this sector may adversely affect our business or financial prospects.

We have been issued registered trademarks in the United States covering certain goods and services for Marchex, Direct Search Inclusion, goClick.com, Sitewise and TrafficLeader. We have also applied for registered trademark status for Enhance Interactive in the United States. In addition, we have been issued registered trademarks for Marchex in Australia, Benelux, China, France, Germany, Japan, Italy, Spain, Sweden, Republic of Korea, Russian Federation and the United Kingdom. We have also applied for registered trademark status for Marchex in a number of other foreign jurisdictions. We do not know whether we will be able to successfully defend our proprietary rights since the validity, enforceability and scope of protection of proprietary rights in Internet-related industries are uncertain and still evolving.

Regulation

The manner in which existing laws and regulations should be applied to the Internet in general, and how they relate to our businesses in particular, is unclear in many cases. Such uncertainty arises under existing laws regulating matters, including user privacy, defamation, pricing, advertising, taxation, gambling, sweepstakes, promotions, content regulation, quality of products and services, and intellectual property ownership and infringement.

To resolve some of the current legal uncertainty, we expect new laws and regulations to be adopted that will be directly applicable to our activities. Any existing or new legislation applicable to us could expose us to substantial liability, including significant expenses necessary to comply with such laws and regulations, and could dampen the growth in use of the Internet in general.

Several new federal laws that could have an impact on our business have already been adopted. The Digital Millennium Copyright Act is intended to reduce the liability of online service providers for listing or linking to third party Web properties that include materials that infringe copyrights or rights of others. The Children's Online Protection Act and the Children's Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children from Sexual Predators Act requires online services providers to report evidence of violations of federal child pornography laws under certain circumstances. The foregoing legislation may impose significant additional costs on our business or subject us to additional liabilities, if we were not to comply fully with their terms, whether intentionally or not. If we did not meet the safe harbor requirements of the Digital Millennium Copyright Act, we could be exposed to copyright actions, which could be costly and time-consuming. The Children's Online Protection Act and the Children's Online Privacy Protection Act impose fines and penalties to persons and operators that are not fully

Table of Contents

compliant with their requirements. The federal government could impose penalties on those parties that do not meet the full compliance practices of the Protection of Children from Sexual Predators Act. We intend to fully comply with the laws and regulations that govern our industry, and we employ internal resources and incur outside professional fees to establish, review and maintain policies and procedures to reduce the risk of noncompliance.

The Name Development asset acquisition subjects us to a new and rapidly developing body of regulations. The acquisition of Internet domain names generally is governed by Internet regulatory bodies, predominantly the Internet Corporation for Assigned Names and Numbers (ICANN). The regulation of Internet domain names in the United States and in foreign countries is subject to change. ICANN and other regulatory bodies could establish additional requirements for previously owned Internet domain names or modify the requirements for holding Internet domain names.

We post our privacy policy and practices concerning the use and disclosure of any user data on our Web properties. Any failure by us to comply with posted privacy policies, Federal Trade Commission requirements or other domestic or international privacy-related laws and regulations could result in proceedings by governmental or regulatory bodies that could potentially harm our businesses, results of operations and financial condition. In this regard, there are a large number of legislative proposals before the U.S. Congress and various state legislative bodies regarding privacy issues related to our businesses. It is not possible to predict whether or when such legislation may be adopted, and certain proposals, if adopted, could harm our business through a decrease in user registrations and revenue. These decreases could be caused by, among other possible provisions, the required use of disclaimers or other requirements before users can utilize our services.

Employees

As of December 31, 2004, we employed a total of 211 full-time employee equivalents. We have never had a work stoppage, and none of our employees are represented by a labor union. We consider our employee relationships to be positive. If we were unable to retain our key employees or we were unable to maintain adequate staffing of qualified employees, particularly during peak sales seasons, our business would be adversely affected.

Web Site

Our web site, www.marchex.com, provides access, without charge, to our annual report on Form 10-KSB, quarterly reports on Form 10-QSB, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission.

ITEM 2. DESCRIPTION OF PROPERTY.

We do not own real estate property. Our corporate offices are located at 413 Pine Street, Suite 500, Seattle, Washington. In March 2004, we entered into a sublease agreement for our current corporate office space in Seattle, Washington, and this commitment extends through 2009. The sublease agreement provides for the leasing of 11,400 square feet of office space at \$16,150 per month, increasing to 26,788 square feet at \$37,950 per month, over the term of the agreement ending in 2009. With respect to our additional office space at 2101 Fourth Avenue, Suite 1980, Seattle, Washington, we currently have approximately 4,073 square feet under lease agreements expiring in June 2006 at a monthly rental of \$8,343. We also have offices located at (i) 360 West 4800 North, Provo, Utah, that are comprised of approximately 13,050 square feet under a sublease agreement expiring in December 2005, at a monthly rental of \$19,590; (ii) 2986 Crescent Avenue, Eugene, Oregon, that are comprised

Edgar Filing: MARCHEX INC - Form 10KSB

of 6,725 square feet under a lease agreement expiring in October 2006 at a monthly rental of \$10,087; and (iii) 101 Convention Drive, Las Vegas, NV, that are comprised of 2,080 square feet at a monthly rental of \$3,432, increasing in April 2006 to \$3,536 per month over the remaining term of the lease agreement expiring in February 2007.

Table of Contents

Our information technology systems are hosted and maintained in third-party facilities under colocation services agreements. See Information Technology and Systems.

ITEM 3. LEGAL PROCEEDINGS.

We are not a party to any material legal proceedings. From time to time, however, we may be subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of intellectual property rights, and a variety of claims arising in connection with our services.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matter was submitted during the fourth quarter of 2004 to a vote of security holders, through solicitation or proxies or otherwise.

Table of Contents**PART II****ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.****Market Information**

Our Class B common stock has been traded on the Nasdaq National Market under the symbol MCHX since March 31, 2004 when we completed our initial public offering at a price of \$6.50 per share. Prior to that time, there was no public market for our Class B common stock. The following table sets forth, for the periods indicated, the high and low closing sales prices for Marchex's Class B common stock as reported on the Nasdaq National Market:

	<u>High</u>	<u>Low</u>
Year ended December 31, 2004		
First Quarter (Beginning March 31, 2004)	\$ 8.88	\$ 8.88
Second Quarter	\$ 13.28	\$ 9.50
Third Quarter	\$ 13.35	\$ 8.56
Fourth Quarter	\$ 21.00	\$ 12.40

The last reported closing sale price of our Class B common stock on the Nasdaq National Market on March 24, 2005 was \$17.40 per share.

Holdings

As of December 31, 2004, there were 25,498,961 shares of common stock outstanding that were held by 161 stockholders of record. Of these shares:

11,987,500 shares were issued as Class A common stock, and as of this date were held by 5 stockholders of record; and

13,511,461 shares were issued as Class B common stock, and as of this date were held by 156 stockholders of record.

Dividends

In February 2005, the Company closed its offering of 230,000 shares of 4.75% convertible exchangeable preferred stock with a liquidation preference of \$250 per share. This amount includes the exercise by the Company's underwriters of their over-allotment option to purchase 30,000 additional shares of preferred stock.

Edgar Filing: MARCHEX INC - Form 10KSB

We currently intend to pay cash dividends on the preferred stock at the annual rate of 4.75% per share. Dividends on the preferred stock are cumulative, meaning that if they are not paid they continue to accrue and must be paid prior to the payment of any dividends on our common stock.

We have never declared or paid any cash dividends on shares of our common stock. Except for dividends payable on the preferred stock, we currently intend to retain our earnings for future growth and do not anticipate paying any cash dividends on shares of our common stock in the foreseeable future. Any future determination to pay dividends on such shares will be at the discretion of our board of directors and will depend on a number of factors, such as our results of operations, capital requirements, financial conditions, future prospects and other factors that the board of directors deems relevant.

Table of Contents**Securities Authorized for Issuance under Equity Compensation Plans**

Equity Compensation Plan Information as of December 31, 2004:

<u>Plan category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u>	<u>Weighted average exercise price of outstanding options, warrants and rights</u>	<u>Number of securities remaining available for future issuance</u>
Equity compensation plans approved by security holders			
2003 stock incentive plan ⁽¹⁾	4,409,570	\$6.06 per share	444,761
2004 employee stock purchase plan	26,735	\$9.17	273,265
Stand-alone options and warrants not approved by security holders ⁽²⁾	120,000	\$8.45	N/A
Total	4,556,305	\$6.06 to \$9.17	718,026

⁽¹⁾ We have reserved 6,288,901 shares of Class B common stock for issuance under our 2003 stock incentive plan, of which an increase of 1,274,948 to the authorized number of shares available under the plan occurred on January 1, 2005 as a result of the evergreen provision under the plan. The evergreen provision provides for annual increases in the number of shares available for issuance under the plan, on the first day of our fiscal year, equal to 5% of the outstanding shares of Class B common stock (including any shares of Class B common stock issuable upon conversion of any outstanding capital stock) on such date.

⁽²⁾ In connection with our initial public offering in April 2004 we granted warrants to the underwriters in that offering to purchase an aggregate of 120,000 shares of Class B common stock upon exercise thereof at an exercise price of \$8.45 per share. The warrants are exercisable over a four year period commencing on April 5, 2005 and ending April 5, 2009.

Use of Proceeds

On March 30, 2004, our registration statement on Form SB-2 (No. 333-111096) was declared effective by the SEC, pursuant to which we registered 4,000,000 shares of our Class B common stock, and another 600,000 shares subject to the underwriters' over-allotment option. The shares of Class B common stock registered under the registration statement, including the 600,000 shares of Class B common stock covered by the over-allotment option, were sold at a price of \$6.50 per share. The offering generated gross offering proceeds of approximately \$29.9 million. The closing of the offering and the exercise in full of the underwriter's over-allotment option, took place on April 5, 2004. The managing underwriters were Sander Morris Harris, Inc. and National Securities Corporation. In connection with the offering, we incurred \$1.5 million in underwriting discounts and commissions, and approximately \$1.2 million in other cash related expenses. The net proceeds from the IPO, after deducting the foregoing expenses, were approximately \$27.2 million. From the effective date of our initial public offering through December 31, 2004, we have used approximately \$7.5 million of these proceeds to fund the acquisition of goClick, approximately \$3.5 million for the 2003 earn-out obligation relating to our acquisition of Enhance Interactive, and \$3.3 million for capital expenditures, personnel, and working capital and other general corporate purposes. Pending further application of the funds, as described in our registration statement on Form SB-2, we have invested the remainder of the net proceeds in short-term, investment grade, interest-bearing securities.

Table of Contents**ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.**

The following discussion should be read in conjunction with the audited consolidated financial statements and the notes to those statements which appear elsewhere in this Annual Report on Form 10-KSB and with the audited consolidated financial statements and the notes thereto of the Predecessor to Marchex, Inc. as of February 28, 2003 and of Marchex, Inc. as of December 31, 2003, included in our final prospectuses dated February 10, 2005 and as filed with the Securities and Exchange Commission. The following discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We use words such as believes, intends, expects, anticipates, plans, may, will and similar expressions to identify forward-looking statements. Discussions containing forward-looking statements may be found in the material set forth under Business, Management's Discussion and Analysis of Financial Condition and Results of Operations and in other sections of the report. All forward-looking statements, including, but not limited to, statements regarding the benefits and risks associated with our recent Name Development asset acquisition, our future operating results, financial position, and business strategy, expectations regarding our growth and the growth of the industry in which we operate, and plans and objectives of management for future operations, are inherently uncertain as they are based on our expectations and assumptions concerning future events. Any or all of our forward-looking statements in this prospectus may turn out to be inaccurate. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. They may be affected by inaccurate assumptions we might make or by known or unknown risks and uncertainties, including the risks, uncertainties and assumptions described in Risk Factors and elsewhere in this report. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this report may not occur as contemplated, and actual results could differ materially from those anticipated or implied by the forward-looking statements. All forward-looking statements in this document are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statement.

Overview

We provide technology-based merchant services that facilitate and drive growth in online transactions. We connect merchants with consumers who are searching for information, products and services on the Internet. Our platform of integrated performance-based advertising and search marketing services enables merchants to more efficiently market and sell their products and services across multiple online distribution channels, including search engines, product shopping engines, directories, Internet domains, and other selected Web properties.

We currently provide our merchant advertisers with the following technology-based services:

Pay-Per-Click Services. We deliver pay-per-click advertising listings that are reflective of our merchant advertisers' products and services to online users in response to their keyword search queries. These pay-per-click listings are generally ordered in the search results based on the amount our merchant advertisers choose to pay for a targeted placement. These targeted listings are displayed to consumers and businesses through our distribution network of leading search engines, product shopping engines, directories and other Web properties.

Feed Management Services. We leverage our proprietary technology to crawl and extract relevant product content from merchant advertisers' databases and Web sites to create highly-targeted product and service listings, which we deliver into our distribution network. These feed management listings are ordered in the results based on relevance to user search queries. Our trusted feed relationships with our distribution partners enable merchant advertisers to deliver comprehensive and up-to-date product and service listings to some of the Web's largest search engines, product shopping engines and directories.

Advertising Campaign Management Services. We enable merchant advertisers to: (1) track, monitor and optimize the placement of performance-based search advertising campaigns across a number of

Table of Contents

search engines and pay-per-click networks using our bid management services; and (2) evaluate the effectiveness of online advertising campaigns using our conversion tracking and detailed reporting services.

Search Engine Optimization Services. We optimize key attributes of merchant advertiser Web sites to ensure the greatest opportunity for proper indexing, listing and inclusion in the editorial results of algorithmic search engines.

Outsourced Search Marketing Services Platform. We provide large aggregators of advertisers, such as yellow page companies, with an outsourced, integrated platform to enable them to market performance-based advertising and search marketing services directly to their customers. We distribute performance-based advertisements through our broad network of distribution partners comprising many of the leading search engines, product shopping engines, directories and other Web properties. Our sources of distribution include industry leaders such as Yahoo!, Google, Shopping.com and many others.

We were incorporated in Delaware on January 17, 2003. Acquisition initiatives have played an important part in our corporate history to date. We have completed four acquisitions since our inception including:

On February 28, 2003, we acquired eFamily together with its direct wholly-owned subsidiary Enhance Interactive. eFamily was incorporated in Utah on November 29, 1999 under the name FocusFilter.com, Inc.

On October 24, 2003, we acquired TrafficLeader which was incorporated in Oregon on January 24, 2000 under the name Sitewise Marketing, Inc.

On July 27, 2004, we acquired goClick which was incorporated in Connecticut on October 25, 2000.

On February 14, 2005, we acquired certain assets of Name Development Ltd. which was incorporated in the British Virgin Islands in July 2000.

From January 17, 2003 (inception) through February 28, 2003, we were involved in business and product development, as well as financing and acquisition initiatives.

We currently have offices in Seattle, Washington; Provo, Utah; Eugene, Oregon and Las Vegas, Nevada.

Prior Acquisitions

Enhance Interactive

In February 2003, we acquired eFamily together with its wholly-owned subsidiary Enhance Interactive, a Provo, Utah-based company, for the following consideration:

Edgar Filing: MARCHEX INC - Form 10KSB

\$13.3 million in net cash and acquisition costs; plus

Additional consideration in the form of a contingent earnings-based cash payment of up to \$13.5 million payable over two years, of which \$3.5 million and \$6.2 million have been paid for the calendar years 2003 and 2004, respectively, which such payments were made in April 2004 and March 2005, respectively.

The additional consideration consists of two components:

A contingent earnings-based payment to the original stockholders (earn-out consideration); and

A contingent earnings-based payment to certain employees (retention consideration).

These amounts were payable by us with respect to the years 2003 and 2004. For the 2003 and 2004 calendar years, the total Enhance Interactive earnings-based payment obligation was approximately \$3.5 million and \$6.2 million, respectively.

Table of Contents

The contingent payment of earn-out consideration, payable to the original stockholders of Enhance Interactive, is calculated based on the formula of 69.44% of earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout cap of \$12.5 million in aggregate. This payment obligation for each calendar year is conditioned on Enhance Interactive meeting the earnings threshold described above. We have accounted for all such amounts paid as additional goodwill. For the 2003 calendar year, the earn-out consideration paid was approximately \$3.2 million. For the 2004 calendar year, the earn-out consideration payment obligation paid was approximately \$5.7 million.

The contingent payment of retention consideration, payable to certain employees of Enhance Interactive, is calculated based on the formula of 5.56% of Enhance Interactive's earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout cap of \$1 million in aggregate. This payment obligation for each calendar year is also conditioned on Enhance Interactive meeting the earnings threshold described above. We have accounted for all such amounts paid as compensation. For the 2003 calendar year, the retention consideration paid was approximately \$283,000. For the 2004 calendar year, the retention consideration payment obligation paid was approximately \$501,000.

In connection with this acquisition, we also issued nonqualified stock options to certain employees of Enhance Interactive, subject to their continued employment, to purchase up to an aggregate of 1,250,000 shares of our Class B common stock with an exercise price per share of \$0.75.

The Enhance Interactive operations were consolidated in our results from the acquisition date of February 28, 2003 and have had a substantial impact on our results.

TrafficLeader

In October 2003, we acquired TrafficLeader, a Eugene, Oregon-based company, for the following consideration:

\$3.2 million in net cash and acquisition costs; plus

425,000 shares of Class B common stock, which had a redemption right that terminated upon the closing of our initial public offering in April 2004; plus

137,500 shares of restricted Class B common stock which will vest over a three-year period in installments of 16.67% after each six month period during that term; plus

Additional consideration in the form of a contingent revenue-based cash incentive payment of up to \$1.0 million. For the 2004 calendar year, no additional consideration was due under this provision.

With respect to the second and third components, the total value of the shares and the redemption right was recorded at \$3.9 million. Prior to its expiration, the redemption right required us to buy back the 425,000 shares for \$8.00 per share, but only at the election of the holders of 75% of such shares in the event we had not completed a firm commitment initial public offering with gross proceeds of at least \$20.0 million prior to October 24, 2005.

Edgar Filing: MARCHEX INC - Form 10KSB

Of the 137,500 restricted shares, 108,432 were issued to employees of TrafficLeader and valued at \$732,000, which amount is recorded as compensation expense over the associated employment period during which these shares vest.

goClick

In July 2004, we acquired goClick, a Norwalk, Connecticut-based company for the following consideration:

\$7.5 million in net cash and acquisition costs; plus

433,541 shares of Class B common stock.

Table of Contents

The shares of Class B common stock were valued at \$9.55 per share (for accounting purposes) for an aggregate amount of \$4.14 million.

Name Development

In February 2005, we acquired substantially all of the assets of Name Development for the following consideration:

\$155.7 million in cash and estimated acquisition costs; plus

419,659 shares of Class B common stock, based on the average of the last quoted sale price for shares of Class B common stock on the Nasdaq National Market for the 10 trading days immediately prior to the closing.

The shares of Class B common stock were valued at \$20.99 per share (for accounting purposes) for an aggregate amount of approximately \$8.8 million.

Under the terms of the agreement, we acquired certain assets of Name Development, including its inventory of Internet domains and Web properties, revenue-generating contracts, technology and systems, for the operation of the Name Development direct navigation business. We did not assume any other obligations with respect to Name Development as part of this asset acquisition.

We expect to account for the Name Development asset acquisition as a business combination.

The results of operations for Name Development are not included in the periods presented.

Consolidated Statements of Operations

Our consolidated statements of operations, stockholders' equity, and cash flows have been presented for:

the period of January 17, 2003 (inception) to December 31, 2003; and

for the year ended December 31, 2004.

The statements of operations, stockholders' equity and cash flows have been presented for the Predecessor, Enhance Interactive:

Edgar Filing: MARCHEX INC - Form 10KSB

for the period of January 1, 2003 to February 28, 2003.

Business planning and other activities related to our business began in late 2002. We were organized and incorporated in Delaware in January 2003. Included in the results of operations subsequent to our incorporation in January 2003 are reimbursements to certain founding officers for approximately \$86,000 in general and administrative pre-incorporation costs. Included in property and equipment are purchases from certain of our founding officers of approximately \$62,000 for the carrying value of the assets.

The assets, liabilities and operations of Enhance Interactive, TrafficLeader and goClick are included in our consolidated financial statements since the date of their respective acquisitions in February 2003, October 2003 and July 2004.

All significant inter-company transactions and balances within Marchex have been eliminated in consolidation. Our purchase accounting resulted in all assets and liabilities from our acquisitions of Enhance Interactive, TrafficLeader and goClick being recorded at their estimated fair values on their respective acquisition dates. For the periods of: (1) February 28, 2003 through December 31, 2003; (2) October 24, 2003 through December 31, 2003; and (3) July 27, 2004 through December 31, 2004, all goodwill, intangible assets and liabilities resulting from the respective Enhance Interactive, TrafficLeader and goClick acquisitions have

Table of Contents

been recorded in our financial statements. Accordingly, our consolidated financial results for periods subsequent to the acquisition of Enhance Interactive, are not comparable to the financial statements of Enhance Interactive presented for prior periods. The consolidated statements of operations, stockholders' equity, and cash flows reflecting Enhance Interactive's historical results have been presented for the period from January 1, 2003 through February 28, 2003.

eFamily and its wholly-owned subsidiary Enhance Interactive are described as Enhance Interactive. In the consolidated financial statements, the statements of operations, stockholders' equity, and cash flows reflecting Enhance Interactive results have been presented as the Predecessor for the period of January 1, 2003 to February 28, 2003.

Presentation of Financial Reporting Periods

For purposes of our discussion, we have included the results of operations of the Predecessor, Enhance Interactive. The comparative periods presented are for:

the year ended December 31, 2003 (the combined periods of Marchex's results from January 17, 2003 (inception) to December 31, 2003 and the Predecessor's results for the period of January 1, 2003 to February 28, 2003), compared to the year ended December 31, 2004.

In the 2003 period, we have included the overlapping operating activities of Enhance Interactive and our operating activities for the period of January 17, 2003 (inception) through February 28, 2003 (the date we acquired Enhance Interactive). From our inception through the date of our acquisition of Enhance Interactive, we were involved in business and product development, as well as financing and acquisition initiatives. During this period we had no revenues. Accordingly, our activities were different from the operating activities of Enhance Interactive.

Revenue

We currently generate revenue through our suite of services, including our pay-per-click services, feed management services, advertising campaign management services, search optimization services and outsourced search marketing services platform.

Our primary sources of revenue are the performance-based advertising services, which include pay-per-click services and feed management services. These primary sources amounted to greater than 93% of our revenues in all periods presented. Our secondary sources of revenue are our advertising campaign management services, search optimization services and outsourced search marketing services platform. These secondary sources amounted to less than 7% of our revenues in all periods presented. We have no barter transactions.

We recognize revenue upon the completion of our performance obligation, provided that: (1) evidence of an arrangement exists; (2) the arrangement fee is fixed and determinable; and (3) collection is reasonably assured.

Performance-Based Advertising Services

In providing pay-per-click advertising services, we generate revenue upon our delivery of qualified and reported click-throughs to our merchant advertisers or advertising service providers listings. These merchant advertisers and advertising service providers pay us a designated transaction fee for each click-through, which occurs when an online user clicks on any of their advertisement listings after it has been placed by us or by our distribution partners. Each click-through on an advertisement listing represents a completed transaction. The advertisement listings are displayed within our distribution network, which includes search engines, directories, destination sites, Internet domains or Web properties, and other targeted Web-based content.

In providing feed management services, merchant advertisers pay for their Web pages and product databases to be crawled, or searched, and included in search engine, directory and product shopping engine results within

Table of Contents

our distribution network. Generally, the feed management listings are presented in a different section of the Web page than the pay-per-click listings. For this service, revenue is generated when an online user clicks on a feed management listing from search engine, directory or product shopping engine results. Each click-through on an advertisement listing represents a completed transaction for which the merchant advertiser pays for on a per-click basis. The placement of a feed management result is largely determined by its relevancy, as determined by the distribution partner.

Search Marketing Services

Merchant advertisers pay us additional fees for services such as advertising campaign management services and search optimization services. Merchant advertisers generally pay us on a click-through basis, although in certain cases we receive a fixed fee for delivery of these services. In some cases we also deliver banner campaigns for select merchant advertisers. We may also charge initial set-up or inclusion fees as part of our services. Total revenue from these services accounted for less than 7% of total revenue in all periods presented.

Banner advertising revenue is primarily based on a fixed fee per click and is generated and recognized on click-through activity. In limited cases, banner payment terms are volume-based with revenue generated and recognized when impressions are delivered.

Non-refundable account set-up fees are paid by merchant advertisers and are recognized ratably over the longer of the term of the contract or the average expected merchant advertiser relationship period, which generally ranges from twelve months to more than two years.

Other inclusion fees are generally associated with monthly or annual subscription-based services where a merchant advertiser pays a fixed amount to be included in our index of listings or our distribution partners' indexes of listings. Revenues from these subscription arrangements are recognized ratably over the service period.

Industry and Market Factors

We enter into agreements with various distribution partners to provide distribution for the URL strings and advertisement listings of our merchant advertisers. We generally pay distribution partners based on a percentage of revenue or a fixed amount per click-through on these listings. The level of click-throughs contributed by our distribution partners has varied, and we expect it will continue to vary, from quarter to quarter and year to year, sometimes significantly. Our current growth will be impacted by our ability to increase our distribution, which impacts the number of Internet users who have access to our merchant advertisers' listings and the rate at which our merchant advertisers are able to convert clicks from these Internet users into completed transactions, such as a purchase or sign up. Our current growth also depends on our ability to continue to increase the number of merchant advertisers who use our services and the amount these merchant advertisers spend on our services.

We anticipate that these variables will fluctuate in the future, affecting our growth rate and our financial results. In particular, it is difficult to project the number of click-throughs we will deliver to our merchant advertisers and how much merchant advertisers will spend with us, and it is even more difficult to anticipate the average revenue per click-through.

Edgar Filing: MARCHEX INC - Form 10KSB

In addition, we believe we will experience seasonality. Our quarterly results have fluctuated in the past and may fluctuate in the future due to seasonal fluctuations in levels of Internet usage and seasonal purchasing cycles of many merchant advertisers. It is generally understood that during the spring and summer months, Internet usage is lower than during other times of the year, especially in comparison to the fourth quarter of the calendar year. The extent to which usage may decrease during these off-peak periods is difficult to predict. Prolonged or severe decreases in usage during these periods may adversely affect our growth rate and results.

Table of Contents

Service Costs

Our service costs represent the cost of providing our performance-based advertising services and our search marketing services. The service costs that we have incurred in the periods presented primarily include:

user acquisition costs;

amortization and impairment of intangible assets;

credit card processing fees;

network operations;

serving our search results;

maintaining our Web sites;

domain name registration renewal fees;

network fees;

fees paid to outside service providers;

delivering customer service;

depreciation of our Web site and network equipment;

colocation service charges of our Web site equipment;

bandwidth and software license fees;

salaries of related personnel; and

stock-based compensation of related personnel.

User Acquisition Costs

For the periods presented the largest component of our service costs consist of user acquisition costs that relate primarily to payments to our distribution partners for access to their online user traffic. We enter into agreements of varying durations with distribution partners that integrate our services into their sites and indexes. The primary economic structure of our distribution partner agreements is a variable payment based on a specified percentage of revenue. These variable payments are often subject to minimum payment amounts per click-through. Other economic structures that we may use to a lesser degree include:

fixed payments, based on a guaranteed minimum amount of usage delivered;

variable payments based on a specified metric, such as number of paid click-throughs; and

a combination arrangement with both fixed and variable amounts.

Our method of expensing user acquisition costs is based on whether the agreement provides for fixed or variable payments. Agreements with fixed payments are generally expensed at the greater of: (1) pro-rata over the term the fixed payment covers; or (2) usage delivered to date divided by the guaranteed minimum amount of usage delivered. Agreements with variable payments based on a percentage of revenue, number of paid click-throughs or other metrics are generally expensed based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

Sales and Marketing

Sales and marketing expenses consist primarily of:

payroll and related expenses for personnel engaged in marketing and sales functions;

advertising and promotional expenditures; and

cost of systems used to sell to and serve merchant advertisers.

Table of Contents

Product Development

Product development costs consist primarily of expenses incurred in the research and development, creation and enhancement of our Internet sites and services.

Our research and development expenses include:

compensation and related expenses;

costs of computer hardware and software; and

costs incurred in developing features and functionality of the services we offer.

For the periods presented, substantially all of our product development expenses are research and development.

Product development costs are expensed as incurred or capitalized into property and equipment in accordance with the American Institute of Certified Public Accountants' Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. This statement requires that costs incurred in the preliminary project and post-implementation stages of an internal use software project be expensed as incurred and that certain costs incurred in the application development stage of a project be capitalized.

General and Administrative

General and administrative expenses consist primarily of:

payroll and related expenses for executive and administrative personnel;

professional services, including accounting, legal and insurance;

bad debt provisions;

facilities costs; and

other general corporate expenses.

Acquisition-Related Retention Consideration

Acquisition-related retention consideration results from our contingent, earnings-based payment obligation to certain employees of Enhance Interactive for each of the calendar years 2003 and 2004, pursuant to the terms of the merger agreement. See subsection **Prior Acquisitions** above.

The contingent payment obligation was calculated based on the formula of 5.56% of Enhance Interactive's earnings before taxes for each of the calendar years 2003 and 2004, up to a maximum payout cap of \$1.0 million in the aggregate. All payments made under this obligation have been accounted for as compensation. For the 2003 calendar year, the retention consideration paid was approximately \$283,000. For the 2004 calendar year, the retention consideration payment obligation paid was approximately \$501,000.

Stock-Based Compensation

Stock-based compensation consists of the following components:

the intrinsic value of employee option and restricted stock issuances in cases where the fair value of the underlying stock was greater than the exercise price on the date of the grant;

the fair value of non-employee option issuances; and

the amount by which the fair value of our Class B common stock exceeds the exercise price at the end of the period for certain options.

Table of Contents

We used variable accounting for the options to purchase 125,000 shares of our Class B common stock that were issued under our stock incentive plan. These options were held in escrow until February 28, 2004 as security for the indemnification obligations under the Enhance Interactive merger agreement, and these options were subject to forfeiture during the escrow period. We accounted for these options as variable awards until February 28, 2004.

Amortization of Intangibles from Acquisitions

Amortization of intangible assets excluding goodwill relates to intangible assets identified in connection with our acquisitions.

Intangible assets identified in connection with the purchase of Enhance Interactive were valued at \$8.4 million at the acquisition date of February 28, 2003. Intangible assets identified in connection with the purchase of TrafficLeader were valued at \$1.3 million at the acquisition date of October 24, 2003. Intangible assets identified in connection with the purchase of goClick were valued at \$3.3 million at the acquisition date of July 27, 2004.

The intangible assets have been identified as:

non-competition agreements;

trade and Internet domain names;

distributor relationships;

merchant advertising customer base relationships; and

acquired technology.

These assets are amortized over useful lives ranging from 12 to 42 months.

Provision for Income Taxes

For income tax purposes, we utilize the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in results of operations in the period

Edgar Filing: MARCHEX INC - Form 10KSB

that includes the enactment date. A valuation allowance is recorded for deferred tax assets when it is more likely than not that such deferred tax assets will not be realized. Although realization is not assured, the Company believes it is more likely than not, based on its operating performance and projections of future taxable income, that the Company's net deferred tax assets will be realized. In determining that it was more likely than not that the Company would realize the deferred tax assets, factors considered included, historical taxable income, historical trends related to merchant advertiser usage rates and projected revenues and expenses. The amount of the net deferred tax assets considered realizable, however, could be reduced in the near term if the Company's projections of future taxable income are reduced or if the Company does not perform at the levels it is projecting. This could result in increases to the valuation allowance for deferred tax assets and a corresponding increase to income tax expense of up to the entire net amount of deferred tax assets. From time to time, various state, federal, and other jurisdictional tax authorities undertake reviews of the Company and its filings. The Company believes any adjustments that may ultimately be required as a result of any of these reviews will not be material to the financial statements.

As of December 31, 2004, we had net operating loss, or NOL, carryforwards of \$1.7 million, which will begin to expire in 2019. The Tax Reform Act of 1986 limits the use of NOL and tax credit carryforwards in

Table of Contents

certain situations where changes occur in the stock ownership of a company. We believe that such a change has occurred, and that the utilization of the approximately \$1.7 million of carryforwards is limited such that substantially all of these NOL carryforwards will never be utilized.

Initial Public Offering

On March 30, 2004, we commenced an initial public offering of 4.6 million shares of our Class B common stock. The closing of our initial public offering took place on April 5, 2004. The proceeds of our initial public offering, net of cash offering expenses, were approximately \$27.2 million. In connection with our initial public offering, those underwriters were also granted warrants, exercisable over a four-year period commencing April 5, 2005 and ending April 5, 2009, to purchase 120,000 shares of Class B common stock at an exercise price equal to \$8.45 per share. Net proceeds have been or are expected to be used to pay for product and business development, acquisitions and strategic relationships, capital expenditures, personnel, facilities, earn-out obligations and working capital and other general corporate purposes.

Accretion to Redemption Value of Redeemable Convertible Preferred Stock

All 6,724,063 shares of our outstanding Series A redeemable convertible preferred stock were automatically converted into 6,724,063 shares of Class B common stock upon the closing of our initial public offering in April 2004. Prior to this conversion, holders of our Series A redeemable convertible preferred stock were entitled to receive annual cumulative dividends at the per annum rate of 8% of the original purchase price per share when and if declared by our board of directors. Upon the conversion of the Series A redeemable convertible preferred stock, dividend rights were automatically terminated and any rights to past dividends were forgiven.

Prior to the automatic conversion, we accounted for the difference between the carrying amount of the redeemable preferred stock and the redemption amount by increasing the carrying amount for periodic accretion using the interest method, so that the carrying amount was equal to redemption amount at the earliest redemption date.

Follow-on Public Offering

In February 2005, we closed a secondary offering of 9,200,000 shares of Class B common stock at a public offering price of \$20.00 per share and 230,000 shares of 4.75% convertible exchangeable preferred stock with a liquidation preference of \$250 per share. These amounts include the exercise by our underwriters of their over-allotment option to purchase 1,200,000 additional shares of Class B common stock and 30,000 additional shares of preferred stock. The common stock and preferred stock proceeds, net of offering costs, are estimated to be approximately \$174.1 million and \$55.3 million, respectively, for an aggregate amount of \$229.4 million. In addition to funding the acquisition of certain assets from Name Development Ltd., we intend to use the proceeds from the offering for working capital and other general corporate purposes, including for future acquisitions.

Holders of the preferred stock are entitled to receive cumulative dividends from the date of original issue at the annual rate of 4.75% of the liquidation preference of the preferred stock, payable quarterly on the 15th day of February, May, August and November, commencing May 15, 2005. Any dividends must be declared by our board of directors and must come from funds which are legally available for dividend payments.

Edgar Filing: MARCHEX INC - Form 10KSB

The preferred stock is convertible at the option of the holder at any time into shares of the our Class B common stock at a conversion rate of approximately 10.2041 shares of Class B common stock for each share of preferred stock, based on an initial conversion price of \$24.50. The initial conversion price is subject to adjustment in certain events, including a non-stock fundamental change or a common stock fundamental change.

We may elect to automatically convert some or all of the preferred stock into Class B common stock if the closing price of our Class B common stock has exceeded \$36.75, which is 150% of the conversion price for at least 20 of the 30 consecutive trading days ending within 5 trading days prior to the notice of automatic conversion.

Table of Contents

If we elect to automatically convert some or all of the preferred stock into Class B common stock prior to February 15, 2008, we will make an additional payment on the preferred stock equal to the aggregate amount of cumulative dividends that would have accrued and become payable on the preferred stock from February 14, 2005 through and including February 15, 2008, less any dividends already paid on the preferred stock. This additional payment is payable in cash or, at our option, in shares of our Class B common stock, or a combination of cash and shares of Class B common stock.

We may elect to redeem the preferred stock, in whole or in part, at declining redemption prices on or after February 20, 2008.

The terms of the preferred stock contain an exchange right, at our option, to convert the preferred stock, in whole but not in part, on any dividend payment date beginning on February 15, 2006 into our 4.75% Convertible Subordinated Debentures (Debentures) at the rate of \$250 principal amount of Debentures for each share of preferred stock. This embedded derivative will be reflected as an asset, if there is any value ascribed to it, and is subject to variable accounting. The right will be marked to market at each reporting date until such time as the right is exercised or expires. Based on a variety of factors including the assessed probability of exercise, no value has been ascribed to this right. The Debentures, if issued, will mature 25 years after the exchange date.

Comparison of the combined periods of January 1, 2003 to February 28, 2003 and January 17, 2003 (inception) to December 31, 2003 (2003 period) to the year ended December 31, 2004 (2004 period)

Revenue. Revenue increased 91%, from \$23.0 million for the 2003 period to \$43.8 million in the same period in 2004. This increase was primarily attributable to our performance-based advertising services, which increased by approximately \$20.0 million for the 2004 period. Of this increase, approximately 68% related to an increase in the average revenue per merchant advertiser, while approximately 32% related to an increase in the number of merchant advertisers.

We believe the increase in revenue is primarily attributable to the growth of our revenue resulting from our existing distribution partners, the increased number of searches and resulting click-throughs performed by users of our services and new merchant advertisers. We had more than 400 distribution partners in December 2003 and 2004. We believe the foregoing factors, combined with our sales efforts and improved operational controls, have contributed to the increase in the average revenue per merchant advertiser. The increase in revenue for the 2004 period is also attributable to the acquisition of TrafficLeader in October 2003, which added 11 unique distribution partners and more than 280 merchant advertisers and the acquisition of goClick in July 2004 which added more than 40 unique distribution partners and more than 5,000 unique merchant advertisers. The operating results of TrafficLeader and goClick were included as of the acquisition dates of October 24, 2003 and July 27, 2004, respectively.

Our growth rate will depend in part on our ability to increase the number of click-throughs performed by users of our service, primarily through our distribution partners. If we do not renew our distribution partner agreements or replace traffic lost from terminated distribution agreements with other sources or if our distribution partners' search businesses do not grow or are adversely affected, our revenue and results of operations may be materially and adversely affected. Our growth rate will also depend in part on our ability to increase the number and volume of transactions with merchant advertisers. We believe this is dependent in part on delivering high quality traffic that ultimately results in purchases or conversions for our merchant advertisers.

Expenses

Edgar Filing: MARCHEX INC - Form 10KSB

Service Costs. Service costs increased 111%, from \$13.0 million for the 2003 period to \$27.4 million in the same period in 2004. This increase was primarily attributable to an increase of \$12.5 million in payments to distribution partners, an increase in personnel costs of \$1.3 million, an increase in facility and other costs of \$262,000, an increase in payment processing fees of \$313,000, and an increase in production technology and bandwidth costs of \$81,000.

Table of Contents

Service costs as a percentage of revenue were 57% for the 2003 period as compared to 63% in the same period in 2004. As a percentage of revenue, the increase in service costs for the 2004 period as compared to the same period in 2003 was primarily a result of the impact as a percentage of revenue from the service cost level from the October 2003 acquisition of TrafficLeader and their feed management services. TrafficLeader's service costs, of which feed management services is the primary component, were 77% of TrafficLeader's revenue for the 2004 period. Payments to feed management services distribution partners account for higher user acquisition costs as a percentage of revenue relative to our overall service cost percentage. To the extent that payments to feed management services distribution partners make up a larger percentage of future operations, we expect that service costs will increase as a percentage of revenue. goClick's operating activities are in the process of being integrated with our other operations. goClick's service costs did not have a significant percentage impact on the consolidated service cost percentage of revenue.

Approximately \$6.8 million and \$3.1 million of the total increase in service costs for the 2004 period was attributable to the October 2003 acquisition of TrafficLeader and the July 2004 acquisition of goClick, respectively. The increase in service costs also resulted from a greater number of searches, an increase in database and hardware capacity requirements as a result of an increase in our distribution partner base and corresponding number of searches, an increase in the number of personnel required to support our services and an increase in fees paid to outside service providers. We expect that service costs will continue to increase in absolute dollars, since we anticipate expanding our operations.

Sales and Marketing. Sales and marketing expenses increased 56%, from \$2.8 million in the 2003 period to \$4.4 million in the same period in 2004. The increase in dollars was primarily attributable to an increase in personnel costs of \$1.2 million, an increase in travel costs of \$214,000 and an increase in other expenses of \$206,000. As a percentage of revenue, sales and marketing expenses were 12% and 10% for the 2003 and 2004 periods, respectively. We expect that sales and marketing expenses will increase in absolute dollars in connection with any revenue increase, to the extent that we also increase our marketing activities.

Product Development. Product development expenses increased 60%, from \$1.4 million in the 2003 period to \$2.3 million in the same period in 2004. The increase in dollars was primarily attributable to an increase in personnel costs of \$706,000, an increase in travel costs of \$53,000 and an increase in other expenses of \$96,000. As a percentage of revenue, the product development expenses were 6% and 5% for the 2003 and 2004 periods, respectively. We expect that product development expenses will increase in absolute dollars as we increase the number of personnel and consultants to enhance our service offerings.

General and Administrative. General and administrative expenses increased 38%, from \$3.0 million in the 2003 period to \$4.1 million in the same period in 2004. As a percentage of revenue, general and administrative expenses decreased to 9% in the 2004 period compared to 13% in the same period in 2003. As a percentage of revenue, the decrease in general and administrative expenses in the 2004 period as compared to the same period in 2003 was primarily a result of general and administrative expenses being compared to a larger revenue base.

The net increase in the dollars was primarily due to an increase in personnel costs of \$876,000, a decrease in travel costs of \$123,000, an increase in insurance of \$99,000, an increase in bad debt expense of \$220,000 and an increase in other expenses of \$62,000. Many of these costs in the 2004 period result from operating in multiple jurisdictions commencing in 2003 and increased operating activity, including the acquisitions of TrafficLeader in October 2003 and goClick in July 2004. We expect that our general and administrative expenses will increase in absolute dollars to the extent that we expand our operations and incur additional costs in connection with being a public company, including expenses related to professional fees and insurance.

Acquisition-Related Retention Consideration. Acquisition-related retention consideration increased 76%, from \$283,000 in the 2003 period to \$499,000 in the same period in 2004. For the 2004 period, the components of acquisition-related retention consideration were as follows: service costs of \$117,000, sales and marketing of \$204,000, product development of \$136,000, and general and administrative of \$42,000.

Table of Contents

The acquisition-related retention consideration was calculated as part of the contingent, earnings-based payment obligation to certain employees of Enhance Interactive and is equal to 5.56% of Enhance Interactive's earnings before taxes in excess of \$3.5 million for the 2004 period of which \$499,000 has been recorded as acquisition-related retention consideration including employer payroll-related taxes. We have accounted for the payment amount as compensation. The acquisition-related retention consideration for the calendar years 2003 and 2004 was subject to an aggregate maximum of \$1.0 million. The earn-out consideration concluded at the end of calendar year 2004.

Facility Relocation. In March 2004, we entered into a sublease agreement for new and larger office facilities in Seattle, Washington, and we relocated from our original office facilities also located in Seattle, Washington. In March 2004, we accrued lease and related costs of \$230,000 for the estimated future obligations of non-cancelable lease and other payments for the original facilities. In the third quarter of 2004, we reduced the lease and related cost accrual by \$30,000 based on a revised estimate for subtenant income. The remaining lease obligations for the original facilities extend through June 30, 2006 and totaled \$150,000 as of December 31, 2004. As of December 31, 2004, we estimate the net sublease income to be approximately \$69,000 over the remaining life of the lease.

The remaining lease accrual is based on estimates of vacancy period and sublease income. The actual vacancy periods may differ from these estimates, and sublease income, if any, may not materialize. Accordingly, these estimates may be adjusted in future periods.

Stock-Based Compensation. The amortization of stock-based compensation decreased 59%, from \$2.2 million in the 2003 period to \$891,000 in the same period in 2004. During the 2004 period, the components of stock-based compensation were service costs of \$11,000, sales and marketing of \$156,000, product development of \$60,000 and general and administrative of \$664,000. Amounts in the 2004 period related primarily to the vesting of stock options granted to employees in which the exercise price was less than the fair market value at the date of grant and \$407,000 related to restricted stock issued to employees for future services in connection with the acquisition of TrafficLeader.

The 2003 period includes \$781,000 of stock-based compensation for 125,000 options issued that were held in escrow as security for the indemnification obligations under the Enhance Interactive merger agreement. These options were subject to forfeiture, until the expiration of the escrow period on February 28, 2004. Accordingly, we have accounted for these options as variable awards during the escrow period. Under variable plan accounting, compensation expense is measured quarterly as the amount by which the fair market value of the shares of our Class B common stock covered by the option grant exceeds the exercise price and is recognized over the option's vesting period. Increases or decreases in the fair market value of our Class B common stock between the date of grant and the date of exercise result in a corresponding increase or decrease in the measure of compensation expense.

Amortization of Intangibles. Intangible amortization expense increased 64%, from \$3.0 million for the 2003 period to \$5.0 million in the same period in 2004. The increase is associated with the acquisitions of Enhance Interactive, TrafficLeader, and goClick. During the 2004 period, the components of amortization of intangibles were service costs of \$3.5 million, sales and marketing of \$701,000 and general and administrative of \$744,000.

Our purchase accounting resulted in all assets and liabilities from our acquisition of Enhance Interactive, TrafficLeader and goClick being recorded at their estimated fair values on the acquisition dates of February 28, 2003, October 24, 2003, and July 27, 2004, respectively. For the period from February 28, 2003 through December 31, 2004, all goodwill, identifiable intangible assets and liabilities resulting from the Enhance Interactive, TrafficLeader and goClick acquisitions have been recorded in our financial statements. The identified intangible assets acquired through these acquisitions amounted to approximately \$13.0 million and are being amortized over a range of useful lives of 12 to 42 months. Our consolidated financial results for periods subsequent to the acquisition of Enhance Interactive are not comparable to the financial statements of Enhance Interactive presented for prior periods. We may acquire identifiable intangible assets as part of future acquisitions and, if so, we expect that our intangible amortization will increase in absolute dollars.

Table of Contents

Other Income. Other income increased 321%, from \$76,000 in the 2003 period to \$319,000 in the same period in 2004. The increase was primarily attributable to an increase in interest income of \$218,000 and the adjustment to fair value of the TrafficLeader redemption obligation of \$30,000 in the 2004 period as compared to the same period in 2003. Interest income increased as a result of the impact of the initial public offering on the average cash balances in the 2004 period.

Income Taxes. The income tax expense in the 2004 period was \$34,000 compared to an income tax benefit of \$860,000 in the same period in 2003.

The effective tax benefit rate was 32% in the 2003 period. This differed from the expected rate of 34% primarily due to state income taxes offset by non-deductible stock compensation amounts. The effective tax rate was 5% in the 2004 period. This differed from the expected rate of 34% primarily due to non-deductible stock compensation amounts.

The periods were also impacted by the following factors:

On February 28, 2003 and October 24, 2003, in connection with the purchase accounting for the respective acquisitions of Enhance Interactive and TrafficLeader, we recorded net deferred tax liabilities in the amount of approximately \$3.5 million, including \$461,000 associated with the acquisition of TrafficLeader, relating to the difference in the book basis and tax basis of its assets and liabilities.

Approximately \$3.6 million of these net deferred tax liabilities, including \$479,000 associated with the acquisition of TrafficLeader, related to the book basis versus tax basis of the identifiable intangible assets in the acquisitions totaling approximately \$9.7 million.

On July 27, 2004, in connection with the purchase accounting for goClick, we recorded net deferred assets of approximately \$11,000 relating to the difference in the book versus tax basis of its liabilities in the amount of approximately \$31,000. The \$9.4 million of goodwill and \$3.3 million of intangible assets relating to the goClick acquisition are being deducted for tax purposes over a 15 year period.

During the period from January 1, 2003 through February 28, 2003 and in the 2004 period, as a result of tax deductions from stock option exercises, Enhance Interactive and the Company recognized tax-effected benefits of approximately \$231,000 and \$444,000 respectively, which were recorded as credits to stockholders' equity.

Accretion to Redemption Value of Redeemable Convertible Preferred Stock. The accretion to redemption value of preferred stock decreased 68%, from \$1.3 million in the 2003 period to \$420,000 in the same period in 2004. The accretion to the redemption value recorded during these periods is based upon 6,724,063 shares of Series A redeemable convertible preferred stock outstanding as of April 5, 2004 with a dividend rate of 8% per annum. All 6,724,063 shares of Series A redeemable convertible preferred stock automatically converted into 6,724,063 shares of Class B common stock upon the closing of the initial public offering on April 5, 2004.

Net Loss Applicable to Common Stockholders. The net loss applicable to common stockholders decreased 63%, from \$3.2 million in the 2003 period to \$1.2 million in the same period in 2004. The decrease was primarily attributable to revenue increasing at a faster rate than sales and marketing, product development and general and administrative expenses, a decrease in accretion to redemption value of the Series A redeemable convertible preferred stock of \$898,000, a decrease in stock-based compensation of \$1.3 million, partially offset by an increase in

Edgar Filing: MARCHEX INC - Form 10KSB

service costs as a percentage of revenue, an increase in amortization of intangible assets of \$1.9 million, an increase in acquisition-related retention consideration of \$216,000 and an increase in facility relocation costs of \$200,000.

Operating Income before Amortization

Our management believes that certain non-GAAP measures, which are calculated and presented on the basis of methodologies other than in accordance with generally accepted accounting principles (GAAP), are helpful, when presented in conjunction with comparable GAAP measures. The non-GAAP measures are not meant to

Table of Contents

replace or supersede the GAAP measures, but rather to supplement the GAAP information and to present to the readers of the financial statements the same information that management considers in assessing our results of operations and performance.

When presenting non-GAAP measures we will present a reconciliation of the most directly comparable GAAP measure. These non-GAAP measures are consistent with how management views our results of operations in assessing performance.

We report operating income before amortization (OIBA) that is a supplemental measure to GAAP. OIBA represents income (loss) from operations before: (1) stock-based compensation expense; and (2) amortization of intangible assets. It is one of the primary metrics by which we evaluate the performance of our business.

Additionally, management uses adjusted OIBA which excludes both: (1) the acquisition-related retention consideration, as we view this as part of the earn-out incentives related to our acquisition of Enhance Interactive; and (2) a facility relocation expense. Both of these items are viewed as non-recurring in nature. The Enhance Interactive earn-out consideration is recorded for its respective calendar year, and the facility relocation expense was recorded in the year ended December 31, 2004.

We refer to adjusted OIBA to facilitate accurate comparisons to our historical operating results, in making operating decisions, for internal budget planning, and in some cases to form the basis upon which management is evaluated. Management believes that investors should have access to, and we are obligated to provide, the same set of tools that we use in analyzing our results. These non-GAAP measures should be considered in addition to results prepared in accordance with GAAP, and should not be considered in isolation, as a substitute for or superior to GAAP results. We believe these measures are useful to investors because they represent our consolidated operating results, taking into account depreciation, which we believe is an ongoing cost of doing business, but excluding the effects of certain other non-cash and non-recurring expenses.

OIBA and adjusted OIBA have certain limitations in that they do not take into account the impact to our statement of operations of certain expenses, including non-cash stock-based compensation associated with our employees, acquisition-related accounting and facility relocation amounts. We endeavor to address the limitations of these non-GAAP measures presented by providing the comparable GAAP measure with equal or greater prominence, GAAP financial statements and detailed descriptions of the reconciling items and adjustments, including quantifying such items, to derive the non-GAAP measure.

The following are the non-cash expenses that are excluded from our non-GAAP measures:

stock-based compensation consists of restricted stock and options expense, which relates mostly to restricted stock and options issued in connection with acquisitions. We view this expense as part of transaction costs which are not paid in cash. Stock-based compensation also includes the expense associated with certain employee stock options where on the date of grant the fair value of the underlying stock exceeded the exercise price.

amortization of intangible assets is a non-cash expense relating primarily to acquisitions. At the time of an acquisition, the intangible assets of the acquired company, such as distribution partner relationships and merchant advertiser customer relationships are valued and amortized over their estimated lives. While it is likely that we will have significant intangible amortization expense as we continue to acquire companies, we believe that since intangibles represent costs incurred by the acquired company to build value prior to the acquisition, they were part of transaction costs and will not be replaced with cash costs when the intangibles are fully

amortized.

Table of Contents

The following is a reconciliation of income (loss) from operations and net income (loss) applicable to common stockholders to the non-GAAP measure of operating income before amortization, also referred to as OIBA, for the period of January 1, 2003 to February 28, 2003, the period from January 17, 2003 (inception) to December 31, 2003 and for the year ended December 31, 2004.

	Predecessor Period	Successor Periods	
	Period from January 1 to February 28, 2003	January 17 (inception) to December 31, 2003	Year ended December 31, 2004
Operating income before amortization (OIBA)	\$ 594,053	\$ 1,820,795	\$ 4,838,277
Stock-based compensation	(38,981)	(2,125,110)	(890,520)
Amortization of intangible assets from acquisitions		(3,023,408)	(4,965,503)
Income (loss) from operations	555,072	(3,327,723)	(1,017,746)
Other income (expense):			
Interest income	1,529	45,874	265,354
Interest expense			(5,654)
Adjustment to fair value of redemption obligation		25,500	55,250
Other		2,685	3,644
Total other income	1,529	74,059	318,594
Income (loss) before provision for income taxes	556,601	(3,253,664)	(699,152)
Income tax expense (benefit)	224,082	(1,084,312)	33,941
Net income (loss)	332,519	(2,169,352)	(733,093)
Accretion to redemption value of redeemable convertible preferred stock		1,318,885	420,430
Net income (loss) applicable to common stockholders	\$ 332,519	\$ (3,488,237)	\$ (1,153,523)

OIBA increased in the 2004 period by \$2.4 million, or 100%, as compared to the same period in 2003. This increase was primarily attributable to revenue increasing at a faster rate than sales and marketing, product development and general and administrative expenses, partially offset by an increase in service costs as a percentage of revenue, an increase in acquisition-related retention consideration of \$216,000 and an increase in facility relocation costs of \$200,000.

Table of Contents**Quarterly Results of Operations**

The following tables set forth our unaudited quarterly results of operations data for the eight most recent quarters and periods ended December 31, 2004, as well as such data expressed as a percentage of our revenues for the periods presented. The information in the tables below should be read in conjunction with our consolidated financial statements and the notes thereto included elsewhere in this prospectus. We have prepared this information on the same basis as the consolidated financial statements and the information includes all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair statement of our financial position and operating results for the quarters or other periods presented. Our quarterly operating results have varied substantially in the past and may vary substantially in the future. You should not draw any conclusions about our future results from the results of operations for any particular quarter or period presented.

	Predecessor		Successor Periods						
	Period		Quarter ended						
	Period from Jan 1 to Feb 28,	Period from Jan 17, (inception) to Mar 31,	June 30,	Sept 30,	Dec 31,	Mar 31,	June 30,	Sept 30,	Dec 31,
	2003	2003	2003	2003	2003	2004	2004	2004	2004
Consolidated Statement of Operations Data:									
Revenue	\$ 3,071,055	\$ 1,715,933	\$ 5,356,286	\$ 5,359,274	\$ 7,460,665	\$ 7,601,911	\$ 8,865,178	\$ 12,215,835	\$ 15,121,348
Expenses:									
Service costs (1)	1,732,813	883,280	2,955,535	2,967,206	4,486,049	4,779,575	5,743,815	7,619,496	9,307,052
Sales and marketing (1)	365,043	214,615	654,182	723,753	868,133	1,009,972	1,030,710	1,156,314	1,217,047
Product development (1)	144,479	104,947	354,927	384,248	447,300	505,535	528,306	602,478	655,111
General and administrative (1)	234,667	426,919	729,856	659,177	927,967	694,748	846,680	1,072,505	1,497,611
Acquisition-related retention consideration (2)					283,269	132,936	122,724	119,198	124,222
Facility relocation						230,459		(30,499)	
Stock-based compensation (3)	38,981	710,991	550,078	326,407	537,634	360,764	235,234	125,405	169,117
Amortization of intangible assets from acquisitions (4)		290,087	869,588	869,588	994,145	1,034,868	1,034,643	1,404,464	1,491,528
Total operating expenses	2,515,983	2,630,839	6,114,166	5,930,379	8,544,497	8,748,857	9,542,112	12,069,361	14,461,688
Income (loss) from operations	555,072	(914,906)	(757,880)	(571,105)	(1,083,832)	(1,146,946)	(676,934)	146,474	659,660
Other income (expense):									
Interest income	1,529	3,092	13,479	16,931	12,372	11,016	70,329	82,462	101,547
Interest expense						(325)	(1,488)	(1,915)	(1,926)
Adjustment to fair value of redemption obligation					25,500	55,250			
Other					2,685	3,644			
Total other income	1,529	3,092	13,479	16,931	40,557	69,585	68,841	80,547	99,621
Income (loss) before provision for income taxes	556,601	(911,814)	(744,401)	(554,174)	(1,043,275)	(1,077,361)	(608,093)	227,021	759,281
Income tax expense (benefit)	224,082	(323,092)	(263,771)	(196,368)	(301,081)	(53,700)	(147,103)	82,787	151,957

Edgar Filing: MARCHEX INC - Form 10KSB

Net income (loss)	332,519	(588,722)	(480,630)	(357,806)	(742,194)	(1,023,661)	(460,990)	144,234	607,324
Accretion to redemption value of redeemable convertible preferred stock		119,081	385,274	407,265	407,265	402,679	17,751		
Net income (loss) applicable to common stockholders	\$ 332,519	\$ (707,803)	\$ (865,904)	\$ (765,071)	\$ (1,149,459)	\$ (1,426,340)	\$ (478,741)	\$ 144,234	\$ 607,324
Basic and diluted net income (loss) per share applicable to common stockholders	\$	(0.05)	\$ (0.07)	\$ (0.06)	\$ (0.09)	\$ (0.11)	\$ (0.02)	\$ 0.01	\$ 0.02

Table of Contents

Predecessor Period	Successor Periods							
Period from Jan 1 to Feb 28, 2003	Period from Jan 17, (inception) to Mar 31, 2003	Quarter ended						Dec 31, 2004
		June 30, 2003	Sept 30, 2003	Dec 31, 2003	Mar 31, 2004	June 30, 2004	Sept 30, 2004	Dec 31, 2004

Other Financial Data:

Operating income before amortization (OIBA)	\$ 594,053	\$ 86,172	\$ 661,786	\$ 624,890	\$ 447,947	\$ 248,686	\$ 592,943	\$ 1,676,343	\$ 2,320,305
(1) Exclude acquisition-related consideration, stock-based compensation and amortization of intangible assets									
(2) Components of acquisition-related retention consideration:									
Service costs	\$	\$	\$	\$	\$ 33,723	\$ 15,826	\$ 14,604	\$ 14,185	\$ 71,970
Sales and marketing					96,262	45,175	41,726	40,503	77,124
Product development					104,233	48,916	45,162	43,865	(1,996)
General and administrative					49,051	23,019	21,232	20,645	(22,876)
(3) Components of stock-based compensation:									
Service costs	\$ 190	\$	\$	\$	\$ 9,776	\$ 4,050	\$ 2,250	\$ 2,250	\$ 2,250
Sales and marketing	715	128,993	99,861	87,720	105,297	67,546	49,042	7,573	31,573
Product development	37,710	69,769	95,108	38,348	37,855	21,902	12,675	12,653	12,653
General and administrative	366	512,229	355,109	200,339	384,706	267,266	171,267	102,929	122,641
(4) Components of amortization of acquired intangible assets from acquisitions:									
Service costs	\$	\$ 215,087	\$ 644,588	\$ 644,588	\$ 712,694	\$ 734,868	\$ 734,643	\$ 978,389	\$ 1,072,978
Sales and marketing		29,167	87,500	87,500	143,951	162,500	162,500	207,527	168,550
General and administrative		45,833	137,500	137,500	137,500	137,500	137,500	218,548	250,000

Consolidated Statement of Operations

Data:									
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Expenses:									
Service costs	56.4	51.5	55.2	55.4	60.1	62.9	64.8	62.4	61.5
Sales and marketing	11.9	12.5	12.2	13.5	11.6	13.3	11.6	9.5	8.0
Product development	4.7	6.1	6.6	7.2	6.0	6.7	6.0	4.9	4.3
General and administrative	7.6	24.9	13.6	12.3	12.4	9.1	9.6	8.8	9.9
Acquisition-related retention consideration					3.8	1.7	1.4	1.0	0.8
Facility relocation						3.0		(0.2)	
Stock-based compensation	1.3	41.4	10.3	6.1	7.2	4.7	2.7	1.0	1.1
Amortization of intangible assets from acquisitions		16.9	16.2	16.2	13.3	13.6	11.7	11.5	9.9
Total operating expenses	81.9	153.3	114.1	110.7	114.5	115.1	107.6	98.8	95.6
Income (loss) from operations	18.1	(53.3)	(14.1)	(10.7)	(14.5)	(15.1)			