

VERTICALNET INC
Form 10-Q
May 13, 2005
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2005

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 000-25269

VERTICALNET, INC.

(Exact name of registrant as specified in its charter)

Pennsylvania (State or other jurisdiction of incorporation or organization)	23-2815834 (I.R.S. Employer Identification No.)
400 CHESTER FIELD PARKWAY MALVERN, PENNSYLVANIA (Address of principal executive offices)	19355 (Zip Code)

Registrant's telephone number, including area code: (610) 240-0600

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

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

The number of shares outstanding of the registrant's common stock as of May 3, 2005 was 42,891,092 (includes 702,927 shares subject to an escrow agreement in connection with a recent acquisition).

Table of Contents

VERTICALNET, INC.

FORM 10-Q

For the Quarterly Period Ended March 31, 2005

TABLE OF CONTENTS

	Page
Part I. <u>FINANCIAL INFORMATION</u>	
Item 1. <u>Consolidated Financial Statements</u>	1
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	29
Item 4. <u>Controls and Procedures</u>	29
Part II. <u>OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	30
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	30
Item 3. <u>Defaults Upon Senior Securities</u>	31
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	31
Item 5. <u>Other Information</u>	31
Item 6. <u>Exhibits</u>	31
<u>SIGNATURES</u>	32

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****VERTICALNET, INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share data)

	March 31,	December 31,
	2005	2004
	<u> </u>	<u> </u>
	(Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 6,675	\$ 9,370
Accounts receivable, net	5,020	5,902
Prepaid expenses and other current assets	1,605	802
	<u> </u>	<u> </u>
Total current assets	13,300	16,074
Property and equipment, net	1,221	1,173
Other investments	606	606
Goodwill	16,319	16,364
Other intangible assets, net	5,053	5,603
Other assets	519	525
	<u> </u>	<u> </u>
Total assets	\$ 37,018	\$ 40,345
	<u> </u>	<u> </u>
Liabilities and Shareholders Equity		
Current liabilities:		
Current portion of long-term debt	\$ 651	\$ 71
Accounts payable and accrued expenses	4,038	4,993
Deferred revenues	3,259	3,147
	<u> </u>	<u> </u>
Total current liabilities	7,948	8,211
Non-current portion of deferred revenues	108	204
Long-term debt	134	42
	<u> </u>	<u> </u>
Total liabilities	8,190	8,457
	<u> </u>	<u> </u>
Commitments and contingencies (see Notes 2, 6, and 7)		
Shareholders equity:		
Preferred stock \$.01 par value, 10,000,000 shares authorized, none issued at March 31, 2005 and December 31, 2004		
	430	427

Edgar Filing: VERTICALNET INC - Form 10-Q

Common stock \$.01 par value, 100,000,000 shares authorized, 42,956,728 shares issued at March 31, 2005 and 42,702,941 shares issued at December 31, 2004

Additional paid-in capital	1,222,429	1,222,210
Deferred compensation	(1,067)	(1,067)
Accumulated other comprehensive loss	(347)	(254)
Accumulated deficit	(1,191,812)	(1,188,623)
	<u>29,633</u>	<u>32,693</u>
Treasury stock at cost, 65,636 shares at March 31, 2005 and December 31, 2004	(805)	(805)
Total shareholders equity	<u>28,828</u>	<u>31,888</u>
Total liabilities and shareholders equity	<u>\$ 37,018</u>	<u>\$ 40,345</u>

See accompanying notes to consolidated financial statements.

Table of Contents**VERTICALNET, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)**

(in thousands, except per share data)

	Three months ended	
	March 31,	
	2005	2004
Revenues:		
Software and software related	\$ 1,515	\$ 549
Services	3,761	3,987
Total revenues	5,276	4,536
Cost of revenues:		
Cost of software and software related	699	256
Cost of services	1,947	1,540
Amortization of acquired technology and customer contracts	239	325
Total cost of revenues	2,885	2,121
Gross profit	2,391	2,415
Operating expenses:		
Research and development	1,711	1,197
Sales and marketing	1,853	1,066
General and administrative	1,512	1,495
Stock-based compensation (a)	220	470
Amortization of other intangible assets	324	131
Total operating expenses	5,620	4,359
Operating loss	(3,229)	(1,944)
Interest and other expense (income), net	(40)	285
Net loss	\$ (3,189)	\$ (2,229)
Basic and diluted loss per common share	\$ (0.08)	\$ (0.10)
Weighted average common shares outstanding:		
Basic and diluted	41,966	23,401

(a) For the three months ended March 31, 2005 and 2004, stock-based compensation expense, net of the effects of cancellations, is attributable to various expense categories as follows (in thousands):

Edgar Filing: VERTICALNET INC - Form 10-Q

Cost of revenues	\$ 12	\$ 200
Research and development	14	70
Sales and marketing	91	70
General and administrative	103	130
	<u> </u>	<u> </u>
Total	\$ 220	\$ 470
	<u> </u>	<u> </u>

See accompanying notes to consolidated financial statements.

Table of Contents**VERTICALNET, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**

(in thousands)

	Three months ended	
	March 31,	
	2005	2004
Operating activities:		
Net loss	\$ (3,189)	\$ (2,229)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	705	549
Stock-based compensation, net of cancellations	220	470
Other non-cash items		281
Change in assets and liabilities, net of effect of acquisition:		
Accounts receivable	882	(205)
Prepaid expenses and other assets	(143)	86
Accounts payable and accrued expenses	(977)	192
Deferred revenues	17	153
Net cash used in operating activities	(2,485)	(703)
Investing activities:		
Capital expenditures	(48)	(42)
Acquisition, net of cash acquired		(3,714)
Proceeds from sale of short-term investments		2
Restricted cash		(311)
Net cash used in investing activities	(48)	(4,065)
Financing activities:		
Principal payments on long-term debt and obligations under capital leases	(102)	(172)
Proceeds from exercise of stock options and warrants	2	547
Proceeds from issuance of common stock and warrants, net		7,062
Net cash provided by (used in) financing activities	(100)	7,437
Effect of exchange rate fluctuation on cash and cash equivalents	(62)	
Net increase (decrease) in cash and cash equivalents	(2,695)	2,669
Cash and cash equivalents - beginning of period	9,370	4,408
Cash and cash equivalents - end of period	\$ 6,675	\$ 7,077
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$ 5	\$ 25
Supplemental schedule of non-cash investing and financing activities:		

Edgar Filing: VERTICALNET INC - Form 10-Q

Capital expenditures financed through capital lease arrangements	\$	141	\$
Issuance of common stock as consideration for the Tigris acquisition			5,740
Assumption of stock option plan as consideration for the Tigris acquisition			2,212

See accompanying notes to consolidated financial statements.

Table of Contents

VERTICALNET, INC.

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(in thousands)

	Common Stock		Additional Paid-in Capital	Deferred Compensation	Accumulated Other Comprehensive Loss	Accumulated Deficit	Treasury Stock	Total
	Shares	Amount						Shareholders Equity
Balance, January 1, 2005	42,703	\$ 427	\$ 1,222,210	\$ (1,067)	\$ (254)	\$ (1,188,623)	\$ (805)	\$ 31,888
Exercise of stock options	177	2						2
Deferred stock-based compensation	77	1	219	(220)				
Amortization of deferred stock-based compensation				220				220
Net loss						(3,189)		(3,189)
Other comprehensive loss					(93)			(93)
Balance, March 31, 2005 (unaudited)	42,957	\$ 430	\$ 1,222,429	\$ (1,067)	\$ (347)	\$ (1,191,812)	\$ (805)	\$ 28,828

See accompanying notes to consolidated financial statements.

Table of Contents

VERTICALNET, INC.

CONSOLIDATED STATEMENTS OF OTHER COMPREHENSIVE LOSS (UNAUDITED)

(in thousands)

	Three months ended	
	March 31,	
	2005	2004
Net loss	\$ (3,189)	\$ (2,229)
Foreign currency translation adjustment	(93)	
Comprehensive loss	\$ (3,282)	\$ (2,229)

See accompanying notes to consolidated financial statements.

Table of Contents

VERTICALNET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of Significant Accounting Policies

Description of Company

Verticalnet, Inc., which was incorporated on July 28, 1995 under the laws of Pennsylvania, is referred to throughout this report as Verticalnet, the Company, the registrant, we, us, or through similar expressions.

We are a provider of Supply Management solutions to Global 2000 companies. We provide a full scope of Supply Management software, services, and domain expertise in areas that include: Program Management, Spend Analysis, eSourcing, Advanced Sourcing, Contract Management, and Supplier Performance Management. Our solutions help our customers to save money on the goods and services they buy.

Historically, we derived our revenue primarily from the licensing of our software, as well as implementation and development services. As a result of the January 2004 acquisition of Tigris Corp (Tigris), we also generate revenues from spend analysis and other supply chain consulting services and as a result of the July 2004 acquisition of B2eMarkets, Inc. (B2eMarkets), we have seen an increase in the amount of our revenue coming from the licensing of our products and maintenance.

Basis of Presentation

Our consolidated financial statements include the accounts of our wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. Certain prior period amounts have been reclassified for comparability with the current period's financial statement presentation.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Restricted Cash

Restricted cash represents certificates of deposit held pursuant to building lease agreements and other financing arrangements. At March 31, 2005 and December 31, 2004, we had approximately \$311,000 of restricted cash classified in non-current other assets on the consolidated balance sheets.

Intangible Assets and Other Long-Lived Assets

In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead are tested for impairment annually or more frequently if certain indicators arise. In addition, SFAS No. 142 also requires that intangible assets with estimable useful lives be amortized over their respective useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

In accordance with SFAS No. 144, long-lived assets, other than goodwill, are reviewed for impairment whenever, in management's judgment, conditions indicate a possible loss. Such impairment tests compare estimated undiscounted cash flows to the carrying value of the asset. If an impairment is indicated, the asset is written down to its fair market value based on an estimate of its discounted cash flows.

Table of Contents

Concentration of Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents in bank deposits accounts and trade receivables. Cash and cash equivalents are held with high quality financial institutions. We periodically perform credit evaluations of our customers and maintain reserves for potential losses, if necessary. We do not anticipate losses from these receivables in excess of the provided allowances. See *Revenue Recognition* below for additional information on credit and revenue concentrations.

Revenue Recognition

Software and software related revenues

Software and software related revenues have been principally derived from the licensing of our products, from maintenance and support contracts, and from hosting services. Customers who license our products also generally purchase maintenance contracts which provide software updates and technical support over a stated term, which is usually a twelve-month period. As part of licensing our products, a customer may also purchase custom development and implementation services from us. The revenue associated with those services is recognized under services revenues as described below.

The license agreements for our products do not provide for a right of return other than during the warranty period, and historically product returns have not been significant. We do not recognize revenue for agreements with cancellation rights or refundable fees until such rights to refund or cancellation have expired. Our products are either acquired under a perpetual license model or under a time-based license model.

We recognize revenue related to software arrangements in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. We recognize revenue when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery of the product has occurred; the fee is fixed or determinable; and collectibility is probable. We consider all arrangements with payment terms extending beyond one year to not be fixed or determinable, and revenue under these agreements is recognized as payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected.

SOP 97-2, as amended, generally requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of the elements. Our determination of fair value of each element in multi-element arrangements is based on vendor-specific objective evidence (VSOE). We limit our assessment of VSOE of fair value for each element to either the price charged when the same element is sold separately or the price established by management, having the relevant authority to do so, for an element not yet sold separately.

If evidence of fair value for all undelivered elements exists but evidence does not exist for one or more delivered elements, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. Revenue allocated to maintenance and support is recognized ratably over the maintenance term and revenue allocated to training and other service elements is recognized as the services are performed. The proportion of revenue recognized upon delivery of the software may vary from quarter to quarter depending upon the relative mix of licensing arrangements, the extent of services that will be required to implement the software, and whether VSOE of fair value exists for all of the undelivered elements.

Software arrangements that include professional services are evaluated to determine whether those services are essential to the functionality of the software elements of the arrangement. When services are not considered essential, the revenue allocable to the professional services is recognized as the services are performed. If we provide professional services that are considered essential to the functionality of the software products, both the software product revenue and professional service revenue are recognized in accordance with the provisions of SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. To date, most of our professional services have been considered essential to the functionality of the software and therefore, the majority of our contracts that involved licenses and professional services have been recognized on a percentage of completion basis.

Hosted term-based licenses, where the customer does not have the contractual right to take possession of the software, are accounted for in accordance with Emerging Issues Task Force (EITF) Issue No. 00-03, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity s Hardware. Revenues related to such arrangements are recognized on a monthly basis over the term of the contract. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met.

Table of Contents

Arrangements that include professional services sold with hosted term-based licenses and support offerings are evaluated under EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables, and the Securities and Exchange Commission's Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. To the extent the professional services have value to the customer on a stand-alone basis and there is objective and reliable evidence of fair value of the undelivered elements, the consideration from the arrangement is allocated among the separate elements based upon their relative fair values and professional services revenues are recognized as the services are rendered. Hosted term-based licenses, as well as any professional services that do not meet the above criteria, are recognized ratably over the term of the agreement.

Services revenues

Consulting contracts with fixed-priced arrangements are recognized using the percentage-of-completion method. Percentage-of-completion accounting involves calculating the percentage of services provided during the period compared to the total estimated services to be provided over the duration of the contract. This method is followed where reasonably dependable estimates of the revenues and costs applicable to various elements of a contract can be made. Estimates of total contract revenues and costs are continuously monitored during the term of the contract, and recorded revenues and costs are subject to revision as the contract progresses. Such revisions may result in increases or decreases to revenues and results of operations and are reflected in the consolidated financial statements in the period in which they are first identified.

Consulting services with fees based on time and materials or cost-plus are recognized in accordance with SAB No. 104 as the services are performed (as measured by time incurred) and amounts earned. We consider amounts to be earned once evidence of an arrangement has been obtained, services are delivered, fees are fixed or determinable, and collectibility is reasonably assured. In such contracts, our efforts, measured by time incurred, typically is reflective of progress against the contractual milestones or output measure, which is the contractual earnings pattern. Contingent or incentive revenues relating to consulting contracts are recognized when the contingency is satisfied and we conclude the amounts are earned.

As of and for the three months ended March 31, 2005 and 2004 revenues and amounts due from our largest customers were as follows (in thousands):

Customer	2005			2004		
	Accounts Receivable		% of Total	Accounts Receivable		% of Total
	Balance (a)	Revenues	Revenues	Balance (a)	Revenues	Revenues
A	\$ 905	\$ 966	18.3%	\$ 2,498	\$ 1,966	43.3%
B	1,260	1,193	22.6%	896	941	20.7%
Total	\$ 2,165	\$ 2,159	40.9%	\$ 3,394	\$ 2,907	64.1%

(a) Represents both billed and unbilled amounts

Cost of Software and Software Related

The cost of software and software related is comprised primarily of headcount related costs, including the cost of the Company's customer support function, which is provided to customers as part of recurring maintenance fees, and third-party provided hosting services, as well as related infrastructure costs.

Cost of Services

The cost of services includes the cost of Company and third-party consultants who are primarily responsible for our software implementations and configurations, as well as providing other supply chain consulting services, and related infrastructure costs.

Research and Development

Research and development costs consist primarily of salaries and benefits, consulting, and other related expenses, which are expensed as incurred.

Sales and Marketing

Sales and marketing expenses consist primarily of headcount related costs, as well as incentive compensation for sales and marketing employees, and related travel and infrastructure expenses, as well as third-party marketing costs such as advertising costs. We expense advertising costs as incurred and report such costs as a component of sales and marketing expense.

Table of Contents**General and Administrative**

General and administrative expenses consist primarily of headcount related costs for our executive, administrative, finance, legal, and human resources personnel, as well as equipment leasing and infrastructure costs, insurance, and professional fees.

Stock Options

Stock-based employee compensation is recognized using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under the intrinsic value method, compensation expense is recorded on the date of grant only if the current market price of the stock exceeds the exercise price. For disclosure purposes, pro forma net loss and loss per common share data are provided in accordance with SFAS No. 123, Accounting for Stock-Based Compensation, as if the fair value method had been applied. The following table illustrates the effect on our net loss and loss per common share if the Company had applied the fair value recognition provisions of SFAS No. 123 (in thousands, except for per share data):

	Three months ended	
	March 31,	
	2005	2004
	<u> </u>	<u> </u>
Net loss:		
As reported	\$ (3,189)	\$ (2,229)
Add: Stock-based employee compensation included in reported net loss	220	470
Deduct: Stock-based employee compensation expense determined under fair-value-based method for all awards	(1,355)	(3,422)
	<u> </u>	<u> </u>
Pro forma	\$ (4,324)	\$ (5,181)
	<u> </u>	<u> </u>
Loss per common share basic and diluted:		
As reported	\$ (0.08)	\$ (0.10)
Pro forma	\$ (0.10)	\$ (0.22)

Foreign Currency Translation

We translate the assets and liabilities of international subsidiaries into U.S. dollars at the current rates of exchange in effect as of each balance sheet date. Revenues and expenses are translated using average rates in effect during the period. Foreign currency translation adjustments are included in accumulated other comprehensive loss on the consolidated balance sheet. Foreign currency transaction gains or losses are recognized in current operations and have not been significant to our operating results in any period. In addition, the effect of foreign currency rate changes on cash and cash equivalents has not been significant in any period.

Comprehensive Loss

Edgar Filing: VERTICALNET INC - Form 10-Q

We report comprehensive loss in accordance with the provisions of SFAS No. 130, Reporting Comprehensive Income, which establishes standards for reporting comprehensive loss and its components in financial statements. Comprehensive loss, as defined, includes all changes in equity during a period from non-owner sources.

Computation of Historical Loss Per Common Share

Basic loss per common share is computed using the weighted average number of common shares outstanding during the period, excluding unvested restricted stock grants. Diluted loss per common share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period, including incremental common shares issuable upon the exercise of stock options and warrants (using the treasury stock method), the conversion of our former 5 1/4% convertible subordinated debentures (using the if-converted method) and unvested restricted stock grants. Common equivalent shares are excluded from the calculation if their effect is anti-dilutive.

During the three months ended March 31, 2005 and 2004, the diluted loss per common share calculation was the same as the basic loss per common share calculation as all potentially dilutive securities were anti-dilutive. As a result, for the three months ended March 31, 2005 and 2004, potentially dilutive common shares of 13,414,117 and 9,976,462, respectively, were excluded from the computation of diluted loss per common share. In addition, 355,209 common shares previously held in escrow in connection with the acquisition of Tigris were only included in the loss per share calculation subsequent to their release date of April 30, 2004.

As a result of the B2eMarkets acquisition, there were 752,454 shares of common stock that were held in escrow. Of those held in escrow, 49,527 shares were owed to the prior owners of Adaptivetrade, Inc., a company that was acquired by B2eMarkets in February 2004. These shares were only included in the loss per share calculation subsequent to their release date of February 27, 2005. The remaining 702,927 shares were placed in escrow upon the conversion of a note given as consideration for the acquisition into common stock and are scheduled to be released from escrow during the second quarter of 2005.

Table of Contents

Adoption of New Pronouncement

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R (revised 2004), Share-Based Payment. SFAS No. 123R is a revision of SFAS No. 123 and supersedes APB Opinion No. 25 and its related implementation guidance. SFAS No. 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. SFAS No. 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. With limited exceptions, the amount of compensation costs will be measured based on the grant date fair value of the equity or liability instrument issued. Compensation cost will be recognized over the period that an employee provides service in exchange for the award. Beginning with the first quarter of 2006, we will recognize compensation expense in accordance with SFAS No. 123R. The adoption of this standard for the expensing of stock options is expected to reduce pretax earnings in future years. The impact of adoption of SFAS No. 123R cannot be predicted at this time because it will depend on the level of share-based payments granted in the future and the model we choose to use. However, had we adopted SFAS No. 123R in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described above in *Stock Options*.

(2) Liquidity

We believe that our current level of liquid assets will be sufficient to finance our capital requirements and anticipated operating losses through at least May 31, 2006. However, to the extent that the current levels of liquid assets prove to be insufficient, we may need to further reduce our operating costs or obtain additional debt or equity financing. Additionally, we may, if the capital markets present attractive opportunities, raise cash through the sale of debt or equity. We can provide no assurance that we will be successful in obtaining any required or desired financing either on acceptable terms or at all.

(3) Acquisitions

B2e Markets, Inc.

On July 19, 2004, a wholly-owned direct subsidiary of Verticalnet merged with B2eMarkets, a privately-held provider of Strategic Sourcing software solutions. B2eMarkets' results have been included in the Company's results since July 20, 2004.

The aggregate purchase price of the B2eMarkets acquisition was \$12.9 million, including transaction costs of approximately \$2.4 million, which primarily consisted of fees paid for investment banking, legal, and professional services. The consideration included the issuance of 5,100,000 shares of common stock (31,215 were held in escrow until February 2005), valued on the date of closing at approximately \$6.6 million, and a promissory note in the principal amount of \$5.9 million, which was valued at \$3.9 million on the date of closing. The note plus interest was converted into 3,029,162 shares of Verticalnet common stock, after the conversion of the note was approved by Verticalnet's shareholders at the November 2004 annual shareholders meeting, of which 18,312 shares were held in escrow until February 2005 and 702,927 shares are being held in escrow until the second quarter of 2005. The promissory note had an effective interest rate of 16.6% annum. The interest expense was recorded as a non-cash item in our consolidated statement of cash flows since the accrued interest was not paid in cash when the note was converted.

Edgar Filing: VERTICALNET INC - Form 10-Q

In accordance with SFAS No. 141, Business Combinations, the Company allocated the purchase price to the tangible and intangible assets acquired and the liabilities assumed, based on their estimated fair values. The excess of the purchase price over the fair values was recorded as goodwill. The fair value assigned to intangible assets acquired was based on a valuation performed by an independent third-party valuation firm. The total purchase price was allocated as follows (in thousands):

Current assets	\$ 1,759
Property and equipment	280
Other assets	19
Goodwill	11,499
Intangible assets	3,780
	<hr/>
Total assets acquired	17,337
Current liabilities	(4,429)
	<hr/>
Total purchase price	\$ 12,908
	<hr/>

Table of Contents*Tigris*

On January 30, 2004, a wholly-owned direct subsidiary of Verticalnet merged with and into Tigris, a privately-held strategic sourcing and supply chain consulting firm based in New York City. Tigris' results have been included in the Company's results since January 31, 2004.

The aggregate purchase price of the Tigris acquisition was approximately \$12.1 million, including transaction costs of approximately \$300,000, which primarily consisted of fees paid for professional services. The consideration included \$3.5 million in cash, 1,870,450 shares of our common stock valued on the date of closing at approximately \$5.7 million (355,029 shares were held in escrow until they were released to Tigris shareholder on April 30, 2004), issuance of employee options to purchase 751,670 shares of our common stock valued as of the date of acquisition at \$2.2 million and assumed debt of approximately \$346,000.

In accordance with SFAS No. 141, the Company allocated the purchase price to the tangible and intangible assets acquired and the liabilities assumed, based on their estimated fair values. The excess of the purchase price over the fair values was recorded as goodwill. The fair value assigned to intangible assets acquired was based on a valuation performed by an independent third-party valuation firm. The total purchase price was allocated as follows (in thousands):

Current assets	\$ 3,375
Property and equipment	1,048
Goodwill	4,865
Intangible assets	3,570
	<hr/>
Total assets acquired	12,858
Current liabilities, less assumed debt	(764)
	<hr/>
Total purchase price	\$ 12,094
	<hr/>

Unaudited Pro Forma Information

The unaudited financial information in the table below summarizes the combined results of operations of Verticalnet, B2eMarkets, and Tigris, on a pro forma basis, as though the companies had been combined as of January 1, 2004. This pro forma financial information is presented for informational purposes only and is not necessarily indicative of the results of operations that would have been achieved had the acquisitions taken place at January 1, 2004. The unaudited pro forma information for the three months ended March 31, 2004 combines the historical results for Verticalnet and B2eMarkets for the three months ended March 31, 2004 and the historical results for Tigris for the period January 1 through January 30, 2004. The following pro forma information is in thousands, except per share amounts.

	Three months ended	
	March 31, 2004	
	<hr/>	
Revenue	\$	7,730
Net loss	\$	(3,668)

Edgar Filing: VERTICALNET INC - Form 10-Q

Loss per share	\$	(0.13)
Weighted average shares outstanding		
Basic and diluted		28,619

Table of Contents**(4) Detail of Certain Balance Sheet Accounts**

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

	March 31,	December 31,
	2005	2004
	<u> </u>	<u> </u>
Accounts receivable, trade	\$ 4,891	\$ 5,590
Unbilled accounts receivable	81	274
Retainage	82	72
	<u> </u>	<u> </u>
	5,054	5,936
Less: allowance for doubtful accounts	(34)	(34)
	<u> </u>	<u> </u>
	<u>\$ 5,020</u>	<u>\$ 5,902</u>

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

	March 31,	December 31,
	2005	2004
	<u> </u>	<u> </u>
Software	\$ 1,608	\$ 1,607
Computer equipment	1,543	1,355
Office equipment and furniture	132	132
Leasehold improvements	919	919
	<u> </u>	<u> </u>
	4,202	4,013
Less: accumulated depreciation and amortization	(2,981)	(2,840)
	<u> </u>	<u> </u>
Property and equipment, net	<u>\$ 1,221</u>	<u>\$ 1,173</u>

Depreciation and amortization related to property and equipment was \$141,000 and \$93,000 for the three months ended March 31, 2005 and 2004, respectively. Amortization applicable to property and equipment under capital leases was \$14,000 for both the three months ended March 31, 2005 and 2004, and is included in such expense.

Accounts payable and accrued expenses consist of the following balances (in thousands):

March 31, December 31,

Edgar Filing: VERTICALNET INC - Form 10-Q

	<u>2005</u>	<u>2004</u>
Accounts payable	\$ 1,323	\$ 1,245
Compensation and related costs	811	1,142
Taxes and interest payable	560	584
Acquisition related costs	330	552
Legal and settlement liabilities	300	594
Other	714	876
	<u>\$ 4,038</u>	<u>\$ 4,993</u>

(5) Goodwill and Other Intangibles

Our goodwill balance consists of \$4.9 million from the Tigris acquisition, which occurred in January 2004 and \$11.4 million from the B2eMarkets acquisition, which occurred in July 2004.

The following table reflects the components of amortizable intangible assets as of March 31, 2005 and December 31, 2004 (in thousands).

Table of Contents

	Gross	
	Carrying	Accumulated
	Amount	Amortization
	<u> </u>	<u> </u>
March 31, 2005:		
Acquired technology	\$ 3,575	\$ 2,311
Customer contracts and relationships	6,249	2,625
Non-compete agreements	240	75
	<u> </u>	<u> </u>
	\$ 10,064	\$ 5,011
	<u> </u>	<u> </u>
December 31, 2004:		
Acquired technology	\$ 3,575	\$ 2,173
Customer contracts and relationships	6,235	2,219
Non-compete agreements	240	55
	<u> </u>	<u> </u>
	\$ 10,050	\$ 4,447
	<u> </u>	<u> </u>

(6) Commitments and Contingencies

The following table outlines future minimum lease payments under our capital and operating leases as of March 31, 2005 (in thousands):

	Lease Obligations		
	Operating	Capital (b)	Total
	<u> </u>	<u> </u>	<u> </u>
2005 (a)	\$ 728	\$ 71	\$ 799
2006	795	76	871
2007	515	51	566
2008	413	13	426
2009	290		290
Thereafter	290		290
	<u> </u>	<u> </u>	<u> </u>
Total	\$ 3,031	\$ 211	\$ 3,242
	<u> </u>	<u> </u>	<u> </u>

- (a) Reflects amounts payable over the last nine months of 2005
(b) Capital lease balances exclude future interest obligations.

These future minimum lease payments include all facility leases for which we are contractually committed to make payments as of March 31, 2005.

Edgar Filing: VERTICALNET INC - Form 10-Q

During 2003, we amended our lease with our primary landlord. The amended agreement provided for occupancy of our main facility in Malvern, Pennsylvania until May 2003, with options to continue the lease on a quarterly basis. We have exercised options to continue the lease up to at least August 2005. The Company is considering moving its corporate headquarters and entering into a longer term lease arrangement with the current landlord.

The Company licenses software to its customers under written agreements. Each agreement contains the relevant terms of the contractual arrangement with the customers, and generally includes provisions for indemnifying the customers against losses, expenses, and liabilities from damages that may be awarded against the customer in the event the software is found to infringe upon certain intellectual property rights of a third party. The agreement generally limits the scope of and remedies for such indemnification obligations in a variety of industry-standard respects. The Company has not identified any losses that are probable under these provisions and, accordingly, no liability related to these indemnification provisions has been recorded.

In July 2000, Verticalnet entered into an Opportunity Grant Program Contract with the Commonwealth of Pennsylvania, Department of Community and Economic Development (the PaDCED) whereby Verticalnet received a grant in the amount of \$1.0 million from the PaDCED. The grant was conditioned upon, among other things, the creation of 1,000 full time jobs and that Verticalnet would operate in its former facility in Horsham, PA for at least five years. In July 2000, Atlas Commerce, Inc. (Atlas Commerce) entered into an Opportunity Grant Program Contract with the PaDCED whereby Atlas Commerce received a grant in the amount of \$400,000 from the Commonwealth, which amount was increased to \$600,000 in June 2001. The grant was conditioned upon, among other things, the creation of 250 full time jobs and that Atlas Commerce would operate in its Malvern facility for at least five years. Both

Table of Contents

contracts contained a provision that required repayment of the grant amount in the event the conditions were not met. In December 2001, Verticalnet acquired Atlas Commerce via a merger. In September 2003, the PaDCED filed a Complaint-Civil Action in the Montgomery County Court of Common Pleas seeking to recover the total amount of the grant to Verticalnet. On January 27, 2005, Verticalnet and Atlas Commerce entered into a Settlement and Release Agreement (the Settlement Agreement) with the PaDCED, resolving (i) the above civil action between the PaDCED and Verticalnet, and (ii) the PaDCED's claims against Atlas Commerce. Pursuant to the Settlement Agreement, Verticalnet agreed to pay the PaDCED an aggregate of \$400,000, payable in four equal quarterly installments in full and complete satisfaction of the PaDCED's claims against Verticalnet and Atlas Commerce. The first payment of \$100,000 was made on January 27, 2005, the second payment of \$100,000 was made on April 1, 2005 and successive payments of \$100,000 will be due on July 1, and October 1, 2005.

In March 2005, the Company entered into a \$141,000 capital lease arrangement for computer equipment with a thirty-six month lease term. The interest rate implicit in the lease is 10.2%.

The Company currently has employment agreements with certain senior executives that provide for a minimum level of salaries in 2005, and automatically renew each year unless either party gives at least one-year advance notice of non-renewal. The terms of these agreements include severance and health insurance coverage, ranging from three months to one year, as well as pro rated portions of target bonuses.

(7) Litigation

On June 12, 2001, a class action lawsuit was filed against us and several of our officers and directors in U.S. Federal Court for the Southern District of New York in an action captioned CJA Acquisition, Inc. v. Verticalnet, et al., C.A. No. 01-CV-5241 (the CJA Action). Also named as defendants were four underwriters involved in the issuance and initial public offering (IPO) of our common stock in February 1999—Lehman Brothers Inc., Hambrecht & Quist LLC, Volpe Brown Whelan & Company LLC, and WIT Capital Corporation. The complaint in the CJA Action alleges violations of Sections 11 and 15 of the Securities Act of 1933 (the Securities Act) and Section 20(a) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 promulgated there under, based on, among other things, claims that the four underwriters awarded material portions of the initial shares to certain favored customers in exchange for excessive commissions. The plaintiff also asserts that the underwriters engaged in a practice known as laddering, whereby the clients or customers agreed that in exchange for IPO shares they would purchase additional shares at progressively higher prices after the IPO. With respect to Verticalnet, the complaint alleges that the Company and its officers and directors failed to disclose in the prospectus and the registration statement the existence of these purported excessive commissions and laddering agreements. After the CJA Action was filed, several copycat complaints were filed in U.S. Federal Court for the Southern District of New York. Those complaints, whose allegations mirror those found in the CJA Action, include Ezra Charitable Trust v. Verticalnet, et al., C.A. No. 01-CV-5350; Kofsky v. Verticalnet, et al., C.A. No. 01-CV-5628; Reeberg v. Verticalnet, C.A. No. 01-CV-5730; Lee v. Verticalnet, et al., C.A. No. 01-CV-7385; Hoang v. Verticalnet, et al., C.A. No. 01-CV-6864; Morris v. Verticalnet, et al., C.A. No. 01-CV-9459; and Murphy v. Verticalnet, et al., C.A. No. 01-CV-8084. None of the complaints state the amount of any damages being sought, but do ask the court to award rescissory damages. All of the foregoing suits were amended and consolidated into a single complaint that was filed with the U.S. Federal Court on April 19, 2002. This amended complaint contains additional factual allegations concerning the events discussed in the original complaints, and asserts that, in addition to Sections 11 and 15 of the Securities Act, the Company and our officers and directors also violated Sections 10(b), 20(a), and Rule 10b-5 of the Exchange Act in connection with the IPO. In addition to this amended and consolidated complaint, the plaintiffs in this lawsuit and in the hundreds of other similar suits filed against other companies in connection with IPOs that occurred in the late 1990s have filed master allegations that primarily focus on the conduct of the underwriters of the IPOs, including our IPO. On October 9, 2002, the U.S. Federal Court for the Southern District of New York entered an order dismissing, without prejudice, the claims against the individual Verticalnet officers and directors who had been named as defendants in the various complaints. In February 2003, the District Court entered an order denying a motion made by the defendants to dismiss the actions in their entirety, but granting the motion as to certain of the claims against some defendants. However, the District Court did not dismiss any claims against Verticalnet. On or about June 5, 2003, Verticalnet's counsel, with the approval of the Company's directors, executed a memorandum of understanding on behalf of Verticalnet with respect to a proposed settlement of the plaintiffs' claims against Verticalnet. This proposed resolution of the litigation has been publicly announced (although not yet formally accepted by the plaintiffs) and widely reported in the press. The proposed settlement, if approved by the District Court, would result in, among other things, the dismissal of all claims against Verticalnet, its officers, and directors. Under the present terms of the proposed settlement described above, Verticalnet would also assign its claims against the underwriters to the plaintiffs in the consolidated actions. In February 2005, the District Court preliminarily approved the proposed settlement.

Edgar Filing: VERTICALNET INC - Form 10-Q

On September 30, 2004, the Company was served with a complaint filed against the Company and several of its former officers and directors in the U.S. District Court for the Eastern District of Pennsylvania in an action captioned Jodek Charitable Trust, R.A., Individually and as Assignee of Zvi Schreiber, LLC et al. v. Vertical Net Inc., et al., C.A. No. 04-4455. The complaint alleges that, with regards to the issuance of the Company's stock to the plaintiffs in connection with the Company's acquisition of Tradeum, Inc. in March 2000, the plaintiffs were damaged by the defendants' delays in registering stock, updating the registration of stock, releasing stock from lock-ups and releasing stock from escrows. The plaintiffs claim they sustained damages in excess of \$65.0 million as a result of the decrease in the stock price during the alleged delays. The Company disputes the allegations raised in the complaint and intends to vigorously defend itself.

Table of Contents

We are also a party to various lawsuits and claims that arise in the ordinary course of business. In the opinion of management, the ultimate resolutions with respect to all of the above actions will not have a material adverse effect on our financial position, liquidity, or results of operations.

(8) Capital Stock

In January 2004, we completed a \$7.7 million private placement of our common stock. The Company issued 3,798,592 shares of common stock along with warrants to purchase 949,649 shares of common stock at an exercise price of \$3.72 per share. The Company received approximately \$7.1 million in net proceeds from this transaction.

Table of Contents

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

The information in this report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Any statements contained in this report that are not statements of historical fact may be deemed forward-looking statements. Words such as may, might, will, would, should, could, project, estimate, pro forma, predict, potential, strategy, anticipate, plan to, believe, continue, intend, expect, and words of similar expression (including the negative of any of the foregoing) are intended to identify forward-looking statements. Additionally, forward-looking statements in this report include statements relating to the design, development, and implementation of our products; the strategies underlying our business objectives; the benefits to our customers, and their trading partners, of our products; our liquidity and capital resources; and the impact of our acquisitions and investments on our business, financial condition, and operating results.

Our forward-looking statements are not meant to predict future events or circumstances and may not be realized because they are based upon current expectations that involve risks and uncertainties. Actual results and the timing of certain events may differ materially from those currently expected as a result of these risks and uncertainties. Factors that may cause or contribute to a difference between the expected or desired results and actual results include, but are not limited to, the availability of and terms of equity and debt financing to fund our business; our reliance on the development of our enterprise software business; our ability to continue to remain listed on the Nasdaq SmallCap Market; competition in our target markets; economic conditions in general and in our specific target markets; our ability to use and protect our intellectual property; and our ability to attract and retain qualified personnel, as well as the risks discussed in the section of this report entitled Factors Affecting Our Business Condition. Given these uncertainties, investors are cautioned not to place undue reliance on our forward-looking statements. We disclaim any obligation to update these factors or to announce publicly the results of any revisions to any of the forward-looking statements contained in this report to reflect future events or developments.

Company Overview

We are a provider of Supply Management solutions to Global 2000 companies. We provide a full scope of Supply Management software, services, and domain expertise in areas that include: Program Management, Spend Analysis, eSourcing, Advanced Sourcing, Contract Management, and Supplier Performance Management. Our solutions help our customers to save money on the goods and services they buy.

Verticalnet's software customers license our software via a perpetual license or time-based license. Our software is licensed by module, with our customers selecting from modules that include: Spend Manager, Program Manager, Negotiation Manager, Contract Manager, and Performance Manager. Verticalnet employs technical consultants to provide project management and training during software implementation. In addition to traditional software installation and ASP hosting, Verticalnet offers the majority of its software products in an On-Demand delivery model. On-Demand delivery enables our customers to pay a single annual fee that includes software license, maintenance, application hosting, customer/community support, and training. The Company believes that its On-Demand delivery model mitigates the software implementation costs for its customers, and reduces the obstacles to a successful supply management initiative.

In addition to implementation services, our consultants provide customers with supply management business process consulting, primarily in the areas of Spend Analysis and Advanced Sourcing. Our customers typically pay for professional services at an hourly rate for the time it takes us to complete the project. Most professional services engagements also include short-term licenses of Verticalnet technology required to complete the engagement. Examples of such technology include our Advanced Bid Collection and Bid Analysis Optimization software.

In addition to our packaged applications and implementation services, Verticalnet offers custom software development for customers that desire to build additional supply management capabilities. Verticalnet's Solution Center works with clients to define custom development requirements and build out the required functionality. Verticalnet offers a flexible software platform that enables rapid, cost effective custom development for customers with advanced, complex requirements. Our Solution Center approach allows Verticalnet to complete customization projects more quickly and cost effectively than internal IT organizations or traditional custom development firms.

Historically, we derived our revenue primarily from the licensing of our software, as well as implementation and development services. As a result of the January 2004 acquisition of Tigris Corp (Tigris), we also generate revenues from spend analysis and other supply chain consulting services and as a result of the July 2004 acquisition of B2eMarkets, Inc. (B2eMarkets), we have seen an increase in the amount of our revenue coming from the licensing of our products and maintenance.

Table of Contents**RESULTS OF CONTINUING OPERATIONS FOR THE THREE MONTHS ENDED****MARCH 31, 2005 AND 2004**

The following table sets forth statement of operations data expressed as a percentage of total revenue for the periods indicated:

	Three months ended	
	March 31,	
	2005	2004
Revenues:		
Software and software related	28.7%	12.1%
Services	71.3%	87.9%
Total revenues	100.0%	100.0%
Cost of revenues:		
Cost of software and software related	13.2%	5.6%
Cost of services	36.9%	34.0%
Amortization of acquired technology and customer contracts	4.5%	7.2%
Total cost of revenues	54.7%	46.8%
Gross profit	45.3%	53.2%
Operating expenses:		
Research and development	32.4%	26.4%
Sales and marketing	35.1%	23.5%
General and administrative	28.7%	33.0%
Stock-based compensation	4.2%	10.4%
Amortization of other intangible assets	6.1%	2.9%
Total operating expenses	106.5%	96.1%
Operating loss	(61.2)%	(42.9)%
Interest and other expense (income), net	(0.8)%	6.2%
Net loss	(60.4)%	(49.1)%

EMPLOYEE HEADCOUNT BY CLASSIFICATION**March 31,**

	2005			2004		
	Dedicated			Dedicated		
	Offshore			Offshore		
	Employees	Consultants	Total	Employees	Consultants	Total
Cost of revenues	74		74	55		55
Research and development	29	38	67	24	22	46
Sales and marketing	30		30	17		17
General and administrative	23		23	16		16
Total	156	38	194	112	22	134

Table of Contents**REVENUES**

<i>(in thousands)</i>	Three months ended			
	March 31,		Difference	
	2005	2004	\$	%
Software and software related	\$ 1,515	\$ 549	\$ 966	176.0%
Services	3,761	3,987	(226)	(5.7)%
Total revenues	\$ 5,276	\$ 4,536	\$ 740	16.3%

Software and software related revenues are comprised of software licenses, hosting, and maintenance revenues. Services revenues represent revenue derived from consulting services.

The increase in total revenues of \$740,000 for the three months ended March 31, 2005 compared to the corresponding period in 2004 is primarily due to the Tigris acquisition, which occurred on January 30, 2004, and the B2eMarkets acquisition, which occurred on July 19, 2004.

Revenues during the three months ended March 31, 2005 decreased by approximately \$2.5 million or 31.7%, compared to the pro forma basis, reflecting the combined results of Verticalnet, B2eMarkets, and Tigris (see Note 3 to the consolidated financial statements). Although revenue decreased on a pro forma basis, net loss improved by approximately \$479,000 due to cost cuts initiated by B2eMarkets prior to the acquisition and expense controls put in place by Verticalnet.

Revenue Concentration

As of and for the three months ended March 31, 2005 and 2004, revenues and amounts due from our largest customers were as follows (in thousands):

Customer	2005			2004		
	Accounts Receivable		% of Total	Accounts Receivable		% of Total
	Balance (a)	Revenues	Revenues	Balance (a)	Revenues	Revenues
A	\$ 905	\$ 966	18.3%	\$ 2,498	\$ 1,966	43.3%
B	1,260	1,193	22.6%	896	941	20.7%

Edgar Filing: VERTICALNET INC - Form 10-Q

Total	<u>\$ 2,165</u>	<u>\$ 2,159</u>	<u>40.9%</u>	<u>\$ 3,394</u>	<u>\$ 2,907</u>	<u>64.1%</u>
--------------	-----------------	-----------------	--------------	-----------------	-----------------	--------------

(a) Represents both billed and unbilled amounts

We have been able to reduce our customer concentration during 2005 by growing revenues from all other customers by 91%. We believe that we have made considerable progress in lowering our revenue concentration from our top customers by increasing our total number of active customers and total revenues being generated from them. As of March 31, 2005, we had 61 active customers as compared to 26 as of March 31, 2004.

COST OF REVENUES

<i>(in thousands)</i>	Three months ended			
	March 31,		Difference	
	2005	2004	\$	%
Cost of software and software related	\$ 699	\$ 256	\$ 443	173.0%
Cost of services	1,947	1,540	407	26.4%
Amortization of acquired technology and customer contracts	239	325	(86)	(26.5)%
Total cost of revenues	\$ 2,885	\$ 2,121	\$ 764	36.0%

Cost of Software and Software Related

The cost of software and software related is comprised primarily of headcount related costs, including the cost of the Company's customer support function, which is provided to customers as part of recurring maintenance fees, and third-party provided hosting services, as well as related infrastructure costs. Also included is the cost of royalties on technology contained in our products that is licensed from third parties. The increase in software and software related costs of \$443,000 during the three months ended March 31, 2005 was primarily related to the acquisition of B2eMarkets, which accounted for an increase of approximately \$399,000. During the three months ended March 31, 2005, headcount and other related costs increased by \$16,000 and \$28,000, respectively as compared to the comparable period in 2004.

Table of Contents**Cost of Services**

The cost of services includes the cost of Company and third-party consultants who are primarily responsible for the software implementations and configurations, as well as providing other supply chain consulting services, and related infrastructure costs. The increase in the three months ended March 31, 2005 was primarily due to the Tigris and B2eMarkets acquisitions that occurred in January and July of 2004, respectively. The addition of the Tigris and B2eMarkets businesses represented \$167,000 and \$365,000 of the increase for the three months ended March 31, 2005, respectively. Historical Verticalnet headcount, third party consulting, and other related costs decreased by \$68,000, \$16,000 and \$81,000 in the three months ended March 31, 2005, respectively. These costs were partially offset by an increase in travel and facilities related costs of \$40,000.

Amortization of Acquired Technology and Customer Contracts

Amortization of acquired technology and customer contracts decreased due to the completion of amortization on the acquired technology that was obtained from the Atlas Commerce acquisition in 2001. The decrease in amortization from the Atlas Commerce acquisition of \$224,000 was partially offset by the increase in amortization related to the Tigris and B2eMarkets acquisitions of \$138,000.

OPERATING EXPENSES

	Three months ended			
	March 31,		Difference	
	2005	2004	\$	%
<i>(in thousands)</i>				
Research and development	\$ 1,711	\$ 1,197	\$ 514	42.9%
Sales and marketing	1,853	1,066	787	73.8%
General and administrative	1,512	1,495	17	1.1%
Stock-based compensation	220	470	(250)	(53.2)%
Amortization of other intangible assets	324	131	193	147.3%
Total operating expenses	\$ 5,620	\$ 4,359	\$ 1,261	28.9%

Research and Development

Research and development costs consist primarily of headcount related costs of the Company's product strategy, development and testing employees and off-shore development contractors, as well as related infrastructure costs. The increase in research and development costs was primarily the result of the addition of the B2eMarkets business, which represents \$673,000 of the increase for the three months ended March 31, 2005 as compared to the same period in 2004. As a result of the increase in demand for our product and services, we have expanded the use of our offshore development provider. The Company's offshore development initiative started during the third quarter of 2003, whereby a significant portion of our product development operations were shifted to India. Although offshore development costs represented \$99,000 of the

Edgar Filing: VERTICALNET INC - Form 10-Q

increase in research and development costs for the three months ended March 31, 2005, as compared to the same period in 2004, the cost to hire and maintain the same number of employees on-shore would have resulted in a much larger increase in headcount related costs. These costs were offset by a decrease in third-party consulting (other than off-shore development), infrastructure and other related costs of \$113,000. In addition, historical Verticalnet headcount related costs decreased by \$145,000 for the three months ended March 31, 2005, as compared to the same period in 2004.

As of March 31, 2005, the Company had a total of 67 people dedicated to development, which includes 38 dedicated offshore developers not directly employed by Verticalnet, compared to a total development headcount of 46, including 22 dedicated offshore developers not directly employed by Verticalnet, as of March 31, 2004.

Sales and Marketing

Sales and marketing expenses consist primarily of headcount related costs, as well as incentive compensation for sales and marketing employees, related travel and infrastructure expenses, and third-party marketing costs. Sales and marketing expense increased \$787,000 for the three months ended March 31, 2005 as compared to the same period in 2004. The increase in sales and marketing expenses was primarily a result of the Tigris and B2eMarkets acquisitions, which represented \$279,000 and \$362,000 of the increase for the three months ended March 31, 2005 as compared to the three months ended March 31, 2004, respectively. Headcount related costs and direct marketing expenses, such as advertising, public relations, and trade shows, increased by \$124,000 and \$97,000, respectively for the three months ended March 31, 2005 as compared to the three months ended March 31, 2004. These costs were partially offset by a decrease in general consulting and other sales and marketing costs of \$75,000.

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

General and administrative expenses consist primarily of headcount related costs for our executive, administrative, finance, legal, and human resources personnel, as well as equipment leasing and related infrastructure costs. In addition, general and administrative expenses include Directors and Officers insurance, and audit, legal, and other professional fees. General and administrative expenses for the three months ended March 31, 2005 increased compared to the same period in 2004, primarily due to the Tigris and B2eMarkets acquisitions, which represented \$47,000 and \$207,000 of the increase, respectively. In addition, other general and administrative expenses, including professional services, infrastructure, travel and entertainment, and other related costs increased by approximately \$18,000. These costs were offset by a decrease in historical Verticalnet headcount related cost and insurance of approximately \$95,000 and \$160,000, respectively.

Stock-based Compensation

The decrease in stock-based compensation expense for the three months ended March 31, 2005 as compared to the same period in 2004 was a result of the full amortization during the three months ended March 31, 2004 of the discounted stock options granted under the Company's 2003 bonus plan, which awarded discounted stock options to the Company's employees in lieu of cash compensation.

Amortization of Other Intangible Assets

The increase in amortization of other intangible assets during the three months ended March 31, 2005 as compared to the same period in 2004 was due to the amortization of intangible assets resulting from the Tigris and B2eMarkets acquisitions which occurred in January 2004 and July 2004, respectively.

Interest and Other Expense (Income), Net

Interest and other expense (income), net were comprised of the following (in thousands):

	Three months ended	
	March 31,	
	2004	2004
Interest expense (income), net	\$ (37)	\$ 3
Transaction loss (gain)	(6)	1
Gain on asset disposal	(5)	
Warrant mark-to-market adjustment		281
Other	8	

Edgar Filing: VERTICALNET INC - Form 10-Q

Interest and other expense (income), net	\$ (40)	\$ 285
--	---------	--------

In February 2004, holders of 320,000 warrants exercised their warrants to purchase common shares at \$1.20 per share. The Company received approximately \$345,000 in net proceeds from the exercise of these warrants and during the three months ended March 31, 2004, recorded a \$281,000 non-cash charge to earnings as a result of mark-to-market adjustments relating to the fair value of the associated warrant liability up to the time of exercise.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES**

The following table highlights key financial measurements of the Company:

<i>(in thousands)</i>	March 31,	December 31,
	2005	2004
Cash and cash equivalents	\$ 6,675	\$ 9,370
Accounts receivable, net	\$ 5,020	\$ 5,902
Working capital	\$ 5,352	\$ 7,863
Current ratio	1.67	1.96
Total debt, including current portion	\$ 785	\$ 113
	Three months ended	
	March 31,	
	2005	2004
Cash flow activities:		
Net cash used in operating activities	\$ (2,485)	\$ (703)
Net cash used in investing activities	(48)	(4,065)
Net cash provided by (used in) financing activities	(100)	7,437

Historically, the Company has funded itself through the sale of equity and debt instruments, as well as revenue from operations.

Operating activities

During the three months ended March 31, 2005, net cash used in operating activities was approximately \$2.5 million and was primarily a result of the net loss from operations of \$3.2 million and the decrease in accounts payable and accrued expenses of \$977,000, offset by \$925,000 in non-cash charges, and a decrease of \$822,000 in accounts receivable.

As a result of the decrease in revenue generated from one of our largest customers, as well as the B2eMarkets acquisition (see Note 3 to the consolidated financial statements), we have experienced a negative impact on our operating cash flows. This has occurred as a result of assumed vendor payables and severance costs, as well as integration costs. In the long term, we believe the acquisition will help us achieve increased software and software related revenues, reduced customer concentration, and improved visibility. We believe that the short term increase in cash used by operations will be more than offset by the growth opportunities for the combined business.

Investing activities

Edgar Filing: VERTICALNET INC - Form 10-Q

During the three months ended March 31, 2005, net cash used in investing activities was approximately \$48,000 and consisted entirely of capital expenditures.

Financing activities

During the three months ended March 31, 2005, net cash used in financing activities was approximately \$100,000 which relates to \$102,000 in principal payments on long-term debt and capital lease obligations, offset by \$2,000 in proceeds from the exercise of stock options.

We believe that our level of liquid assets will be sufficient to finance our capital requirements and anticipated operating losses through at least May 31, 2006. However, to the extent that the current levels of liquid assets prove to be insufficient, we may need to further reduce our operating costs or obtain additional debt or equity financing. Additionally, we may, if the capital markets present attractive opportunities, raise cash through the sale of debt or equity. We can provide no assurance that we will be successful in obtaining any required or desired financing either on acceptable terms or at all.

Part of our growth strategy is to pursue strategic acquisitions of businesses. We have made acquisitions in the past, and intend to make acquisitions in the future. Historically, we have financed our acquisitions with the proceeds of our private placements, cash on hand, and shares of our common stock. We expect to finance any future acquisitions with cash generated by operations, additional sales or issuances of shares of our common stock, or a combination of the foregoing.

Table of Contents**Contractual Commitments**

The following table outlines future contractual commitments (see Note 6 to the consolidated financial statements):

Expected Cash Payment by Period

(in thousands)

	Due after						Total
	2005(a)	2006	2007	2008	2009	2010	
Operating leases	\$ 728	\$ 795	\$ 515	\$ 413	\$ 290	\$ 290	\$ 3,031
Capital leases (b)	83	86	55	14			238
PaDCED grant settlement	300						300
Insurance financing (c)	561						561
Employment agreements (d)	1,069	53					1,122
Other obligations (e)	444	47	40	12			543
Total	\$ 3,185	\$ 981	\$ 610	\$ 439	\$ 290	\$ 290	\$ 5,795

(a) Reflects amount payable over the last nine months of 2005.

(b) Capital lease balances include future interest obligations.

(c) Relates to insurance policy financing.

(d) Represents minimum salaries due to certain executives based on existing employment agreements. In addition, these agreements provide for additional payments upon employee separation of approximately \$1.2 million.

(e) Relates to third-party hosting facilities and minimum off-shore development resources commitments.

Off-Balance Sheet Arrangements

We do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as special purpose entities (SPEs) or variable interest entities (VIEs), which would have been established for the purpose of facilitating off-balance sheet arrangements or other limited purposes. As of March 31, 2005 and December 31, 2004, we were not involved with any unconsolidated SPEs or VIEs and we had no derivatives.

FACTORS AFFECTING OUR BUSINESS CONDITION

We may require additional capital for our operations and obligations, and, as a result, we are exploring alternatives to preserve and enhance value.

Edgar Filing: VERTICALNET INC - Form 10-Q

Although, based on our most recent projections, we believe our current level of liquid assets and the expected cash flows from contractual revenue arrangements will be sufficient to finance our capital requirements and anticipated operating losses through at least May 31, 2006, any projection of future long-term cash needs and cash flows are inherently subject to uncertainty. There is no assurance that our resources will be sufficient for anticipated or unanticipated working capital and capital expenditure requirements during this period. We may need, or find it advantageous, to raise additional funds in the future to fund our growth, pursue sales and licensing opportunities, develop new or enhanced products and services, respond to competitive pressures, or acquire complementary businesses, technologies, or services.

If we are ultimately unable, for any reason, to receive cash payments expected from our customers, our business, financial condition, and results of operations may be materially and adversely affected.

We may not generate an operating profit.

As of March 31, 2005, our accumulated deficit was approximately \$1.2 billion. We may never again generate an operating profit or, even if we do become profitable from operations at some point, we may be unable to sustain that profitability.

We generate a significant portion of our revenues and accounts receivable from two customers.

During the three months ended March 31, 2005, two customers accounted for \$2.2 million or 41% of our total revenues. During the three months ended March 31, 2004, these same two customers accounted for \$2.9 million or 64% of our total revenue. A termination of our professional services by either of these customers could have a material adverse effect on our business, operating results, and financial condition.

Table of Contents

As of March 31, 2005, these two largest customers accounted for \$2.2 million of our accounts receivable balance. As of May 11, 2005, approximately \$704,000 of the March 31, 2005 balance for these two customers remained outstanding. Although we have had a successful collection history with these two customers, and do not foresee any collection issues, there can be no assurance that we will be able to collect these outstanding balances and future invoices.

We have contractual obligations to provide consulting services over many periods.

We maintain a professional services and consulting workforce to fulfill contracts that we enter into with our customers that may extend over multiple periods. Our profitability is largely a function of performing against customer contractual arrangements within the estimated costs to perform these obligations. If we exceed these estimated costs, our profitability under these contracts may be negatively impacted. In addition, if we are not able to obtain sufficient work to keep all of our professionals on revenue generating projects, our business, financial condition, and results of operations may be adversely affected.

If we fail to meet client expectations in the performance of our services, our business could suffer.

Our failure to meet client expectations in the performance of our services, including the quality, cost, and timeliness of our services, may adversely affect our ability to attract and retain clients. If a client is not satisfied with our services, we will generally spend additional human and other resources at our own expense to ensure client satisfaction. Such expenditures will typically result in a lower margin on such engagements and could have a material adverse effect on our business, financial condition, and results of operations.

We may be unable to maintain our listing on the Nasdaq SmallCap Market, which could cause our stock price to fall and decrease the liquidity of our common stock.

Our common stock is currently listed on the Nasdaq SmallCap Market. A continued listing on the Nasdaq SmallCap Market requires us to meet certain qualitative standards, including maintaining a certain number of independent Board members and independent Audit Committee members, and certain quantitative standards, including that we maintain \$2.5 million in shareholders' equity and that the closing price of our common stock not be less than \$1.00 per share for 30 consecutive trading days. Our stock closed below \$1.00 for 43 consecutive trading days as of May 12, 2005. On April 27, 2005, we received written notification from The Nasdaq Stock Market that the bid price of our common stock for the last 30 consecutive trading days had closed below the minimum \$1.00 per share required for continued listing under Nasdaq Marketplace Rule 4310(c)(4) (the "Rule"). Pursuant to Nasdaq Marketplace Rule 4310(c)(8)(D), the Company has been provided an initial period of 180 calendar days, or until October 24, 2005, to regain compliance. The notice states that the Nasdaq staff (the "Staff") will provide written notification that the Company has achieved compliance with the Rule if at any time before October 24, 2005, the bid price of the Company's common stock closes at \$1.00 per share or more for a minimum of 10 consecutive business days, although the notice also states that the Staff has the discretion to require compliance for a period in excess of 10 consecutive business days, but generally no more than 20 consecutive business days, under certain circumstances.

If the Company cannot demonstrate compliance with the Rule by October 24, 2005, the Staff will determine whether the Company meets the Nasdaq SmallCap Market initial listing criteria as set forth in Marketplace Rule 4310(c), except for the bid price requirement. If the Company meets the initial listing criteria, the Staff will notify the Company that it has been granted an additional 180 calendar days compliance period. If the Company is not eligible for an additional compliance period, the Staff will provide written notice that the Company's securities will be delisted. At that time, the Company may appeal the Staff's determination to de-list its securities to a Listing Qualifications Panel.

We expect to regain compliance with Nasdaq's listing qualifications for continued listing of our stock. However, there can be no assurance that we will be able to meet all qualitative and quantitative listing qualifications in the future. In the event we do not meet such listing qualifications, our common stock could be subject to delisting from the Nasdaq SmallCap Market.

If our stock is delisted from the Nasdaq SmallCap Market or our share price declines significantly, then our stock may be deemed to be penny stock.

If our common stock is considered penny stock, it would be subject to rules that impose additional sales practices on broker-dealers who sell our securities. Because of these additional obligations, some brokers may be unwilling to effect transactions in our stock. This could have an adverse effect on the liquidity of our common stock and the ability of investors to sell their common stock. For example, broker-dealers must make a special suitability determination for the purchaser and have received the purchaser's written consent to the transaction prior to sale. Also, a disclosure schedule must be prepared prior to any transaction involving a penny stock and disclosure is required about sales commissions payable to both the broker-dealer and the registered representative and current quotations for the securities. Monthly statements are required to be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stock.

Table of Contents

If our stock is delisted from the Nasdaq SmallCap Market, we may be unable to license our products and sell our services to prospective or existing customers.

If our stock is delisted, our prospective and existing customers may lose confidence that we can continue as a viable business to provide support necessary to further develop our solutions and provide ongoing maintenance and consulting services. Prospective and existing customers could consider alternative solutions or significantly reduce the value they are willing to pay for our solutions to compensate for the potential added risk to their business. If our stock is delisted, our ability to meet our revenue goals could be adversely impacted, resulting in deterioration of the financial condition of our business.

Our success depends on our ability to retain key management personnel, whom we may not be able to retain.

We believe that our success depends on the continued employment of our senior management team. If one or more members of our senior management team were unable or unwilling to continue in their present positions, our success could be adversely affected.

We may not be able to hire or retain enough additional personnel to meet our hiring needs.

Our success also depends on having highly trained professional services and software development personnel. If we are unable to retain our personnel, it could limit our ability to service our customers and design and develop products, which could reduce our attractiveness to potential customers, investors, or acquirers. We may need to hire additional personnel if our business grows. A shortage in the number of trained consultants and developers could limit our ability to implement our software if we are able to license software to new customers or if our present customers ask us to perform more services for them. Competition for personnel, particularly for employees with technical expertise, could be strong. Our business, financial condition, and operating results will be materially adversely affected if we cannot hire and retain suitable personnel.

Fluctuations in our quarterly operating results may cause our stock price to decline.

Our quarterly operating results are difficult to forecast and could vary significantly. If our operating results in a future quarter or quarters do not meet the expectations of securities analysts or investors, the price of our common stock may fall. Our quarterly operating results will be substantially dependent on software licenses and professional services booked and delivered in that quarter. Any delay in the recognition of revenue for any of our license transactions or professional services could cause significant variations in our quarterly operating results and could cause our revenues to fall significantly short of anticipated levels. We also expect that our quarterly operating results will fluctuate significantly due to other factors, many of which are beyond our control, including:

anticipated lengthy sales cycle for our products;

the size and timing of individual license transactions;

intense and increased competition in our target markets;

our ability to develop, introduce, and bring to market new products and services, or enhancements to our existing products and services, on a timely basis; and

risks associated with past acquisitions.

If we are able to grow our business, we may not be able to manage the growth successfully.

If we are able to grow our business, such growth could place a significant strain on our resources and systems. To manage our growth, we must implement systems and train and manage our employees. In addition, we may not be able to limit our exposure to non-creditworthy customers.

We may seek to acquire another business or raise additional capital, which could dilute the ownership of our existing shareholders.

We may seek to grow our business by acquiring another business. In addition, we may seek to raise additional capital. We may be required to incur debt or issue equity securities to pay for acquisitions or to raise additional capital, which may be dilutive to our existing shareholders.

New versions and releases of our products may contain errors or defects.

Our enterprise software products may contain undetected errors or failures when first introduced or as new versions are released. This may result in loss of, or delay in, market acceptance of our products. Errors in new releases and new products after their introduction could result in delays in release, lost revenues, and customer frustration during the period required to correct these errors. We may in the future discover errors and defects in new releases or new products after they are shipped or released.

Table of Contents

We utilize third-party software that we incorporate into and include with our products and solutions, and impaired relations with these third-parties, defects in third-party software, or their inability or failure to enhance their software over time could have a material adverse effect on our operating performance and financial condition.

We incorporate and include third-party software into and with our products and solutions. We are likely to incorporate and include additional third-party software into and with our products and solutions as we expand our product offerings. If our relations with any of these third-party software providers become impaired, and if we are unable to obtain or develop a replacement for the software, our business could be harmed. Our products may be impacted if errors occur in the third-party software that we utilize. It may be more difficult for us to correct any defects in third-party software because the software is not within our control. Accordingly, our business could be adversely affected in the event of any errors in this software. There can be no assurance that these third-parties will continue to invest the appropriate levels of resources in their products and services to maintain and enhance the capabilities of their software.

We have shifted a significant portion of our product development operations to India, which poses significant risks.

Since September 2003, an unrelated third-party has provided us with software development services in Bangalore, India. We assumed a second software development agreement with another company in Bangalore in connection with our acquisition of B2eMarkets. Since September 2003, we have increased the proportion of our product development work being performed by contractors in India in order to take advantage of cost efficiencies associated with India's lower wage scale. However, we may not achieve the cost savings and other benefits we anticipate from this program and we may not be able to find sufficient numbers of developers with the necessary skill sets in India to meet our needs. We have a heightened risk exposure to changes in the economic, security, and political conditions of India. Economic and political instability, military actions, and other unforeseen occurrences in India could impair our ability to develop and introduce new software applications and functionality in a timely manner, which could put our products at a competitive disadvantage whereby we lose existing customers and/or fail to attract new customers.

Our target markets are evolving and characterized by rapid technological change, with which we may not be able to keep pace.

The markets for our products and services are evolving and characterized by rapid technological change, changing customer needs, evolving industry standards, and frequent new product and service announcements. The introduction of products employing new technologies and emerging industry standards could render our existing products or services obsolete or unmarketable. If we are unable to respond to these developments successfully or do not respond in a cost-effective way, our business, financial condition, and operating results will suffer. To be successful, we must continually improve and enhance the responsiveness, services, and features of our enterprise software products and introduce and deliver new product and service offerings and new releases of existing products. We may fail to improve or enhance our software products or fail to introduce and deliver new releases or new offerings on a timely and cost-effective basis or at all. If we experience delays in the future with respect to our software products, or if our improvements, enhancements, offerings, or releases to these products do not achieve market acceptance, we could experience a delay or loss of revenues and customer dissatisfaction. Our success will also depend in part on our ability to acquire or license third-party technologies that are useful in our business, which we may not be able to do.

We may ultimately be unable to compete in the markets for the products and services we offer.

The markets for our enterprise software products and services are intensely competitive, which may result in low or negative profit margins and difficulty in achieving market share, either of which could seriously harm our business. We expect the intensity of competition to increase. Our enterprise software products and services face competition from software companies whose products or services compete with a particular aspect

Edgar Filing: VERTICALNET INC - Form 10-Q

of the solution we provide, as well as several major enterprise software developers and consulting firms. Many of our competitors have longer operating histories, greater brand recognition, and greater financial, technical, marketing, and other resources than we do, and may have well-established relationships with our existing and prospective customers. This may place us at a disadvantage in responding to our competitors pricing strategies, technological advances, advertising campaigns, strategic partnerships, and other initiatives. Our competitors may also develop products or services that are superior to or have greater market acceptance than ours. If we are unable to compete successfully against our competitors, our business, financial condition, and operating results would be negatively impacted.

We have had decreases in the fair value, and in some cases a complete loss, of our equity investments.

As of March 31, 2005, we held a cost method investment with a carrying value of \$606,000. We may never realize any return on our equity interests that we continue to hold, and we may suffer a complete loss of this interest, which could materially and adversely affect our business, financial condition, and operating results.

Table of Contents

If we do not develop the Verticalnet brand in the supply management solution industry, our revenues might not increase.

We must establish and continuously strengthen the awareness of the Verticalnet brand in the supply management solution industry. If our brand awareness as a maker of supply management solution software does not develop, or if developed, is not sustained as a respected brand, it could decrease the attractiveness of our products and services to potential customers, which could result in decreased revenues.

We may not be able to protect our proprietary rights and may infringe the proprietary rights of others.

Proprietary rights are important to our success and to our competitive position. We may be unable to register, maintain, and protect our proprietary rights adequately or to prevent others from claiming violations of their proprietary rights. Although we file copyright registrations for the source code underlying our software, enforcement of our rights might be too difficult and costly for us to pursue effectively. We have filed patent applications for the proprietary technology underlying our software, but our ability to fully protect this technology is contingent upon the ultimate issuance of the corresponding patents. Effective patent, copyright, and trade secret protection of our software may be unavailable or limited in certain countries.

Several lawsuits have been brought against us and the outcome of these lawsuits is uncertain.

Several lawsuits have been brought against us and the underwriters of our stock in our initial public offering. These lawsuits allege, among other things, that the underwriters engaged in sales practices that had the effect of inflating our stock price, and that our prospectus for that offering was materially misleading because it did not disclose these sales practices. In addition, a lawsuit has been brought against us and several of our former officers and directors alleging, among other things, that we failed to properly register certain Verticalnet stock delivered pursuant to an acquisition in 2000. We intend to vigorously defend ourselves against these lawsuits; however, no assurance can be given as to the outcome of these lawsuits.

Shares eligible for future sale by our current or future shareholders may cause our stock price to decline.

If our shareholders or option and warrant holders sell substantial amounts of our common stock in the public market, including shares issued in completed or future acquisitions or upon the exercise of outstanding options and warrants, then the market price of our common stock could fall. As of March 31, 2005, the holders of 2,476,192 shares of common stock and warrants to purchase 62,703 shares of common stock have demand and/or piggyback registration rights. The exercise of such rights could adversely affect the market price of our common stock. We also have filed a shelf registration statement to facilitate our acquisition strategy, as well as registration statements to register shares of common stock under our equity compensation and employee stock purchase plans. Shares issued pursuant to existing or future shelf registration statements, upon exercise of stock options and warrants, and in connection with our employee stock purchase plan will be eligible for resale in the public market without restriction.

Anti-takeover provisions and our right to issue preferred stock could make a third-party acquisition of us difficult.

Edgar Filing: VERTICALNET INC - Form 10-Q

Verticalnet is a Pennsylvania corporation. Anti-takeover provisions of Pennsylvania law could make it more difficult for a third party to acquire control of us, even if such change in control would be beneficial to our shareholders. Our articles of incorporation provide that our Board of Directors may issue preferred stock without shareholder approval. In addition, our bylaws provide for a classified board, with each board member serving a staggered three-year term. The issuance of preferred stock and the existence of a classified board could make it more difficult for a third party to acquire us.

Our common stock price is likely to remain highly volatile.

The market for stocks of technology companies has been highly volatile since our initial public offering in 1999. Throughout this period, the market price of our common stock has reached extreme highs and lows, and our daily trading volume has been, and will likely continue to be, highly volatile. Investors may not be able to resell their shares of our common stock following periods of price or trading volume volatility because of the market's adverse reaction to such volatility. Factors that could cause volatility in our stock price and trading volume, in some cases regardless of our operating performance, include, among other things:

general economic conditions, including suppressed demand for technology products and services;

actual or anticipated variations in quarterly operating results;

announcements of technological innovations;

new products or services;

changes in the market valuations of other software or technology companies;

failure to meet analysts' or investors' expectations;

announcements by us or our competitors of significant acquisitions, strategic partnerships, or joint ventures;

our cash position and cash commitments;

Table of Contents

our prospects for enterprise software sales and new customers; and

additions or departures of key personnel.

Acquisitions may disrupt or otherwise have a negative impact on our business.

We have made, and plan to continue to make, investments in and acquisitions of complementary companies, technologies, and assets. Future and past acquisitions are subject to the following risks:

acquisitions may cause a disruption in our ongoing business, distract our management and other resources, and make it difficult to maintain our standards, controls, and procedures;

we may acquire companies in markets in which we have little experience;

we may not be able to successfully integrate the services, products, and personnel of any acquisition into our operations;

we may be required to incur debt or issue equity securities, which may be dilutive to existing shareholders, to pay for the acquisitions;

we may be exposed to unknown or undisclosed liabilities; and

our acquisitions may not result in any return on our investment and we may lose our entire investment.

Interruptions or delays in service from our third-party Web hosting facility could impair the delivery of our service and harm our business.

We provide our service through computer hardware that is currently located in a third-party Web hosting facility in Dulles, Virginia operated by ServerVault, Inc. We do not control the operation of this facility, and it may be subject to damage or interruption from floods, fires, power loss, telecommunications failures, and similar events. It may also be subject to break-ins, sabotage, intentional acts of vandalism, and similar misconduct. Despite precautions taken at the facility, the occurrence of a natural disaster, a decision to close the facility without adequate notice, or other unanticipated problems at the facility could result in lengthy interruptions in our service. In addition, the failure by the ServerVault facility to provide our required data communications capacity could result in interruptions in our service. While we are not aware of any such interruptions, if an actual or perceived interruption of our applications occurred or if our applications become unstable or unavailable, the perception by existing or potential customers of our applications could be harmed and we could lose sales and customers. In addition we may be subject to service level penalties, which could materially and adversely affect our business, financial condition, and operating results.

If our security measures are breached and unauthorized access is obtained to a customer's data, our on-demand applications may be perceived as not being secure and customers may curtail or stop using our service.

Edgar Filing: VERTICALNET INC - Form 10-Q

Our on-demand supply management application model involves the storage, analysis, and transmission of customers' proprietary information, and security breaches could expose us to a risk of loss or corruption of this information, litigation, and possible liability. If our security measures are breached as a result of third-party action, employee error, malfeasance, or otherwise, and, as a result, an unauthorized party obtains access to one or more of our customers' data, our reputation could be damaged, our business may suffer, and we could incur significant liability. Because techniques used to obtain unauthorized access or to sabotage computer systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. While we are not aware of any such breach, if an actual or perceived breach of our security occurs, the perception by existing or potential customers of the effectiveness of our security measures could be harmed and we could lose sales and customers.

If the third-party software we use to support and enable our applications is subject to intrusion or corruption by third parties, our applications could become unstable or unavailable to our customers.

We use third-party software to support or enable our applications which may be subject to intrusion or corruption by third parties, which may render our on-demand applications unstable or unavailable to our customers. While we are not aware of any such intrusion, if an actual or perceived intrusion or corruption of our applications or third-party software which we use to support or enable our applications occurs, and our applications become unstable or unavailable, the perception by existing or potential customers of our applications could be harmed and we could lose sales and customers.

Table of Contents

If our on-demand application model is not widely accepted, our operating results will be harmed.

We expect to derive a portion of our revenue from subscriptions to our on-demand applications. As a result, widespread acceptance of our on-demand supply management applications is critical to our future success. Factors that may affect market acceptance of our on-demand applications include:

potential reluctance by enterprises to migrate to an on-demand application model;

the price and performance of our on-demand applications;

the level of customization we can offer;

the availability, performance and price of competing products and services; and

potential reluctance by enterprises to trust third parties to store and manage their internal data.

Many of these factors are beyond our control. The inability of our on-demand applications model to achieve widespread market acceptance would harm our business.

Because we will recognize revenue from our on-demand applications over the term of the agreement, downturns or upturns in sales may not be immediately reflected in our operating results.

We will recognize our revenue from customers with hosted term-based licenses over the term of their agreements, which are typically 12 to 24 months, although terms can range from one to 60 months. As a result, a portion of the revenue we report in each quarter will be deferred revenue from agreements entered into during previous quarters. Consequently, a decline in new or renewed agreements in any one quarter will not necessarily be fully reflected in the revenue in that quarter and will negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure to reflect these reduced revenues. Accordingly, the effect of significant downturns in sales and market acceptance of our service may not be fully reflected in our results of operations until future periods. Our on-demand application model will also make it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable agreement term.

We do not have an adequate history with our on-demand application model to predict the rate of customer renewals and the impact these renewals will have on our revenue or operating results.

Our customers have no obligation to renew their agreements for our service after the expiration of their initial contract period and some customers have elected not to do so. In addition, our customers may decide not to renew unless we offer lower prices or agree to reduce the number of users. We have limited historical data with respect to rates of customer renewals, so we may not be able to accurately predict customer renewal rates. Our customers' renewal rates may decline or fluctuate as a result of a number of factors, including their dissatisfaction

Edgar Filing: VERTICALNET INC - Form 10-Q

with our applications or the customers' ability to continue their operations and spending levels. If our customers do not renew their agreements for our on-demand supply management applications, our revenue may decline and our business may suffer.

Our future success also depends in part on our ability to sell additional features or functions of our applications, additional applications, or additional services to our current customers. This may require increasingly sophisticated and costly sales efforts that are targeted at our customers' senior management. If these efforts are not successful, our business may suffer.

Any failure to adequately expand our direct sales force will impede our growth.

We expect to be substantially dependent on our direct sales force to obtain new customers, particularly large enterprise customers, and to manage our customer base. We believe that there is significant competition for direct sales personnel with the advanced sales skills and technical knowledge we need. Our ability to achieve significant growth in revenue in the future will depend, in large part, on our success in recruiting, training, and retaining sufficient direct sales personnel. New hires require significant training and may, in some cases, take more than a year before they achieve full productivity. Our recent hires and planned hires may not become as productive as we would like, and we may be unable to hire sufficient numbers of qualified individuals in the future in the markets where we do business. If we are unable to hire and develop sufficient numbers of productive sales personnel, sales of our products and services may suffer.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk related changes in interest rates relates primarily to our cash and cash equivalents. We have invested in instruments that meet high quality credit standards, as specified in our investment policy. The policy also limits the amount of credit exposure we may have to any one issue, issuer, or type of investment. Due to the nature of our investment portfolio, we believe that a sudden change in interest rates would not have a material effect on the value of the portfolio since in most cases the average yield on our investments is less than 1% at March 31, 2005. The impact on our future interest income and future changes in investment yields will depend largely on the gross amount of our investment portfolio.

We have invested in equity instruments of privately held companies for business and strategic purposes. These investments are included in other investments and are accounted for under the cost method when ownership is less than 20% and we do not have the ability to exercise significant influence over operations. As of March 31, 2005 we hold a cost method equity investment with a carrying value of approximately \$606,000. For these investments in privately held companies, our policy is to regularly review the assumptions underlying the operating performance and cash flow forecasts in assessing the recoverability of the carrying values. We identify and record impairment losses when events and circumstances indicate that such assets might be impaired.

We had no derivatives as of March 31, 2005.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of disclosure controls and procedures. Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2005. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of March 31, 2005 have been designed and are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchanges Commission's rules and forms. We believe that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

(b) Changes in internal controls. The evaluation referred to in paragraph (a) of this Item did not identify any changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2005 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

On June 12, 2001, a class action lawsuit was filed against us and several of our officers and directors in U.S. Federal Court for the Southern District of New York in an action captioned *CJA Acquisition, Inc. v. Verticalnet, et al.*, C.A. No. 01-CV-5241 (the *CJA Action*). Also named as defendants were four underwriters involved in the issuance and initial public offering (IPO) of our common stock in February 1999—Lehman Brothers Inc., Hambrecht & Quist LLC, Volpe Brown Whelan & Company LLC, and WIT Capital Corporation. The complaint in the *CJA Action* alleges violations of Sections 11 and 15 of the Securities Act of 1933 (the *Securities Act*) and Section 20(a) of the Securities Exchange Act of 1934 (the *Exchange Act*) and Rule 10b-5 promulgated there under, based on, among other things, claims that the four underwriters awarded material portions of the initial shares to certain favored customers in exchange for excessive commissions. The plaintiff also asserts that the underwriters engaged in a practice known as *laddering*, whereby the clients or customers agreed that in exchange for IPO shares they would purchase additional shares at progressively higher prices after the IPO. With respect to Verticalnet, the complaint alleges that the Company and its officers and directors failed to disclose in the prospectus and the registration statement the existence of these purported excessive commissions and laddering agreements. After the *CJA Action* was filed, several *copycat* complaints were filed in U.S. Federal Court for the Southern District of New York. Those complaints, whose allegations mirror those found in the *CJA Action*, include *Ezra Charitable Trust v. Verticalnet, et al.*, C.A. No. 01-CV-5350; *Kofsky v. Verticalnet, et al.*, C.A. No. 01-CV-5628; *Reeberg v. Verticalnet, et al.*, C.A. No. 01-CV-5730; *Lee v. Verticalnet, et al.*, C.A. No. 01-CV-7385; *Hoang v. Verticalnet, et al.*, C.A. No. 01-CV-6864; *Morris v. Verticalnet, et al.*, C.A. No. 01-CV-9459; and *Murphy v. Verticalnet, et al.*, C.A. No. 01-CV-8084. None of the complaints state the amount of any damages being sought, but do ask the court to award *rescissory* damages. All of the foregoing suits were amended and consolidated into a single complaint that was filed with the U.S. Federal Court on April 19, 2002. This amended complaint contains additional factual allegations concerning the events discussed in the original complaints, and asserts that, in addition to Sections 11 and 15 of the Securities Act, the Company and our officers and directors also violated Sections 10(b), 20(a), and Rule 10b-5 of the Exchange Act in connection with the IPO. In addition to this amended and consolidated complaint, the plaintiffs in this lawsuit and in the hundreds of other similar suits filed against other companies in connection with IPOs that occurred in the late 1990s have filed *master allegations* that primarily focus on the conduct of the underwriters of the IPOs, including our IPO. On October 9, 2002, the U.S. Federal Court for the Southern District of New York entered an order dismissing, without prejudice, the claims against the individual Verticalnet officers and directors who had been named as defendants in the various complaints. In February 2003, the District Court entered an order denying a motion made by the defendants to dismiss the actions in their entirety, but granting the motion as to certain of the claims against some defendants. However, the District Court did not dismiss any claims against Verticalnet. On or about June 5, 2003, Verticalnet's counsel, with the approval of the Company's directors, executed a memorandum of understanding on behalf of Verticalnet with respect to a proposed settlement of the plaintiffs' claims against Verticalnet. This proposed resolution of the litigation has been publicly announced (although not yet formally accepted by the plaintiffs) and widely reported in the press. The proposed settlement, if approved by the District Court, would result in, among other things, the dismissal of all claims against Verticalnet, its officers, and directors. Under the present terms of the proposed settlement described above, Verticalnet would also assign its claims against the underwriters to the plaintiffs in the consolidated actions. In February 2005, the District Court preliminarily approved the proposed settlement.

On September 30, 2004, the Company was served with a complaint filed against the Company and several of its former officers and directors in the U.S. District Court for the Eastern District of Pennsylvania in an action captioned *Jodek Charitable Trust, R.A., Individually and as Assignee of Zvi Schreiber, LLC et al. v. Vertical Net Inc., et al.*, C.A. No. 04-4455. The complaint alleges that, with regards to the issuance of the Company's stock to the plaintiffs in connection with the Company's acquisition of Tradeum, Inc. in March 2000, the plaintiffs were damaged by the defendants' delays in registering stock, updating the registration of stock, releasing stock from lock-ups and releasing stock from escrows. The plaintiffs claim they sustained damages in excess of \$65.0 million as a result of the decrease in the stock price during the alleged delays. The Company disputes the allegations raised in the complaint and intends to vigorously defend itself.

We are also a party to various lawsuits and claims that arise in the ordinary course of business. In the opinion of management, the ultimate resolutions with respect to all of the above actions will not have a material adverse effect on our financial position, liquidity, or results of operations.

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

(a) Not applicable

(b) Not applicable.

(c) Not applicable.

Table of Contents

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

(a) None.

(b) None.

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

No matters were submitted to a vote of security holders during the quarter ended March 31, 2005.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

The following exhibits are filed as part of this Form 10-Q:

Exhibit Number	Description
31.1	Certification of the Registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 *
31.2	Certification of the Registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
32.1	Certification of the Registrant's Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Registrant's Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith.
Furnished herewith.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in Malvern, Pennsylvania, on May 13, 2005.

VERTICALNET, INC.

By: /s/ NATHANAEL V. LENTZ

Name: **Nathanael V. Lentz**
President and Chief Executive Officer

By: /s/ GENE S. GODICK

Name: **Gene S. Godick**
Executive Vice President and

Chief Financial Officer