

EVOLVING SYSTEMS INC

Form 10-Q

November 13, 2018

[Table of Contents](#)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**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 September 30, 2018**

**OR**

**o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the transition period from            to**

**Commission File Number: 001-34261**

**EVOLVING SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**

(State or other jurisdiction of incorporation or organization)

**84-1010843**

(I.R.S. Employer Identification No.)

**9800 Pyramid Court, Suite 400**

**Englewood, Colorado**

(Address of principal executive offices)

**80112**

(Zip Code)

**(303) 802-1000**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act

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

As of November 9, 2018, there were 12,117,014 shares outstanding of Registrant's Common Stock (par value \$0.001 per share)



Table of Contents

**EVOLVING SYSTEMS, INC.**

	<b><u>PART I FINANCIAL INFORMATION</u></b>	
<u>Item 1</u>	<u>Unaudited Condensed Consolidated Financial Statements</u>	3
	<u>Condensed Consolidated Balance Sheets</u>	3
	<u>Condensed Consolidated Statements of Income</u>	4
	<u>Condensed Consolidated Statements of Comprehensive (Loss) Income</u>	5
	<u>Condensed Consolidated Statement of Changes in Stockholders' Equity</u>	6
	<u>Condensed Consolidated Statements of Cash Flows</u>	7
	<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	8
<u>Item 2</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24
<u>Item 3</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	30
<u>Item 4</u>	<u>Controls and Procedures</u>	31
	<b><u>PART II OTHER INFORMATION</u></b>	
<u>Item 1</u>	<u>Legal Proceedings</u>	33
<u>Item 1A</u>	<u>Risk Factors</u>	33
<u>Item 2</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	33
<u>Item 3</u>	<u>Defaults upon Senior Securities</u>	33
<u>Item 4</u>	<u>Mine Safety Disclosures</u>	33
<u>Item 5</u>	<u>Other Information</u>	33
<u>Item 6</u>	<u>Exhibits</u>	33
<u>Signatures</u>		35

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****EVOLVING SYSTEMS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share data)

(unaudited)

	September 30, 2018	December 31, 2017
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 8,522	\$ 7,562
Contract receivables, net of allowance for doubtful accounts of \$786 and \$970 at September 30, 2018 and December 31, 2017, respectively	7,689	10,151
Unbilled work-in-progress, net of allowance for doubtful accounts of \$536 and \$107 at September 30, 2018 and December 31, 2017, respectively	3,880	5,823
Prepaid and other current assets	1,509	2,053
Total current assets	21,600	25,589
Property and equipment, net	187	258
Amortizable intangible assets, net	4,829	5,613
Goodwill	24,857	25,216
Deferred income taxes, net	440	274
Total assets	\$ 51,913	\$ 56,950
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Term loans - current portion	\$ 3,577	\$ 2,805
Accounts payable and accrued liabilities	4,299	6,890
Contingent earn-out	824	396
Income taxes payable	415	1,107
Unearned revenue	4,720	5,397
Total current liabilities	13,835	16,595
Long-term liabilities:		
Term loans, net of current portion	3,393	5,942
Total liabilities	17,228	22,537
Commitments and contingencies (Note 11)		
Stockholders equity:		
Preferred stock, \$0.001 par value; 2,000,000 shares authorized; no shares issued and outstanding as of September 30, 2018 and December 31, 2017, respectively		
Common stock, \$0.001 par value; 40,000,000 shares authorized; 12,295,903 shares issued and 12,117,014 outstanding as of September 30, 2018 and 12,119,961 shares issued and 11,941,072 outstanding as of December 31, 2017	12	12
Additional paid-in capital	99,107	98,517
	(1,253)	(1,253)

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Treasury stock, 178,889 shares as of September 30, 2018 and December 31, 2017,  
at cost

Accumulated other comprehensive loss	(9,712)	(8,202)
Accumulated deficit	(53,469)	(54,661)
Total stockholders' equity	34,685	34,413
Total liabilities and stockholders' equity	\$ 51,913	\$ 56,950

The accompanying notes are an integral part of these condensed consolidated financial statements

Table of Contents

## EVOLVING SYSTEMS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share data)

(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>REVENUE</b>				
License fees	\$ 255	\$ 1,068	\$ 839	\$ 2,131
Services	7,165	6,479	22,876	17,513
Total revenue	7,420	7,547	23,715	19,644
<b>COSTS OF REVENUE AND OPERATING EXPENSES</b>				
Costs of revenue, excluding depreciation and amortization	2,357	2,569	8,105	5,678
Sales and marketing	1,663	1,439	4,899	3,485
General and administrative	1,511	1,562	5,439	3,555
Product development	1,074	356	2,882	1,499
Depreciation	20	55	101	156
Amortization	240	226	733	618
Restructuring		131		131
Total costs of revenue and operating expenses	6,865	6,338	22,159	15,122
Income from operations	555	1,209	1,556	4,522
Other income (expense)				
Interest income	23	1	53	2
Interest expense	(120)	(91)	(369)	(234)
Other income	71		58	
Foreign currency exchange income (loss)	362	(176)	498	(568)
Other income (expense), net	336	(266)	240	(800)
Income from operations before income taxes	891	943	1,796	3,722
Income tax expense	342	184	604	888
Net income	\$ 549	\$ 759	\$ 1,192	\$ 2,834
Basic income per common share - net income	\$ 0.05	\$ 0.06	\$ 0.10	\$ 0.24
Diluted income per common share - net income	\$ 0.05	\$ 0.06	\$ 0.10	\$ 0.24
Weighted average basic shares outstanding	12,117	11,940	12,103	11,932
Weighted average diluted shares outstanding	12,124	11,992	12,124	11,975

The accompanying notes are an integral part of these condensed consolidated financial statements





Table of Contents

**EVOLVING SYSTEMS, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME**

(in thousands)

(unaudited)

	For the Three Months Ended				For the Nine Months Ended			
	September 30,		September 30,		September 30,		September 30,	
	2018	2017	2018	2017	2018	2017	2018	2017
<b>Net income</b>	\$ 549	\$ 759	\$ 1,192	\$ 2,834				
<b>Other comprehensive (loss) income</b>								
Foreign currency translation (loss) income	(569)	314	(1,510)	1,481				
Comprehensive (loss) income	\$ (20)	\$ 1,073	\$ (318)	\$ 4,315				

The accompanying notes are an integral part of these condensed consolidated financial statements

Table of Contents

## EVOLVING SYSTEMS, INC.

## CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands, except share data)

(unaudited)

	Common stock Shares	Common stock Amount	Additional paid-in capital	Treasury stock	Accumulated other comprehensive loss	Accumulated deficit	Total stockholders equity
<b>Balance at December 31, 2017</b>	<b>11,941,072</b>	<b>\$ 12</b>	<b>\$ 98,517</b>	<b>\$ (1,253)</b>	<b>\$ (8,202)</b>	<b>\$ (54,661)</b>	<b>\$ 34,413</b>
Stock option exercises	1,857						
Common stock issued pursuant to the Employee Stock Purchase Plan	85						
Restricted stock vested	174,000						
Share-based compensation expense			590				590
Net income						1,192	1,192
Foreign currency translation loss					(1,510)		(1,510)
<b>Balance at September 30, 2018</b>	<b>12,117,014</b>	<b>\$ 12</b>	<b>\$ 99,107</b>	<b>\$ (1,253)</b>	<b>\$ (9,712)</b>	<b>\$ (53,469)</b>	<b>\$ 34,685</b>

The accompanying notes are an integral part of these condensed consolidated financial statements

Table of Contents

## EVOLVING SYSTEMS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	For the Nine Months Ended September 30,	
	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 1,192	\$ 2,834
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	101	156
Amortization of intangible assets	733	618
Amortization of debt issuance costs	8	10
Share-based compensation expense	590	486
Bad debt expense, net	410	
Change in fair value of contingent earn-out	413	
Unrealized foreign currency transaction (income) loss, net	(498)	568
Provision for deferred income taxes	(165)	(335)
Change in operating assets and liabilities:		
Contract receivables	2,098	(2,474)
Unbilled work-in-progress	1,137	(1,225)
Prepaid and other assets	235	562
Accounts payable and accrued liabilities	(2,927)	(759)
Unearned revenue	(501)	1,831
Other long-term obligations		376
Net cash provided by operating activities	2,826	2,648
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(48)	(71)
Business combinations, net of cash received		(5,938)
Net cash used in investing activities	(48)	(6,009)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Capital lease payments		(1)
Proceeds from term loans		4,730
Principal payments on notes payable	(1,763)	(1,500)
Payments for debt issuance costs		(20)
Proceeds from the issuance of stock		29
Net cash (used in) provided by financing activities	(1,763)	3,238
Effect of exchange rate changes on cash and cash equivalents	(55)	86
Net increase (decrease) in cash and cash equivalents	960	(37)
Cash and cash equivalents at beginning of period	7,562	7,614
Cash and cash equivalents at end of period	\$ 8,522	\$ 7,577
Supplemental disclosure of cash and non-cash transactions:		
Income taxes paid	\$ 1,623	\$ 1,320
Property and equipment purchased and included in accounts payable	\$	\$ 35
Measurement period adjustment to goodwill and intangible assets	\$ 281	\$

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Table of Contents

**EVOLVING SYSTEMS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 BASIS OF PRESENTATION**

**Organization** Evolving Systems, Inc. ( we, us, our, the Company , and Evolving Systems ) is a provider of real-time digital engagement solutions and services of software solutions and services to the wireless carrier and consumer financial services markets. We maintain long-standing relationships with many of the largest wireless companies worldwide. The Company's portfolio includes market-leading solutions and services for real-time analytics, customer acquisition and activation, customer value management and loyalty for the telecom industry promoting partnerships into retail and financial services.

In 2016, we began a shift from selling technology to offering business solutions. The value proposition has moved from cost savings to revenue increases for the carrier and our business model has moved from classic capital expenditure license and services to operating expenditure models based on recurring managed services with performance fees. Our software solution platforms enable carriers' marketing departments to innovate, execute and manage highly-personalized and contextually-relevant, interactive campaigns that engage consumers in real time and enhance customer retention through deploying loyalty programs. Our service activation solution, Tertio® ( TSA ) is used to activate bundles of voice, video and data services for wireless, wireline and cable network operators; our SIM card activation solution, Dynamic SIM Allocation™ ( DSA ), is used to dynamically allocate and assign resources to Mobile Network Operators ( MNOs ) devices that rely on SIM cards; our Mobile Data Enablement™ ( MDE ) solution provides a data consumption and policy management solution for wireless carriers and Mobile Virtual Network Operators ( MVNOs ) that monitor the usage and consumption of data services; our Total Number Management ( TNM ) product is a scalable and fully automated database solution that enables operators to reliably and efficiently manage their telephone numbers as well as other communication identifiers (i.e. SIMs, MSISDNs, IMSIs, ICCIDs, IPs). Our solutions can be deployed on premise or as a Software-as-a-Service ( SaaS ).

In July 2017 we completed the acquisition of Business Logic Systems ( BLS ). BLS, headquartered in Newbury, United Kingdom, specializes in data-driven customer value management and customer engagement solutions that have been implemented in over 20 mobile operators in Europe, Africa, Asia-Pacific and the Caribbean. BLS solutions turn customer data into actionable insights and personalized contextual offers. Customer engagement occurs through in-bound and out-bound offers and is further extended through a suite of loyalty and retention solutions.

In September 2017 we completed the acquisition of four business operating units of Lumata Holdings Ltd. (the Lumata Entities ). The Lumata Entities are a leading global provider of real-time, next generation loyalty and customer lifecycle management software and services that helps businesses gain value from their customer data for relevant and contextual insights and actions of value to both customers and enterprises. Its customers include mobile operators including Orange, Telefonica and other Tier-1 and emerging operators in Europe and around the world.

We believe the acquisitions of BLS and the Lumata Entities further reinforced our commitment to the customer acquisition and customer value management ( CVM ) domains that began with the acquisition of Sixth Sense Media ( Evolving Systems NC, Inc. ). With these recent acquisitions, we now have a customer base of more than 100 customers spanning 64 countries across the world. The experienced team and technology from BLS, which provides actionable insights and relevant offers based on customer data, greatly complements our software portfolio and 25 years of expertise in customer acquisition, activation and retention. The technology further expands our Managed Services platform for delivering on-tap

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strategic and tactical solutions. The Lumata Entities' value lies in its patented technology, industry expertise and strong customer relationships, in particular, those across Western Europe. Led by the explosive growth in mobile, the next generation of CVM is moving beyond traditional CRM and points-based loyalty systems to highly personalized and contextual, real-time, omni-channel consumer engagement in multiple verticals including telecom, finance, and retail.

**Interim Condensed Consolidated Financial Statements** The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) and in conformity with the instructions to Form 10-Q and Rule 8-03 of Regulation S-X and the related rules and regulations of the Securities and Exchange Commission ( SEC ). Accordingly, certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. However, we believe that the disclosures included in these consolidated financial statements are adequate to make the information presented not misleading. The unaudited condensed consolidated financial statements included in this document have been prepared on the same basis as the annual consolidated financial statements, and in our opinion reflect all adjustments, which include normal recurring adjustments necessary for a fair presentation in accordance with GAAP and SEC regulations for interim financial statements. The results for the three and nine months ended September 30, 2018 are not necessarily indicative of the results that we will have for any subsequent period. These unaudited condensed consolidated financial statements should be read in

Table of Contents

conjunction with the audited consolidated financial statements and the notes to those statements for the year ended December 31, 2017 included in our Annual Report on Form 10-K. We have reclassified certain prior-year amounts to conform to the current-year's presentation.

**Use of Estimates** The preparation of condensed consolidated financial statements in conformity with GAAP requires us 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 consolidated financial statements, as well as the reported amounts of revenue and expenses during the reporting period. We made estimates with respect to revenue recognition for progress toward completion and direct profit or loss on contracts, allowance for doubtful accounts, income tax valuation allowance, fair values of long-lived assets, valuation of intangible assets and goodwill, useful lives for property, equipment and intangible assets, business combinations, capitalization of internal software development costs and fair value of stock-based compensation amounts. Actual results could differ from these estimates.

**Foreign Currency** Our functional currency is the U.S. dollar. The functional currency of our foreign operations, generally, is the respective local currency for each foreign subsidiary. Assets and liabilities of foreign operations denominated in local currencies are translated at the spot rate in effect at the applicable reporting date. Our condensed consolidated statements of income are translated at the weighted average rate of exchange during the applicable period. The resulting unrealized cumulative translation adjustment is recorded as a component of accumulated other comprehensive income (loss) in stockholders' equity. Realized and unrealized transaction gains and losses generated by transactions denominated in a currency different from the functional currency of the applicable entity are recorded in other income (loss) in the period in which they occur.

**Principles of Consolidation** The unaudited condensed consolidated financial statements include the accounts of Evolving Systems, Inc. and subsidiaries, all of which are wholly owned. All significant intercompany transactions and balances have been eliminated in consolidation.

**Revenue Recognition** Effective January 1, 2018, we adopted Financial Accounting Standards Board ( FASB ) Topic 606, Revenue from Contracts with Customers ( ASC 606 ). ASC 606 was applied using the modified retrospective method. Accordingly, comparative periods have not been adjusted and continue to be reported under FASB ASC Topic 605, Revenue Recognition ( ASC 605 ). There was no cumulative effect of the initial application to be recognized as an adjustment to opening retained earnings at January 1, 2018 as the adoption did not have a material impact on the Company's results of operations or financial condition.

The majority of our license fees and services revenue is generated from fixed-price contracts, this provides for licenses to our software products and services that customize such software to meet our customers' needs. In most instances, customization services are determined to be essential to the functionality of the delivered software. Under ASC 606, revenue is recognized when our customer obtains control of promised goods or services in an amount that reflects the consideration we expect to receive in exchange for those goods or services. We measure revenue based on consideration specified in a contract with a customer and exclude any sales incentives. Furthermore, we recognize revenue when we satisfy a performance obligation by transferring control over the service to our customer.

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A performance obligation is a promise in a contract to transfer a distinct service to the customer. The transaction price of a contract is allocated to each distinct performance obligation and recognized as revenue when or as the customer receives the benefit of the performance obligation. Our customers typically receive the benefit of our services as they are performed. Substantially all customer contracts provide that we are compensated for services performed to date. Losses on fixed-price projects are recorded when identified. Taxes assessed by a governmental authority that are both imposed on and concurrent with a specific revenue-producing transaction, that are collected by us from a customer, are excluded from revenue.

### *Nature of goods and services*

The following is a description of our products and services from which we generate revenue, as well as the nature, timing of satisfaction of performance obligations, and significant payment terms for each:

#### *i. License Revenue*

License fees represent the fees we receive from the licensing of our software products. In most instances, customization services are determined to be essential to the functionality of the delivered software. The license along with the customization services are transferred to our customers over time. In arrangements where the services are not essential to the functionality of the delivered software, we recognize license revenue when the license agreement has been approved and the software has been delivered. We can identify each party's rights, payment terms, and commercial substance of the content. Where applicable, we identify multiple



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### Table of Contents

performance obligations and record as revenue as the performance obligations are fulfilled based on their estimated allocated value. The selection of the method to measure progress towards completion requires judgment and is based on the extent of progress towards completion of the performance obligation.

#### *ii. Customer Support Revenue*

Customer support services includes annual support fees, recurring maintenance fees, warranty support fees and minor product upgrades. The warranty support fees represent a separate performance obligation that is provided for up to a year with initial license purchase. The Company allocates the contract transaction price related to warranty support fees based on pricing consistent with what we would offer to other market participants. Upon the conclusion of the warranty period, the customer can choose to continue to receive support and maintenance services via our customer support offerings. We recognize revenue from our support ratably over the service contract period.

#### *iii. Services Revenue*

We recognize revenue from fixed-price service contracts using the input method of accounting. Under the input method, revenue is recognized revenue on the basis of an entity's efforts or inputs toward satisfying a performance obligation. We recognize revenue from professional services provided pursuant to time-and-materials based contracts and training services as the services are performed, as that is when our performance obligation to our customers under such arrangements is fulfilled.

#### *iv. Managed Services*

We recognize revenue from our managed services contracts primarily over the service contract period. On occasion, our managed services contracts will contain a specified number of hours to work over the term of the contract. Revenue for this type of managed service contract is recognized using the input method of accounting, as previously described.

### ***Disaggregation of revenue***

In the following table, revenue is disaggregated by primary geographical market, major products/service lines, and timing of revenue recognition (in thousands):

	For the Three Months Ended		For the Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
<b>Primary geographical markets</b>				
United Kingdom	\$ 1,512	\$ 1,381	\$ 4,945	\$ 3,858
Other	5,908	6,166	18,770	15,786

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	\$	7,420	\$	7,547	\$	23,715	\$	19,644
<b>Major products/service lines</b>								
Licensing fees	\$	255	\$	1,068	\$	839	\$	2,131
Customer support, including warranty support fees		2,481		2,343		7,602		6,380
Services		2,034		2,532		7,337		6,408
Managed services		2,650		1,604		7,937		4,725
Total services		7,165		6,479		22,876		17,513
	\$	7,420	\$	7,547	\$	23,715	\$	19,644
<b>Timing of revenue recognition</b>								
Products transferred at a point in time	\$	187	\$	109	\$	509	\$	710
Products and services transferred over time		7,233		7,438		23,206		18,934
	\$	7,420	\$	7,547	\$	23,715	\$	19,644

Table of Contents**Contract balances**

The following table provides information about receivables, assets, and liabilities from contracts with customers (in thousands):

	September 30, 2018		December 31, 2017	
<b>Assets</b>				
Contract receivables, net	\$	7,689	\$	10,151
Unbilled work-in-progress, net	\$	3,880	\$	5,823
<b>Liabilities</b>				
Unearned revenue	\$	4,720	\$	5,397

Contract receivables are recorded at the invoiced amount and do not bear interest. Credit is extended based on the evaluation of a customer's financial condition and collateral is not required. Unbilled work-in-progress is revenue which has been earned but not invoiced. The contract assets are transferred to the receivables when invoiced.

The contract liabilities primarily relate to unearned revenue. Amounts billed in advance of performance obligations being satisfied are booked as unearned revenue.

**Transaction price allocated to the remaining performance obligations**

Remaining performance obligations represent the transaction price of firm orders for which work has not been performed as of the period end date and excludes unexercised contract options and potential orders under ordering-type contracts (e.g., indefinite-delivery, indefinite-quantity). As of September 30, 2018, the aggregate amount of the transaction price allocated to remaining performance obligations with lives greater than one-year totals \$2.0 million. The Company expects approximately 80% of remaining performance obligations to be recognized into revenue within the next twelve months, with the remaining 20% recognized thereafter.

We apply the practical expedient in paragraph 606-10-50-14 and do not disclose information about remaining performance obligations that have original expected durations of one-year or less. We apply the transition practical expedient in paragraph 606-10-65-1(f)(3) and do not disclose the amount of the transaction price allocated to the remaining performance obligations and an explanation of when we expect to recognize that amount as revenue. Additionally, applying the practical expedient in paragraph 340-40-25-4, the Company recognizes the incremental costs of obtaining contracts (i.e., commissions) as an expense when incurred if the amortization period of the assets that the Company otherwise would have recognized is one-year or less.

**Stock-based Compensation** We account for stock-based compensation by applying a fair-value-based measurement method to account for share-based payment transactions with employees and directors. We record compensation costs associated with the vesting of unvested options on a straight-line basis over the vesting period. Stock-based compensation is a non-cash expense because we settle these obligations by issuing shares of our common stock instead of settling such obligations with cash payments. We use the Black-Scholes model to estimate the fair value of

each option grant on the date of grant. This model requires the use of estimates for expected term of the options and expected volatility of the price of our common stock.

**Income Taxes** We record deferred tax assets and liabilities for the estimated future tax effects of temporary differences between the tax bases of assets and liabilities and amounts reported in the accompanying condensed consolidated balance sheets, as well as operating losses and tax credit carry-forwards. We measure deferred tax assets and liabilities using enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. We reduce deferred tax assets by a valuation allowance if, based on available evidence, it is more likely than not that these benefits will not be realized.

We use a recognition threshold and a measurement attribute for financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more likely than not to be sustained upon examination by taxing authorities.

**Segment Information** We define operating segments as components of our enterprise for which separate financial information is reviewed regularly by the chief operating decision-makers to evaluate performance and to make operating decisions. We have identified our Chief Executive Officer and Senior Vice President of Finance as our chief operating decision-makers ( CODM ). These chief operating decision makers review revenues by segment and review overall results of operations.

Table of Contents

We currently operate our business as one operating segment which includes two revenue types: license fees revenue and services revenue (as shown on the condensed consolidated statements of income). License fees revenue represents the fees received from the license of software products. Services revenue includes services directly related to the delivery of the licensed products, such as fees for custom development, integration services, SaaS service, managed services, annual support fees, recurring maintenance fees, fees for maintenance upgrades and warranty services. Warranty services that are similar to software maintenance services are typically bundled with a license sale.

**Recent Accounting Pronouncements** In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which requires lessees to put most leases on their balance sheets by recognizing a lessee's rights and obligations, while expenses will continue to be recognized in a similar manner to today's legacy lease accounting guidance. In July 2018, the FASB issued Accounting Standards Update No 2018-10, Codification Improvements to Topic 842 Leases (ASU 2018-10). ASU 2018-10 provides narrow amendments to clarify how to apply certain aspects of the new lease standard. In July 2018, the FASB issued ASU 2018-11, Leases Targeted Improvements (ASU 2018-11) which provides an additional (and optional) transition method to recognize the cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. ASU 2018-11 also provides lessor with the practical expedient to not separate non-lease components from associated lease component under limited circumstances. We are continuing to evaluate this guidance and the impact to us, as both lessor and lessee, on our consolidated financial statements. The effective date and transition requirements for ASU 2016-02, ASU 2018-01, ASU 2018-10 and ASU 2018-11 are the same. This ASU could also significantly affect the financial ratios used for external reporting and other purposes, such as debt covenant compliance. This ASU will be effective for us on January 1, 2019, with early adoption permitted. We are currently in the process of assessing the impact of this ASU on our condensed consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, Income Statement Reporting Comprehensive Income (Topic 220); Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The amendments in this ASU allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Act. Consequently, the amendments eliminate the stranded tax effects resulting from the Act and will improve the usefulness of information reported to financial statement users. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted in any interim period after issuance of the ASU. We are currently in the process of assessing the impact of this ASU on our condensed consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. ASU 2018-07 is intended to reduce cost and complexity and to improve financial reporting for share-based payments issued to nonemployees. This ASU expands the scope of ASC Topic 718, Compensation - Stock Compensation, which currently only includes share-based payments issued to employees, to also include share-based payments issued to nonemployees for goods and services. Consequently, the accounting for share-based payments to nonemployees and employees will be substantially aligned. ASU 2018-07 supersedes ASC Subtopic 505-50, Equity - Equity-Based Payments to Non-Employees. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. We are currently in the process of assessing the impact of this ASU on our condensed consolidated financial statements.

**Recently Adopted Accounting Pronouncements** In November 2016, the FASB issued ASU 2016-18, Restricted Cash (Topic 230): Statement of Cash Flows (ASU No. 2016-18). ASU No. 2016-18 requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents. Restricted cash and restricted cash equivalents will be included with cash and cash

equivalents when reconciling the beginning of period and end of period balances on the statement of cash flows upon adoption of this standard.

**NOTE 2 ACQUISITIONS**

*Business Logic Systems*

On July 3, 2017, we completed the purchase by BLS Limited ( EVOL BLS ), a wholly owned subsidiary of Evolving Systems, Inc., a Delaware corporation, of Business Logic Systems Limited ( Seller ). EVOL BLS and Seller are both companies incorporated under the laws of England and Wales. Under the terms of the Asset Purchase Agreement, dated as of May 5, 2017 (the Purchase Agreement ), the Seller agreed to sell substantially all of its assets and transfer certain liabilities relating to Seller 's business of providing customer value management solutions and data driven marketing solutions for £1.2 million (\$1.6 million) in cash, plus (a) an additional sum of £100,000 (\$134,000), which was reduced in full by the sums paid by EVOL BLS to certain employees ' severance obligations (collectively, the Cash Payments ); (b) a percentage of collections on certain receivables over a 24 month period; and (c) an earnout equal to 50% of BLS based revenue over \$4.8 million per year for 3 years after the closing date. The Company agreed to guarantee EVOL BLS ' obligations under the Purchase Agreement.

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### Table of Contents

The Purchase Agreement contains a two year no solicitation provision which restricts the Seller's ability to compete with EVOL BLS with respect to the BLS business or to solicit BLS customers or BLS employees serving in an executive, managerial, sales or technical role.

We accounted for this business combination by applying the acquisition method, and accordingly, the purchase price was allocated to the assets and liabilities assumed based upon their fair values at the acquisition date. The excess of the purchase price over the net assets and liabilities, approximately \$0.3 million, was recorded as goodwill. The results of EVOL BLS's operations have been included in the consolidated financial statements since the acquisition date. The amortization of the intangible assets is deductible for tax purposes.

During the second quarter of 2018, we identified and recorded measurement period adjustments to our preliminary purchase price allocation that was disclosed in our Form 10-K for the fiscal year ended December 31, 2017. These adjustments are reflected in the tables below. If the measurement period adjustments were reflected in the Form 10-K, it would have increased operating expenses by approximately \$1,000 consisting of increases to amortization expense. The measurement period adjustments were the result of additional analysis performed and updated information.

When we acquired EVOL BLS on July 3, 2017, we agreed to make up to three annual cash payments equal to 50% of the EVOL BLS revenue in excess of \$4.8 million for the 12-month periods ending July 3, 2018, 2019 and 2020. The Company also agreed to guarantee the EVOL BLS obligations under the Purchase Agreement. As of June 30, 2018, we estimated the total annual cash payments for the three 12-month periods to be \$0.8 million which is a \$0.4 million increase from our \$0.4 million estimate as of December 31, 2017. This amount is shown in the contingent earnout financial statement line item on our unaudited condensed consolidated balance sheet at September 30, 2018. We recognized \$0.4 million in the other income (expense) financial statement line item on our unaudited condensed consolidated statements of income prior to the three months but included in the nine months ended September 30, 2018, respectively, as a result of our increased obligation.

On November 2, 2018, we paid the \$0.8 million in contingent earn-out liability for the EVOL BLS acquisition.

The following table summarizes the purchase price and fair values of the assets acquired and liabilities assumed at the date of acquisition as disclosed in the Form 10-K and as adjusted for measurement period adjustments identified during the current quarter (in thousands):

	At July 3, 2017 (preliminary)	Measurement Period Adjustments	At July 3, 2017 (adjusted)
Total cash consideration	\$ 1,553	\$	\$ 1,553
Earnout	380	47	427
Total purchase price	\$ 1,933	\$ 47	\$ 1,980

  

	At July 3, 2017 (preliminary)	Measurement Period Adjustments	At July 3, 2017 (adjusted)
Contract receivables	\$ 1,037	\$	\$ 1,037
Unbilled work-in-progress	1,039		1,039
Intangible assets	246	18	264
Prepaid and other current assets	437		437
Other assets, non-current	55		55
Total identifiable assets acquired	2,814	18	2,832

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Accounts payable and accrued liabilities	\$	792	\$	\$	792
Deferred revenue		338			338
Total identifiable liabilities acquired		1,130			1,130
Net identifiable assets acquired		1,684		18	1,702
Goodwill		249		29	278
Net assets acquired	\$	1,933	\$	47	\$ 1,980



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### Table of Contents

#### *Lumata*

On September 4, 2017, Evolving Systems Holdings Limited ( EVOL Holdings ), a wholly owned subsidiary of Evolving Systems, Inc., completed the acquisition under a Share Purchase Agreement (the Purchase Agreement ) with Lumata Holdings Limited ( Lumata Holdings or Seller ) and Francisco Partners III (Cayman) L.P., as Guarantor (the Acquisition ). EVOL Holdings acquired all of the issued and outstanding shares of four Lumata Holdings subsidiaries, Lumata France SAS, Lumata Spain S.L., Lumata UK Ltd and Lumata Deutschland GmbH (collectively, Lumata Entities ) in exchange for a cash payment totaling 4.0 million (\$4.8 million), subject to certain adjustments. The Seller and certain members of the Seller s management entered into Management Warranty Deeds to secure Lumata Holdings representations and warranties under the Purchase Agreement and, to the extent the amounts provided under the Management Warranty Deeds are not sufficient to satisfy post-closing claims, EVOL Holdings may seek recovery from the Guarantor in an amount not to exceed 400,000 (\$476,000). EVOL Holdings and Seller are both companies incorporated under the laws of England and Wales.

We accounted for this business combination by applying the acquisition method, and accordingly, the purchase price was allocated to the assets and liabilities assumed based upon their fair values at the acquisition date. The excess of the purchase price over the net assets and liabilities, approximately \$3.3 million, was recorded as goodwill. The Company is in the process of finalizing the purchase price allocation, thus the provisional measures of deferred income taxes, intangibles and goodwill are subject to change. The results of the Lumata Entities operations have been included in the consolidated financial statements since the acquisition date. The amortization of the intangible assets is not deductible for tax purposes.

During the second and third quarter of 2018, we identified and recorded measurement period adjustments to our preliminary purchase price allocation that was disclosed in our Form 10-K for the fiscal year ended December 31, 2017. These adjustments are reflected in the tables below. If the measurement period adjustments were reflected in the Form 10-K, it would have resulted in no change in operating expenses. The measurement period adjustments were the result of additional analysis performed and information identified during the second quarter of 2018 based on facts and circumstances that existed as of the purchase date.

The following table summarizes the purchase price and fair values of the assets acquired and liabilities assumed at the date of acquisition as disclosed in the Form 10-K and as adjusted for measurement period adjustments identified during the current quarter (in thousands):

	At September 4, 2017 (preliminary)	Measurement Period Adjustments	At September 4, 2017 (adjusted)
Total Cash Consideration	\$ 4,766	\$	\$ 4,766
Total purchase price	\$ 4,766	\$	\$ 4,766

	At September 4, 2017 (preliminary)	Measurement Period Adjustments	At September 4, 2017 (adjusted)
Cash and cash equivalents	\$ 386	\$	\$ 386
Contract receivables	1,444		1,444
Unbilled work-in-progress	110	(82)	28
Intangible assets	1,935		1,935
Prepaid and other current assets	1,539		1,539
Other assets, non-current	19		19
Total identifiable assets acquired	5,433	(82)	5,351

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Accounts payable and accrued liabilities	\$	3,086	\$	\$	3,086
Deferred tax liability		329			329
Deferred revenue		325		152	477
Total identifiable liabilities acquired		3,740		152	3,892
Net identifiable assets acquired		1,693		(234)	1,459
Goodwill		3,073		234	3,307
Net assets acquired	\$	4,766	\$	\$	4,766

Table of Contents*Pro Forma*

The following table presents the unaudited pro forma results of the Company for the three and nine months ended September 30, 2018 and 2017 as if the acquisitions of EVOL BLS and Lumata Entities occurred on January 1, 2017. The pro forma results include estimates and assumptions which management believes are necessary. For EVOL BLS, which was acquired on July 3, 2017, there is no unaudited pro forma revenue or net income (loss) for the three months ended September 30, 2017 and proforma unaudited revenue was \$1.4 million and net loss was \$2.0 million for the nine months ended September 30, 2017. For the Lumata entities acquired on September 4, 2017, the unaudited pro forma revenue was \$0.9 million and \$4.6 million and net losses were \$0.3 million and \$0.2 million for the three and nine months ended September 30, 2017, respectively. The amortization expense was \$0.04 million for the three months and \$0.2 million for the nine months ended September 30, 2017. However, the pro forma results do not include any anticipated cost savings or their effects of the planned integration of EVOL BLS and Lumata Entities and are not necessarily indicative of the results that would have occurred if the business combination had been in effect on the dates indicated, or which may result in the future. The pro forma information includes adjustments for the amortization of intangible assets.

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,				
	2018		2017		2018		2017	
Revenue	\$	7,420	\$	8,460	\$	23,715	\$	25,652
Net income	\$	549	\$	393	\$	1,192	\$	463

EVOL BLS and the Lumata Entities did not have any material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings.

**NOTE 3 GOODWILL AND INTANGIBLE ASSETS**

Changes in the carrying amount of goodwill were as follows (in thousands):

	<b>Total Goodwill</b>	
Balance at December 31, 2017	\$	25,216
Measurement period adjustments		263
Effects of changes in foreign currency exchange rates (1)		(622)
Balance at September 30, 2018	\$	24,857

(1) Represents the impact of foreign currency translation for instances when goodwill is recorded in foreign entities whose functional currency is also their local currency. Goodwill balances are translated into U.S. dollars using exchange rates in effect at period end. Adjustments related to foreign currency translation are included in other comprehensive income.

We performed our annual goodwill impairment test as of July 31, 2018, at which time we had \$25.0 million of goodwill. The fair value of the reporting unit was estimated using both market and income-based approaches. Specifically, we incorporated observed market multiple data from selected guideline public companies and values arrived at through the application of discounted cash flow analyses, which in turn were based

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upon our financial projections as of the valuation date. We believe that a market participant would weigh both possibilities without a bias to one or the other. Consequently, we gave equal consideration to both. This analysis requires significant judgments, including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, estimation of the useful life over which cash flows will occur, and determination of our weighted average cost of capital. Changes in these estimates and assumptions could materially affect the determination of fair value and goodwill impairment for each reporting unit. If the carrying value of a reporting unit were to exceed its fair value, we would then compare the fair value of the reporting unit's goodwill to its carrying amount, and any excess of the carrying amount over the fair value would be charged to operations as an impairment loss. If the projected future performance of our segment as estimated in the income valuation approach is adjusted downward or is lower than expected in the future, we could be required to record a goodwill

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Table of Contents

impairment charge. As a result of the first step of the 2018 goodwill impairment analysis, the fair value of the reporting unit exceeded its carrying value by \$0.1 million. Therefore, the second step was not necessary. From July 31, 2018, through the date of this report, no events have occurred that we believe may have impaired goodwill.

We amortized identifiable intangible assets for Evolving Systems Labs, Evolving Systems NC, EVOL BLS, and the Lumata entities on a straight-line basis over their estimated useful lives. As of September 30, 2018, and December 31, 2017, identifiable intangibles were as follows (in thousands):

	September 30, 2018			Weighted-Average Amortization Period
	Gross Amount	Accumulated Amortization	Net Carrying Amount	
Purchased software	\$ 2,921	\$ (1,056)	\$ 1,865	4.9 yrs
Trademarks and tradenames	311	(223)	88	2.4 yrs
Non-competition	40	(38)	2	0.6 yrs
Customer relationships	4,380	(1,506)	2,874	6.1 yrs
	\$ 7,652(1)	\$ (2,823)(2)	\$ 4,829	5.5 yrs

	December 31, 2017			Weighted-Average Amortization Period
	Gross Amount	Accumulated Amortization	Net Carrying Amount	
Purchased software	\$ 2,921	\$ (743)	\$ 2,178	7.7 yrs
Trademarks and tradenames	310	(189)	121	3.7 yrs
Non-competition	40	(35)	5	2.0 yrs
Customer relationships	4,363	(1,054)	3,309	8.7 yrs
	\$ 7,634	\$ (2,021)(3)	\$ 5,613	6.8 yrs

(1) 2018 increase in gross amount due to measurement period adjustments relating to the EVOL BLS purchase price allocation. See Note 2 Acquisitions for additional information.

(2) Includes functional currency adjustment of \$69,000.

(3) Includes functional currency adjustment of \$1,000.

Amortization expense of identifiable intangible assets was \$0.2 million for both the three months ended September 30, 2018 and 2017, respectively, and \$0.7 million and \$0.6 million for the nine months ended September 30, 2018 and 2017, respectively. Expected future amortization expense related to identifiable intangibles based on our carrying amount as of September 30, 2018 was as follows (in thousands):

Twelve months ending September 30, 2019	\$	949
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2020		946
2021		946
2022		864
2023		404
Thereafter		720
	\$	4,829

Table of Contents**NOTE 4 BALANCE SHEET COMPONENTS**

The components of accounts payable and accrued liabilities are as follows (in thousands):

	September 30, 2018		December 31, 2017	
<b>Accounts payable and accrued liabilities:</b>				
Accounts payable	\$	944	\$	1,530
Accrued compensation and related expenses		1,753		1,749
Accrued liabilities		1,602		3,611
	\$	4,299	\$	6,890

**NOTE 5 EARNINGS PER COMMON SHARE**

We compute basic earnings per share ( EPS ) by dividing net income or loss available to common stockholders by the weighted average number of shares outstanding during the period, including common stock issuable under participating securities. We compute diluted EPS using the weighted average number of shares outstanding, including participating securities, plus all potentially dilutive common stock equivalents. Common stock equivalents consist of stock options and restricted stock.

Our policy is to treat unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents, whether paid or unpaid, as participating securities, included in the computation of both basic and diluted earnings per share. We exclude unvested restricted stock from our basic earnings per share. Our restricted stock, which vests based on the passage of time is included in dilutive earnings per share. Our restricted stock which vests contingent upon the attainment of annual performance goals is included in dilutive earnings per share as the performance goals are achieved. The following is the reconciliation of the denominator of the basic and diluted EPS computations (in thousands, except per share data):

	For the Three Months Ended September 30,			For the Nine Months Ended September 30,		
	2018	2017		2018	2017	
<b>Basic income per common share:</b>						
Net income	\$	549	\$	759	\$	1,192
Basic weighted average shares outstanding		12,117		11,940		12,103
Basic income per common share:	\$	0.05	\$	0.06	\$	0.10
<b>Diluted income per common share:</b>						
Net income	\$	549	\$	759	\$	1,192
Weighted average shares outstanding		12,117		11,940		12,103
Effect of dilutive securities - options and restricted stock		7		52		21
Diluted weighted average shares outstanding		12,124		11,992		12,124
Diluted income per common share:	\$	0.05	\$	0.06	\$	0.10

For the three months ended September 30, 2018 and 2017, 0.6 million and 0.4 million shares, respectively, underlying stock options were excluded from the dilutive stock calculation because their exercise prices were greater than the average fair value of our common stock for the

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period. For the nine months ended September 30, 2018 and 2017, 0.6 million and 0.4 million shares, respectively, underlying stock options were excluded from the dilutive stock calculation because their exercise prices were greater than the average fair value of our common stock for the period.

For the three and nine months ended September 30, 2018 and 2017, 0.4 million and 0.6 million shares, respectively, of unvested restricted stock were excluded from basic earnings per share, but a portion of the 0.4 and 0.6 million shares, respectively, were included in the dilutive EPS calculation with the results being antidilutive.



Table of Contents**NOTE 6 SHARE-BASED COMPENSATION**

We recognized \$0.1 million and \$0.2 million of compensation expense in the consolidated statements of operations, with respect to our stock-based compensation plans for the three months ended September 30, 2018 and 2017, and \$0.6 million and \$0.5 million for the nine months ended September 30, 2018 and 2017, respectively.

The following table summarizes share-based compensation expenses recorded in the consolidated statement of operations (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Cost of revenue, excluding depreciation and amortization	\$ 14	\$ 4	\$ 40	\$ 15
Sales and marketing	10	5	30	9
General and administrative	73	199	496	414
Product development		14	24	48
Total share-based compensation	\$ 97	\$ 222	\$ 590	\$ 486

**Stock Incentive Plans**

At September 30, 2018 and December 31, 2017, no shares were available for grant under the 2007 Stock Plan, as amended. At September 30, 2018 and December 31, 2017, 0.3 million and 0.7 million options were issued and outstanding under the 2007 Stock Plan as amended, respectively.

At September 30, 2018 and December 31, 2017, there were approximately 0.3 million shares and 0.1 million shares available for grant under the 2016 Stock Plan, respectively.

The fair market value of restricted shares for share-based compensation expensing is equal to the closing price of our common stock on the date of grant. Of the restrictions on the stock awards granted during the three months ended March 31, 2017, 20% vested in January 2018, and 10% will vest annually beginning on the one-year anniversary of their grant thereafter for four years. The remaining 40%, will be released evenly over four years beginning in 2018 contingent upon the attainment of annual performance goals established by our Board of Directors. In the nine months ended September 30, 2018, the first tranche was forfeited and no compensation was recognized based on not attaining the annual performance goals established.

The following is a summary of restricted stock activity under the plans for the nine months ended September 30, 2018:

	<b>Restricted Stock Number of Shares (in thousands)</b>
Unvested restricted stock at December 31, 2017	597
Less restricted stock vested	(178)
Less restricted stock forfeited/expired	(67)
Unvested restricted stock at September 30, 2018	352

## Edgar Filing: EVOLVING SYSTEMS INC - Form 10-Q

### Table of Contents

The following is a summary of stock option activity under the plans for the nine months ended September 30, 2018:

	Number of Shares (in thousands)		Weighted- Average Exercise Price		Weighted- Average Remaining Contractual Term (Years)		Aggregate Intrinsic Value (in thousands)
Options outstanding at December 31, 2017	713	\$	5.71		8.23	\$	128
Less options forfeited/cancelled	(114)		5.37				49
Less options exercised	(2)		2.03				2
Add options granted	30		2.25				
Options outstanding at September 30, 2018	627	\$	5.62		7.61	\$	22
Options exercisable at September 30, 2018	308	\$	6.70		6.37	\$	15

There were 30,000 and 50,000 stock options granted during the three and nine months ended September 30, 2018 and 2017, respectively. The weighted-average grant-date fair value of stock options granted were \$1.84 and \$1.92 during the three and nine months ended September 30, 2018 and 2017, respectively. As of September 30, 2018, there were approximately \$2.0 million of total unrecognized compensation costs related to unvested stock options and restricted stock. These costs are expected to be recognized over a weighted average period of 2.56 years. The total fair value of stock options vested during the three months ended September 30, 2018 and 2017 was approximately \$0.02 million and \$0.04 million, respectively. The total fair value of stock options vested during the nine months ended September 30, 2018 and 2017 was approximately \$0.02 million and \$0.1 million, respectively.

Cash received from stock option exercises for the three months ended September 30, 2018 and 2017 was \$0 and \$3,000, respectively. Cash received from stock option exercises for the nine months ended September 30, 2018 and 2017 was \$900 and \$27,000, respectively.

During the nine months ended September 30, 2018, we had no net settlement exercises of stock options. Net settlement exercises during the nine months ended September 30, 2017, resulted in 18,951 shares issued and 75,327 options cancelled in settlement of shares issued. There were no net settlement exercises during the three months ended September 30, 2017.

### **NOTE 7 CONCENTRATION OF CREDIT RISK**

For the three and nine months ended September 30, 2018, one significant customer (defined as contributing at least 10%) accounted for 11% of revenue from operations. The significant customer for the three and nine months ended September 30, 2018 is a large telecommunications operator in Europe.

For the three months ended September 30, 2017, one significant customer accounted for 12% of revenue from operations. The significant customer for the three months ended September 30, 2017 was a large telecommunications operator in Europe. For the nine months ended September 30, 2017, one significant customer accounted for 13% of revenue from operations. The significant customer for the nine months ended September 30, 2017 was a large telecommunications operator in Europe.

As of September 30, 2018 and December 31, 2017, no customers accounted for 10% of contract receivables and unbilled work-in-progress.

**NOTE 8 LONG-TERM DEBT**

On August 16, 2017, we entered into a Term Loan Facility Agreement with East West Bank as lender in the amount of \$4.7 million (the Loan Facility). The Loan Facility requires the Company to pay an Arrangement Fee ( Origination Fee ) of \$23,650, payable in four equal installments, with the first payment due on the date of the Loan Facility and the remaining three payments on the first, second and third anniversary thereof. The Company also agreed to pay East West Bank's legal fees in connection with the transaction. The Company may prepay the Loan Facility at any time, in a minimum amount of \$250,000 and increments of \$50,000, subject to a prepayment fee of 2% of the amount prepaid, on any prepayment made before the second anniversary date of the Agreement. The unpaid balance of the Loan Facility is due on August 16, 2021.

## Edgar Filing: EVOLVING SYSTEMS INC - Form 10-Q

### Table of Contents

The Loan Facility includes financial covenants to maintain a minimum current ratio, a specified ratio of Total Liabilities to EBITDA and a minimum fixed charge coverage ratio as well as negative covenants that place restrictions on EVOL Holdings, the Parent and Original Guarantors and the additional obligors' ability to, among other things: incur additional indebtedness; create liens or other encumbrances on assets; make loans, enter into letters of credit, guarantees, investments and acquisitions; sell or otherwise dispose of assets; declare dividends, cause or permit a change of control; merge or consolidate with another entity; enter into affiliate transactions; and change the nature of its business materially, subject to standard exceptions.

On February 29, 2016, we entered into the Fifth Amendment to the Loan and Security Agreement with East West Bank which provides for a Term Loan (the "Term Loan") for \$6.0 million. The \$6.0 million Term Loan bears interest at a floating rate equal to the U.S. Prime Rate plus 1.0%. As of September 30, 2018, the U.S. Prime Rate was 5.25%. The Term Loan is secured by substantially all of the assets of Evolving Systems, including a pledge, subject to certain limitations with respect to stock of foreign subsidiaries, of the stock of the existing and future direct subsidiaries of Evolving Systems. Interest accrues from the date the Term Loan was made at the aforementioned rate and is payable monthly. The Term Loan shall be repaid in 36 equal monthly installments of principal, plus accrued but unpaid interest, commencing on January 1, 2017 and continuing on the first day of each month thereafter through and including January 1, 2020. We must maintain a minimum current ratio, a specified ratio of Total Liabilities to EBITDA and a minimum fixed charge coverage ratio which are as defined in the Term Loan. The Term Loan requires us to pay two annual credit facility fees of \$18,750 and legal fee equal to \$1,000. The Term Loan matures on January 1, 2020.

The Term Loan and the Loan Facility (collectively, "Loans") include negative covenants that place restrictions on the Company's ability to, among other things: incur additional indebtedness; create liens or other encumbrances on assets; make loans, enter into letters of credit, guarantees, investments and acquisitions; sell or otherwise dispose of assets; cause or permit a change of control; merge or consolidate with another entity; make negative pledges; enter into affiliate transactions; limits the amount of cash distributions to our stockholders; and change the nature of our business materially. Outstanding amounts under the Term Loan may be accelerated by East West Bank upon the occurrence and continuance of certain events of default.

As of September 30, 2018, we are in compliance with the covenants and have a \$7.0 million balance under the Term Loan. As of September 30, 2018, our fixed charge ratio, as defined in the Loans, was 1.25, which met the minimum required 1.25 fixed charge coverage ratio.

### **NOTE 9 INCOME TAXES**

On December 22, 2017, the Tax Cuts and Jobs Act (the "Tax Act") was enacted in the United States. The Tax Act includes a number of changes to existing U.S. tax laws that impact the Company including the reduction of the U.S. corporate income tax rate from 35 percent to 21 percent for tax years beginning after December 31, 2017. The Tax Act also provides for a one-time transition tax on indefinitely reinvested foreign earnings and the acceleration of depreciation for certain assets placed into service after September 27, 2017, as well as prospective changes beginning in 2018, including the elimination of certain domestic deductions and credits, capitalization of research and development expenditures, and additional limitations on the deductibility of executive compensation and interest.

The income tax effects of the Tax Act in 2017 recognized in the Company's financial statements are provisional in accordance with Staff Accounting Bulletin No. 118, which provides SEC staff guidance for the application of ASC Topic 740, Income Taxes, in the reporting period in which the Tax Act was signed into law. As such, the Company's financial results reflect the income tax effects of the Tax Act for which accounting under ASC Topic 740 is incomplete, but a reasonable estimate could be determined. The Company did not identify items for which

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the income tax effects of the Tax Act have not been completed and a reasonable estimate could not be determined as of September 30, 2018 and December 31, 2017.

We recorded net income tax expense of \$0.3 million and \$0.2 million for the three months ended September 30, 2018 and 2017, respectively. The net expense during the three months ended September 30, 2018 consisted of current income tax expense of \$0.3 million. The current tax expense consists of income tax primarily from our U.K. based operations. The net expense during the three months ended September 30, 2017 consisted of current income tax expense of \$0.4 million and a deferred tax benefit of \$0.2 million. The current tax expense consists of income tax from our U.S., U.K., France and India based operations and unrecoverable foreign withholding taxes in the U.K. The deferred tax benefit was related primarily to the increase of certain net deferred tax assets and amortization of stock options and the intangible assets related to the acquisition of Evolving Systems NC, Inc. in September 2015.

We recorded net income tax expense of \$0.6 million and \$0.9 million for the nine months ended September 30, 2018 and 2017, respectively. The net expense during the nine months ended September 30, 2018 consisted of current income tax expense of \$0.9 million and a deferred tax benefit of \$0.3 million. The current tax expense consists of income tax primarily from our U.K. based operations. The deferred tax benefit was related primarily to the amortization of deferred tax liabilities in the U.S. The net expense during the nine months ended September 30, 2017 consisted of current income tax expense of \$1.2 million and a deferred tax benefit

## Edgar Filing: EVOLVING SYSTEMS INC - Form 10-Q

### Table of Contents

of approximately \$0.3 million. The current tax expense consists of income tax from our U.K. and India based operations and unrecoverable foreign withholding taxes in the U.K.

Our effective tax rate was 38% and 19% for the three months ended September 30, 2018 and 2017, respectively. The increase in our effective tax rate relates to our net income coming from non-U.S. operations and net losses from our U.S. operations for which we do not recognize a net deferred tax benefit.

Our effective tax rate was 34% and 24% for the nine months ended September 30, 2018 and 2017, respectively. The increase in our effective tax rate relates to our net income coming from non-U.S. operations and net losses from our U.S. operations for which we do not recognize a net deferred tax benefit.

As of September 30, 2018, and December 31, 2017 we continued to maintain a valuation allowance on our domestic net deferred tax asset for foreign tax credit ( FTC ) carryforwards, certain state NOL carryforwards and research and development tax credits. We have \$0.8 million in AMT tax credits that are a deferred tax asset that, as a result of U.S. tax reform, carry no valuation allowance. Our deferred tax assets and liabilities as of September 30, 2018 and December 31, 2017, were comprised of the following (in thousands):

	September 30, 2018	December 31, 2017
<b>Deferred tax assets:</b>		
Foreign tax credits carryforwards	\$ 4,750	\$ 4,731
Net operating loss carryforwards	2,847	3,294
Research & development credits	303	303
AMT credits	770	770
Stock compensation	685	570
Depreciable assets	29	33
Accrued liabilities and reserves	256	66
Total deferred tax assets	9,640	9,767
<b>Deferred tax liabilities:</b>		
Intangibles	(1,034)	(1,045)
Accrued liabilities and reserves	(176)	(120)
Total deferred tax liability	(1,210)	(1,165)
Net deferred tax assets, before valuation allowance	8,430	8,602
Valuation allowance	(7,990)	(8,328)
Net deferred tax asset	\$ 440	\$ 274

Two Indian subsidiaries of SSM were acquired pursuant to the terms of the Agreement and Plan of Merger dated September 30, 2015. We have reason to believe there is uncertainty related to the lack of historical U.S. International reporting for these two foreign subsidiaries, and are in the process of determining whether either or both of these subsidiaries are controlled foreign corporations ( CFCs ) within the meaning of the Internal Revenue Code and related Regulations, or if a check-the-box election has taken place to effectively treat one or both of these subsidiaries as disregarded entities for U.S. federal tax reporting purposes. The Company is in the process of obtaining pertinent information to assess the degree of uncertainty and to quantify related costs or liabilities.

As of September 30, 2018, and December 31, 2017 we had no liability for unrecognized tax benefits.

We conduct business globally and, as a result, Evolving Systems, Inc. or one or more of our subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. Throughout the world, in the normal course of business, we are subject to examination by taxing authorities up until, two years in the U.K. and four years in India, following the end of the accounting period. As of the date of this report, none of our income tax returns are under examination.



Table of Contents**NOTE 10 GEOGRAPHICAL INFORMATION**

We are headquartered in Englewood, a suburb of Denver, Colorado. We use customer locations as the basis for attributing revenues to individual countries. We provide products and services on a global basis through our headquarters, our London-based Evolving Systems U.K. subsidiary, EVOL BLS, Lumata Entities and our North Carolina based Evolving Systems NC, Inc. subsidiary. Additionally, personnel in Bangalore and Kolkata, India, Grenoble, France and Cluj-Napoca, Romania provide software development and support services to our global operations. Financial information relating to long-lived assets by geographic region is as follows (in thousands):

	September 30, 2018		December 31, 2017
<b>Long-lived assets, net</b>			
United States	\$ 10,745	\$	11,276
United Kingdom	17,252		17,968
Other	1,876		1,843
	\$ 29,873	\$	31,087

**NOTE 11 COMMITMENTS AND CONTINGENCIES****(a) Other Commitments**

As permitted under Delaware law, we have agreements with officers and directors under which we agree to indemnify them for certain events or occurrences while the officer or director is, or was, serving at our request in this capacity. The term of the indemnification period is indefinite. There is no limit on the amount of future payments we could be required to make under these indemnification agreements; however, we maintain Director and Officer insurance policies, as well as an Employment Practices Liability Insurance Policy, that may enable us to recover a portion of any amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal. Accordingly, there were no liabilities recorded for these agreements as of September 30, 2018 or December 31, 2017.

We enter into standard indemnification terms with customers and suppliers, in the ordinary course of business, for third party claims arising under our contracts. In addition, as we may subcontract the development of deliverables under customer contracts, we could be required to indemnify customers for work performed by subcontractors. Depending upon the nature of the indemnification, the potential amount of future payments we could be required to make under these indemnification agreements may be unlimited. We may be able to recover damages from a subcontractor or other supplier if the indemnification results from the subcontractor's or supplier's failure to perform. To the extent we are unable to recover damages from a subcontractor or other supplier, we could be required to reimburse the indemnified party for the full amount. We have never incurred costs to defend lawsuits or settle claims relating to an indemnification. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, there were no liabilities recorded for these agreements as of September 30, 2018 or December 31, 2017.

Our standard license agreements contain product warranties that the software will be free of material defects and will operate in accordance with the stated requirements for a limited period of time. The product warranty provisions require us to cure any defects through any reasonable means. We believe the estimated fair value of the product warranty provisions in the license agreements in place with our customers is minimal. Accordingly, there were no liabilities recorded for these product warranty provisions as of September 30, 2018 or December 31, 2017.

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Our software arrangements generally include a product indemnification provision whereby we will indemnify and defend a customer in actions brought against the customer for claims that our products infringe upon a copyright, trade secret, or valid patent of a third party. We have not historically incurred any significant costs related to product indemnification claims. Accordingly, there were no liabilities recorded for these indemnification provisions as of September 30, 2018 or December 31, 2017.

When we acquired Telespree on October 24, 2013, we agreed to make a final cash payment on October 24, 2014 of \$0.5 million. This payment was subject to reduction for certain claims and we notified the seller's representative that we were asserting claims against the final cash payment prior to October 24, 2014. The contractually agreed time period for mandatory arbitration, as well as the applicable Delaware state law, has lapsed. Accordingly, we eliminated the liability as of June 30, 2018 and recognized \$0.5 million in other income prior to the three months but included in the nine months ended September 30, 2018, respectively.

Table of Contents

**(b)                    Litigation**

In June 2018, we agreed to a Mutual Release and Settlement Agreement and a Contribution Agreement (the "SSM Agreements") with certain parties related to our September 30, 2015 acquisition of SSM. The SSM Agreements settled a dispute with a former SSM contractor, for which the Company asserted indemnification from the SSM sellers. Under the SSM Agreements, in July 2018 we paid \$0.3 million toward the settlement, \$0.1 million of which was on the Company's behalf and recorded as other expense for the nine months ended September 30, 2018. The Company and the SSM sellers agreed to offset the Company's contribution to the settlement against the final payment due to the SSM sellers and, therefore, we were released from a \$0.3 million final payment due to the sellers of SSM.

From time to time, we are involved in various legal matters arising in the normal course of business. We do not expect the outcome of such proceedings, either individually or in the aggregate, to have a material effect on our financial position, cash flows or results of operations.

Table of Contents

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

**SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS**

*This Quarterly Report on Form 10-Q contains forward-looking statements that have been made pursuant to the provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on current expectations, estimates, and projections about Evolving Systems' industry, management's beliefs, and certain assumptions made by management. Forward-looking statements include our expectations regarding product, services, and maintenance revenue, annual savings associated with the organizational changes effected in prior years, and short- and long-term cash needs. In some cases, words such as anticipates, expects, intends, plans, believes, estimates, variations of these words, and similar expressions are intended to identify forward-looking statements. The statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially from those expressed or forecasted in any forward-looking statements. Risks and uncertainties of our business include those set forth in our Annual Report on Form 10-K for the year ended December 31, 2017 under Item 1A. Risk Factors as well as additional risks described in this Form 10-Q. Unless required by law, we undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or otherwise. However, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the Securities and Exchange Commission, particularly the Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.*

**OVERVIEW**

Evolving Systems, Inc. is a provider of real-time digital engagement solutions and services to the wireless carrier and consumer financial services markets. We operate a managed services business model through which we maintain long-standing relationships with many of the largest wireless companies worldwide. The Company's portfolio includes market-leading solutions and services for real-time analytics, customer acquisition and activation, customer value management and loyalty for the telecom industry promoting partnerships into retail and financial services. The Company has moved from selling technology to offering business solutions. The value proposition likewise has moved away from cost savings to a focus on revenue increases for the carrier and our business model has moved from classic capital expenditure license and services to operating expense models based on managed services with performance fees.

In July 2017, we completed our acquisition of BLS, a company headquartered in Newbury, United Kingdom that specializes in data-driven customer value management and customer engagement solutions that have been implemented in over 20 mobile operators in Europe, Africa, Asia-Pacific and the Caribbean. BLS solutions can turn customer data into actionable insights and personalized contextual offers. Customer engagement occurs through in-bound and out-bound offers and is further extended through a suite of loyalty and retention solutions.

In September 2017, we completed the acquisition of four business operating units of the Lumata Entities. The Lumata Entities are a leading global provider of real-time, next generation loyalty and customer lifecycle management software and services that help businesses gain value from their customer data for relevant and contextual insights and actions of value to both customers and enterprises. Lumata's customers include wireless carriers Orange, Telefonica and other Tier-1 and emerging wireless carriers in Europe, Asia, the Middle East, Africa, the Caribbean and Central and South America.

**RECENT DEVELOPMENTS**

Consolidated revenue was \$7.4 million and \$7.5 million for the three months ended September 30, 2018 and 2017, respectively. The decrease was due to the decline in licensing revenue as the Company transitions to a managed services model and decline in services with our historical client relationships, offset by the increase in revenue from the acquired Lumata Entities. Consolidated revenue was \$23.7 million and \$19.6 million for the nine months ended September 30, 2018 and 2017, respectively. The increase in revenue for the nine months ended is due to additional contractual relationships from BLS and Lumata Entities (the Acquired Companies ) partially offset by a decline in licensing and service fees from our historical client relationships.

We have operations in foreign countries that use their respective local currencies to prepare the financial statements and we translate into our reporting currency, United States ( U.S. ) Dollars. Changes in the exchange rates between these currencies and the U.S. dollar are partially responsible for some of the changes from period to period in our financial statement amounts. The chart below summarizes how our revenue and expenses would change had they been reported on a constant currency basis. The constant currency basis assumes that the exchange rate was constant for the periods presented (in thousands):

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Table of Contents

	For the Three Months Ended September 30, 2018 vs. 2017		For the Nine Months Ended September 30, 2018 vs. 2017	
<b>Changes in:</b>				
Revenue	\$	(72)		542
Costs of revenue and operating expenses		(2,105)		(3,502)
Income from operations	\$	(2,177)		(2,960)

The net effect of our foreign currency translations for the three months ended September 30, 2018 was a \$0.1 million decrease in revenue and a \$2.1 million decrease in operating expenses versus the three months ended September 30, 2017. The net effect of our foreign currency translations for the nine months ended September 30, 2018 was a \$0.5 million increase in revenue and a \$3.5 million decrease in operating expenses versus the nine months ended September 30, 2017.

**RESULTS OF OPERATIONS**

The following table presents the unaudited consolidated statements of operations reflected as a percentage of total revenue:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>REVENUE</b>				
License fees	3%	14%	4%	11%
Services	97%	86%	96%	89%
Total revenue	100%	100%	100%	100%
<b>COSTS OF REVENUE AND OPERATING EXPENSES</b>				
Costs of revenue, excluding depreciation and amortization	32%	34%	34%	29%
Sales and marketing	22%	19%	21%	18%
General and administrative	20%	20%	23%	18%
Product development	15%	5%	12%	7%
Depreciation	0%	1%	0%	1%
Amortization	3%	3%	3%	3%
Restructuring	0%	2%	0%	1%
Total costs of revenue and operating expenses	92%	84%	93%	77%
Income from operations	8%	16%	7%	23%
Other income (expense)				
Interest income	0%		0%	0%
Interest expense	(2)%	(1)%	(2)%	(1)%
Other income	1%		0%	
Foreign currency exchange income (loss)	5%	(3)%	2%	(3)%
Other income (expense), net	4%	(4)%	0%	(4)%
Income from operations before income taxes	12%	12%	7%	19%
Income tax expense	5%	2%	3%	5%

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Net income	7%	10%	4%	14%
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Table of Contents

***Revenue***

Revenue is comprised of license fees and services. License fees represent the fees we receive from the licensing of our software products. Services revenue are directly related to the delivery of the licensed product as well as integration services, managed services, SaaS services, time and materials work and customer support services. Customer support services include annual support fees, recurring maintenance fees, minor product upgrades and warranty fees. Warranty fees are typically deferred and recognized over the warranty period.

***License Fees***

License fees revenue was \$0.3 million and \$1.1 million for the three months ended September 30, 2018 and 2017, respectively. The decrease in revenues of \$0.8 million is related to a decline in services to implement license solutions from the same quarter prior year and a decline in licensing activity of the historical products as the Company transitions to a managed services model.

License fees revenue was \$0.8 million and \$2.1 million for the nine months ended September 30, 2018 and 2017, respectively. The decrease in revenues of \$1.3 million resulted from a \$0.8 million decline in services to implement license solutions from the same quarter prior year and a decline of \$0.5 million in licensing activity of First Use Activations as the Company transitions to a managed services model.

***Services***

Services revenue increased \$0.7 million, or 11%, to \$7.2 million for the three months ended September 30, 2018 from \$6.5 million for the three months ended September 30, 2017. The increase is related to \$1.1 million in service revenue from the acquired Lumata Entities offset by a decline in our services revenues related to our historical relationships related to fewer new implementations and pricing pressures.

Services revenue increased \$5.4 million, or 31%, to \$22.9 million for the nine months ended September 30, 2018 from \$17.5 million for the nine months ended September 30, 2017. The increase is related to \$6.6 million in service revenue from the Acquired Companies offset by a net decline in our services revenues related to historical relationships of \$1.2 million due to fewer new implementations and pricing pressures.

***Costs of Revenue, Excluding Depreciation and Amortization***

Costs of revenue, excluding depreciation and amortization, consist primarily of personnel costs and other direct costs associated with these personnel, facilities costs, costs of third party software and partner commissions. Costs of revenue includes product development expenses related to software features requested in advance of their scheduled availability which are funded by customers as part of a managed service offering. Costs of revenue, excluding depreciation and amortization decreased \$0.2 million, or 8%, to \$2.4 million for the three months ended September 30, 2018 from \$2.6 million for the three months ended September 30, 2017. The decrease in costs of revenue of \$0.2 million is primarily attributable to lower service project hours allowing resources to work on internal projects and product development offset by an increase in additional service hours from Lumata of \$0.4 million. As a percentage of revenue, costs of revenue, excluding depreciation and



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amortization, decreased to 32% for the three months ended September 30, 2018 from 34% for the three months ended September 30, 2017. The decrease as a percentage of revenue is primarily due to the decreased hours worked on client projects as staff was used to support internal efforts including product development partially offset by the increase of resources from the acquired Lumata Entities involved in projects generating lower margins.

Costs of revenue, excluding depreciation and amortization increased \$2.4 million, or 42%, to \$8.1 million for the nine months ended September 30, 2018 from \$5.7 million for the nine months ended September 30, 2017. The increase in costs of revenue is primarily attributable to higher service project hours from the Acquired Companies of \$3.2 million partially offset by lower service project hours allowing resources to work on internal projects and product development. As a percentage of revenue, costs of revenue, excluding depreciation and amortization, increased to 34% for the nine months ended September 30, 2018 from 29% for the nine months ended September 30, 2017. The increase as a percentage of revenue is primarily due to the increased hours and resource costs from the Acquired Companies on projects generating lower margins.

### *Sales and Marketing*

Sales and marketing expenses primarily consist of compensation costs, including incentive compensation and commissions, travel expenses, advertising, marketing and facilities expenses. Sales and marketing expenses increased \$0.3 million, or 21%, to \$1.7

Table of Contents

million for the three months ended September 30, 2018 from \$1.4 million for the three months ended September 30, 2017. The increase in expenses is attributable to \$0.2 million in costs from Lumata and \$0.1 million in additional staff. As a percentage of total revenue, sales and marketing expenses increased to 22% for the three months ended September 30, 2018 from 19% for the three months ended September 30, 2017. The increase in sales and marketing expenses as a percentage of revenue is primarily due to the aforementioned higher costs.

Sales and marketing expenses increased \$1.4 million, or 40%, to \$4.9 million for the nine months ended September 30, 2018 from \$3.5 million for the nine months ended September 30, 2017. The increase in expenses is attributable to \$1.4 million in costs from the Acquired Companies. As a percentage of total revenue, sales and marketing expenses increased to 21% for the nine months ended September 30, 2018 from 18% for the nine months ended September 30, 2017. The increase in sales and marketing expenses as a percentage of revenue is primarily due to the aforementioned higher costs.

***General and Administrative***

General and administrative expenses consist principally of employee-related costs for the following departments: finance, human resources, and certain executive management; facilities costs; and professional and legal fees. General and administrative expenses decreased \$0.1 million or 6% to \$1.5 million for the three months ended September 30, 2018 from \$1.6 million for the three months ended September 30, 2017. The decrease in costs attributed to Lumata of \$0.2 million as the same quarter prior year included \$0.3 million of acquisition fees offset by a \$0.1 million increase in 2018 to professional fees related to legal, audits and routine regulatory filings in connection with the Acquired Companies. As a percentage of revenue, general and administrative expenses remained at 20% for the three months ended September 30, 2018 and 2017, respectively.

General and administrative expenses increased \$1.8 million or 50% to \$5.4 million for the nine months ended September 30, 2018 from \$3.6 million for the nine months ended September 30, 2017. The increase in costs was related to \$0.4 million in costs related to the Acquired Companies, \$0.6 million in legal costs related to finalizing a matter regarding our September 2015 SSM acquisition, a \$0.4 million increase in our unbilled work in progress mostly related to one customer project and \$0.4 million in professional fees related to audits and routine regulatory filings in connection with the Acquired Companies. As a percentage of revenue, general and administrative expenses increased to 23% for the nine months ended September 30, 2018 from 18% for the nine months ended September 30, 2017. The increase in general and administrative expenses as a percentage of revenue is primarily due to the aforementioned higher costs.

***Product Development***

Product development expenses consist primarily of employee-related costs and subcontractor expenses. Product development expenses increased \$0.7 million, or 175%, to \$1.1 million for the three months ended September 30, 2018 from \$0.4 million for the three months ended September 30, 2017. The increase is primarily related to \$0.2 million in additional costs related to Lumata and \$0.5 million related to additional work by the technical staff in building and enhancing our product offerings. As a percentage of revenue, product development expenses increased to 15% for the three months ended September 30, 2018 from 5% for the three months ended September 30, 2017. The increase in product development expenses as a percentage of revenue is primarily due to the aforementioned higher costs.

Product development expenses increased \$1.4 million, or 93%, to \$2.9 million for the nine months ended September 30, 2018 from \$1.5 million for the nine months ended September 30, 2017. The increase is primarily related to \$1.2 million in additional costs related to the Acquired Companies and additional work by the technical staff in building and enhancing our product offerings. As a percentage of revenue, product

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development expenses increased to 12% for the nine months ended September 30, 2018 from 7% for the nine months ended September 30, 2017. The increase in product development expenses as a percentage of revenue is primarily due to the aforementioned higher costs.

### *Depreciation*

Depreciation expense consists of depreciation of long-lived property and equipment. Depreciation expense was approximately \$0.02 million and \$0.06 million for the three months ended September 30, 2018 and 2017, respectively. As a percentage of total revenue, depreciation expense for the three months ended September 30, 2018 and 2017 was less than 1%.

Depreciation expense was approximately \$0.1 million and \$0.2 million for the nine months ended September 30, 2018 and 2017. As a percentage of total revenue, depreciation expense for the nine months ended September 30, 2018 and 2017 was less than 1%.

Table of Contents

***Amortization***

Amortization expense consists of amortization of identifiable intangible assets acquired through our acquisitions of Evolving Systems Labs, Inc., Evolving Systems NC, Inc., BLS, and the Lumata Entities. Amortization expense remained at \$0.2 million for the three months ended September 30, 2018 and 2017, respectively. As a percentage of total revenue, amortization expense remained at 3% for the three months ended September 30, 2018 and 2017.

Amortization expense was \$0.7 million and \$0.6 million for the nine months ended September 30, 2018 and 2017, respectively. As a percentage of total revenue, amortization expense remained at 3% for the nine months ended September 30, 2018 and 2017.

***Interest Expense***

Interest expense includes the amortization of debt issuance costs and interest expense from our term loans. Interest expense for the three months ended September 30, 2018 and 2017, remained at \$0.1 million. As a percent of revenue, interest expense was 2% and 1% for the three months ended September 30, 2018 and 2017, respectively.

Interest expense was \$0.4 million and \$0.2 million for the nine months ended September 30, 2018 and 2017, respectively. As a percent of revenue, interest expense was 2% and 1% for the nine months ended September 30, 2018 and 2017, respectively. The increase is related to the term loan borrowings used to acquire the Lumata Entities.

***Other Income (Expense)***

In the three months ended September 30, 2018, we determined that we no longer needed to carry certain allowances and unearned revenue that came from the Lumata entities at the time of our acquisition and we recognized \$0.07 million in other income, net by eliminating the items. For the three months ended September 30, 2017, we had no other income.

For the nine months ended September 30, 2018, we had \$0.06 million in other income, net, which consisted of the \$0.07 million in other income noted above and the following items recognized in the three months ended June 30, 2018: (1) When we acquired Telespree on October 24, 2013, we agreed to make a final cash payment on October 24, 2014 of \$0.5 million. This payment was subject to reduction for certain claims and we notified the seller's representative that we were asserting claims against the final cash payment and the contractually agreed time period has lapsed. Accordingly, we eliminated the liability as of June 30, 2018 and recognized \$0.5 million in other income; (2) At the end of the second quarter we agreed to a Mutual Release and Settlement Agreement and a Contribution Agreement (the SSM Agreements) with certain parties related to our September 30, 2015 acquisition of SSM. The SSM Agreements settled a dispute with a former SSM contractor, of which \$0.1 million was on the Company's behalf and recorded as other expense; (3) When we acquired EVOL BLS on July 3, 2017, we agreed to make up to three annual cash payments equal to 50% of the EVOL BLS revenue in excess of \$4.8 million for the 12-month periods ending July 3, 2018, 2019 and 2020. The Company also agreed to guarantee the EVOL BLS obligations under the Purchase Agreement. As of June 30, 2018, EVOL BLS has exceeded their projected revenues and we estimated the total annual cash payments for the three 12-month periods to be \$0.8 million, which is a \$0.4 million increase. We recognized \$0.4 million in the other expense as a result of our increased obligation.

For the nine months ended September 30, 2017, we had no other income.

***Foreign Currency Exchange Income***

Foreign currency exchange income resulted from transactions denominated in a currency other than the functional currency of the respective subsidiary increased \$0.6 million or 300% to \$0.4 million of income for the three months ended September 30, 2018 from a loss of \$0.2 million for the three months ended September 30, 2017 and increased \$1.1 million or 183% to \$0.5 million of income for the nine months ended September 30, 2018 from a loss of \$0.6 million for the nine months ended September 30, 2017, respectively. The income was generated primarily through the re-measurement of certain non-functional currency denominated financial assets and liabilities of our foreign subsidiaries.

***Other Comprehensive (Loss) Income***

Other comprehensive (loss) income refers to revenue, expenses, gains, and losses that under GAAP are recorded as an element of stockholders equity but are excluded from net income. Other comprehensive (loss) income consists of foreign currency translation adjustments from those subsidiaries not using the U.S. dollar as their functional currency. Other comprehensive loss was \$0.6 million during the three months ended September 30, 2018 compared to income of \$0.3 million during the three months ended September 30, 2017. The current period loss is related to the strengthening of the U.S. Dollar and the related translation of

Table of Contents

our U.K. subsidiaries' assets and liabilities to the U.S. Dollar for consolidation purposes. The gain for the three months ended September 30, 2017 was due to a strengthening of the British Pound Sterling and the related translation of our U.K. subsidiaries' assets and liabilities to the U.S. Dollar for consolidation purposes.

For the nine months ended September 30, 2018, other comprehensive loss was \$1.5 million compared to income of \$1.5 million for the nine months ended September 30, 2017. The loss for the nine months ended September 30, 2018 was due to the strengthening of the U.S. Dollar and the related translation of our U.K. subsidiaries' assets and liabilities to the U.S. Dollar for consolidation purposes. The gain for the nine months ended September 30, 2017 was due to a strengthening of the British Pound Sterling during the prior year and the related translation of our U.K. subsidiaries' assets and liabilities to the U.S. Dollar for consolidation purposes.

***Income Taxes***

We recorded income tax expense of \$0.3 million and \$0.2 million for the three months ended September 30, 2018 and 2017, respectively. The net expense during the three months ended September 30, 2018 consisted of current income tax expense of \$0.3 million. The current tax expense primarily consists of income tax from our U.K.-based operations. The net expense during the three months ended September 30, 2017 consisted of current income tax expense of \$0.4 million and a deferred tax benefit of approximately \$0.2 million. The current tax expense consists of income tax from our U.S., U.K., France and India based operations. The deferred tax benefit was related primarily to the increase of certain net deferred tax assets and amortization of stock options and the intangible assets related to the acquisition of Evolving Systems NC, Inc. in September 2015.

We recorded net income tax expense of \$0.6 million and \$0.9 million for the nine months ended September 30, 2018 and 2017, respectively. The net expense during the nine months ended September 30, 2018 consisted of current income tax expense of \$0.9 million and a deferred tax benefit of \$0.3 million. The current tax expense consists of income tax from our U.K. based operations. The deferred tax benefit was related primarily to the decrease in deferred tax liabilities in the U.S. The net expense during the nine months ended September 30, 2017 consisted of current income tax expense of \$1.2 million and a deferred tax benefit of approximately \$0.3 million. The current tax expense consists of income tax from our U.S., U.K., France and India based operations. The deferred tax benefit was primarily related to the increase of certain net deferred tax assets and amortization of stock options and the intangible assets related to the acquisition of Evolving Systems NC, Inc.

Our effective tax rate was 38% and 19% for the three months ended September 30, 2018 and 2017, respectively. The increase in our effective tax rate relates to our net income coming from non-U.S. operations and net losses from our U.S. operations for which we do not recognize a net deferred tax benefit.

Our effective tax rate was 34% and 24% for the nine months ended September 30, 2018 and 2017, respectively. The increase in our effective tax rate relates to our net income coming from non-U.S. operations and net losses from our U.S. operations for which we do not recognize a net deferred tax benefit.

As of September 30, 2018, and December 31, 2017 we continued to maintain a valuation allowance on our domestic net deferred tax asset for FTC carryforwards, certain state NOL carryforwards and research and development tax credits. We have \$0.8 million in AMT tax credits that are a deferred tax asset that, as a result of U.S. tax reform, carry no valuation allowance. See Note 9 to the financial statements for a summary of our deferred tax assets and liabilities.

#### **FINANCIAL CONDITION**

Our working capital position decreased \$1.2 million, or 13%, to \$7.8 million as of September 30, 2018 from \$9.0 million as of December 31, 2017. The decrease in working capital is related to decrease in accounts receivable, unbilled work in progress, prepaids and other assets along with an increase in current notes payable and offset by increases in cash coinciding with the decrease in accounts payable and accrued liabilities and unearned revenue.

#### **CONTRACTUAL OBLIGATIONS**

There have been no material changes to the contractual obligations as disclosed in our 2017 Annual Report on Form 10-K.

#### **LIQUIDITY AND CAPITAL RESOURCES**

We have historically financed operations through cash flows from operations as well as debt and equity transactions. At September 30, 2018, our principal source of liquidity was \$8.5 million in cash and cash equivalents and \$7.7 million in contract receivables, net of allowances. Our anticipated uses of cash in the future will be to fund the expansion of our business through both

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### Table of Contents

organic growth as well as possible acquisition activities, the expansion of our customer base internationally and term loan payments. Other uses of cash may include capital expenditures and technology expansion.

Net cash provided by operating activities for the nine months ended September 30, 2018 and 2017 was \$2.8 million and \$2.6 million, respectively. Cash provided by operating activities for the nine months ended September 30, 2018 was primarily due to decrease in contract receivables of \$2.1 million, unbilled work-in-process of \$1.1 million, amortization of intangible assets of \$0.7 million, change in fair value of contingent consideration earn-out of \$0.4 million and offset by an decrease in unearned revenue of \$0.5 million, accounts payable and accrued liabilities of approximately \$2.9 million related primarily to vendor payments. Cash provided by operating activities for the nine months ended September 30, 2017 was primarily due to net income and amortization of intangible assets coupled with increase in unearned revenue related to the Acquired Companies, increase in prepaid and other assets, and long-term obligation related to the contingent consideration earn-out, offset by a decrease in accounts payable and accrued liabilities related primarily to vendor payments coupled with an increase in contract receivables and unbilled work-in-process related to the Acquired Companies.

Net cash used in investing activities during the nine months ended September 30, 2018 and 2017 was \$0.05 million and \$6.0 million, respectively. Cash used for the nine months ended September 30, 2018 was primarily due to the purchase of property and equipment of \$0.05 million. Cash used for the nine months ended September 30, 2017 was primarily due to the acquisition of the Acquired Companies of \$5.9 million and the purchase of property and equipment of \$0.07 million.

Net cash used in financing activities of \$1.8 million compared to net cash provided by financing activities of \$3.2 million during the nine months ended September 30, 2018 and 2017, respectively, was primarily related to principal payments on our term loan.

We believe that our current cash and cash equivalents, together with anticipated cash flow from operations will be sufficient to meet our working capital, capital expenditure and financing requirements for at least the next twelve months from the date of issuance of these condensed consolidated financial statements. In making this assessment we considered the following:

- Our cash and cash equivalents balance at September 30, 2018 of \$8.5 million;
- Our working capital balance of \$7.8 million; and
- Our demonstrated ability to generate positive cash flows from operations.

As set forth in our Annual Report on Form 10-K for the year ended December 31, 2017 under Item 1A. Risk Factors, our term loan borrowings require us to maintain a minimum current ratio, a specified ratio of Total Liabilities to EBITDA and a minimum fixed charge coverage ratio, as defined in the Term Loan and the Loan Facility. As of September 30, 2018, our fixed charge coverage ratio was 1.25, which met the minimum required 1.25 fixed charge coverage ratio.



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We are exposed to foreign currency rate risks which impact the carrying amount of our foreign subsidiaries and our consolidated equity, as well as our consolidated cash position due to translation adjustments. For the nine months ended September 30, 2018 and 2017, the effect of exchange rate changes resulted in a \$0.02 million increase and \$0.1 million increase, respectively. We do not currently hedge our foreign currency exposure, but we monitor rate changes and may hedge our exposures if we see significant negative trends in exchange rates.

### **OFF-BALANCE SHEET ARRANGEMENTS**

We have no off-balance sheet arrangements that have a material current effect or that are reasonably likely to have a material future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In the ordinary course of business, we are exposed to certain market risks, including changes in interest rates and foreign currency exchange rates. Uncertainties that are either non-financial or non-quantifiable such as political, economic, tax, other regulatory, or credit risks are not included in the following assessment of market risks.

Table of Contents**Interest Rate Risks**

Our cash balances are subject to interest rate fluctuations and as a result, interest income amounts may fluctuate from current levels. Refer to Note 8, Long-Term Debt, of our Unaudited Condensed Consolidated Financial Statements included elsewhere in this Quarterly Report on Form 10-Q for more information regarding the Term Loan. A 1% change in the interest rates on our loans would change interest expense by approximately \$0.1 million.

**Foreign Currency Risk**

We are exposed to favorable and unfavorable fluctuations of the U.S. dollar (our functional currency) against the currencies of our operating subsidiaries. Any increase (decrease) in the value of the U.S. dollar against any foreign currency that is the functional currency of one of our operating subsidiaries will cause the parent company to experience unrealized foreign currency translation losses (gains) with respect to amounts already invested in such foreign currencies. In addition, we and our operating subsidiaries are exposed to foreign currency risk to the extent that we enter into transactions denominated in currencies other than our respective functional currencies, such as accounts receivable (including intercompany amounts) that are denominated in a currency other than their own functional currency. Changes in exchange rates with respect to these items will result in unrealized (based upon period-end exchange rates) or realized foreign currency transaction gains and losses upon settlement of the transactions. In addition, we are exposed to foreign exchange rate fluctuations related to our operating subsidiaries' monetary assets and liabilities and the financial results of foreign subsidiaries and affiliates when their respective financial statements are translated into U.S. dollars for inclusion in our consolidated financial statements. Cumulative translation adjustments are recorded in accumulated other comprehensive income (loss) as a separate component of equity. As a result of foreign currency risk, we may experience economic loss and a negative impact on earnings and equity with respect to our holdings solely as a result of foreign currency exchange rate fluctuations.

The relationship between the British pound sterling Euro, Indian rupee and the U.S. dollar, which is our functional currency, is shown below, per one U.S. dollar:

	September 30, 2018		December 31, 2017	
<b>Spot rates:</b>				
British pound sterling	0.76750		0.74071	
Euro	0.86179		0.83348	
Indian rupee	72.51330		63.84000	
	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>Average rates:</b>				
British pound sterling	0.76773	0.76414	0.74073	0.78463
Euro	0.86034	N/A	0.83766	N/A
Indian rupee	70.09840	64.27852	67.16048	65.24591

At the present time, we do not hedge our foreign currency exposure or use derivative financial instruments that are designed to reduce our long-term exposure to foreign currency exchange risk. To the extent that translation and transaction gains and losses become significant, we will consider various options to reduce this risk.

**ITEM 4. CONTROLS AND PROCEDURES**

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act ), that are designed to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Senior Vice President of Finance, as appropriate, to allow timely decisions regarding required disclosure.

Our management, including our Chief Executive Officer and Senior Vice President of Finance, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Senior Vice President of Finance have concluded that our disclosure controls and procedures were effective as of the end of such period.

Table of Contents

In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

During the three and nine months ended September 30, 2018, there were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) or in other factors that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

In June 2018, we agreed to a Mutual Release and Settlement Agreement and a Contribution Agreement (the "SSM Agreements") with certain parties related to our September 30, 2015 acquisition of SSM. The SSM Agreement settled a dispute with a former SSM contractor, for which the Company asserted indemnification from the SSM sellers. Under the SSM Agreements, in July 2018 we paid \$0.3 million toward the settlement, \$0.1 million of which was on its own behalf and recorded as other expense for the three months ended June 30, 2018. The Company and the SSM sellers agreed to offset the Company's contribution to the settlement against the final payment due to the SSM sellers and, therefore, we were released from the \$0.3 million final payment due to the sellers of SSM.

We are involved in various legal matters arising in the normal course of business. Losses, including estimated costs to defend, are recorded for these matters to the extent they were probable of loss and the amount of loss could be reasonably estimated. We do not believe that any such matters, either individually or in the aggregate, will have a material impact on our results of operations and financial position.

**ITEM 1A. RISK FACTORS**

There have been no material changes in the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017, filed with the SEC on April 2, 2018.

This Quarterly Report on Form 10-Q should be read in conjunction with the risk factors defined in our Annual Report on Form 10-K for the year ended December 31, 2017 under Item 1A. Risk Factors.

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

None

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4. MINE SAFETY DISCLOSURES**

None

**ITEM 5. OTHER INFORMATION**

The 2019 Annual Meeting of Stockholders of Evolving Systems, Inc. (the Company) was previously scheduled for June 2019. The Board of Directors of the Company has designated February 27, 2019 as the rescheduled date for the 2019 Annual Meeting of Stockholders of the Company. Pursuant to Rule 14a-5(f) and Rule 14a-8(e)(2) under the Securities Exchange Act of 1934, as amended (the Exchange Act), because the meeting date is more than 30 days from the anniversary of the Company's 2018 Annual Meeting of Stockholders, the Company has set December 14, 2018 as the new deadline for the receipt of shareholder proposals submitted pursuant to Rule 14a-8 of the Exchange Act, for inclusion in the Company's proxy materials for the 2019 Annual Meeting. In order to be considered timely, such proposals must be received in writing by the Company before the close of business on December 14, 2018 and delivered to the Company's Secretary at the Company's principal executive offices located at 9800 Pyramid Court, Suite 400, Englewood, Colorado 10370. A stockholder proposal or nomination for director for consideration at the 2019 Annual Meeting but not included in the proxy materials must be received by the Company's Secretary no earlier than November 28, 2018 and no later than December 28, 2018.

**ITEM 6. EXHIBITS**

(a) Exhibits

Exhibit 31.1 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

Exhibit 101 The following financial information from the quarterly report on Form 10-Q of Evolving Systems, Inc. for the quarter ended September 30, 2018, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets, (ii) Condensed Consolidated Statements of Income, (iii) Condensed Consolidated Statements of Comprehensive Income, (iv) Condensed Consolidated Statement of Changes in Stockholders' Equity, (v) Condensed Consolidated Statements of Cash Flows, and (vi) Notes to the Condensed Consolidated Financial Statements.

Table of Contents

**SIGNATURE**

Pursuant to the requirements 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.

Date: November 13, 2018

/s/ Mark P. Szynkowski  
Mark P. Szynkowski  
Senior Vice President of Finance and Secretary  
  
(Principal Financial and Accounting Officer)