

Mattersight Corp
Form 10-Q
May 07, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2015

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File Number 0-27975

Mattersight Corporation

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

36-4304577
(I.R.S. Employer
Identification No.)

200 S. Wacker Drive

Suite 820

Chicago, Illinois 60606

(Address of Registrant's Principal Executive Offices) (Zip Code)

(877) 235-6925

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

The number of shares of the registrant's Common Stock outstanding as of April 29, 2015 was 22,763,269.

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Table of Contents**Part I. Financial Information****Item 1. Financial Statements****MATTERSIGHT CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited and in thousands, except share and per share data)**

	March 31, 2015	December 31, 2014
ASSETS:		
Current Assets:		
Cash and cash equivalents	\$ 14,785	\$ 14,238
Receivables (net of allowances of \$22 and \$17, respectively)	4,450	3,460
Prepaid expenses	5,493	4,449
Other current assets	217	236
Total current assets	24,945	22,383
Equipment and leasehold improvements, net	5,148	4,657
Goodwill	972	972
Intangibles, net	3,470	571
Other long-term assets	3,159	3,495
Total assets	\$ 37,694	\$ 32,078
LIABILITIES AND STOCKHOLDERS EQUITY:		
Current Liabilities:		
Short-term debt	\$ 7,000	\$
Accounts payable	1,865	1,183
Accrued compensation and related costs	2,134	2,241
Unearned revenue	6,252	7,859
Capital leases	1,594	1,637
Other current liabilities	3,397	2,549
Total current liabilities	22,242	15,469
Long-term unearned revenue	2,524	2,532
Long-term intangible assets liability	1,792	
Long-term capital leases	1,307	1,176
Other long-term liabilities	363	282
Total liabilities	28,228	19,459
Series B Stock, \$0.01 par value; 5,000,000 shares authorized and designated; 1,648,185 and 1,648,185 shares issued and outstanding at March 31, 2015 and	8,406	8,406

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December 31, 2014, with a liquidation preference of \$10,024 and \$9,877 at March 31, 2015 and December 31, 2014, respectively		
Stockholders' Equity:		
Preferred Stock, \$0.01 par value; 35,000,000 shares authorized; none issued and outstanding		
Common Stock, \$0.01 par value; 50,000,000 shares authorized; 24,555,664 and 24,046,977 shares issued at March 31, 2015 and December 31, 2014, respectively; and 22,741,560 and 22,324,093 outstanding at March 31, 2015 and December 31, 2014, respectively	246	240
Additional paid-in capital	244,568	243,282
Accumulated deficit	(230,221)	(226,404)
Treasury stock, at cost, 1,814,104 and 1,722,884 shares at March 31, 2015 and December 31, 2014, respectively	(9,506)	(8,879)
Accumulated other comprehensive loss	(4,027)	(4,026)
Total stockholders' equity	1,060	4,213
Total liabilities and stockholders' equity	\$ 37,694	\$ 32,078

See accompanying notes to the Condensed Consolidated Financial Statements.

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MATTERSIGHT CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited and in thousands, except per share data)

	For the Three Months Ended	
	March 31, 2015	March 31, 2014
Revenue:		
Subscription revenue	\$ 8,332	\$ 6,057
Other revenue	984	956
 Total revenue	 9,316	 7,013
Operating expenses:		
Cost of Subscription revenue	1,868	1,722
Cost of Other revenue	707	511
 Total cost of revenue, exclusive of depreciation and amortization shown below:	 2,575	 2,233
Sales, marketing and development	6,564	5,221
General and administrative	2,882	2,250
Depreciation and amortization	995	743
 Total operating expenses	 13,016	 10,447
 Operating loss	 (3,700)	 (3,434)
Interest and other expense, net	(114)	(150)
Change in fair value of warrant liability	5	(370)
 Loss before income taxes	 (3,809)	 (3,954)
Income tax provision	(8)	(9)
 Net loss	 (3,817)	 (3,963)
Dividends related to Series B Stock	(147)	(147)
 Net loss available to Common Stock holders	 \$ (3,964)	 \$ (4,110)
 Per share of Common Stock:		
Basic net loss available to Common Stock holders	\$ (0.18)	\$ (0.22)
Diluted net loss available to Common Stock holders	\$ (0.18)	\$ (0.22)
 Shares used to calculate basic net loss per share	 21,877	 18,503

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Shares used to calculate diluted net loss per share	21,877	18,503
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Stock-based compensation, primarily restricted stock, is included in individual line items above:

Total cost of revenue	\$ 59	\$ 56
Sales, marketing and development	632	590
General and administrative	674	442

See accompanying notes to the Condensed Consolidated Financial Statements.

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MATTERSIGHT CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(Unaudited and in thousands)

	For the Three Months Ended	
	March 31, 2015	March 31, 2014
Net loss	\$ (3,817)	\$ (3,963)
Other comprehensive loss:		
Effect of currency translation	(1)	5
Comprehensive net loss	\$ (3,818)	\$ (3,958)

See accompanying notes to the Condensed Consolidated Financial Statements.

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MATTERSIGHT CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited and in thousands)

	For the Three Months Ended	
	March 31,	March 31,
	2015	2014
Cash Flows from Operating Activities:		
Net loss	\$ (3,817)	\$ (3,963)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	995	743
Stock-based compensation	1,365	1,088
Change in fair value of warrant liability	(5)	370
Changes in assets and liabilities:		
Receivables	(990)	(51)
Prepaid expenses	(1,069)	(664)
Other assets	19	66
Accounts payable	536	55
Accrued compensation and related costs	(107)	(420)
Unearned revenue	(1,615)	(1,481)
Other liabilities	111	62
Total Adjustments	(760)	(232)
Net cash used in operating activities	(4,577)	(4,195)
Cash Flows from Investing Activities:		
Capital expenditures and other	(659)	(23)
Intangible assets	(255)	(136)
Net cash used in investing activities	(914)	(159)
Cash Flows from Financing Activities:		
Proceeds from line of credit	7,000	
Principal payments under capital lease obligations	(437)	(422)
Acquisition of treasury stock	(627)	(549)
Fees from issuance of Common Stock		(2)
Proceeds from stock compensation and employee stock purchase plans, net	110	36
Net cash provided by (used in) financing activities	6,046	(937)
Effect of exchange rate changes on cash and cash equivalents	(8)	

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Increase (decrease) in cash and cash equivalents	547	(5,291)
Cash and cash equivalents, beginning of period	14,238	13,392
Cash and cash equivalents, end of period	\$ 14,785	\$ 8,101
Non-Cash Investing and Financing Transactions:		
Capital lease obligations incurred	\$ 581	\$ 420
Capital equipment purchased on credit	581	420
Fair value of warrants classified as liability	376	1,155
Fair value of intangible asset liability	2,446	
Supplemental Disclosures of Cash Flow Information:		
Interest paid	\$ 80	\$ 76

See accompanying notes to the Condensed Consolidated Financial Statements.

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MATTERSIGHT CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note One General

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of Mattersight Corporation (we, Mattersight, or the Company) include all normal and recurring adjustments necessary for a fair presentation of our condensed consolidated financial position as of March 31, 2015 and December 31, 2014, the condensed consolidated results of our operations for the three months ended March 31, 2015 and March 31, 2014, the condensed consolidated statements of our comprehensive loss for the three months ended March 31, 2015 and March 31, 2014, and our condensed consolidated cash flows for the three months ended March 31, 2015 and March 31, 2014, and are in accordance with United States generally accepted accounting principles (GAAP) and in conformity with Securities and Exchange Commission (SEC) Article 8-03 of Regulation S-X; provided, that certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted.

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in Mattersight s Annual Report on Form 10-K for the fiscal year ended December 31, 2014 filed with the SEC on March 12, 2015. The results of operations for the three months ended March 31, 2015 are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Note Two Summary of Significant Accounting Policies

For a description of the Company s Summary of Significant Accounting Policies, see Note Two Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2014.

Change in Presentation

Beginning in the first quarter of 2015, Mattersight will report Subscription revenue, which consists of Behavioral Analytics Subscription revenue and Marketing Managed Services revenue, and Other revenue, which consists of Deployment revenue, Professional Services revenue, CRM Services revenue, and Reimbursed Expenses revenue. We feel the revised presentation provides a clearer understanding of our business and revenue streams.

Previously in 2014, Mattersight reported Behavioral Analytics revenue, which consisted of Subscription revenue, Deployment revenue, and Professional Services revenue, and Other revenue, which consisted of CRM Services revenue and Marketing Managed Services revenue. Reimbursed Expenses revenue was reported separately.

The changes in presentation did not have an impact on total revenue or total cost of revenue. There was no change to our significant accounting policies. The 2014 revenue has been revised to conform to our current presentation.

Note Three Revenue Recognition

Revenue Recognition

Subscription Revenue

Subscription revenue consists of Behavioral Analytics Subscription revenue and Marketing Managed Services revenue derived from the performance of services on a continual basis.

Subscription revenue is based on a number of factors, including the number of users to whom the Company provides one of its Behavioral Analytics-related service offerings, including Predictive Behavioral Routing, Performance Management, and Predictive Analytics, the type and number of Behavioral Analytics offerings deployed to the client, and in some cases, the number of hours of calls analyzed during the relevant month of the subscription period. Subscription periods generally range from three to five years after the go-live date or, in cases where the Company contracts with a client for a short-term pilot of a Behavioral Analytics offering prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. This revenue is recognized over the applicable subscription period, as the service is performed for the client.

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Marketing Managed Services revenue is derived from marketing application hosting. This revenue is generally in the form of fixed monthly fees received from the Company's clients and is recognized as the services are performed for the client. Any related setup fee would be recognized over the term of the hosting contract.

Other Revenue

Other revenue consists of Deployment revenue, Professional Services revenue, and Reimbursed Expenses revenue.

Deployment revenue consists of planning, deployment, and training fees derived from Behavioral Analytics contracts. These fees, which are considered to be installation fees related to Behavioral Analytics subscription contracts, are deferred until the installation is complete and are then recognized over the applicable subscription period. In cases where the Company contracts with a client for a short-term pilot of a Behavioral Analytics offering prior to committing to a longer subscription period, if any, the period in which pilot deployment revenue is recognized, generally ranges from three to twelve months after the go-live date. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. These costs are included in Prepaid expenses and Other long-term assets. Such costs are amortized over the subscription period. Costs in excess of the foregoing revenue amount are expensed in the period incurred.

Professional Services revenue primarily consists of fees charged to the Company's clients to provide post-deployment follow-on consulting services, which include custom data analysis, the implementation of enhancements, and training, as well as fees generated from the Company's operational consulting services. Professional Services are performed for the Company's clients on a fixed-fee or time-and-materials basis. Revenue is recognized as the services are performed, with performance generally assessed on the ratio of actual hours incurred to-date compared to the total estimated hours over the entire term of the contract.

Reimbursed Expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for the Company's clients. The cost of third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting. An equivalent amount of reimbursable expenses is included in Cost of revenue.

Note Four Stock-Based Compensation

The Company has two stock-based compensation plans, the Mattersight Corporation 1999 Stock Incentive Plan (the 1999 Plan) and the Mattersight Corporation Employee Stock Purchase Plan (the ESPP), each as described more fully in Note Thirteen in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

	For the Three Months Ended	
	March 31,	March 31,
	2015	2014
Stock-based compensation expense (in millions)	\$ 1.4	\$ 1.1

The Company recognizes stock-based compensation expense on a straight-line basis over the vesting period. The Company has established its forfeiture rate based on historical experience.

As of March 31, 2015, there were a total of 2,072,905 shares of the Company's common stock, par value \$0.01 per share (Common Stock), available for future grants under the 1999 Plan and from treasury stock. The Common Stock

is traded on the NASDAQ Global Market under the symbol MATR .

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Restricted stock award activity was as follows for the three months ended March 31, 2015:

	Shares	Weighted Average Price
Unvested balance at December 31, 2014	556,194	\$ 5.76
Granted	518,051	\$ 6.99
Vested	(291,558)	\$ 6.22
Forfeited	(32,281)	\$ 6.67
Unvested balance at March 31, 2015	750,406	\$ 6.39

(In millions)	For the Three Months Ended	
	March 31, 2015	March 31, 2014
Total fair value of restricted and installment stock awards vested	\$ 2.0	\$ 1.6
Compensation expense related to restricted stock awards	0.6	0.5

As of March 31, 2015, there remained \$4.0 million of unrecognized compensation expense related to restricted stock awards. These costs are expected to be recognized over a weighted average period of 2.1 years.

Stock Options

During the three months ended March 31, 2015, the Company granted options to purchase a total of 122,625 shares of Common Stock to certain employees. The exercise price per share is \$6.90, the closing price for shares of Common Stock on February 11, 2015, the grant date. Certain of the options will vest 6.25% on February 28, 2015, with the balance vesting ratably over the following 15 quarters, whereas others will vest 25% on February 28, 2016, with the balance vesting ratably over the following 12 quarters. The options expire on February 11, 2025.

Option activity was as follows for the three months ended March 31, 2015:

	Options	Weighted Average Exercise Price
Outstanding as of December 31, 2014	2,636,596	\$ 7.42
Granted	122,625	\$ 6.90
Exercised	(13,020)	\$ 4.75

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Forfeited	(75,510)	\$	6.57
Outstanding as of March 31, 2015	2,670,691	\$	7.44
Exercisable as of March 31, 2015	1,689,013	\$	8.51
Outstanding intrinsic value at March 31, 2015 (in millions)	\$	1.9	
Exercisable intrinsic value at March 31, 2015 (in millions)	\$	1.2	

	For the Three Months Ended	
	March 31,	March 31,
	2015	2014
Compensation expense related to option awards (in millions)	\$ 0.4	\$ 0.3

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(In millions)	For the Three Months Ended	
	March 31, 2015	March 31, 2014
Total fair value of stock options vested	\$ 0.4	\$ 0.3
Intrinsic value of stock options exercised		
Proceeds received from option exercises	0.1	

As of March 31, 2015, there remained \$3.0 million of unrecognized compensation expense related to stock options. These costs are expected to be recognized over a weighted average period of 1.8 years.

The fair value of options granted during the three months ended March 31, 2015 and March 31, 2014 was estimated on the grant date using a Black-Scholes option-pricing model. The following assumptions represent the year-to-date weighted average for all options granted:

	For the Three Months Ended	
	March 31, 2015	March 31, 2014
Risk-free interest rates	1.40%	1.22%
Expected dividend yield		
Expected volatility	60%	64%
Expected lives	6 years	6 years

Historical Company information is the primary basis for the selection of expected life, expected volatility, and expected dividend yield assumptions. The risk-free interest rate is selected based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued.

Other Stock Compensation***Employee Stock Purchase Plan***

The ESPP is intended to qualify as an employee stock purchase plan under section 423 of the Internal Revenue Code. Under the ESPP, eligible employees are permitted to purchase shares of Common Stock at below-market prices. The purchase period opens on the first day and ends on the last business day of each calendar quarter. The shares of Common Stock issued in respect of employee purchases under the ESPP were as follows:

	For the Three Months Ended	
	March 31, 2015	March 31, 2014
Shares of Common Stock issued	9,897	8,706
Expense related to ESPP (in thousands)	\$ 14	\$ 10

The fair value of ESPP purchases for the three months ended March 31, 2015 and March 31, 2014 was estimated using a Black-Scholes pricing model. The Company used the following year-to-date weighted average assumptions:

	For the Three Months Ended	
	March 31,	March 31,
	2015	2014
Risk-free interest rates	0.02%	0.07%
Expected dividend yield		
Expected volatility	39%	40%
Expected lives	0.24 years	0.24 years

Note Five Current Prepaid Expenses

Current prepaid expenses primarily consist of deferred costs and prepaid commissions related to Behavioral Analytics contracts. These costs are recognized over the subscription periods of the respective contracts, generally three to five years after the go-live date or, in cases where the Company contracts with a client for a short-term pilot of a Behavioral Analytics offering prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. Costs included in current prepaid expenses will be recognized within the next twelve months.

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Current prepaid expenses consisted of the following:

(In millions)	March 31, 2015	As of December 31, 2014
Deferred costs	\$ 1.5	\$ 1.4
Prepaid commissions	1.8	1.5
Other	2.2	1.6
Total	\$ 5.5	\$ 4.5

Note Six Intangible Assets, net

Intangible assets reflect costs related to patent and trademark applications, Marketing Managed Services customer relationships, and a license for certain intellectual property purchased in 2015. The costs related to patent and trademark applications and the license for certain intellectual property are amortized over 120 months. The other intangible assets are fully amortized. Amortization expense of intangible assets for the three months ended March 31, 2015 was \$0.1 million and will be \$0.4 million annually thereafter. Amortization expense of intangible assets for the three months ended March 31, 2014 was less than \$0.1 million.

(In millions)	March 31, 2015	As of December 31, 2014
Gross intangible assets	\$ 6.5	\$ 3.4
Accumulated amortization of intangible assets	(3.0)	(2.8)
Total	\$ 3.5	\$ 0.6

Note Seven Other Long-Term Assets

Other long-term assets primarily consist of deferred costs and prepaid commissions related to Behavioral Analytics. These costs are recognized over the terms of the respective contracts, generally three to five years. Costs included in long-term assets will be recognized over the remaining term of the contracts beyond the first twelve months. Other long-term assets consisted of the following:

(In millions)	March 31, 2015	As of December 31, 2014
Deferred costs	\$ 1.2	\$ 1.3
Prepaid commissions	1.5	1.7
Noncurrent deferred tax asset	0.1	0.1
Other	0.4	0.4

Total	\$ 3.2	\$	3.5
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Note Eight Short-Term Debt

During fiscal year 2014, the Company provided written notice of termination, effective as of August 14, 2014, of the Loan and Security Agreement entered into by the Company, together with its wholly-owned subsidiaries Mattersight Europe Holding Corporation and Mattersight International Holding, Inc., as co-borrowers (the Co-Borrowers), and Partners for Growth IV, L.P. (PfG) on August 19, 2013 (the PfG Credit Facility). The Company voluntarily terminated the Credit Facility. At the time of termination, there were no amounts outstanding under the PfG Credit Facility and no penalties were incurred or paid by the Company in connection with the termination.

In connection with the execution of the PfG Credit Facility, the Company granted to PfG, certain affiliates of PfG, and Silicon Valley Bank, warrants (collectively, the PfG Warrants) to purchase shares of Common Stock. See Note Twelve Stock Warrants for additional information.

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On March 10, 2015, the Company entered into a Second Amended and Restated Loan and Security Agreement (Second Amended and Restated Credit Facility) with Silicon Valley Bank. The Second Amended and Restated Credit Agreement provides for, among other things, a maximum credit limit of \$15 million, a term through March 2017, and an interest rate of prime plus 1.25%. The Second Amended and Restated Credit Agreement additionally provides for an annual commitment fee of \$0.1 million and an early termination fee of 1.0% in the first year and 0.25% thereafter, prior to maturity. There was less than \$0.1 million of interest expense for the three months ended March 31, 2015. There was no interest expense for the three months ended March 31, 2014. The interest rate for the three months ended March 31, 2015 was 4.5%. The Company was in compliance with all of its debt covenants under the Second Amended and Restated Credit Facility as of March 31, 2015. The Company has a \$7.0 million outstanding balance under the Second Amended and Restated Credit Facility as of March 31, 2015.

Note Nine Loss Per Share

The following table sets forth the computation of the loss and shares used in the calculation of basic and diluted loss per share:

(In millions)	For the Three Months Ended	
	March 31,	March 31,
	2015	2014
Net loss	\$ (3.8)	\$ (4.0)
Dividends related to Series B Stock ⁽¹⁾	(0.2)	(0.1)
Net loss available to Common Stock holders	\$ (4.0)	\$ (4.1)
Per common share:		
Basic/diluted net loss available to Common Stock holders	\$ (0.18)	\$ (0.22)
 (In thousands)		
Weighted average shares of Common Stock outstanding	21,877	18,503
Currently antidilutive Common Stock equivalents ⁽²⁾	2,095	2,169

(1) The Board of Directors did not declare a dividend payment on the Company's 7% Series B Convertible Preferred Stock (the Series B Stock), which was accrued, for each of the dividend periods from July 1, 2012 through December 31, 2014 (the aggregate amount of these dividends was approximately \$1.5 million). If the Company's Board of Directors were to declare a semi-annual cash dividend on the Series B Stock for dividend periods subsequent to January 1, 2015, the dividend payment would be approximately \$0.3 million on the 1,648,185 shares of Series B Stock issued and outstanding as of March 31, 2015, at the cash dividend rate of \$0.1785.

(2) In periods in which there was a loss, the effect of Common Stock equivalents, which is primarily related to the Series B Stock, was not included in the diluted loss per share calculation as it was antidilutive.

Note Ten Leases

Capital Leases

The Company acquired \$0.6 million and \$0.4 million of computer equipment and leasehold improvements using capital leases during the first three months of 2015 and 2014, respectively. There was \$0.5 million and \$0.4 million of depreciation on capital leases in the first three months of 2015 and 2014, respectively. All capital leases are for a term of twenty-four, thirty, or thirty-six months.

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The following is a schedule, by year, of future minimum lease payments under capital leases, together with the present value of the net minimum lease payments as of March 31, 2015:

(In millions)		Amount
Year		
2015		\$ 1.5
2016		1.3
2017		0.5
2018		
Total minimum lease payments		\$ 3.3
Less: estimated executory costs		(0.2)
Net minimum lease payments		\$ 3.1
Less: amount representing interest		(0.2)
Present value of minimum lease payments		\$ 2.9

Capital leases consisted of the following:

(In millions)	March 31,	As of
	2015	December 31,
		2014
Current capital leases	\$ 1.6	\$ 1.6
Long-term capital leases	1.3	1.2
Total	\$ 2.9	\$ 2.8

Note Eleven Other Current Liabilities

(In millions)	March 31,	As of
	2015	December 31,
		2014
Warrant liability	\$ 0.4	\$ 0.4
Series B Stock dividend payable	1.6	1.5
Other	1.4	0.6
Total	\$ 3.4	\$ 2.5

Note Twelve Stock Warrants

During the second half of fiscal year 2013, the Company granted the following warrants: (i) to PfG, a warrant to purchase up to a value of \$360,000 or 129,032 shares of Common Stock, (ii) to PfG Equity Investors, LLC, a warrant to purchase up to a value of \$28,800 or 10,322 shares of Common Stock, and (iii) to Silicon Valley Bank, a warrant to purchase up to a value of \$211,200 or 75,698 shares of Common Stock (collectively, the PfG Warrants). The Company received approximately \$4 thousand in connection with the issuance of the PfG Warrants, which the parties agreed was fair consideration.

The PfG Warrants, and the shares of Common Stock to be issued upon exercise of the PfG Warrants, have not been and will not be registered under the Securities Act of 1933, as amended, or any state securities law and were issued pursuant to an exemption from registration provided by Section 4(2) of the Securities Act and/or Regulation D promulgated thereunder. Neither the PfG Warrants nor the shares of Common Stock issuable upon exercise of the PfG Warrants may be subsequently offered or sold within the United States absent registration or exemption from such registration requirements and compliance with applicable state laws. The warrant liability as of March 31, 2015 and December 31, 2014 was \$0.4 million.

On June 4, 2014, PfG elected to partially exercise its warrant by exchanging 57,196 of the 129,032 warrant shares through a cashless exercise on the terms provided in the applicable warrant agreement. As a result, the Company issued 35,862 shares of Common Stock to PfG on June 4, 2014, and 71,836 warrant shares remain exercisable as of March 31, 2015.

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On June 4, 2014, PfG Equity Investors, LLC elected to partially exercise its warrant by exchanging 4,945 of the 10,322 warrant shares through a cashless exercise on the terms provided in the applicable warrant agreement. As a result, the Company issued 3,100 shares of Common Stock to PfG Equity Investors, LLC on June 4, 2014, and 5,377 warrant shares remain exercisable as of March 31, 2015.

On May 20, 2014, Silicon Valley Bank elected to fully exercise its warrant by exchanging 75,698 warrant shares through a cashless exercise on the terms provided in the applicable warrant agreement. As a result, the Company issued 47,404 shares of Common Stock to Silicon Valley Bank, in full settlement of the warrant.

A summary of the status of the PfG Warrants at March 31, 2015, and the changes during the three months ended March 31, 2015, are presented in the following table:

	Date	Shares of Common Stock, par value \$0.01, represented by Warrants	Exchange Price	Expiration Date
Outstanding as of December 31, 2014		77,213	\$2.79, subject to adjustment	August 19, 2018
Granted				
Exercised				
Expired				
Outstanding as of March 31, 2015		77,213	\$2.79, subject to adjustment	August 19, 2018
Exercisable as of March 31, 2015		77,213	\$2.79, subject to adjustment	August 19, 2018

The fair value of the warrant liability was estimated using the Monte Carlo option pricing model and the following assumptions:

	March 31, 2015	March 31, 2014
Risk-free interest rates	0.98%	1.48%
Expected dividend yield		
Expected volatility	55%	57%
Expected lives	3.4 years	4.4 years
Weighted average grant date fair value	\$ 4.85	\$ 5.37

Note Thirteen Segment Information

The Company operates in a single business segment, focused primarily on Behavioral Analytics.

Note Fourteen Fair Value Measurements

The Company reports certain assets and liabilities at fair value. Fair value is an exit price and establishes a three-tier valuation hierarchy for ranking the quality and reliability of the information used to determine fair values. The first tier, Level 1, uses quoted market prices in active markets for identical assets or liabilities. Level 2 uses inputs, other than quoted market prices for identical assets or liabilities in active markets, which are observable either directly or indirectly. Level 3 uses unobservable inputs in which there are little or no market data, and requires the entity to develop its own assumptions. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

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The following table provides the assets and liabilities carried at fair value measured on a recurring basis as of March 31, 2015 and December 31, 2014:

(In millions)

	Fair Value Measurements at March 31, 2015 Using			
	Total carrying value at March 31, 2015	Quoted Prices in Active Markets (Level 1)	Other Observable (Level 2)	Significant Unobservable (Level 3)
Money market fund	\$ 14.2	\$ 14.2	\$	\$
Warrant liability	\$ 0.4	\$	\$	\$ 0.4

	Fair Value Measurements at December 31, 2014 Using			
	Total carrying value at December 31, 2014	Quoted Prices in Active Markets (Level 1)	Other Observable (Level 2)	Significant Unobservable (Level 3)
Money market fund	\$ 13.7	\$ 13.7	\$	\$
Warrant liability	\$ 0.4	\$	\$	\$ 0.4

The following table represents the activity in the Company's Level 3 warrants:

(In millions)	Amount
Level 3 warrants, end of period at December 31, 2014	\$ 0.4
Change in fair value of warrant liability	
Warrant exercise	
Level 3 warrants, end of period at March 31, 2015	\$ 0.4

Note Fifteen Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, accounts receivable, accounts payable, and short-term debt approximated their fair values as of March 31, 2015 and December 31, 2014 due to the short-term nature of these instruments.

Note Sixteen Recent Accounting Pronouncements

In November 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-16, Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity (ASU 2014-16). ASU 2014-16 does not change the current criteria in GAAP for determining when separation of certain embedded derivative features in a hybrid financial instrument is required, but clarifies how current GAAP should be interpreted in the evaluation of the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a

share, reducing existing diversity in practice. The adoption of this ASU is not expected to have a material impact on the Company's condensed consolidated financial statements.

In August 2014, FASB issued ASU No. 2014-15: Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern (ASU 2014-15). The update sets forth a requirement for management to evaluate whether there are conditions and events that raise substantial doubt about an entity's ability to continue as a going concern, a responsibility that did not previously exist in U.S. GAAP. The amendments included in this update require management to assess an entity's ability to continue as a going concern by incorporating and expanding upon certain principles that are currently in U.S. auditing standards. Specifically, the amendments (i) provide a definition of the term substantial doubt, (ii) require an evaluation every reporting period, including interim periods, (iii) provide principles for considering the mitigating effect of management's plans, (iv) require certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans, (v) require an express statement and other disclosures when substantial doubt is not alleviated, and (vi) require an assessment for a period of one year after the date that the financial statements are issued (or available to be issued). ASU 2014-15 will be effective for the Company in fiscal year 2016. The adoption of this ASU is not expected to have a material impact on the Company's condensed consolidated financial statements.

In May 2014, FASB issued ASU No. 2014-09: Revenue from Contracts with Customers (Topic 606) (ASU 2014-09). The guidance sets forth a new five-step revenue recognition model that replaces the prior revenue recognition guidance in its entirety and is intended to eliminate numerous industry-specific pieces of revenue recognition guidance that have historically existed in U.S. GAAP. The underlying principle of the new standard is that a business or other organization will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. ASU 2014-09 provides alternative methods of initial adoption and is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods. Early adoption is not permitted. The Company is currently evaluating the impact that this standard will have on the Company's condensed consolidated financial statements.

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Note Seventeen Litigation and Other Contingencies

The Company is a party to various agreements, including all client contracts, under which it may be obligated to indemnify the other party with respect to certain matters, including, but not limited to, indemnification against third-party claims of infringement of intellectual property rights with respect to services, software, and other deliverables provided by the Company. These obligations may be subject to various limitations on the remedies available to the other party, including, without limitation, limits on the amounts recoverable and the time during which claims may be made, and may be supported by indemnities given to the Company by applicable third parties. Payment by the Company under these indemnification clauses is generally subject to the other party making a claim that is subject to challenge by the Company. Historically, the Company has not been obligated to pay any claim for indemnification under its agreements, and management is not aware of future indemnification payments that it would be obligated to make.

Under its By-Laws, subject to certain exceptions, the Company has agreed to indemnify its corporate officers and directors for certain events or occurrences while the officer or director is, or was, serving at its request in such capacity or in certain related capacities. The Company has separate indemnification agreements with each of its directors and corporate officers that requires it, subject to certain exceptions, to indemnify them to the fullest extent authorized or permitted by its By-Laws and the Delaware General Corporation Law. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer liability insurance policy that limits its exposure and enables it to recover a portion of any amounts paid under these indemnification agreements. As a result of its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company had no liabilities recorded for these agreements as of March 31, 2015.

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

Background

Mattersight Corporation (together with its subsidiaries and predecessors, Mattersight, we, us, or the Company) is a pioneer in personality-based software applications. Through these applications, including Predictive Behavioral Routing, Performance Management, Quality Assurance, and Predictive Analytics (collectively, Behavioral Analytics), Mattersight captures and analyzes customer and employee interactions, employee desktop data, and other contextual information to optimally route customers to the best available employee, improve operational performance, and predict future customer and employee outcomes. Mattersight's analytics are based on millions of proprietary algorithms and the application of unique behavioral models. The Company's SaaS delivery model combines analytics in the cloud with deep customer partnerships to drive significant business value. Leading companies in the healthcare, insurance, financial services, telecommunications, cable, utilities, education, hospitality, and government industries use Mattersight's solutions.

The Company's multi-channel technology captures the unstructured data of voice interactions (conversations), related customer and employee data, and employee desktop activity, and applies millions of proprietary algorithms against those interactions. Each interaction contains hundreds of attributes that get scored and ultimately detect patterns of behavior or business process that provide the transparency and predictability necessary to enhance revenue, improve the customer experience, improve efficiency, and predict and navigate outcomes. Adaptive across industries, programs, and industry-specific processes, the Company's Behavioral Analytics offerings enable its clients to drive measurable economic benefit through the improvement of contact center performance, customer satisfaction and retention, fraud reduction, and streamlined back office operations. Specifically, through its Behavioral Analytics offerings, Mattersight helps its clients:

Identify optimal customer/employee behavioral pairing for call routing;

Identify and understand customer personality;

Automatically measure customer satisfaction and agent performance on every analyzed call;

Improve rapport between agent and customer;

Reduce call handle times while improving customer satisfaction;

Identify opportunities to improve self-service applications;

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Improve cross-sell and up-sell success rates;

Improve the efficiency and effectiveness of collection efforts;

Measure and improve supervisor effectiveness and coaching;

Improve agent effectiveness by analyzing key attributes of desktop usage;

Predict likelihood of customer attrition;

Predict customer satisfaction and Net Promoter Scores® without customer surveys;

Predict likelihood of debt repayment;

Predict likelihood of a sale or cross-sell; and

Identify fraud callers and improve authentication processes.

Mattersight's mission is to help brands have more effective and effortless conversations with their customers. Using a suite of innovative personality-based software applications, Mattersight can analyze and predict customer behavior based on the language exchanged during service and sales interactions. The Company operates a highly scalable, flexible, and adaptive application platform to enable clients to implement and operate these applications.

Through the sale of its services featuring these applications, the Company generates the following revenue:

- (1) Subscription revenue, which is recurring, annuity revenue from long-term contracts (generally three- to five-year) and pilots, which are shorter-term contracts (generally three to twelve months); and
- (2) Other revenue, which is generally project-based and sold on a fixed-fee or time-and-materials basis and includes follow-on Professional Services revenue.

Types of Revenue

Subscription & Deployment Revenue

Subscription and deployment revenue is primarily driven by the execution of new Behavioral Analytics contracts, under which we deploy and provide our proprietary Behavioral Analytics offerings on a subscription basis. Based on each client's business requirements, the client's selection of our Behavioral Analytics offerings are configured and integrated into the client's environment and then deployed in either a remote-hosted or an on-premise hosted

environment. Thereafter, the Behavioral Analytics offerings are provided, on a subscription basis, for a period that is generally three to five years after the go-live date or, in the cases where the Company contracts with a client for a short-term pilot of a Behavioral Analytics offering prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. The fees and costs related to the initial deployment are deferred and amortized over the subscription period. We also generate revenue from Marketing Managed Services, specifically, from hosted customer and campaign data management.

Professional Services Revenue

Professional Services revenue primarily consists of fees charged to the Company's clients to provide post-deployment follow-on consulting services, which include custom data analysis, the implementation of enhancements, and training, as well as fees generated from the Company's operational consulting services. The Professional Services are performed for the Company's clients on a fixed-fee or time-and-materials basis. Revenue is recognized as the services are performed, with performance generally assessed on the ratio of actual hours incurred to-date compared to the total estimated hours over the entire term of the contract.

Business Outlook

Based on research from third-party analysts, we believe the call center industry is ripe for disruption and innovation. We believe what the call center was designed to accomplish and how it was measured are parts of an outdated mode of business that is disconnected from the needs of today's consumer. In fact, research from the Corporate Executive Board suggests that any call center interaction is four times more likely to drive customer disloyalty. Given a rise in self-service, these interactions are only becoming more complex and fraught with greater risk.

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Through Behavior Analytics, we seek to provide our clients with personality-based software applications that mitigate the complexity and reduce the risk of these call center interactions. According to Gartner, there are 6 million call center seats in North America. Our estimation is that less than 3% of this market is penetrated by personality-based software applications. We believe that we are uniquely positioned to capitalize on this opportunity. Our strategy to increase revenue and capture market share includes the following elements:

Drive new bookings growth and increase operating leverage;

Leverage a land & expand model, focused on personality-based routing as the catalyst for new client acquisition;

Cross-sell coaching, quality assurance and analytic products after delivering a routing solution;

Continue to invest in innovative linguistic models and behavioral science;

Expand our sales and marketing capacity; and

Test the applicability of our proprietary behavioral model with clients outside of the call center industry. Our personality-based software applications, which have been developed through substantial investment over the past decade, are deeply embedded into our clients' infrastructure and workflows. Our long-term client relationships are made up largely of multi-year contracts and high contract renewal rates. Our aspiration is that the introduction of a land & expand model with our routing product will accelerate the acquisition of new clients.

Critical Accounting Policies and Estimates

Our management's discussion and analysis of financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to the costs and timing of completion of client projects, our ability to collect accounts receivable, the timing and amounts of expected payments associated with cost reduction activities, and the ability to realize our net deferred tax assets, contingencies, and litigation. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our condensed consolidated financial statements.

Revenue Recognition

Subscription Revenue

Subscription revenue consists of Behavioral Analytics Subscription revenue and Marketing Managed Services revenue derived from the performance of services on a continual basis.

Subscription revenue is based on a number of factors, including the number of users to whom the Company provides one of its Behavioral Analytics-related service offerings, including Predictive Behavioral Routing, Performance Management, and Predictive Analytics, the type and number of Behavioral Analytics offerings deployed to the client, and in some cases, the number of hours of calls analyzed during the relevant month of the subscription period. Subscription periods generally range from three to five years after the go-live date or, in cases where the Company contracts with a client for a short-term pilot of a Behavioral Analytics offering prior to committing to a longer subscription period, if any, the subscription or pilot periods generally range from three to twelve months after the go-live date. This revenue is recognized over the applicable subscription period, as the service is performed for the client.

Marketing Managed Services revenue is derived from marketing application hosting. This revenue is generally in the form of fixed monthly fees received from the Company's clients and is recognized as the services are performed for the client. Any related setup fee would be recognized over the term of the hosting contract.

Other Revenue

Other revenue consists of Deployment revenue, Professional Services revenue, and Reimbursed Expenses revenue.

Deployment revenue consists of planning, deployment, and training fees derived from Behavioral Analytics contracts. These fees, which are considered to be installation fees related to Behavioral Analytics subscription contracts, are deferred until the installation is complete and are then recognized over the applicable subscription period. In cases where the Company contracts with a client for a short-term pilot of a Behavioral Analytics offering prior to committing to a longer subscription period, if any, the period in which pilot deployment revenue is recognized, generally ranges from three to twelve months after the go-live date. Installation costs incurred are deferred up to an amount not to exceed the amount of deferred installation revenue and additional amounts that are recoverable based on the contractual arrangement. These costs are included in Prepaid expenses and Other long-term assets. Such costs are amortized over the subscription period. Costs in excess of the foregoing revenue amount are expensed in the period incurred.

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Professional Services revenue primarily consists of fees charged to the Company's clients to provide post-deployment follow-on consulting services, which include custom data analysis, the implementation of enhancements, and training as well as fees generated from the Company's operational consulting services. The Professional Services are performed for the Company's clients on a fixed-fee or time-and-materials basis. Revenue is recognized as the services are performed, with performance generally assessed on the ratio of actual hours incurred to-date compared to the total estimated hours over the entire term of the contract.

Reimbursed Expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for the Company's clients. The cost of third-party product and support may be included within this category if the transaction does not satisfy the requirements for gross reporting. An equivalent amount of reimbursable expenses is included in Cost of revenue.

Unearned Revenue

Payments received for Behavioral Analytics contracts in excess of the amount of revenue recognized for these contracts are recorded as unearned revenue until revenue recognition criteria are met.

Allowance for Doubtful Accounts

The Company maintains allowances for doubtful accounts for estimated losses resulting from clients not paying for unpaid or disputed invoices for contractual services provided. Additional allowances may be required if the financial condition of our clients deteriorates.

Stock Warrants

In accordance with ASC 480-10, *Distinguishing Liabilities from Equity*, the Company classified certain warrants to purchase Common Stock that do not meet the requirements for classification as equity, as liabilities. Such liabilities are initially recorded at fair value with subsequent changes in fair value recorded as a component of gain or loss on warrant liability on the condensed consolidated statements of operations in each reporting period. If these warrants subsequently meet the requirements of equity classification, the Company will reclassify the fair value to equity. Fair value of the warrants was measured using a Monte Carlo option pricing model and in applying this model certain assumptions were used. See Note Twelve, *Stock Warrants*, of the *Notes to Condensed Consolidated Financial Statements* included elsewhere in this Quarterly Report on Form 10-Q.

Stock-Based Compensation

Stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the vesting period. Determining fair value of stock-based awards at the grant date requires certain assumptions. The Company uses historical information as the basis for the selection of expected life, expected volatility, expected dividend yield assumptions, and anticipated forfeiture rates. The risk-free interest rate is selected based on the yields from U.S. Treasury Strips with a remaining term equal to the expected term of the options being valued.

Intangible Assets

Intangible assets reflect costs related to patent and trademark applications, Marketing Managed Services customer relationships and a license for certain intellectual property purchased in 2015. Patent and trademark applications and the license for certain intellectual property are amortized over 120 months. The other intangible assets are fully

amortized.

Income Taxes

We have recorded income tax valuation allowances on our net deferred tax assets to account for the unpredictability surrounding the timing of realization of our U.S. and non-U.S. net deferred tax assets due to uncertain economic conditions. The valuation allowances may be reversed at a point in time when management determines realization of these tax assets has become more likely than not, based on a return to predictable levels of profitability.

The Company uses an asset and liability approach for financial accounting and reporting of income taxes. Deferred income taxes are provided when tax laws and financial accounting standards differ with respect to the amount of income for the year, the basis of assets and liabilities and for tax loss carryforwards. The Company does not provide U.S. deferred income taxes on earnings of U.S. or foreign subsidiaries, which are expected to be indefinitely reinvested.

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The Company may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. Significant judgment is used to determine the likelihood of the benefit. There is additional guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods, and disclosure requirements.

Other Significant Accounting Policies

For a description of the Company's other significant accounting policies, see Note Two, Summary of Significant Accounting Policies, of the Notes to Consolidated Financial Statements included in our Annual Report filed on Form 10-K for the year ended December 31, 2014.

Forward-Looking Statements

Statements in this Quarterly Report on Form 10-Q that are not historical facts are forward-looking statements and are made pursuant to the safe harbor provisions of Section 27A of the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements, which may be identified by use of words such as plan, may, might, believe, expect, intend, could, would, should, and other words with similar meaning, in connection with any discussion of our prospects, financial statements, business, financial condition, revenues, results of operations, or liquidity, involve risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. In addition to other factors and matters contained or incorporated in this document, important factors that could cause actual results or events to differ materially from those indicated by such forward-looking statements include, without limitation, those noted under Risk Factors included in Part I Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014, as well as the following:

Uncertainties associated with the attraction of, and the ability to execute contracts with, new clients, the continuation of existing, and execution of new, engagements with existing clients, the conversion of free pilots to paid subscription contracts, and the timing of related client commitments;

Reliance on a relatively small number of clients for a significant percentage of our revenue;

Risks involving the variability and predictability of the number, size, scope, cost, and duration of, and revenue from, client engagements;

Management of the other risks associated with complex client projects and new service offerings, including execution risk; and

Management of growth and development of, and introduction of, new service offerings.

We cannot guarantee any future results, levels of activity, performance, or achievements. The statements made in this Quarterly Report on Form 10-Q represent our views as of the date of this Report, and it should not be assumed that the

statements made in this Report remain accurate as of any future date. Moreover, we assume no obligation to update forward-looking statements, except as may be required by law.

First Quarter of 2015 Compared with First Quarter of 2014

Revenue

Our total revenue increased \$2.3 million, or 33%, to \$9.3 million in the first quarter of 2015, from \$7.0 million in the first quarter of 2014. The \$2.3 million increase in total revenue in the first quarter of 2015 was primarily due to the increased subscription fees associated with the conversion of several Behavioral Analytics deployments to the subscription phase of the contract.