ELOYALTY CORP
Form 10-Q
May 10, 2007
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2007

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

eLoyalty Corporation

(Exact Name of Registrant as Specified in Its Charter)

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

150 Field Drive, Suite 250

Lake Forest, Illinois 60045

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

Registrant s telephone number, including area code: (847) 582-7000

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

Common Stock, par value $0.01 per share

Preferred Stock Purchase Rights

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

The number of shares of the registrant s Common Stock, $0.01 par value per share, outstanding as of May 1, 2007 was 9,349,149.

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Part I. Financial Information

Item 1. ***Financial Statements***

eLoyalty Corporation

CONDENSED CONSOLIDATED BALANCE SHEETS

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

	March 31, 2007	December 30, 2006
ASSETS:		
Current Assets:		
Cash and cash equivalents	$ 30,412	$ 31,645
Restricted cash	307	283
Receivables, (net of allowances of $93 and $93)	16,327	12,816
Prepaid expenses	7,032	5,352
Other current assets	2,929	2,125
Total current assets	57,007	52,221
Equipment and leasehold improvements, net	5,057	4,793
Goodwill	2,643	2,643
Intangibles, net	1,003	1,034
Other long-term assets	4,707	3,877
Total assets	$ 70,417	$ 64,568
LIABILITIES AND STOCKHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	$ 6,295	$ 4,247
Accrued compensation and related costs	4,143	3,479
Unearned revenue	10,729	7,435
Other current liabilities	4,562	4,420
Total current liabilities	25,729	19,581
Long-term unearned revenue	7,746	5,411
Other long-term liabilities	67	60
Total liabilities	33,542	25,052
Commitments and contingencies		
Redeemable Series B convertible preferred stock, $0.01 par value; 5,000,000 shares authorized and designated; 4,090,549 and 4,098,369 shares issued and outstanding with a liquidation preference of $21,227 and $21,633 at March 31, 2007 and December 30, 2006, respectively	20,862	20,902
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; 9,398,548 and 9,078,794 shares issued at March 31, 2007 and December 30, 2006; and 9,331,197 and 9,078,794 outstanding at March 31, 2007 and December 30, 2006, respectively	94	91
Additional paid-in capital	165,369	162,059
Accumulated deficit	(144,357)	(139,810)

Treasury stock, at cost, 67,351 shares		(1,386)		
Accumulated other comprehensive loss		(3,707)		(3,726)
Total stockholders equity		16,013		18,614
Total liabilities and stockholders equity	$	70,417	$	64,568

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of this financial information.

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eLoyalty Corporation

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited and in thousands, except per share data)

	For the Three Months Ended March 31, 2007	For the Three Months Ended April 1, 2006
Revenue:		
Services	$ 22,177	$ 16,879
Product	4,407	1,960
Revenue before reimbursed expenses (net revenue)	26,584	18,839
Reimbursed expenses	1,338	788
Total revenue	27,922	19,627
Operating Expenses:		
Cost of services	14,737	14,248
Cost of product	3,514	1,182
Cost of revenue before reimbursed expenses	18,251	15,430
Reimbursed expenses	1,338	788
Total cost of revenue, exclusive of depreciation and amortization shown below:	19,589	16,218
Selling, general and administrative	12,438	6,033
Severance and related costs		387
Depreciation and amortization	773	534
Total operating expenses	32,800	23,172
Operating loss	(4,878)	(3,545)
Interest and other income (expense), net	327	150
Loss before income taxes	(4,551)	(3,395)
Income tax benefit (provision)	4	(42)
Net loss	(4,547)	(3,437)
Dividends related to Series B preferred stock	(366)	(366)
Net loss available to common stockholders	$ (4,913)	$ (3,803)
Basic net loss per common share	$ (0.61)	$ (0.58)
Diluted net loss per common share	$ (0.61)	$ (0.58)
Shares used to calculate basic net loss per share	8,035	6,596
Shares used to calculate diluted net loss per share	8,035	6,596

Non-cash compensation, primarily restricted stock, included in individual line items above:

Cost of services	$	296	$	257
Selling, general and administrative		3,311		449

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of this financial information.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited and in thousands)

	For the Three Months Ended	
	March 31, 2007	April 1, 2006
Cash Flows from Operating Activities:		
Net loss	$ (4,547)	$ (3,437)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	773	534
Non-cash compensation	3,607	706
Changes in assets and liabilities:		
Receivables	(3,500)	(1,252)
Prepaid expenses	(2,504)	(931)
Accounts payable	2,049	191
Accrued compensation and related costs	661	351
Unearned revenue	5,612	1,312
Other liabilities	504	1,827
Other assets	(785)	(555)
Net cash provided by (used in) operating activities	1,870	(1,254)
Cash Flows from Investing Activities:		
Capital expenditures and other	(1,007)	(503)
Net cash used in investing activities	(1,007)	(503)
Cash Flows from Financing Activities:		
Acquisition of treasury stock	(1,386)	
Payment of Series B dividends	(732)	(732)
Proceeds from exercise of stock options	8	38
Other	1	115
Net cash used in financing activities	(2,109)	(579)
Effect of exchange rate changes on cash and cash equivalents	13	75
Decrease in cash and cash equivalents	(1,233)	(2,261)
Cash and cash equivalents, beginning of period	31,645	17,851
Cash and cash equivalents, end of period	$ 30,412	$ 15,590
Supplemental Disclosures of Cash Flow Information:		
Cash refunded for income taxes, net	$	$

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of this financial information.

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eLoyalty Corporation

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 General

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of eLoyalty Corporation (we , eLoyalty or the Company) include all normal and recurring adjustments necessary for a fair presentation of our condensed consolidated financial position as of March 31, 2007, the condensed consolidated results of our operations for the three months ended March 31, 2007 and April 1, 2006 and our condensed consolidated cash flows for the three months ended March 31, 2007 and April 1, 2006, and are in conformity with Securities and Exchange Commission (SEC) Rule 10-01 of Regulation S-X.

The results of operations for any interim period are not necessarily indicative of the results for the full year. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto in our Annual Report on Form 10-K for the fiscal year ended December 30, 2006.

Note 2 Summary of Significant Accounting Policies

Reclassifications and Revisions

Beginning in the first quarter of 2007, eLoyalty has classified certain expenses, which have been previously reported within Cost of services, as Selling, general, and administrative expense. We feel this revised classification provides a clearer understanding of the key profit/loss drivers and investments in our business. These changes in classification are the result of the ongoing evolution of our business model from Consulting to Managed services and the investments we are making to build market share and competitive advantage with our Behavioral Analytics Service Line. The changes will be reflected prospectively as the Company cannot accurately and reliably estimate prior periods under the new approach. The three changes are:

Solution Development/Support: Costs associated with our Behavioral Analytics solution development teams and other Managed services administrative and support personnel will be classified as Selling, general and administrative expense. When these resources are working specifically on client revenue generating activities, their direct costs will be classified as Cost of services.

Account Management: Costs associated with our vertical industry teams, made up of industry experts, account partners and project managers, will be classified as Selling, general and administrative expense. When these resources are working specifically on client revenue generating activities, their direct costs will be classified as Cost of services.

Delivery Executive/Support: Costs associated with overall delivery executive management and administrative support personnel will be classified as Selling, general and administrative expense.

The impact of these changes in the first quarter of 2007 was to decrease Cost of services and, correspondingly, increase Selling, general, and administrative expense by $4.7 million, non-cash compensation was $1.6 million of this amount.

Note 3 Revenue Recognition

Behavioral Analytics Service Line

Consulting services revenue included in the Behavioral Analytics Service Line primarily consists of fees charged to our clients to perform Behavioral Analytics Assessments. These assessments are generally performed for our clients on a fixed fee 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 contract.

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Managed services revenue included in the Behavioral Analytics Service Line consists of planning, deployment and subscription fees. The planning and deployment fees are considered to be installation fees related to the long-term subscription contract and are deferred until the installation is complete and is then recognized over the term of the applicable subscription contract. The terms of these subscription contracts generally range from three to five years. As of March 31, 2007 and December 30, 2006, eLoyalty had deferred revenue totaling $5.9 million and $5.5 million, respectively. 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. Such costs are amortized over the term of the subscription contract. Costs in excess of the foregoing revenue amount are expensed in the period incurred. eLoyalty had deferred costs totaling $3.7 million as of March 31, 2007 and December 30, 2006.

Revenue associated with the Behavioral Analytics subscription fees are recognized as the services are performed for the client. For example, the monthly subscription fee will consist of the number of customer service representatives accessing the system and/or hours of calls analyzed during the specific month.

CIPCC Service Line

Consulting services revenue included in the Converged Internet Protocol Contact Center (CIPCC) Service Line consists of operational consulting and integrating or building a system for the client. These services are provided to the client on a time and materials basis or on a fixed fee basis. For the integration or building of a system, eLoyalty recognizes revenue based on services performed with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire contract. For all other consulting services, we recognize revenue as the services are performed for the client.

Managed Services revenue included in the CIPCC Service Line consists of contact center support and monitoring. Support and monitoring fees are generally contracted for a fixed fee and the revenue is recognized ratably over the term of the contract. Support fees that are contracted on a time and materials basis would be recognized as the services are performed for the client.

For fixed price Managed service contracts where we provide support for third-party software and hardware, revenue is recorded at the gross amount of the sale because the contracts satisfy the requirements of Emerging Issues Task Force (EITF) 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent . If the contract does not meet the requirements of EITF 99-19, Managed services revenue is recorded at the net amount of the sale. Historically, very few transactions did not satisfy the requirements of EITF 99-19. However, in mid 2006, the Company signed a new reseller agreement with its largest vendor that may increase the number of transactions that require the revenue to be recognized for the net amount of the sale.

Revenue from the sale of Product, which consists primarily of third-party software and hardware resold by eLoyalty, is generally recorded at the gross amount of the sale because the contracts satisfy the requirements of EITF 99-19. Software revenue is recognized in accordance with Statement of Position (SOP) 97-2 Software Revenue Recognition .

Within the CIPCC Service Line, Consulting services, Managed services and the resale of Product may be sold and delivered together. In arrangements that include the resale of software, SOP 97-2 requires determination of vendor specific objective evidence (VSOE) for each of the individual elements. If VSOE does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement is deferred until all elements of the arrangement without VSOE have been delivered to the client. If the remaining undelivered elements are post contract support (PCS) or other deliverables with similar attribution periods, the arrangement revenue is then recognized ratably over the remaining period of the PCS. Revenue of $2.2 million and $2.1 million has been deferred as of March 31, 2007 and December 30, 2006, respectively, due to the lack of VSOE for elements within these arrangements. This revenue will be recognized when the elements without VSOE are delivered to the client or will be recognized ratably over the remaining term of the PCS period if the VSOE for the PCS is not established.

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Traditional CRM

Consulting services revenue included in the Traditional CRM Service Line consists of operational consulting and integrating or building a system for the client. These services are provided to the client on a time and materials basis or on a fixed fee basis. For the integration or building of a system, eLoyalty recognizes revenue based on services performed with performance generally assessed on the ratio of hours incurred to date compared to the total estimated hours over the entire contract. For all other consulting services, we recognize revenue as the services are performed for the client.

Managed Services revenue included in the Traditional CRM Service Line consists of marketing application hosting, email fulfillment and remote application support. Revenue related to hosting services, generally a fixed monthly fee, is recognized as the services are performed for the client. Any related setup fee would be recognized over the contract period of the hosting arrangement. Revenue related to the email fulfillment services is recognized as the services are provided to the client. For example, the monthly email fulfillment fee is based on the number of emails distributed for the client. Contracts for remote application support can be based on a fixed fee or time and materials basis. Revenue is recognized ratably over contract period for fixed fee support. Revenue is recognized as the services are provided to the client for time and material contracts.

In accordance with EITF 00-21 Revenue Arrangements with Multiple Elements , arrangements containing multiple services are segmented into separate elements when the services represent separate earning processes. Revenue related to contracts with multiple elements is allocated based on the fair value of the element and is recognized in accordance with our accounting principles for each element, as described above. If the fair value for each element cannot be established, revenue is deferred until all elements have been delivered to the client. If PCS is the only remaining activity without established fair value, the revenue is recognized ratably over the service period. Each of our Service Lines may have arrangements that could be reviewed in accordance with EITF 00-21.

Reimbursed expenses revenue includes billable costs related to travel and other out-of-pocket expenses incurred while performing services for our clients. The cost of third-party product and support may be included within this category if the transaction does not satisfy the requirements of EITF 99-19 and the net revenue is recognized as Product or Managed services revenue. An equivalent amount of reimbursable expenses is included in Cost of revenue.

Payments received for Managed services contracts in excess of the amount of revenue recognized for these contracts are recorded as Unearned revenue until revenue recognition criteria are met.

If our estimates indicate that a contract loss will occur, a loss provision is recorded in the period in which the loss first becomes probable and reasonably estimable.

Note 4 Stock-Based Compensation

Stock-Based Plans

The Company issues stock awards under two stock incentive plans: the eLoyalty Corporation 1999 Stock Incentive Plan (the 1999 Plan) and the eLoyalty Corporation 2000 Stock Incentive Plan (the 2000 Plan). Under the 1999 Plan and the 2000 Plan, awards of restricted stock or bonus (installment) stock, salary replacement, stock options, stock appreciation rights and performance shares may be granted to directors, officers, employees, consultants, independent contractors and agents of eLoyalty and its subsidiaries. Awards granted under the 1999 Plan and 2000 Plan are made at the discretion of the Compensation Committee of eLoyalty s Board of Directors or another duly constituted committee of the Board (the Compensation Committee). If shares or options awarded under the 1999 Plan and the 2000 Plan are not issued due to cancellation of unvested or unexercised options or shares, then those options or shares again become available for issuance under the plans. Under the 1999 Plan, on the first day of each fiscal year, beginning in 2000, the aggregate number of shares available for issuance under the Plan is automatically increased by an amount equal to 5% of the total number of shares of common stock that are outstanding. Under the 2000 Plan, the Company originally reserved 280,000 shares of eLoyalty common stock for issuance. As of March 31, 2007, there were a total of 237,060 shares available for future grants under the 1999 and 2000 Plans and Treasury stock.

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Stock compensation expense was $3.6 million and $0.7 million for the three months ended March 31, 2007 and April 1, 2006, respectively. eLoyalty recognized stock-based compensation under Statement of Financial Accounting Standards (SFAS) No. 123R Shared-Based Payment in 2006. eLoyalty recognizes stock compensation expense on a straight-line basis over the vesting period. The Company has established its forfeiture rate based on historical experience. eLoyalty did not recognize the windfall tax benefit related to the excess tax deduction because we currently do not anticipate realizing the tax savings associated with this deduction. The amount of this excess tax deduction was $1.5 million for the three months ended March 31, 2007 and $4.5 million for the year ended December 30, 2006.

Restricted Stock

Restricted stock awards are shares of eLoyalty common stock granted to an individual. During the restriction period, the holder of the restricted stock receives all of the benefits of ownership (right to dividends, voting rights, etc.), other than the right to sell or otherwise transfer any interest in the stock. Installment stock awards are grants to an individual of a contractual right to receive future grants of eLoyalty common stock in specified amounts on specified vesting dates, subject to the individual remaining an eLoyalty employee on the specified vesting dates.

Restricted and installment stock award activity was as follows for the quarter ended March 31, 2007:

	Shares	Weighted Average Price
Nonvested balance at December 30, 2006	1,263,107	$ 9.69
Granted	289,493	$ 21.95
Vested	(209,084)	$ 13.33
Forfeited	(6,500)	$