

VERTICALNET INC
Form 10-Q
August 14, 2003
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2003

or

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

For the transition period from _____ to _____

Commission File Number 000-25269

VERTICALNET, INC.

(Exact name of Registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction
of incorporation or organization)

23-2815834
(I.R.S. Employer
Identification No.)

Edgar Filing: VERTICALNET INC - Form 10-Q

400 Chester Field Parkway

Malvern, Pennsylvania 19355

(Address of principal executive offices)

Registrant's telephone number, including area code:

(610) 240-0600

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

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

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

The number of shares outstanding of the registrant's common stock as of August 1, 2003 was 16,418,686.

Table of Contents

VERTICALNET, INC.

FORM 10-Q

For the Quarterly Period Ended June 30, 2003

Table of Contents

	Page
Part I. FINANCIAL INFORMATION	
<u>Item 1. Consolidated Financial Statements</u>	1
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	27
<u>Item 4. Controls and Procedures</u>	28
Part II. OTHER INFORMATION	
<u>Item 1. Legal Proceedings</u>	29
<u>Item 2. Changes in Securities and Use of Proceeds</u>	30
<u>Item 3. Defaults Upon Senior Securities</u>	30
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	30
<u>Item 5. Other Information</u>	30
<u>Item 6. Exhibits and Reports on Form 8-K</u>	31
<u>Signatures</u>	32

Table of Contents**Part I. Financial Information****Item 1. Consolidated Financial Statements****Verticalnet, Inc.****Consolidated Balance Sheets**

(in thousands, except per share data)

	June 30, 2003	Pro Forma June 30, 2003 (See Note 7)	December 31, 2002
	(Unaudited)	(Unaudited)	
Assets			
Current assets:			
Cash and cash equivalents	\$ 5,644	\$ 5,278	\$ 7,979
Accounts receivable, net of allowance for doubtful accounts of \$0 at June 30, 2003 and \$1,684 at December 31, 2002	1,510	1,510	1,586
Prepaid expenses and other current assets	2,702	2,702	3,892
	<u>9,856</u>	<u>9,490</u>	<u>13,457</u>
Total current assets	9,856	9,490	13,457
Property and equipment, net	353	353	912
Other investments	606	606	606
Intangible assets, net	1,350	1,350	1,800
Other assets	147	92	1,678
	<u>12,312</u>	<u>11,891</u>	<u>18,453</u>
Total assets	\$ 12,312	\$ 11,891	\$ 18,453
Liabilities and Shareholders' Equity (Deficit)			
Current liabilities:			
Current portion of long-term debt	\$ 115	\$ 115	\$ 415
Accounts payable and accrued expenses	3,882	3,817	7,652
Deferred revenues	352	352	279
Other current liabilities	1,266	1,266	1,172
	<u>5,615</u>	<u>5,550</u>	<u>9,518</u>
Total current liabilities	5,615	5,550	9,518
Long-term debt and convertible notes	7,135	728	7,293
	<u>12,750</u>	<u>6,278</u>	<u>16,811</u>
Total liabilities	12,750	6,278	16,811
Commitments and contingencies (see Notes 5 and 6)			
Shareholders' equity (deficit):			
Preferred stock \$.01 par value, 10,000,000 shares authorized, none issued at June 30, 2003 and December 31, 2002			

Edgar Filing: VERTICALNET INC - Form 10-Q

Common stock \$.01 par value, 100,000,000 shares authorized, 13,790,222 shares issued at June 30, 2003 (16,484,322 shares pro forma) and 13,708,546 shares issued at December 31, 2002			
	138	176	137
Additional paid-in capital	1,171,242	1,182,955	1,170,742
Deferred compensation	(466)	(466)	(239)
Accumulated other comprehensive loss	(727)	(727)	(736)
Accumulated deficit	(1,169,820)	(1,175,520)	(1,167,457)
Treasury stock at cost, 65,636 shares at June 30, 2003 and December 31, 2002	(805)	(805)	(805)
	<u> </u>	<u> </u>	<u> </u>
Total shareholders' equity (deficit)	(438)	5,613	1,642
	<u> </u>	<u> </u>	<u> </u>
Total liabilities and shareholders' equity (deficit)	\$ 12,312	\$ 11,891	\$ 18,453
	<u> </u>	<u> </u>	<u> </u>

See accompanying notes to consolidated financial statements.

Table of Contents**Verticalnet, Inc.****Consolidated Statements of Operations (Unaudited)**

(in thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2003	2002	2003	2002
Revenues:				
Software license	\$ 35	\$ 4,649	\$ 274	\$ 10,907
Services and maintenance	2,142	1,593	5,334	3,341
Total revenues	2,177	6,242	5,608	14,248
Cost of revenues:				
Cost of software license	175	259	363	686
Cost of services and maintenance	563	1,470	1,283	2,933
Total cost of revenues	738	1,729	1,646	3,619
Gross profit	1,439	4,513	3,962	10,629
Research and development	904	2,841	2,023	6,358
Sales and marketing	598	1,450	1,265	3,199
General and administrative	944	2,706	2,497	6,256
Restructuring and asset impairment charges	(302)	411	(309)	1,765
Amortization expense		1,056		2,112
	2,144	8,464	5,476	19,690
Operating loss	(705)	(3,951)	(1,514)	(9,061)
Interest and other expense, net	(465)	(5,907)	(849)	(6,560)
Loss from continuing operations	(1,170)	(9,858)	(2,363)	(15,621)
Discontinued operations:				
Income from operations of discontinued operations		1,027		8,508
Loss on disposal of discontinued operations		(165)		(165)
Net loss	(1,170)	(8,996)	(2,363)	(7,278)
Preferred stock dividends and accretion		(1,943)		(3,861)
Repurchase of convertible redeemable preferred stock		101,041		101,041
Income (loss) attributable to common shareholders	\$ (1,170)	\$ 90,102	\$ (2,363)	\$ 89,902
Basic income (loss) per common share:				
Income (loss) from continuing operations	\$ (0.09)	\$ 7.91	\$ (0.17)	\$ 7.30

Edgar Filing: VERTICALNET INC - Form 10-Q

Income from discontinued operations		0.09		0.76
Loss on disposal of discontinued operations		(0.02)		(0.02)
		<u> </u>	<u> </u>	<u> </u>
Income (loss) per common share	\$ (0.09)	\$ 7.98	\$ (0.17)	\$ 8.04
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Diluted income (loss) per common share:				
Loss from continuing operations	\$ (0.09)	\$ (0.86)	\$ (0.17)	\$ (1.38)
Income from discontinued operations		0.09		0.75
Loss on disposal of discontinued operations		(0.02)		(0.01)
		<u> </u>	<u> </u>	<u> </u>
Loss per common share	\$ (0.09)	\$ (0.79)	\$ (0.17)	\$ (0.64)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Weighted average common shares outstanding:				
Basic	13,676	11,286	13,539	11,180
Diluted	13,676	11,413	13,539	11,310

See accompanying notes to consolidated financial statements.

Table of Contents**Verticalnet, Inc.****Consolidated Statements of Cash Flows (Unaudited)**

(in thousands)

	Six Months Ended June 30,	
	2003	2002
Cash flows from operating activities:		
Net loss	\$ (2,363)	\$ (7,278)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	761	6,182
Write-down of investments		5,250
Other non-cash charges	(821)	1,474
Loss (gain) on disposal of property and equipment	8	(95)
Loss on disposal of discontinued operations		165
Realized gain on investments	(113)	
Change in assets and liabilities:		
Accounts receivable	76	(811)
Prepaid expenses and other assets	377	5,958
Accounts payable and accrued expenses	(3,329)	(11,874)
Deferred revenues	73	(16,085)
Other current liabilities		145
Net cash used in operating activities	(5,331)	(16,969)
Cash flows from investing activities:		
Proceeds from sale of cost and equity method investments		305
Proceeds from sale of short-term investments	979	
Purchase of cost and equity method investments		(3,500)
Restricted cash	1,686	1,531
Proceeds from sale of assets	292	343
Capital expenditures	(40)	(717)
Discontinued operation investing activities		2,350
Net cash provided by investing activities	2,917	312
Cash flows from financing activities:		
Payments to repurchase convertible redeemable preferred stock		(5,000)
Payment related to BT put and call obligation		(2,076)
Principal payments on long-term debt and obligations under capital leases		(1,052)
Proceeds from employee stock plans	81	455
Net cash provided by (used in) financing activities	81	(7,673)
Effect of exchange rate fluctuation on cash and cash equivalents	(2)	61

Edgar Filing: VERTICALNET INC - Form 10-Q

Net decrease in cash	(2,335)	(24,269)
Cash and cash equivalents beginning of period	7,979	50,252
	<u> </u>	<u> </u>
Cash and cash equivalents end of period	\$ 5,644	\$ 25,983
	<u> </u>	<u> </u>
Supplemental disclosure of cash flow information		
Cash paid during the period for interest	\$ 189	\$ 1,527
Supplemental schedule of non-cash investing and financing activities		
Preferred dividends paid through issuance of additional securities	\$	\$ 3,861
Common stock issued to BT under put and call obligation		1,755

See accompanying notes to consolidated financial statements.

Table of Contents**Verticalnet, Inc.****Consolidated Statement of Shareholders Equity (Deficit)**

(in thousands)

	<u>Common Stock</u>		<u>Additional Paid-In Capital</u>	<u>Deferred Compensation</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Accumulated Deficit</u>	<u>Treasury Stock</u>	<u>Total Shareholders Equity (Deficit)</u>
	<u>Shares</u>	<u>Amount</u>						
Balance, December 31, 2002	13,709	\$ 137	\$ 1,170,742	\$ (239)	\$ (736)	\$ (1,167,457)	\$ (805)	\$ 1,642
Exercise of restricted units	9		1					1
Exercise of stock options	72	1	79					80
Unearned compensation			420	(420)				
Amortization of unearned compensation				193				193
Net loss						(2,363)		(2,363)
Other comprehensive income					9			9
Balance, June 30, 2003 (Unaudited)	13,790	\$ 138	\$ 1,171,242	\$ (466)	\$ (727)	\$ (1,169,820)	\$ (805)	\$ (438)

See accompanying notes to consolidated financial statements.

Table of Contents**Verticalnet, Inc.****Consolidated Statements of Other Comprehensive loss (Unaudited)**

(in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net loss	\$ (1,170)	\$ (8,996)	\$ (2,363)	\$ (7,278)
Unrealized gain on forward sale		529		1,253
Foreign currency translation adjustment	(9)	(6)	(2)	62
Unrealized gain (loss) on investments	(2)	(481)	11	(1,209)
Comprehensive loss	\$ (1,181)	\$ (8,954)	\$ (2,354)	\$ (7,172)

See accompanying notes to consolidated financial statements.

Table of Contents

Verticalnet, Inc.

Notes to Consolidated Financial Statements (Unaudited)

(1) BACKGROUND AND BASIS OF PRESENTATION

Company Overview

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

We are a provider of Strategic Sourcing and Supply Management solutions that enable companies to identify, negotiate, realize, and sustain supply chain savings and supply base performance improvement. Led by our Spend Analysis solution that provides companies with insight into enterprise-wide spending, Verticalnet's full suite of Supply Management solutions enables companies to achieve lower prices, improved contract compliance, better supplier service, and shorter sourcing cycles.

With the completion of the June 2002 sale of our Small/Medium Business (SMB) unit that operated and managed 59 industry-specific online marketplaces, we have completed a business transformation from our origins as an operator of online public vertical communities to a business solely focused on delivering supply chain solutions to enterprise customers. The operating results of this unit through June 28, 2002 have been reflected as a discontinued operation in our consolidated financial statements.

Our consolidated financial statements as of and for the three and six months ended June 30, 2003 and 2002 have been prepared without audit pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC). In the opinion of management, the unaudited interim consolidated financial statements that accompany these notes reflect all adjustments, consisting only of normal recurring adjustments, necessary to present fairly our financial position as of June 30, 2003, the results of operations for the three and six months ended June 30, 2003 and 2002 and the cash flows for the six months ended June 30, 2003 and 2002. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the SEC's rules and regulations relating to interim financial statements. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2002.

Basis of Presentation

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

Edgar Filing: VERTICALNET INC - Form 10-Q

On July 1, 2002, the Company announced that its board of directors had approved a one-for-ten reverse stock split effective with the commencement of trading on July 15, 2002. All references in the consolidated financial statements to shares and per share amounts have been adjusted for this split.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include the allowance for doubtful accounts; carrying values for intangible assets and non-publicly held investments; and restructuring charges for abandoned operating leases.

Restricted Cash

Restricted cash represents certificates of deposit held pursuant to building lease agreements and other financing arrangements. At December 31, 2002, we had approximately \$1.1 million and \$0.5 million of restricted cash classified in current and non-current other assets, respectively, on the consolidated balance sheet. As of June 30, 2003 all restricted cash balances have been released and are now included as part of cash and cash equivalents.

Table of Contents

Verticalnet, Inc.

Notes to Consolidated Financial Statements (Unaudited)

Capitalized Software

Software costs capitalized under Statement of Position (SOP) 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, or Statement of Financial Accounting Standards (SFAS) No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed, were \$0.3 and \$0.6 million for the three and six months ended June 30, 2002, respectively. There were no software costs capitalized for the three and six months ended June 30, 2003. Amortization expense related to previously capitalized costs for the three and six months ended June 30, 2003 was immaterial. Amortization expense related to previously capitalized costs for the three and six months ended June 30, 2002 was \$0.1 million and \$0.3 million, respectively. The carrying value of the software is regularly reviewed and an impairment is recognized if the value of the estimated undiscounted cash flow benefits related to the asset is less than the remaining unamortized cost. No impairment of capitalized software was recognized during the six months ended June 30, 2003 and 2002.

Intangible and Other Long-Lived Assets

We adopted SFAS No. 142, Goodwill and Other Intangible Assets, effective January 1, 2002. Under SFAS No. 142, goodwill is no longer amortized but is reviewed for impairment annually, or more frequently if certain indicators arise. We performed a goodwill impairment test as of September 30, 2002 under SFAS No. 142. As a result of this test, the Company recorded a goodwill impairment charge of approximately \$27.6 million, which represented the full amount of unamortized goodwill at the time of the test. Long-lived assets, other than goodwill, are reviewed for impairment whenever, in management's judgment, conditions indicate a possible loss. Such impairment tests compare estimated undiscounted cash flows to the reduced value of the asset. If an impairment is indicated, the asset is written down to its fair market value based on an estimate of its discounted cash flows.

Revenue Recognition

Software licensing and related services revenues are principally derived from the licensing of our products, from maintenance and support contracts and from the delivery of professional services. Customers who license our products also generally purchase maintenance contracts which provide software updates and technical support over a stated term, which is usually a twelve-month period. Customers may also purchase custom development and implementation services from us.

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

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

Edgar Filing: VERTICALNET INC - Form 10-Q

agreements is recognized as payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected.

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

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

Table of Contents**Verticalnet, Inc.****Notes to Consolidated Financial Statements (Unaudited)**

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

Deferred revenue includes amounts received from customers for which revenue has not been recognized, which in most cases relates to maintenance or license fees that are deferred until they can be recognized. The majority of our deferred revenue at December 31, 2001 was related to license fee payments received from Converge, Inc. (Converge). Such amounts were to be recognized as revenue on a straight-line basis over the contract term, which was scheduled to end on December 31, 2003. This revenue comprised the majority of our revenue (69% and 67%) for the three and six months ended June 30, 2002, respectively. The Converge license agreement was amended in November 2002, at which time we recognized the remaining deferred revenue related to Converge.

Stock Options

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Income (loss) attributable to common shareholders:				
As reported	\$ (1,170)	\$ 90,102	\$ (2,363)	\$ 89,902
Add: Stock based employee compensation included in reported net income (loss) attributable to common shareholders	102	44	193	75
Deduct: Stock-based employee compensation expense determined under fair-value-based method for all awards	(4,093)	(6,858)	(9,032)	(14,233)
Pro forma	\$ (5,161)	\$ 83,288	\$ (11,202)	\$ 75,744
Income (loss) per common share basic:				
As reported	\$ (0.09)	\$ 7.98	\$ (0.17)	\$ 8.04

Edgar Filing: VERTICALNET INC - Form 10-Q

Pro forma	\$ (0.38)	\$ 7.38	\$ (0.83)	\$ 6.77
Loss per common share diluted:				
As reported	\$ (0.09)	\$ (0.79)	\$ (0.17)	\$ (0.64)
Pro forma	\$ (0.38)	\$ (1.39)	\$ (0.83)	\$ (1.90)

Table of Contents**Verticalnet, Inc.****Notes to Consolidated Financial Statements (Unaudited)***Computation of Historical Net Income (Loss) Per Share*

Basic income (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted income (loss) per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period, including incremental common shares issuable upon the exercise of stock options and warrants (using the treasury stock method) and the conversion of our 5¼% convertible subordinated debentures and our former Series A 6.00% convertible redeemable preferred stock (using the if-converted method). Common equivalent shares are excluded from the calculation if their effect is anti-dilutive.

During the three and six months ended June 30, 2003, the dilutive loss per common share calculation was the same as the basic loss per common share calculation as all potentially dilutive securities were anti-dilutive.

The following tables set forth the computation of income (loss) per common share for the three and six months ended June 30, 2002 (in thousands, except per share data):

Three months ended June 30, 2002:

	Net Income (Loss)	Shares	Per Share Amount
	<u> </u>	<u> </u>	<u> </u>
Net loss	\$ (8,996)		
Less: Preferred stock dividends and accretion	(1,943)		
Plus: Repurchase of convertible redeemable preferred stock	101,041		
	<u> </u>		
Basic Income Per Common Share			
Income attributable to common shareholders	90,102	11,286	\$ 7.98
			<u> </u>
Effect of Dilutive Securities			
Convertible redeemable preferred stock	(99,098)	127	
	<u> </u>	<u> </u>	
Diluted Income Per Common Share			
Loss attributable to common shareholders	\$ (8,996)	11,413	\$ (0.79)
	<u> </u>	<u> </u>	<u> </u>

Six months ended June 30, 2002:

Edgar Filing: VERTICALNET INC - Form 10-Q

	Net Income (Loss)	Shares	Per Share Amount
	<u> </u>	<u> </u>	<u> </u>
Net loss	\$ (7,278)		
Less: Preferred stock dividends and accretion	(3,861)		
Plus: Repurchase of convertible redeemable preferred stock	101,041		
	<u> </u>		
Basic Income Per Common Share			
Income attributable to common shareholders	89,902	11,180	\$ 8.04
			<u> </u>
Effect of Dilutive Securities			
Convertible redeemable preferred stock	(97,180)	130	
	<u> </u>	<u> </u>	
Diluted Income Per Common Share			
Loss attributable to common shareholders	\$ (7,278)	11,310	\$ (0.64)
	<u> </u>	<u> </u>	<u> </u>

Table of Contents

Verticalnet, Inc.

Notes to Consolidated Financial Statements (Unaudited)

Potentially dilutive common shares of 4,242,713 and 1,759,109 were excluded from the computation of diluted loss per common share because their effect was anti-dilutive for the three and six months ending June 30, 2003 and the three and six months June 30, 2002, respectively. In addition, 247,939 common shares that were previously held in escrow in connection with the Atlas Commerce, Inc. (Atlas Commerce) transaction are only included in the loss per common share calculation subsequent to their release date of March 31, 2003.

Adoption of New Pronouncements

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 4, Reporting Gains and Losses from Extinguishment of Debt, required that gains and losses from extinguishments of debt be included in the determination of net income and be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. Although SFAS No. 145 became effective January 1, 2003, the Company elected to early adopt the provisions of SFAS No. 145 in 2002. During the third quarter of 2002, in connection with the settlement of obligations involving British Telecommunications Plc. (BT), the Company recognized a \$4.8 million gain representing the difference between the fair value of the consideration issued in the settlement transaction and the carrying value of the amounts due BT. As a result of the early adoption of SFAS No. 145, the Company evaluated the classification of this gain in accordance with the provisions of APB Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, and determined that the gain did not meet the criteria for classification as an extraordinary item.

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses the financial accounting and reporting of expenses related to restructurings initiated after 2002, and applies to costs associated with an exit activity (including a restructuring) or with a disposal of long-lived assets. Those activities can include eliminating or reducing product lines, terminating employees and contracts, and relocating facilities or personnel. Under SFAS No. 146, a company will record a liability for a cost associated with an exit or disposal activity when the liability is incurred and can be measured at fair value. The provisions of SFAS No. 146 are effective prospectively for exit or disposal activities initiated after December 31, 2002.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amends SFAS No. 123 to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for interim periods ending after December 15, 2002, which the Company has applied in these consolidated financial statements.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, except for certain items and for hedging relationships designated after June 30, 2003. The adoption of SFAS No. 149 will not have a significant impact on our consolidated financial statements.

Edgar Filing: VERTICALNET INC - Form 10-Q

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. Some of the provisions of SFAS No. 150 are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements. The remaining provisions of SFAS No. 150 are consistent with the FASB's proposal to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares, depending on the nature of the relationship established between the holder and the issuer. While the FASB still plans to revise that definition through an amendment to Concepts Statement 6, it has decided to defer issuing that amendment until it has concluded its deliberations on the next phase of this project. That next phase will deal with certain compound financial instruments including puttable shares,

Table of Contents

Verticalnet, Inc.

Notes to Consolidated Financial Statements (Unaudited)

convertible bonds, and dual-indexed financial instruments. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 is not expected to have an effect on the Company's financial position, results of operations, or cash flows.

(2) LIQUIDITY

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

In July 2003, we completed a repurchase of \$6.4 million of our 5¼% convertible subordinated debentures due September 2004 for total consideration of \$5.7 million in cash, stock and warrants. This consideration included \$1.3 million in cash, common stock with a fair market value of \$4.3 million and change of control warrants valued at \$0.1 million. See note 7 to these consolidated financial statements regarding this subsequent event.

In August 2003, we completed a \$1.1 million private placement of our common stock. The Company received approximately \$0.9 million in net proceeds from this transaction. See Note 7 to these consolidated financial statements regarding this subsequent event.

We may attempt to settle outstanding non-cancelable lease obligations and/or the Company's remaining \$728,000 of convertible debentures. If successful, our financial resources will be reduced.

(3) DISCONTINUED OPERATIONS

SMB

On June 28, 2002, we completed the sale of the SMB unit to Vert Markets, Inc., an affiliate of Corry Publishing, Inc. The SMB unit generated revenue from e-enablement and e-commerce, as well as advertising and services. As consideration for the transaction, we received cash of \$2.35 million. In addition, we may receive up to an additional \$6.5 million based on a four-year performance-based earn-out provision. We recorded a loss on disposal of approximately \$0.2 million in the three months ended June 30, 2002 for the sale of the SMB unit.

Edgar Filing: VERTICALNET INC - Form 10-Q

The results of the SMB unit have been shown as a discontinued operation and prior periods have been restated. Revenues and losses from this discontinued operation are as follows:

	Three Months Ended June 30, 2002	Six Months Ended June 30, 2002
	(in thousands)	
E-commerce, advertising, software, maintenance and other revenues	\$ 8,042	\$ 21,094
Income from discontinued operations	1,027	8,508
Loss on disposal of discontinued operations	(165)	(165)

Table of Contents**Verticalnet, Inc.****Notes to Consolidated Financial Statements (Unaudited)****(4) RESTRUCTURING CHARGES AND ASSET WRITE-DOWN**

During 2003, we continued to make payments under previous restructuring charges incurred in connection with strategic and organizational initiatives designed to realign business operations, eliminate acquisition related redundancies and reduce costs. The aggregate remaining restructuring accrual at June 30, 2003 of \$0.7 million, included in accrued expenses on the consolidated balance sheet, is expected to be adequate to cover actual amounts to be paid. Differences, if any, between the estimated amounts accrued and the actual amounts paid will be reflected in operating expenses in future periods.

The following table provides a summary by category and a roll forward of the changes in the restructuring accrual for the six months ended June 30, 2003 (in thousands):

	Accrual at December 31, 2002	Cash payments	Adjustments	Accrual at June 30, 2003
Lease termination costs	\$ 3,484	\$ (2,485)	\$ (302)	\$ 697
Employee severance and related benefits	50	(40)	(10)	
Other exit costs		(3)	3	
	<u>\$ 3,534</u>	<u>\$ (2,528)</u>	<u>\$ (309)</u>	<u>\$ 697</u>

(5) COMMITMENTS AND CONTINGENCIES*SEC Comment Letter*

In connection with our acquisition of Atlas Commerce, we filed a registration statement on Form S-3 with the SEC registering the resale of shares of our common stock issued to acquire Atlas Commerce. In connection with a routine review and comment letter process related to this filing, we have received comments from the SEC. The remaining open comments relate primarily to the presentation and recognition of certain previously reported revenue and expense items of our SMB business and whether one element of a material agreement should be accounted for as barter in accordance with Emerging Issues Task Force (EITF) Issue No. 99-17, Accounting for Advertising Barter Transactions. During the year ended December 31, 2002 we recognized no advertising revenues under the subject agreement. From inception of the agreement through completion, we recorded advertising revenues of \$22.2 million and advertising expenses of \$19.3 million. We believe the ultimate resolution of such comments would not change our accumulated deficit at June 30, 2003. The consolidated balance sheets as of June 30, 2003 and December 31, 2002 do not include any assets or liabilities associated with advertising activities under the subject agreement. We further believe that the cash flows from operations for the year ended December 31, 2002 would be unaffected by any potential change in presentation.

Pennsylvania Tax Grants

In July 2000, we entered into an Opportunity Grant Program Contract with the Commonwealth of Pennsylvania Department of Community and Economic Development (PaDCED) whereby we received a grant in the amount of \$1.0 million from the Commonwealth. The grant was conditioned upon, among other things, the creation of 1,000 full time jobs and that we would operate in the Horsham facility for at least five years. In July 2000, Atlas Commerce entered into an Opportunity Grant Program Contract with the PaDCED whereby Atlas Commerce received a grant in the amount of \$0.4 million from the Commonwealth, which amount was increased to \$0.6 million in June 2001. The grant was conditioned upon, among other things, the creation of 250 full time jobs and that Atlas Commerce would operate in the Malvern facility for at least five years. Both contracts contain a provision that requires repayment of the grant amount in the event the conditions are not met.

In November 2002, the PaDCED requested that we repay the entire grant amount of \$1.0 million for the July 2000 grant. The Company responded to the PaDCED that it believes it had substantially complied with the conditions. Although we intend to negotiate an amicable settlement of the matter, we will vigorously defend any action to recover the grant amount.

Table of Contents**Verticalnet, Inc.****Notes to Consolidated Financial Statements (Unaudited)****(6) LITIGATION**

On June 12, 2001, a class action lawsuit was filed against us and several of our officers and directors in U.S. Federal Court for the Southern District of New York in an action captioned *CJA Acquisition, Inc. v. Verticalnet, et al.*, C.A. No. 01-CV-5241 (the *CJA Action*). Also named as defendants were four underwriters involved in the issuance and initial public offering of our common stock in February 1999: Lehman Brothers Inc., Hambrecht & Quist LLC, Volpe Brown Whelan & Company LLC and WIT Capital Corporation. The complaint in the *CJA Action* alleges violations of Sections 11 and 15 of the Securities Act of 1933 and Section 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated there under, based on, among other things, claims that the four underwriters awarded material portions of the initial shares to certain favored customers in exchange for excessive commissions. The plaintiff also asserts that the underwriters engaged in a practice known as laddering, whereby the clients or customers agreed that in exchange for IPO shares they would purchase additional shares at progressively higher prices after the IPO. With respect to Verticalnet, the complaint alleges that the Company and its officers and directors failed to disclose in the prospectus and the registration statement the existence of these purported excessive commissions and laddering agreements. After the *CJA Action* was filed, several copycat complaints were filed in U.S. Federal Court for the Southern District of New York. Those complaints, whose allegations mirror those found in the *CJA Action*, include *Ezra Charitable Trust v. Verticalnet, et al.*, C.A. No. 01-CV-5350; *Kofsky v. Verticalnet, et al.*, C.A. No. 01-CV-5628; *Reeberg v. Verticalnet*, C.A. No. 01-CV-5730; *Lee v. Verticalnet, et al.*, C.A. No. 01-CV-7385; *Hoang v. Verticalnet, et al.*, C.A. No. 01-CV-6864; *Morris v. Verticalnet, et al.*, C.A. No. 01-CV-9459, and *Murphy v. Verticalnet, et al.*, C.A. No. 01-CV-8084. None of the complaints state the amount of any damages being sought, but do ask the court to award rescissory damages. All of the foregoing suits were amended and consolidated into a single complaint that was filed with the U.S. Federal Court on April 19, 2002. This amended complaint contains additional factual allegations concerning the events discussed in the original complaints, and asserts that, in addition to Sections 11 and 15 of the Securities Act, the Company and our officers and directors also violated Sections 10(b), 20(a) and Rule 10b-5 of the Exchange Act in connection with the IPO. In addition to this amended and consolidated complaint, the plaintiffs in this lawsuit and in the hundreds of other similar suits filed against other companies in connection with IPOs that occurred in the late 1990s have filed master allegations that primarily focus on the conduct of the underwriters of the IPOs, including our IPO. On October 9, 2002, the U.S. Federal Court for the Southern District of New York entered an order dismissing, without prejudice, the claims against the individual Verticalnet officers and directors who had been named as defendants in the various complaints. In February 2003, the District Court entered an order denying a motion made by the defendants to dismiss the actions in their entirety, but granting the motion as to certain of the claims against some defendants. However, the District Court did not dismiss any claims against Verticalnet. On or about June 5, 2003, Verticalnet's counsel, with the approval of the Company's directors, executed a Memorandum of Understanding on behalf of Verticalnet with respect to a proposed settlement of the plaintiff's claims against Verticalnet. This proposed resolution of the litigation has been publicly announced (although not yet formally accepted by the plaintiffs) and widely reported in the press. The proposed settlement, if approved by the District Court, would result in, among other things, the dismissal of all claims against Verticalnet, its officers and directors. It is expected that the proposed resolution will be reviewed by the District Court in late 2003 or early 2004. Under the present terms of the proposed settlement described above, Verticalnet would also assign its claims against the underwriters to the plaintiffs in the consolidated actions.

On May 15, 2003, Silicon Valley Bank commenced a lawsuit against certain of the Company's subsidiaries in the U.S. District Court for the Eastern District of Pennsylvania, captioned *Silicon Valley Bank v. Tradeum, Inc. and Verticalnet Solutions, LLC*, C.A.

No. 03-2949. The lawsuit alleges that Silicon Valley Bank provided a letter of credit on behalf of these affiliates in connection with a lease of office space in San Francisco, and that these affiliates must reimburse Silicon Valley Bank for certain draws upon the letter of credit by the landlord, totaling \$133,690, as well as a remittance or deposit of \$501,309 as security for the remaining undrawn amount of the letter of credit. We have retained counsel and intend to vigorously defend ourselves in connection with the allegations raised in the lawsuit.

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

Table of Contents

Verticalnet, Inc.

Notes to Consolidated Financial Statements (Unaudited)

(7) SUBSEQUENT EVENT

On July 28, 2003, we completed the repurchase of \$6.4 million of our 5¼% convertible subordinated debentures due September 2004 for total consideration of \$5.7 million. This consideration included 2,694,100 shares of common stock with a fair market value of \$4.3 million, \$1.3 million of cash and change of control warrants to purchase 305,120 shares of common stock. The warrants are exercisable only upon a change of control and expire on September 27, 2004 and were valued at \$0.1 million. In connection with the repurchase, the Company expects to record a charge to operations in the third quarter of 2003 of \$5.7 million representing an inducement for conversion of the convertible debentures, in accordance with SFAS No. 84, Induced Conversions of Convertible Debt. Shareholders' equity will increase by \$5.1 million as a result of the repurchase transaction.

On August 12, 2003, we completed a \$1.1 million private placement of our common stock. The Company issued 1,140,000 shares of common stock along with warrants to purchase 456,000 shares of common stock at \$1.20 per share. Shareholders' equity will increase by \$0.9 million as a result of the private placement.

Due to the significance of these two transactions on the Company's financial position, we have presented a pro forma balance sheet reflecting these transactions as if they had occurred on June 30, 2003.

Table of Contents

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

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

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

Company Overview

We are a provider of Strategic Sourcing and Supply Management solutions that enable companies to identify, negotiate, realize, and sustain supply chain savings and supply base performance improvement. Led by our Spend Analysis solution that quickly provides companies with insight into enterprise-wide spending, Verticalnet's full suite of Supply Management solutions enables companies to achieve lower prices, improved contract compliance, better supplier service, and shorter sourcing cycles.

In June 2002, we completed the sale of certain assets of the Small/Medium Business (SMB) unit that operated and managed online marketplaces. The SMB unit was sold to Corry Publishing for \$2.35 million in cash consideration, plus up to an additional \$6.5 million as an earn-out over the four-year period after the closing date. Additionally, during the quarter ended June 30, 2002, other assets in the SMB unit were sold under a separate agreement. Together, the transactions substantially finalized the operations of the SMB unit as part of Verticalnet and helped complete our transformation from an online operator of online public vertical communities to an enterprise software company. The operating results of this unit through June 28, 2002 have been reflected as a discontinued operation in our consolidated financial statements.

With our transformation to an enterprise software business model complete, management has taken the following significant actions since June 2002 to restructure our balance sheet and improve the financial viability of our business:

Edgar Filing: VERTICALNET INC - Form 10-Q

In June 2002, the Company completed the repurchase of all of its outstanding shares of Series A 6.00% convertible redeemable preferred stock due 2010, plus accrued dividends thereon, for a purchase price of \$5.0 million, and cancelled a common stock purchase warrant, dated April 7, 2000. The effect of the transaction was a net increase to shareholders' equity of \$101.0 million.

In July 2002, we completed the repurchase of \$13.85 million of our 5¼% convertible subordinated debentures due September 2004 for total consideration of \$2.9 million. This consideration included 1,270,854 shares of common stock valued at \$0.8 million and \$2.1 million in cash consideration. Additionally, we made a payment for accrued but unpaid interest of \$0.3 million, also in cash. In connection with the transaction, \$0.2 million of deferred debt offering costs attributable to the portion of debt repurchased were written off against additional paid-in capital. In addition, the Company also recorded a charge to operations of \$2.9 million representing an inducement for conversion of the convertible debentures, in accordance with Statement of Financial Accounting Standards (SFAS) No. 84, Induced Conversions of Convertible Debt. The net effect on

Table of Contents

shareholders' equity was an increase of \$11.5 million. In December 2002, we completed the repurchase of \$0.7 million of our 5¼% convertible subordinated debentures for total consideration of \$0.1 million. We recognized a gain of \$0.6 million in connection with the December repurchase. In July 2003, the Company completed the repurchase of \$6.4 million of our 5¼% convertible subordinated debentures due September 2004 for total consideration of \$5.4 million. This consideration included 2,694,100 shares of common stock with a fair market value of \$4.0 million, \$1.3 million of cash and change of control warrants to purchase 305,120 shares of common stock. The warrants expire on September 27, 2004 and were valued at \$0.1 million. In connection with the repurchase, the Company expects to record a charge to operations in the third quarter of 2003 of \$5.3 million representing an inducement for conversion of the convertible debentures, in accordance with SFAS No. 84. Shareholders' equity will increase by \$5.1 million as a result of the repurchase transaction.

In September 2002, we completed the repurchase of the remaining 10% interest in Verticalnet Europe, B.V. that we did not own (the BV Shares), for consideration of \$6.5 million in cash and 1,000,000 shares of common stock valued at \$1.2 million (200,000 shares were previously issued in 2002 as partial payments toward the obligation, along with an additional \$3.0 million payment which included payment of accrued interest). In connection with this settlement, the put and call agreement between Verticalnet and British Telecommunications Plc. (BT) was terminated. Separately, the Company and BT also agreed to terminate a Reseller Agreement between the parties, including a \$1.5 million prepaid license obligation. As a result of this settlement, the Company recorded a \$4.8 million gain representing the difference between the fair value of the consideration issued in the settlement transaction and the carrying value of the amounts due BT.

Also in September 2002, the Company and its wholly-owned subsidiary, VNI Holdings, Inc. (VNI) entered into an agreement with another investor in Converge, Inc. (Converge) to sell all of the Company's equity interests in, and notes receivable from, Converge for cash consideration of approximately \$1.9 million. At the first closing on September 30, 2002, VNI transferred the notes receivable and a portion of the Converge equity to the buyer and received the entire \$1.9 million cash consideration. Under the terms of the agreement, the Company was to transfer to the buyer all of the outstanding capital stock of VNI at a second closing. If the Company was not able to transfer the stock of VNI, the Company could have been required to refund \$0.1 million to the buyer. The Company was relieved of this obligation as part of the sale of Converge's assets in the first quarter of 2003.

We completed a goodwill impairment test as of September 30, 2002, under SFAS No. 142, Goodwill and Other Intangible Assets. This test requires a comparison of the fair value of a reporting unit with its carrying amount, including goodwill. We did not consider the market capitalization of the Company, which consists of only one reporting unit, to be representative of its fair value due to the volatility of the market price. Therefore, we estimated the fair value of the business based upon the amounts we could reasonably expect to realize in the sale of the assets of the business. As a result of this test, the Company recorded an impairment charge to goodwill of \$27.6 million. Of this amount, \$21.6 million related to the December 2001 acquisition of Atlas Commerce, Inc. (Atlas Commerce) and \$6.0 million related to the Company's acquisition of Isadra, Inc. (Isadra) in August 1999.

In November 2002, the Company entered into a second amendment to the amended and restated subscription license agreement with Converge. This amendment eliminated the obligation of the Company to provide future Verticalnet products to Converge at no cost for the term of the original subscription license agreement. As there remained no further obligation by Verticalnet under the license agreement with Converge, the remaining deferred license revenue balance of \$19.6 million was recognized during the fourth quarter of 2002. Since all amounts due under the amended and restated subscription license agreement had been collected, the revenue recognized did not represent additional cash inflows to the Company. This amendment did not alter the maintenance and support agreement between the Company and Converge.

In January 2003, the Company amended the lease agreement with its primary landlord resulting in an annual savings of \$2.7 million of operating expenses and reducing the Company's off balance sheet obligations by \$16.4 million, which consisted of both future minimum lease payment and related operations expenses. The amended agreement terminated the Company's financial obligation for the lease of the 700 Dresher Road and 300 Chester Field Parkway locations. Additionally, the agreement provided for occupancy of the 400 Chester Field Parkway premises until May 31, 2003 with options to continue the lease on a quarterly basis. We have exercised the option to continue the lease for an additional 90 days, commencing September 1, 2003.

In August 2003, we completed a \$1.1 million private placement of our common stock. The Company issued 1,140,000 shares of common stock along with warrants to purchase 456,000 shares of common stock at \$1.20 per share. See Note 7 to the accompanying consolidated financial statements included elsewhere in this report regarding this subsequent event.

Table of Contents

Results of Continuing Operations for the Three and Six Months Ended June 30, 2003 and June 30, 2002

Revenues

Total revenues for the quarter ended June 30, 2003 were \$2.2 million as compared to \$6.2 million for the quarter ended June 30, 2002. For the six month period ended June 30, 2003 and 2002, total revenues were \$5.6 million and \$14.2 million, respectively.

Revenues in the ongoing business are comprised of software license revenues and service and maintenance revenues. For the three months ended June 30, 2003 and 2002, software license revenues were \$35,000 and \$4.6 million, respectively. For the six months ended June 30, 2003, software license revenues were \$0.3 million versus \$10.9 million in the same period last year. The decline relates primarily to changes in our agreement with Converge and a more difficult macro economic market for software. There have been no new license agreements signed since March 2002. Revenues derived from the Converge arrangement represented approximately 4% and 61% of total revenues for the six months ended June 30, 2003 and 2002, respectively.

Services and maintenance revenues increased to \$2.1 million for the three months ended June 30, 2003 from \$1.6 million for the three months ended June 30, 2002 and increased year to date to \$5.3 million compared to \$3.3 million for the same period in 2002. The increase in service and maintenance revenues is due to selling additional services to our customers.

For the three and six months ended June 30, 2003, 80% and 75% of total revenues were derived from the Company's two largest customers.

Cost of Revenues

Cost of revenues is comprised of the cost of software license and the cost of services and maintenance. The cost of software license itself is comprised of royalties and the cost of acquired technology, which is the non-cash amortization of currently used technologies acquired through acquisitions.

The cost of software license was \$0.2 million and \$0.3 million for the three months ended June 30, 2003 and 2002, respectively. For the six months ended June 30, 2003, the cost of software licenses decreased to \$0.4 million compared to \$0.7 million for the same period last year. The decrease for the three and six months ended June 30, 2003 is due primarily to the decrease in the amortization of the technology acquired in the Isadra and Tradeum, Inc. (Tradeum) acquisitions, which had been fully amortized as of December 31, 2002. The cost of acquired technology for the three and six months of 2003 relates primarily to the Atlas Commerce acquisition, which occurred in December 2001.

The cost of services and maintenance includes the cost of the Company's consultants who are primarily responsible for the software implementations and configurations. Also included is the cost of the Company's customer support function, which is provided to customers as part of the recurring maintenance fees. For the three months ended June 30, 2003 and 2002 these costs were \$0.6 million and \$1.5 million, respectively. During the six months ended June 30, 2003 the costs decreased to \$1.3 million from \$2.9 million during the same period of 2002. The decrease is primarily due to reduced facilities and infrastructure costs and a significant reduction in headcount in the first nine months of

Edgar Filing: VERTICALNET INC - Form 10-Q

2002 as a result of the restructuring actions that occurred during 2002. For the six months ended June 30, 2003, the combination of these items accounted for approximately \$1.3 million of the decrease.

Research and Development

Research and development costs consist primarily of salaries and fringe benefits costs of our customer funded development, product strategy, development, and testing employees. For the six months ended June 30, 2003, research and development costs decreased \$4.3 million to \$2.0 million as compared to the same period in the prior year. Research and development costs decreased to \$0.9 million from \$2.8 million for the three months ended June 30, 2003 and 2002, respectively. The decrease was primarily due to headcount reductions associated with the restructuring actions that occurred during 2002. During the three and six months ended June 30, 2003, reductions in salary and fringe benefits related costs accounted for approximately \$1.2 million and \$2.9 million of the decrease, respectively. Reduction in facilities and infrastructure costs attributable to the research and development group contributed approximately \$0.4 million and \$0.9 million to the overall decrease, respectively. In addition, third-party consulting costs decreased approximately \$0.3 million and \$0.4 million, respectively.

Table of Contents

Sales and Marketing

Sales and marketing expenses consist primarily of salaries and fringe benefits costs, as well as commissions, for sales and marketing employees. In addition, the travel costs associated with business development are included in sales and marketing expenses. The sales and marketing expenses for the six months ended June 30, 2003 and 2002 were \$1.3 million and \$3.2 million, respectively. The sales and marketing expenses for the three months ended June 30, 2003 and 2002 were \$0.6 million and \$1.5 million, respectively. For the three and six months ended June 30, 2003, the significant decrease in sales and marketing expenses is primarily related to headcount reductions, which resulted in salary and fringe benefits decreasing by \$0.4 million and \$1.0 million, respectively. For the three and six months ended June 30, 2003, facilities and infrastructure costs attributable to the group decreased by \$0.2 million and \$0.5 million, respectively, while direct marketing expenses, such as advertising, public relations and trade shows, declined approximately \$0.1 million and \$0.2 million, respectively.

General and Administrative

General and administrative expenses consist primarily of salaries and related costs for our executive, administrative, finance, legal and human resources personnel. General and administrative expenses decreased \$3.8 million to \$2.5 million for the six months ended June 30, 2003 from \$6.3 million for the six months ended June 30, 2002. For the three months ended June 30, 2003, general and administrative expenses decreased to \$0.9 million from \$2.7 million for the same period in 2002. These expenses declined primarily as a result of the restructuring actions undertaken in 2002. For the three and six months ended June 30, 2003, headcount related cost reductions accounted for \$0.5 million and \$2.3 million of the decline, respectively, and general and administrative expenses, such as rent, contributed \$0.2 million and \$0.5 million in cost reductions, respectively.

Restructuring and Asset Impairment Charges

Restructuring and impairment charges for the three and six months ended June 30, 2003 reflect the net adjustment to the restructuring accrual. For the three and six months ended June 30, 2002 the Company recognized approximately \$0.4 million and \$1.8 million in restructuring and impairment charges, respectively. The charges taken during the first six months of 2002 relate to severance benefits and facility leases and include adjustments to amounts previously recorded. The severance benefits related to positions that were redundant as a result of the December 28, 2001 acquisition and subsequent integration of Atlas Commerce and amounted to approximately \$0.7 million. The accrual for facility leases was adjusted by \$1.4 million to reflect the difficult sublet market that existed for office space in certain markets where the Company leased office space.

Amortization Expense

For the three and six months ended June 30, 2002 amortization expense totaled \$1.1 million and \$2.1 million, respectively, which primarily reflected the non-cash amortization of deferred costs related to warrants and Series A preferred stock issued to Microsoft. The Company did not incur any such amortization expense during the three or six months ended June 30, 2003.

Interest and Other Expense, net

Edgar Filing: VERTICALNET INC - Form 10-Q

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2003	2002	2003	2002
Gain (loss) on asset disposal	\$	\$	\$ (9)	\$ 108
Transaction gain (loss)	25		25	(13)
Realized gain (loss) on investments	21	(5,250)	134	(5,240)
Interest expense	(511)	(657)	(999)	(1,415)
Interest and other expense, net	\$ (465)	\$ (5,907)	\$ (849)	\$ (6,560)

In June 2002, the Company repurchased all of its outstanding Series A 6% convertible redeemable preferred stock. At the time of the repurchase, the carrying value of the preferred stock and the related accumulated dividends was approximately \$106.0 million. The Company paid \$5.0 million in cash consideration for the preferred shares, resulting in an increase in paid-in capital of \$101.0 million, which is included in income attributable to common shareholders for the three and six months ended June 30, 2002.

Table of Contents

Liquidity and Capital Resources

As of June 30, 2003, our primary source of liquidity consists of cash and cash equivalents. The majority of such funds are readily available for operating purposes. At June 30, 2003, we had cash and cash equivalents totaling \$5.6 million, compared to cash, cash equivalents and short-term investments of \$9.0 million at December 31, 2002. At June 30, 2003, working capital increased \$0.3 million to \$4.2 million from \$3.9 million at December 31, 2002.

Net cash used in operating activities was \$5.3 million for the six months ended June 30, 2003 compared to \$17.0 million for the six months ended June 30, 2002. Net cash used in operating activities for the six months ended June 30, 2003 consisted primarily of losses from continuing operations and decreases in accounts payable and accrued expenses, offset by decreases in accounts receivable, and prepaid expenses and other assets and an increase in deferred revenues.

During the six months ended June 30, 2003, \$2.9 million of cash was provided by investing activities compared to \$2.4 million during the six months ended June 30, 2002. Cash provided by investing activities for the six months ended June 30, 2003 includes \$1.0 million from the sale of our investment in corporate bonds, \$0.3 million from the sale of property and equipment, and \$1.7 million from the release of previously restricted funds.

Net cash provided by financing activities was \$81,000 for the six months ended June 30, 2003, compared to net cash used in financing activities of \$7.7 million in 2002. The 2002 amount primarily relates to \$5.0 million for the repurchase of all of the Company's outstanding convertible redeemable preferred stock, and approximately \$2.1 million paid toward the principal of the BT put and call agreement, as well as \$1.1 million of principal payments on capital leases, offset by proceeds from employee stock plans.

In July 2003, we completed the repurchase of \$6.4 million of our 5¼% convertible subordinated debentures due September 2004 for total consideration of \$5.4 million. This consideration included 2,694,100 shares of common stock with a fair market value of \$4.0 million, \$1.3 million of cash and change of control warrants to purchase 305,120 shares of common stock. The warrants are exercisable only upon a change of control and expire on September 27, 2004, and were valued at \$0.1 million. See note 7 to the accompanying consolidated financial statements included elsewhere in this report regarding this subsequent event.

In August 2003, we completed a \$1.1 million private placement of our common stock. The Company issued 1,140,000 shares of common stock along with warrants to purchase 456,000 shares of common stock at \$1.20 per share. See Note 7 to the accompanying consolidated financial statements including elsewhere in this report regarding this subsequent event.

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

We may attempt to settle outstanding non-cancelable lease obligations and/or the Company's remaining convertible debentures. If successful, our resources will be reduced.

Table of Contents**Contractual Commitments**

The following table outlines the remaining future commitments reflecting the effects of the repurchase of \$6.4 million of our convertible debentures (see note 7 to our consolidated financial statements).

Expected Cash Payments by Year

(in thousands)

	2003*	2004	2005	2006	2007 and beyond	Total
Convertible notes	\$	\$ 728	\$	\$	\$	\$ 728
Operating leases	129	125	124	31		409
Total	\$ 129	\$ 853	\$ 124	\$ 31	\$	\$ 1,137

* Reflects amounts payable over the last six months of 2003

Recent Accounting Pronouncements

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections. SFAS No. 4, Reporting Gains and Losses from Extinguishment of Debt, required that gains and losses from extinguishments of debt be included in the determination of net income and be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. Although SFAS No. 145 became effective January 1, 2003, the Company elected to early adopt the provisions of SFAS No. 145 in 2002. During the third quarter of 2002, in connection with the settlement of obligations involving BT, the Company recognized a \$4.8 million gain representing the difference between the fair value of the consideration issued in the settlement transaction and the carrying value of the amounts due BT. As a result of the early adoption of SFAS No. 145, the Company evaluated the classification of this gain in accordance with the provisions of APB Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, and determined that the gain did not meet the criteria for classification as an extraordinary item.

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses the financial accounting and reporting of expenses related to restructurings initiated after 2002, and applies to costs associated with an exit activity (including a restructuring) or with a disposal of long-lived assets. Those activities can include eliminating or reducing product lines, terminating employees and contracts, and relocating facilities or personnel. Under SFAS No. 146, a company will record a liability for a cost associated with an exit or disposal activity when the liability is incurred and can be measured at fair value. The provisions of SFAS No. 146 are effective prospectively for exit or disposal activities initiated after December 31, 2002.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, which amends SFAS No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123

Edgar Filing: VERTICALNET INC - Form 10-Q

to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for interim periods ending after December 15, 2002, which the Company has applied in the notes to the consolidated financial statements included elsewhere in this report.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, except for certain items and for hedging relationships designated after June 30, 2003. The adoption of SFAS No. 149 will not have a significant impact on our consolidated financial statements.

Table of Contents

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. Some of the provisions of SFAS No. 150 are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements. The remaining provisions of SFAS No. 150 are consistent with the FASB's proposal to revise that definition to encompass certain obligations that a reporting entity can or must settle by issuing its own equity shares, depending on the nature of the relationship established between the holder and the issuer. While the FASB still plans to revise that definition through an amendment to Concepts Statement 6, it has decided to defer issuing that amendment until it has concluded its deliberations on the next phase of this project. That next phase will deal with certain compound financial instruments including puttable shares, convertible bonds, and dual-indexed financial instruments. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 is not expected to have an effect on the Company's financial position, results of operations or cash flows.

FACTORS AFFECTING OUR BUSINESS CONDITION

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

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

In November 2002, we announced that we had retained US Bancorp Piper Jaffray, an investment banker, to pursue a potential sale of the Company. While we now believe a sale of the Company is unlikely given our announced intention to actively pursue continued operations and growth of the Company, we may not be able to achieve that growth and may in the future again pursue a sale of the Company. In the event that we complete a sale, certain severance and third-party obligations could be triggered, which could be substantial.

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

We may not generate an operating profit.

As of June 30, 2003, our accumulated deficit was approximately \$1.2 billion. Although we generated a profit in the fourth quarter of 2002, we expect to incur operating losses for the foreseeable future. We may never generate an operating profit or, even if we do become profitable from operations at some point, we may be unable to sustain that profitability.

Table of Contents

We may not develop significant revenues from enterprise software licensing and professional services, which could adversely affect our future revenue growth and ability to achieve profitability.

If we do not develop and consistently generate significant revenues from enterprise software licensing and professional services, our business, financial condition and operating results will be impaired. Our ability to generate software revenues depends on the overall demand for enterprise software solutions and professional services, as well as general economic and business conditions. Suppressed demand for software solutions and services caused by a weakening economy and reduced levels of spending on technology solutions may result in less revenue growth than expected or even a decline in revenues. We cannot offer any assurances that we will be able to develop, enhance or promote our enterprise software solutions and professional services effectively, whether as a result of general economic conditions or otherwise.

We anticipate lengthy sales cycles for our software products, and difficulty in obtaining customer commitments.

The Company has not executed a software license agreement since March 2002. Looking forward, we anticipate the sales cycle for our enterprise software products to average approximately three to nine months. We have experienced an increase in the length of the sales cycle during 2002 and 2003. We have also experienced difficulty in obtaining customer commitments to enter into contracts even after we have been selected as the preferred vendor due to financial flux at prospective customers. If the economy and the market for technology solutions remain depressed or continue to worsen, then our average sales cycle could become increasingly longer and our ability to enter into customer agreements could become increasingly more difficult. By purchasing our products, we may be asking potential customers in many cases to change their established business practices and conduct business in new ways. In addition, potential customers must generally consider additional issues, such as product benefits, ease of installation, ability to work with existing technology, functionality and reliability, and adoption by their suppliers, before committing to purchase our products. Additionally, we believe that the purchase of our products is often discretionary and generally involves a significant commitment of capital and other resources by a customer, which frequently requires approval at a number of management levels within the customer organization. Likewise, the implementation and deployment of our enterprise software products requires a significant commitment of resources by our customers and our professional services organization. The challenges we face in attempting to obtain commitments and approvals from our customers may be exacerbated by worsening economic conditions in general and in our target markets, as well as by competition from other software solution providers whose brands, products and services may be better known to, and more widely accepted by, potential customers than ours.

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

Our common stock is currently listed on the Nasdaq Stock Market, which has requirements for the continued listing of stock. In May 2002, we transferred our listing from the Nasdaq National Market to the Nasdaq SmallCap Market due to our inability to comply with the Nasdaq National Market bid price and shareholders' equity requirements. Continued listing on the Nasdaq SmallCap Market requires us to maintain \$2.5 million in shareholders' equity and our common stock to maintain a minimum bid price of \$1.00 per share. Although we completed a one-for-ten reverse split of our common stock on July 15, 2002, the bid price for our common stock has closed below \$1.00 for several weeks at a time. We will not meet the continued listing standard if the closing price of our common stock is less than \$1.00 for 30 consecutive trading days. Our stock was trading above \$1.00 as of August 13, 2003. As of June 30, 2003, our shareholders' deficit was approximately \$0.4 million, which is below the Nasdaq SmallCap Market continued listing requirement. On April 8, 2003, we received a letter from Nasdaq stating that Nasdaq was reviewing our eligibility for continued listing on the Nasdaq SmallCap Market due to (i) the Company's failure to maintain the minimum shareholders' equity of \$2.5 million, and (ii) Nasdaq's belief that the members of the Company's Audit Committee were not independent within the meaning of the Nasdaq rules. The letter stated that delisting procedures would begin if Nasdaq believed the Company's plan to achieve and maintain compliance with listing standards was inadequate. On April 22, 2003, the Company responded to Nasdaq and asserted that (i) the Company has a plan to improve the Company's net worth sufficient to meet Nasdaq listing requirements, and (ii) that the Company believes that under existing law and proposed SEC and Nasdaq rules, the members of the Company's Audit Committee are independent, and that no further modification of the Audit Committee would be required until the annual meeting in 2004. On June 5, 2003, we received a letter from Nasdaq rejecting our request that our stock remain listed on the Nasdaq SmallCap Market. The Company filed an immediate appeal, which stayed the delisting until a

Edgar Filing: VERTICALNET INC - Form 10-Q

hearing could be held before a hearing panel. On July 24, 2003, the Company attended a hearing convened by Nasdaq before a Listing Qualifications Panel to consider the delisting of Verticalnet's common stock. On August 5, 2003, we received a letter from Nasdaq informing us that the Listing Qualifications Panel had determined to continue our listing of the Company's securities on the Nasdaq SmallCap Market, subject to our completion of certain matters, including (i) the timely filing of this Quarterly Report containing the pro forma balance sheet (note 7 to the accompanying

Table of Contents

consolidated financial statements included elsewhere in this report regarding this subsequent event); (ii) submitting documentation evidencing the election of independent directors and audit committee members, and (iii) timely filing a Quarterly Report for the third calendar quarter of 2003 which evidences shareholders' equity in excess of \$2,500,000. We have already complied with all but the last requirement, and although we believe we will comply with that requirement when required, there can be no assurance that we will be able to meet the minimum shareholders' equity balance at that time.

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

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

If our stock is delisted from the Nasdaq Stock Market and our share price declines significantly, then we may be unable to license our products and sell our services to prospective or existing customers.

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

Our ability to complete the business repositioning and financial restructuring of the Company depends on our key management and experienced software personnel, whom we may not be able to retain.

We believe that our ability to complete a successful business repositioning and financial restructuring of the Company depends on continued employment of our senior management team and on maintaining a highly trained product development staff. If one or more members of our senior management team were unable or unwilling to continue in their present positions, our prospects for reorganizing the Company could be materially adversely affected. If we are unable to retain trained technical personnel, it could limit our ability to design and develop products, which could reduce our attractiveness to potential investors or acquirers.

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

Our success also depends on having highly trained professional services and development personnel. We may need to hire additional personnel if our business grows. A shortage in the number of trained consultants and developers could limit our ability to implement our software if we are able to license software to new customers or if our present customers ask us to perform more services for them. Competition for personnel,

Edgar Filing: VERTICALNET INC - Form 10-Q

particularly for employees with technical expertise, could be strong. Our business, financial condition and operating results will be materially adversely affected if we cannot hire and retain suitable personnel.

We may have to amend previously filed reports with respect to revenue and expense items of our discontinued SMB business if we cannot otherwise resolve comments we have received from the SEC.

In connection with our acquisition of Atlas Commerce, we filed a registration statement on Form S-3 with the SEC registering the resale of shares of our common stock issued in the acquisition. In connection with a routine review and comment letter process related to this filing, we have received comments from the SEC. The remaining open comments relate primarily to the presentation and recognition of certain previously reported revenue and expense items of our SMB business and whether one element of a material agreement should be accounted for as barter in accordance with EITF Issue No. 99-17, Accounting for Advertising Barter Transactions. We believe the ultimate resolution of such comments would not change our accumulated deficit at June 30, 2003, although there could be differences in reported quarterly operating results (refer to note 5 to the consolidated financial

Table of Contents

statements for additional information). The remaining open SEC comments do not relate in any way to our ongoing Strategic Sourcing and Supply Management solutions operations. The SMB business was sold on June 28, 2002, and that business unit is reflected in our financial statements as a discontinued operation for all periods presented, which requires that all elements of revenue and expense be netted as a single line item to report net results of discontinued operations. As a result, revenues and expenses of our SMB business are no longer separately presented in our financial statements. We filed a response to the matters raised by the SEC and are awaiting their response. We believe the historical presentations and recognition of revenue and expense for the SMB business are appropriate. If the SEC will not declare the Form S-3 effective without us first revising the historical presentation and recognition of previously reported revenue and expense items of our SMB business, then we will have to amend the reports that are incorporated into the Form S-3.

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

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

anticipated lengthy sales cycle for our products;

the size and timing of individual license transactions;

intense and increased competition in our target markets;

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

risks associated with past acquisitions.

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

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

We may seek to raise or acquire additional capital, which could dilute our existing shareholders.

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

to our existing shareholders.

We expect to rely on third parties to implement our products.

We expect to rely on third parties to implement our software products at customer sites. If we are unable to establish and maintain effective, long-term relationships with implementation providers, or if these providers do not meet the needs or expectations of our customers, our business could be seriously harmed. As a result of the limited resources and capacities of many third-party implementation providers, we may be unable to establish or maintain relationships with third parties having sufficient resources to provide the necessary implementation services to support our needs. If these resources are unavailable, we will be required to provide these services internally, which could significantly limit our ability to meet our customers' implementation needs. A number of our competitors have significantly more well established relationships with third parties that we may potentially partner with. As a result, these third parties may be more likely to recommend competitors products and services rather than our own. In addition, we would not be able to control the level and quality of service provided by our implementation partners.

Table of Contents

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

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

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

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

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

The markets for our software products and services are intensely competitive, which may result in low or negative profit margins and difficulty in achieving market share, either of which could seriously harm our business. We expect the intensity of competition to increase. Our enterprise software products and services face competition from software companies whose products or services compete with a particular aspect of the solution we provide, as well as several major enterprise software developers. Many of our competitors have longer operating histories, greater brand recognition and greater financial, technical, marketing and other resources than we do, and may have well-established relationships with our existing and prospective customers. This may place us at a disadvantage in responding to our competitors' pricing strategies, technological advances, advertising campaigns, strategic partnerships and other initiatives. Our competitors may also develop products or services that are superior to or have greater market acceptance than ours. If we are unable to compete successfully against our competitors, our business, financial condition and operating results would be negatively impacted.

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

We hold investments in equity instruments of privately held companies. Such items are included in other investments on our balance sheet. For the year ended December 31, 2002, we recorded an aggregate of \$12.0 million in impairment charges for other than temporary declines in the fair value of our cost method, equity method and available-for-sale investments, \$9.6 million of which was a write-down of the fair value of our equity investment in, and note receivable from, Converge, for which we entered into a sale agreement as of September 30, 2002. As of June 30, 2003, we held cost method investments with a carrying value of \$0.6 million. We may never realize any return on our equity interests that we continue to hold, and we may suffer a complete loss of these interests, which could materially and adversely affect our business, financial condition and operating results.

If we do not develop the Verticalnet brand in the enterprise software industry, our revenues might not increase.

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

Table of Contents

Our interests may conflict with those of Internet Capital Group, our largest shareholder, which may affect our business strategy and operations negatively.

As a result of its stock ownership and board representation, Internet Capital Group, Inc. (Internet Capital Group) is in a position to affect our business strategy and operations, including corporate actions such as mergers or takeover attempts, in a manner that could conflict with the interests of our public shareholders. At June 30, 2003, Internet Capital Group beneficially owned 3,579,172 shares, or approximately 26%, of our common stock, which includes 62,703 shares of our common stock underlying warrants issued to Internet Capital Group prior to our initial public offering. One representative of Internet Capital Group is a member of our board of directors. We may compete with Internet Capital Group and its partner companies for enterprise software opportunities, in part through acquisitions and investments. Internet Capital Group, therefore, may seek to acquire or invest in companies that we would find attractive. While we may partner with Internet Capital Group on future acquisitions or investments, neither we nor they have any current contractual obligations to do so. We do not have any contracts or other understandings that would govern resolution of this potential conflict. This competition, and the potential conflict posed by the designated director, may deter companies from partnering with us and may limit our business opportunities.

Internet Capital Group may have to buy or sell our stock to avoid registration under the Investment Company Act of 1940, which may negatively affect our stock price.

To avoid registration under the Investment Company Act of 1940, Internet Capital Group may need to continue to own more than 25% of our voting securities and to continue to have a representative on our board of directors. Under the Investment Company Act, a company is considered to control another company if it owns more than 25% of that company's voting securities and is the largest stockholder of such company. A company may be required to register as an investment company if more than 45% of its total assets consist of, and more than 45% of its income/loss and revenue attributable to it over the last four quarters is derived from, ownership interests in companies it does not control. Internet Capital Group has publicly stated that it is not feasible to be regulated as an investment company because the Investment Company Act rules are inconsistent with their corporate strategy. As of June 30, 2003, Internet Capital Group's ownership interest in us was 18%. Internet Capital Group's total beneficial ownership in us is 3,579,172 or 26% of our common stock, because it has an agreement with Safeguard Scientifics, Inc. (Safeguard Scientific) that provides it with the right of first refusal to purchase the 1,052,308 shares of our stock that Safeguard Scientific owns. If its ownership interest falls below 25%, Internet Capital Group may need to purchase additional voting securities to return to an ownership interest of at least 25% to avoid having to register as an investment company. The possible need of Internet Capital Group to maintain a 25% ownership position could adversely influence its decisions regarding actions that may otherwise be in the best interests of our public shareholders. If Internet Capital Group sells all or part of its investment in us, whether to comply with the Investment Company Act of 1940, to raise additional capital or otherwise, it could adversely affect our common stock's market price.

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

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

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

Edgar Filing: VERTICALNET INC - Form 10-Q

Several lawsuits have been brought against us and the underwriters of our stock in our initial public offering. These lawsuits allege, among other things, that the underwriters engaged in sales practices that had the effect of inflating our stock price, and that our prospectus for that offering was materially misleading because it did not disclose these sales practices. In addition, a lawsuit was brought by Silicon Valley Bank alleging that two of our subsidiaries are indebted to them under a letter of credit which had secured a terminated lease obligation of those subsidiaries. We intend to vigorously defend against these lawsuits. No assurance can be given as to the outcome of these lawsuits.

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

If our shareholders or option and warrant holders sell substantial amounts of our common stock in the public market, including shares issued in completed or future acquisitions or upon the exercise of outstanding options and warrants, then the market price of

Table of Contents

our common stock could fall. As of June 30, 2003, the holders of 3,528,500 shares of common stock and warrants to purchase 62,703 shares of common stock have demand and/or piggyback registration rights. The exercise of such rights could adversely affect the market price of our common stock. We also have filed a shelf registration statement to facilitate our acquisition strategy, as well as registration statements to register shares of common stock under our stock option and employee stock purchase plans. Shares issued pursuant to existing or future shelf registration statements, upon exercise of stock options and in connection with our employee stock purchase plan will be eligible for resale in the public market without restriction.

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

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

Our common stock price is likely to remain highly volatile.

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

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

actual or anticipated variations in quarterly operating results;

announcements of technological innovations;

new products or services;

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

failure to meet analysts' or investors' expectations;

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

our cash position and cash commitments;

our prospects for software sales and new customers; and

additions or departures of key personnel.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk related changes in interest rates relates primarily to our investment portfolio. We have invested in instruments that meet high quality credit standards, as specified in our investment policy. The policy also limits the amount of credit exposure we may have to any one issue, issuer or type of investment. As of June 30, 2003, our portfolio of investments included \$5.6 million in cash and cash equivalents. Due to the conservative nature of our investment portfolio, we believe that a sudden change in interest rates would not have a material effect on the value of the portfolio since in most cases the average yield on our investments is less than 1% at June 30, 2003. The impact on our future interest income and future changes in investment yields will depend largely on the gross amount of our investment portfolio.

We have invested in equity instruments of privately held companies for business and strategic purposes. These investments are included in other investments and are accounted for under the cost method when ownership is less than 20% and we do not have the ability to exercise significant influence over operations. As of June 30, 2003 we hold cost method equity investments with a carrying value of approximately \$0.6 million. For these investments in privately held companies, our policy is to regularly review the assumptions underlying the operating performance and cash flow forecasts in assessing the recoverability of the carrying values. We identify and record impairment losses when events and circumstances indicate that such assets might be impaired.

In connection with Ariba Inc.'s (Ariba) acquisition of Tradex Technologies, Inc., we received Ariba common stock. In July 2000, we entered into forward sale contracts relating to our investment in Ariba. Under these contracts, we pledged our shares of Ariba's common stock to the counter-party for a three-year period in return for approximately \$47.4 million of cash. In July 2003, the three

Table of Contents

year period concluded, and we elected to deliver the pledged Ariba shares to satisfy the forward sale, rather than delivering cash. As of the date of this filing, we have not been advised whether the pledged shares have been delivered to the counter-party. We have no further obligations under the forward sale contract. We have only limited involvement with derivative financial instruments and do not use them for trading purposes.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of disclosure controls and procedures.* The Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of June 30, 2003. The Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that are filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that these controls and procedures are effective.

(b) *Changes in internal controls.* The evaluation referred to in paragraph (a) of this Item did not identify any changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2003 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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

On June 12, 2001, a class action lawsuit was filed against us and several of our officers and directors in U.S. Federal Court for the Southern District of New York in an action captioned *CJA Acquisition, Inc. v. Verticalnet, et al.*, C.A. No. 01-CV-5241 (the *CJA Action*). Also named as defendants were four underwriters involved in the issuance and initial public offering of our common stock in February 1999: Lehman Brothers Inc., Hambrecht & Quist LLC, Volpe Brown Whelan & Company LLC and WIT Capital Corporation. The complaint in the *CJA Action* alleges violations of Sections 11 and 15 of the Securities Act of 1933 and Section 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated there under, based on, among other things, claims that the four underwriters awarded material portions of the initial shares to certain favored customers in exchange for excessive commissions. The plaintiff also asserts that the underwriters engaged in a practice known as laddering, whereby the clients or customers agreed that in exchange for IPO shares they would purchase additional shares at progressively higher prices after the IPO. With respect to Verticalnet, the complaint alleges that the Company and its officers and directors failed to disclose in the prospectus and the registration statement the existence of these purported excessive commissions and laddering agreements. After the *CJA Action* was filed, several copycat complaints were filed in U.S. Federal Court for the Southern District of New York. Those complaints, whose allegations mirror those found in the *CJA Action*, include *Ezra Charitable Trust v. Verticalnet, et al.*, C.A. No. 01-CV-5350; *Kofsky v. Verticalnet, et al.*, C.A. No. 01-CV-5628; *Reeberg v. Verticalnet*, C.A. No. 01-CV-5730; *Lee v. Verticalnet, et al.*, C.A. No. 01-CV-7385; *Hoang v. Verticalnet, et al.*, C.A. No. 01-CV-6864; *Morris v. Verticalnet, et al.*, C.A. No. 01-CV-9459, and *Murphy v. Verticalnet, et al.*, C.A. No. 01-CV-8084. None of the complaints state the amount of any damages being sought, but do ask the court to award rescissory damages. All of the foregoing suits were amended and consolidated into a single complaint that was filed with the U.S. Federal Court on April 19, 2002. This amended complaint contains additional factual allegations concerning the events discussed in the original complaints, and asserts that, in addition to Sections 11 and 15 of the Securities Act, the Company and our officers and directors also violated Sections 10(b), 20(a) and Rule 10b-5 of the Exchange Act in connection with the IPO. In addition to this amended and consolidated complaint, the plaintiffs in this lawsuit and in the hundreds of other similar suits filed against other companies in connection with IPOs that occurred in the late 1990s have filed master allegations that primarily focus on the conduct of the underwriters of the IPOs, including our IPO. On October 9, 2002, the U.S. Federal Court for the Southern District of New York entered an order dismissing, without prejudice, the claims against the individual Verticalnet officers and directors who had been named as defendants in the various complaints. In February 2003, the District Court entered an order denying a motion made by the defendants to dismiss the actions in their entirety, but granting the motion as to certain of the claims against some defendants. However, the District Court did not dismiss any claims against Verticalnet. On or about June 5, 2003, Verticalnet's counsel, with the approval of the Company's directors, executed a Memorandum of Understanding on behalf of Verticalnet with respect to a proposed settlement of the plaintiff's claims against Verticalnet. This proposed resolution of the litigation has been publicly announced (although not yet formally accepted by the plaintiffs) and widely reported in the press. The proposed settlement, if approved by the District Court, would result in, among other things, the dismissal of all claims against Verticalnet, its officers and directors. It is expected that the proposed resolution will be reviewed by the District Court in late 2003 or early 2004. Under the present terms of the proposed settlement described above, Verticalnet would also assign its claims against the underwriters to the plaintiffs in the consolidated actions.

On May 15, 2003, Silicon Valley Bank commenced a lawsuit against certain of the Company's subsidiaries in the U.S. District Court for the Eastern District of Pennsylvania, captioned *Silicon Valley Bank v. Tradeum, Inc. and Verticalnet Solutions, LLC*, C.A. No. 03-2949. The lawsuit alleges that Silicon Valley Bank provided a letter of credit on behalf of these affiliates in connection with a lease of office space in San Francisco, and that these affiliates must reimburse Silicon Valley Bank for certain draws upon the letter of credit by the landlord, totaling \$133,690, as well as a remittance or deposit of \$501,309 as security for the remaining undrawn amount of the letter of credit. We have retained counsel and intend to vigorously defend ourselves in connection with the allegations raised in the lawsuit.

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

Table of Contents

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(a) None.

(b) None.

(c) None.

(d) Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

(a) None.

(b) None.

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

(a) We held our 2003 Annual Meeting of Shareholders on June 18, 2003.

(b) Per Instruction 3 to item 4 of Form 10-Q, no response is required.

(c) The matters voted upon at the annual meeting, and the results of the vote on each such matter, are set forth below.

(1) Election of Directors. The result of the vote tabulated at the meeting for the following three director nominees was as follows:

	Number of Shares	
	Voted in	
	Favor	Withheld
Robert F. Bernstock	10,365,795	77,880

Edgar Filing: VERTICALNET INC - Form 10-Q

Walter W. Buckley III	10,396,548	47,127
Mark L. Walsh	10,328,971	114,704

- (2) Approval of the amendment to the Verticalnet, Inc. 2000 Equity Compensation Plan. The result of the vote tabulated at the meeting for the amendment was as follows:

Number of Votes FOR	4,220,597
Number of Votes AGAINST	239,813
Number of Abstentions	12,743

ITEM 5. OTHER INFORMATION

None.

Table of Contents

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

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

<u>Exhibit Number</u>	<u>Description</u>
10.1	Agreement Assigning and Terminating Lease Agreements and Releasing Parties dated January 16, 2003, by and among Liberty Property Limited Partnership, Verticalnet, Inc. and Atlas Commerce, Inc.
10.2	Letter Agreement dated March 20, 2003 by and among Converge, LLC, Converge, Inc., PCG Trading, LLC, Verticalnet, Inc. and Verticalnet Enterprises, LLC.
31.1*	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification by the Chief Executive Officer Relating to a Periodic Report Containing Financial Statements, dated August 14, 2003.
32.2**	Certification by the Chief Financial Officer Relating to a Periodic Report Containing Financial Statements, dated August 14, 2003.

* Filed herewith.

** Furnished herewith.

(b) Reports on Form 8-K.

On April 17, 2003, we filed a Current Report on Form 8-K regarding the replacement of the Independent Auditors Consent filed as Exhibit 23.1 with the Annual Report filed on Form 10-K.

On May 8, 2003, we filed a Current Report on Form 8-K, dated May 6, 2003, regarding our press release of May 6, 2003 setting forth financial information for the quarter ended March 31, 2003.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in Malvern, Pennsylvania, on August 14, 2003.

VERTICALNET, INC.

By: /s/ NATHANAEL V. LENTZ

Name: Nathanael V. Lentz

President and Chief Executive
Officer

By: /s/ GENE S. GODICK

Name: Gene S. Godick

Executive Vice President and

Chief Financial Officer