

Net Element, Inc.
Form 10-Q
August 15, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2016

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: **001-34887**

Net Element, Inc.

Edgar Filing: Net Element, Inc. - Form 10-Q

(Exact name of registrant as specified in its charter)

Delaware **90-1025599**
(State or other jurisdiction of incorporation (I.R.S. Employer
or organization) Identification No.)

3363 NE 163rd Street, Suite 705
North Miami Beach, Florida 33160
(Address of principal executive offices) (Zip Code)

(305) 507-8808

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer

Accelerated filer

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

Edgar Filing: Net Element, Inc. - Form 10-Q

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

The number of outstanding shares of common stock, \$.0001 par value, of the registrant as of August 12, 2016 was
14,002,959

Defined Terms

Net Element, Inc. is a corporation organized under the laws of the State of Delaware. As used in this Quarterly Report on Form 10-Q (this “Report”), unless the context otherwise requires, the terms “Company,” “we,” “us” and “our” refer to Net Element, Inc. and, as applicable, its majority-owned and consolidated subsidiaries. References in this Report to “PayOnline” refer, collectively, to PayOnline System LLC, Innovative Payment Technologies LLC, Polimore Capital Limited and Brosword Holding.

Forward-Looking Statements

This Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Any statements contained in this Report that are not statements of historical fact may be deemed forward-looking statements. Forward-looking statements generally are identified by the words “expects,” “anticipates,” “believes,” “intends,” “estimates,” “aims,” “plans,” “will,” “continue,” “seeks,” “should,” “believe,” “potential” or the negative of such terms and similar expressions. Forward-looking statements are based on current plans, estimates and projections, and therefore you should not place too much reliance on them. Forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to update any forward-looking statement in light of new information or future events, except as expressly required by law. Forward-looking statements involve inherent risks and uncertainties, most of which are difficult to predict and are generally beyond the Company’s control. The Company cautions you that a number of important factors could cause actual results or outcomes to differ materially from those expressed in, or implied by, the forward-looking statements. These factors include, among other factors:

- the impact of any new or changed laws, regulations, card network rules or other industry standards affecting our business including the U.S. government decision to impose sanctions or other legal restrictions that may restrict our ability to do business in Russia;
- the impact of any significant chargeback liability and liability for merchant or customer fraud, which we may not be able to accurately anticipate and/or collect;
- our ability to secure or successfully migrate merchant portfolios to new bank sponsors if current sponsorships are terminated;
- our and our bank sponsors’ ability to adhere to the standards of the Visa® and MasterCard® payment card associations;
- our reliance on third-party processors and service providers;
- our dependence on independent sales groups (“ISGs”) that do not serve us exclusively to introduce us to new merchant accounts;
- our ability to pass along increases in interchange costs and other costs to our merchants;
- our ability to protect against unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems or otherwise;
-

Edgar Filing: Net Element, Inc. - Form 10-Q

- the effect of the loss of key personnel on our relationships with ISGs, card associations, bank sponsors and our other service providers;
- the effects of increased competition, which could adversely impact our financial performance;
- the impact of any increase in attrition due to an increase in closed merchant accounts and/or a decrease in merchant charge volume that we cannot anticipate or offset with new accounts;
- the effect of adverse business conditions on our merchants;
- our ability to adopt technology to meet changing industry and customer needs or trends;
- the impact of any decline in the use of credit cards as a payment mechanism for consumers or adverse developments with respect to the credit card industry in general;
- the impact of any adverse conditions in industries in which we obtain a substantial amount of our bankcard processing volume;
- the impact of seasonality on our operating results;
- the impact of any failure in our systems due to factors beyond our control;
- the impact of any material breaches in the security of third-party processing systems we use;
- the impact of any new and potential governmental regulations designed to protect or limit access to consumer information;
- the impact on our profitability if we are required to pay federal, state or local taxes on transaction processing or VAT on content;
- the impact on our growth and profitability if the markets for the services that we offer fail to expand or if such markets contract;
- our ability (or inability) to continue as a going concern;
- the willingness of the Company's majority stockholders, and/or other affiliates of the Company, to continue investing in the Company's business to fund working capital requirements;
- the Company's ability (or inability) to obtain additional financing in sufficient amounts or on acceptable terms when needed;
- the impact on our operating results as a result of impairment of our goodwill and intangible assets;
- our material weaknesses in internal control over financial reporting and our ability to maintain effective controls over financial reporting in the future; and
- the other factors described in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 and in Part II, Item 1A of this Report and our subsequent filings with the U.S. Securities and Exchange Commission (the "Commission").

If these or other risks and uncertainties (including those described in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015 and in Part II, Item 1A of this Report and the Company's subsequent filings with the Commission) materialize, or if the assumptions underlying any of these statements prove incorrect, the Company's actual results may be materially different from those expressed or implied by such statements. We undertake no obligation to publicly revise any forward-looking statement to reflect circumstances or events after the date of this Report to reflect the occurrence of unanticipated events. You should, however, review the factors and risks described in the reports we file from time-to-time with the Commission after the date of this Report.

World Wide Web addresses contained in this Report are for explanatory purposes only and they (and the content contained therein) do not form a part of and are not incorporated by reference into this Report.

Net Element, Inc.

Form 10-Q

For the Three Months Ended June 30, 2016

Table of Contents

	Page No.
<u>PART I — FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	4
<u>Unaudited Condensed Consolidated Balance Sheets – at June 30, 2016 and December 31, 2015</u>	4
<u>Unaudited Condensed Consolidated Statements of Operations and Comprehensive Loss – for the Three and Six Months Ended June 30, 2016 and 2015</u>	5
<u>Unaudited Condensed Consolidated Statements of Cash Flows – for the Six Months Ended June 30, 2016 and 2015</u>	6
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	7
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	24
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	33
Item 4. <u>Controls and Procedures</u>	33
<u>PART II — OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	35
Item 1A. <u>Risk Factors</u>	35
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	35
Item 3. <u>Defaults Upon Senior Securities</u>	35
Item 4. <u>Mine Safety Disclosures</u>	35
Item 5. <u>Other Information</u>	35

Item 6. <u>Exhibits</u>	35
<u>Signatures</u>	36

PART I — FINANCIAL INFORMATION**NET ELEMENT, INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

	June 30, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash	\$ 633,591	\$ 1,025,747
Accounts receivable, net	5,827,586	5,198,993
Prepaid expenses and other assets	806,202	1,106,016
Total current assets, net	7,267,379	7,330,756
Fixed assets, net	142,409	162,123
Intangible assets, net	4,513,823	5,423,880
Goodwill	9,643,752	9,643,752
Other long term assets	553,302	353,050
Total assets	22,120,665	22,913,561
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	6,075,259	5,858,837
Deferred revenue	326,023	743,910
Accrued expenses	4,205,599	2,975,066
Notes payable (current portion)	384,209	518,437
Due to related parties	329,921	329,881
Total current liabilities	11,321,011	10,426,131
Notes payable (net of current portion)	3,823,921	3,446,563
Total liabilities	15,144,932	13,872,694
STOCKHOLDERS' EQUITY		
Preferred stock (\$.0001 par value, 1,000,000 shares authorized, no shares issued and outstanding at June 30, 2016 and December 31, 2015)	-	-
Common stock (\$.0001 par value, 400,000,000 shares authorized and 13,356,092 and 11,261,960 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively)	1,336	1,126
Paid in capital	160,092,967	154,361,694
Accumulated other comprehensive loss	(2,091,604)	(1,565,822)
Accumulated deficit	(151,149,215)	(143,955,048)
Noncontrolling interest	122,249	198,917
Total stockholders' equity	6,975,733	9,040,867
Total liabilities and stockholders' equity	\$ 22,120,665	\$ 22,913,561

See accompanying notes to unaudited condensed consolidated financial statements.

NET ELEMENT, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

	Three months ended June 30,		Six months ended June 30,	
	2016	2015	2016	2015
Net revenues				
Service fees	\$ 12,117,708	\$ 6,906,916	\$ 21,481,528	\$ 12,447,123
Branded content	1,575,140	-	3,472,379	-
Total Revenues	13,692,848	6,906,916	24,953,907	12,447,123
Costs and expenses:				
Cost of service fees	10,003,934	5,467,819	17,602,087	10,081,890
Cost of branded content	1,480,859	-	3,267,947	-
General and administrative	1,999,391	2,583,474	4,087,624	4,619,578
Non-cash compensation	2,014,589	601,371	2,375,573	1,202,742
Bad debt expense	125,238	131,511	376,979	140,841
Depreciation and amortization	844,535	626,497	1,732,653	1,065,267
Total costs and operating expenses	16,468,546	9,410,672	29,442,863	17,110,318
Loss from operations	(2,775,698)	(2,503,756)	(4,488,956)	(4,663,195)
Interest expense, net	(438,976)	(1,284,591)	(589,414)	(1,402,183)
Gain on change in fair value and settlement of beneficial conversion derivative	-	2,022,036	-	2,022,036
Loss from stock value guarantee	(2,162,861)	-	(2,162,861)	-
Other income (expense)	(7,705)	(8,501)	(29,604)	20,575
Net loss before income taxes	(5,385,240)	(1,774,812)	(7,270,835)	(4,022,767)
Income taxes	-	-	-	-
Net loss	(5,385,240)	(1,774,812)	(7,270,835)	(4,022,767)
Net loss attributable to the noncontrolling interest	38,792	10,527	76,668	19,274
Net loss attributable to Net Element, Inc. stockholders	(5,346,448)	(1,764,285)	(7,194,167)	(4,003,493)
Dividends for the benefit of preferred stockholders	-	(525,197)	-	(525,197)
Net loss attributable to common stock	(5,346,448)	(2,289,482)	(7,194,167)	(4,528,690)
Foreign currency translation	(496,041)	(116,353)	(525,782)	(224,524)
Comprehensive loss attributable to common stockholders	\$ (5,842,489)	\$ (2,405,835)	\$ (7,719,949)	\$ (4,753,214)
Loss per share - basic and diluted	\$ (0.46)	\$ (0.46)	\$ (0.63)	\$ (0.95)
Weighted average number of common shares outstanding - basic and diluted	11,635,434	4,970,714	11,464,434	4,789,264

See accompanying notes to unaudited condensed consolidated financial statements.

NET ELEMENT, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

	Six Months Ended June	
	30,	
	2016	2015
Cash flows from operating activities		
Net loss	\$(7,194,167)	\$(4,003,493)
Adjustments to reconcile net loss to net cash used in operating activities		
Non controlling interest	(76,668)	(12,145)
Share based compensation	2,375,573	1,202,742
Deferred revenue	(417,887)	(310,241)
Gain on Change in fair value and settlement of beneficial conversion derivative	-	(2,022,036)
Depreciation and amortization	1,732,652	1,065,267
Non cash interest	297,434	349,146
Amortization of debt discount	-	983,715
Net recovery of loan losses	-	(94,770)
Gain on disposal of fixed asset	-	(23,854)
Changes in assets and liabilities		
Accounts receivable	(331,566)	266,529
Advances to aggregators	-	(92,017)
Prepaid expenses and other assets	270,932	173,598
Accounts payable	220,990	507,737
Accrued expenses (includes \$2.2M accrual for stock price guarantee)	1,655,971	(460,826)
Net cash used in operating activities	(1,466,736)	(2,470,648)
Cash flows from investing activities		
Purchase of portfolio and client acquisition costs	(741,514)	(303,775)
Acquisition of PayOnline assets, net of cash received	-	(3,195,452)
Purchase of fixed and other assets	(214,046)	(65,050)
Net cash used in investing activities	(955,560)	(3,564,277)
Cash flows from financing activities		
Proceeds from preferred stock	-	5,500,000
Proceeds from indebtedness	1,215,000	650,000
Related party advances	910,045	84,256
Net cash provided by financing activities	2,125,045	6,234,256
Effect of exchange rate changes on cash	(94,905)	(27,443)
Net (decrease) increase in cash	(392,156)	171,888
Cash at beginning of period	1,025,747	503,343

Edgar Filing: Net Element, Inc. - Form 10-Q

Cash at end of period	\$633,591	\$675,231
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	\$589,414	\$121,253
Taxes	\$94,718	\$90,211
Non Cash activities:		
Share issuance for settlement of unpaid compensation	\$1,042,509	\$-
Shares issued for redemption of indebtedness	\$971,871	\$-
Shares issued in settlement of advances from from board member	\$909,285	\$-
Notes payable (net of discount)	\$-	\$277,778
Funds in escrow from issuance of notes	\$-	\$5,000,000
Derivative Liability - warrants	\$-	\$3,623,182
Preferred dividends paid in common stock	\$-	\$525,197

See accompanying notes to unaudited condensed consolidated financial statements.

NET ELEMENT, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Net Element, Inc. (“We”, “us”, “our” or the “Company”) is a financial technology-driven group specializing in mobile payments and other transactional services in emerging countries and in the United States. We have three reportable segments: (i) North America Transaction Solutions for electronic commerce, (ii) Mobile Solutions (primarily servicing the Russian Federation and Commonwealth of Independent States (“CIS”)) and (iii) Online Solutions. We are differentiated by our proprietary technology which enables us to provide a broad suite of payment products, end-to-end transaction processing services and superior client support. We are able to deliver these services across multiple points of access, or “multi-channel,” including brick and mortar locations, software integration, e-commerce, mobile operator billing, mobile and tablet-based solutions. In the United States, via our U.S. based subsidiaries, we generate revenues from transactional services and other payment technologies for small and medium-sized businesses. Through TOT Group Russia and Net Element Russia, we provide transactional services, mobile payment transactions, online payment transactions and other payment technologies in emerging countries in the Russian Federation, CIS, Europe and Asia.

Business

Our transactional services business enables merchants to accept credit cards as well as other forms of payment, including debit cards, checks, gift cards, loyalty programs and alternative payment methods in traditional card-present or swipe transactions, as well as card-not-present transactions, such as those conducted over the phone or through the Internet or a mobile device. We market and sell our services through both independent sales groups (“ISGs”), which are non-employee, external sales organizations and other third-party resellers of our products and services, and directly to merchants through electronic media, telemarketing and other programs, including utilizing partnerships with other companies that market products and services to local and international merchants. In addition, we partner with banks such as BMO Harris Bank, N.A. in the United States and VTB Bank, Bank of Moscow, Raiffeisen Bank, Kazkommertsbank, and Rietumu Bank in the Russian Federation, CIS, Europe and Asia to sponsor us for membership in Visa[®], MasterCard[®] and/or other card associations and to settle transactions with merchants. We perform core functions for merchants such as application processing, underwriting, account set-up, risk management, fraud detection, merchant assistance and support, equipment deployment and chargeback services.

Edgar Filing: Net Element, Inc. - Form 10-Q

Our mobile payments business, Digital Provider, LLC (f/k/a Tot Money, LLC) (“Digital Provider”) provides carrier-integrated mobile payments solutions. Our relationships with mobile operators give us substantial geographic coverage, a strong capacity for innovation in mobile payments and messaging, and the ability to offer our clients in-app, premium SMS, online and carrier billing services. We also market our own branded content which is a new business line for our mobile commerce business.