

DIGITAL RIVER INC /DE
Form 10-Q
November 09, 2005

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2005

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 000-24643

DIGITAL RIVER, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

41-1901640
(I.R.S. Employer
Identification Number)

Edgar Filing: DIGITAL RIVER INC /DE - Form 10-Q

9625 WEST 76TH STREET, SUITE 150
EDEN PRAIRIE, MINNESOTA 55344
(Address of principal executive offices)

(952) 253-1234

(Registrant's telephone number, including area code)

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

COMMON STOCK, \$0.01 PAR VALUE
(Class)

35,208,759 SHARES
Outstanding as of October 31, 2005

DIGITAL RIVER, INC.

Form 10-Q

Index

PART I.

FINANCIAL INFORMATION

Item 1.

Financial Statements

Condensed Consolidated Balance Sheets as of September 30, 2005 and December 31, 2004

Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2005 and 2004

Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2005 and 2004

Notes to Condensed Consolidated Financial Statements

Item 2.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 3.

Qualitative and Quantitative Disclosure about Market Risk

Item 4.

Controls and Procedures

PART II.

OTHER INFORMATION

Item 1.

Legal Proceedings

Item 2.

Unregistered Sales of Equity Securities and Use of Proceeds

Item 6.

Exhibits

SIGNATURES

EXHIBIT INDEX

PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****DIGITAL RIVER, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

	September, 30 2005	December 31, 2004
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 145,068	\$ 127,734
Short-term investments	210,217	164,402
Accounts receivable, net of allowance of \$782 and \$1,146	25,540	21,520
Other current assets	5,123	3,317
Total current assets	385,948	316,973
PROPERTY AND EQUIPMENT, NET	18,470	17,367
GOODWILL	156,515	148,086
INTANGIBLE ASSETS, net of accumulated amortization of \$34,811 and \$28,245	13,089	17,297
OTHER ASSETS	9,637	10,113
TOTAL ASSETS	\$ 583,659	\$ 509,836
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 91,983	\$ 88,052
Accrued payroll	7,263	5,332
Deferred revenue	4,309	3,901
Accrued acquisitions expenses	5,297	6,720
Other accrued liabilities	16,903	14,221
Total current liabilities	125,755	118,226
NON-CURRENT LIABILITIES:		
Convertible senior notes	195,000	195,000
Deferred tax liability	3,245	3,841
Total non current liabilities	198,245	198,841
Total liabilities	324,000	317,067
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred Stock, \$.01 par value; 5,000,000 shares authorized; no shares issued or outstanding		
Common Stock, \$.01 par value; 60,000,000 shares authorized; 35,181,798 and 33,652,149 shares issued and outstanding	352	337
Additional paid-in capital	277,021	243,926
Accumulated deficit	(16,721)	(51,164)
Accumulated other comprehensive loss	(993)	(330)

Edgar Filing: DIGITAL RIVER INC /DE - Form 10-Q

Total stockholders' equity		259,659		192,769
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$	583,659	\$	509,836

See accompanying notes to condensed consolidated financial statements.

DIGITAL RIVER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data; unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
REVENUE	\$ 53,179	\$ 39,439	\$ 158,851	\$ 106,171
COSTS AND EXPENSES (exclusive of depreciation and amortization expense shown separately below)				
Direct cost of services	1,050	1,621	3,538	3,688
Network and infrastructure	4,983	4,253	14,199	11,059
Sales and marketing	16,713	13,338	48,829	36,213
Product research and development	5,210	3,732	14,796	10,301
General and administrative	5,294	4,045	16,210	10,738
Depreciation and amortization	2,308	2,207	6,805	5,677
Amortization of acquisition related intangibles	2,089	2,434	6,595	6,280
Total costs and expenses	37,647	31,630	110,972	83,956
INCOME FROM OPERATIONS	15,532	7,809	47,879	22,215
OTHER INCOME/(EXPENSE), NET	1,526	317	3,572	281
INCOME BEFORE INCOME TAX EXPENSE	\$ 17,058	\$ 8,126	\$ 51,451	\$ 22,496
Income tax expense	4,700		14,830	
NET INCOME	\$ 12,358	\$ 8,126	\$ 36,621	\$ 22,496
NET INCOME PER SHARE:				
BASIC	\$ 0.35	\$ 0.25	\$ 1.07	\$ 0.70
DILUTED	\$ 0.31	\$ 0.22	\$ 0.92	\$ 0.63
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:				
BASIC	34,824	32,459	34,342	32,049
DILUTED	41,972	40,233	41,558	37,575

See accompanying notes to condensed consolidated financial statements.

DIGITAL RIVER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands; unaudited)

	Nine Months Ended September 30,	
	2005	2004
OPERATING ACTIVITIES:		
Net income	\$ 36,621	\$ 22,496
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of acquisition related costs	6,595	6,280
Change in accounts receivable allowance	(257)	360
Depreciation and amortization	6,715	5,634
Tax benefit of stock based compensation	10,496	
Deferred and other income taxes	3,030	
Change in operating assets and liabilities:		
Accounts receivable	(2,431)	(2,685)
Prepaid and other assets	(987)	246
Accounts payable	499	23,134
Deferred revenue	527	(164)
Accrued payroll and other accrued liabilities	3,495	2,506
Net cash provided by operating activities	64,303	57,807
INVESTING ACTIVITIES:		
Purchases of investments	(144,509)	(95,389)
Sales of investments	97,427	59,328
Cash paid for acquisitions, net of cash received	(9,482)	(125,856)
Purchases of property, equipment and capitalized software	(7,318)	(6,125)
Net cash used in investing activities	(63,882)	(168,042)
FINANCING ACTIVITIES:		
Principal amount on line of credit		45,000
Repayment of principal on line of credit		(45,000)
Net proceeds on issuance of 1.25% convertible senior notes due 1/1/2024		188,398
Exercise of stock options	22,154	10,104
Sales of common stock under employee stock purchase plan	1,488	904
Repurchase of common stock	(3,205)	
Net cash provided by financing activities	20,437	199,406
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(3,524)	329
NET INCREASE IN CASH AND CASH EQUIVALENTS	17,334	89,500
CASH AND CASH EQUIVALENTS, beginning of period	127,734	101,878
CASH AND CASH EQUIVALENTS, end of period	\$ 145,068	\$ 191,378
SUPPLEMENTAL DISCLOSURES:		
Cash paid for interest on Convertible Senior Notes	\$ 2,641	\$

See accompanying notes to condensed consolidated financial statements.

DIGITAL RIVER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BASIS OF PRESENTATION

The unaudited condensed consolidated financial statements included herein reflect all adjustments, including normal recurring adjustments, which in our opinion are necessary to fairly state our consolidated financial position, results of operations and cash flows for the periods presented. These condensed consolidated financial statements should be read in conjunction with our audited consolidated financial statements included in our Form 10-K for the year ended December 31, 2004 as filed with the Securities and Exchange Commission. The results of operations for the three and nine months ended September 30, 2005 are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2005. The December 31, 2004 balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States.

Summary of Significant Accounting Policies

A detailed description of our significant accounting policies can be found in our most recent Annual Report filed on Form 10-K for the fiscal year ended December 31, 2004.

Foreign Currency Translation

Foreign currency denominated revenue and expense transactions are remeasured to our functional currency using average exchange rates for the fiscal period. Foreign currency denominated assets and liabilities are remeasured to our functional currency using the exchange rate in effect at the respective balance sheet dates. Any gains or losses are included in the consolidated statement of operations within other income (expense), net. The financial position and results of operations of our foreign subsidiaries are currently measured using local currency as the functional currency. Assets and liabilities are translated to their U.S. dollar equivalents at rates in effect at the respective balance sheet dates and statements of operations and cash flows are translated using average exchange rates for the fiscal period. The resulting translation adjustments are recorded as a component of stockholders' equity.

Research and Development and Software Development

Research and development expenses consist primarily of development personnel and external contractor costs related to the development of new products and services, enhancement of existing products and services, quality assurance and testing. We follow AICPA Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, in accounting for internally developed software. Consistent with SOP 98-1, we capitalized approximately, \$0 million and \$0.4 million of software development costs related to those efforts for the three and nine months ended September 30, 2005, respectively. We did not capitalize any costs related to software development

Edgar Filing: DIGITAL RIVER INC /DE - Form 10-Q

during the three months ended September 30, 2005 and do not expect to capitalize any such costs for the balance of 2005. These capitalized costs are included in the investing activities section on our Consolidated Statement of Cash Flows.

2. NET INCOME PER SHARE

The table below sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts):

6

Edgar Filing: DIGITAL RIVER INC /DE - Form 10-Q

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
EARNINGS PER SHARE BASIC				
Net income basic	\$ 12,358	\$ 8,126	\$ 36,621	\$ 22,496
Weighted average shares outstanding basic	34,824	32,459	34,342	32,049
Earning per share basic	\$ 0.35	\$ 0.25	1.07	0.70
EARNINGS PER SHARE DILUTED				
Net income basic	12,358	8,126	36,621	22,496
Exclude: Interest expense and amortized financing				
cost of convertible senior notes, net of tax benefit	501	843	1,470	1,080
Net income diluted	\$ 12,859	\$ 8,969	38,091	23,576
Weighted average shares outstanding basic	34,824	32,459	34,342	32,049
Dilutive impact of options outstanding	2,723	3,349	2,791	3,565
Dilutive impact of convertible senior notes	4,425	4,425	4,425	1,961
Diluted weighted average shares outstanding	41,972	40,233	41,558	37,575
Diluted net income per share	\$ 0.31	\$ 0.22	\$ 0.92	\$ 0.63

Subsequent to our issuance of 1.25% convertible senior notes on June 1, 2004, the Emerging Issues Task Force (EITF), Issue No. 04-08, required that the unissued shares underlying contingent convertible notes be treated as if such shares were issued and outstanding for the purposes of calculating GAAP diluted earnings per share. The notes are contingently convertible into approximately 4.4 million shares of common stock at an initial conversion price of \$44.063 per share, which have been included in our weighted average shares outstanding calculation since the date of issuance.

3. GOODWILL AND INTANGIBLE ASSETS

We account for our goodwill in accordance with SFAS No. 142, Goodwill and Other Intangible Asset. SFAS No. 142 precludes the amortization of goodwill and intangible assets with indefinite lives, but these assets are reviewed annually (or more frequently if impairment indicators arise) for impairment.

We complete our annual impairment test in the fourth quarter of each fiscal year, and reassess any intangible assets, including goodwill, recorded in connection with earlier acquisitions. There was no impairment of goodwill in the three and nine months ended September 30, 2005 and 2004.

Edgar Filing: DIGITAL RIVER INC /DE - Form 10-Q

Information regarding our other intangible assets is as follows (in thousands):

	Carrying Amount Gross	As of September 30, 2005		Net
		Accumulated Amortization		
Customer relationships	\$ 27,189	\$ 20,054	\$	7,135
Non-compete agreements	5,137	4,118		1,019
Technology/tradename	15,574	10,639		4,935
Total	\$ 47,900	\$ 34,811	\$	13,089

	Carrying Amount Gross	As of December 31, 2004		Net
		Accumulated Amortization		
Customer relationships	\$ 25,406	\$ 14,784	\$	10,622
Non-compete agreements	5,134	3,549		1,585
Technology/tradename	15,002	9,912		5,090
Total	\$ 45,542	\$ 28,245	\$	17,297

Amortization expense for the three months ended September 30, 2005 and 2004 was \$2.1 million and \$2.4 million, respectively, and \$6.6 million and \$6.3 million for the nine months ended September 30, 2005 and 2004, respectively. Estimated amortization expense for the remaining life of the intangible assets, based on intangible assets as of September 30, 2005, is as follows (in thousands):

Year	As of September 30, 2005
2005	2,076
2006	7,650
2007	2,765
2008	491
2009	103
2010	4
Total	\$ 13,089

4. STOCK BASED COMPENSATION

Prior to the annual stockholders meeting held in May 2005, we had two stock-based employee compensation plans, which are described more fully in Note 11 of our 2004 Annual Report on Form 10-K. At the annual stockholders meeting held in May 2005, stockholders approved an amendment and restatement of our 1998 Stock Option Plan that combined the 1998 plan with our 1999 Stock Option Plan and gave us the flexibility to grant restricted stock awards, restricted stock unit awards and performance shares, in addition to incentive and nonstatutory stock options, to our directors, employees, and consultants under the combined plan. We account for these plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of the grant.

We have elected to apply the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation* as amended by SFAS No. 148. Accordingly, we account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Compensation cost for stock options is measured as the excess, if any, of the fair value of our common stock at the date of grant over the stock option exercise price.

Edgar Filing: DIGITAL RIVER INC /DE - Form 10-Q

The following table illustrates the effect on net income and net income per share if we had applied the fair value recognition provision of Financial Accounting Standards Board Statement No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income, as reported	\$ 12,358	\$ 8,126	\$ 36,621	\$ 22,496
Deduct: Total stock-based compensation determined under fair value based method for all awards	(3,519)	(6,369)	(10,100)	(19,909)
Adjusted net income, fair value method for all stock-based awards	\$ 8,839	\$ 1,757	\$ 26,521	\$ 2,587
Basic income per share as reported	\$ 0.35	\$ 0.25	\$ 1.07	\$ 0.70
Diluted income per share as reported	\$ 0.31	\$ 0.22	\$ 0.92	\$ 0.63
Basic income per share SFAS No. 123 adjusted	\$ 0.25	\$ 0.05	\$ 0.77	\$ 0.08
Diluted income per share SFAS No. 123 adjusted	\$ 0.23	\$ 0.06	\$ 0.68	\$ 0.10

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model using the following weighted average assumptions:

	Nine Months Ended September 30,	
	2005	2004
Risk-free interest rate	4%	4%
Expected life (years)	4	1.3
Volatility factor	0.93	1.3