DIGI INTERNATIONAL INC
Form 10-Q
August 08, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended: June 30, 2006

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: 0-17972

DIGI INTERNATIONAL INC.
(Exact name of registrant as specified in its charter)

Delaware	**41-1532464**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

11001 Bren Road East
Minnetonka, Minnesota 55343
(Address of principal executive offices, including zip code)
(952) 912-3444
(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 þ No o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

On July 31, 2006, there were 24,837,672 shares of the registrant s $.01 par value Common Stock outstanding.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three months ended June 30,		Nine months ended June 30,	
	2006	2005	2006	2005
	(in thousands, except per common share data)			
Net sales	$ 35,860	$ 30,208	$ 103,616	$ 88,989
Cost of sales	15,222	12,003	44,126	34,489
Gross profit	20,638	18,205	59,490	54,500
Operating expenses:				
Sales and marketing	7,277	6,446	20,830	19,300
Research and development	5,402	3,778	15,227	11,850
General and administrative	4,208	3,998	13,591	11,070
Acquired in-process research and development		300		300
Total operating expenses	16,887	14,522	49,648	42,520
Operating income	3,751	3,683	9,842	11,980
Interest income and other, net	575	306	1,461	809
Income before income taxes	4,326	3,989	11,303	12,789
Income tax provision (benefit)	978	1,505	3,205	(1,455)
Net income	$ 3,348	$ 2,484	$ 8,098	$ 14,244
Net income per common share:				
Basic	$ 0.14	$ 0.11	$ 0.35	$ 0.64
Diluted	$ 0.14	$ 0.11	$ 0.34	$ 0.61
Weighted average common shares, basic	23,124	22,588	22,968	22,381
Weighted average common shares, diluted	23,904	23,296	23,695	23,420

The accompanying notes are an integral part of the condensed consolidated financial statements.

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DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	June 30, 2006	September 30, 2005
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,422	$ 12,990
Marketable securities	51,442	37,184
Accounts receivable, net	19,232	16,897
Inventories	19,090	18,527
Other	5,419	5,115
Total current assets	109,605	90,713
Property, equipment and improvements, net	19,904	20,808
Identifiable intangible assets, net	21,152	26,342
Goodwill	38,612	38,675
Other	1,041	1,093
Total assets	$ 190,314	$ 177,631
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Capital lease obligations, current portion	$ 406	$ 414
Accounts payable	5,235	6,272
Income taxes payable	6,944	3,306
Accrued expenses:		
Compensation	4,223	5,308
Other	5,172	5,048
Deferred revenue	293	370
Total current liabilities	22,273	20,718
Capital lease obligations, net of current portion	817	1,181
Net deferred tax liabilities	255	2,195
Total liabilities	23,345	24,094
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $.01 par value; 2,000,000 shares authorized; none issued and outstanding		
Common stock, $.01 par value; 60,000,000 shares authorized; 25,873,164 and 25,456,755 shares issued	259	255

Additional paid-in capital	141,649	136,513
Retained earnings	43,994	35,896
Accumulated other comprehensive income	396	639
Treasury stock, at cost, 2,732,834 and 2,794,562 shares	(19,329)	(19,766)
Total stockholders equity	166,969	153,537
Total liabilities and stockholders equity	$ 190,314	$ 177,631

The accompanying notes are an integral part of the condensed consolidated financial statements.

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DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine months ended June 30, 2006	2005
	(in thousands)	
Operating activities:		
Net income	$ 8,098	$ 14,244
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of property, equipment and improvements	1,949	1,710
Amortization of identifiable intangible assets and other assets	5,744	4,667
Acquired in-process research and development		300
Deferred income taxes	(1,987)	(3,602)
Tax benefit related to the exercise of stock options		2,045
Stock-based compensation	1,742	
Other	(436)	(479)
Changes in operating assets and liabilities:		
Accounts receivable	(696)	(1,949)
Inventories	(1,068)	169
Other assets	(293)	(709)
Accounts payable and accrued expenses	(2,838)	(1,879)
Income taxes payable	3,636	(3,276)
Net cash provided by operating activities	13,851	11,241
Investing activities:		
(Purchase) settlement of held-to-maturity marketable securities, net	(14,258)	19,836
Purchase of property, equipment, improvements and certain other identifiable intangible assets	(1,055)	(772)
Acquisitions, net of cash acquired		(53,665)
Net cash used in investing activities	(15,313)	(34,601)
Financing activities:		
Borrowing from short-term loans, net of payments		5,000
Payments on line of credit		(1,250)
Payments on capital lease obligations	(372)	(38)
Proceeds from exercise of stock options	2,931	5,415
Tax benefit related to the exercise of stock options	485	
Proceeds from employee stock purchase plan transactions	555	576
Net cash provided by financing activities	3,599	9,703

Effect of exchange rate changes on cash and cash equivalents	(705)	474
Net increase (decrease) in cash and cash equivalents	1,432	(13,183)
Cash and cash equivalents, beginning of period	12,990	19,528
Cash and cash equivalents, end of period	$ 14,422	$ 6,345

The accompanying notes are an integral part of the condensed consolidated financial statements.

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DIGI INTERNATIONAL INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION OF UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The interim unaudited condensed consolidated financial statements included in this Form 10-Q have been prepared by Digi International Inc. (the Company or Digi) pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures, normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted, pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto, including the summary of significant accounting policies, presented in the Company s 2005 Annual Report on Form 10-K as filed with the SEC.

The condensed consolidated financial statements presented herein reflect, in the opinion of management, all adjustments which consist only of normal, recurring adjustments (except for the reversal of certain income tax reserves described in Note 8) necessary for a fair statement of the condensed consolidated financial position and the condensed consolidated results of operations and cash flows for the periods presented. The condensed consolidated results of operations for any interim period are not necessarily indicative of results for the full year.

Recently Issued Accounting Pronouncements

In July, 2006 the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48) Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 prescribes a recognition threshold and measurement process for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 will be effective for the Company beginning October 1, 2007. The Company is in the process of determining the effect, if any, that the adoption of FIN 48 will have on its consolidated financial statements.

2. COMPREHENSIVE INCOME

For the Company, comprehensive income is comprised of net income and foreign currency translation adjustments. Foreign currency translation adjustments are charged or credited to accumulated other comprehensive income within stockholders equity.

Comprehensive income was as follows (in thousands):

	Three months ended June 30,		Nine months ended June 30,	
	2006	2005	2006	2005
Net income	$ 3,348	$ 2,484	$ 8,098	$ 14,244
Foreign currency translation gain (loss), net of income tax	85	(496)	(243)	384
Comprehensive income	$ 3,433	$ 1,988	$ 7,855	$ 14,628

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

3. NET INCOME PER COMMON SHARE

Basic net income per common share is calculated based on the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares of the Company s stock result from dilutive common stock options and shares purchased through the employee stock purchase plan.

The following table is a reconciliation of the numerators and denominators in the net income per common share calculations (in thousands, except per common share data):

	Three months ended June 30,		Nine months ended June 30,	
	2006	2005	2006	2005
Numerator:				
Net income	$ 3,348	$ 2,484	$ 8,098	$ 14,244
Denominator:				
Denominator for basic net income per common share weighted average shares outstanding	23,124	22,588	22,968	22,381
Effect of dilutive securities:				
Employee stock options and employee stock purchase plan	780	708	727	1,039
Denominator for diluted net income per common share adjusted weighted average shares	23,904	23,296	23,695	23,420
Net income per common share, basic	$ 0.14	$ 0.11	$ 0.35	$ 0.64
Net income per common share, diluted	$ 0.14	$ 0.11	$ 0.34	$ 0.61

Potentially dilutive shares related to stock options to purchase 1,084,850 and 1,324,850 common shares for the three and nine month periods ended June 30, 2006, respectively, and 990,800 and 615,650 common shares for the three and nine month periods ended June 30, 2005, respectively, were not included in the computation of diluted earnings per common share because the options exercise prices were greater than the average market price of common shares and, therefore, their effect would be anti-dilutive.

4. STOCK-BASED COMPENSATION

Stock-based awards are granted under the terms of the Company s Stock Option Plan (the Stock Option Plan), Non-Officer Stock Option Plan (the Non-Officer Plan) and the 2000 Omnibus Stock Plan (the Omnibus Plan) (collectively, the Plans). The Plans provide for the issuance of stock-based incentives, including incentive stock options (ISOs) and nonstatutory stock options (NSOs), to employees and others who provide services to the Company, including consultants, advisers and directors. Options granted under the Plans generally vest over a four year service period and will expire if unexercised after ten years from the date of grant.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

4. STOCK-BASED COMPENSATION (CONTINUED)

The exercise price for ISOs and non-employee director options granted under the Stock Option Plan or the Omnibus Plan is set at the fair market value of the Company s common stock based on the closing price on the date of grant. The exercise price for nonstatutory options granted under the Plans is set by the Compensation Committee of the Board of Directors. While the Plans expressly permit grants at less than fair market value, the Company s practice is to only award grants at fair market value. The authority to grant options under the Plans and set other terms and conditions rests with the Compensation Committee. The Stock Option Plan and Non-Officer Plan terminate in 2006 and the Omnibus Plan terminates in 2010.

Additionally, the Company has outstanding stock options for shares of the Company s stock under various plans assumed in connection with its prior acquisition of NetSilicon, Inc. (the Assumed Plans). Additional awards cannot be made by the Company under the Assumed Plans.

Also, the Company sponsors an Employee Stock Purchase Plan covering all domestic employees with at least 90 days of service. The Purchase Plan allows eligible participants the right to purchase common stock on a quarterly basis at the lower of 85% of the market price at the beginning or end of each three-month offering period.

Prior to October 1, 2005, the Company accounted for its stock-based awards using the intrinsic-value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) and related interpretations, in accordance with Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation (FAS No. 123). Accordingly, compensation costs for stock options granted were measured as the excess, if any, of the fair value of the Company s common stock at the date of grant over the exercise price to acquire the common stock. Such compensation expense, if any, was amortized on a straight-line basis over the option vesting period.

Effective October 1, 2005, the Company adopted Statement of Financial Accounting Standard No. 123 (revised 2004), Share-Based Payment (FAS No. 123R), as amended by FASB Staff Position No. FAS 123(R)-4 (FSP FAS 123(R)-4), using the modified prospective method of application. Under this method, compensation expense is recognized both for (i) awards granted, modified or settled subsequent to September 30, 2005 and (ii) the nonvested portion of awards granted prior to October 1, 2005. Compensation expense recorded during the three and nine month periods ended June 30, 2006 includes approximately $0.2 million and $0.5 million, respectively, related to awards issued subsequent to September 30, 2005. In addition, compensation expense recorded during the three and nine month periods ended June 30, 2006 includes approximately $0.3 million and $1.2 million, respectively, related to the current vesting portion of awards issued prior to September 30, 2005.

The impact of adopting FAS No. 123R for the Company s three and nine month period ended June 30, 2006 was an increase in compensation expense of $0.5 million ($0.3 million after tax) and $1.7 million ($1.1 million after tax), respectively, and a reduction of $0.02 and $0.05, respectively, for both basic and diluted earnings per share. The adoption of FAS No. 123R, effective October 1, 2005, is expected to incrementally increase pre-tax compensation expense by approximately $2.3 million during fiscal 2006.

FAS No. 123R also requires that the windfall tax benefit resulting from the tax deductibility of the increase in the value of share-based arrangements be presented as a component of cash flows from financing activities in the Condensed Consolidated Statement of Cash Flows. In periods prior to October 1, 2005, such amounts were presented as a component of cash flows from operating activities.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

4. STOCK-BASED COMPENSATION (CONTINUED)

A summary of option activity under the Plans as of June 30, 2006 and changes during the nine months then ended is presented below (in thousands, except per common share amounts):

	Available for Grant	Options Outstanding	Weighted Average Exercise Price per Common Share	Weighted Average Contractual Term (in years)	Aggregate Intrinsic Value
Balances, September 30, 2005	950	4,511	$ 9.98		
Granted	(468)	468	12.33		
Exercised		(417)	7.04		
Forfeited	92	(92)	10.15		
Expired	25	(25)	22.73		
Balances, June 30, 2006	599	4,445	$ 10.43	5.55	$ 13,899
Exercisable at June 30, 2006		3,420	$ 9.96	4.56	$ 12,771

The intrinsic value of an option is the amount by which the fair value of the underlying stock exceeds its exercise price. The total intrinsic value of all options exercised during the nine month period was $1.9 million. The weighted average fair value of options granted during the nine months ended June 30, 2006 was $5.79. The weighted average fair value was determined based upon the fair value of each option on the grant date, utilizing the Black-Scholes option-pricing model and the following assumptions:

Risk free interest rate	4.28% - 4.97 %
Expected option holding period	3 - 5 years
Expected volatility	50% - 60%
Weighted average volatility	55%
Expected dividend yield	0

The fair value of each option award granted during the periods presented was estimated using the Black-Scholes option valuation model that uses the assumptions noted in the table above. Expected volatilities are based on the historical volatility of our stock. We use historical data to estimate option exercise and employee termination information within the valuation model; separate groups of grantees that have similar historical exercise behaviors are considered separately for valuation purposes. The expected term of options granted is derived from the vesting period and historical information and represents the period of time that options granted are expected to be outstanding. The risk-free rate used is the zero-coupon U.S. Treasury bond rate in effect at the time of the grant whose maturity equals the expected term of the option.

A summary of the Company s nonvested options as of June 30, 2006 and changes during the nine months then ended is presented below (in thousands, except per common share amounts):

	Weighted Average Grant Date

	Number of Options	Fair Value per Common Share
Nonvested at September 30, 2005	967	$ 4.81
Granted	468	5.79
Vested	(318)	4.08
Forfeited	(92)	5.55
Nonvested at June 30, 2006	1,025	$ 5.42

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

4. STOCK-BASED COMPENSATION (CONTINUED)

The Company used historical data to estimate pre-vesting forfeiture rates. As of June 30, 2006 the total unrecognized compensation cost related to nonvested stock-based compensation arrangements net of expected forfeitures was $5.3 million and the related weighted average period over which it is expected to be recognized is approximately 2.8 years.

The Company s pro forma net income and pro forma earnings per share for the three months and nine months ended June 30, 2005, which include pro forma net income and earning per share amounts as if the fair-value-based method of accounting had been used, are as follows (in thousands, except per common share amounts):

	Three months ended June 30, 2005	Nine months ended June 30, 2005
Net income as reported	$ 2,484	$ 14,244
Add: Total stock-based compensation expense included in reported net income, net of related tax effects		37
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(311)	(1,044)
Pro forma net income	$ 2,173	$ 13,237

Net income per common share: