DIGI INTERNATIONAL INC
Form 10-Q
February 02, 2015

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: December 31, 2014

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: 1-34033

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)	(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 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 þ No o

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

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

On January 30, 2015, there were 24,357,747 shares of the registrant's $.01 par value Common Stock outstanding.

INDEX

2

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	Three months ended December 31,	
	2014	2013
	(in thousands, except per common share data)	
Revenue:		
Hardware product	$44,933	$41,989
Service	3,790	5,333
Total revenue	48,723	47,322
Cost of sales:		
Cost of hardware product	23,112	20,263
Cost of service	3,689	4,151
Total cost of sales	26,801	24,414
Gross profit	21,922	22,908
Operating expenses:		
Sales and marketing	10,792	10,219
Research and development	7,562	7,257
General and administrative	5,188	4,723
Restructuring charges, net	—	81
Total operating expenses	23,542	22,280
Operating (loss) income	(1,620)	628
Other income, net:		
Interest income	38	43
Other income, net	388	93
Total other income, net	426	136
(Loss) income before income taxes	(1,194)	764
Income tax (benefit) provision	(855)	76
Net (loss) income	$(339)	$688
Net (loss) income per common share:		
Basic	$(0.01)	$0.03
Diluted	$(0.01)	$0.03
Weighted average common shares:		
Basic	24,150	25,716
Diluted	24,150	26,229

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

DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME
(UNAUDITED)

	Three months ended December 31,			
	2014		2013	
	(in thousands)			
Net (loss) income	$(339	)	$688	
Other comprehensive (loss) income, net of tax:				
Foreign currency translation adjustment	(2,373	)	343	
Change in net unrealized (loss) gain on investments	(29	)	38	
Less income tax benefit (provision)	11		(15	)
Other comprehensive (loss) income, net of tax (1)	(2,391	)	366	
Comprehensive (loss) income	$(2,730	)	$1,054	

(1) No portion of other comprehensive income (loss) was attributed to reclassification adjustments during the three month periods ended December 31, 2014 or 2013.
The accompanying notes are an integral part of the condensed consolidated financial statements.

Table of Contents

DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	December 31, 2014	September 30, 2014
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$45,043	$47,490
Marketable securities	32,624	32,898
Accounts receivable, net	23,281	28,576
Inventories	33,364	31,247
Deferred tax assets	3,206	3,221
Other	5,372	4,249
Total current assets	142,890	147,681
Marketable securities, long-term	14,600	11,541
Property, equipment and improvements, net	13,864	13,231
Identifiable intangible assets, net	6,061	6,785
Goodwill	102,674	103,398
Deferred tax assets	6,766	7,383
Other	396	440
Total assets	$287,251	$290,459
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$12,032	$10,451
Accrued compensation	7,517	8,133
Other	3,664	3,170
Total current liabilities	23,213	21,754
Income taxes payable	2,017	2,724
Deferred tax liabilities	37	272
Other noncurrent liabilities	600	411
Total liabilities	25,867	25,161
Contingencies (see Note 9)		
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; 30,704,895 and 30,703,895 shares issued	307	307
Additional paid-in capital	219,419	218,689
Retained earnings	117,477	117,816
Accumulated other comprehensive loss	(20,668)	(18,277)
Treasury stock, at cost, 6,560,774 and 6,313,937 shares	(55,151)	(53,237)
Total stockholders' equity	261,384	265,298
Total liabilities and stockholders' equity	$287,251	$290,459

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

Table of Contents

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

	Three months ended December 31, 2014	2013
	(in thousands)	
Operating activities:		
Net (loss) income	$(339)	$688
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation of property, equipment and improvements	752	897
Amortization of identifiable intangible assets	770	952
Stock-based compensation	1,184	1,023
Excess tax benefits from stock-based compensation	—	(20)
Deferred income tax provision (benefit)	412	(506)
Bad debt/product return provision	30	22
Inventory obsolescence	230	229
Restructuring charges, net	—	81
Other	(6)	102
Changes in operating assets and liabilities	2,310	(3,805)
Net cash provided by (used in) operating activities	5,343	(337)
Investing activities:		
Purchase of marketable securities	(12,135)	—
Proceeds from maturities of marketable securities	9,321	7,109
Purchase of property, equipment, improvements and certain other intangible assets	(1,469)	(975)
Net cash (used in) provided by investing activities	(4,283)	6,134
Financing activities:		
Excess tax benefits from stock-based compensation	—	20
Proceeds from stock option plan transactions	9	2,813
Proceeds from employee stock purchase plan transactions	261	296
Purchases of common stock	(2,257)	—
Net cash (used in) provided by financing activities	(1,987)	3,129
Effect of exchange rate changes on cash and cash equivalents	(1,520)	224
Net (decrease) increase in cash and cash equivalents	(2,447)	9,150
Cash and cash equivalents, beginning of period	47,490	41,320
Cash and cash equivalents, end of period	$45,043	$50,470

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

Table of Contents
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," "Digi," "we," "our," or "us") pursuant to the rules and regulations of the United States Securities and Exchange Commission (the "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 ("U.S. GAAP"), 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 (but not limited to) the summary of significant accounting policies, presented in our Annual Report on Form 10-K for the year ended September 30, 2014 as filed with the SEC ("2014 Financial Statements").
The condensed consolidated financial statements presented herein reflect, in the opinion of management, all adjustments which consist only of normal, recurring adjustments necessary for a fair statement of the condensed consolidated balance sheets and condensed consolidated statements of operations, comprehensive income 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. The year-end condensed consolidated balance sheet data were derived from our 2014 Financial Statements, but do not include all disclosures required by U.S. GAAP.
Recently Issued Accounting Pronouncements
Adopted
In July 2013, the Financial Accounting Standards Board ("FASB") issued ASU 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists." This guidance relates to the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The standard update provides that a liability related to an unrecognized tax benefit should be offset against same jurisdiction deferred tax assets for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. This guidance is effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. We adopted this guidance during the fiscal quarter ended December 31, 2014, resulting in a reclassification of $0.4 million of unrecognized tax benefits to noncurrent deferred tax assets.
In March 2013, FASB issued ASU 2013-05, "Foreign Currency Matters (Topic 830): Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity." This guidance applies to the release of the cumulative translation adjustment into net income when a parent either sells a part or all of its investment in a foreign entity or no longer holds a controlling financial interest in a subsidiary or group of assets that is a business within a foreign entity. ASU 2013-05 is effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. We adopted this guidance during the fiscal quarter ended December 31, 2014. There was no impact on our condensed consolidated financial statements as we did not sell any foreign entities for which we hold a controlling financial interest.
Not Yet Adopted
In August 2014, FASB issued ASU 2014-15, "Presentation of Financial Statements - Going Concern." This guidance requires management to evaluate whether there is substantial doubt about a company's ability to continue as a going concern and to provide related footnote disclosures. These amendments are effective for the annual period ending after

December 15, 2016, and for annual periods and interim periods thereafter, which for us, will be the fourth fiscal quarter ended September 30, 2017. Early adoption is permitted. While we are evaluating the impact of the adoption of ASU 2014-15, we do not expect it to have an impact on our consolidated financial statements.

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

In May 2014, FASB issued ASU 2014-09, “Revenue from Contracts with Customers.” This guidance provides a five-step analysis in determining when and how revenue is recognized so that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods and services. It also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. This guidance is effective for fiscal years (and interim reporting periods within those years) beginning after December 15, 2016. We expect to adopt this guidance beginning with our fiscal quarter ended December 31, 2017. We are evaluating the impact that the adoption will have on our consolidated financial statements.

2. EARNINGS PER SHARE

Basic net (loss) 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 shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares result from dilutive common stock options and restricted stock units. Diluted net loss per common share is computed by dividing net loss by the weighted average number of common shares. All potentially dilutive common equivalent shares are excluded from the calculations of net loss per diluted share due to their anti-dilutive effect for the three month period ended December 31, 2014.

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

	Three months ended December 31,	
	2014	2013
Numerator:		
Net (loss) income	$(339)	$688
Denominator:		
Denominator for basic net (loss) income per common share — weighted average shares outstanding	24,150	25,716
Effect of dilutive securities:		
Stock options and restricted stock units	—	513
Denominator for diluted net (loss) income per common share — adjusted weighted average shares	24,150	26,229
Net (loss) income per common share, basic	$(0.01)	$0.03
Net (loss) income per common share, diluted	$(0.01)	$0.03

For the three months ended December 31, 2014 and 2013, there were 5,676,561 and 2,699,776 potentially dilutive shares, respectively, related to stock options to purchase common shares that were not included in the above computation of diluted earnings per common share. This is because the options’ exercise prices were greater than the average market price of our common shares. In addition, due to the net loss for the three months ended December 31, 2014, there were 312 thousand common stock options and restricted stock units that were not included in the above computation of diluted earnings per share.

Table of Contents

3. SELECTED BALANCE SHEET DATA
(in thousands)

	December 31, 2014	September 30, 2014
Accounts receivable, net:		
Accounts receivable	$23,629	$28,943
Less allowance for doubtful accounts	348	367
	$23,281	$28,576
Inventories:		
Raw materials	$28,165	$26,402
Work in process	486	315
Finished goods	4,713	4,530
	$33,364	$31,247

Inventories are stated at the lower of cost or market value, with cost determined using the first-in, first-out method.

4. MARKETABLE SECURITIES

Our marketable securities consist of certificates of deposit, corporate bonds and government municipal bonds. We analyze our available-for-sale marketable securities for impairment on an ongoing basis. When we perform this analysis, we consider factors such as the length of time and extent to which the securities have been in an unrealized loss position and the trend of any unrealized losses. We also consider whether an unrealized loss is a temporary loss or an other-than-temporary loss based on factors such as: (a) whether we have the intent to sell the security, (b) whether it is more likely than not that we will be required to sell the security before its anticipated recovery, or (c) permanent impairment due to bankruptcy or insolvency.

In order to estimate the fair value for each security in our investment portfolio, we obtain quoted market prices and trading activity for each security where available. We obtain relevant information from our investment advisor and, if warranted, also may review the financial solvency of certain security issuers. As of December 31, 2014, 33 of our 72 securities that we held were trading below our amortized cost basis. We determined each decline in value to be temporary based upon the above described factors. We expect to realize the fair value of these securities, plus accrued interest, either at the time of maturity or when the security is sold. All of our current holdings are classified as available-for-sale marketable securities and are recorded at fair value on our consolidated balance sheet with the unrealized gains and losses recorded in accumulated other comprehensive loss. All of our current marketable securities will mature in less than one year and our non-current marketable securities will mature in less than three years. During the three months ended December 31, 2014 and 2013, we received proceeds from our available-for-sale marketable securities of $9.3 million and $7.1 million, respectively.

At December 31, 2014 our marketable securities were (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses	Fair Value (1)
Current marketable securities:				
Corporate bonds	$23,409	$—	$(34)	$23,375
Commercial paper	5,997	—	(1)	5,996
Certificates of deposit	3,251	2	—	3,253
Current marketable securities	32,657	2	(35)	32,624
Non-current marketable securities:				
Corporate bonds	5,122	—	(18)	5,104
Certificates of deposit	9,506	16	(26)	9,496
Non-current marketable securities	14,628	16	(44)	14,600
Total marketable securities	$47,285	$18	$(79)	$47,224

(1) Included in amortized cost and fair value is purchased and accrued interest of $163.

Table of Contents

4. MARKETABLE SECURITIES (CONTINUED)

At September 30, 2014 our marketable securities were (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses	Fair Value (1)
Current marketable securities:				
Corporate bonds	$24,668	$1	$(22)	$24,647
Commercial paper	3,998	—	(1)	3,997
Certificates of deposit	4,252	2	—	4,254
Current marketable securities	32,918	3	(23)	32,898
Non-current marketable securities:				
Corporate bonds	2,051	—	(4)	2,047
Certificates of deposit	9,502	14	(22)	9,494
Non-current marketable securities	11,553	14	(26)	11,541
Total marketable securities	$44,471	$17	$(49)	$44,439

(1) Included in amortized cost and fair value is purchased and accrued interest of $213.

The following tables show the fair values and gross unrealized losses of our available-for-sale marketable securities that have been in a continuous unrealized loss position deemed to be temporary, aggregated by investment category (in thousands):

	December 31, 2014			
	Less than 12 Months		More than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	$28,324	$(52)	$—	$—
Commercial paper	1,997	(1)	—	—
Certificates of deposit	2,975	(25)	499	(1)
Total	$33,296	$(78)	$499	$(1)

	September 30, 2014			
	Less than 12 Months		More than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	$23,475	$(26)	$—	$—
Commercial paper	3,998	(1)	—	—
Certificates of deposit	2,980	(20)	748	(2)
Total	$30,453	$(47)	$748	$(2)

5. FAIR VALUE MEASUREMENTS

Fair value is defined as the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. This standard also establishes a hierarchy for inputs used in measuring fair value. This standard maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs market participants would use in valuing the asset or liability based on market data obtained from independent sources. Unobservable inputs are inputs that reflect our assumptions about the factors market participants would use in valuing the asset or liability based upon the best information available in the circumstances. The categorization of financial assets and liabilities within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Table of Contents

5. FAIR VALUE MEASUREMENTS (CONTINUED)

The hierarchy is broken down into the following three levels:

- Level 1 — Inputs are quoted prices in active markets for identical assets or liabilities.
- Level 2 — Inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly.
- Level 3 — Inputs are unobservable for the asset or liability and their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 may also include certain investment securities for which there is limited market activity or a decrease in the observability of market pricing for the investments, such that the determination of fair value requires significant judgment or estimation.

Fair value is applied to financial assets such as our marketable securities, which are classified and accounted for as available-for-sale. These items are stated at fair value at each reporting period using the above guidance.

The following tables provide information by level for financial assets that are measured at fair value on a recurring basis (in thousands):

		Fair Value Measurements at December 31, 2014 using:		
	Total carrying value at December 31, 2014	Quoted price in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	$7,851	$7,851	$—	$—
Available-for-sale marketable securities:				
Corporate bonds	28,479	—	28,479	—
Commercial paper	5,996	—	5,996	—
Certificates of deposit	12,749	—	12,749	—
Total cash equivalents and marketable securities measured at fair value	$55,075	$7,851	$47,224	$—

		Fair Value Measurements at September 30, 2014 using:		
	Total carrying value at September 30, 2014	Quoted price in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Cash equivalents:				
Money market	$19,630	$19,630	$—	$—
Available-for-sale marketable securities:				
Corporate bonds	26,694	—	26,694	—
Commercial paper	3,997	—	3,997	—
Certificates of deposit	13,748	—	13,748	—
Total cash equivalents and marketable securities	$64,069	$19,630	$44,439	

measured at fair value