DIGITAL RIVER INC /DE
Form 10-Q
November 04, 2008

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 SEPTEMBER 30, 2008
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)

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DELAWARE	**41-1901640**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

9625 WEST 76TH STREET
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 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, 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 þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company 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
Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.
The number of shares of common stock outstanding at October 1, 2008 was 37,090,614 shares.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

DIGITAL RIVER, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	(Unaudited) September 30, 2008	December 31, 2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 345,249	$ 381,788
Short-term investments	149,907	315,636
Accounts receivable, net of allowance of $3,004 and $2,489	54,699	64,914
Deferred income taxes	2,784	7,899
Prepaid expenses and other	17,438	4,577
Total current assets	570,077	774,814
Property and equipment, net	34,235	31,102
Goodwill	278,732	261,885
Intangible assets, net of accumulated amortization of $64,859 and $59,493	35,454	32,382
Long-term investments	109,008	
Deferred income taxes	15,606	15,606
Other assets	6,631	11,955
TOTAL ASSETS	$ 1,049,743	$ 1,127,744
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Convertible senior notes	$ 195,000	$
Accounts payable	181,033	180,386
Accrued payroll	17,345	12,704
Deferred revenue	12,289	10,384
Accrued acquisition costs	4,500	399
Other accrued liabilities	31,491	41,229
Total current liabilities	441,658	245,102
NON-CURRENT LIABILITIES:		
Convertible senior notes		195,000
Other liabilities	11,377	11,362
Total non-current liabilities	11,377	206,362

TOTAL LIABILITIES	453,035	451,464
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; 120,000,000 shares authorized; 43,294,562 and 42,502,019 shares issued	433	425
Treasury stock at cost; 6,203,948 and 1,952,884 shares	(215,952)	(77,707)
Additional paid-in capital	617,087	597,128
Retained earnings	172,637	125,501
Accumulated other comprehensive income	22,503	30,933
Total stockholders equity	596,708	676,280
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,049,743	$ 1,127,744

See accompanying notes to condensed consolidated financial statements.

DIGITAL RIVER, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share data; unaudited)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Revenue	$ 96,301	$ 82,539	$ 298,309	$ 252,397
Costs and expenses:				
Direct cost of services	3,913	3,009	12,557	7,998
Network and infrastructure	10,552	7,983	31,136	22,812
Sales and marketing	35,419	32,945	114,396	99,927
Product research and development	12,993	10,170	38,737	27,057
General and administrative	9,861	9,055	30,939	28,711
Depreciation and amortization	4,047	3,120	11,838	9,269
Amortization of acquisition-related intangibles	2,001	1,611	6,347	5,964
Total costs and expenses	78,786	67,893	245,950	201,738
Income from operations	17,515	14,646	52,359	50,659
Interest income	4,513	7,831	15,057	23,977
Other expense, net	(1,387)	(303)	(3,789)	(1,449)
Income before income tax expense	20,641	22,174	63,627	73,187
Income tax expense	5,007	6,875	16,491	22,689
Net income	$ 15,634	$ 15,299	$ 47,136	$ 50,498
Net income per share basic	$ 0.43	$ 0.38	$ 1.27	$ 1.25
Net income per share diluted	$ 0.39	$ 0.35	$ 1.15	$ 1.12
Shares used in per-share calculation basic	36,495	40,078	37,186	40,555
Shares used in per-share calculation diluted	41,620	45,386	42,203	46,099

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,	
	2008	**2007**
OPERATING ACTIVITIES:		
Net income	$ 47,136	$ 50,498
Adjustments to reconcile net income to net cash provided by operating activities		
Amortization of acquisition-related intangibles	6,347	5,964
Change in accounts receivable allowance, net of acquisitions	632	628
Depreciation and amortization	11,838	9,269
Stock-based compensation expense related to stock-based compensation plans	10,161	10,536
Excess tax benefits from stock-based compensation	(1,685)	(11,297)
Deferred and other income taxes	6,927	17,337
Change in operating assets and liabilities		
Accounts receivable	10,204	(8,373)
Prepaid and other assets	(7,819)	(1,652)
Accounts payable	1,310	810
Deferred revenue	1,789	1,782
Income tax payable	(10,289)	3,314
Other accrued liabilities	39	5,912
Net cash provided by operating activities	76,590	84,728
INVESTING ACTIVITIES:		
Purchases of investments	(460,549)	(228,342)
Sales of investments	516,108	197,645
Cash paid for acquisitions, net of cash received	(22,221)	(30,573)
Purchases of equipment and capitalized software	(15,169)	(9,752)
Net cash provided by/(used for) investing activities	18,169	(71,022)
FINANCING ACTIVITIES:		
Exercise of stock options	6,841	11,244
Sales of common stock under employee stock purchase plan	1,446	1,244
Repurchase of common stock	(137,858)	(62,968)
Repurchase of restricted stock to satisfy tax withholding obligation	(387)	(382)
Excess tax benefits from stock-based compensation	1,685	11,297
Net cash used for financing activities	(128,273)	(39,565)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(3,025)	6,716
NET DECREASE IN CASH AND CASH EQUIVALENTS	(36,539)	(19,143)
CASH AND CASH EQUIVALENTS, beginning of period	381,788	390,243

CASH AND CASH EQUIVALENTS, end of period	$ 345,249	$ 371,100
SUPPLEMENTAL DISCLOSURES:		
Cash paid for interest on convertible senior notes	$ 2,438	$ 2,438
Cash paid for income taxes	$ 17,039	$ 1,819
Noncash investing and financing activities:		
Common stock issued in acquisitions and earn-outs	$	$ 986

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, 2007, as filed with the Securities and Exchange Commission. The results of operations for the three and nine months ended September 30, 2008, are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2008. The December 31, 2007, balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles 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, 2007.

Research and Development and Software Development

Research and development expenses consist primarily of development personnel and non-employee contractor costs related to the development of new products and services, enhancement of existing products and services, quality assurance, and testing. Costs to develop software for internal use are required to be capitalized and amortized over the estimated useful life of the software in accordance with AICPA Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. We capitalized $1.6 million related to software development during the nine months ended September 30, 2008, inclusive of small amounts outside of Product Research and Development as recorded in our Condensed Consolidated Statement of Income. We did not capitalize any significant costs related to software development during the nine months ended September 30, 2007.

Stock-Based Compensation Expense

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payments made to employees and directors including stock options, restricted stock grants and employee stock purchases made through our Employee Stock Purchase Plan based on estimated fair values.

We have adopted SFAS 123(R) using the modified prospective transition method under which prior periods are not revised. Stock-based compensation expense recognized during the period is based on the value of the portion of share-based awards that are ultimately expected to vest during the period. Stock-based compensation expense recognized in our Condensed Consolidated Statement of Income for 2007 and 2008 includes compensation expense for share-based awards granted prior to, but not yet vested, as of December 31, 2005, as well as compensation expense for the share-based payment awards granted subsequent to December 31, 2005. The fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option pricing model. The fair value of restricted stock is determined based on the number of shares granted and the closing price of our common stock on the date of grant. Compensation expense for all share-based payment awards is recognized using the straight-line amortization method over the vesting period. As stock-based compensation expense recognized in our Condensed Consolidated Statement of Income is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

SFAS 123(R) also requires the benefits of tax deductions in excess of recognized stock-based compensation expense be reported as a financing cash flow, rather than an operating cash flow as required prior to adoption of SFAS 123(R) in our Condensed Consolidated Statement of Cash Flows.

See Note 4 in the Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q for further information regarding our stock-based compensation plans.

DIGITAL RIVER, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Comprehensive Income

The components of our comprehensive income include net income and adjustments to stockholders equity for the foreign currency translation adjustments which was a $7.3 million loss for the nine months ended September 30, 2008, and net unrealized gain (loss) on available-for-sale securities which was a $1.2 million loss for the nine months ended September 30, 2008.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), Business Combinations. This revised Statement, which we refer to as SFAS No. 141(R), is intended to simplify existing guidance and converge rulemaking under U.S. GAAP with international accounting rules. SFAS No. 141(R) will significantly change the accounting for business combinations in a number of areas, including the treatment of contingent consideration, contingencies, acquisition costs and restructuring costs. Also under this Statement, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008.

In September 2006, the FASB issued FAS No. 157, Fair Value Measurements (FAS 157). This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Statement applies under other accounting pronouncements that require or permit fair value measurements and, accordingly, does not require any new fair value measurements. This Statement was initially effective as of January 1, 2008, but in February 2008, the FASB delayed the effective date for applying this standard to nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. We adopted FAS 157 as of January 1, 2008 for assets and liabilities within its scope and the impact was immaterial to our financial statements. Nonfinancial assets and liabilities for which we have not applied the provisions of FAS 157 include those measured at fair value in goodwill and indefinite lived intangible asset impairment testing, and asset retirement obligations initially measured at fair value and will be adopted in 2009. See Note 7 for further information.

2. NET INCOME PER SHARE

Basic income per common share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share is calculated by dividing net income, adjusted to exclude interest expense and financing cost amortization related to potentially dilutive securities, by the weighted average number of common shares outstanding during the period, plus any additional common shares that would have been outstanding if potentially dilutive common shares had been issued during the period.

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

DIGITAL RIVER, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Earnings per share basic				
Net income basic	$ 15,634	$ 15,299	$ 47,136	$ 50,498
Weighted average shares outstanding basic	36,495	40,078	37,186	40,555
Earnings per share basic	$ 0.43	$ 0.38	$ 1.27	$ 1.25
Earnings per share diluted				
Net income basic	$ 15,634	$ 15,299	$ 47,136	$ 50,498
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit	435	434	1,304	1,304
Net income diluted	$ 16,069	$ 15,733	$ 48,440	$ 51,802
Weighted average shares outstanding basic	36,495	40,078	37,186	40,555
Dilutive impact of non-vested stock and options outstanding	700	883	592	1,119
Dilutive impact of convertible senior notes	4,425	4,425	4,425	4,425
Weighted average shares outstanding diluted	41,620	45,386	42,203	46,099
Net income per share diluted	$ 0.39	$ 0.35	$ 1.15	$ 1.12

In accordance with the Emerging Issues Task Force (EITF), Issue No. 04-8, the unissued shares underlying contingent convertible notes are treated as if such shares were issued and outstanding for the purposes of calculating GAAP diluted earnings per share beginning with the issuance of our 1.25% convertible senior notes on June 1, 2004.

3. BUSINESS COMBINATIONS, GOODWILL AND INTANGIBLE ASSETS

Acquisitions completed in 2008

On September 1, 2008, we acquired all of the capital stock of Think Subscription, Inc. (Think Subscription), a privately-held company based in Provo, Utah, for approximately $5.1 million in cash. Think Subscription provides subscription management and fulfillment software to content publishers, online service providers, media vendors and other subscription-based businesses. The agreement also provides Think Subscription shareholders with an earn-out opportunity based on Think Subscription achieving certain revenue and earnings targets during the first three years subsequent to the acquisition. Any future earn-out will result in additional goodwill. The allocation of the purchase price of Think Subscription will be finalized upon completion of the analysis of the fair market value of Think Subscription s assets. The result of the allocation of the purchase price between amortizable costs and goodwill could have an impact on our future operating results.

On January 1, 2008, we acquired all of the capital stock of DigitalSwift Corporation (DigitalSwift), a privately-held company based in Madison, Georgia, for approximately $9.2 million in cash. DigitalSwift is a manufacturer and fulfiller of on-demand, dynamic and build-to-order CDs and DVDs to consumers. The agreement also provides DigitalSwift shareholders with an earn-out opportunity based on DigitalSwift achieving certain revenue and earnings targets during the first year subsequent to the acquisition. Any future earn-out will result in additional goodwill.

On January 1, 2008, we acquired the assets of IA Users Club d.b.a. CustomCD, Inc. (CustomCD), a privately held company based in Portland, Oregon and Krefeld, Germany, for approximately $7.0 million in cash. This acquisition involved an asset purchase of the US-based business and a stock purchase of the business located in Germany. CustomCD creates, sells and delivers to consumers custom CDs and DVDs containing software, games, and other licensed content. The agreement also provides CustomCD shareholders with an earn-out opportunity based on CustomCD achieving certain revenue and earnings targets during the first two years subsequent to the acquisition. Any future earn-out will result in additional goodwill.

DIGITAL RIVER, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Acquisitions completed in 2007

On September 1, 2007, we acquired all of the capital stock of NetGiro Systems AB (NetGiro), a privately held company based in Stockholm, Sweden, for approximately $27.4 million in cash. NetGiro is a payment service provider. The agreement also provides NetGiro shareholders with an earn-out opportunity based on NetGiro achieving certain revenue and earnings targets during the first year subsequent to the acquisition. Any future earn-out will result in additional goodwill.

Future Earn-outs

As of September 30, 2008, there was an estimated potential for future earn-outs of $4.2 million in accrued acquisition liabilities. Any of the estimated maximum potential future earn-out beyond the $4.2 million accrual will result in additional goodwill.

Pro Forma Operating Results (Unaudited)

The consolidated financial statements include the operating results of each business from the date of acquisition. The following unaudited pro forma condensed results of operations for the three and nine months ended September 30, 2008 and 2007 have been prepared as if each of the acquisitions in 2008 and 2007 had occurred on January 1, 2007 (in thousands, except per share amounts):

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2008	**2007**	**2008**	**2007**
Revenue	$96,687	$86,580	$299,780	$265,548
Income from operations	17,101	14,081	51,516	48,226
Net income	15,220	14,735	46,296	48,068
Basic net income per share	$ 0.42	$ 0.37	$ 1.24	$ 1.19
Diluted net income per	$ 0.38	$ 0.33	$ 1.13	$ 1.07

This pro forma financial information does not purport to represent results that would actually have been obtained if the transactions had been completed on January 1, 2007, or any future results that may be realized.

Goodwill and Other Intangible Assets

We account for our goodwill in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. 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 using a two-step approach based in the fourth quarter of each fiscal year, and reassess any intangible assets, including goodwill, recorded in connection with earlier acquisitions. There was no material impairment of goodwill or other intangible assets in the three and nine months ended September 30, 2008 and 2007.

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

DIGITAL RIVER, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

	As of September 30, 2008		
	Carrying Amount Gross	Accumulated Amortization	Carrying Amount Net
Customer relationships	$ 63,375	$ 37,067	$ 26,308
Non-compete agreements	5,441	5,319	122
Technology/tradename	31,497	22,473	9,024
Total	$ 100,313	$ 64,859	$ 35,454

	As of December 31, 2007		
	Carrying Amount Gross	Accumulated Amortization	Carrying Amount Net
Customer relationships	$ 57,327	$ 33,761	$ 23,566
Non-compete agreements	5,351	5,328	23
Technology/tradename	29,197	20,404	8,793
Total	$ 91,875	$ 59,493	$ 32,382

Amortization expense for the three months ended September 30, 2008 and 2007 was $2.0 million and $1.6 million, respectively and $6.3 million and $6.0 million for the nine months ended September 30, 2008 and 2007 respectively. The result of the allocation of the purchase price between amortizable costs and goodwill could have an impact on our future operating results. Estimated amortization expense for the remaining life of the intangible assets, based on intangible assets as of September 30, 2008, is as follows (in thousands):

Year	
2008	$ 2,118
2009	7,660
2010	6,132
2011	4,856
2012	4,587
2013	2,689
Thereafter	7,412
Total	$ 35,454

4. STOCKHOLDERS EQUITY

Option and Restricted Stock Awards

2007 Plan

Our stockholders approved the Digital River, Inc. 2007 Equity Incentive Plan (the 2007 Plan) at the Company s annual stockholder meeting held on May 31, 2007. The number of shares issuable under the 2007 Plan equals 2,000,000 shares of our common stock. In addition, shares not issued under the 1998 Plan shall become available for issuance under the 2007 Plan to the extent a stock option or other stock award under the 1998 Plan expires or terminates before shares of common stock are issued under the award. Under our 2007 Equity Incentive Plan we have the flexibility to grant incentive and non-statutory stock options, restricted stock awards, restricted stock unit awards and performance shares to our directors, employees, and consultants.

1998 Plan

The 1998 Equity Incentive Plan expired in June 2008 except as to options still outstanding under the Plan.

General Stock Award Information

As of September 30, 2008, there were 1,698,054 shares available for future awards under our 2007 Plan. The number of shares available has been reduced by three shares for every two shares of restricted stock awards granted under the Plans.