DIGITAL RIVER INC /DE
Form 10-Q
November 04, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2011

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 000-24643

DIGITAL RIVER, INC.

(Exact name of registrant as specified in its charter)

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

10380 BREN ROAD WEST

MINNETONKA, MINNESOTA 55343

(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 x 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 x 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 (as defined in Exchange Act Rule 12b-2). See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company ¨

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

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, 2011, was 37,335,141 shares.

DIGITAL RIVER, INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DIGITAL RIVER, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	(Unaudited) September 30, 2011	December 31, 2010
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 457,121	$ 565,086
Short-term investments	207,108	163,029
Accounts receivable, net of allowance of $4,375 and $4,902	56,281	50,922
Deferred tax assets	10,719	10,628
Prepaid expenses and other	34,926	30,375
Total current assets	766,155	820,040
Property and equipment, net	51,157	49,599
Goodwill	288,581	283,940
Intangible assets, net of accumulated amortization of $86,953 and $80,106	30,186	37,911
Long-term investments	109,864	110,736
Deferred income taxes	18,137	17,721
Other assets	10,205	13,820
TOTAL ASSETS	$ 1,274,285	$ 1,333,767
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 181,833	$ 188,915
Accrued payroll	13,438	21,117
Deferred revenue	9,356	10,446
Accrued acquisition liabilities	0	1,615
Other accrued liabilities	42,138	58,083
Total current liabilities	246,765	280,176
NON-CURRENT LIABILITIES		
Senior convertible notes	353,805	353,805
Other liabilities	11,487	16,038
Total non-current liabilities	365,292	369,843
TOTAL LIABILITIES	612,057	650,019
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; 47,140,392 and 46,323,799 shares issued	471	463

Treasury stock at cost; 9,805,251 and 7,297,174 shares	(311,109)	(255,196)
Additional paid-in capital	702,295	683,307
Retained earnings	267,430	254,602
Accumulated other comprehensive income (loss)	3,141	572
Total stockholders equity	662,228	683,748
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 1,274,285	$ 1,333,767

See accompanying notes to consolidated financial statements.

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DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data; unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	**2010**	**2011**	**2010**
Revenue	$ 95,411	$ 84,987	$ 286,116	$ 265,545
Costs and expenses (exclusive of depreciation and amortization expense shown separately below):				
Direct cost of services	3,663	4,548	11,682	13,541
Network and infrastructure	12,017	11,146	37,106	34,696
Sales and marketing	40,535	33,558	117,733	110,767
Product research and development	16,781	14,018	50,507	45,928
General and administrative	9,741	10,965	31,364	32,560
Depreciation and amortization	5,693	6,086	16,657	17,662
Amortization of acquisition-related intangibles	2,184	2,188	6,511	5,281
Total costs and expenses	90,614	82,509	271,560	260,435
Income (loss) from operations	4,797	2,478	14,556	5,110
Interest income	1,565	660	4,793	2,032
Interest expense	(2,264)	(32)	(6,764)	(153)
Other income (expense), net	(511)	(2,013)	27	(1,107)
Income (loss) before income taxes	3,587	1,093	12,612	5,882
Income tax expense (benefit)	(1,931)	(4,768)	(216)	(4,466)
Net income (loss)	$ 5,518	$ 5,861	$ 12,828	$ 10,348
Net income (loss) per share basic	$ 0.15	$ 0.16	$ 0.34	$ 0.28
Net income (loss) per share diluted	$ 0.15	$ 0.15	$ 0.34	$ 0.27
Shares used in per-share calculation basic	37,294	37,688	37,416	37,613
Shares used in per-share calculation diluted	37,799	38,504	38,177	38,389

See accompanying notes to consolidated financial statements.

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DIGITAL RIVER, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands; unaudited)

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
OPERATING ACTIVITIES		
Net income (loss)	$ 12,828	$ 10,348
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Amortization of acquisition-related intangibles	6,511	5,281
Provision for doubtful accounts	916	2,703
Depreciation and amortization	16,657	17,662
Debt issuance cost amortization	1,492	0
Stock-based compensation expense	16,235	15,278
Excess tax benefits from stock-based compensation	(1,517)	(620)
Deferred and other income taxes	1,121	(499)
Impairment of equity investments	0	1,561
Change in operating assets and liabilities, net of acquisitions:		
Accounts receivable	(5,342)	(6,204)
Prepaid and other assets	651	(906)
Accounts payable	(9,212)	(36,402)
Deferred revenue	(1,198)	(1,247)
Income tax payable	(5,525)	(4,469)
Other accrued liabilities	(28,562)	(2,513)
Net cash provided by (used in) operating activities	5,055	(27)
INVESTING ACTIVITIES		
Purchases of investments	(207,790)	(65,889)
Sales of investments	172,288	40,199
Cash paid for cost method investments	(10,000)	0
Funding of restricted cash	0	(2,156)
Cash paid for acquisitions, net of cash received	0	(14,585)
Purchases of equipment and capitalized software	(17,744)	(13,666)
Net cash provided by (used in) investing activities	(63,246)	(56,097)
FINANCING ACTIVITIES		
Debt issuance costs	(342)	0
Exercise of stock options	365	1,909
Sales of common stock under employee stock purchase plan	1,251	1,138
Repurchase of restricted stock to satisfy tax withholding obligation	(5,905)	(3,175)
Repurchase of common stock	(50,008)	0
Excess tax benefits from stock-based compensation	1,517	620
Net cash provided by (used in) financing activities	(53,122)	492
EFFECT OF EXCHANGE RATE CHANGES ON CASH	3,348	(7,558)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(107,965)	(63,190)
CASH AND CASH EQUIVALENTS, beginning of period	565,086	392,704

CASH AND CASH EQUIVALENTS, end of period	$ 457,121	$ 329,514
SUPPLEMENTAL DISCLOSURES		
Cash paid for interest on senior convertible notes	$ 3,560	$ 110
Cash paid for income taxes	$ 3,361	$ 5,130

See accompanying notes to consolidated financial statements.

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1. BASIS OF PRESENTATION

The unaudited 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 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, 2010, as filed with the Securities and Exchange Commission. The results of operations for the three and nine months ended September 30, 2011, are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2011. The December 31, 2010, information was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles (GAAP) 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, 2010. There were no material changes in significant accounting policies during the quarter ended September 30, 2011.

Restricted Cash

Restricted cash consists of cash and cash equivalents that are held in escrow accounts and restricted by agreements with third parties for a particular purpose. Restricted cash and cash equivalents are included in current assets under Prepaid expenses and other on our Consolidated Balance Sheets, and are recorded at fair value. As of September 30, 2011, we had $1.4 million of restricted cash, and $2.1 million of restricted cash as of December 31, 2010.

Software Development

Costs to develop software for internal use are required to be capitalized and amortized over the estimated useful life of the software. For the three months ended September 30, 2011 and 2010, we capitalized $0.6 million and $0.8 million related to software development, respectively. For the nine months ended September 30, 2011 and 2010, we capitalized $3.7 million and $3.8 million related to software development, respectively. This capitalization is primarily related to the development of our enterprise resource planning (ERP) system, new data management and reporting infrastructure. We expect these investments to drive long-term operational efficiencies across the organization and provide further competitive differentiation.

Comprehensive Income (Loss)

Comprehensive income (loss) includes revenues, expenses, and gains and losses that are excluded from net earnings under GAAP. Items of comprehensive income (loss) are unrealized gains and losses on investments and foreign currency translation adjustments which are added to net income (loss) to compute comprehensive income. Comprehensive income (loss) is net of income tax benefit or expense excluding cumulative translation adjustments as these funds are indefinitely invested.

The components of comprehensive income (loss) are (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income (loss)	$ 5,518	$ 5,861	$ 12,828	$ 10,348
Other comprehensive income (loss):				
Unrealized foreign exchange gain (loss) on the revaluation of investments in foreign subsidiaries	(18,385)	31,468	5,415	(9,955)
Unrealized gain (loss) on investments	(4,148)	124	(2,979)	(47)
Tax benefit (expense)	689	(37)	133	19
Other comprehensive income (loss)	(21,844)	31,555	2,569	(9,983)

Comprehensive income (loss)	$ (16,326)	$ 37,416	$ 15,397	$ 365

Foreign Currency

Substantially all of our foreign subsidiaries use the local currency of their respective countries as their functional currency. Assets and liabilities are translated at exchange rates prevailing at the balance sheet dates. Revenues, costs and expenses are translated at the average exchange rates for the reported period. Gains and losses resulting from translation are recorded as a component of Accumulated other comprehensive income (loss) within stockholders equity. Gains and losses resulting from foreign currency transactions are recognized as Other income (expense), net .

We are exposed to market risk from changes in foreign currency exchange rates. Our primary risk is the effect of foreign currency exchange rate fluctuations on the U.S. dollar value of foreign currency denominated operating sales and expenses. These exposures are mitigated by the use of foreign exchange forward contracts with maturities up to one week. Our derivatives are not designated as hedges and are adjusted to fair value through income each period. The principal exposures mitigated were euro, pound sterling and Australian dollar currencies. For the three and nine months ended September 30, 2011 and September 30, 2010, the gain/loss on derivative settlements was immaterial. As of September 30, 2011 and December 31, 2010, the notional amounts held and the underlying gain/loss were determined to be immaterial when compared to our overall cash and cash equivalents and the net income (loss) reported for the respective periods.

Our foreign currency contracts contain credit risk to the extent that our bank counterparties may be unable to meet the terms of the agreements. We minimize such risk by limiting our counterparties to major financial institutions of high credit quality.

Recent Accounting Pronouncements

Accounting Standards Update (ASU) 2009-13 Multiple-Deliverable Revenue Arrangements: In October 2009, the Financial Accounting Standards Board (FASB) issued ASU 2009-13. This update provides amendments to Accounting Standards Codification (ASC) Topic 605 Revenue Recognition that enables vendors to account for products or services (deliverables) separately rather than as a combined unit. The amendments eliminate the residual method of allocation and require that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. The amendments also require that a vendor determine its best estimate of selling price in a manner that is consistent with that used to determine the price to sell the deliverable on a standalone basis. Additionally, disclosures related to multiple-deliverable revenue arrangements have also been expanded. The provisions were effective for fiscal years beginning on or after June 15, 2010. We have adopted the new guidance in ASU 2009-13 as of January 1, 2011, and it did not have a material impact on our Consolidated Financial Statements.

ASU 2010-28 Goodwill Impairment Testing: In December 2010, the FASB issued ASU 2010-28. This update provides amendments to ASC Topic 350 Intangibles-Goodwill and Other that require additional qualitative analysis within step 1 of the goodwill impairment test if a reporting unit s carrying value is zero or negative. If it is more likely than not that a goodwill impairment exists, step 2 of the goodwill impairment test is required. We have adopted the new guidance in ASU 2010-28 as of the period ended March 31, 2011, and it did not have a material impact on our Consolidated Financial Statements.

ASU 2010-29 Disclosure of Supplementary Pro Forma Information for Business Combinations: In December 2010, the FASB issued ASU 2010-29. This amendment to ASC Topic 805 Business Combinations requires public entities to disclose pro forma revenue and earnings of a combined entity for the current reporting period for all material business combinations as though the acquisition date that occurred during the year had been as of the beginning of the annual reporting period. If comparative financial statements are presented, this same disclosure requirement is applicable. Additionally, supplemental pro forma disclosures were amended to require a description of the nature and amount of material pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. We have adopted the new disclosure requirements as of the period ended March 31, 2011.

ASU 2011-04 Fair Value Measurements: In May 2011, the FASB issued ASU 2011-04. This update provides amendments to ASC Topic 820 Fair Value Measurements and Disclosures by creating a uniform framework for applying fair value measurements principles and clarified existing guidance in U.S. GAAP. The amendments called for additional disclosures regarding quantitative information about the significant unobservable inputs used for all Level 3 measurements, information about the sensitivity of a fair value measurement categorized within Level 3 of the fair value hierarchy to changes in unobservable inputs and any interrelationships between those unobservable inputs and a description of the valuation process. Additionally, disclosures are required when current use of a non-financial assets measured at fair value differs from its highest and best use, any transfers from Level 1 and Level 2 and the hierarchy classification for items whose fair value is not recorded on the balance sheet but disclosed in the footnotes. ASU No. 2011-04 is effective for interim and annual periods beginning after December 15, 2011, and is to be completed on a prospective basis. Adoption of ASU 2011-04 is not anticipated to have a material impact on our Consolidated Financial Statements.

ASU 2011-05 Comprehensive Income: In June 2011, the FASB issued ASU 2011-05. This amendment requires nonowner changes in stockholders equity, reclassifications and all other items affecting comprehensive income be presented in either a single continuous statement or in two separate but consecutive statements for all periods presented. The amendments do not change the items that must be reported in comprehensive income or when an item of other comprehensive income must be

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reclassified to net income (loss). ASU No. 2011-05 is effective for interim and annual periods beginning after December 15, 2011, and is to be completed on a retrospective basis. Adoption of ASU 2011-05 is not anticipated to have a material impact on our Consolidated Financial Statements.

ASU 2011-08 Goodwill Impairment Testing: In September 2011, the FASB issued ASU 2011-08. Under this amendment, qualitative factors are first assessed to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that goodwill is impaired. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step good impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing it against the carrying amount. ASU No. 2011-08 is effective for interim and annual periods beginning after December 15, 2011 and early adoption is permitted. Adoption of ASU 2011-08 is not anticipated to have a material impact on our Consolidated Financial Statements.

We have determined that all other recently issued accounting standards will not have a material impact on our Consolidated Financial Statements, or do not apply to our operations.

2. NET INCOME (LOSS) PER SHARE

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

	Three Months Ended September 30, 2011	2010	Nine Months Ended September 30, 2011	2010
Net income (loss) per share basic				
Net income (loss) basic	$ 5,518	$ 5,861	$ 12,828	$ 10,348
Weighted average shares outstanding basic	37,294	37,688	37,416	37,613
Net income (loss) per share basic	$ 0.15	$ 0.16	$ 0.34	$ 0.28
Net income (loss) per share diluted				
Net income (loss) basic	$ 5,518	$ 5,861	$ 12,828	$ 10,348
Exclude: Interest expense and amortized financing cost of convertible senior notes, net of tax benefit	20	21	59	63
Net income (loss) diluted	$ 5,538	$ 5,882	$ 12,887	$ 10,411
Weighted average shares outstanding basic	37,294	37,688	37,416	37,613
Dilutive impact of non-vested stock and options outstanding	305	616	561	576
Dilutive impact of 2004 senior convertible notes	200	200	200	200
Weighted average shares outstanding diluted	37,799	38,504	38,177	38,389
Net income (loss) per share diluted	$ 0.15	$ 0.15	$ 0.34	$ 0.27

Options to purchase 1,411,245 and 1,405,283 shares for the three months ended September 30, 2011 and 2010, respectively, and 1,274,390 and 1,405,283 shares for the nine months ended September 30, 2011 and 2010, respectively were not included in the computation of diluted net income (loss) per share, because their effect on diluted net income (loss) per share would have been anti-dilutive.

The unissued shares underlying our 2010 senior convertible notes, 7,022,027 shares for three and nine months ended September 30, 2011, were excluded for the purposes of calculating GAAP diluted net income (loss) per share, because their effect on diluted net income (loss) per share would have been anti-dilutive.

3. FAIR VALUE MEASUREMENTS

Financial assets and liabilities that are remeasured and reported at fair value at each reporting period are classified and disclosed in one of the following three categories:

Level 1 Observable inputs such as quoted prices in active markets;

Level 2 Other observable inputs available at the measurement date, other than quoted prices included in Level 1, either directly or indirectly, including:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets in non-active markets;
- Inputs other than quoted prices that are observable for assets or liabilities; and
- Inputs that are derived principally from or corroborated by other observable market data.

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Level 3 Unobservable inputs that cannot be corroborated by observable market data and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management s estimate of market participant assumptions.

Assets and Liabilities that are Measured at Fair Value on a Recurring Basis

The fair value hierarchy requires the use of observable market data when available. In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Our assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability. The Company s policy is to recognize transfers between levels at the end of the quarter.

The following table sets forth by level within the fair value hierarchy, our financial assets that were accounted for at fair value on a recurring basis at September 30, 2011 and December 31, 2010, (in thousands), according to the valuation techniques we used to determine their fair values. There have been no transfers of assets between the fair value hierarchies presented below:

		Fair Value Measurements		
	Total	**Level 1**	**Level 2**	**Level 3**
Balance as of September 30, 2011				
Cash and cash equivalents	$ 457,121	$ 457,121	$ 0	$ 0
Restricted cash	1,435	1,435	0	0
U.S. government sponsored entities	38,058	38,058	0	0
Corporate bonds	141,552	141,552	0	0
Asset backed securities	27,498	27,498	0	0
Market basis equity investments	1,293	1,293	0	0
Student loan bonds	74,745	0	0	74,745
Total assets measured at fair value	$ 741,702	$ 666,957	$ 0	$ 74,745
Balance as of December 31, 2010				
Cash and cash equivalents	$ 565,086	$ 565,086	$ 0	$ 0
Restricted cash	2,070	2,070	0	0
Certificates of deposit	93	93	0	0
U.S. government sponsored entities	34,965	34,965	0	0
Corporate bonds	121,944	121,944	0	0
Asset backed securities	6,027	6,027	0	0
Market basis equity investments	3,818	3,818	0	0
Student loan bonds	83,678	0	0	83,678
Total assets measured at fair value	$ 817,681	$ 734,003	$ 0	$ 83,678

The following table is a reconciliation of assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3 inputs) (in thousands):

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	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	Short-term Investments	Long-term Investments	Total
Balance as of December 31, 2009	$ 0	$ 92,801	$ 92,801
Total gains or losses (realized/unrealized) included in other comprehensive income	0	(623)	(623)
Purchases	0	0	0
Issuances			