DIGITAL ANGEL CORP
Form 10-K
March 08, 2007

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 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: 1-15177
Digital Angel Corporation
(Exact name of registrant as specified in its charter)

Delaware	**52-1233960**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
490 Villaume Avenue, South St. Paul, MN	**55075**
(Address of principal executive offices)	(Zip Code)

(651) 455-1621
(Registrant s telephone number, including area code)
Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $.005 par value per share	**American Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
Yes o No þ

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 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 o Non-accelerated filer þ

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

As of June 30, 2006, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $61.4 million based on the closing sale price as reported on the American Stock Exchange.
Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at March 7, 2007
Common Stock, $.005 par value per share	44,515,823 shares

DOCUMENTS INCORPORATED BY REFERENCE

Document	Parts Into Which Incorporated
Proxy Statement for the 2007 Annual Meeting of Stockholders, which proxy statement will be filed no later than 120 days after the close of the Registrant s fiscal year ended December 31, 2006	Part III

DIGITAL ANGEL CORPORATION
TABLE OF CONTENTS

Table of Contents

PART I

Item 1. Business

Unless the context otherwise provides, when we refer to the Company, we, our, or us, we are referring to Digital Angel Corporation and its subsidiaries.

Overview

We and our subsidiaries (either wholly or majority-owned) currently engage in the following principal business activities:

- the development, manufacture and marketing of visual and electronic identification tags and implantable Radio Frequency Identification, or RFID, microchips, primarily for identification, tracking and location of companion pets, horses, livestock (e.g., cattle and hogs), fish and wildlife worldwide, and, more recently, for animal bio-sensing applications, such as temperature reading for companion pet, horse and livestock applications; and

- the design, manufacture, and marketing of global position system, or GPS, enabled equipment used for location tracking and message monitoring of vehicles, aircraft, and people in remote locations.

We presently operate in two business segments: Animal Applications and GPS and Radio Communications.

As of March 1, 2007, Applied Digital Solutions, Inc., or Applied Digital, (NasdaqCM: ASDX) owns 24,573,788 shares (or 55.2%) of our outstanding shares of common stock. Applied Digital is a public company that also owns approximately 60.7% of VeriChip Corporation, or VeriChip, (NasdaqGM: CHIP) and approximately 50.9% of InfoTech USA, Inc. (OTC: IFTH).

We were incorporated in Delaware on December 1, 1981. Our corporate headquarters are located at 490 Villaume Avenue, South St. Paul, MN 55075. Our telephone number is 651-455-1621.

Recent Events

Proposed Acquisition of the Assets of McMurdo Ltd.

On December 14, 2006, Signature Industries Limited, or Signature, our London-based subsidiary operating in our GPS and Radio Communications business segment, entered into an agreement to acquire certain assets and customer contracts of McMurdo Ltd., or McMurdo, a U.K. manufacturer of emergency location beacons, from Chemring Group PLC. Pursuant to the agreement, Signature will acquire certain assets of McMurdo s marine electronics business, including fixed assets, inventory, customer lists, customer and supplier contracts and relations, trade and business names, and associated assets. The assets exclude certain accrued liabilities and obligations and real property, including the plant facility which Signature will have a license to occupy for a period of nine months after completion of the sale. Under the terms of the agreement, Signature will retain McMurdo s employees related to the marine electronics business after closing the sale.

The purchase price for the assets is approximately £3,117,000 (approximately $6,106,000 at December 31, 2006), subject to certain adjustments, plus an additional deferred payment of up to £1,500,000 (approximately $2,938,000 at December 31, 2006) based on the value of specified products sold between November 1, 2006 and October 31, 2007. The deferred payment is determined on a threshold basis with a minimum threshold, based on the invoiced value of sales during such period and payable when the parties finalize a statement of the sales. Upon signing the agreement, we paid £250,000 (approximately $490,000 at December 31, 2006) of the purchase price to McMurdo. The balance of the initial purchase price is payable upon closing. If the agreement is terminated or the sale is not completed, McMurdo will be entitled, under certain circumstances, to retain the £250,000 deposit. Under the terms of the agreement, we will guarantee Signature s obligations for the deferred payment and Chemring will guarantee McMurdo s obligations for retained liabilities and obligations.

10.25% Senior Secured Debenture Financing

On February 6, 2007, we entered into a securities purchase agreement pursuant to which we sold a 10.25% senior secured debenture in the original principal amount of $6,000,000 and a five-year warrant to purchase 699,600 shares of our common stock. The debenture matures on February 6, 2010, but we may, at our option, prepay the debenture in cash at any time by paying a premium of 2% of the outstanding principal amount of the debenture. We are obligated to make monthly payments of principal plus accrued but unpaid interest (including default interest, if any) beginning

on September 4, 2007.

Table of Contents

The debenture is not convertible by the holder(s). However, upon satisfaction of certain conditions set forth in the Debenture, including approval by our stockholders of the Debenture and the availability of an effective registration statement covering the resale of shares by the holder(s), we may, at our option, elect to pay one or more monthly payments of principal and interest with shares of our common stock in lieu of cash. Our decision to make a monthly payment with cash or with shares of our common stock, or a combination of both, will be determined on a monthly basis. Currently, we anticipate making monthly payments with cash. If we elect to make a monthly payment with shares of our common stock, the shares will be valued at an 8% discount to the then current market price of a share of our common stock . If an event of default or a change of control occurs, the holder(s) has the right to require us to redeem the debenture for a cash amount equal to 110% of the outstanding principal plus interest. The proceeds from the financing, approximately $5.6 million, will be used by us to fund a portion of our planned acquisition of certain assets of McMurdo and to invest in the continued growth of our business.

Industry Overview

Our current activities encompass the development and marketing of RFID and GPS enabled identification and location products.

RFID has become an important technology widely adopted and used in the automotive identification market, an industry characterized by identifying and locating objects electronically. RFID systems identify objects using radio frequency transmissions, typically achieved with communication between a microchip or tag and a scanner or reader. Historically, RFID has been used to identify objects in the retail, transportation and logistics industries, as well as to identify and locate livestock and companion pets. Prior to the adoption of RFID, users identified and tracked objects manually as well as through the use of bar code technology. These solutions were limited because of the need for ongoing human intervention and the lack of instantaneous location capabilities. RFID technology seems to possess greater range, accuracy, speed and lower line-of-sight requirements than bar code technology.

The basic components of an RFID system consist of:

a tag, containing a microchip-equipped transponder, an antenna and a capacitor, attached to the item to be identified, located or tracked, which wirelessly transmits stored information to a receiver;

one or more receivers, also referred to as readers, which are devices that read the tag by sending out an RF signal to which a tag, in the range of the signal, responds; and

the equipment, cabling, computer network and software applications to use the processed data for one or more applications.

Most RFID systems use either active or passive tags, with the choice reflecting the different characteristics of the tags and the nature of the RFID system application. The key difference in the technology is that active RFID systems deploy tags with battery-powered microchips that emit a signal at regular intervals or continuously and do not rely on power from the reader to operate, while passive RFID systems deploy tags with microchips that have no attached power supply and receive an activating charge from the reader s signal. Applications that require receipt of signals between the tag and the reader beyond approximately 10 meters in range usually need a battery in the tags.

Our RFID businesses focus on (1) companion pet identification and safeguarding, and (2) livestock/fish identification tracking and food safety and traceability (e.g., livestock tracking).

Pet Identification and Safeguarding

Pet identification and safeguarding systems involve the insertion of a microchip with identifying information in the animal. RFID scanners at animal shelters, veterinary clinics and other locations read the microchip s unique identification number. Through the use of a database, the unique identification number identifies the animal, the animal s owner, and other relevant information. As a result of the recent expansion of the capabilities of the electronic chips (e.g., providing feedback on the health of the animal, such as a temperature reading), we believe the market is expected to expand even further and more rapidly.

Table of Contents

Livestock/Fish Identification Tracking and Food Safety and Traceability

The use of RFID technology in the tracking of livestock in the U.S. received a boost in December 2003 when a cow in Mabton, Washington was found to have Chronic Wasting Disease (commonly referred to as Mad Cow Disease), resulting in the banning of the U.S. cattle industry s exports. Since that time, the U.S. Department of Agriculture (USDA) and other state agencies, and the Canadian government, have been initiating pilot programs designed to test the viability of large-scale food animal identification and tracking systems. Currently, most livestock producers use visual rather than electronic identification tags. Cattle and other livestock tend to move from place to place, and from owner to owner. For this reason, visual tags have limitations in terms of the ability to trace where a diseased animal has been and what other animals could have been exposed to it. The USDA is targeting a national identification system that would allow such tracing within 48 hours, enabling the implementation of quarantines effectively and efficiently and helping to protect the value of farmers livestock investments. During 2006, the Canadian government decided to extend a national program through December 2007 for the funding of livestock RFID readers and scanning systems. The government-backed program is part of Food Safety and Quality within Agri-Food Canada to reimburse eligible participants by defraying a part of the cost of RFID equipment used to scan electronically identified animals as they move from farm to market.

RFID microchips are also used for the tagging of fish, especially salmon, for identification by biologists and governments in environmental programs and studies, migratory studies, and other purposes. These microchips are accepted as a safe, reliable alternative to traditional identification methods because once the fish are implanted with the microchips, they can be identified without recapturing or sacrificing the fish.

GPS and Radio Communications

Global Navigation Satellite System (GNSS) is the standard generic term for satellite navigation systems that provide autonomous geospatial positioning with global coverage. The Navigation Satellite Timing and Ranging Global Position System, or NAVSTAR GPS, which was developed by the U.S. Department of Defense, is the only fully operational GNSS. The satellite constellation is managed by the U.S. Air Force 50th Space Wing. Although the cost of maintaining the system is approximately $400 million per year, including the replacement of aging satellites, GPS is free for civilian use as a public good. In addition to NAVSTAR GPS, there is some indication that other nations may begin deploying GNSS. The Russian GLONASS positioning system is a GNSS in the process of being restored to full operation. The European Union Galileo positioning system is a next generation GNSS in the initial deployment phase, scheduled to be operational in a few years and China has indicated it may expand its regional Beidou navigation system into a global system.

A GPS receiver calculates its position by measuring the distance between itself and three or more GPS satellites. Measuring the time delay between transmission and reception of each GPS radio signal gives the distance to each satellite, since the signal travels at a known speed. The signals also carry information about the satellites location. By determining the position of, and distance to, at least three satellites, the receiver can compute its position using trilateration. Receivers typically do not have perfectly accurate clocks and, therefore, track one or more additional satellites to correct the receiver s clock error.

The original motivation for satellite navigation was for military applications. Today, GNSS systems have a wide variety of civilian uses such as:

Navigation, ranging from personal hand-held devices for trekking, to devices fitted to cars, trucks, ships and aircraft;

Synchronization

Location-based services such as enhanced 911;

Surveying

Entering data into a geographic information system;

Search and rescue;

Geophysical sciences; and

Tracking devices used in wildlife management.

Our focus is in the areas of search and rescue and locator beacons, and tracking systems, which include mobile satellite data communications service and software for mapping and messaging for a variety of industries including the military, air and ground ambulance operators, law enforcement agencies and energy companies. We believe that there is excellent growth potential in each of our markets and particularly, for us, in sales of our military personnel location beacons due to recent technology improvements. However, each market in which we compete is highly competitive.

Table of Contents

Operating Segments

We operate in two business segments: Animal Applications and GPS and Radio Communications. In the year ended December 31, 2006, the Animal Applications segment represented 66.8% of our consolidated revenue and the GPS and Radio Communications segment represented 33.2% of our consolidated revenue. Each of these segments is presented below.

Animal Applications Segment

Principal Products and Services

Our Animal Applications segment develops, manufactures and markets visual and electronic identification tags and RFID microchips, primarily for the identification, tracking and location of companion pets, horses, livestock, fish and wildlife worldwide, and, more recently, for animal bio-sensing applications, such as temperature reading for companion pet, horse and livestock applications. Our Animal Applications segment s proprietary products focus on pet identification and safeguarding and the positive identification and tracking of livestock and fish, which is crucial for asset management and for disease control and food safety. This segment s principal products are:

We hold patents on our syringe-injectable microchip for use in animals. Each microchip is individually inscribed and programmed to store a unique, permanent 10 to 16-digit alphanumeric identification code. These microchips are passive electronic devices ranging in size from 12 to 28 millimeters in length and 2.1 to 3.5 millimeters in diameter. The microchip is coupled with an antenna and placed either in a two-piece plastic e.Tag or in a glass-like injectable capsule. The e.Tag is primarily used in livestock application and typically affixed to the ear of the animal. The implantable microchip is injected under the skin using a hypodermic syringe, without requiring surgery. Each capsule is coated with a polymer, BioBond ™ to form adherence to tissue, thereby preventing migration in the host s body. An associated scanner device uses radio frequency to interrogate the microchips and read the code. During 2006, we received a patent for our Bio-Thermo® implantable microchip product, which provides temperature readings of animals by simply passing an RFID handheld scanner over the animal or by having the animal walk through a portal scanner.

Our pet identification and safeguarding systems involve the insertion of a microchip with identifying information in the animal. RFID scanners at animal shelters, veterinary clinics and other locations read the microchip s unique identification number. Through the use of a database, the unique identification number identifies the animal, the animal s owner, and other relevant information. We have an established infrastructure with RFID scanners placed in approximately 75,000 global animal shelters and veterinary clinics. More than 3.5 million companion animals in the U.S. have been enrolled in our distributor s database, and a pet is recovered in the U.S. by that system every six minutes.

Our miniature RFID microchips are also used for the tagging of fish, especially salmon, for identification by biologists and governments in environmental programs and studies, migratory studies, and other purposes. These microchips are accepted as a safe, reliable alternative to traditional identification methods because once the fish are implanted with the microchips, they can be identified without recapturing or sacrificing the fish. During 2006, we installed what we believe is the world s largest RFID ready system, a 16-foot by 16-foot RFID antenna designed to electronically track indigenous salmon populations. In addition, we launched our second generation unitary core transponders. These updated transponders are designed to provide greater reader reliability while increasing reader range.

In addition to pursuing the market for permanent identification of companion animals and tracking microchips for fish, we also produce visual and RFID identification products, principally for livestock producers. The tracking of cattle and hogs is crucial in order to provide security both for asset management and for disease control and food safety. We have marketed visual identification products for livestock since the 1940s. We have marketed electronic identification products for livestock since the late 1990s. Visual identification products typically include numbered ear tags. Electronic identification products for livestock are currently being utilized by livestock producers and as part of various pilot studies for the USDA s and other state and governmental cattle identification programs. Currently, sales of visual products represent a substantial percentage of our sales to livestock producers. However, the use of electronic identification products by livestock producers has been steadily increasing, and we expect the trend toward electronic identification products to continue.

Table of Contents

In addition to the use in animal applications, our implantable microchip was cleared by the FDA (Food and Drug Administration) for medical applications in humans in the United States in October 2004. We have a long-term exclusive distribution and licensing agreement with Verichip covering the manufacturing, purchasing and distribution of the implantable microchip. Sales to Verichip were $0.4 million, $0.7 million, and $0.1 million in the years ended December 31, 2006, 2005 and 2004, respectively.

Growth Strategy

The principal components of our Animal Applications segment s growth strategy are to:

Focus on animal identification products in the growing livestock, fish and wildlife industries;

Become a major player in the food source traceability and safety tracking systems arena; and

Increase our market share in the pet identification and equine markets with enhanced products such as our Bio-Thermo product.

Through our Animal Applications segment, we are one of the leading suppliers in the U.S. of RFID-enabled implantable microchip products for companion animals, laboratory animals, fish and wildlife, and visual and electronic identification tags for livestock. The chipping of companion pets has increased in Europe, in part, because in 2004, several European countries began requiring that all pets crossing their borders be identified with either a tattoo or a microchip. In addition, world-wide standardization of the frequency on which the microchips operate will most likely lead to higher world-wide chipping rates. Our chips can be read by the world standard, which is 134.2 kilohertz.

The USDA, the states of Kansas and Minnesota, and the government of Canada are utilizing our RFID system for use in their respective large-scale food animal identification programs. These pilot programs may lead to implementation of national and/or regional RFID-enabled identification programs.

In April 2006, we were awarded a U.S. Patent for our Bio-Thermo® temperature sensing implantable RFID microchip designed for non-laboratory applications that uses RFID technology to determine the body temperature of its host animal. Potential applications for the Bio-Thermo® chip include non-invasive monitoring of temperatures in cats, dogs, livestock and horses and early detection of infectious diseases such as Avian Bird Flu in poultry. We have begun a national initiative to target the use of our Bio-Thermo microchips to address the more than $100 million U.S. equine market for identification products. There are approximately eight million horses in the U.S. that are covered by identification and health status surveillance, which is required by local and state equine animal health professionals. Since late 2005, the California Horseracing Board, a division of the California Department of Agriculture, has been using federal funds to implant all new, in-coming young horses entering their racing career, with our Bio-Thermo microchips. To date, the California Horseracing Board has purchased 1,500 Bio-Thermo chips, out of an order of 4,000, and an estimated 500 horses at Southern California racetracks have already been successfully implanted. The New York State Horse Health Assurance Program recently implemented a comprehensive health campaign that utilizes Bio-Thermo microchips, and other state agencies are expected to launch similar programs.

In addition, future product enhancements include read/write microchips and new scanning systems that will extend the capabilities of our products while integrating them with evolving animal management systems. We intend to continue to develop new products based on our customers needs. We plan to continue to provide product offerings to identified market needs including, but not limited to, Country of Origin Labeling (COOL) and food traceability safety.

Sales, Marketing and Distribution

Our companion pet identification and location system is marketed in the U.S. by Schering-Plough Animal Health Corporation, or Schering-Plough, under the brand name Home Again® Pet Recovery Service. In February 2007, we signed a new exclusive distribution agreement with Schering-Plough Home Again LLC, a wholly owned subsidiary of Schering-Plough, to provide electronic identification microchips and scanners as part of the Home Again® Proactive Pet Recovery Network. Schering-Plough s new network, which markets the complete electronic pet identification system under the brand name HomeAgain®, is the nation s first comprehensive system to assist in the search for lost pets. The new Schering-Plough distribution agreement is for a period of two years, which may be extended for one year, and does not provide for minimum purchase requirements by Schering-Plough.

Our product is also marketed by various other companies, including (i) in some countries in Europe by Merial Pharmaceutical under the Indexel® brand; (ii) in the United Kingdom and Ireland by Animalcare under the idENTICHIP® brand; and (iii) in other European countries and in Australia, New Zealand and Japan by various distributors under the LifeChip® brand. We have an established infrastructure with readers placed in approximately 75,000 global animal shelters and veterinary clinics.

Table of Contents

BioMark, Inc. is our U.S. distributor for our fish and wildlife RFID microchip products. Electronic identification products for livestock are sold directly to our customers under the Destron brand. We have multi-year supply and distribution agreements with certain customers, which have varying expiration dates. The remaining terms of such agreements are between one and eight years. The supply and distribution agreements describe products, delivery and payment terms and distribution territories. Our agreements generally do not have minimum purchase requirements and can be terminated without penalty.

For the year ended December 31, 2006, Schering-Plough accounted for approximately 15% of our revenues. We believe we would be able to arrange for a third party to distribute our implantable microchips in the U.S. if Schering-Plough no longer distributed them. However, it may be difficult and time-consuming for us to arrange for distribution of the implantable microchip by a third party, which may negatively affect future sales.

Our principal customers for electronic identification devices for fish are Pacific States Marine and the U.S. Army Corps of Engineers. The loss of, or a significant reduction in, orders from these customers could have a material adverse effect on our financial condition and results of operations.

Competition

The animal identification market is highly competitive. The principal competitors in the U.S. visual identification market are AllFlex USA, Inc. and Y-Tex Corporation, and the principal competitors in the RFID identification market are Avid Identification Systems, Inc., AllFlex, USA, Inc., and Datamars SA. We believe that our intellectual property position and reputation for high quality products are our competitive advantages.

Our principal competitors in Europe are Allflex and Merko. We believe that our efficient low cost production, reputation for high quality ear tags and our clear focus on the market are our competitive advantages. We expect our competitors to continue to improve the performance of and support for their current products. We also expect that, like us, they will introduce new products, technologies or services. Our competitors new or upgraded products could adversely affect sales of our current and future products.

Manufacturing; Supply Arrangements

Our Animal Applications segment has not been materially adversely affected by the inability to obtain raw materials or products during the past three years. The segment relies solely on a production arrangement with Raytheon Microelectronics España, a subsidiary of Raytheon Company, (RME), for the assembly of its patented syringe-injectable transponders. The term of that agreement ends on June 30, 2010, subject to earlier termination by either party if, among other things, the other party breaches the agreement and does not remedy the breach within 30 days of receiving notice. Under the agreement, RME is our preferred supplier of the glass encapsulated, syringe-implantable transponders, provided that RME s pricing remains market competitive. Certain of the automated equipment and tooling used in the production of the transponders are owned by us; other automated equipment and tooling is owned by RME. It would be difficult and time-consuming for us to arrange for production of the transponders by a third party. Accordingly, we cannot assure that we would be able to procure alternative manufacturing capability if we are unable to obtain the implantable microchip from RME or another supplier.

Our Animal Applications segment s other principal suppliers are TSI Molding, Inc., BASF Corporation and Creation Technologies. We generally do not enter into contracts with these suppliers.

Table of Contents

GPS and Radio Communications Segment

Principal Products and Services

Our GPS and Radio Communications segment s proprietary products provide location tracking and message monitoring of vehicles, aircraft, and people in remote locations. This segment s principal products are:

- GPS enabled search and rescue equipment and intelligent communications products and services for telemetry, mobile data and radio communications applications, including our SARBE™ brand, which serve commercial and military markets;

- GPS and geosynchronous satellite tracking systems, including tracking software systems for mapping and messaging associated with the security of high-value assets; and

- Alarm sounders for industrial use and other electronic components.

GPS Enabled Search and Rescue Equipment and Intelligent Communications Products

Our Personal Locator Beacons, or PLB s, which are sold under the SARBE brand name are used by military air crew in the event of an ejection or other event requiring emergency evacuation of an aircraft in a remote, possibly hostile location. Our majority owned subsidiary, Signature, which is based in the United Kingdom, has been developing and manufacturing PLB s for five decades. Reports of Second World War airmen and sailors at sea awaiting rescue with little more than the faint hope that a passing ship would find them was the catalyst that inspired Signature to develop a new way of saving lives by making the search part of search and rescue more effective. Today, we believe that we are a world-leading supplier of PLB s and our SARBE trademark is widely considered a generic term for these devices, which are now found on ships, aircraft and submarines in the armed forces of over 40 countries. United Kingdom airmen were among the first to carry these lifesaving devices. Today every Royal Air Force, Royal Navy and Army airman carries a SARBE. PLB s are also packed in the survival packs of life rafts on military ships. Our latest generation SARBE for military personnel is the software-defined SARBE G2R, which provides true global reach and recovery. This programmable radio features peacetime and combat modes. As with previous PLB s, G2R can be configured to operate with any fast jet ejection seat and incorporates a specially designed system that automatically activates the beacon and deploys the antenna to the optimum position. This ensures that even if aircrew are unconscious or injured, the SARBE transmission will be initiated immediately as no human intervention is required, reducing the time it takes to initiate a search. Our SARBE™ G2R has been approved to operate on the COSPAS-SARSAT Satellite System. COSPAS-SARSAT is the internationally funded satellite system operator that detects activated search and rescue beacons and is responsible for approving all rescue beacons.

We are also a distributor of two-way communications equipment in the United Kingdom. Our products range from conventional radio systems for the majority of radio users, for example, safety and security, construction, manufacturing, and trunked radio systems for large scale users, for example local authorities and public utilities. We also offer marine radios, air band radios and Immarsat communication equipment for use on a global basis.

GPS and Geosynchronous Satellite Tracking Systems

Our GPS and geosynchronous satellite tracking systems, which are sold through our wholly-owned subsidiary, OuterLink Corporation, or OuterLink, include tracking software systems for mapping, automatic vehicle location, and voice and text messaging. These systems provide security of high-value assets, such as airplanes, helicopters, trucks, ambulances and marine fleet. The systems consist of a terminal, interface/display units, antennas, management software and messaging and voice services. Mounted in either mobile or fixed assets, our terminals are bi-directional satellite transceivers that provide remote processing and interface to sensors, switches and real-time GPS services. Our terminals interface with display units to deliver arm/disarm control, 2-way text and voice messaging and emergency alerts. We provide a variety of antennas that match environmental, operational and installation equipment. Our CommTrack 2007 system software is a powerful base-station platform for mobile resource management. Our real-time, 2-way data voice and voice messaging services between operation centers and mobile assets allow for automatic flight following asset tracking and fleet management.

Alarm Sounders

We also manufacture electronic alarm sounders under the Clifford & Snell name. These products are used to provide audible and or visual signals, which alert personnel in hazardous areas, including the oil and petrochemical industry, and in the fire and security market. Our recent Yodalex explosion proof sounders and strobes include an omni-directional, high-sound output with sounder/strobe combination all sharing a common explosion proof enclosure.

Table of Contents

Growth Strategy

We believe that our PLB s offer the greatest source of growth for our GPS and Radio Communications segment. We expect to see an increase in the demand for our beacons over the next two years as air forces upgrade their gear. Air forces in the United Kingdom and the U.S. will be required to replace their existing beacons with the new generation 406 MHz beacons in the future. In August 2006, we were awarded a contract by the U.S. Air Force to develop a new survival radio for military aircraft. We were one of only two companies to win the contract to develop a new radio to replace the URT33, which is carried in aircrew survival packs and sets off a distress signal in an emergency. The URT33 will become obsolete when existing frequencies on 121.5 and 243 MHz cease to be monitored by COSPAS-SARSAT on February 1, 2009.

In addition, on December 14, 2006, Signature, our London-based subsidiary, entered into an agreement to acquire certain assets and customer contracts of McMurdo Ltd., a U.K. manufacturer of emergency location beacons, from Chemring Group PLC. McMurdo has a worldwide distribution network of approximately 60 outlets. We believe this acquisition will increase the revenue base of our survival radio business and significantly broadens our product offerings in both the maritime and military sectors.

We are also developing, under a joint venture agreement, an automatically activated and deployed emergency radio for the Royal Netherlands Navy, which will alert rescue authorities and pinpoint a stricken submarine submerged or on the surface. We are also pursing opportunities to supply beacons to Scorpene submarines that have been ordered by the Navies of Malaysia, India and Chile.

We believe that another significant growth opportunity will come in the next few years when the Galileo GNNS network of satellites is launched and becomes operational. This European GNNS system is set to begin satellite launches in 2007 and is likely to add the facility for a confirmation message to be relayed back to the active beacon, so those awaiting rescue will know immediately that their signal has been received and that help is at hand; something the present satellite structure can t do. It will add an additional degree of confidence to anyone in distress with a PLB.

Sales and Distribution

We sell our PLB s and our GPS and Geosynchronous Satellite Tracking Systems directly to our customers through a direct sales force of approximately six personnel, and through supply and distribution agreements, which have varying expiration dates. The remaining terms of such agreements are between one and three years.

We sell our alarm sounders through various distributors located in Europe, Australia, New Zealand, Hong Kong, Japan, South Africa Singapore and the U.S. We are also a distributor of two-way communication equipment in the United Kingdom. Our agreements with these distributors have varying expiration dates.

Competition

Principal methods of competition in our GPS and Radio Communications segment include geographic coverage, service and product performance. The principal competitors for our PLB s are Boeing North American Inc., General Dynamics Decision Systems, Tadiran Spectralink Ltd., Becker Avionic Systems, and ACR Electronics, Inc. We believe that being first to market with GPS in our search and rescue beacons as well as the use of our search and rescue beacons in over forty countries are competitive advantages. In addition, the barriers to entry in this market are high due to the technical demands of the market.

The principal competitors for our GPS and Geosynchronous Satellite Tracking Systems are Blue Sky Networks, Sky Connect and Comtech Mobile Data Com. We believe our competitive advantages are lower cost communications, more frequent reporting on a near real time basis and the ability to provide additional messaging capabilities in addition to vehicle tracking.

Manufacturing; Supply Arrangements

Our GPS and Radio Communications segment has not been materially or adversely affected by the inability to obtain raw materials or products during the past three years. This segment s principal suppliers are Contract Components LTD., Motorola LTD., and Delta Impact LTD. We generally do not enter into contracts with these suppliers.

Table of Contents

Financial Information About Segments

Revenues from our various segments over the prior three years can be broken down as follows:

	For the Years Ended December 31,		
(In thousands)	**2006**	**2005**	**2004**
Animal Applications	$ 38,058	$ 35,972	$ 25,871
GPS and Radio Communications	18,922	20,854	20,431
Total	$ 56,980	$ 56,826	$ 46,302

Refer to the segment information in Note 19 to our Financial Statements.

Warranties

We offer our customers a limited warranty for a period of between twelve and twenty four months on certain of our products that the products will be free from defects in workmanship and quality. Under the terms of our warranty, we shall, at our sole option, repair or replace the covered products at no cost to our distributor or customer.

Backlog

We generally produce goods to fill orders received and anticipated orders based on distributors forecasts. We also maintain inventories of finished goods to fill customer orders with short lead times. As a result, we generally do not have a significant backlog of orders, and any such backlog is not indicative of future sales.

Research and Development

During 2006, we spent $4.8 million ($2.7 million in the Animal Applications segment and $2.1 million in the GPS and Radio Communications segment) on research and development activities relating to the development of new products or improvements of existing products. We spent $4.7 million ($3.0 million in the Animal Applications segment and $1.7 million in the GPS and Radio Communications segment) in 2005 and $2.8 million ($2.2 million in the Animal Applications segment and $0.6 million in the GPS and Radio Communications segment) in 2004.

Government Agreements

Customers for our electronic identification devices for fish include government contractors that rely on funding from the United States government. Since these contractors rely heavily on government funds, any decline in the availability of such funds could result in a decreased demand by these contractors for our products. Any decrease in demand by such customers could have a material adverse effect on our financial condition and results of operations and result in a decline in the market value of our common stock. The GPS and Radio Communications segment is heavily dependent on contracts with domestic government agencies and foreign governments, primarily relating to military applications. The loss of, or a significant reduction in, orders from these or our other major customers could have a material adverse effect on our financial condition and results of operations.

Employees

As of March 1, 2007 we have 314 full time employees, including 11 in management, 20 in sales positions, 78 in administrative positions, 29 in technical positions and 176 in production positions. Our Animal Applications production workforce is party to a collective bargaining agreement which expires May 31, 2008. We believe our relations with our employees are good.

Table of Contents

Government Regulation

Regulation of RFID Technologies

Our active RFID systems, as well as our RFID systems that use our implantable microchip, rely on low-power, localized use of radio frequency spectrum to operate. As a result, we must comply with numerous laws and regulations in the U.S. and other jurisdictions where we sell our products. These laws and regulations relate to, among other things, the design, testing, marketing, operation and sale of RFID devices, and seek to ensure that such devices do not cause interference to licensed spectrum services, mislead consumers regarding their operational capabilities, or produce emissions that are harmful to human health. In the U.S., the Federal Communications Commission, (or FCC) is the regulatory agency responsible for implementing these regulations and requires that RFID devices, including those we market, and sell must be authorized and comply with all applicable technical standards, operational and design requirements, and labeling requirements prior to being marketed in the U.S. Other countries in which we market and sell our RFID systems impose similar regulatory requirements upon us and often require us to pre-register and clear our products prior to actively marketing and selling to customers. As we enter new markets, the time required to comply with these requirements can delay our ability to actively market and sell our products.

Regulation by the FDA

Generally speaking, unless an exemption applies, each medical device we wish to distribute commercially in the U.S. will require either prior clearance under Section 510(k) of the Federal Food, Drug, and Cosmetic Act, or FFDCA, or a pre-market approval application, or PMA, from the FDA. Medical devices are classified into one of three classes Class I, Class II or Class III depending on the degree of risk to the patient associated with the medical device and the extent of control needed to ensure safety and effectiveness. Devices deemed to pose lower risks are placed in either Class I or II. The manufacturer of a Class II device is typically required to submit to the FDA a pre-market notification requesting permission to commercially distribute the device and demonstrating that the proposed device is substantially equivalent to a previously cleared and legally marketed 510(k) device or a device that was in commercial distribution before May 28, 1976 for which the FDA has not yet called for the submission of a PMA. This process is known as 510(k) clearance. Devices deemed by the FDA to pose the greatest risk, such as life-sustaining, life-supporting or implantable devices, or devices deemed not substantially equivalent to a previously cleared 510(k) device, are generally placed in Class III, requiring pre-market approval.

We have registered with the FDA as a medical device manufacturer. The FDA has broad post-market and regulatory enforcement powers. We are subject to unannounced inspections by the FDA to determine our compliance with the quality system regulation, or QSR, which requires manufacturers, including third-party manufacturers, to follow stringent design, testing, control, documentation, and other quality assurance procedures during all aspects of the manufacturing process. These inspections may include the manufacturing facilities of our suppliers. Our manufacturing facility located in St. Paul, Minnesota, was inspected by the FDA in late May and early June 2006, during which the FDA inspector conducted a routine Level II Quality System Inspectional Technique inspection. During the inspection, the FDA inspector made three verbal observations regarding deviations in our quality system unrelated to our implantable microchip. It is our understanding that we have corrected the three deviations. To our knowledge, the Raytheon Microelectronics España facility has not yet been inspected by the FDA.

Failure to comply with applicable regulatory requirements can result in enforcement action by the FDA, which may include any of the following sanctions:

warning letters, fines, injunctions, consent decrees and civil penalties;

repair, replacement, issuance of refunds, recall or seizure of products;

operating restrictions, partial suspension or total shutdown of production;

refusing requests for 510(k) clearance or pre-market approval of new products, new intended uses or modifications to existing products;

withdrawing 510(k) clearance or pre-market approvals that have already been granted; and

criminal prosecution.

Table of Contents

Federal Aviation Authority and Transport Canada

We are licensed by the FCC to transmit at specified frequencies on satellites. Our aviation equipment must meet the approval of the Federal Aviation Authority and Transport Canada for manufacturing, installation and repair.

National Animal Identification System

The USDA is involved in the development and implementation of a planned National Animal Identification System (NAIS) as well as in the regulation of certain aspects of the companion animal business. While the regulations governing these activities are not yet finalized, we believe that such regulations will have an impact on our operations in the livestock and companion animal markets. Animal products for food producing animals have been reviewed by the FDA s Center for Veterinary Medicine, and the FDA has determined that our product, as presently configured, is unregulated.

Foreign Regulations

In addition to the regulations discussed above, certain of our products are subject to compliance with applicable regulatory requirements in those foreign countries where these products are sold. The contracts we maintain with our distributors in these foreign countries generally require the distributor to obtain all necessary regulatory approvals from the governments of the countries in which these distributors sell our products.

Environmental Matters

We do not anticipate any material effect on our capital expenditures, earnings, or competitive position due to compliance with government regulations involving environmental matters.

Intellectual Property

We own various patents and trademarks which we consider in the aggregate to constitute a valuable asset. We believe certain of our patents may offer a significant competitive advantage and/or barrier to entry in the Animal Applications segments.

Digital Angel and Bio-Thermo are registered trademarks. SARBE has trademark protection in Europe. The following patents are among those owned by us:

U.S. Patent No. 5,211,129, Syringe-Implantable Identification Transponders, issued on May 18, 1993. This patent covers a portion of the implantable microchip technology, which we license to VeriChip. In 1994, Destron/IDI, Inc., a predecessor company to us, granted a co-exclusive license under this patent, other than for certain specific fields of use related to our Animal Application segment, which were retained by the predecessor company, to Hughes Aircraft Company, or Hughes, and its then wholly-owned subsidiary, Hughes Identification Devices, Inc., or HID. We retained all rights to the patent in connection with our animal applications business. This patent expires in 2008.

U.S. Patent No. 7,176,846, Passive Integrated Transponder Tag With Unitary Antenna Core, issued on February 13, 2007 covers our method of manufacturing an RFID microchip wherein the coil and integrated circuit are unified thereby allowing more space for coil material, which enables a greater capture of magnetic field resulting in longer read distance. This patent expires in 2020.

U.S. Patent No. 7,015,826, Method And Apparatus For Sensing And Transmitting A Body Characteristic Of A HOST, issued on March 21, 2006. This patent covers our Bio-Thermo temperature sensing implantable RFID microchip designed for non-laboratory applications that use RFID technology to determine the body temperature of its host animal. This patent expires in 2023.

U.S. Patent No. 5,952,935, Programmable Channel Search Reader, issued on September 14, 1999. This patent covers our RFID tag readers that are capable of reading different RFID tags of different frequencies or differing communications protocols. The patent expires in 2016.

U.S. Patent No. 5,041,826, Identification System, issued on August 20, 1991. This patent covers our RFID tag readers and the communication protocol used to communicate with RFID tags. This patent expires in 2008.

Table of Contents

U.S. Patent No. 5,166,676, Identification System, issued on November 24, 1992. This patent covers our RFID tags and the communication protocol used to communicate with RFID tag readers. This patent expires in 2009.

U.S. Patent No. 6,369,694, Apparatus And Method For Remotely Testing A Passive Integrated Transponder Tag Interrogation System, issued on April 9, 2002. This patent covers our method for remotely testing transponders within a fixed field. This patent expires in 2020.

U.S. Patent No. 6,700,547, Multidirectional Walkthrough Antenna, issued on March 2, 2004. This patent covers our walkthrough antenna for communicating with interrogators used to read information from transponders attached to livestock. This patent expires in 2020.

U.S. Patent No. 6,833,790, Livestock Chute Scanner, issued on December 21, 2004. This patent covers our interrogator device for reading a plurality of transponders including reading a plurality of transponders attached to livestock. This patent expires in 2020.

Seasonality

No significant portion of our business is considered to be seasonal, however, our Animal Applications and GPS and Radio Communications segments revenue, while not considered to be seasonal, may vary significantly based on government procurement cycles and technological development. Our Animal Applications segment s revenues and operating income can be affected by the timing of animal reproduction cycles.

Financial Information About Geographic Areas

Information concerning principal geographic areas as of and for the years ended December 31, 2006, 2005, and 2004, was as follows:

(In thousands)	United States	United Kingdom/Denmark	All Other Foreign Countries	Consolidated
2006				
Net revenue from external customers	$ 29,183	$ 14,970	$ 12,827	$ 56,980
Long-lived assets excluding goodwill and other intangible assets, net	5,797	4,242	220	10,259
2005				
Net revenue from external customers	$ 26,019	$ 16,830	$ 13,977	$ 56,826
Long-lived assets excluding goodwill and other intangible assets, net	4,508	3,824	270	8,602
2004				
Net revenue from external customers	$ 29,743	$ 4,369	$ 12,190	$ 46,302
Long-lived assets excluding goodwill and other intangible assets, net	4,569	1,101	277	5,947

Availability of Reports and Other Information

Our corporate website is www.digitalangelcorp.com. We make available, free of charge, access to our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statement on Schedule 14A and amendments to those materials filed or furnished pursuant to Section 13(a) or 15(d) of the Securities and Exchange Act of 1934 on our website under News-SEC Filings, as soon as reasonably practicable after we file electronically such material with, or furnish it to, the United States Securities and Exchange Commission (the SEC). In addition, the SEC s website is www.sec.gov. The SEC makes available on this website, free of charge, reports, proxy and information statements, and other information regarding issuers, such as us, that file electronically with the SEC. Additionally, our reports, proxy, and information statements may be read and copied at the SEC s public reference room at 100 F. Street, NE, Washington DC 20549. Information on our website or the SEC s website is not

part of this document.

Table of Contents

Item 1A. Risk Factors

We have a history of operating losses and negative cash flows and we may not become profitable in the future, which could ultimately result in our inability to continue operations in the normal course of business.

Historically, we have incurred losses and have generated negative cash flows from operations. We incurred a consolidated loss from continuing operations of $6.8 million, $9.7 million, and $3.9 million in 2006, 2005, and 2004, respectively. Our consolidated operating activities used cash of $5.5 million and $3.2 million during the years ended December 31, 2006 and 2005, respectively and provided cash of $2.5 million during the year ended December 31, 2004. During these periods, we have funded our operating cash requirements, as well as our capital needs, with the proceeds from investing and financing activities.

We expect to continue to incur consolidated operating losses for the foreseeable future. Our ability in the future to achieve or sustain profitability is based on a number of factors, many of which are beyond our control, including the future demand for our RFID and GPS systems. If demand for such systems does not reach anticipated levels, or if we fail to manage our cost structure, we may not achieve or be able to sustain profitability.

As of December 31, 2006, we and our subsidiaries, had cash and cash equivalents aggregating $1.6 million. We believe that we currently have sufficient funds to operate our business over the next twelve months. However, our goal is to achieve profitability and to generate positive cash flows from operations. Our profitability and cash flows from operations depend on many factors, including the success of our marketing programs, the maintenance and reduction of expenses and our ability to successfully develop and bring to market our new products and technologies. If, in the future, we are not successful in managing these factors and achieving our goal of profitability and positive cash flows from operations, we may not have sufficient funds to operate our business, which could ultimately result in our inability to continue operations in the normal course.

The terms of our 10.25% Senior Secured Debenture subject us to the risk of foreclosure on substantially all of our assets and the assets of our subsidiaries.

We may not have sufficient funds to repay our obligations on the 10.25% senior secured debenture when it matures. Accordingly, we may be required to obtain the funds necessary to repay these obligations either through refinancing, the issuance of additional equity or debt securities or the sale of assets. There can be no assurance that we can obtain the funds needed, if any, to repay the obligations from any one or more of these other sources on favorable economic terms or at all. If we are unable to obtain funds to repay this indebtedness, we may be forced to dispose of assets or take other actions on disadvantaged terms, which could result in losses to us and could have a material adverse effect on our financial condition.

To secure the repayment of all debts, liabilities and obligations owed in connection with the 10.25% Senior Secured Indenture, we and our subsidiaries Digital Angel Technology Corporation, OuterLink Corporation, DSD Holding A/S, Signature Industries Limited, Digital Angel International, Inc., and Digital Angel Holdings, LLC have granted to the holder(s) security interests in and liens upon substantially all of our and such subsidiaries property and assets. In addition, such subsidiaries have guaranteed all of our debts, liabilities and obligations to the holder(s). If an event of default occurs under the debenture, we could be required to redeem the debenture at a premium of 110% of outstanding principal and would subject us to foreclosure by the holder(s) of our 10.25% Senior Secured Debenture on substantially all of our and our subsidiaries property and assets to the extent necessary to repay any amounts due. Any such default and resulting foreclosure will have a material adverse effect on our financial condition.

Applied Digital has significant voting control over us. This may delay, prevent or deter corporate actions that may be in the best interest of our stockholders.

As of March 1, 2007, Applied Digital is the beneficial owner of 55.2% of our common stock, and it controls us with respect to all matters upon which our stockholders may vote, including the selection of the Board of Directors, mergers, acquisitions and other significant corporate transactions. This concentration of ownership may have the effect of delaying, preventing, or deterring a change in control of our company even when such a change may be in the best interests of all our stockholders. It could also have the effect of depriving stockholders of an opportunity to receive a premium for their common stock as part of a sale of our company or assets and might affect the prevailing market price of our common stock.

15

Table of Contents

Conflicts of interest may arise among Applied Digital, Verichip and us that could be resolved in a manner unfavorable to us.

Questions relating to conflicts of interest may arise between Applied Digital, our parent company, and/or Verichip, a subsidiary of Applied Digital, on the one hand, and us, on the other, in a number of areas relating to our past and ongoing relationships. The chairman of our board of directors, Scott R. Silverman also serves as the chairman of the board of Applied Digital and Verichip.

Areas in which conflicts of interest between or among Applied Digital, Verichip and us could arise include, but are not limited to, the following:

Cross directorships and stock ownership. The equity interests of our directors in Applied Digital or service as a director of both Applied Digital and us could create, or appear to create, conflicts of interest when directors are faced with decisions that could have different implications for the two companies. For example, these decisions could relate to, among other matters:

- the nature, quality and cost of services rendered to us by Applied Digital;
- the desirability of a potential acquisition or joint venture opportunity;
- employee retention or recruiting; and
- our dividend policy.

Intercompany transactions. From time to time, Applied Digital or its affiliates, including Verichip, may enter into transactions with us or our subsidiaries or other affiliates. Although the terms of any such transactions will be established based upon negotiations between employees of Applied Digital and/or the applicable affiliate and us and, when appropriate, subject to the approval of the independent directors on our board or a committee of disinterested directors, there can be no assurance that the terms of any such transactions will be as favorable to us or our subsidiaries or affiliates as may otherwise be obtained in arm s-length negotiations with an unaffiliated third party.

Intercompany agreements. We are the sole supplier of our implantable microchip under an agreement with Verichip. The terms of this agreement were established while we and Verichip were controlled by Applied Digital and were not the result of arm s-length negotiations. In addition, conflicts could arise in the interpretation, or in connection with any extension or renegotiation, of the existing agreement.

Since we are controlled by Applied Digital, certain independence protections provided by the AMEX Rules are currently not in place.

As we are controlled by Applied Digital, we are not required to comply with certain rules and requirements of the American Stock Exchange, which we refer to as the AMEX Rules. Specifically, we are not required to have a majority of independent directors or an independent Nominating Committee. Instead, our full Board of Directors considers and nominates candidates proposed for election. One of our six directors serves as a director of Applied Digital. Therefore, certain independence protections provided by the AMEX Rules are not currently in place.

We obtain the implantable microchip used in our Animal Applications segment s products from a single supplier, making us vulnerable to supply disruptions that could constrain our sales of such systems and/or increase our per-unit cost of production of the microchip.

We obtain the implantable microchip used in our Animal Applications segment s products from RME, the actual manufacturer, under a supply agreement between us and RME. The term of that agreement expires on June 30, 2010, subject to earlier termination by either party if, among other things, the other party breaches the agreement and does not remedy the breach within 30 days of receiving notice. We and RME each own certain of the automated equipment and tooling used in the manufacture of the microchip. Accordingly, it would be difficult for us to arrange for a third party, other than RME, to manufacture the implantable microchip if for any reason RME was unable or unwilling to manufacture the implantable microchip or if RME did not manufacture sufficient implantable microchips for us to satisfy our requirements. Even if we were able to arrange to have the implantable microchip manufactured in another facility, we currently believe making such arrangements and commencement of production could take at least three to six months. A supply disruption of this length could cause customers to cancel orders, negatively affect future sales,

and damage our business reputation. In addition, the per-unit cost of production at another facility could be more than the price per unit that we currently pay.

Table of Contents

We compete with other companies in the visual and electronic identification and pilot locator beacon markets, and the products sold by our competitors could become more popular than our products or render our products obsolete.

The markets for visual and electronic identification and pilot locator beacon products are highly competitive. We believe that our principal competitors in the visual identification market for livestock are AllFlex USA and Y-Tex Corporation, that our principal competitors in the electronic identification market are AllFlex USA, Datamars SA and Avid Identification Systems, Inc. and that our principal competitors in the pilot locator beacon market are Boeing North American Inc., General Dynamics Decision Systems, Tadiran Spectralink Ltd., Becker Avionic Systems, and ACR Electronics, Inc.

In addition, other companies could enter this line of business in the future. Many of our competitors have substantially greater financial and other resources than us. We may not be able to compete successfully with these competitors, and those competitors may develop or market technologies and products that are more widely accepted than ours or that would render our products obsolete or noncompetitive.

The expiration of patents in 2008 and 2009 covering the implantable microchip technology used in our Animal Applications segment will expose us to potential competition that may have a material adverse effect on our sales and results of operations.

We rely on patents covering our implantable microchip technology used in our Animal Applications segment. For the year ended December 31, 2006, sales of our products relying on this technology were $13.8 million. These patents expire in 2008 and 2009. Without patent protection, our competitors may independently develop similar technology or duplicate our systems, which may have a material adverse effect on our sales and results of operations.

Infringement by third parties on our intellectual property or development of substantially equivalent proprietary technology by our competitors could negatively affect our business.

Our success depends significantly on our ability to:

maintain patent and trade secret protection;

obtain future patents and licenses; and

operate without infringing on the proprietary rights of third parties.

There can be no assurance that the measures we have taken to protect our intellectual property will prevent the misappropriation or circumvention of our intellectual property. In addition, there can be no assurance that any patent application, when filed, will result in an issued patent, or that our existing patents, or any pate