DIGI INTERNATIONAL INC
Form 10-Q
January 31, 2017

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

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: December 31, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .
Commission file number: 1-34033
DIGI INTERNATIONAL INC.
(Exact name of registrant as specified in its charter)

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

11001 Bren Road East

Minnetonka, Minnesota	55343
(Address of principal executive offices)	(Zip Code)

(952) 912-3444
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

On January 25, 2017, there were 26,430,854 shares of the registrant's $.01 par value Common Stock outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	Three months ended December 31,	
	2016	2015
	(in thousands, except per share data)	
Revenue:		
Hardware product	$43,173	$48,247
Service	2,002	2,012
Total revenue	45,175	50,259
Cost of sales:		
Cost of hardware product	22,438	24,710
Cost of service	1,284	1,192
Total cost of sales	23,722	25,902
Gross profit	21,453	24,357
Operating expenses:		
Sales and marketing	8,322	8,518
Research and development	6,905	7,838
General and administrative	3,804	4,061
Restructuring charge	—	651
Total operating expenses	19,031	21,068
Operating income	2,422	3,289
Other income, net:		
Interest income	159	108
Interest expense	(33)	(8)
Other income, net	574	123
Total other income, net	700	223
Income from continuing operations, before income taxes	3,122	3,512
Income tax provision	765	381
Income from continuing operations	2,357	3,131
Income from discontinued operations, after income taxes	—	3,319
Net income	$2,357	$6,450
Basic net income per common share:		
Continuing operations	$0.09	$0.12
Discontinued operations	$—	$0.13
Net income	$0.09	$0.25
Diluted net income per common share:		
Continuing operations	$0.09	$0.12
Discontinued operations	$—	$0.13

Net income	$0.09	$0.25
Weighted average common shares:		
Basic	26,175	25,331
Diluted	26,972	26,171

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

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

	Three months ended December 31,	
	2016	2015
	(in thousands)	
Net income	$2,357	$6,450
Other comprehensive loss, net of tax:		
Foreign currency translation adjustment	(3,755)	(1,867)
Change in net unrealized loss on investments	(24)	(63)
Less income tax benefit	9	23
Reclassification of realized gain on investments included in net income (1)	—	(7)
Less income tax benefit (2)	—	3
Other comprehensive loss, net of tax	(3,770)	(1,911)
Comprehensive (loss) income	$(1,413)	$4,539

(1) Recorded in Other income, net on our Condensed Consolidated Statements of Operations.
(2) Recorded in Income tax provision in our Condensed Consolidated Statements of Operations.
The accompanying notes are an integral part of the condensed consolidated financial statements.

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DIGI INTERNATIONAL INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	December 31, 2016	September 30, 2016
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$81,142	$ 75,727
Marketable securities	51,939	58,382
Accounts receivable, net	28,005	28,685
Inventories	24,338	26,276
Receivable from sale of business	1,968	2,997
Other	4,623	3,578
Total current assets	192,015	195,645
Marketable securities, long-term	3,275	3,541
Property, equipment and improvements, net	13,983	14,041
Identifiable intangible assets, net	4,299	4,041
Goodwill	111,116	109,448
Deferred tax assets	6,644	7,295
Receivable from sale of business	—	1,959
Other	147	196
Total assets	$331,479	$ 336,166
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$7,924	$ 8,569
Income taxes payable	163	167
Accrued compensation	3,968	10,787
Accrued warranty	1,025	1,033
Contingent consideration on acquired business	1,841	513
Other	2,861	2,739
Total current liabilities	17,782	23,808
Income taxes payable	1,367	1,490
Deferred tax liabilities	575	616
Contingent consideration on acquired businesses	8,819	9,447
Other non-current liabilities	828	776
Total liabilities	29,371	36,137
Contingencies (see Note 11)		
Stockholders' equity:		
Preferred stock, $.01 par value; 2,000,000 shares authorized; none issued and outstanding	—	—
Common stock, $.01 par value; 60,000,000 shares authorized; 32,826,739 and 32,471,175 shares issued	328	325
Additional paid-in capital	241,115	237,492
Retained earnings	143,469	141,112
Accumulated other comprehensive loss	(28,461)	(24,691)
Treasury stock, at cost, 6,429,147 and 6,430,797 shares	(54,343)	(54,209)
Total stockholders' equity	302,108	300,029

Total liabilities and stockholders' equity	$331,479	$ 336,166

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

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

	Three months ended December 31,	
	2016	2015
	(in thousands)	
Operating activities:		
Net income	$2,357	$6,450
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation of property, equipment and improvements	656	724
Amortization of identifiable intangible assets	345	468
Stock-based compensation	1,173	816
Excess tax benefits from stock-based compensation	(183)	(190)
Deferred income tax provision	619	1,300
Gain on sale of business	—	(2,912)
Change in fair value of contingent consideration	(82)	—
Bad debt/product return provision	264	168
Inventory obsolescence	450	409
Restructuring charges	—	651
Other	(12)	40
Changes in operating assets and liabilities	(7,622)	(4,369)
Net cash (used in) provided by operating activities	(2,035)	3,555
Investing activities:		
Purchase of marketable securities	(25,470)	(8,079)
Proceeds from maturities of marketable securities	32,155	7,106
Proceeds from sale of Etherios	3,000	2,866
Acquisition of business, net of cash acquired	(1,690)	(2,860)
Purchase of property, equipment, improvements and certain other identifiable intangible assets	(554)	(545)
Net cash provided by (used in) investing activities	7,441	(1,512)
Financing activities:		
Acquisition earn-out payments	(518)	—
Excess tax benefits from stock-based compensation	183	190
Proceeds from stock option plan transactions	2,787	5,752
Proceeds from employee stock purchase plan transactions	297	301
Purchases of common stock	(390)	(403)
Net cash provided by financing activities	2,359	5,840
Effect of exchange rate changes on cash and cash equivalents	(2,350)	(711)
Net increase in cash and cash equivalents	5,415	7,172
Cash and cash equivalents, beginning of period	75,727	45,018
Cash and cash equivalents, end of period	$81,142	$52,190
Supplemental schedule of non-cash investing and financing activities:		
Receivable related to sale of Etherios	$—	$5,015
Liability related to acquisition of business	$(1,300)	$(10,550)
Accrual for purchase of property, equipment, improvements and certain other identifiable intangible assets	$(105)	$—

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

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

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

Basis of Presentation
The interim unaudited condensed consolidated financial statements included in this Form 10-Q have been prepared by Digi International Inc. (the "Company," "Digi," "we," "our," or "us") pursuant to the rules and regulations of the United States Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures, normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"), have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto, including (but not limited to) the summary of significant accounting policies, presented in our Annual Report on Form 10-K for the year ended September 30, 2016, as filed with the SEC ("2016 Financial Statements").
The condensed consolidated financial statements presented herein reflect, in the opinion of management, all adjustments which consist only of normal, recurring adjustments necessary for a fair presentation of the condensed consolidated balance sheets and condensed consolidated statements of operations, comprehensive (loss) income and cash flows for the periods presented. The condensed consolidated results of operations for any interim period are not necessarily indicative of results for the full year. The year-end condensed consolidated balance sheet data were derived from our 2016 Financial Statements, but do not include all disclosures required by U.S. GAAP.
Recently Issued Accounting Pronouncements
Adopted
In April 2015, Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2015-05, "Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40) - Customer's Accounting for Fees Paid in a Cloud Computing Arrangement." The new standard provides guidance to customers about whether a cloud computing arrangement includes a software license. If the arrangement does include a software license, the software license element of the arrangement should be accounted for in the same manner as the acquisition of other software licenses. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015, with early adoption permitted. We adopted this guidance beginning with our fiscal quarter ending December 31, 2016. The adoption of this standard did not have a material impact on our consolidated financial statements.
Not Yet Adopted
In August 2016, FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments." The amendments in this update provide guidance on eight specific cash flow issues, thereby reducing the diversity in practice in how certain transaction are classified in the statement of cash flows. This ASU is effective for annual periods and interim periods for those annual periods beginning after December 15, 2017, which for us is the first quarter ended December 31, 2018. Early adoption is permitted. We are currently evaluating the impact of the adoption of ASU 2016-15 on our consolidated financial statements.
In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments." The amendments in this update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses. This update is intended to provide financial statement users with more decision-useful information about the expected credit losses. This ASU is effective for annual periods and interim periods for those annual periods beginning after December 15, 2019, which for us is the first quarter ended December 31, 2020. Entities may early adopt beginning after December 15, 2018. We are currently evaluating the impact of the adoption of ASU 2016-13 on our consolidated financial statements.
In March 2016, FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting." This update includes provisions intended to simplify various aspects related to how share-based payments are accounted for

and presented in the financial statements. This ASU is effective for annual periods and interim periods within those annual periods beginning after December 15, 2016, which for us is the first fiscal quarter ending December 31, 2017. Early adoption is permitted. We will adopt ASU 2016-09 beginning October 1, 2017. We are currently evaluating the impact of the adoption of ASU 2016-09

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

on our consolidated financial statements. Prospectively, beginning October 1, 2017, excess tax benefits and tax deficiencies will be reflected as income tax benefit or expense in our Consolidated Statement of Operations and could result in a material impact. The extent of the excess tax benefits or tax deficiencies are subject to variation in our stock price and the timing of RSU vestings and employee stock option exercises.

In February, 2016, FASB issued ASU 2016-02, “Leases (Topic 842)”, which amends the existing guidance to require lessees to recognize lease assets and lease liabilities from operating leases on the balance sheet. This ASU is effective using the modified retrospective approach for annual periods and interim periods within those annual periods beginning after December 15, 2018, which for us is the first fiscal quarter ending December 31, 2019. Early adoption is permitted. We are currently evaluating the impact of the adoption of ASU 2016-02 on our consolidated financial statements.

In January 2016, FASB issued ASU 2016-01, “Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities.” ASU 2016-01 will require equity investments in unconsolidated entities (other than those accounted for using the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. The amendments in this update will also simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, eliminate the requirement for public business entities to disclose the method and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet and require these entities to use the exit price notion when measuring fair value of financial instruments for disclosure purposes. This ASU would also change the presentation and disclosure requirements for financial instruments. In addition, this ASU clarifies the guidance related to valuation allowance assessment when recognizing deferred tax assets resulting from unrealized losses on available-for-sale debt securities. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, which for us is the first fiscal quarter ending December 31, 2018. Early adoption is permitted for financial statements of fiscal years and interim periods that have not been issued. We are currently evaluating the impact of the adoption of ASU 2016-01.

In July 2015, FASB issued ASU 2015-11, “Simplifying the Measurement of Inventory.” This provision would require inventory that was previously recorded using first-in, first-out (“FIFO”) to be recorded at lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This guidance is effective for fiscal years beginning after December 15, 2016 and interim periods within those years, which for us will be the first fiscal quarter ending December 31, 2017. The amendments in this guidance should be applied prospectively with earlier application permitted as of the beginning of an interim or annual period. We are currently evaluating the impact of the adoption of ASU 2015-11 and whether it would have a material impact on our consolidated financial statements.

In August 2014, FASB issued ASU 2014-15, “Presentation of Financial Statements - Going Concern.” This guidance requires management to evaluate whether there is substantial doubt about a company’s ability to continue as a going concern and to provide related footnote disclosures. These amendments are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter, which for us, will be our annual period ended September 30, 2017. Early adoption is permitted. While we are evaluating the impact of the adoption of ASU 2014-15, we do not expect it to have an impact on our consolidated financial statements.

In May 2014, FASB issued ASU 2014-09, “Revenue from Contracts with Customers.” This guidance provides a five-step analysis in determining when and how revenue is recognized so that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods and services. It also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued ASU 2015-14 “Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date” which approved a one-year deferral of the effective date of ASU 2014-09. As a result of this deferral, ASU 2014-09 is effective for our fiscal 2019, including interim periods within that reporting period. The FASB also agreed to allow us to choose to adopt the standard effective for our fiscal 2018. In addition, the FASB issued ASU 2016-08, ASU

2016-10 and ASU 2016-12 in March 2016, April 2016 and May 2016, respectively, to provide interpretive clarifications on the new guidance in ASC Topic 606. We are currently working through an adoption plan and have identified our revenue streams and completed a preliminary analysis of how we currently account for revenue transactions compared to the revenue accounting required under the new standard. We intend to complete our adoption plan in fiscal 2017. This plan includes a review of transactions supporting each revenue stream to determine the impact of

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

accounting treatment under ASC 606, evaluation of the method of adoption, and completing a rollout plan for implementation of the new standard with affected functions in our organization. Because of the nature of the work that remains, at this time we are unable to reasonably estimate the impact of adoption on our consolidated financial statements. We plan to adopt the new guidance beginning October 1, 2018.

2. ACQUISITION

Acquisition of FreshTemp, LLC

On November 1, 2016, we purchased all of the outstanding interests of FreshTemp, LLC (“FreshTemp”), a Pittsburgh-based provider of temperature monitoring and task management solutions for the food industry. We believe this is a complementary acquisition for us as the acquired technology will continue to be supported to create an advanced portfolio of products for the Digi Cold Chain Solution's market.

The terms of the acquisition included an upfront cash payment together with future earn-out payments and a holdback amount. Cash of $1.7 million was paid at time of closing. The earn-out payments are based on revenue related to certain customer contracts entered into by June 30, 2017. The final calculation date will be on June 30, 2018. The cumulative amount of these earn-out payments will not exceed $2.3 million. The fair value of this contingent consideration was $1.3 million at the date of acquisition (see Note 7 to the Condensed Consolidated Financial Statements). We have determined that the earn-out will be considered as part of the purchase price consideration as there are no continuing employment requirements associated with the earn-out. Costs directly related to the acquisition, including legal, accounting and valuation fees, of approximately $0.1 million have been charged directly to operations and are included in general and administrative expense in our Condensed Consolidated Statements of Operations for the first quarter of fiscal 2017.

The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The purchase price allocation resulted in the recognition of $2.7 million of goodwill, all of which is expected to be deductible for tax purposes. We believe that the acquisition resulted in the recognition of goodwill because this is a complementary acquisition for us and will provide a source of recurring revenue in a new vertically focused solutions business.

Operating results for FreshTemp are included in our Condensed Consolidated Statements of Operations from November 1, 2016. The Condensed Consolidated Balance Sheet as of December 31, 2016 reflects the preliminary allocation of the purchase price to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The identifiable intangibles values and net working capital values are preliminary and we expect to finalize them in the second fiscal quarter of 2017.

The FreshTemp acquisition has been accounted for using the acquisition method of accounting which requires, among other things, that assets acquired and liabilities assumed pursuant to the purchase agreement be recognized at fair value as of the acquisition date.

The following table summarizes the preliminary values of FreshTemp assets acquired and liabilities assumed as of the acquisition date (in thousands):

Cash	$1,690
Purchase price payable upon completion of diligence matters	310
Fair value of contingent consideration on acquired business	1,300
Total purchase price consideration	$3,300
Fair value of net tangible assets acquired	$(37)
Fair value of identifiable intangible assets acquired:	
Purchased and core technology	350
Customer relationships	250
Goodwill	2,737
Total	