

DIGITAL RIVER INC /DE
Form 10-Q
August 14, 2002

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2002

OR

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

FOR THE TRANSITION PERIOD FROM TO

Commission file number 000-24643

DIGITAL RIVER, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE
(State or other jurisdiction of
incorporation or organization)

41-1901640
(I.R.S. Employer
Identification Number)

9625 WEST 76TH STREET, SUITE 150
EDEN PRAIRIE, MINNESOTA 55344
(Address of principal executive offices)

(952) 253-1234
(Registrant's telephone number, including area code)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

COMMON STOCK, \$0.01 PAR VALUE
(Class)

26,904,097 SHARES
Outstanding as of August 12, 2002

DIGITAL RIVER, INC.

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****DIGITAL RIVER, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share data)

| | June 30, 2002 | December 31, 2001 |
|---|--------------------------|------------------------------|
| | (unaudited) | |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 18,710 | \$ 21,677 |
| Short-term investments | 13,459 | 9,978 |
| Accounts receivable, net | 11,079 | 8,719 |
| Prepaid expenses and other | 1,371 | 1,455 |
| Total current assets | 44,619 | 41,829 |
| PROPERTY AND EQUIPMENT, net | 16,226 | 16,146 |
| GOODWILL | 16,206 | 11,273 |
| CUSTOMER BASE, NONCOMPETE AGREEMENTS, TECHNOLOGY/TRADENAME, and OTHER, net | 10,909 | 8,979 |
| | \$ 87,960 | \$ 78,227 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Notes payable | \$ | \$ 2,500 |
| Accounts payable | 29,961 | 19,360 |
| Accrued payroll | 2,433 | 2,803 |
| Deferred revenue | 1,168 | 1,106 |
| Other accrued liabilities | 3,720 | 2,036 |
| Total current liabilities | 37,282 | 27,805 |
| STOCKHOLDERS EQUITY: | | |
| Preferred Stock, \$.01 par value; 5,000,000 shares authorized; no shares issued or outstanding | | |
| Common Stock, \$.01 par value; 60,000,000 shares authorized; 26,879,734 and 26,462,905 shares issued and outstanding, respectively | 269 | 265 |
| Additional paid-in capital | 157,401 | 153,308 |
| Deferred compensation | | (37) |
| Accumulated deficit | (106,992) | (103,114) |

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| | | |
|----------------------------|-----------|-----------|
| Total stockholders' equity | 50,678 | 50,422 |
| | \$ 87,960 | \$ 78,227 |

See accompanying notes to condensed consolidated financial statements.

DIGITAL RIVER, INC.**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data; unaudited)

| | Three months ended | | Six months ended | |
|---|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2002 | 2001 | 2002 | 2001 |
| REVENUE | \$ 19,347 | \$ 13,055 | \$ 37,417 | \$ 26,102 |
| COSTS AND EXPENSES (exclusive of depreciation and amortization expense shown separately below): | | | | |
| Direct cost of services | 556 | 655 | 1,171 | 1,212 |
| Network and infrastructure | 2,810 | 2,494 | 5,522 | 5,458 |
| Sales and marketing | 8,402 | 6,480 | 16,415 | 13,265 |
| Product research and development | 3,289 | 2,729 | 6,563 | 5,198 |
| General and administrative | 1,708 | 1,005 | 3,323 | 2,102 |
| Litigation and other charges | | | 2,500 | |
| Depreciation and amortization | 1,436 | 1,177 | 2,810 | 2,297 |
| Amortization of goodwill and other intangibles and acquisition related costs | 1,651 | 3,839 | 3,200 | 8,483 |
| Total costs and expenses | 19,852 | 18,379 | 41,504 | 38,015 |
| LOSS FROM OPERATIONS | (505) | (5,324) | (4,087) | (11,913) |
| INTEREST INCOME | 157 | 262 | 209 | 610 |
| NET LOSS | \$ (348) | \$ (5,062) | \$ (3,878) | \$ (11,303) |
| BASIC AND DILUTED NET LOSS PER SHARE | \$ (0.01) | \$ (0.21) | \$ (0.15) | \$ (0.48) |
| BASIC AND DILUTED WEIGHTED AVERAGE COMMON SHARES OUTSTANDING | 26,688 | 24,383 | 26,569 | 23,432 |

See accompanying notes to condensed consolidated financial statements.

DIGITAL RIVER, INC.**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands; unaudited)

| | Six months ended June 30, | |
|---|--------------------------------------|------------------|
| | 2002 | 2001 |
| OPERATING ACTIVITIES: | | |
| Net loss | \$ (3,878) | \$ (11,303) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: | | |
| Amortization of goodwill and other intangibles and acquisition related costs | 3,200 | 8,483 |
| Depreciation and amortization | 2,810 | 2,297 |
| Deferred compensation expense | 37 | 101 |
| Litigation and other charges | 2,500 | |
| Change in operating assets and liabilities: | | |
| Accounts receivable and prepaid expenses | (2,299) | (1,707) |
| Accounts payable | 6,860 | 1,596 |
| Other current liabilities and deferred revenue | (1,989) | (55) |
| Net cash provided (used in) by operating activities | 7,241 | (588) |
| INVESTING ACTIVITIES: | | |
| Sales (purchases) of investments, net | (3,481) | 9,000 |
| Cash paid for acquisitions, net of cash received | (2,778) | (307) |
| Purchases of equipment | (2,636) | (3,140) |
| Patent acquisition costs | | (7) |
| Net cash provided by (used in) investing activities | (8,895) | 5,546 |
| FINANCING ACTIVITIES: | | |
| Exercise of stock options and warrants | 807 | 193 |
| Sales of Common Stock | 380 | 267 |
| Repurchase of Common Stock | | (225) |
| Repayment of notes payable | (2,500) | |
| Net cash provided by (used in) financing activities | (1,313) | 235 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (2,967) | 5,193 |
| CASH AND CASH EQUIVALENTS, beginning of period | 21,677 | 16,920 |
| CASH AND CASH EQUIVALENTS, end of period | \$ 18,710 | \$ 22,113 |
| SUPPLEMENTAL CASH FLOW DISCLOSURE: | | |
| Common Stock issued in acquisitions and earn-outs | \$ | \$ 10,386 |

See accompanying notes to condensed consolidated financial statements.

DIGITAL RIVER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION:

The unaudited condensed consolidated financial statements included herein reflect all adjustments, consisting only of normal recurring adjustments, which in the opinion of management are necessary to fairly state the Company's consolidated financial position, results of operations and cash flows for the periods presented. These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements included in the Company's Form 10-K for the year ended December 31, 2001 as filed with the Securities and Exchange Commission. The results of operations for the three and six months ended June 30, 2002 are not necessarily indicative of the results to be expected for any subsequent quarter or for the entire fiscal year ending December 31, 2002. The December 31, 2001 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

2. PRINCIPLES OF CONSOLIDATION

The condensed consolidated financial statements include the accounts of Digital River, Inc. and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

3. NET LOSS PER SHARE

Basic loss per common share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the year. The computation of diluted earnings per common share is similar to the computation of basic loss per common share, except that the denominator is increased for the assumed conversion of convertible securities and the exercise of dilutive options using the treasury stock method. The weighted average shares used in computing basic and diluted loss per share were the same in each of the three-month and six-month periods ended June 30, 2002 and 2001. Stock options and warrants totaling 6,652,834 and 7,538,063 for the three and six month periods ended June 30, 2002 and 2001, respectively, were excluded from the computation of loss per share as their effect is antidilutive.

4. GOODWILL AND INTANGIBLE ASSETS

In July 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations and No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives will no longer be amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. For acquisitions consummated by the Company subsequent to July 1, 2001, the Company adopted the provisions of SFAS No. 141 and 142 effective July 1, 2001. The Company has adopted the full provisions of SFAS No. 141 and 142 during the first quarter of 2002.

The Company has assessed goodwill impairment using a two-step approach based on reportable segments and reassessed any intangible assets, including goodwill, recorded in connection with earlier acquisitions. The Company's assessment has indicated that there is no impairment of goodwill or other intangibles during the first quarter of 2002.

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Upon adoption of SFAS No. 142, the Company discontinued the amortization of goodwill. The following table presents a reconciliation of net loss and net loss per share adjusted for the exclusion of goodwill amortization:

| | Three months ended June 30, | | Six months ended June 30, | |
|-----------------------------|--------------------------------|----------------|------------------------------|-----------------|
| | 2002 | 2001 | 2002 | 2001 |
| Reported net loss | \$ (348,000) | \$ (5,062,000) | \$ (3,878,000) | \$ (11,303,000) |
| Add goodwill amortization | | 2,661,000 | | 4,956,000 |
| Adjusted net loss | \$ (348,000) | \$ (2,401,000) | \$ (3,878,000) | \$ (6,347,000) |
| Reported net loss per share | \$ (0.01) | \$ (0.21) | \$ (0.15) | \$ (0.48) |
| Add goodwill amortization | | 0.11 | | 0.21 |
| Adjusted net loss per share | \$ (0.01) | \$ (0.10) | \$ (0.15) | \$ (0.27) |

The changes in the carrying amount of goodwill for the six months ended June 30, 2002, by operating segment, are as follows:

| | Software and Digital Commerce Services Division | E-Business Services Division | Total |
|-------------------------------------|---|---------------------------------|---------------|
| Balance as of December 31, 2001 | \$ 8,280,000 | \$ 2,993,000 | \$ 11,273,000 |
| Goodwill acquired during the period | 298,000 | 4,635,000 | 4,933,000 |
| Balance as of June 30, 2002 | \$ 8,578,000 | \$ 7,628,000 | \$ 16,206,000 |

Information regarding the Company's other intangible assets is as follows:

| | Carrying amount | As of June 30, 2002 Accumulated amortization | Net |
|------------------------|--------------------|--|---------------|
| Customer base | \$ 14,117,000 | \$ 6,575,000 | \$ 7,542,000 |
| Non compete agreements | 3,150,000 | 2,111,000 | 1,039,000 |
| Technology/tradename | 5,675,000 | 3,372,000 | 2,303,000 |
| Total | \$ 22,942,000 | \$ 12,058,000 | \$ 10,884,000 |

| | Carrying amount | As of December 31, 2001 Accumulated amortization | Net |
|---------------|--------------------|--|--------------|
| Customer base | \$ 9,317,000 | \$ 4,728,000 | \$ 4,589,000 |

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| | | | |
|------------------------|---------------|--------------|--------------|
| Non compete agreements | 3,050,000 | 1,610,000 | 1,440,000 |
| Technology/tradename | 5,425,000 | 2,520,000 | 2,905,000 |
| Total | \$ 17,792,000 | \$ 8,858,000 | \$ 8,934,000 |

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Amortization expense for the six months ended June 30, 2002 was \$3,200,000. Estimated amortization expense for the remaining life of the intangible assets, based on intangible assets as of June 30, 2002, is as follows:

Year ending December 31,

| | | |
|------|----|-----------|
| 2002 | \$ | 5,738,000 |
| 2003 | | 4,727,000 |
| 2004 | | 3,190,000 |
| 2005 | | 429,000 |

5. ACQUISITIONS AND EARN-OUT ARRANGEMENTS

In March 2002, pursuant to an Asset Purchase Agreement between the Company and Innuity Acquisition Corp. (IAC), the Company purchased certain assets and assumed approximately \$3,600,000 in merchant liabilities in exchange for approximately \$2,400,000 in cash. The Company will amortize intangible assets acquired, consisting of customer base, non-compete agreements and technology/tradename over a three-year period. The agreement includes an opportunity for a cash earn-out based on revenue generated from the IAC assets during the 12-month period following the close of the transaction. Such amounts, if any, will be recorded as additional goodwill.

In March 2002, pursuant to an Amended and Restated Asset Purchase Agreement (the Agreement) between the Company and Beyond.com Corporation (Beyond.com), in exchange for 179,096 shares of the Company's Common Stock, the Company purchased those assets and assumed those liabilities of Beyond.com related to its eStores business, which manages online stores for clients. The Company will amortize intangible assets acquired, consisting of customer base and non-compete agreements, over a three-year period. The purchase was approved by the U.S. Bankruptcy Court following Beyond.com's filing for Chapter 11 bankruptcy protection. Immediately following the closing of the Agreement, the Company entered into a Post-Closing Amendment to the Agreement with Beyond.com (the Post-Closing Amendment), pursuant to which, among other things, the Company agreed to increase the number of shares to be delivered to Beyond.com under the Agreement to 222,842, in exchange for a release of certain potential claims by Beyond.com against the Company. The Post-Closing Amendment is subject to approval by the U.S. Bankruptcy Court. The Official Committee of Unsecured Creditors has objected to the Post-Closing Amendment, asserting that the increase in shares to be delivered to Beyond.com under the Post-Closing Amendment is inadequate. The U.S. Bankruptcy Court is currently scheduled to consider the approval of the Post-Closing Amendment on September 10, 2002. Beyond.com is also asserting that it is entitled to additional shares with a value of \$910,000 under the Agreement pursuant to provisions of the Agreement under which Beyond.com could earn additional consideration post-closing if certain clients of Beyond.com immediately prior to the closing maintain or establish client relationships with the Company following the closing. The Company disagrees that any of such shares are due to Beyond.com under the Agreement. Of the shares issued at closing, 70,000 shares were placed in escrow to secure certain indemnification obligations contained in the agreement. The parties have agreed that 8,277 of these shares are to be returned to the Company to satisfy outstanding claims under the escrow. An additional 13,792 of these shares are subject to additional outstanding claims and will remain in escrow pending resolution of such claims; the remaining 47,931 shares will be released to Beyond.com.

The former owners of FreeMerchant.com, a company purchased by the Company in December 2001, received earn-out payments totaling \$420,000 during the six months ended June 30, 2002. The Company recorded such amounts as additional goodwill.

Following is an allocation of the purchase price for the acquisitions consummated in the six months ended June 30, 2002:

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| | | |
|------------------------|----|-------------|
| Tangible assets | \$ | 231,000 |
| Liabilities assumed | | (3,717,000) |
| Customer base | | 4,800,000 |
| Non-compete agreements | | 100,000 |
| Technology/tradename | | 250,000 |
| Goodwill | | 4,513,000 |
| Total purchase price | \$ | 6,177,000 |

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The following unaudited pro forma condensed results of operations for the six months ended June 30, 2002 and 2001 has been prepared as if each of the acquisitions had occurred on January 1, 2001:

| | Six months ended June 30, | |
|--------------------------------------|------------------------------|---------------|
| | 2002 | 2001 |
| Revenue | \$ 39,406,000 | \$ 29,299,000 |
| Loss from operations | (6,596,000) | (17,418,000) |
| Net loss | (7,222,000) | (17,996,000) |
| Basic and diluted net loss per share | \$ (0.27) | \$ (0.76) |

This financial information does not purport to represent results that would actually have been obtained if the transactions had been in effect on January 1, 2001 or any future results that may in fact be realized.

6. SEGMENT INFORMATION

The Company has two operating segments, Software and Digital Commerce Services and E-Business Services, which have been identified as components of the Company that are reviewed regularly by management to determine resource allocation and assess performance. Unallocated corporate items consist of pending litigation and other charges, depreciation, amortization of goodwill and other intangibles and acquisition related costs, and interest income for operational results and consist of certain cash, investments and goodwill and other intangibles for total assets. Segment information is as follows:

| | Software and Digital Commerce Services Division | E-Business Services Division | Unallocated Corporate Items | Consolidated |
|---|---|---------------------------------|-----------------------------------|---------------|
| Three months ended June 30, 2002 | | | | |
| Revenue | \$ 15,104,000 | \$ 4,243,000 | \$ | \$ 19,347,000 |
| Gross profit | 12,789,000 | 3,192,000 | | 15,981,000 |
| Income (loss) from operations | 4,610,000 | (2,028,000) | (3,087,000) | (505,000) |
| Net income (loss) | 4,610,000 | (2,028,000) | (2,930,000) | (348,000) |
| Total assets at June 30, 2002 | \$ 29,913,000 | \$ 16,622,000 | \$ 41,425,000 | \$ 87,960,000 |
| Three months ended June 30, 2001 | | | | |
| Revenue | \$ 9,461,000 | \$ 3,594,000 | \$ | \$ 13,055,000 |
| Gross profit | 7,367,000 | 2,539,000 | | 9,906,000 |
| Income (loss) from operations | 1,551,000 | (1,859,000) | (5,016,000) | (5,324,000) |
| Net income (loss) | 1,551,000 | (1,859,000) | (4,754,000) | (5,062,000) |
| Total assets at June 30, 2001 | \$ 18,141,000 | \$ 8,277,000 | \$ 44,213,000 | \$ 70,631,000 |

| | Software and Digital Commerce Services Division | E-Business Services Division | Unallocated Corporate Items | Consolidated |
|---------------------------------------|---|---------------------------------|-----------------------------------|---------------|
| Six months ended June 30, 2002 | | | | |
| Revenue | \$ 29,801,000 | \$ 7,616,000 | \$ | \$ 37,417,000 |
| Gross profit | 25,171,000 | 5,553,000 | | 30,724,000 |
| Income (loss) from operations | 8,985,000 | (4,562,000) | (8,510,000) | (4,087,000) |
| Net income (loss) | 8,985,000 | (4,562,000) | (8,301,000) | (3,878,000) |
| Six months ended June 30, 2001 | | | | |
| Revenue | \$ 19,973,000 | \$ 6,129,000 | \$ | \$ 26,102,000 |
| Gross profit | 15,171,000 | 4,261,000 | | 19,432,000 |
| Income (loss) from operations | 3,200,000 | (4,333,000) | (10,780,000) | (11,913,000) |
| Net income (loss) | 3,200,000 | (4,333,000) | (10,170,000) | (11,303,000) |

7. RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board issued SFAS No. 144, *Impairment or Disposal of Long-Lived Assets*, which is effective for fiscal years beginning after December 15, 2001. The provisions of this statement provide a single accounting model for impairment of long-lived assets. The Company adopted SFAS No. 144 effective January 1, 2002. The adoption of this statement did not have a material impact on the Company's financial position or results of operations.

8. LITIGATION AND OTHER CHARGES

During March 2002, the Company recorded a charge for pending litigation of \$2,300,000. This reserve was established based upon developments in new and existing litigation for which management determined, in the first quarter of 2002, that payment is both probable and estimable. Additionally, the Company recorded a charge of \$200,000 during March 2002 in connection with its decision during the period to consolidate one of its offices.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The Company notes that, except for the historical information contained herein, the matters discussed below contain forward-looking statements which involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. The Company expressly disclaims any obligation to update this information or publicly release any revision or reflect events or circumstances after the date of this report. Such factors include, among others: the Company's limited operating history and variability of operating results, expectation of future losses, risks associated with electronic software delivery, dependence on the Internet and growth in electronic commerce and Internet infrastructure development, dependence on software publishers, dependence on online retailers, system development and electronic commerce security risks, rapid technological changes, competition in the electronic commerce industry, the importance of attracting and retaining personnel, management of the company's growth, integration of acquired companies, dependence on key employees and other risk factors referenced in the Company's Form 10-K for the year ended December 31, 2001.

Overview

The Company is a leading provider of comprehensive electronic commerce outsourcing solutions. The Company was incorporated in February 1994 and commenced offering products for sale through its clients' Web stores in August 1996. From inception through August 1996, the Company had no sales, and its activities related primarily to the development of its Commerce Network Server (CNS) technology related to electronic commerce. In 1996, the Company began to focus its business development efforts on the software industry, building its inventory of software products through contracts with software publishers. In 1997, the Company began to develop software distribution relationships through contracts with online retailers. In late 1998, the Company began to offer its comprehensive electronic commerce outsourcing services in the form of a transaction fee-based e-commerce service to clients outside of the software industry. The Company currently offers more than 32,000 companies the ability to cut costs and grow their businesses by using its complete e-commerce systems and services.

The Company derives its revenue primarily from transaction and service fees associated with the e-commerce services that the Company provides to its clients. These services include Web commerce development and hosting, transaction processing, digital delivery, integration to physical fulfillment, fraud screening, customer service and merchandising and analytical marketing services. The Company acts as the merchant of record on the majority of the transactions processed and has contractual relationships with its clients, primarily software publishers and online retailers, which obligate the Company to pay to the client a specified percentage of each sale. The Company retains its transaction fee and also charges for various service fees. The Company also derives revenue from fees charged to use its software, integration, development and consulting services provided to its clients. This revenue is recognized as services are performed, except for software usage fee and certain integration and development fees, which are recognized evenly over the term of the contract.

The Company has a limited operating history upon which investors may evaluate its business and prospects. Since inception, the Company has incurred significant losses, and as of June 30, 2002, had an accumulated deficit of \$106,992,000. The Company intends to expend financial and management resources on the development of additional services, sales and marketing, technology and operations to support larger-scale operations and greater service offerings, particularly with respect to the E-Business Services division. Although the Company expects to generate positive cash flow from operations in 2002, there can be no assurance that the Company's revenue will increase or even continue at its current level or that the Company will achieve or maintain profitability or generate cash from operations in future periods.

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The Company's prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in their early stage of development, particularly companies in new and rapidly evolving markets such as electronic commerce. To address these risks, the Company must, among other things, maintain existing and develop new relationships with software publishers, online retailers and E-Business Services clients, implement and successfully execute its business and marketing strategy, continue to develop and upgrade its technology and transaction-processing systems, provide superior customer service and order fulfillment, respond to competitive developments, and attract, retain and motivate qualified personnel. There can be no assurance that the Company will be successful in addressing such risks, and the failure to do so would have a material adverse effect on the Company's business, financial condition and results of operations.

The Company's current and future expense levels are based largely on its planned operations and estimates of future revenue. Revenue and operating results generally depend on the volume and timing of orders received, which are difficult to forecast. The Company may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. Accordingly, any significant shortfall in revenue could have an immediate adverse effect on the Company's business, financial condition and results of operations. The Company is also likely to continue to see revenue in its Software and Digital Commerce Services Division fluctuate on a seasonal basis typical for the software publishing market in general. The Company believes that its fiscal first and fourth quarters are seasonally stronger than its second and third quarters due to the timing of demand for tax preparation software and the holiday selling period. In addition, it is the Company's belief that software publishers generally avoid new product releases in the summer months. In view of the rapidly evolving nature of the Company's business and its limited operating history, the Company is unable to accurately forecast its revenue and believes that period-to-period comparisons of its operating results are not necessarily meaningful and should not be relied upon as an indication of future performance.

Results of Operations

The following table sets forth certain items from the Company's condensed consolidated statements of operations as a percentage of total revenue for the periods indicated.

| | Three months ended June 30, | | Six months ended June 30, | |
|---|--------------------------------|---------|------------------------------|---------|
| | 2002 | 2001 | 2002 | 2001 |
| Revenue | 100.0% | 100.0% | 100.0% | 100.0% |
| Operating expenses | | | | |
| Direct cost of services | 2.9 | 5.0 | 3.1 | 4.6 |
| Network and infrastructure | 14.5 | 19.1 | 14.8 | 20.9 |
| Sales and marketing | 43.4 | 49.6 | 43.9 | 50.8 |
| Product research and development | 17.0 | 20.9 | 17.5 | 19.9 |
| General and administrative | 8.8 | 7.7 | 8.9 | 8.1 |
| Litigation and other charges | | | 6.7 | |
| Depreciation and amortization | 7.4 | 9.0 | 7.5 | 8.8 |
| Amortization of goodwill and other intangibles and acquisition related costs | 8.6 | 29.5 | 8.5 | 32.5 |
| Total operating expenses | 102.6 | 140.8 | 110.9 | 145.6 |
| Loss from operations | (2.6) | (40.8) | (10.9) | (45.6) |
| Interest income, net | 0.8 | 2.0 | 0.5 | 2.3 |
| Net loss | (1.8)% | (38.8)% | (10.4)% | (43.3)% |

REVENUE. Revenue increased to \$19,347,000 for the three months ended June 30, 2002 from \$13,055,000 for the same period in the prior year, an increase of \$6,292,000 or 48.2%. For the six months ended June 30, 2002, revenue totaled \$37,417,000, an increase of \$11,315,000 or 43.3% from revenue of \$26,102,000 recorded in the same period of the prior year. Revenue for the Software and Digital Commerce Services division increased to \$15,104,000 for the three months ended June 30, 2002 from \$9,461,000 for the three months ended June 30, 2001 and increased to \$29,801,000 for the six months ended June 30, 2002, up from \$19,973,000 for the same period in 2001. The increase in the three and six-month periods primarily resulted from growth in the number of the Company's software publisher and online retailer clients, including the impact of the clients gained in the acquisition of the eStore Group of Beyond.com Corporation in March 2002, as well as increasing market acceptance of electronic software delivery. In addition, results for the current year three and six-month periods include the impact of revenue generated by RegSoft.com, a company acquired by the Company in August 2001. Revenue for the E-Business Services division increased to \$4,243,000 for the three months ended June 30, 2002 from \$3,594,000 for the three months ended June 30, 2001 and increased to \$7,616,000 for the six months ended June 30, 2002, up from \$6,129,000 for the same period in 2001. These increases primarily reflect the impact of the Company's acquisitions of Orbit Commerce assets in September 2001, the FreeMerchant.com assets of Network Commerce in December 2001 and the CCNow assets of Innuity Acquisition Corp. in March 2002.

International sales represented approximately 22% of total revenue in the three-month periods ended June 30, 2002 and 2001, and approximately 20% and 14% of total revenue in the six-month periods ended June 30, 2002 and 2001, respectively.

GROSS PROFIT. Cost of revenue, which consists of direct cost of services and network and infrastructure costs (both shown exclusive of depreciation and amortization expense), increased to \$3,366,000 for the three months ended June 30, 2002 from \$3,149,000 for the same period in the prior year. For the six months ended June 30, 2002, cost of revenue increased to \$6,693,000, up from \$6,670,000 for the same period in the prior year. The increase for the three-month period primarily resulted from increased personnel costs in customer service to handle the additional client load along with increases in information systems and bandwidth costs. For the six-month period, decreases in customer service costs were offset by increases in information systems and bandwidth costs. The gross profit margin for the Software and Digital Commerce Services division rose in the three and six months ended June 30, 2002 to 84.7% and 84.5%, respectively, from 77.9% and 76.0% for the same periods of the prior year. The gross profit margin for the E-Business Services division increased in the three and six months ended June 30, 2002 to 75.2% and 72.9%, respectively, compared to 70.6% and 69.5% for the same periods of the prior year. The increase in margin in both divisions is primarily due to leveraging the Company's infrastructure over significantly more revenue and clients. The Company believes that Internet commerce and related services could become more competitive in the future. Accordingly, the Company may reduce or alter its pricing structure and policies in the future and any such change could reduce gross margins.

SALES AND MARKETING. Sales and marketing expense consists primarily of personnel and related expenses, advertising and promotional expenses, credit card chargebacks and bad debt expense, and credit card transaction fees. Sales and marketing expense increased to \$8,402,000 for the three months ended June 30, 2002 from \$6,480,000 for the same period in the prior year, an increase of \$1,922,000 or 29.7%. For the six months ended June 30, 2002, sales and marketing expense increased to \$16,415,000 compared to \$13,265,000 for the same period in the prior year, an increase of \$3,150,000 or 23.7%. These increases primarily resulted from an increase in credit card fees and chargeback costs along with an increase in personnel costs, offset by a decrease in advertising and marketing expense. Sales and marketing expense for the Software and Digital Commerce Services division increased to \$5,585,000 and \$11,097,000 for the three and six months ended June 30, 2002, respectively, from \$3,929,000 and \$8,309,000 for the same periods in the prior year. Sales and marketing expense for the E-Business Services division increased to \$2,817,000 and \$5,318,000 for the three and six months ended June 30, 2002, respectively, from \$2,551,000 and \$4,956,000 for the same periods in the prior year. As a percentage of revenue, sales and marketing expense was 43.4% and 43.9% in the three and six-month periods ended June 30, 2002, respectively, compared to 49.6% and 50.8% for the same periods in the prior year, primarily reflecting the Company's increased revenue. The Company expects that sales and marketing expense will continue to increase in absolute dollars as the Company continues to build its sales and marketing infrastructure and develops marketing programs and as volume driven credit card expenses increase. As a percentage of revenue, these expenses are expected to decrease as revenue increases.

PRODUCT RESEARCH AND DEVELOPMENT. Product research and development expense consists primarily of personnel and related expenses and consulting costs associated with developing and enhancing the Company's CNS and related internal systems. Product research and development expense increased to \$3,289,000 for the three months ended June 30, 2002 from \$2,729,000 for the same period in the prior year, an increase of \$560,000 or 20.5%. For the six months ended June 30, 2002, product research and development expense increased to \$6,563,000 compared to \$5,198,000 for the same period in the prior year, an increase of \$1,365,000 or 26.3%. These increases primarily resulted from the discontinuance of capitalizing product development costs in 2002. In the prior year three and six-month periods, the Company capitalized product development costs related to the Company's new platform, which totaled \$460,000 and \$672,000, respectively. No product development costs were capitalized in the current year periods. The increase in the current year six-month period is also due to increased personnel costs, offset by a reduction in consulting costs. Product research and development expense for the Software and Digital Commerce Services division increased to \$1,364,000 and \$2,770,000 for the three and six months ended June 30, 2002, respectively, from \$978,000 and \$2,005,000 for the same periods in the prior year. Product research and development expense for the E-Business Services division increased to \$1,925,000 and \$3,793,000 for the three and six months ended June 30, 2002, respectively, from \$1,751,000 and \$3,193,000 for the same periods in the prior year. As a percentage of revenue, product research and development expense was 17.0% and 17.5% in the three and six-month periods ended June 30, 2002, respectively, compared to 20.9% and 19.9% for the same periods in the prior year. As a percentage of revenue, these expenses are expected to decrease further as revenue increases.

GENERAL AND ADMINISTRATIVE. General and administrative expense consists primarily of executive, accounting and administrative personnel and related expenses including professional fees and investor relations expenses. General and administrative expenses increased to \$1,708,000 for the three months ended June 30, 2002 from \$1,005,000 for the same period in the prior year, an increase of \$703,000 or 70.0%. For the six months ended June 30, 2002, general and administrative expense increased to \$3,323,000 compared to \$2,102,000 for the same period in the prior year, an increase of \$1,221,000 or 58.1%. These increases resulted from an increase in legal costs related to the outstanding claims against the Company. In addition, the Company has incurred increased personnel and insurance related costs in the current year periods. General and administrative expense for the Software and Digital Commerce Services division increased to \$1,230,000 and \$2,319,000 for the three and six months ended June 30, 2002, respectively, from \$696,000 and \$1,444,000 for the same periods in the prior year. General and administrative expense for the E-Business Services division increased to \$478,000 and \$1,005,000 for the three and six months ended June 30, 2002, respectively, from \$309,000 and \$658,000 for the same periods in the prior year. As a percentage of revenue, general and administrative expense was 8.8% and 8.9% in the three and six-month periods ended June 30, 2002, respectively, compared to 7.7% and 8.1% for the same periods in the prior year, primarily reflecting the increase in legal fees in the current year periods. The Company expects that general and administrative expense will increase in absolute dollars over time as the Company defends its position related to legal claims and as it continues to build infrastructure to support its growth.

LITIGATION AND OTHER CHARGES. During the six months ended June 30, 2002, the Company recorded a charge for pending litigation of \$2,300,000. This reserve was established based upon developments in new and existing litigation for which management determined, in the first quarter of 2002, that payment is both probable and estimable. Additionally, the Company recorded a charge of \$200,000 during the six months ended June 30, 2002 in connection with its decision during the period to consolidate one of its offices.

AMORTIZATION OF GOODWILL AND OTHER INTANGIBLES AND ACQUISITION RELATED COSTS. Amortization of goodwill and other intangibles and acquisition related costs decreased to \$1,651,000 for the three months ended June 30, 2002 from \$3,839,000 for the same period in the prior year. For the six months ended June 30, 2002, amortization of goodwill and other intangibles and acquisition related costs decreased to \$3,200,000 compared to \$8,483,000 for the same period in the prior year. The decrease is primarily related to the impact of the Company's adoption of Statement of Financial Accounting Standards No. 142, resulting in goodwill no longer being amortized (see Note 4 of Notes to Condensed Consolidated Financial Statements). In addition, compensation based earn-out payments totaling \$1,514,000 were made in the six months ended June 30, 2001. There were no compensation based earn-out payments in the six months ended June 30, 2002.

INCOME TAXES. The Company paid no income taxes in any reported period. The Company has incurred a net loss for each period since inception. As of June 30, 2002, the Company had approximately \$86,278,000 of net operating loss carryforwards for federal income tax purposes, which expire beginning in 2009. Due to the uncertainty of future profitability, a valuation allowance equal to the deferred tax asset has been recorded. Certain changes in ownership that resulted from the sales of common and preferred stock will limit the future annual realization of the tax operating loss carryforwards to a specified percentage under Section 382 of the Internal Revenue Code.

Liquidity and Capital Resources

During the six months ended June 30, 2002, the Company's operations generated \$7,241,000 of cash compared to a \$588,000 use of cash for the same period of the prior year. The improvement is mainly due to the reduction in the net loss and improved balance sheet leverage in the current year six-month period compared to the same period last year. Net cash used in investing activities during the six months ended June 30, 2002, totaled \$8,895,000. This was comprised of investments in equipment and for acquired companies totaling \$5,414,000 along with net purchases of investments totaling \$3,481,000. Net cash used in financing activities during the six months ended June 30, 2002 totaled \$1,313,000, comprised of the payoff of a \$2,500,000 note payable offset by cash received upon the sale of stock and the exercise of stock options and warrants.

As of June 30, 2002, the Company had \$18,710,000 of cash and cash equivalents and \$13,459,000 of short-term investments. The Company's principal commitments consisted of obligations outstanding under operating leases. Although the Company has no material commitments for capital expenditures, it anticipates continued capital expenditures consistent with its anticipated growth in operations, infrastructure and personnel. The Company anticipates that it will expend approximately \$12,000,000 over the next 18 months on capital expenditures based on its current anticipated growth rate. The Company further anticipates that it will expend approximately \$16,000,000 over the next 18 months on product development based on its current anticipated growth rate in operations. The Company may also use cash to acquire or license technology, products or businesses related to the Company's current business. The Company also anticipates that it will experience growth in its operating expenses for the foreseeable future and that its operating expenses will be a material use of the Company's cash resources.

In April 2001, the Company initiated a share repurchase program of up to \$5,000,000 of its outstanding shares of Common Stock. Repurchases will be at the Company's discretion based on ongoing assessments of the capital needs of the business and the market price of its shares. No time limit was set for completion of the repurchase program. Through June 30, 2002, the Company expended approximately \$267,000 to repurchase its shares.

The Company believes that existing sources of liquidity and the results of its operations will provide adequate cash to fund its operations for at least the next 18 months, although the Company may seek to raise additional capital during that period. In January 2002, the Company filed a universal shelf registration statement with the Securities and Exchange Commission pursuant to which the Company will be permitted to issue up to \$100,000,000 in common stock, preferred stock, debt securities and/or warrants. The sale of additional equity or convertible securities could result in additional dilution to the Company's stockholders. There can be no assurance that financing will be available in amounts or on terms acceptable to the Company, if at all.

Recent Accounting Pronouncements

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In July 2001, the Financial Accounting Standards Board issued SFAS No. 144, Impairment or Disposal of Long-Lived Assets, which is effective for fiscal years beginning after December 15, 2001. The provisions of this statement provide a single accounting model for impairment of long-lived assets. The Company adopted SFAS No. 144 effective January 1, 2002. The adoption of this statement did not have a material impact on the Company's financial position or results of operations.

Item 3. Qualitative and Quantitative Disclosure About Market Risk

The Company does not enter into financial instruments for trading or speculative purposes and does not currently utilize derivative financial instruments. The operations of the Company are conducted primarily in the United States and as such are not subject to material foreign currency exchange rate risk. The Company has no long-term debt.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is party to a patent infringement lawsuit filed against it and over 200 additional defendants regarding United States Patent No. 4,500,919 assigned to the Massachusetts Institute of Technology. The suit was filed in April 2002 and is pending in the U.S. District Court in the Eastern District of Texas. The Company intends to tender the defense of the lawsuit to the clients of the allegedly infringing products and to seek full indemnification from its clients. The Company has denied the patent infringement allegations.

Item 4. Submission of Matters to a Vote of Security Holders

The Company's annual meeting of stockholders was held on May 20, 2002. The stockholders were asked to consider the election of a director nominee, Thomas F. Madison, as a director to serve until the 2005 annual meeting of stockholders. The proposal received 20,850,183 affirmative votes and 191,124 votes were withheld. Timothy C. Choate, William J. Lansing and Frederic M. Seegal will continue in office as directors until the 2003 annual meeting of stockholders. Joel A. Ronning, Perry W. Steiner and J. Paul Thorin will continue in office as directors until the 2004 annual meeting of stockholders.

Item 6. Exhibits and Reports on Form 8-K

(A) Exhibits

| EXHIBIT NUMBER | DESCRIPTION OF DOCUMENTS |
|---------------------------|---|
| 3.1 | (1) Amended and Restated Certificate of Incorporation, as amended, as currently in effect |
| 3.2 | (2) Amended and Restated Bylaws, as currently in effect |
| 4.1 | (3) Specimen of Common Stock Certificate |
| 11.1 | (4) Statement of Computation of Per Share Earnings |

- (1) Filed as Exhibits 3.1 and 3.3 to the Company's Registration Statement on Form S-3, File No. 333-81626, filed on January 29, 2002, declared effective on February 12, 2002, and incorporated herein by reference.
- (2) Filed as an exhibit to the Company's Annual Report on Form 10-K for the year ended December 31, 2000, filed on March 27, 2001, and incorporated herein by reference.
- (3) Filed as an exhibit to the Company's Registration Statement on Form S-1, File No. 333-56787, declared effective on August 11, 1998, and incorporated herein by reference.
- (4) See Note 3 to Condensed Consolidated Financial Statements.

(B) Reports on Form 8-K

On April 15, 2002, the Company filed a current report on Form 8-K reporting the acquisition (the "Acquisition") on March 31, 2002 of the assets and liabilities of the eStore Group, a division of Beyond.com Corporation ("Beyond.com").

On June 14, 2002, the Company filed a current report on Form 8-K/A providing, in connection with the Acquisition, certain financial statements of Beyond.com's eStore Group. The Company provided the audited financial statements of the eStore Group as of and for the year ended December 31, 2000 and the unaudited interim financial statements of the eStore Group for the nine months ended September 30, 2001 and 2000. The Company also provided a pro forma unaudited condensed consolidated balance sheet as of September 30, 2001 and pro forma unaudited condensed consolidated statements of operations for the nine months ended September 30, 2001 and for the year ended December 31, 2000.

On June 18, 2002, the Company filed a current report on Form 8-K announcing that on June 13, 2002, based upon the approval of its Audit Committee, the Company had terminated Arthur Andersen LLP and engaged Ernst & Young LLP as its independent accountants for the fiscal year ending December 31, 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 14, 2002

DIGITAL RIVER, INC.

By: */s/ CARTER D. HICKS*
Carter D. Hicks
Chief Financial Officer
(Principal Financial and Accounting Officer)

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