DIGI INTERNATIONAL INC
Form 10-Q
January 30, 2018

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, 2017
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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o
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, 2018, there were 27,028,529 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,	
	2017	2016
	(in thousands, except per share data)	
Revenue:		
Hardware product	$38,454	$43,173
Services and solutions	6,743	2,002
Total revenue	45,197	45,175
Cost of sales:		
Cost of hardware product	19,210	22,337
Cost of services and solutions	3,443	1,174
Amortization of intangibles	607	211
Total cost of sales	23,260	23,722
Gross profit	21,937	21,453
Operating expenses:		
Sales and marketing	9,760	8,322
Research and development	7,751	6,905
General and administrative	6,549	3,804
Total operating expenses	24,060	19,031
Operating (loss) income	(2,123)	2,422
Other income, net:		
Interest income	208	159
Interest expense	(3)	(33)
Other (expense) income, net	(45)	574
Total other income, net	160	700
(Loss) income before income taxes	(1,963)	3,122
Income tax provision	2,606	765
Net (loss) income	$(4,569)	$2,357
Net (loss) income per common share:		
Basic	$(0.17)	$0.09
Diluted	$(0.17)	$0.09
Weighted average common shares:		
Basic	26,748	26,175
Diluted	26,748	26,972

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
(UNAUDITED)

	Three months ended December 31,	
	2017	2016
	(in thousands)	
Net (loss) income	$(4,569)	$2,357
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustment	271	(3,755)
Change in net unrealized loss on investments	(21)	(24)
Less income tax benefit	3	9
Other comprehensive income (loss), net of tax	253	(3,770)
Comprehensive loss	$(4,316)	$(1,413)

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, 2017	September 30, 2017
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$45,610	$ 78,222
Marketable securities	28,204	32,015
Accounts receivable, net	30,292	28,855
Inventories	31,119	30,238
Receivable from sale of business	—	1,998
Other	4,823	3,032
Total current assets	140,048	174,360
Marketable securities, long-term	4,247	4,753
Property, equipment and improvements, net	12,723	12,801
Identifiable intangible assets, net	34,469	11,800
Goodwill	149,333	131,995
Deferred tax assets	6,237	9,211
Other	451	269
Total assets	$347,508	$ 345,189
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$6,330	$ 6,240
Accrued compensation	4,555	4,325
Accrued warranty	1,164	987
Accrued professional fees	793	928
Accrued restructuring	1,631	1,656
Unearned revenue	4,135	1,343
Contingent consideration on acquired businesses	2,411	388
Other	2,451	2,113
Total current liabilities	23,470	17,980
Income taxes payable	685	877
Deferred tax liabilities	486	534
Contingent consideration on acquired businesses	3,570	6,000
Other non-current liabilities	681	654
Total liabilities	28,892	26,045
Contingencies (see Note 12)		
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; 33,480,707 and 33,007,993 shares issued	335	330
Additional paid-in capital	249,591	245,528
Retained earnings	145,876	150,478
Accumulated other comprehensive loss	(22,406)	(22,659)
Treasury stock, at cost, 6,455,136 and 6,436,578 shares	(54,780)	(54,533)

Total stockholders’ equity	318,616	319,144
Total liabilities and stockholders’ equity	$347,508	$ 345,189

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,	
	2017	2016
	(in thousands)	
Operating activities:		
Net (loss) income	$(4,569)	$2,357
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Depreciation of property, equipment and improvements	711	656
Amortization of identifiable intangible assets	1,694	345
Stock-based compensation	1,053	1,173
Excess tax benefits from stock-based compensation	—	(183)
Deferred income tax provision	2,954	619
Change in fair value of contingent consideration	(407)	(82)
Bad debt/product return provision	14	264
Inventory obsolescence	450	450
Other	57	(12)
Changes in operating assets and liabilities (net of acquisitions)	(3,285)	(7,622)
Net cash used in operating activities	(1,328)	(2,035)
Investing activities:		
Purchase of marketable securities	—	(25,470)
Proceeds from maturities and sales of marketable securities	4,296	32,155
Proceeds from sale of Etherios	2,000	3,000
Acquisition of businesses, net of cash acquired	(40,084)	(1,690)
Purchase of property, equipment, improvements and certain other identifiable intangible assets	(453)	(554)
Net cash (used in) provided by investing activities	(34,241)	7,441
Financing activities:		
Acquisition earn-out payments	—	(518)
Excess tax benefits from stock-based compensation	—	183
Proceeds from stock option plan transactions	2,972	2,787
Proceeds from employee stock purchase plan transactions	380	297
Purchases of common stock	(636)	(390)
Net cash provided by financing activities	2,716	2,359
Effect of exchange rate changes on cash and cash equivalents	241	(2,350)
Net (decrease) increase in cash and cash equivalents	(32,612)	5,415
Cash and cash equivalents, beginning of period	78,222	75,727
Cash and cash equivalents, end of period	$45,610	$81,142
Supplemental schedule of non-cash investing and financing activities:		
Liability related to acquisition of businesses	$—	$(1,300)
Accrual for purchase of property, equipment, improvements and certain other identifiable intangible assets	$(27)	$(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, 2017, as filed with the SEC ("2017 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 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 2017 Financial Statements, but do not include all disclosures required by U.S. GAAP.

Recently Issued Accounting Pronouncements

Adopted

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Updated ("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. We adopted ASU 2016-09 on October 1, 2017. There was no material impact on our condensed consolidated financial statements. Below is a summary of the impact upon adoption of ASU 2016-09:

- In accordance with ASU 2016-09, we prospectively will record excess tax benefits/deficiencies as an income tax benefit/expense in the statement of operations. This resulted in a $0.5 million tax deficiency in the three months ended December 31, 2017, resulting in an unfavorable impact to EPS of $0.02 per diluted share. This amount was recognized as a discrete item within income tax expense in the condensed consolidated statement of operations.
- We adjusted our dilutive shares to remove the excess tax benefits from the calculation of EPS on a prospective basis. The revised calculation is more dilutive, but did not have a material impact on the Company's diluted EPS calculation for the three months ended December 31, 2017.
- Further, we had no tax benefits that were not previously recognized because the related tax deduction had not reduced taxes payable, therefore, there was no cumulative-effect adjustment to our beginning retained earnings.
- Additionally, we prospectively adopted the provision to classify excess tax benefits and deficiencies within cash flows from operating activities as part of cash payments for taxes on the statement of cash flows. Prior periods on the statement of cash flows have not been adjusted.
- Upon adoption of ASU 2016-09, we account for forfeitures as they occur, rather than estimating forfeitures as of an awards grant date. This change in accounting policy election was adopted using a modified retrospective transition method and recognized a cumulative effect unfavorable adjustment to retained earnings of approximately $33,000.
- We have previously shown separately, tax payments made on behalf of an employee by repurchasing shares of stock as cash outflows from financing activities on the statement of cash flows. This provision was retrospectively adopted and prior period cash flows already conformed with this presentation.

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

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. We adopted this guidance beginning October 1, 2017. The amendments in this guidance should be applied prospectively with earlier application permitted as of the beginning of an interim or annual period. The adoption of ASU 2015-11 did not have a material impact on our consolidated financial statements.

Not Yet Adopted

In May 2017, FASB issued ASU 2017-09, "Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting." ASU 2017-09 provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. The amendments in this update should be applied prospectively to an award modified on or after the adoption date. This ASU is effective for annual periods and interim periods within those annual periods beginning after December 15, 2017, which for us is the first quarter ending December 31, 2018. Early adoption is permitted. We do not expect the adoption of this guidance to have a material impact to our consolidated financial statements.

In January 2017, FASB issued ASU 2017-04, "Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." ASU 2017-04 eliminates the second step in the goodwill impairment test which requires an entity to determine the implied fair value of the reporting unit’s goodwill. Instead, an entity should perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying value and recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value, not to exceed the total amount of goodwill allocated to the reporting unit. The standard, which should be applied prospectively, is effective for fiscal years beginning after December 15, 2019, which for us is our fiscal year ending September 30, 2021. Early adoption is permitted. We are currently evaluating the impact of the adoption of ASU 2017-04 on our consolidated financial statements.

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 ending 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, 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 U.S. 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 ending 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 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

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

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 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, 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 year ending September 30, 2019, including interim periods within that reporting period. In addition, 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 by June 30, 2018. This plan includes a review of transactions supporting each revenue stream to determine the impact of 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 with our fiscal quarter ending December 31, 2018.

2. ACQUISITIONS

Acquisition of TempAlert LLC

On October 20, 2017, we purchased all the outstanding interests of TempAlert LLC (“TempAlert”), a Boston-based provider of automated, real-time temperature monitoring and task management solutions. The purchase price was $45.0 million in cash adjusted for certain net working capital adjustments. We believe this is a complementary acquisition for us as the acquired technology will continue to be supported to further enhance and expand the capabilities of the IoT Solutions segment (see Note 9 to our Condensed Consolidated Financial Statements).

The terms of the acquisition included an upfront cash payment together with future earn-out payments. Cash of $40.7 million (excluding cash acquired of $0.6 million) was paid at the time of closing. The earn-out payments are scheduled to be paid after December 31, 2018 and December 31, 2019 which is the end of the earn-out periods. The cumulative amount of these earn-outs for the periods ended December 31, 2018 and 2019, will not exceed $35.0 million and $45.0 million, respectively. The fair value of this contingent consideration was zero at the date of acquisition and at December 31, 2017 (see Note 7 to the Condensed Consolidated Financial Statements).

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 $17.3 million of goodwill. For tax purposes, this acquisition is treated as an asset acquisition, therefore the goodwill is deductible. 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.

The TempAlert 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.

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2. ACQUISITIONS (CONTINUED)

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

Cash	$40,741
Fair value of contingent consideration on acquired business	—
Total purchase price consideration	$40,741
Fair value of net tangible assets acquired	$(900)
Fair value of identifiable intangible assets acquired:	
Customer relationships	18,300
Purchased and core technology	4,000
Trade name and trademarks	2,000
Goodwill	17,341
Total	$40,741

Operating results for TempAlert are included in our Condensed Consolidated Statements of Operations from October 20, 2017. The Condensed Consolidated Balance Sheet as of December 31, 2017 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 net working capital values are preliminary and we expect to finalize them in the second fiscal quarter of 2018.

The weighted average useful life for all the identifiable intangibles listed above is 6.5 years. For purposes of determining fair value, the purchased and core technology identified above is assumed to have a useful life of five years, the customer relationships are assumed to have useful lives of seven years and the trade name and trademarks are assumed to have useful lives of five years. Useful lives for identifiable intangible assets are estimated at the time of acquisition based on the periods of time from which we expect to derive benefits from the identifiable intangible assets.

The amounts of revenue and net loss included in the Condensed Consolidated Statements of Operations from the acquisition date of October 20, 2017 were $2.1 million and $1.1 million, respectively. Costs directly related to the acquisition of $1.4 million incurred in the first quarter of fiscal 2018 and $0.4 million incurred in fiscal 2017 for the have been charged directly to operations and are included in general and administrative expense in our Condensed Consolidated Statements of Operations. These acquisition costs include legal, accounting, valuation and success fees.

The following consolidated pro forma information is as if the acquisition had occurred on October 1, 2016 (in thousands):

	Three months ended December 31,	
	2017	2016
Revenue	$46,128	$50,341
Net (loss) income	$(3,000)	$469

Pro forma income from continuing operations and net income were both adjusted to exclude interest expense related to debt that was paid off prior to acquisition, interest income related to promissory note that was settled prior to acquisition, adjust amortization to the fair value of the intangibles acquired and remove any costs associated with the sale transaction.

Acquisition of SMART Temps, LLC

On January 9, 2017, we purchased all of the outstanding interests of SMART Temps, LLC (“SMART Temps”), an Indiana-based provider of real-time temperature management for pharmacies, education, and hospital settings as well as real-time temperature management for blood bank, laboratory environments, restaurants, and grocery. We believe this is a complementary acquisition for us as the acquired technology will continue to be supported to further enhance our portfolio of products for the IoT Solutions segment (see Note 9 to our Condensed Consolidated Financial

Statements).

The terms of the acquisition included an upfront cash payment together with future earn-out payments. Cash of $28.8 million (excluding cash acquired of $0.5 million) was paid at time of closing. The earn-out payments was scheduled to be paid after December 31, 2017 which is the end of the earn-out period. The cumulative amount of these earn-out payments could not

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2. ACQUISITIONS (CONTINUED)

exceed $7.2 million. The fair value of this contingent consideration was $10,000 at the date of acquisition and zero at December 31, 2017, therefore no earn-out was paid (see Note 7 to the Condensed Consolidated Financial Statements).

The purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The final purchase price allocation resulted in the recognition of $18.8 million of goodwill. For tax purposes, this acquisition is treated as an asset acquisition, therefore the goodwill is deductible. 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 IoT Solutions segment.

Operating results for SMART Temps are included in our Condensed Consolidated Statements of Operations from January 9, 2017. The Condensed Consolidated Balance Sheet as of December 31, 2017 reflects the final allocation of the purchase price to the assets acquired and liabilities assumed based on their estimated fair values at the date of 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 automated 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 IoT Solutions segment.

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 fair value of this contingent consideration was $1.3 million at the date of acquisition and $0.3 million at December 31, 2017 (see Note 7 to the Condensed Consolidated Financial Statements). The final calculation date will be on June 30, 2018. The cumulative amount of these earn-out payments will not exceed $2.3 million. 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 $60,000 have been charged directly to operations and are included in general and administrative expense in our Condensed Consolidated Statements of Operations.

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. For tax purposes, this acquisition is treated as an asset acquisition, therefore the goodwill is deductible. 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, 2017 reflects the final 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 were finalized in the second fiscal quarter of 2017.

Acquisition of Bluenica Corporation

On October 5, 2015, we purchased all of the outstanding stock of Bluenica Corporation (“Bluenica”), a company focused on temperature monitoring of perishable goods in the food industry by using wireless sensors, which are installed in grocery and convenience stores, restaurants, and in products during shipment and storage to ensure that quality, freshness and public health requirements are met. This acquisition formed the basis for our IoT Solutions segment.

The terms of the acquisition included an upfront cash payment together with earn-out payments. Cash of $2.9 million was paid at time of closing. The earn-out payments are scheduled to be paid in installments over a four-year period based on revenue achievement of the acquired business. Each of the earn-out payments will be calculated based on the revenue performance of the IoT Solutions segment for each respective earn-out period. The cumulative amount of these earn-out payments will not exceed $11.6 million. An additional payment, not to exceed $3.5 million, may also be due depending on revenue performance.

The fair value of this contingent consideration was $10.4 million at the date of acquisition and $5.6 million at December 31, 2017 (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.

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2. ACQUISITIONS (CONTINUED)

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 $11.0 million of goodwill. 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 Bluenica are included in our Condensed Consolidated Statements of Operations from October 6, 2015.

3. DISCONTINUED OPERATIONS

On October 23, 2015, we sold all the outstanding stock of our wholly owned subsidiary, Etherios Inc. ("Etherios") to West Monroe Partners, LLC. We sold Etherios as part of a strategy to focus on providing highly reliable machine connectivity solutions for business and mission-critical application environments. Etherios was included in our single operating segment prior to fiscal 2017.

The terms of the sale agreement provided that West Monroe Partners, LLC would pay us $3.0 million on October 23, 2016 and $2.0 million on October 23, 2017. The present value of these amounts was included within the total fair value of consideration received. These receivable amounts were unsecured and non-interest bearing. We received $3.0 million in October 2016 and $2.0 million in October 2017.

4. EARNINGS PER SHARE

Basic net (loss) income per common share is calculated based on the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares result from dilutive common stock options and restricted stock units. Diluted net loss per common share is computed by dividing net loss by the weighted average number of common shares. All potentially dilutive common equivalent shares are excluded from the calculations of net loss per diluted share due to their anti-dilutive effect for the three month period ended December 31, 2017.

The following table is a reconciliation of the numerators and denominators in the net (loss) income per common share calculations (in thousands, except per common share data):

	Three months ended December 31,	
	2017	2016
Numerator:		
Net (loss) income	$(4,569)	$2,357
Denominator:		
Denominator for basic net (loss) income per common share — weighted average shares outstanding	26,748	26,175
Effect of dilutive securities:		
Stock options and restricted stock units	—	797
Denominator for diluted net (loss) income per common share — adjusted weighted average shares	26,748	26,972
Net (loss) income per common share, basic	$(0.17)	$0.09
Net (loss) income per common share, diluted	$(0.17)	$0.09

For the three months ended December 31, 2017 and 2016, there were 1,998,740 and 1,108,900 potentially dilutive shares, respectively, related to stock options to purchase common shares that were not included in the above computation of diluted earnings per common share. This is because the options' exercise prices were greater than the average market price of our common shares. In addition, due to the net loss for the three months ended December 31, 2017, there were 331,021 common stock options and restricted stock units that were not included in the above computation of diluted earnings per share.

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5. SELECTED BALANCE SHEET DATA

The following table shows selected balance sheet data (in thousands):

	December 31, 2017	September 30, 2017
Accounts receivable, net:		
Accounts receivable	$ 32,861	$ 31,365
Less allowance for doubtful accounts	476	341
Less reserve for future returns and pricing adjustments	2,093	2,169
Accounts receivable, net	$ 30,292	$ 28,855
Inventories:		
Raw materials	$ 24,622	$ 24,050
Work in process	22	484
Finished goods	6,475	5,704
Inventories	$ 31,119	$ 30,238

Inventories are stated at the lower of cost or net realizable value, with cost determined using the first-in, first-out method.

6. MARKETABLE SECURITIES

Our marketable securities consist of certificates of deposit, commercial paper, corporate bonds and government municipal bonds. We analyze our available-for-sale marketable securities for impairment on an ongoing basis. When we perform this analysis, we consider factors such as the length of time and extent to which the securities have been in an unrealized loss position and the trend of any unrealized losses. We also consider whether an unrealized loss is a temporary loss or an other-than-temporary loss based on factors such as: (a) whether we have the intent to sell the security, (b) whether it is more likely than not that we will be required to sell the security before its anticipated recovery, or (c) permanent impairment due to bankruptcy or insolvency.

In order to estimate the fair value for each security in our investment portfolio, we obtain quoted market prices and trading activity for each security where available. We obtain relevant information from our investment advisor and, if warranted, also may review the financial solvency of certain security issuers. As of December 31, 2017, 31 of our 41 securities that we held were trading below our amortized cost basis. We determined each decline in value to be temporary based upon the above described factors. We expect to realize the fair value of these securities, plus accrued interest, either at the time of maturity or when the security is sold. All of our current holdings are classified as available-for-sale marketable securities and are recorded at fair value on our consolidated balance sheet with the unrealized gains and losses recorded in accumulated other comprehensive income (loss). All of our current marketable securities will mature in less than one year and our non-current marketable securities will mature in less than two years. Our balance sheet classification of available for sale securities is based on our best estimate of when we expect to liquidate such investments and, presently, is consistent with the stated maturity dates of such investments. However, we are not committed to holding these investments until their maturity and may determine to liquidate some or all of these investments earlier based on our liquidity and other needs. During the three months ended December 31, 2017 and 2016, we received proceeds from our available-for-sale marketable securities of $4.3 million and $32.2 million, respectively.

At December 31, 2017 our marketable securities were (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses	Fair Value (1)
Current marketable securities:				
Corporate bonds	$ 24,217	$ —	$ (26)	$ 24,191
Certificates of deposit	4,013	1	(1)	4,013
Current marketable securities	28,230	1	(27)	28,204

Non-current marketable securities:				
Certificates of deposit	4,262	—	(15)	4,247
Total marketable securities	$ 32,492	$ 1	$ (42)	$ 32,451

(1) Included in amortized cost and fair value is purchased and accrued interest of $201.

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6. MARKETABLE SECURITIES (CONTINUED)

At September 30, 2017 our marketable securities were (in thousands):

	Amortized Cost (1)	Unrealized Gains	Unrealized Losses	Fair Value (1)
Current marketable securities:				
Corporate bonds	$ 28,275	$ —	$ (20)	$28,255
Certificates of deposit	3,756	4	—	3,760
Current marketable securities	32,031	4	(20)	32,015
Non-current marketable securities:				
Certificates of deposit	4,757	—	(4)	4,753
Total marketable securities	$ 36,788	$ 4	$ (24)	$36,768

(1) Included in amortized cost and fair value is purchased and accrued interest of $211.

The following tables show the fair values and gross unrealized losses of our available-for-sale marketable securities that have been in a continuous unrealized loss position deemed to be temporary, aggregated by investment category (in thousands):

	December 31, 2017			
	Less than 12 Months		More than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	$24,191	$ (26)	$ —	$ —
Certificates of deposit	5,754	(16)	—	—
Total	$29,945	$ (42)	$ —	$ —

	September 30, 2017			
	Less than 12 Months		More than 12 Months	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate bonds	$26,196	$ (20)	$ —	$ —
Certificates of deposit	3,751	(4)	—	—
Total	$29,947	$ (24)	$ —	$ —

7. FAIR VALUE MEASUREMENTS

Fair value is defined as the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. This standard also establishes a hierarchy for inputs used in measuring fair value. This standard maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs market participants would use in valuing the asset or liability based on market data obtained from independent sources. Unobservable inputs are inputs that reflect our assumptions about the factors market participants would use in valuing the asset or liability based upon the best information available in the circumstances.

The categorization of financial assets and liabilities within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The hierarchy is broken down into three levels. Level 1 inputs are quoted prices in active markets for identical assets or liabilities. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs (other than quoted prices) that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable for the asset or liability and their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable. Level 3 may also include certain investment securities for which there is limited market activity or a decrease in the observability of market pricing for the investments, such that the determination of fair value requires significant judgment or estimation.

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7. FAIR VALUE MEASUREMENTS (CONTINUED)

Fair value is applied to financial assets such as our marketable securities, which are classified and accounted for as available-for-sale and to financial liabilities for contingent consideration. These items are stated at fair value at each reporting period using the above guidance.

The following tables provide information by level for financial assets and liabilities that are measured at fair value on a recurring basis (in thousands):

	Total Fair Value at December 31, 2017	Fair Value Measurements Using Inputs Considered as Level 1	Level 2	Level 3
Assets:				
Money market	$ 4,520	$4,520	$—	$—
Corporate bonds	24,191	—	24,191	—
Certificates of deposit	8,260	—	8,260	—
Total assets measured at fair value	$ 36,971	$4,520	$32,451	$—
Liabilities:				
Contingent consideration on acquired businesses	$ 5,981	$—	$—	$5,981
Total liabilities measured at fair value	$ 5,981	$—	$—	$5,981

	Total Fair Value at September 30, 2017	Fair Value Measurements Using Inputs Considered as Level 1	Level 2	Level 3
Assets:				
Money market	$ 39,524	$39,524	$—	$—
Corporate bonds	28,255	—	28,255	—
Certificates of deposit	8,513	—	8,513	—
Total assets measured at fair value	$ 76,292	$39,524	$36,768	$—
Liabilities:				
Contingent consideration on acquired businesses	$ 6,388	$—	$—	$6,388
Total liabilities measured at fair value	$ 6,388	$—	$—	$6,388

Our money market funds, which have been determined to be cash equivalents, are measured at fair value using quoted market prices in active markets for identical assets and are therefore classified as Level 1 assets. We value our Level 2 assets using inputs that are based on market indices of similar assets within an active market. There were no transfers into or out of our Level 2 financial assets during the three months ended December 31, 2017.

The use of different assumptions, applying different judgment to matters that inherently are subjective and changes in future market conditions could result in different estimates of fair value of our securities or contingent consideration, currently and in the future. If market conditions deteriorate, we may incur impairment charges for securities in our investment portfolio. We may also incur changes to our contingent consideration liability as discussed below.

As discussed in Note 2, we are required to make contingent payments for our acquisitions. In connection with the Bluenica acquisition, we are required to make contingent payments over a period of up to four years, subject to the IoT Solutions segment achieving specified revenue thresholds. The fair value of the liability for contingent payments recognized upon acquisition was $10.4 million. In connection with the FreshTemp acquisition, we are required to make a contingent payment after June 30, 2018, for revenue related to specific customer contracts signed by June 30, 2017. The fair value of the liability recognized upon acquisition was $1.3 million. For the SMART Temps acquisition, we are required to make a contingent payment after December 31, 2017 based on achieving specified revenue thresholds. The fair value of the liability for contingent payments recognized upon acquisition was $10,000. For the

TempAlert acquisition, we are required to make contingent payments for the twelve month periods ending December 31, 2018 and December 31, 2019 based on the total Digi IoT Solutions segment revenue. The fair value of the liability for contingent payments recognized upon acquisition of TempAlert was zero. The fair values of these contingent payments was estimated by discounting to present value the probability-weighted contingent payments expected to be made. Assumptions used in these calculations include the discount

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7. FAIR VALUE MEASUREMENTS (CONTINUED)

rate and various probability factors. This liability is considered to be a Level 3 financial liability that is re-measured each reporting period as a charge or credit to general and administrative expense within the Condensed Consolidated Statements of Operations.

The following table presents a reconciliation of the contingent consideration liability measured at fair value on a recurring basis using significant unobservable inputs (Level 3) (in thousands):

	Three months ended December 31,	
	2017	2016
Fair value at beginning of period	$6,388	$9,960
Purchase price contingent consideration	—	1,300
Contingent consideration payments	—	(518)
Change in fair value of contingent consideration	(407)	(82)
Fair value at end of period	$5,981	$10,660

The change in fair value of contingent consideration relates to the acquisitions of Bluenica, FreshTemp and SMART Temps and is included in general and administrative expense. The change in fair value of contingent consideration reflects our estimate of the probability of achieving the relevant targets and is discounted based on our estimated discount rate. We have estimated the fair value of the contingent consideration based on the probability of achieving the specified revenue thresholds at 93.5% to 98.7% for Bluenica, between 15% and 100% for FreshTemp, 0% for both SMART Temp and TempAlert. A significant increase (decrease) in our estimates of achieving the relevant targets could materially increase (decrease) the fair value of the contingent consideration liability.

8. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS, NET

Amortizable identifiable intangible assets were (in thousands):

	December 31, 2017			September 30, 2017		
	Gross carrying amount	Accum. amort.	Net	Gross carrying amount	Accum. amort.	Net
Purchased and core technology	$55,296	$(46,841)	$8,455	$51,292	$(46,304)	$4,988
License agreements	18	(17)	1	18	(17)	1
Patents and trademarks	14,553	(11,505)	3,048	12,484	(11,280)	1,204
Customer relationships	40,230	(17,745)	22,485	21,914	(16,817)	5,097
Non-compete agreements	600	(120)	480	600	(90)	510
Total	$110,697	$(76,228)	$34,469	$86,308	$(74,508)	$11,800

Amortization expense was $1.7 million and $0.3 million for the three month periods ended December 31, 2017 and 2016, respectively. Amortization expense is recorded on our consolidated statements of operations within cost of sales and in general and administrative expense.

Estimated amortization expense related to identifiable intangible assets for the remainder of fiscal 2018 and the five succeeding fiscal years is (in thousands):

2018 (nine months)	$4,770
2019	6,167
2020	5,856
2021	5,311
2022	5,028
2023	3,622

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8. GOODWILL AND OTHER IDENTIFIABLE INTANGIBLE ASSETS, NET (CONTINUED)

The changes in the carrying amount of goodwill are (in thousands):

	Three months ended December 31,	
	2017	2016
Beginning balance, October 1	$131,995	$109,448
Acquisitions	17,341	2,737
Foreign currency translation adjustment	(3)	(1,069)
Ending balance, December 31	$149,333	$111,116

Goodwill is tested for impairment on an annual basis as of June 30, or more frequently if events or circumstances occur which could indicate impairment. The calculation of goodwill impairment requires us to make assumptions about the fair value of our reporting unit(s), which historically has been approximated by using our market capitalization plus a control premium for our reporting unit(s). Control premium assumptions require judgment and actual results may differ from assumed or estimated amounts.

As of the third quarter of fiscal 2017, we determined that we have two reportable operating segments, our IoT Solutions segment and our IoT Products & Services segment (see Note 9 to the Condensed Consolidated Financial Statements). As a result, we concluded that the IoT Solutions segment and the IoT Products & Services segment constitute separate reporting units for purposes of the ASC 350-20-35 “Goodwill Measurement of Impairment” assessment and both units were tested individually for impairment.

Our test for potential goodwill impairment is a two-step approach. First, we estimate the fair values for each reporting unit by comparing the fair value to the carrying value. If the carrying value of the reporting unit exceeds its estimated fair value, then we conduct the second step, which requires us to measure the amount of the impairment loss. The impairment loss, if any, is calculated by comparing the implied fair value of the goodwill to its carrying amount. To calculate the implied fair value of goodwill, the fair value of the reporting unit’s assets and liabilities, excluding goodwill, is estimated. The excess of the fair value of the reporting unit over the amount assigned to its assets and liabilities, excluding goodwill, is the implied fair value of the reporting unit’s goodwill.

At June 30, 2017, we had a total of $98.6 million of goodwill on our Condensed Consolidated Balance Sheet for the IoT Products & Services reporting unit and the implied fair value of this reporting unit exceeded its carrying value by approximately 7%. At June 30, 2017, we had a total of $32.5 million of goodwill on our Condensed Consolidated Balance Sheet for the Solutions reporting unit and the implied fair value of this reporting unit exceeded its carrying value by approximately 8%.

Based on that data, we concluded that no impairment was indicated for either reporting unit and we were not required to complete the second step of the goodwill impairment analysis. No goodwill impairment charges were recorded.

During the first quarter of fiscal 2018, we assessed various qualitative factors to determine whether or not an additional goodwill impairment assessment was required as of December 31, 2017, and we concluded that no additional impairment assessment was required.

Should the facts and circumstances surrounding our assumptions change, the first step of our goodwill impairment analysis may fail. Assumptions and estimates to determine fair values are complex and often subjective. They can be affected by a variety of factors, including external factors such as industry and economic trends, and internal factors such as changes in our business strategy and our internal forecasts. For example, if our future operating results do not meet current forecasts or if we experience a sustained decline in our market capitalization that is determined to be indicated of a reduction in fair value of one or more of our reporting units, we may be required to record future impairment charges for goodwill. An impairment could have a material effect on our consolidated balance sheet and results of operations. We have had no goodwill impairment losses since the adoption of Accounting Standards Codification (ASC) 350, Intangibles-Goodwill and Others, in fiscal 2003.

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9. SEGMENT INFORMATION

We have two reportable operating segments for purposes of ASC 280-10-50 "Segment Reporting": (1) IoT Products & Services (formerly M2M), and (2) IoT Solutions (formerly Solutions). Our segments are described below:

IoT Products & Services

Our IoT Products & Services segment is composed of the following communications products and development services:

- Cellular routers and gateways;
- Radio frequency (RF) which include our XBee® modules as well as other RF solutions;
- Embedded products include Digi Connect® and Rabbit® embedded systems on module and single board computers;
- Network products, which has the highest concentration of mature products, including console and serial servers and USB connected products;
- Digi Wireless Design Services;
- Digi Remote Manager®; and
- Support services which offers various levels of technical services for development assistance, consulting and training.

IoT Solutions

We have formed the IoT Solutions segment primarily through four acquisitions: the October 2015 acquisition of Bluenica, the November 2016 acquisition of FreshTemp, the January 2017 acquisition of SMART Temps and the October 2017 acquisition of TempAlert, LLC (TempAlert). Our IoT Solutions segment offers wireless temperature and other environmental condition monitoring services as well as employee task management services. These products and services are provided to food service, transportation, education, healthcare and pharma, and industrial markets and are marketed as Digi Smart Solutions™.

We measure our segment results primarily by reference to revenue and operating income (loss). IoT Solutions revenue includes both product and service revenue. Certain costs incurred at the corporate level are allocated to our segments. These costs include information technology, employee benefits and shared facility services. The information technology and shared facility costs are allocated based on headcount and the employee benefits costs are allocated based on compensation costs.

Summary operating results for each of our segments were as follows (in thousands):

	Three months ended December 31, 2017	2016
Revenue		
IoT Products & Services	$40,880	$44,936
IoT Solutions	4,317	239
Total revenue	$45,197	$45,175
Operating (loss) income		
IoT Products & Services	$1,264	$3,087
IoT Solutions	(3,387)	(665)
Total operating (loss) income	$(2,123)	$2,422
Depreciation and amortization		
IoT Products & Services	$849	$847
IoT Solutions	1,556	154
Total depreciation and amortization	$2,405	$1,001

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9. SEGMENT INFORMATION (CONTINUED)

Total expended for property, plant and equipment was as follows (in thousand):

	Three months ended December 31, 2017	2016
Expended for property, plant and equipment		
IoT Products & Services	$453	$483
IoT Solutions	—	71
Total expended for property, plant and equipment	$453	$554

Total assets for each of our segments were as follows (in thousands):

	December 31, 2017	September 30, 2017
Assets		
IoT Products & Services	$177,401	$ 182,555
IoT Solutions	92,046	47,644
Unallocated*	78,061	114,990
Total assets	$347,508	$ 345,189

*Unallocated consists of cash and cash equivalents, current marketable securities and long-term marketable securities.

Total goodwill for each of our segments were as follows (in thousands):

	December 31, 2017	September 30, 2017
Goodwill		
IoT Products & Services	$99,063	$ 98,981
IoT Solutions	50,270	33,014
Total goodwill	$149,333	$ 131,995

10. INCOME TAXES

Income tax provision was $2.6 million for the three months ended December 31, 2017. Net tax expense discretely related to the three months ended December 31, 2017 was $2.8 million, primarily as a result of new U.S. tax legislation that was enacted during the first quarter of fiscal 2018 and the adoption of ASU 2016-09 related to the accounting for the tax effects of stock compensation.

The Tax Cuts and Jobs Act of 2017 (the “Act”) was enacted on December 22, 2017. The Act lowered the U.S. federal corporate tax rate from 35% to 21% as of January 1, 2018 and requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred. Due to our fiscal year end, our statutory rate for fiscal 2018 will be a blend of the new and old tax rates. At December 31, 2017 we did not fully complete our accounting for the tax effects of enactment of the Act; however in certain cases, as described below, we have made a reasonable estimate of the effects on our existing deferred tax balances and the one-time transition tax. For the items for which we were able to determine a reasonable estimate, we recognized a provisional income tax expense amount of $2.6 million which is included as a component of income tax expense.

We remeasured U.S. deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which requires estimates of our changes in deferred tax assets and liabilities before and after the new statutory rate was enacted. As a result, we are still analyzing certain aspects of the legislation and refining our calculations such as, refining current year estimates and filings of tax returns, of which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. As of December 31, 2017, the provisional amount recorded related to the re-measurement of this deferred tax balance was $2.5 million.

In addition, we considered the potential tax expense impacts of the one-time transition tax. The transition tax is based on our total post-1986 earnings and profits ("E&P") that we previously deferred from U.S. income taxes. We recorded a provisional amount for our one-time transition tax liability for our foreign subsidiaries, resulting in an increase in income tax expense of

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10. INCOME TAXES (CONTINUED)

$0.1 million. We have not yet completed the calculation of the post-1986 E&P for these foreign subsidiaries and, further, this transition tax is based in part on the amount of those earnings held in cash and other specified assets. This amount may change when we finalize the calculation of post-1986 foreign E&P previously deferred from U.S. federal taxation, evaluate the testing periods for cash and E&P measurement and finalize substantiation of material foreign taxes paid or accrued. Furthermore, it is expected that further guidance will be forthcoming from U.S. Treasury which may or may not impact the final transition tax required. It should be noted, that we continue to review the outside basis differential of our foreign investments. At this point, no additional income taxes have been provided for any undistributed foreign earnings not subject to the transition tax and additional outside basis difference inherent in these entities, as these amounts continue to be indefinitely reinvested in foreign operations. Determining the amount of unrecognized deferred tax liability related to any remaining undistributed foreign earnings not subject to the transition tax and additional outside basis difference in these entities (i.e., basis difference in excess of that subject to the one-time transition tax) is not practical at this time, but it is expected that with inclusion of the transition tax, the potential outstanding basis difference as of December 31, 2017 is expected to be a deductible temporary difference for which no deferred tax asset would be allowed.

As discussed in Note 1 to the Condensed Consolidated Financial Statements, we adopted ASU 2016-09 “Improvements to Employee Share-Based Payment Accounting” on October 1, 2017. As a result of the adoption, we recorded $0.5 million of excess tax expense related to our share-based payments in our provision for income taxes for the three months ended December 31, 2017. Historically, this was record in additional paid-in capital. The excess tax expense related to share-based payments are recognized as tax expense discretely related to the three months ended December 31, 2017.

For the three months ended December 31, 2017, our effective tax rate before items discretely related to the period was less than the U.S. statutory rate due primarily to the mix of income between taxing jurisdictions, certain of which have lower statutory tax rates than the U.S., and also due to certain income tax credits generated in the U.S.

Income tax provision was $0.8 million for the three months ended December 31, 2016. Net tax benefits discretely related to the three months ended December 31, 2016 were $0.1 million resulting primarily from the reversal of tax reserves due to the expiration of statutes of limitation from U.S. and foreign tax jurisdictions. For the three months ended December 31, 2016, our effective tax rate before items discretely related to the period was less than the U.S. statutory rate primarily due to the mix of income between taxing jurisdictions, certain of which have lower statutory tax rates than the U.S., and certain tax credits in the U.S.

Our effective tax rate will vary based on a variety of factors, including overall profitability, the geographical mix of income before taxes and related statutory tax rate in each jurisdiction, and tax items discretely related to the period, such as settlements of audits. We expect that we may record other benefits or expenses in the future that are specific to a particular quarter such as expiration of statutes of limitation, the completion of tax audits, or legislation that is enacted for both U.S. and foreign jurisdictions.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is (in thousands):

Unrecognized tax benefits as of September 30, 2017	$1,335
Decreases related to:	
Expiration of statute of limitations	(116)
Unrecognized tax benefits as of December 31, 2017	$1,219

The total amount of unrecognized tax benefits that, if recognized, would affect our effective tax rate is $1.1 million, after considering the impact of interest and deferred benefit items. We expect that the total amount of unrecognized tax benefits will decrease by approximately $0.1 million over the next 12 months.

11. PRODUCT WARRANTY OBLIGATION

In general, we warrant our products to be free from defects in material and workmanship under normal use and service. The warranty periods generally range from one to five years. We typically have the option to either repair or replace products we deem defective with regard to material or workmanship. Estimated warranty costs are accrued in the period that the related revenue is recognized based upon an estimated average per unit repair or replacement cost applied to the estimated number of units under warranty. These estimates are based upon historical warranty incidents and are evaluated on an ongoing basis to ensure the adequacy of the warranty accrual.

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11. PRODUCT WARRANTY OBLIGATION (CONTINUED)

The following table summarizes the activity associated with the product warranty accrual (in thousands) and is included on our Condensed Consolidated Balance Sheets within current liabilities:

Period	Balance at October 1	Warranties issued	Settlements made	Balance at December 31
Three months ended December 31, 2017	$ 987	$ 354	$ (177)	$ 1,164
Three months ended December 31, 2016	$ 1,033	$ 169	$ (177)	$ 1,025

We are not responsible for, and do not warrant, that custom software versions created by original equipment manufacturer ("OEM") customers based upon our software source code will function in a particular way, will conform to any specifications or are fit for any particular purpose. Further, we do not indemnify these customers from any third-party liability as it relates to or arises from any customization or modifications made by the OEM customer.

12. CONTINGENCIES

In the normal course of business, we are subject to various claims and litigation. There can be no assurance that any claims by third parties, if proven to have merit, will not materially adversely affect our business, liquidity or financial condition.

13. STOCK-BASED COMPENSATION

Stock-based awards were granted under the 2017 Omnibus Incentive Plan (the "2017 Plan") beginning January 30, 2017 and, prior to that, were granted under the 2016 Omnibus Incentive Plan (the "2016 Plan"). Upon stockholder approval of the 2017 Plan, we ceased granting awards under any prior plan. Shares remaining in the 2016 Plan were moved into the 2017 Plan. The authority to grant options under the 2017 Plan and to set other terms and conditions rests with the Compensation Committee of the Board of Directors.

The 2017 Plan authorizes the issuance of up to 1,500,000 common shares in connection with awards of stock options, stock appreciation rights, restricted stock, restricted stock units, performance-based full value awards or other stock-based awards. Eligible participants include our employees, our affiliates, non-employee directors of our Company and any consultant or advisor who is a natural person and provides services to us or our affiliates. Options that have been granted under the 2017 Plan typically vest over a four-year period and will expire if unexercised after seven years from the date of grant. Restricted stock unit awards ("RSUs") that have been granted to directors typically vest in one year. RSUs that have been granted to executives and employees typically vest in January over a four-year period. Awards may be granted under the 2017 Plan until January 29, 2027. Options under the 2017 Plan can be granted as either incentive stock options ("ISOs") or non-statutory stock options ("NSOs"). The exercise price of options and the grant date price of restricted stock units shall be determined by our Compensation Committee but shall not be less than the fair market value of our common stock based on the closing price on the date of grant. Upon exercise, we issue new shares of stock. As of December 31, 2017, there were approximately 1,172,108 shares available for future grants under the 2017 Plan.

Our equity plans and corresponding forms of award agreements generally have provisions allowing employees to elect to satisfy tax withholding obligations through the delivery of shares, having us retain a portion of shares issuable under the award or paying cash to us for the withholding. During the three months ended December 31, 2017 and 2016, our employees forfeited 64,276 shares and 28,701 shares, respectively in order to satisfy $0.6 million and $0.4 million, respectively of withholding tax obligations related to stock-based compensation, pursuant to terms of awards under our board and shareholder-approved compensation plans for each respective period.

Cash received from the exercise of stock options was $3.0 million and $2.8 million during the three months ended December 31, 2017 and 2016, respectively.

We sponsor an Employee Stock Purchase Plan (the "Purchase Plan"), covering all domestic employees with at least 90 days of continuous service and who are customarily employed at least 20 hours per week. The Purchase Plan allows eligible participants the right to purchase common stock on a quarterly basis at the lower of 85% of the market price at the beginning or end of each three-month offering period. Employee contributions to the Purchase Plan were $0.4

million and $0.3 million during both three month periods ended December 31, 2017 and 2016. Pursuant to the Purchase Plan, 45,718 and 30,351 common shares were issued to employees during the three months ended December 31, 2017 and 2016, respectively. Shares

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13. STOCK-BASED COMPENSATION (CONTINUED)

are issued under the Purchase Plan from treasury stock. As of December 31, 2017, 395,304 common shares were available for future issuances under the Purchase Plan.

Stock-based compensation expense is included in the consolidated results of operations as follows (in thousands):

	Three months ended December 31,	
	2017	2016
Cost of sales	$50	$62
Sales and marketing	334	340
Research and development	8	182
General and administrative	661	589
Stock-based compensation before income taxes	1,053	1,173
Income tax benefit	(221)	(375)
Stock-based compensation after income taxes	$832	$798

Stock-based compensation cost capitalized as part of inventory was immaterial as of December 31, 2017 and September 30, 2017.

The following table summarizes our stock option activity (in thousands, except per common share amounts):

	Options Outstanding	Weighted Average Exercised Price	Weighted Average Contractual Term (in years)	Aggregate Intrinsic Value (1)
Balance at September 30, 2017	3,902	$10.54		
Granted	592	10.27		
Exercised	(331)	8.97		
Forfeited / Canceled	(408)	13.28		
Balance at December 31, 2017	3,755	$10.34	4.7	$ 1,375
Exercisable at December 31, 2017	2,357	$9.97	3.9	$ 1,132

(1) The aggregate intrinsic value represents the total pre-tax intrinsic value, based on our closing stock price of $9.55 as of December 31, 2017, which would have been received by the option holders had all option holders exercised their options as of that date. The intrinsic value of an option is the amount by which the fair value of the underlying stock exceeds its exercise price.

The total intrinsic value of all options exercised during the three months ended December 31, 2017 was $0.4 million and during the three months ended December 31, 2016 was $0.8 million.

The table below shows the weighted average fair value, which was determined based upon the fair value of each option on the grant date utilizing the Black-Scholes option-pricing model and the related assumptions:

	Three months ended December 31,	
	2017	2016
Weighted average per option grant date fair value	$3.71	$4.64
Assumptions used for option grants:		
Risk free interest rate	2.12% - 2.18%	1.46% - 1.96%
Expected term	6.00 years	6.00 years
Expected volatility	33% - 34%	33% - 34%

Weighted average volatility	33%	34%
Expected dividend yield	0	0

Expected volatilities are based on the historical volatility of our stock. We use historical data to estimate option exercise and employee termination information within the valuation model. The expected term of options granted is derived from the

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13. STOCK-BASED COMPENSATION (CONTINUED)

vesting period and historical information and represents the period of time that options granted are expected to be outstanding. The risk-free rate used is the zero-coupon U.S. Treasury bond rate in effect at the time of the grant whose maturity equals the expected term of the option.

As of December 31, 2017 the total unrecognized compensation cost related to non-vested stock options was $5.4 million and the related weighted average period over which it is expected to be recognized is approximately 3.0 years.

A summary of our non-vested restricted stock units as of December 31, 2017 and changes during the three months then ended is presented below (in thousands, except per common share amounts):

	Number of Awards	Weighted Average Grant Date Fair Value
Nonvested at September 30, 2017	566	$ 11.28
Granted	255	$ 10.26
Vested	(141)	$ 10.78
Canceled	(28)	$ 11.55
Nonvested at December 31, 2017	652	$ 10.98

As of December 31, 2017, the total unrecognized compensation cost related to non-vested restricted stock units was $6.3 million, and the related weighted average period over which it is expected to be recognized is approximately 1.8 years.

14. RESTRUCTURING

Below is a summary of the restructuring charges and other activity (in thousands):

	Q3 2017 Restructuring Employee Termination Costs	Other	Total
Balance at September 30, 2017	$1,528	$128	$1,656
Refunds (payments)	5	(53)	(48)
Foreign currency fluctuation	22	1	23
Balance at December 31, 2017	$1,555	$76	$1,631

Q3 2017 Restructuring

In May 2017, we approved a restructuring plan primarily impacting our France location. We also eliminated certain employee costs in the U.S. The restructuring is a result of a decision to consolidate our France operations to our Europe, Middle East and Africa (“EMEA”) headquarters in Munich. The total restructuring charges amounted to $2.5 million that included $2.3 million of employee costs and $0.2 million of contract termination costs during the third quarter of fiscal 2017. These actions resulted in an elimination of 10 positions in the U.S. and 8 positions in France. The payments associated with these charges are expected to be completed by the fourth quarter ending September 30, 2018.

15. COMMON STOCK REPURCHASE

On May 2, 2017, our Board of Directors authorized a new program to repurchase up to $20.0 million of our common stock primarily to return capital to shareholders. This repurchase authorization expires on May 1, 2018. Shares repurchased under the new program will be made through open market and privately negotiated transactions from time to time and in amounts that management deems appropriate. The amount and timing of share repurchases depends upon market conditions and other corporate considerations. During the third quarter of fiscal 2017, we began to repurchase our common stock on the open market. During the third quarter of fiscal 2017, we repurchased 28,691 shares for $0.3 million. As of December 31, 2017, $19.7 million remains available for repurchase. No further repurchases of common stock has been made under this program.

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16. SUBSEQUENT EVENT

Acquisition of Accelerated Concepts, Inc.

Subsequent to end of the first fiscal quarter of 2018, as announced on January 22, 2018, Digi purchased all the outstanding stock of Accelerated Concepts, Inc., a Tampa-based provider of secure, enterprise-grade, cellular (LTE) networking equipment for primary and backup connectivity applications. The terms of the acquisition included an upfront cash payment together with future earn-out payments. Cash of $16.8 million was paid at closing.

ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Our management’s discussion and analysis should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended September 30, 2017, as well as our subsequent reports on Form 8-K and any amendments thereto.

SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Form 10-Q contains certain statements that are “forward-looking statements” as that term is defined under the Private Securities Litigation Reform Act of 1995, and within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended.

Forward-Looking Statements

The words “anticipate,” “assume,” “believe,” “continue,” “estimate,” “expect,” “intend,” “may,” “plan,” “should,” or “will” or thereof or other variations thereon or similar terminology, which are predictions of or indicate future events and trends and which do not relate to historical matters, identify forward-looking statements. Among other items, these statements relate to expectations of the business environment in which we operate, estimated future values and projections of future performance, perceived marketplace opportunities and statements regarding our mission and vision. Such statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, including risks related to the highly competitive market in which our company operates, rapid changes in technologies that may displace products sold by us, declining prices of networking products, our reliance on distributors and other third parties to sell our products, delays in product development efforts, uncertainty in user acceptance of our products, the ability to integrate our products and services with those of other parties in a commercially accepted manner, potential liabilities that can arise if any of our products have design or manufacturing defects, our ability to defend or settle satisfactorily any litigation, uncertainty in global economic conditions and economic conditions within particular regions of the world which could negatively affect product demand and the financial solvency of customers and suppliers, the impact of natural disasters and other events beyond our control that could negatively impact our supply chain and customers, potential unintended consequences associated with restructuring or other similar business initiatives that may impact our operations and our ability to retain important employees, the ability to achieve the anticipated benefits and synergies associated with acquisitions or divestitures, and changes in our level of revenue or profitability, which can fluctuate for many reasons beyond our control. These and other risks, uncertainties and assumptions identified from time to time in our filings with the United States Securities and Exchange Commission, including without limitation, our Annual Report on Form 10-K for the year ended September 30, 2017, and subsequent quarterly reports on Form 10-Q and other filings, could cause the company’s future results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. Many of such factors are beyond our ability to control or predict. These forward-looking statements speak only as of the date for which they are made. We disclaim any intent or obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

Presentation of Non-GAAP Financial Measures

This report includes Adjusted EBITDA from continuing operations, which is a non-GAAP measure. We understand that there are material limitations on the use of non-GAAP measures. Non-GAAP measures are not substitutes for GAAP measures, such as net (loss) income, for the purpose of analyzing financial performance. The disclosure of these measures does not reflect all charges and gains that were actually recognized by the company. Non-GAAP measures are not prepared in accordance with, or as an alternative for measures prepared in accordance with, generally accepted accounting principles and may be different from non-GAAP measures used by other companies. In addition, non-GAAP measures are not based on any comprehensive set of accounting rules or principles. We believe that non-GAAP measures have limitations in that they do not reflect all of the amounts associated with our results of operations as determined in accordance with GAAP and that these measures should only be used to evaluate our results of operations in conjunction with the corresponding GAAP measures. Additionally, we

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

understand that Adjusted EBITDA from continuing operations does not reflect our cash expenditures, the cash requirements for the replacement of depreciated and amortized assets, or changes in or cash requirements for our working capital needs.

We believe that the presentation of Adjusted EBITDA from continuing operations as a percentage of revenue is useful because it provides a reliable and consistent approach to measuring our performance from year to year and in assessing our performance against that of other companies. We believe this information helps compare operating results and corporate performance exclusive of the impact of our capital structure and the method by which assets were acquired. Adjusted EBITDA from continuing operations is used as an internal metric for executive compensation, as well as incentive compensation for the broader employee base, and it is monitored quarterly for these purposes.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of our condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, the disclosure of contingent assets and liabilities and the values of purchased assets and assumed liabilities in acquisitions. We base our estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

A description of our critical accounting policies and estimates was provided in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the year ended September 30, 2017. There have been no material changes to our critical accounting policies as disclosed in that report, except for the stock-based compensation policy updated below.

Stock-Based Compensation

Stock-based compensation expense represents the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. This cost must be recognized over the period during which an employee is required to provide the service (usually the vesting period). Upon adoption of ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting," we will now account for forfeitures as they occur. Previously, we applied an estimated forfeiture rate to awards granted.

OVERVIEW

We are a leading global provider of business and mission-critical Internet-of-Things ("IoT") Products, Services and Solutions. We have two reportable operating segments for purposes of ASC 280-10-50 "Segments Reporting":

- IoT Products & Services (formerly "M2M") segment ; and
- IoT Solutions (formerly "Solutions") segment.

Our IoT Products & Services segment consists primarily of distinct communications products and communication product development services. Among other things, these products and services help our customers create next generation connected products and deploy and manage critical communications infrastructures in demanding environments with high levels of security and reliability. We create secure, easy to implement embedded solutions and services to help customers build IoT connectivity. We also deploy ready to use, complete box solutions to connect remote machinery. We also offer dedicated professional services for the design of specialized wireless communications products for customers. Finally, through this segment we offer managed cloud services that enable customers to capture and manage data from devices they connect to networks. The products and services of this segment are used by a wide range of businesses and institutions.

All of the revenue we report in our consolidated financial statements as hardware product revenue is derived from products included in this segment. These products include our cellular routers and gateways, radio frequency ("RF"), embedded and network products. Our cellular product category includes our cellular routers and all gateways. Our RF product category includes our XBee® modules as well as other RF Solutions. Our Embedded product category includes Digi Connect® and Rabbit® embedded systems on module and single board computers. Our network product category, which has the highest concentration of mature products, includes console and serial servers and USB connected products. Revenues we report as

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

services and solutions revenue in our consolidated financial statements from this segment include Digi Wireless Design Services, Digi Remote Manager® and support services we provide for our hardware products.

Our IoT Solutions segment offers wireless temperature and other environmental condition monitoring services as well as employee task management services. These products and services are provided to the food service, transportation, education, healthcare and pharma, and industrial and are marketed as Digi Smart Solutions™. We have formed the IoT Solutions segment through a series of acquisitions including the October 2015 acquisition of Bluenica Corporation ("Bluenica"), the November 2016 acquisition of FreshTemp, LLC ("FreshTemp"), the January 2017 acquisition of SMART Temps, LLC ("SMART Temps") and the October 2017 acquisition of TempAlert LLC ("TempAlert") to enhance and expand the capabilities of the IoT Solutions segment. All revenues from this segment are reported in our consolidated financial statements as services and solutions revenue as customers subscribe for ongoing monitoring services that are enabled by the deployment of hardware and related software.

For further detail on segment performance, see Segment Results of Operations section of the management discussion and analysis.

We compete for customers on the basis of existing and planned product features, service and software application capabilities, company reputation, brand recognition, technical support, alliance relationships, quality and reliability, product development capabilities, price and availability.

On October 20, 2017, we purchased all the outstanding interests of TempAlert, a Boston-based provider of automated, real-time temperature monitoring and task management solutions. The purchase price was $45.0 million in cash adjusted for certain net working capital adjustments. The terms of the acquisition included an upfront cash payment together with future earn-out payments. Cash of $40.7 million (excluding cash acquired of $0.6 million) was paid at the time of closing. The earn-out payments are scheduled to be paid after December 31, 2018 and December 31, 2019 which is the end of the earn-out periods. The cumulative amount of the these earn-outs for the periods ended December 31, 2018 and 2019, will not exceed $35.0 million and $45.0 million, respectively. The fair value of this contingent consideration was zero at the date of acquisition and at December 31, 2017 (see Note 7 to the Condensed Consolidated Financial Statements).

Subsequent to end of the first fiscal quarter of 2018, as announced on January 22, 2018, Digi purchased all the outstanding stock of Accelerated Concepts, Inc., a Tampa-based provider of secure, enterprise-grade, cellular ("LTE") networking equipment for primary and backup connectivity applications. The terms of the acquisition included an upfront cash payment together with future earn-out payments. Cash of $16.8 million was paid at closing (see Note 16 to the Condensed Consolidated Financial Statements).

We utilize many financial, operational, and other metrics to evaluate our financial condition and financial performance. Below we highlight the metrics for the first quarter of fiscal 2017 that we feel are most important in these evaluations:

Total Revenue was $45.2 Million. Our revenue was $45.2 million for both the first quarters of fiscal 2018 and fiscal 2017. Hardware product revenue decreased by $4.7 million, or 10.9%. Hardware product revenue performance decreased in all product categories, with the exception of RF product revenue, which increased $2.1 million or 32.1% compared to the same period a year ago. Revenue was also favorably impacted by $0.3 million due to the strengthening of the British Pound and Euro compared to the U.S. Dollar.

Services and solutions revenue increased by $4.7 million, or 236.8% in the first quarter of fiscal 2018 compared to the first quarter of fiscal 2017. This increase was driven primarily by the continued growth and expansion of our IoT Solutions segment, which included incremental revenue of $3.5 million from our recent acquisitions of TempAlert in

October 2017 and our acquisition of SMART Temps in January 2017 (see Note 2 to our Condensed Consolidated Financial Statements).

Gross Margin was 48.5%. Our gross margin increased as a percentage of revenue to 48.5% in the first quarter of fiscal 2018 as compared to 47.5% in the first quarter of fiscal 2017. Gross margin was positively impacted by increased sales from the IoT Solutions segment, which had a higher gross margin, compared to the same period in the prior fiscal year, partially offset by increased amortization expense, primarily related to IoT Solutions.

Income tax expense for the first fiscal quarter of 2018 was $2.6 million. Income tax expense of $2.6 million for the first quarter of fiscal 2018 included three non-cash adjustments related to recent Tax Cuts and Jobs Act of 2017 (the “Act”) enacted on December 22, 2017 and the adoption of Federal Accounting Standards Board (“FASB”) Accounting Standards Update 2016-09 (“ASU 2016-09”) in the first quarter of fiscal 2018. The first is a one-time adjustment of $2.5 million, or $0.09 per diluted

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

share, related to the re-measurement of our net deferred tax assets as a result of the Tax Cuts and Jobs Act of 2017 which lowered the U.S. corporate tax rate from 35% to 21%. The second is an adjustment of $0.1 million for the one-time transition tax based on our post-1986 earnings and profits ("E&P") that we previously deferred from U.S. income taxes. At December 31, 2017 we did not fully complete our accounting for the tax effects of the enactment of the Act, however, in certain cases we have made a reasonable estimate of the effects on our existing deferred tax balances and the one-time transition tax. The third is an adjustment of $0.5 million, or $0.02 per diluted share, for the adoption of ASU 2016-09 which requires the expensing of the tax deficiencies related to stock awards that historically were recorded in additional paid-in capital.

Net loss for the first fiscal quarter of 2018 was $4.6 million, or $0.17 loss per diluted share. Net income for the first fiscal quarter of 2017 was $2.4 million, or $0.09 per diluted share.

Adjusted EBITDA for the first fiscal quarter of 2018 was $2.8 Million, or 6.2% of total revenue. In the first fiscal quarter of fiscal 2017, Adjusted EBITDA was $5.4 million, or 12.0% of total revenue.

Below is a reconciliation of net (loss) income to Adjusted EBITDA:

($ in thousands)	Three months ended December 31, 2017	% of total revenue	2016	% of total revenue
Total revenue	$45,197	100.0%	$45,175	100.0%
Net (loss) income	$(4,569)		$2,357	
Interest income, net	(205)		(126)	
Income tax provision	2,606		765	
Depreciation and amortization	2,405		1,001	
Stock-based compensation	1,053		1,173	
Acquisition expense	1,501		259	
Adjusted EBITDA	$2,791	6.2 %	$5,429	12.0 %

CONSOLIDATED RESULTS OF OPERATIONS

The following table sets forth selected information derived from our interim condensed consolidated statements of operations:

($ in thousands)	Three months ended December 31, 2017		2016		% incr. (decr.)
Revenue:					
Hardware product	$38,454	85.1 %	$43,173	95.6 %	(10.9)
Services and solutions	6,743	14.9	2,002	4.4	236.8
Total revenue	45,197	100.0	45,175	100.0	—
Cost of sales:					
Cost of hardware product	19,210	42.5	22,337	49.4	(14.0)
Cost of services and solutions	3,443	7.6	1,174	2.6	193.3
Amortization of intangibles	607	1.4	211	0.5	187.7
Total cost of sales	23,260	51.5	23,722	52.5	(1.9)

Gross profit	21,937	48.5	21,453	47.5	2.3
Operating expenses	24,060	53.2	19,031	42.1	26.4
Operating (loss) income	(2,123)	(4.7)	2,422	5.4	(187.7)
Other income, net	160	0.4	700	1.5	(77.1)
(Loss) income before income taxes	(1,963)	(4.3)	3,122	6.9	(162.9)
Income tax provision	2,606	5.8	765	1.7	240.7
Net (loss) income	$(4,569)	(10.1)%	$2,357	5.2 %	(293.8)

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ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

REVENUE
Hardware Product
Below is our revenue by hardware product category :

	Three months ended December 31,				% incr.
($ in thousands)	2017		2016		(decr.)
Cellular routers and gateways	$9,577	24.9 %	$13,756	31.9 %	(30.4)
RF	8,682	22.6	6,574	15.2	32.1
Embedded	11,061	28.8	11,841	27.4	(6.6)
Network	9,134	23.7	11,002	25.5	(17.0)
Total hardware product revenue	$38,454	100.0 %	$43,173	100.0 %	(10.9)

Cellular router and gateway revenue decreased $4.2 million, or 30.4%, for the three months ended December 31, 2017 compared to the same period a year ago. In the prior year fiscal quarter we had a large sale to a significant customer. The cellular router and gateway revenue is driven by large awards-based customer projects and is subject to revenue fluctuations from period to period.

RF product revenue increased $2.1 million, or 32.1%, for the three months ended December 31, 2017 compared to the same period a year ago. This increase was primarily a result of larger sales in the first quarter of fiscal 2018 to certain customers in both the North America and EMEA regions.

Embedded product revenue decreased $0.8 million, or 6.6%, for the three months ended December 31, 2017 compared to the same period a year ago. The decrease, primarily in North America, was mostly related to our legacy embedded products, which are in the mature portion of their product life cycle. While we expect mature products to face ongoing challenges, we continue to be encouraged by the design wins and growing pipeline for our new ConnectCore 6UL, released for general availability in April 2017. The ConnectCore 6UL is a power efficient, low cost and small industrial System-on-Module (“SOM”). We expect design wins for this product to convert to revenues when production volumes contribute later this fiscal year.

Network products revenue decreased by $1.9 million, or 17.0%, for the three months ended December 31, 2017 compared to the same period a year ago. The decrease was primarily due to decreased sales of USB connected products as we had significant sales to a large customer in the prior fiscal year. Most of our network products are in the mature phase of their product life cycles and are facing a long-term trend of revenue decline. Absent the significant decline from another large customer, we expect that network product revenue will decline in the future at a rate of approximately 10% to 15% annually.

Services and Solutions

Revenue from our services and solutions offerings increased $4.7 million, or 236.8%, for the three months ended December 31, 2017 compared to the same period a year ago. This increase was driven primarily by the continued growth and expansion of our IoT Solutions segment as we acquired TempAlert in October 2017. This IoT Solutions segment growth, was primarily related to $3.5 million of incremental revenue from our recent acquisitions of TempAlert and SMART Temps, which were acquired in October 2017 and January 2017, respectively (see Note 2 to our Condensed Consolidated Financial Statements). Revenue from FreshTemp and SafeTemp increased $0.5 million for the three months ended December 31, 2017 compared to the same period a year ago. We are now servicing more than 38,000 sites and our annual recurring revenue continues to grow. Revenue in Digi Wireless Design Services and our Digi Remote Manager increased $0.7 million in the three months ended December 31, 2017 compared to the same period a year ago.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Revenue by Geographic Location

The following summarizes our revenue by geographic location of our customers:

	Three months ended December 31,		$ incr.	% incr.
($ in thousands)	2017	2016	(decr.)	(decr.)
North America, primarily United States	$29,579	$29,662	(83)	(0.3)
Europe, Middle East & Africa	10,156	9,811	345	3.5
Asia	4,528	4,568	(40)	(0.9)
Latin America	934	1,134	(200)	(17.6)
Total revenue	$45,197	$45,175	22	—

Revenue in North America decreased by $0.1 million, or 0.3%, for the three months ended December 31, 2017 compared to the same period a year ago. The decrease in revenue was from cellular, network and embedded products. This was partially offset by an increase in revenue primarily related to an increase in services and solutions revenue of $4.7 million, which includes incremental revenue from the acquisitions of TempAlert and Smart Temps of $3.5 million, along with an increase in RF product revenue.

Revenue in EMEA increased by $0.3 million, or 3.5%, for the three months ended December 31, 2017 compared to the same period a year ago. The increase was primarily due to increased revenue for embedded modules and RF products, partially offset by a decline in network products revenue compared to the same periods in the prior fiscal year. We had large sales of RF products to certain customers in the first quarter of fiscal 2018. In addition, revenue was favorably impacted by $0.3 million for the three months ended December 31, 2017 compared to the same period a year ago, as both the Euro and British Pound strengthened against the U.S. Dollar (see Foreign Currency Risk in Part I, Item 3, of this Form 10-Q).

Revenue in Asia remained flat for the three months ended December 31, 2017 compared to the same period a year ago. We experienced an increase in embedded modules, offset by a decrease in legacy embedded products as they are in the mature portion of their product life cycle.

Revenue in Latin America decreased by $0.2 million, or 17.6% for the three months ended December 31, 2017 compared to the same period a year ago, primarily related to decreases in both network and RF product revenue.

No significant changes were made to our pricing strategy that impacted revenue during the three months ended December 31, 2017 as compared to the same period in the prior fiscal year. As foreign currency rates fluctuate, we may from time to time adjust the prices of our products, services and solutions.

GROSS PROFIT

Gross profit for the three months ended December 31, 2017 and 2016 was $21.9 million and $21.5 million, respectively, an increase of $0.4 million, or 2.3%.

Hardware product gross profit for the three months ended December 31, 2017 was $19.2 million, or 50.0%, compared to $20.8 million, or 48.3%, for the three months ended December 31, 2016. The decrease in gross profit of $1.6 million was due primarily to lower revenue performance in our network category, which includes traditionally higher margin products. We expect the network category to continue to decline and create pressure on our gross profit in future periods.

Services and solutions gross profit was $3.3 million, or 48.9%, and $0.8 million, or 41.4% for the three months ended December 31, 2017 and 2016, respectively. The increase in the three month comparable period was primarily a result of increased sales from the IoT Solutions segment, which have a higher gross margin. Services and solutions gross profit may vary from quarter to quarter, as our wireless product design and development service margins are highly dependent on the utilization rates of our personnel. However, we expect our IoT Solutions segment gross margin to increase in future periods as recurring revenue from this segment increases.

Gross profit was negatively impacted by amortization of $0.6 million and $0.2 million for the three months ended December 31, 2017 and 2016, respectively. This increase in amortization expense is primarily related to our IoT

Solutions segment.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

OPERATING EXPENSES

The following summarizes our total operating expenses in dollars and as a percentage of total revenue:

	Three months ended December 31,				$ incr.
($ in thousands)	2017		2016		(decr.)
Sales and marketing	$9,760	21.6%	$8,322	18.4%	$1,438
Research and development	7,751	17.1%	6,905	15.3%	846
General and administrative	6,549	14.5%	3,804	8.4 %	2,745
Total operating expenses	$24,060	53.2%	$19,031	42.1%	$5,029

Sales and marketing expenses increased $1.4 million for the three months ended December 31, 2017 compared to the same period a year ago primarily due to incremental expenses for TempAlert and SMART Temps of $1.3 million.

Research and development expenses increased $0.8 million for the three months ended December 31, 2017 compared to the same period a year ago. The increase was primarily due to incremental costs for research and development expenses for TempAlert and SMART Temps of $0.8 million.

General and administrative expenses increased $2.7 million for the three months ended December 31, 2017 compared to the same period a year ago. The increase included $1.7 million of incremental costs for general and administrative expenses for TempAlert and SMART Temps and $1.2 million of additional acquisition related costs. This was partially offset by a decrease of $0.3 million in earn-out adjustments for fair value of contingent consideration.

OTHER INCOME, NET

We recorded a decrease in other income, net of $0.5 million for the three months ended December 31, 2017, compared to the same period a year ago primarily related to foreign currency gains recognized in the prior fiscal year. The foreign currency gains in the prior fiscal year were mostly related to the weakening of the Euro and Japanese Yen against the U.S. dollar, as non-functional currencies were remeasured at the current rate.

INCOME TAXES

Income tax provision was $2.6 million for the three months ended December 31, 2017. Net tax expense discretely related to the three months ended December 31, 2017 was $2.8 million, primarily as a result of new U.S. tax legislation that was enacted during the first quarter of fiscal 2018 and the adoption of ASU 2016-09 related to the accounting for the tax effects of stock compensation.

The Tax Cuts and Jobs Act of 2017 (the "Act") was enacted on December 22, 2017. The Act lowered the U.S. federal corporate tax rate from 35% to 21% as of January 1, 2018 and requires companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred. Due to our fiscal year end, our statutory rate for fiscal 2018 will be a blend of the new and old tax rates. At December 31, 2017 we did not fully complete our accounting for the tax effects of enactment of the Act; however in certain cases, as described below, we have made a reasonable estimate of the effects on our existing deferred tax balances and the one-time transition tax. For the items for which we were able to determine a reasonable estimate, we recognized a provisional income tax expense amount of $2.6 million which is included as a component of income tax expense.

We remeasured U.S. deferred tax assets and liabilities based on the rates at which they are expected to reverse in the future, which requires estimates of our changes in deferred tax assets and liabilities before and after the new statutory rate was enacted. As a result, we are still analyzing certain aspects of the legislation and refining our calculations such as, refining current year estimates and filings of tax returns, of which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. As of December 31, 2017, the provisional amount recorded related to the re-measurement of this deferred tax balance was $2.5 million.

In addition, we considered the potential tax expense impacts of the one-time transition tax. The transition tax is based on our total post-1986 earnings and profits ("E&P") that we previously deferred from U.S. income taxes. We recorded a provisional amount for our one-time transition tax liability for our foreign subsidiaries, resulting in an increase in income tax expense of $0.1 million. We have not yet completed the calculation of the post-1986 E&P for these foreign subsidiaries and, further, this

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

transition tax is based in part on the amount of those earnings held in cash and other specified assets. This amount may change when we finalize the calculation of post-1986 foreign E&P previously deferred from U.S. federal taxation, evaluate the testing periods for cash and E&P measurement and finalize substantiation of material foreign taxes paid or accrued. Furthermore, it is expected that further guidance will be forthcoming from U.S. Treasury which may or may not impact the final transition tax required. It should be noted, that we continue to review the outside basis differential of our foreign investments. At this point, no additional income taxes have been provided for any undistributed foreign earnings not subject to the transition tax and additional outside basis difference inherent in these entities, as these amounts continue to be indefinitely reinvested in foreign operations. Determining the amount of unrecognized deferred tax liability related to any remaining undistributed foreign earnings not subject to the transition tax and additional outside basis difference in these entities (i.e., basis difference in excess of that subject to the one-time transition tax) is not practical at this time, but it is expected that with inclusion of the transition tax, the potential outstanding basis difference as of December 31, 2017 is expected to be a deductible temporary difference for which no deferred tax asset would be allowed.

As discussed in Note 1 to the Condensed Consolidated Financial Statements, we adopted ASU 2016-09 "Improvements to Employee Share-Based Payment Accounting" on October 1, 2017. As a result of the adoption, we recorded $0.5 million of excess tax expense related to our share-based payments in our provision for income taxes for the three months ended December 31, 2017. Historically, this was record in additional paid-in capital. The excess tax expense related to share-based payments are recognized as tax expense discretely related to the three months ended December 31, 2017.

For the three months ended December 31, 2017, our effective tax rate before items discretely related to the period was less than the U.S. statutory rate due primarily to the mix of income between taxing jurisdictions, certain of which have lower statutory tax rates than the U.S., and also due to certain income tax credits generated in the U.S.

Income tax provision was $0.8 million for the three months ended December 31, 2016. Net tax benefits discretely related to the three months ended December 31, 2016 were $0.1 million resulting primarily from the reversal of tax reserves due to the expiration of statutes of limitation from U.S. and foreign tax jurisdictions. For the three months ended December 31, 2016, our effective tax rate before items discretely related to the period was less than the U.S. statutory rate primarily due to the mix of income between taxing jurisdictions, certain of which have lower statutory tax rates than the U.S., and certain tax credits in the U.S.

Our effective tax rate will vary based on a variety of factors, including overall profitability, the geographical mix of income before taxes and related statutory tax rate in each jurisdiction, and tax items specific to the period, such as settlements of audits. We expect that we may record other benefits or expenses in the future that are specific to a particular quarter such as expiration of statutes of limitation, the completion of tax audits, or legislation that is enacted for both U.S. and foreign jurisdictions.

SEGMENT RESULTS OF OPERATIONS

IoT PRODUCTS & SERVICES

($ in thousands)	Three months ended December 31, 2017		2016		% incr. (decr.)
Revenue:					
Hardware product	$38,454	94.1%	$43,173	96.1%	(10.9)
Services	2,426	5.9	1,763	3.9	37.6
Total revenue					