

DIGITAL POWER CORP

FORM 10QSB

(Quarterly Report of Financial Condition)

Filed 8/14/1998 For Period Ending 6/30/1998

Address	41920 CHRISTY ST FREMONT, California 94538
Telephone	510-657-2635
CIK	0000896493
Industry	Electronic Instr. & Controls
Sector	Technology
Fiscal Year	12/31

U.S. Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-QSB

☒ **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES**
EXCHANGE ACT OF 1934 for the quarterly period ended June 30,
1998

☐ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES**
EXCHANGE ACT OF 1934 for the transition period from _____ to _____

COMMISSION FILE NUMBER 1-12711

DIGITAL POWER CORPORATION

(Exact name of small business issuer as specified in its charter)

California 94-1721931
(State or other jurisdiction of (IRS Employer Identification No.)
incorporation or organization)

41920 Christy Street, Fremont, CA 94538-3158
(Address of principal executive offices)

(510) 657-2635
(Issuer's telephone number)

Check whether the issuer (1) filed all reports required to be filed by
Section 13 or 15(d) of the Exchange Act during the past 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 <square> No <checked-box>

Number of shares of common stock outstanding as of June 30, 1998: 2,717,435

DIGITAL POWER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEET
JUNE 30, 1998

ASSETS	
CURRENT ASSETS:	
Cash	\$ 149,207
Cash - Restricted	600,000
Accounts receivable - trade, net of allowance for doubtful accounts of \$200,000	3,642,494
Other receivables	285,624
Inventory, net	6,676,864
Prepaid expenses and deposits	218,672
Deferred income taxes	119,139
Total current assets	\$11,692,000
PROPERTY AND EQUIPMENT, net	1,299,216
GOODWILL, net	1,099,397
DEPOSITS	30,901

TOTAL ASSETS	\$14,121,514
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Current debt	\$ 1,750,000
Current portion of long-term debt	85,596
Current portion of capital lease obligations	12,283
Accounts payable	1,999,675
Accrued liabilities	1,851,064

Total current liabilities	5,698,618
LONG-TERM DEBT, less current portion	192,267
LONG-TERM DEFERRED INCOME TAX LIABILITY	32,227

Total liabilities	5,923,112

COMMITMENTS AND CONTINGENCIES	-
STOCKHOLDERS' EQUITY:	
Series A cumulative redeemable convertible preferred stock, no par value, 2,000,000 shares authorized; 0 shares issued and outstanding	-
Common Stock, no par value, 10,000,000 shares authorized; 2,717,435 shares issued and outstanding	8,918,323
Warrants	96,678
Additional paid-in capital	381,260
Accumulated deficit	(990,090)
Unearned employee stock ownership plan shares	(277,863)
Foreign currency translation adjustment	70,094

Total stockholders' equity	8,198,402

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$14,121,514
	=====

See accompanying notes to these condensed consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	JUNE 30,		JUNE 30,	
	1998	1997	1998	1997
REVENUES	\$4,575,030	\$5,023,548	\$9,630,361	\$8,822,702
COST OF GOODS SOLD	3,535,150	3,843,359	7,070,504	6,642,805
	-----	-----	-----	-----
Gross Margin	1,039,880	1,180,189	2,559,857	2,179,897
	-----	-----	-----	-----
OPERATING EXPENSES				
Engineering and product development	271,223	209,583	541,119	415,829
Marketing and selling	369,636	162,027	714,115	281,088
General and administrative	388,775	208,283	694,827	435,926
	-----	-----	-----	-----
Total operating expenses	1,029,634	579,893	1,950,061	1,132,843
	-----	-----	-----	-----
INCOME FROM OPERATIONS	10,246	600,296	609,796	1,047,054
	-----	-----	-----	-----
OTHER INCOME (EXPENSES):				
Interest income	109	7,576	1,989	30,763
Interest expense	(67,841)	(15,590)	(115,075)	(43,350)
Translation loss	(11,439)	(11,907)	(14,960)	(14,107)
	-----	-----	-----	-----
Other income (expense)	(79,171)	(19,921)	(128,046)	(26,694)
	-----	-----	-----	-----
INCOME (LOSS) BEFORE INCOME TAXES	(68,925)	580,375	481,750	1,020,360
PROVISION (BENEFIT) FOR INCOME TAXE	(73,342)	213,543	182,900	418,895
	-----	-----	-----	-----
NET INCOME	4,417	366,832	298,850	601,465
	-----	-----	-----	-----
Other comprehensive income from foreign currency translation adjustment	(12,573)	-	70,094	-
	-----	-----	-----	-----
Comprehensive income	\$ (8,156)	\$ 366,832	\$ 368,944	\$ 601,465
	=====	=====	=====	=====
NET INCOME PER SHARE				
BASIC	\$ *	\$ 0.15	\$ 0.11	\$ 0.24
	=====	=====	=====	=====
DILUTED	\$ *	\$ 0.11	\$ 0.09	\$ 0.17
	=====	=====	=====	=====

* Less than \$0.01

See accompanying notes to these condensed consolidated financial statements.

DIGITAL POWER CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

SIX MONTHS ENDED
JUNE 30,

	1998	1997
Cash Flows from Operating Activities:		
Net income	\$ 298,850	\$ 601,465
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	179,325	65,581
Deferred income taxes		(67,700)
Deferred tax expense	(15,234)	
Compensation recognized upon issuance of stock or stock options	48,032	
Contribution to ESOP	47,560	41,128
Foreign currency translation adjustment	14,960	14,107
Changes in operating assets and liabilities:		
Cash - restricted	(600,000)	
Accounts Receivable	509,305	(720,390)
Other receivable	(9,075)	(47,418)
Inventory	(1,090,776)	(978,601)
Prepaid expenses	(89,422)	(28,539)
Other assets		(2,070)
Deposits	(13,641)	
Accounts payable	(1,089,267)	440,551
Accrued liabilities	953,080	(353,824)
Net adjustments	(1,155,153)	(1,637,175)
Net cash used in operating activities	(856,303)	(1,035,710)
Cash Flows from Investing Activities:		
Acquisition of Gresham Power Electronics	(2,974,411)	
Purchases of property and equipment	(46,695)	(264,272)
Proceeds from sale of asset	8,528	
Net cash used in investing activities	(3,012,578)	(264,272)
Cash Flows from Financing Activities:		
Proceeds from sale of common stock and warrants		495,628
Payments on long-term debt	(47,560)	
Principal payments on notes payable		(176,607)
Payments on capital lease obligations	(5,918)	(6,549)
Net proceeds from exercise of stock options and warrants	61,150	22,500
Proceeds from line of credit	1,750,000	1,990,000
Principal payments on line of credit		(3,187,330)
Net cash provided by financing activities	1,757,672	(862,358)
Effect of Exchange Rate Changes on Cash	55,134	(14,107)
Net Increase (Decrease) in cash	(2,056,075)	(2,176,447)
Cash and cash equivalents, beginning of period	2,205,282	2,955,299
Cash and cash equivalents, end of period	\$ 149,207	\$ 778,852
Supplemental Cash Flow Information:		
Cash payments for:		
Interest	\$ 108,877	\$ 53,789
Income taxes	\$ 288,850	\$ 637,402

See accompanying notes to these condensed consolidated financial statements.

DIGITAL POWER CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 1998

(UNAUDITED)

NOTE 1 - BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-KSB for the fiscal year ended December 31, 1997.

In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments consisting only of normal recurring accruals considered necessary to present fairly the Company's financial position at June 30, 1998, the results of operations for the three month and six month periods ended June 30, 1998 and 1997, and cash flows for the six months ended June 30, 1998 and 1997. The results for the period ended June 30, 1998, are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 1998.

On January 26, 1998, the Company acquired the assets of Gresham Power Electronics, a division of Gresham Lion Technology Ltd., a European corporation. The Company paid U.S. \$2.7 million cash plus earn-out and acquisition costs. The net asset value (NAV) will be determined as of January 26, 1998, and will be equal to the value of the fixed assets, accounts receivable, and inventory, less the value of the agreed liabilities. The cash consideration will be increased by U.S. \$1.6284 for each pound that the NAV exceeds U.K. <pound-sterling>1,100,000 and decreased in the same way. From the transfer date to June 30, 1998, an accounting will be done and additional consideration shall be paid as follows: (a) U.S. \$1.15 for every pound of earnings before interest, taxes, and purchaser group charges in excess of U.K. <pound-sterling>250,000 up to a maximum payment of U.S. \$300,000; and (b) U.S. \$300,000 in the event that the post-compensation NAV equals or exceeds U.K. <pound-sterling>1,000,000. The additional consideration due under the agreement is currently estimated to be U.S. \$400,000. As a result of the acquisition, the financial statements for the period ended June 30, 1998, are not comparable to the financial statements for the period ended June 30, 1997.

The Company has filed a Form 8-K announcing this acquisition. However, the required audited financial statements and pro forma financial information have not been filed and will be filed as soon as practicable.

NOTE 2 - EARNINGS PER SHARE

The following represents the calculation of earnings per share:

	FOR THE THREE MONTHS ENDED JUNE 30,		FOR THE SIX MONTHS ENDED JUNE 30,	
	1998	1997	1998	1997
BASIC				
Net Income	\$ 4,417	\$ 366,832	\$ 298,850	\$ 601,465
Less - preferred stock dividends	-	-	-	-
	-----	-----	-----	-----
Net income applicable to common shareholders	\$ 4,417	\$ 366,832	\$ 298,850	\$ 601,465
Weighted average number of common shares	2,704,377	2,521,627	2,701,566	2,512,137
Basic earnings per share	\$ *	\$ 0.15	\$ 0.11	\$ 0.24
	-----	-----	-----	-----
DILUTED				
Net income applicable to common shareholders	\$ 4,417	\$ 366,832	\$ 298,850	\$ 601,465
Preferred stock dividend	-	-	-	-
	-----	-----	-----	-----
Net income available to common shareholders plus assumed conversion	\$ 4,417	\$ 366,832	\$ 298,850	\$ 601,465
	-----	-----	-----	-----
Weighted average number of common shares	2,704,377	2,521,627	2,701,566	2,512,137
Common stock equivalent shares representing shares issuable upon exercise of stock options	367,409	517,579	386,347	508,108
Common stock equivalent shares representing shares issuable upon exercise of warrants	65,468	451,615	116,228	450,138
	-----	-----	-----	-----
Weighted average number of shares used in calculation of diluted income per share	3,137,254	3,490,821	3,204,141	3,470,383
	-----	-----	-----	-----
Diluted earnings per share	\$ *	\$ 0.11	\$ 0.09	\$ 0.17
	-----	-----	-----	-----

*Less than \$0.01

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

With the exception of historical facts stated herein, the matters discussed in this report are "forward looking" statements that involve risks and uncertainties that could cause actual results to differ materially from projected results. Such "forward looking" statements include, but are not necessarily limited to, statements regarding anticipated levels of future revenues and earnings from operations of the Company. Factors that could cause actual results to differ materially include, in addition to other factors

identified in this report, a high degree of customer concentration, dependence on the computer and other electronic equipment industry, competition in the power supply industry, dependence on the Guadalajara, Mexico facility, and other risks factors detailed in the Company's Securities and Exchange Commission ("SEC") filings including the risk factors set forth in Company's Registration Statement on Form SB-2, SEC File No. 333-14199, and "Certain Considerations" section in the Company's Form 10-KSB for the year ended December 31, 1997. Readers of this report are cautioned not to put undue reliance on "forward looking" statements which are, by their nature, uncertain as reliable indicators of future performance. The Company disclaims any intent or obligation to publicly update these "forward looking" statements, whether as a result of new information, future events, or otherwise.

THREE AND SIX MONTH PERIODS ENDED JUNE 30, 1998, COMPARED TO JUNE 30, 1997

REVENUES

Revenues decreased by 8.9% to \$4,575,030 for the three months ended June 30, 1998, from \$5,023,548 for the three months ended June 30, 1997. Revenues from the Company's United Kingdom's operations of Digital Power Ltd. were \$1,725,583 for the second quarter ended June 30, 1998. However, revenues attributed to the United States operations decreased by 25.0% from the same quarter during the prior year. The decrease in revenues can be attributed to the loss of the Company's largest customer at the end of 1997. Although this customer had some minor purchases during the first quarter, no revenues were recorded during the three months ended June 30, 1998. In addition, the electronics industry is experiencing some softness in the demand for the Company's products which adversely affect the Company's revenues during the second quarter.

For the six months ended June 30, 1998, revenues increased by 9.2% to \$9,630,361 from \$8,822,702 for the six months ended June 30, 1997. The increase in revenues during the six months ended June 30, 1998, can be attributed to the acquisition of Gresham Power in the United Kingdom on January 26, 1998. For the six months ended June 30, 1998, Gresham Power contributed \$3,505,450 to the Company's revenues.

GROSS MARGINS

Gross margins were 22.7% for the three months ended June 30, 1998, compared to 23.5% for the three months ended June 30, 1997. The decrease in gross margins can primarily be attributed to reduced shipment level of higher margin products.

Gross margins were 26.6% for the six months ended June 30, 1998, compared to 24.7% for the six months ended June 30, 1997. The improvement in gross margins can primarily be attributed to favorable product mix.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses were 16.6% of revenues for the three months ended June 30, 1998, compared to 7.4% for the three months ended June 30, 1997. Selling, general and administrative expenses were 14.6% of revenues for the six months ended June 30, 1998, compared to 8.1% for the six months ended June 30, 1997. The increase is due, in part, to the inclusion of selling, general and administrative expenses related to the acquisition of Gresham Power in January 1998. In addition, during the second quarter ended June 30, 1998, the Company reduced the number of workers at its plant located in Guadalajara, Mexico. In

connection with the reduction in workers, the Company was required to make severance payments in the amount of approximately \$60,000, which were recorded during the second quarter.

ENGINEERING AND PRODUCT DEVELOPMENT

Engineering and product development expenses were 5.9% of revenues for the three months ended June 30, 1998, and 4.2% for the three months ended June 30, 1997. Engineering and product development expenses were 5.6% of revenues for the six months ended June 30, 1998, compared to 4.7% for the six months ended June 30, 1997. The increase in engineering and product development is a result of an effort by the Company to develop new products for its customers. The increase is due primarily to the engagement of engineering consultants to help develop new products.

INTEREST EXPENSE

Interest expense, net of interest income, was \$67,732 for the three months ended June 30, 1998, compared to \$8,014 for the three months ended June 30, 1997. Interest expense, net of interest income, was \$113,086 for the six months ended June 30, 1998, compared to \$12,587 for the six months ended June 30, 1997. The increase in interest expense related to the increase in borrowing used to acquire Gresham Power.

INCOME (LOSS) BEFORE INCOME TAXES

For the three months ended June 30, 1998, the Company incurred a net loss of (\$68,925) compared to income before income taxes of \$580,375 for the three months ended June 30, 1997. For the six months ended June 30, 1998, the Company had an income of before income taxes of \$481,750 compared to \$1,020,360 for the six months ended June 30, 1997.

INCOME TAX

Provision for income tax decreased from \$213,543 for the three months ended June 30, 1997, to a credit of \$73,342 for the three months ended June 30, 1998, and from \$418,895 for the six months ended June 30, 1997, to \$182,900 for the six months ended June 30, 1998, as a result of a loss during the three months ended June 30, 1998.

NET INCOME

Net income for the three months ended June 30, 1998, was \$4,417 compared to \$366,832 for the three months ended June 30, 1997, a decrease of 98.8%. Net income for the six months ended June 30, 1998, was \$298,850 compared to \$601,465 for the six months ended June 30, 1997, a decrease of 50.3%. The decrease in net income was due to decreased revenues during the second quarter ended June 30, 1998, primarily related to the Company's United States operations, and an increase in expenses related to severance payments made to laid-off workers in Mexico.

LIQUIDITY AND CAPITAL RESOURCES

On June 30, 1998, the Company had cash of \$149,207 and working capital of \$5,993,382. This compares with cash of \$778,852 and working capital of \$5,314,256 at June 30, 1997. The increase in working capital was due to an increase in inventory and receivables, offset by an increase in accounts payable and bank line of credit borrowings resulting in a decrease in cash and cash equivalents, although the decrease in cash is related to cash used to acquire Gresham Power. Cash used in operating activities for the Company totaled \$856,303 and \$1,035,710 for the six months ended June 30, 1998 and 1997.

Cash used in investing activities was \$3,012,578 for the six months ended June 30, 1998, compared to \$264,272 for the six months ended June 30, 1997. During the six months ended June 30, 1998, the Company completed the acquisition of Gresham Power. Net cash provided (used) by financing activities was \$1,757,672 for the six months ended June 30, 1998, compared to \$(862,358). During the six months ended June 30, 1998, the Company borrowed \$1,750,000 from the bank in connection with the acquisition of Gresham Power.

As previously reported, a large OEM customer canceled a contract in late 1997. This customer was billed cancellation charges for the cost of unique materials and assemblies. After negotiations between the Company and OEM, the Company and the OEM agreed to an amount of cancellation charges. These cancellation charges were recorded and paid in July and will have a positive impact on operating income in the third quarter although the exact amount of the impact cannot be determined at this time.

IMPACT OF THE YEAR 2000 ISSUE

The Year 2000 Issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's, or its suppliers' and customers' computer programs that have date-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in system failures or miscalculations causing disruptions of operations including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities.

The Company has recently acquired new software and has been informed by its suppliers that such software used by the Company is Year 2000 compliant. The software from these suppliers is used in major areas of the Company's operations such as for financial, sales, warehousing and administrative purposes. The Company has no internally generated software. In connection with the acquisition of Gresham Power, the Company has determined that Gresham Power's existing software will not be Year 2000 compliant, and intends to acquire new software to address the Year 2000 Issue. Other than Gresham Power, and after reasonable investigation, the Company has not yet identified any other Year 2000 problem but will continue to monitor the issue. However, there can be no assurances that the Year 2000 problem will not occur with respect to the Company's computer systems.

Neither the Company nor its subsidiaries has initiated formal communications with significant suppliers and large customers to determine the extent to which those third parties' failure to remedy their own Year 2000 Issues would materially effect the Company and its subsidiaries. The Company has not received any indication from its suppliers and large customers that the Year 2000 Issue may materially effect their ability to conduct business and the Company has no current plans to formally undertake such an assessment.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDS

As previously reported on Form 10-QSB for the quarter ended March 31, 1998, the Company is involved in certain litigation. No new material developments occurred during the quarter ended June 30, 1998.

ITEM 2. CHANGES IN SECURITIES

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On May 20, 1998, the Company held its annual meeting of shareholders for the election of directors and to approve an amendment to increase the number of shares of Common Stock subject to the 1996 stock option plan as follows:

ELECTION OF DIRECTOR	FOR	VOTES WITHHELD
Robert J. Boschert	1,282,658	154,739
Scott C. MacDonald	1,283,581	153,816
Thomas W. O'Neill, Jr.	1,282,658	154,739
Chris Schofield	1,282,658	154,739
Robert O. Smith	1,282,658	154,739

FOR	AGAINST	ABSTAIN
-----	---------	---------

Approval to amendment to increase the
number of shares subject to the 1996 1,226,959 191,455 12,133 stock option plan

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

27.1 Financial Data Schedule

SIGNATURES

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

DIGITAL POWER CORPORATION (Registrant)

Date: August 14, 1998

ROBERT O. SMITH

Robert O. Smith
Chief Executive Officer
(Principal Executive Officer)

Date: August 14, 1998

PHILIP G. SWANY

Philip G. Swany
Chief Financial Officer
(Principal Financial Officer)

ARTICLE 5

THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE 10-QSB FOR THE PERIOD ENDED JUNE 30, 1998 FOR DIGITAL POWER CORPORATION AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

PERIOD TYPE	6 MOS
FISCAL YEAR END	DEC 31 1998
PERIOD END	JUN 30 1998
CASH	149,207
SECURITIES	0
RECEIVABLES	3,842,494
ALLOWANCES	(200,000)
INVENTORY	6,676,864
CURRENT ASSETS	11,692,000
PP&E	2,368,000
DEPRECIATION	(1,068,784)
TOTAL ASSETS	14,121,514
CURRENT LIABILITIES	5,698,618
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	8,918,323
OTHER SE	(719,921)
TOTAL LIABILITY AND EQUITY	14,121,514
SALES	9,630,361
TOTAL REVENUES	9,630,361
CGS	7,070,504
TOTAL COSTS	7,070,504
OTHER EXPENSES	1,950,061
LOSS PROVISION	0
INTEREST EXPENSE	(115,075)
INCOME PRETAX	481,750
INCOME TAX	182,900
INCOME CONTINUING	298,850
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	298,850
EPS PRIMARY	0.11
EPS DILUTED	0.09

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