

DIGITAL POWER CORP

FORM 10-Q (Quarterly Report)

Filed 5/20/1998 For Period Ending 3/31/1998

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 March 31,
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
(State or other jurisdiction of
incorporation or organization)

94-1721931
(IRS Employer Identification
No.)

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

(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 ☐ No ☒

Number of shares of common stock outstanding as of May 8, 1998: 2,700,685

Transitional Small Business disclosure format Yes ☐ No ☒

<PAGE2>

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DIGITAL POWER CORPORATION AND SUBSIDIARY CONDENSED CONSOLIDATED BALANCE SHEET

MARCH 31, 1998
ASSETS

CURRENT ASSETS:

Cash	\$	287,067
Cash - Restricted		600,000
Accounts receivable - trade, net of allowance for doubtful accounts of \$235,000		4,601,928
Other receivables		262,772
Inventory, net		6,648,842
Prepaid expenses and deposits		82,019
Deferred income taxes		119,139

Total current assets		12,601,767

PROPERTY AND EQUIPMENT, net	1,362,451
GOODWILL, net	1,101,311
DEPOSITS	22,668

TOTAL ASSETS	\$ 15,088,197
	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:

Current debt	\$ 1,500,000
Current portion of long-term debt	99,541
Current portion of capital lease obligations	13,093
Accounts payable	2,912,818
Accrued liabilities	2,173,163

Total current liabilities	6,698,615
LONG-TERM DEBT, less current portion	201,871
DEFERRED INCOME TAXES	32,227
OBLIGATIONS UNDER CAPITAL LEASE, less current portion	2,625

Total liabilities	6,935,338

(Continued)

<PAGE3>

DIGITAL POWER CORPORATION AND SUBSIDIARY CONDENSED CONSOLIDATED BALANCE SHEET

(Continued)

COMMITMENTS AND CONTINGENCIES (Note 3)	-
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, 2,700,685 shares issued and outstanding	8,888,173
Warrants	96,678
Additional Paid-in Capital	381,260
Accumulated deficit	(994,507)
Unearned employee stock ownership plan shares	(301,412)
Foreign currency translation adjustment	82,667

Total stockholders' equity	8,152,859

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$15,088,197
	=====

SEE ACCOMPANYING NOTES TO THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

<PAGE4>

DIGITAL POWER CORPORATION AND SUBSIDIARY CONDENSED CONSOLIDATED STATEMENTS OF INCOME

THREE MONTHS ENDED
MARCH 31,

REVENUES	\$ 5,055,331	\$ 3,799,154
COST OF GOODS SOLD	3,535,354	2,799,446
	-----	-----
Gross Margin	1,519,977	999,708
	-----	-----
OPERATING EXPENSES:		
Engineering and product development	269,896	206,246
Marketing and selling	344,479	119,061
General and administrative	306,052	227,643
	-----	-----
Total operating expenses	920,427	552,950
	-----	-----
INCOME FROM OPERATIONS	599,550	446,758
	-----	-----
OTHER INCOME (EXPENSE):		
Interest income	1,880	23,187
Interest expense	(47,234)	(27,760)
Translation loss	(3,521)	(2,200)
	-----	-----
Other income (expense)	(48,875)	(6,773)
	-----	-----
INCOME BEFORE INCOME TAXES	550,675	439,985
PROVISION FOR INCOME TAXES	256,242	205,352
	-----	-----
NET INCOME	\$ 294,433	\$ 234,633
	=====	=====
NET INCOME PER COMMON SHARE:		
Basic	\$ 0.11	\$ 0.09
	=====	=====
Diluted	\$ 0.09	\$ 0.07
	=====	=====

SEE ACCOMPANYING NOTES TO THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

<PAGE5>

DIGITAL POWER CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

THREE MONTHS ENDED
MARCH 31,

	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 294,433	\$ 234,633
	-----	-----
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	74,265	29,231
Deferred income taxes	(15,234)	(67,700)
Contribution to ESOP	24,011	20,417
Compensation costs recognized upon issuance of warrants	48,032	-
Foreign currency translation adjustment	3,521	2,200
Changes in operating assets and liabilities:		
Cash restricted	(600,000)	-
Accounts receivable	(450,129)	(142,724)
Other receivables	13,777	(108,141)
Inventory	(1,062,754)	(868,085)
Prepaid expenses	47,231	(31,182)
Other assets	(5,408)	(4,263)
Accounts payable	(174,290)	452,498
Other accrued liabilities	1,275,179	(48,481)
	-----	-----
Net adjustments	(821,799)	(766,230)

Net cash used in operating activities	(527,366)	(531,597)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of Gresham Technology	(2,939,590)	-
Purchases of property and equipment	(34,911)	(156,503)
Net cash used in investing activities	(2,974,501)	(156,503)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock and warrants	-	493,628
Proceeds from exercise of stock options and warrants	31,000	13,500
Principal payments on notes payable	(24,011)	(155,896)
Principal payments on capital lease obligations	(2,483)	(3,230)
Proceeds from line of credit	1,500,000	1,990,000
Principal payments on line of credit	-	(3,187,330)
Net cash provided by (used in) financing activities	1,504,506	(849,328)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	79,146	(2,200)

(Continued)

<PAGE6>

DIGITAL POWER CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Continued)

NET DECREASE IN CASH	(1,918,215)	(1,539,628)
CASH AND CASH EQUIVALENTS, beginning of period	2,205,282	2,955,299
CASH AND CASH EQUIVALENTS, end of period	\$ 287,067	\$ 1,415,671
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash payments for:		
Interest	\$ 27,854	\$ 40,757
Income taxes	\$ 30,000	\$ 256,402

SEE ACCOMPANYING NOTES TO THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

<PAGE7>

DIGITAL POWER CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 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 considered necessary to present fairly the Company's financial position at March 31, 1998, results of operations for the three month periods ended March 31, 1998 and 1997 and cash flows for the three months ended March 31, 1998 and 1997. The results for the period ended March 31, 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 US\$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 US\$1.6284 for each pound that the NAV exceeds UK<POUND-STERLING>1,100,000 and decreased in the same way. From the transfer date to March 31, 1998, an accounting will be done and additional consideration shall be paid as follows: (a) US\$1.15 for every pound of earnings before interest, taxes, and purchaser group charges in excess of UK<POUND-STERLING>250,000 up to a maximum payment of US\$300,000; and (b) US\$300,000 in the event that the post compensation NAV equals or exceeds UK<POUND-STERLING>1,000,000. The additional consideration due under the agreement is currently estimated to be US\$354,000. As a result of the acquisition, the financial statements for the period ended March 31, 1998 are not comparable to the financial statements for the period ended March 31, 1997.

<PAGE8>

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

NOTE 2 - EARNINGS PER SHARE

The following represents the calculation of the earnings per share:

	March 31, 1998	1997
BASIC		
Net income	\$ 294,433	\$ 234,633
Less - preferred stock dividends	-	-
	-----	-----
Net income applicable to common shareholders	\$ 294,433	\$ 234,633
	=====	=====
Weighted average number of common shares	2,698,723	2,502,542
Basic earnings per share	\$ 0.11	\$ 0.09
	=====	=====
DILUTED		
Net income available to common shareholders	\$ 294,433	\$ 234,633
Preferred stock dividend	-	-
	-----	-----
Net income available to common shareholders plus assumed conversion	\$ 294,433	\$ 234,633
	=====	=====
Weighted average number of common shares	2,698,723	2,502,542
	=====	=====
Common stock equivalent shares representing shares issuable upon exercise of stock options	421,735	437,309
Common stock equivalent shares representing shares issuable upon exercise of warrants	160,523	260,543
	-----	-----
Weighted average number of shares used in calculation of diluted income per share	3,280,981	3,200,394
	=====	=====
Diluted earnings per share	\$ 0.09	\$ 0.07
	=====	=====

NOTE 3 - COMMITMENTS AND CONTINGENCIES

On April 20, 1998, the Company was served with a complaint in the Superior Court of California in and for the County of Santa Clara (Case No. CV773108) by KDK Electronics, Inc. ("KDK"). In its complaint, KDK alleges breach of contract, misappropriation of trade secrets, fraud, and negligent misrepresentation in connection with, among other things, the Company's alleged failure to pay KDK royalties on sales of products that were allegedly derived from KDK's designs, and for failure to issue 100,000 shares of the Company's Common Stock based on revenues from those products. KDK's complaint seeks economic damages of approximately \$300,000, punitive and exemplary damages, injunctive relief, attorneys' fees and costs. The Company has answered the complaint and intends to vigorously defend itself in the lawsuit. The litigation is in its initial stages.

On March 17, 1998, a lawsuit was filed by Ignacio Valencia against the Company in the Superior Court of Santa Clara County (No. CV772665) alleging deceit and breach of contract. In the complaint, Mr. Valencia alleges that in 1986, Mr. Valencia moved his family to Guadalajara, Mexico on reliance that he would become president of Poder Digital S.A. de C.V. ("Poder"), the Company's wholly-owned subsidiary and would receive forty percent of the profits of Poder. Mr. Valencia is claiming lost wages of \$52,000 and lost stock options of \$350,000 and punitive damages. The litigation is in its initial stages, and the Company intends to vigorously defend itself in the lawsuit.

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 Consideration" section in the Company's Form 10-KSB for the year

<PAGE10>

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 MONTHS ENDED MARCH 31, 1998, COMPARED TO MARCH 31, 1997.

REVENUES

Revenues increased by 33% to \$5,055,331 for the first quarter ended March 31, 1998, from \$3,799,154 for the first quarter ended March 31, 1997. This increase in sales can be attributed to the acquisition on January 26, 1998, of Gresham Power in the United Kingdom which contributed \$1,799,867 to the Company's revenues of the first quarter ended March 31, 1998. The electronics industry is experiencing some softness and demand for the Company's products will be adversely affected through at least the Company's second quarter.

GROSS MARGINS

Gross margins were 30.0% for the first quarter ended March 31, 1998, compared to 26.3% for the first quarter ended March 31, 1997. The improvement in gross margins can primarily be attributed to greater capacity utilization and increased sales of higher wattage supplies which generated higher gross margins.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses were 12.9% of revenues for the first quarter ended March 31, 1998, compared to 9.1% for the first quarter ended March 31, 1997. The increase in selling, general and administrative expenses was due primarily to the increased legal and accounting expenses required by public companies for financial and regulatory reporting.

ENGINEERING AND PRODUCT DEVELOPMENT

Engineering and product development expenses increased by \$63,650 for the first quarter ended March 31, 1998, compared to the first quarter ended March 31, 1997. This increase in expenses was due primarily to engineering staff additions and increased consulting fees for advanced development effort.

INTEREST EXPENSE

Interest expense, net of interest income, was \$45,354 for the first quarter ended March 31, 1998, compared to \$4,573 for the first quarter ended March 31, 1997. The increase in interest was due to increased borrowings on the bank line of credit for partial financing of the Gresham Power acquisition.

INCOME BEFORE INCOME TAXES

Income before income taxes increased by \$110,690 from \$439,985 for the first quarter ended March 31, 1997, to \$550,675 for the first quarter ended March 31, 1998. This increase can be attributed to the improvement in gross margins, which more than offset the increases in the Company's operating expenses.

INCOME TAX

Provision for income tax increased from \$205,352 in the first quarter ended March 31, 1997, to \$256,242 for the first quarter ended March 31, 1998. For the quarter ended March 31, 1998, taxes were provided at an effective rate of 41% for income earned in the United States and 24% for income earned in the United Kingdom.

NET INCOME

Net income for the first quarter ended March 31, 1998, was \$294,433 compared to \$234,633 for the first quarter ended March 31, 1997, an increase of 25%. The increase in net income was due to increased revenues and improved gross margins which more than offset increases in operating expenses.

LIQUIDITY AND CAPITAL RESOURCES

On March 31, 1998, the Company had cash and cash equivalents of \$287,067 and working capital of \$5,903,152. This compares with cash and cash equivalents of \$1,415,671 and working capital of \$5,011,466 at March 31, 1997. The increase in working capital is primarily due to an increase in receivables and inventory, offset by an increase in accounts payable and bank line of credit borrowings resulting in a decrease in cash and cash equivalents. Cash used by operating activities for the Company totaled \$527,366 and \$531,597 for the three months ended March 31, 1998 and 1997, respectively. Cash used in investing activities consisted of expenditures for the acquisition of Gresham Power in the United Kingdom and expenditures for the purchase of production and testing equipment. Such expenditures increased to \$2,974,501

<PAGE12>

during the three months ended March 31, 1998, from \$156,503 during the prior year period. During the three months ended March 31, 1998, cash provided by financing activities included net increase in borrowings of \$1,473,506 plus proceeds from the sale of warrants of \$31,000. The increase in the borrowings came from the Company's amended line of credit and was used to pay part of the purchase price of the acquisition of Gresham. The line of credit allows for borrowings up to a maximum of \$3,000,000, requires monthly interest payments at the bank's prime rate and expires June 15, 1998. During the three months ended March 31, 1997, cash used in financing activities included net reduction in borrowings of \$1,356,456 offset by proceeds of \$507,128 from the sale of common stock, warrants and the exercise of stock options. During the three months ended March 31, 1997, the Company's line of credit and bank loans were paid in full.

The Company will be required to pay additional consideration related to the Gresham acquisition currently estimated to be \$354,000. The Company has placed \$600,000 in an escrow account to pay for the additional consideration. As of March 31, 1998, the \$600,000 was included in restricted cash.

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 mis-calculations 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.

<PAGE13>

Neither the Company nor its subsidiary 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.

On April 20, 1998, the Company was served with a complaint in the Superior Court of California in and for the County of Santa Clara (Case No. CV773108) by KDK Electronics, Inc. ("KDK"). In its complaint, KDK alleges breach of contract, misappropriation of trade secrets, fraud, and negligent misrepresentation in connection with, among other things, the Company's alleged failure to pay KDK royalties on sales of products that were allegedly derived from KDK's designs, and for failure to issue 100,000 shares of the Company's Common Stock based on revenues from those products. KDK's complaint seeks economic damages of approximately \$300,000, punitive and exemplary damages, injunctive relief, attorneys' fees and costs. The Company has answered the complaint and intends to vigorously defend itself in the lawsuit. The litigation is in its initial stages.

On March 17, 1998, a lawsuit was filed by Ignacio Valencia against the Company in the Superior Court of Santa Clara County (No. CV772665) alleging deceit and breach of contract. In the complaint, Mr. Valencia alleges that in 1986, Mr. Valencia moved his family to Guadalajara, Mexico on reliance that he would become president of Poder Digital S.A. de C.V. ("Poder"), the Company's wholly-owned subsidiary and would receive forty percent of the profits of Poder. Mr. Valencia is claiming lost wages of \$52,000 and lost stock options of \$350,000 and punitive damages. The litigation is in its initial stages, and the Company intends to vigorously defend itself in the lawsuit.

<PAGE14>

ITEMS 2, 3, 4, AND 5.

Not Applicable.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) None

(b) Report on Form 8-K for the period ended January 26, 1998, was filed February 10, 1998, regarding the acquisition of Gresham Power.

<PAGE15>

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: May 20, 1998

ROBERT O. SMITH

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

Date: May 20, 1998

PHILIP SWANY

Philip Swany
Chief Financial Officer
(Principal Financial Officer)

ARTICLE 5

THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE 10-QSB FOR THE PERIOD ENDED MARCH 31, 1998 FOR DIGITAL POWER CORPORATION AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

PERIOD TYPE	3 MOS
FISCAL YEAR END	DEC 31 1998
PERIOD END	MAR 31 1998
CASH	287,067
SECURITIES	0
RECEIVABLES	4,836,928
ALLOWANCES	(235,000)
INVENTORY	6,648,842
CURRENT ASSETS	12,601,767
PP&E	2,385,511
DEPRECIATION	(1,023,060)
TOTAL ASSETS	15,088,197
CURRENT LIABILITIES	6,698,615
BONDS	0
PREFERRED MANDATORY	0
PREFERRED	0
COMMON	8,888,173
OTHER SE	(735,314)
TOTAL LIABILITY AND EQUITY	15,088,197
SALES	5,055,331
TOTAL REVENUES	5,055,331
CGS	3,535,354
TOTAL COSTS	3,535,354
OTHER EXPENSES	920,427
LOSS PROVISION	0
INTEREST EXPENSE	(47,234)
INCOME PRETAX	550,675
INCOME TAX	256,242
INCOME CONTINUING	294,433
DISCONTINUED	0
EXTRAORDINARY	0
CHANGES	0
NET INCOME	294,433
EPS PRIMARY	.11
EPS DILUTED	.09

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