J2 GLOBAL COMMUNICATIONS INC
Form 10-Q
May 10, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2006

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: 0-25965

j2 GLOBAL COMMUNICATIONS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**51-0371142**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6922 Hollywood Boulevard, Suite 500
Los Angeles, California 90028
(Address of principal executive offices)

(323) 860-9200
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required 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 x No o

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

As of April 27, 2006, the registrant had 24,842,248 shares of Common Stock outstanding.

j2 GLOBAL COMMUNICATIONS, INC.

FOR THE QUARTER ENDED MARCH 31, 2006

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

j2 Global Communications, Inc.
Condensed Consolidated Balance Sheets
(In thousands)

	March 31, 2006 (Unaudited)	December 31, 2005
ASSETS		
Cash and cash equivalents	$ 50,731	$ 36,301
Short-term investments	89,115	76,525
Accounts receivable,		
net of allowances of $677 and $627, respectively	10,143	10,211
Prepaid expenses and other current assets	2,652	3,350
Deferred income taxes	1,091	1,091
Total current assets	153,732	127,478
Long-term investments	22,490	31,673
Property and equipment, net	17,012	17,248
Goodwill	21,260	20,681
Other purchased intangibles, net	21,051	20,299
Other assets	283	307
Deferred income taxes	4,903	4,559
Total assets	$ 240,731	$ 222,245
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable and accrued expenses	$ 7,028	$ 7,611
Income taxes payable	5,986	2,809
Deferred revenue	8,384	7,201
Current portion of long-term debt	451	593
Total current liabilities	21,849	18,214
Deferred rent	113	—
Long-term debt	121	149
Total liabilities	22,083	18,363
Total stockholders' equity	218,648	203,882
Total liabilities and stockholders' equity	$ 240,731	$ 222,245

See accompanying notes to condensed consolidated financial statements

j2 Global Communications, Inc.
Condensed Consolidated Statements of Operations
(Unaudited, in thousands except share and per share data)

	Three Months Ended March 31,			
	2006		2005	
Revenues:				
Subscriber	$	40,562	$	31,275
Other		1,456		949
		42,018		32,224
Cost of revenues (including non-cash compensation of $109 for 2006)		9,010		6,497
Gross profit		33,008		25,727
Operating expenses				
Sales and marketing (including non-cash compensation of $265 for 2006)		6,864		5,462
Research, development and engineering (including non-cash compensation of $110 for 2006)		1,892		1,761
General and administrative (including non-cash compensation of $940 for 2006)		7,900		5,145
Total operating expenses		16,656		12,368
Operating earnings		16,352		13,359
Interest and other income, net		1,256		597
Earnings before income taxes		17,608		13,956
Income tax expense		5,297		3,768
Net earnings	$	12,311	$	10,188
Net earnings per common share:				
Basic	$	0.50	$	0.43
Diluted	$	0.48	$	0.40
Weighted average shares outstanding:				
Basic		24,624,889		23,666,910
Diluted		25,518,689		25,382,088

See accompanying notes to condensed consolidated financial statements

j2 Global Communications, Inc.
Condensed Consolidated Statements of Cash Flows
(Unaudited, in thousands)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Cash flows from operating activities:		
Net earnings	$ 12,311	$ 10,188
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	1,989	1,689
Stock compensation expense	1,424	—
Tax benefit of stock option exercises	506	1,273
Excess tax benefits on stock compensation expense	(482)	—
Deferred income taxes	(343)	—
Changes in assets and liabilities, net of effects of business acquisitions:		
Decrease (increase) in:		
Accounts receivable	79	(1,531)
Prepaid expenses	153	247
Other assets	(122)	43
(Decrease) increase in:		
Accounts payable and accrued expenses	(1,446)	157
Income taxes payable	3,880	1,646
Deferred rent	113	—
Deferred revenue	1,183	50
Net cash provided by operating activities	19,245	13,762
Cash flows from investing activities:		
Net redemptions (purchases) of available-for-sale investments	(22,479)	3,950
Net redemptions (purchases) of held-to-maturity investments	19,065	(10,957)
Purchases of property and equipment	(757)	(2,473)
Acquisition of businesses, net of cash received	—	(3,587)
Purchases of intangible assets	(1,068)	(2,869)
Net cash used in investing activities	(5,239)	(15,936)
Cash flows from financing activities:		
Issuance of common stock under employee stock purchase plan	130	124
Exercise of stock options and warrants	183	311
Excess tax benefits on stock compensation expense	482	—
Repayment of long-term debt	(170)	(501)
Net cash provided by (used in) financing activities	625	(66)
Effect of exchange rate changes on cash and cash equivalents	(201)	(67)
Net increase (decrease) in cash and cash equivalents	14,430	(2,307)
Cash and cash equivalents at beginning of period	36,301	18,814
Cash and cash equivalents at end of period	$ 50,731	$ 16,507

See accompanying notes to condensed consolidated financial statements

j2 GLOBAL COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006
(UNAUDITED)

NOTE 1 — BASIS OF PRESENTATION

j2 Global Communications, Inc. ("j2 Global" or the "Company") is a Delaware corporation founded in 1995. The Company leverages the power of the Internet to provide outsourced, value-added messaging and communications services to individuals and businesses throughout the world. j2 Global offers faxing and voicemail solutions; hosted email services and bundled suites of certain of these services. j2 Global markets its services principally under the brand names eFax®, jConnect®, UniFax™, Onebox®, Electric Mail®and eVoice®.

The accompanying interim condensed consolidated financial statements include the accounts of j2 Global and its direct and indirect wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

The accompanying interim condensed consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") including those for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X issued by the Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and note disclosures required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been reflected in these interim financial statements. These financial statements should be read in conjunction with the audited financial statements and related notes for the year ended December 31, 2005 included in the Company's Annual Report on Form 10-K filed with the SEC on March 27, 2006.

The results of operations for these interim periods are not necessarily indicative of the operating results for the full year or for any future period.

Stock-based compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" (SFAS 123(R)), which requires all share-based payments to employees, including grants of employee stock options and purchases under certain employee stock purchase plans, to be recognized as compensation expense in the results of operations. Share-based compensation expense as required by SFAS 123(R) is recognized over the requisite employee service period based on the grant date fair value of those awards.

The Company adopted SFAS 123(R) using the modified prospective method and accordingly, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized during the first quarter of 2006 applies to unvested stock options granted prior to December 31, 2005 based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, "Accounting for Stock-Based Compensation" (SFAS 123), and any new share-based awards granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with SFAS 123(R). Additionally, stock-based compensation expense recognized during the first quarter of 2006 has been reduced by estimated pre-vesting forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The prospective application of SFAS 123(R) had a material impact on the Company's consolidated financial positions, results of operations and cash flows. See Note 3 regarding the Company's stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods as if the Company had recorded stock-based compensation expense. The cumulative effect upon adoption of SFAS 123(R) was not material.

NOTE 2 — USE OF ESTIMATES

The preparation of consolidated financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenue and expenses during the reporting period. On an ongoing basis, management evaluates its estimates, including those related to revenue recognition, allowances for doubtful accounts and the valuation of deferred income taxes, tax contingencies, stock-based compensation expense and long-lived and intangible assets and goodwill.

NOTE 3 — STOCK-BASED COMPENSATION

The Company's stock-based compensation plans include the Second Amended and Restated 1997 Stock Option Plan and the 2001 Employee Stock Purchase Plan (discussed below).

Effective January 1, 2006, the Company adopted SFAS 123(R), applying the modified prospective method. Prior to the adoption of SFAS 123(R), the Company applied the provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees", (APB 25) in accounting for stock options, and accordingly, no compensation cost was recognized for stock option grants other than for its restricted stock awards.

Under the modified prospective method, SFAS 123(R) applies to new awards and to the unvested portion of awards that were outstanding on January 1, 2006 and to awards that are subsequently modified, repurchased or cancelled. Compensation cost recognized in the first quarter of fiscal 2006 includes compensation cost for all share-based awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and compensation cost for all share-based awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Prior periods were not restated to reflect the impact of adopting the new standard.

The following table represents the stock-based compensation expense that was included in cost of revenues and operating expenses in the accompanying condensed consolidated statements of operations for the three month period ended March 31, 2006 (in thousands):

Cost of revenues	$	109
Sales and marketing		265
Research, development and engineering		110
General and administrative		940
	$	1,424

The Company receives a tax deduction for certain stock option exercises during the period the options are exercised, generally for the excess of the fair value of stock at the date of exercise over the exercise price of the options. Prior to the adoption of SFAS 123(R), the Company presented all tax benefits resulting from the exercise of stock options as operating cash flows in the statements of cash flows. SFAS 123(R) requires cash flows resulting from excess tax benefits to be classified as part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. In accordance with SFAS 123(R), the Company reported $482,000 of excess tax benefits as financing cash flows for the three months ended March 31, 2006. The total tax benefit realized from stock option exercises for the three months ended March 31, 2006 and 2005 was $0.5 million and $1.3 million, respectively. Cash received from stock option exercises was $183,000 and $311,000 for the three months ended March 31, 2006 and 2005, respectively.

Prior to January 1, 2006, the Company applied the intrinsic value-based method of accounting prescribed by APB 25, and related interpretations to account for its stock option plans, but disclosed the pro forma effect on net earnings and net earnings per share as if compensation expense had been recognized based on the fair value-based method at the date of grant for stock options awarded consistent with the provisions of SFAS 123. The Company's reported and pro forma information for the three months ended March 31, 2005 was as follows (in thousands, except per share amount):

Net earnings, as reported	$	10,188
Deduct: Stock based employee compensation expense determined under the fair value-based method, net of tax		(674)
Pro forma net earnings	$	9,514
Basic net earnings per common share:		
As reported	$	0.43
Pro forma	$	0.40
Diluted net earnings per common share:		
As reported	$	0.40
Pro forma	$	0.38

Second Amended and Restated 1997 Stock Option Plan (1997 Plan)

The 1997 Plan was adopted in November 1997 and has twice been amended and restated. This Plan provides for the granting of incentive stock options, nonqualified stock options and restricted stock awards. Options under the 1997 Plan may be granted at exercise prices determined by the Compensation Committee of the Board of Directors, or the Board of Directors as a whole, provided that the exercise prices shall not be less than the fair market value of the Company's Common Stock on the date of grant for incentive stock options and not less than 85% of the fair value of the Company's Common Stock on the date of grant for non-statutory stock options. Under the Plan, 5 million authorized shares of Common Stock were reserved for issuance upon exercise of options or as restricted stock. At March 31, 2006, there were 34,603 shares available for future awards under the Plan. At the Company's 2006 Annual Meeting of Shareholders, held May 3, 2006, the Company's shareholders approved a proposal to increase the number of shares of Common Stock authorized for use under the 1997 Plan to 6 million.

The Company uses the Black-Scholes option pricing model to calculate the fair-value of each option grant. The expected volatility for the first quarter of 2006 was based on historical volatility of the Company's traded stock. The Company elected to use the simplified method for estimating the expected term as allowed by Staff Accounting Bulletin (SAB) No. 107, "Share-Based Payment". Under the simplified method, the expected term is equal to the midpoint between the vesting period and the contractual term of the stock option. The risk-free interest rate is based on U.S. Treasury zero-coupon issues with a term equal to the expected term of the option assumed at the date of grant. Forfeitures are estimated at the date of grant based on historical experience. The following weighted average assumptions were used for the respective periods.

	Three Months Ended March 31,	
	2006	**2005**
Risk-free interest rates	4.7%	3.4%
Expected term (in years)	6.50	3.00
Dividend yield	0%	0%
Expected volatility	93%	80%
Weighted-average volatility	93%	80%

-8-

The following table represents stock option activity for the three months ended March 31, 2006:

	Shares		Weighted Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)		Aggregate Intrinsic Value
Outstanding at January 1, 2006	2,435,796	$	16.17			
Granted	50,000		44.62			
Exercised	(47,176)		3.89			
Forfeited/Cancelled	(8,977)		32.50			
Outstanding at March 31, 2006	2,429,643		16.93	7.1	$	68,169,845
Vested and expected to vest at March 31, 2006	2,416,643		16.78	7.1	$	68,165,373
Exercisable at March 31, 2006	1,345,233		5.59	5.7	$	53,020,642

For the three months ended March 31, 2006, the Company granted 50,000 options to purchase shares of Common Stock pursuant to the Plan to new members of management. The stock options have a vesting period of five-years and expire 10 years from the date of grant. The weighted-average grant-date fair values of stock options granted during the three months ended March 31, 2006 and 2005 was $35.62 and $18.03, respectively. The aggregate intrinsic value of options exercised during the three months ended March 31, 2006 and 2005 was $1.9 million and $3.5 million, respectively, determined as of the date of option exercise. As of March 31, 2006, there was approximately $16.9 million of total unrecognized compensation cost related to unvested share-based arrangements granted under the 1997 Plan. The cost is expected to be recognized over a weighted-average period of 4.0 years.

Restricted Stock

The Company has awarded restricted shares of Common Stock to executive officers and directors of the Company pursuant to the 1997 Plan. Restricted stock grants are generally measured at fair value on the date of grant based on the value of the award and are recognized as stock-based compensation expense generally over a five year vesting period. The Company granted 16,670 shares of restricted stock to new members of management pursuant to the 1997 Plan during the three months ended March 31, 2006. As of March 31, 2006, the Company has unrecognized stock-based compensation of $6.2 million associated with these awards. The cost is expected to be recognized a weighted-average period of 4.5 years.

The following table represents restricted stock activity for the three months ended March 31, 2006:

	Shares		Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2006	162,500	$	37.88
Granted	16,670		44.62
Nonvested at March 31, 2006	179,170		38.51

Upon the adoption of SFAS 123(R) on January 1, 2006, the Company reclassified the unrecognized deferred compensation costs associated with restricted stock granted to certain employees of approximately $5.8 million with a corresponding reduction to the Company’s additional paid-in capital.

2001 Employee Stock Purchase Plan (Purchase Plan)

The Purchase Plan provides for stock purchases by all eligible employees. Under the Purchase Plan, eligible employees can have up to 15% of their earnings withheld, up to certain maximums, to be used to purchase shares of the Company’s Common Stock at certain plan-defined dates. Through the offering period ended April 30, 2006, the price of the Common Stock purchased under the Purchase Plan for the offering periods is equal to 90% of the lower of the fair market value of the Common Stock on the commencement date of each three-month offering period or the specified purchase date. For the three months ended March 31, 2006 and 2005, 3,264 and 4,563 shares were purchased under the plan, respectively. Cash received upon the issuance of common stock under the plan was $130,000 and $124,000 for the three months ended March 31, 2006 and 2005, respectively. Effective May 1, 2006, the Company's Board of Directors removed the compensatory features of the Purchase Plan by changing the purchase price of a share of Common Stock for each offering period to 95% of its fair market value at the end of the offering period.

NOTE 4 - EARNINGS PER COMMON SHARE

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the dilutive effect of common stock equivalents using the "treasury stock" method. The components of basic and diluted earnings per share are as follows:

	Three Months Ended March 31,	
	2006	**2005**
	(In thousands, except share and per share data)	
Numerator for basic and diluted net earnings per common share:		
Net earnings	$ 12,311	$ 10,188
Denominator:		
Weighted average outstanding shares of common stock	24,624,889	23,666,910
Dilutive effect of:		
Employee stock options	857,552	1,505,298
Restricted stock	36,248	—
Warrants	—	209,880
Common stock and common stock equivalents	25,518,689	25,382,088
Net earnings per share:		
Basic	$ 0.50	$ 0.43
Diluted	$ 0.48	$ 0.40

NOTE 5 - COMPREHENSIVE INCOME

The components of comprehensive income were net earnings and accumulated other comprehensive income. The change in accumulated other comprehensive income for all periods presented resulted from foreign translation gains and losses and the unrealized gains and losses in marketable securities. Comprehensive income for the three months ended March 31, 2006 and 2005 is as follows (in thousands):

	Three Months Ended March 31,	
	2006	**2005**
Net income	$ 12,311	$ 10,188
Foreign currency translation adjustment	217	(159)
Unrealized loss in marketable securities	(6)	—

Comprehensive income	$	12,522	$	10,029

NOTE 6 - GOODWILL AND PURCHASED INTANGIBLE ASSETS

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in a business combination. Intangible assets resulting from the acquisitions of entities accounted for using the purchase method of accounting are estimated by management based on the fair value of assets acquired. Identifiable intangible assets subject to amortization are being amortized using the straight-line method over estimated useful lives ranging from two to twenty years.

In November 2005, the Company purchased substantially all of the assets and operations of a European provider of fax-to email and unified messaging services. The purchase price (in U.S. dollars), including acquisition costs, was approximately $3.1 million. As of March 2006, the Company has not completed the allocation of excess aggregate purchase price between goodwill and identifiable intangible assets.

The changes in carrying amount of goodwill and other intangible assets for the three months ended March 31, 2006 are as follows (in thousands):

	Balance as of January 1, 2006	Additions	Amortization	Foreign Exchange Translation	Balance as of March 31, 2006
Goodwill	$ 20,681	$ 307	$ —	$ 272	$ 21,260
Intangible assets with indefinite lives	1,590	175	—	—	1,765
Intangible assets subject to amortization	15,270	1,086	(579)	102	15,879
Other - unallocated	3,439	—	(66)	34	3,407
	$ 40,980	$ 1,568	$ (645)	$ 408	$ 42,311

Intangible assets with indefinite lives relate primarily to a trade name. As of March 31, 2006, intangible assets subject to amortization relate primarily to the following (in thousands):

	Weighted-Average Amortization period	Historical cost	Accumulated amortization	Net
Patents	10.36 years	$ 12,465	$ 1,916	$ 10,549
Technology	2.43 years	3,219	2,864	355
Customer relationships	4.82 years	2,391	966	1,425
Trade name	17.24 years	3,820	270	3,550
Total		$ 21,895	$ 6,016	$ 15,879

Amortization expense, included in general and administrative expense, during the three-month periods ended March 31, 2006 and 2005 approximated $645,000 and $409,000, respectively. Amortization expense is estimated to approximate $2.3 million, $2.0 million, $2.0 million, $1.8 million and $1.3 million for fiscal years 2006 through 2010, respectively.

NOTE 7 - SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the three-month periods ended March 31, 2006 and 2005 approximated $11,000 and $22,000, respectively, substantially all of which related to long-term debt.

The Company paid approximately $1.3 million for income taxes during the three-month period ended March 31, 2006. The Company paid zero cash for income taxes for the three months ended March 31, 2005.

The Company acquired property and equipment for approximately $345,000 which has not yet been paid at March 31, 2006.

Through the three months ended March 31, 2006 and 2005, the Company recorded the tax benefit from the exercise of stock options as a reduction of its income tax liability and an increase in equity in the amount of approximately $0.5 million and $1.3 million, respectively.

NOTE 8 - GEOGRAPHIC INFORMATION

The Company maintains operations in the United States, Canada, Ireland, the United Kingdom and other international territories. Geographic information about the United States and international territories for the reporting period is as follows:

	Three Months Ended March 31,	
	2006	**2005**
	(in thousands)	
Revenue:		
United States	$ 37,140	$ 28,647
All other countries	4,878	