

DIGITAL IMPACT INC /DE/

Form 10-K

June 14, 2004

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549
FORM 10-K

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

For the fiscal year ended March 31, 2004

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

Commission File Number: 000-27787

DIGITAL IMPACT, INC.

(Exact name of the registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

94-3286913
(I.R.S. employer
Identification No.)

177 Bovet Road, San Mateo, California
(Address of principal executive offices)

94402
(Zip Code)

Registrant's telephone number, including area code: (650) 356-3400

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$0.001 par value

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes No

The aggregate market value of the voting Common Stock held by non-affiliates of the Registrant, based upon the closing sale price of the Common Stock on September 30, 2003 as reported on the Nasdaq National Market, was approximately \$67 million.

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As of June 8, 2004, the Registrant had outstanding approximately 34 million shares of Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of our definitive Proxy Statement for our 2004 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission within 120 days after the end of our fiscal year, are incorporated by reference into Part III hereof.

FORM 10-K

ANNUAL REPORT For the Year Ended March 31, 2004

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PART I

Forward-Looking Information

THIS REPORT CONTAINS FORWARD-LOOKING STATEMENTS RELATED TO FUTURE EVENTS AND OUR FUTURE PERFORMANCE WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES AND EXCHANGE ACT OF 1934, AS AMENDED. STOCKHOLDERS ARE CAUTIONED THAT SUCH STATEMENTS INVOLVE RISKS AND UNCERTAINTIES. OUR ACTUAL RESULTS AND TIMING OF CERTAIN EVENTS COULD DIFFER MATERIALLY FROM THOSE ANTICIPATED IN THESE FORWARD-LOOKING STATEMENTS AS A RESULT OF CERTAIN FACTORS, INCLUDING, BUT NOT LIMITED TO, THOSE SET FORTH UNDER RISK FACTORS AND ELSEWHERE IN THIS REPORT AND IN OUR OTHER PUBLIC FILINGS WITH THE SECURITIES AND EXCHANGE COMMISSION. IT IS ROUTINE FOR INTERNAL PROJECTIONS AND EXPECTATIONS TO CHANGE AS THE YEAR OR EACH QUARTER IN THE YEAR PROGRESSES, AND THEREFORE IT SHOULD BE CLEARLY UNDERSTOOD THAT THE INTERNAL PROJECTIONS AND BELIEFS UPON WHICH WE BASE OUR EXPECTATIONS MAY CHANGE PRIOR TO THE END OF EACH QUARTER OR THE YEAR. ALTHOUGH THESE EXPECTATIONS MAY CHANGE, WE MAY NOT INFORM YOU IF THEY DO. OUR COMPANY POLICY IS GENERALLY TO PROVIDE OUR EXPECTATIONS ONLY ONCE PER QUARTER, BUT WE MAY CHOOSE NOT TO UPDATE THAT INFORMATION UNTIL THE NEXT QUARTER EVEN IF CIRCUMSTANCES CHANGE.

**Item 1. Business
Overview**

Digital Impact, Inc. (Digital Impact or the Company) was incorporated in California in October 1997 and reincorporated in Delaware in October 1999. Digital Impact is a leading provider of integrated digital marketing solutions for enterprises. Our solutions enable corporations to create and deliver integrated digital marketing programs that drive revenue, influence behavior and deepen customer relationships. Our solutions provide customer insight and powerful program execution through a combination of hosted applications, technology infrastructure and world class services.

The IMPACTTM hosted application (IMPACT) forms the core of our integrated digital marketing solutions. Leveraging a scalable, hosted technology infrastructure, the IMPACT application facilitates many aspects of integrated digital marketing including data management, marketing analytics, campaign management and message delivery. IMPACT is the first integrated digital marketing application built specifically for enterprise marketing teams to collaborate across departments, geographies and external agencies to quickly analyze, design, implement and execute complex targeted email marketing campaigns.

Enterprise marketers face two major challenges in their email marketing programs: easily accessing and analyzing large quantities of cross-channel customer information, often stored in Customer Relationship Management (CRM) databases, as well as coordinating the time-sensitive email campaign process across marketing groups, corporate divisions and outside agencies. IMPACT solves these problems by providing integrated marketing and analytics workflow and task management. IMPACT lets marketers control and accelerate the process of creating coordinated email marketing campaigns with collaboration among all stakeholders.

We provide our technology through a flexible outsourcing model minimizing systems and application support burden and giving clients a range of full-service and self-service alternatives. Many of our clients contract for a combination of professional services and industry-leading technology, ensuring that we jointly create and implement marketing campaigns that achieve optimal results.

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Digital Impact is organized into two segments: Customer Marketing and Professional Services. The respective revenue and gross profit of each of these segments is detailed in Note 7 to the Consolidated Financial Statements.

Customer Marketing Solutions

We provide comprehensive solutions for creating and executing digital marketing programs. Our solutions are designed to enable marketers to build the foundation required to reach new customers and maximize the value of existing customers. Our solutions consist of the following offerings:

IMPACT

IMPACT is a leading hosted online direct marketing application built specifically to address the complex needs of global enterprise marketers. IMPACT provides round-trip integration of sophisticated marketing analytics with collaborative email campaign management. Marketers can quickly access and analyze a wide range of cross-channel CRM data, identify new customer segments, easily create and deliver email campaigns to those segments, and track and measure the results, all in one application.

Campaign Services provide clients with an account team to efficiently execute their online direct marketing programs. Based upon a client's guidance, Campaign Services target, test, and execute email marketing campaigns utilizing the IMPACT hosted application. Clients maintain control and visibility over the entire process.

Program Services provide clients with an expert team designed to proactively build and manage their online direct marketing programs around their email marketing goals. This team delivers insight, analysis and management to optimize the value of online customer relationships.

Professional Services

Professional services provide specific solutions to enhance marketing programs and improve results. Digital Impact offers services to fulfill clients' online direct marketing needs in each of the following categories: Strategy, Analysis, Data Management, Solutions Engineering, Web Development, Creative Design and Customer Acquisition.

Customer Acquisition is a full service marketing offering that enables clients to cost-effectively reach new prospects and drive online revenue by converting prospects into customers. Digital Impact helps clients achieve superior results by providing access to a rich base of prospect sources, negotiating competitive rates and optimizing campaigns to reach the highest value customers. Our Customer Acquisition clients receive full service program management including strategic media plan development, comprehensive testing and results analysis.

Research and Development

We believe that strong product development capabilities are essential to our strategy of enhancing our core technology, developing additional applications incorporating that technology and maintaining the competitiveness of our product and service solutions. Digital Impact invests significant time and resources in creating a structured process for undertaking all product development. This process involves several functional groups at all levels within our organization and is designed to provide a framework for defining and addressing the activities required to bring product concepts and development projects to market successfully. For the fiscal year ended March 31, 2004 we spent \$5.1 million on research and development activities.

Sales and Marketing

We sell our products and services in the United States through a sales, client services and marketing organization that consisted of 178 employees as of March 31, 2004. These employees are primarily located at our headquarters in San Mateo, California and also in our office in New York. We also maintain a sales and client services organization of 13 employees in London, England supporting the European region.

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Clients

Our clients consist of a diverse group of companies operating in many industries primarily throughout the United States, ranging from Fortune 500 to smaller corporations. For the year ended March 31, 2004, two clients, Hewlett-Packard and Gap Inc. Direct, accounted for 12% and 11% of our total revenue, respectively.

Competition

The market for online direct marketing services is highly competitive, evolves rapidly and experiences rapid technological change. We expect these market conditions to continue as the use of the Internet for direct marketing expands and because there are limited barriers to entry into our market.

We believe that the factors on which we successfully compete include:

Quality of online direct marketing services

Technology-enhanced service offerings

Sophistication and reliability of technology

Speed of implementation of online direct marketing campaigns

Cost-effective online direct marketing solutions

Measurable results

Credibility of clients and their willingness to act as references

Our principal competitors include providers of online direct marketing solutions such as DoubleClick, Responsys, Experian, Silverpop, Bigfoot Interactive and InfoUSA, as well as the in-house information technology departments of our existing and prospective clients. In the future, we may experience competition from Internet service providers, advertising and direct marketing agencies and other large established businesses possessing large, existing customer bases, substantial financial resources and established distribution channels and could develop, market or resell a number of online direct marketing solutions. These potential competitors may also choose to enter, or have already entered, the market for online direct marketing by acquiring one of our existing competitors or by forming strategic alliances with a competitor.

Intellectual Property

We rely upon a combination of patent, copyright, trade secret and trademark laws to protect our intellectual property. We currently have one issued U.S. patent and several U.S. patent applications pending.

In addition, we have several registered U.S. trademarks and several more trademark applications pending in the U.S., Europe and Japan. Although we rely on patent, copyright, trade secret and trademark law to protect our technology, we believe that factors such as the technological and creative skills of our personnel, new product developments, frequent product enhancements and reliable product maintenance are more essential to establishing and maintaining a technology leadership position. Others may develop technologies that are similar or superior to our technology and may receive and enforce patents on such technology.

Seasonality

The traditional direct marketing industry has typically generated lower revenue during the summer months and higher revenue during the calendar year-end months. We believe our business is affected by similar revenue fluctuations, driven primarily by our retail clients, but we are unable to isolate and predict the magnitude of these effects due to service and client mix variables.

Employees

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As of March 31, 2004, we had 278 employees. Of the total number of employees, 27 were engaged in research and development, 34 in sales, marketing and business development, 157 in account management, professional services and production and 60 in operations, finance, and administration. None of our employees

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is represented by a labor union. We have not experienced any work stoppages and consider our relations with our employees to be good.

Executive Officers

For information related to our executive officers, please refer to our Proxy Statement.

Website Access to Reports

Our website address is *www.digitalimpact.com* and our periodic and current reports, and amendments to those reports, are available free of charge on our website as soon as reasonably practicable after such material is electronically filed with, or furnished to, the SEC.

Risk Factors

Our future operating results may vary substantially from period to period due to a number of factors, many of which are beyond our control. The following discussion highlights some of these factors and the possible impact of these factors on future results of operations. If any of the following factors actually occur, our business, financial condition or results of operations could be harmed. In that case, the price of our common stock could decline, and investors could experience losses on their investment.

Because of our limited operating history and the emerging nature of the online direct marketing industry, any predictions about our future revenues and expenses may not be as accurate as they would be if we had a longer business history, and we cannot determine trends that may affect our business.

We were incorporated in October 1997 in California and reincorporated in Delaware in October 1999. Our limited operating history makes financial forecasting and evaluation of our business difficult. Since we have limited financial data, any predictions about our future revenues and expenses may not be as accurate as they would be if we had a longer business history. Because of the emerging nature of the online direct marketing industry, we cannot determine trends that may emerge in our market or affect our business. The revenue and income potential of the online direct marketing industry, and our business, are unproven.

Our operating results have varied significantly in the past and are likely to vary significantly from period to period, and our stock price may decline if we fail to meet the expectations of analysts and investors.

Our operating results have varied significantly in the past and are likely to vary significantly from period to period. As a result, our operating results are difficult to predict and may not meet the expectations of securities analysts or investors. If this occurs, the price of our common stock would likely decline.

We derive our revenue from marketing services, which revenues tend to be cyclical and dependent on the economic prospects of our clients and the economy in general. A sustained reduction in expenditures by our clients or a sustained downturn in the economy could cause our revenues to decline significantly in any given period.

Our clients' marketing and advertising expenditures tend to be cyclical, reflecting overall economic conditions as well as budgeting and buying patterns. The overall market for marketing and advertising services, including Internet marketing and advertising services, has experienced lower prices in recent quarters. We also cannot assure you that if economic conditions improve, marketing budgets and advertising spending will increase from current levels. A continued decline in the economic prospects of our clients or the economy in general could alter pending priorities or increase the time it takes to close a sale with a prospective client. As a result, our revenues from marketing services may decline significantly in any given period.

We may not be able to forecast our revenues accurately because our customers' marketing budgets are difficult to predict and may fluctuate from period to period.

Our revenue and operating results depend upon the marketing budgets of our existing and new customers. These marketing budgets are difficult to predict and may vary from period to period as a result of factors that

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are beyond our control, including our customers' marketing objectives for a particular period, the general state of the economy and our customers' success in the marketplace. Consequently, we face difficulty in predicting the amount of revenues each client will generate in any particular quarter. As a result, our operating results are difficult to predict and may not meet the expectations of securities analysts or investors. If this occurs, the price of our common stock would likely decline.

Seasonal trends may cause our quarterly operating results to fluctuate, which may adversely affect the market price of our common stock.

The traditional direct marketing industry has typically generated lower revenues during the summer months and higher revenues during the calendar year-end months. We believe our business is affected by similar revenue fluctuations, but our limited operating history is insufficient to isolate and predict the magnitude of these effects. Because we do experience these effects, analysts and investors may not be able to predict our quarterly or annual operating results. If we fail to meet expectations of analysts and investors, our stock price could decline.

If businesses and consumers fail to accept online direct marketing as a means to attract new customers, demand for our services may not develop and the price of our stock could decline.

The market for online direct marketing services is relatively new and rapidly evolving, and our business may be harmed if sufficient demand for our services does not develop. Our current and planned services are very different from the traditional methods that many of our clients have historically used to attract new customers and maintain customer relationships.

The loss of a major client could result in lower than expected revenues.

The loss of a major client could harm our business. While only two clients each accounted for more than 10% of our revenues for the fiscal year 2004, the loss of one of these clients or another major client could have a material adverse effect on our business and results of operations.

The online direct marketing industry is highly competitive, and if we are unable to compete effectively, the demand for, or the prices of, our services may decline.

The market for online direct marketing is highly competitive, rapidly evolving and experiencing rapid technological change. Intense competition may result in price reductions, reduced sales, gross margins and operating margins, and loss of market share. Our principal competitors include providers of online direct marketing solutions such as DoubleClick, Responsys, Experian, Silverpop, Bigfoot Interactive and InfoUSA, as well as the in-house information technology departments of our existing and prospective clients. The loss of a client due to service quality or technology problems could result in reputational harm to us and, as a result, increase the effect of competition and negatively impact our ability to attract new clients.

In addition, we expect competition to persist and intensify in the future, which could harm our ability to increase sales and maintain our prices. In the future, we may experience competition from Internet service providers, advertising and direct marketing agencies and other large established businesses possessing large, existing customer bases, substantial financial resources and established distribution channels and could develop, market or resell a number of online direct marketing solutions. These potential competitors may also choose to enter, or have already entered, the market for online direct marketing by acquiring one of our existing competitors or by forming strategic alliances with a competitor.

Many of these potential competitors have broad distribution channels and they may bundle competing products or services. As a result of future competition, the demand for our services could substantially decline. Any of these occurrences could harm our ability to compete effectively.

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If we fail to respond to changing customer preferences in our market, demand for our technology and services may decline, causing our revenues to suffer.

If we do not continue to develop new technology and services that keep pace with competitive developments, satisfy diverse and rapidly evolving customer requirements and achieve market acceptance, we might be unable to attract new customers and retain existing customers. The development of proprietary technology and service enhancements and the migration of customers to this new technology entail significant technical and business risks and requires substantial expenditures and lead-time. We might not be successful in marketing and supporting recently released versions of our technology and services on a timely or cost-effective basis. In addition, even if new technology and services are developed and released, they might not achieve market acceptance. We have experienced delays in releasing new or enhanced technology and services in the past and could experience similar delays in the future, which could cause us to lose customers. Also, if we are not successful in a smooth migration of our customers to our new or enhanced technology and services, we could lose customers.

If we do not attract and retain additional highly skilled personnel, we may be unable to execute our business strategy.

Our business depends on the continued technological innovation of our core products and services and our ability to provide comprehensive online direct marketing expertise. Our main offices are located in the San Francisco Bay Area and New York City, where competition for personnel with Internet-related technology and marketing skills has traditionally been intense. In addition, we restructure our organization from time to time, including reductions in our workforce, to streamline operations and reduce costs. These measures may have unanticipated consequences, such as low morale, unexpected litigation and difficulty in future employee hiring and retention. If we fail to identify, attract, retain and motivate these highly skilled personnel, we may be unable to successfully introduce new services or otherwise implement our business strategy.

If the delivery of our email messages is limited or blocked, then the amount we may be able to charge our clients for producing and sending their campaigns may be reduced and our clients may discontinue their use of our services.

Our business model relies on our ability to deliver emails over the Internet through Internet service providers and to recipients in major corporations. In particular, a significant percentage of our emails are sent to recipients who use AOL. We do not have, nor are we required to have, an agreement with AOL to deliver emails to their customers. AOL uses a proprietary set of technologies to handle and deliver email and the value of our services will be reduced if we are unable to provide emails compatible with these technologies.

In addition, AOL and other Internet service providers are able to block messages from reaching their users. Recent releases of Internet service provider software and the implementation of stringent new policies by Internet service providers have caused periodic temporary blockages of our ability to successfully deliver emails to their customers. We continually improve our own technology and work with Internet service providers to improve our ability to successfully deliver our emails. However, if Internet service providers materially limit or halt the delivery of our emails, or if we fail to deliver emails in such a way as to be compatible with these companies' email handling technologies, then the amount we may be able to charge our clients for producing and sending their online direct marketing campaigns may be reduced and our clients may discontinue their use of our services. In addition, the effectiveness of email marketing may decrease as a result of increased consumer resistance to email marketing in general.

Our facilities and systems are vulnerable to natural disasters and other unexpected events, and any of these events could result in an interruption of our ability to execute our clients' online direct marketing campaigns.

We depend on the efficient and uninterrupted operations of our data center and hardware systems. Our data center and hardware systems are located in northern California, an area susceptible to earthquakes. Our data center and hardware systems are also vulnerable to damage from fire, floods, power loss, telecommunica-

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tions failures, and similar events. If any of these events results in damage to our data center or systems, we may be unable to execute our clients online direct marketing campaigns until the damage is repaired, and may accordingly lose clients and revenues. In addition, subject to applicable insurance coverage, we may incur substantial costs in repairing any damage.

Our data center is located at facilities provided by a third party, and if this party is unable to adequately protect our data center, our reputation may be harmed and we may lose clients.

Our data center, which is critical to our ongoing operations, is located at facilities provided by a third party. Our operations depend on this party's ability to protect our data center from damage or interruption from human error, break-ins, sabotage, computer viruses, intentional acts of vandalism and similar events. If this party is unable to adequately protect our data center and information is lost or our ability to deliver our services is interrupted, our reputation may be harmed and we may lose clients.

If we are unable to protect our intellectual property or if third parties develop superior intellectual property, third parties could use our intellectual property without our consent and prevent us from using their technology.

Our ability to successfully compete is substantially dependent upon our internally developed technology and intellectual property, which we protect through a combination of patent, copyright, trade secret and trademark law, as well as contractual obligations. We have one issued U.S. patent and have three U.S. patent applications pending. We have several registered trademarks in the U.S. and Japan and have several more applications pending in the U.S., Europe and Japan. We may not be able to protect our proprietary rights. Unauthorized parties may attempt to obtain and use our proprietary information. Policing unauthorized use of our proprietary information is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

We are one of several companies rapidly building new technologies in our industry. It is possible that a third party could be awarded a patent that applies to some portion of our technology. If this occurs, we may be required to incur substantial legal fees, cease using the technology or pay significant licensing fees for such use.

If we are unable to safeguard the confidential information in our data warehouse, our reputation may be harmed and we may be exposed to liability.

We currently store confidential customer information in a secure data warehouse. We cannot be certain, however, that we will be able to prevent unauthorized individuals from gaining access to this data warehouse. If any compromise or breach of security were to occur, it could harm our reputation and expose us to possible liability. Any unauthorized access to our servers could result in the misappropriation of confidential customer information or cause interruptions in our services. It is also possible that one of our employees could attempt to misuse confidential customer information, exposing us to liability. In addition, our reputation may be harmed if we lose customer information maintained in our data warehouse due to systems interruptions or other reasons.

Activities of our clients could damage our reputation or give rise to legal claims against us.

Our clients' promotion of their products and services may not comply with federal, state and local laws. We cannot predict whether our role in facilitating these marketing activities would expose us to liability under these laws. Any claims made against us could be costly and time-consuming to defend. If we are exposed to this kind of liability, we could be required to pay fines or penalties, redesign our business methods, discontinue some of our services or otherwise expend resources to avoid liability.

Our services involve the transmission of information through the Internet. Our services could be used to transmit harmful applications, negative messages, unauthorized reproduction of copyrighted material, inaccurate data or computer viruses to end-users in the course of delivery. Any transmission of this kind could damage our reputation or could give rise to legal claims against us. We could spend a significant amount of time and money defending against these legal claims.

Table of Contents***New regulation of, and uncertainties regarding the application of existing laws and regulations to, online direct marketing and the Internet could prohibit, limit or increase the cost of our business.***

Congress recently enacted the CAN-SPAM Act of 2003, legislation that regulates the sending of commercial email. This legislation pre-empts state laws regulating commercial email. The effect of this legislation on marketers is difficult to predict. We cannot assure you that this or future legislation regarding commercial email will not harm our business. Moreover, list rental and other types of affiliate marketing programs must be modified to comply with certain aspects of CAN-SPAM. Some of these modifications may add to the cost of conducting these types of programs. As a result, there may be a decline in our Customer Acquisition revenues.

Our business could be negatively impacted by new laws or regulations applicable to online direct marketing or the Internet, the application of existing laws and regulations to online direct marketing or the Internet or the application of new laws and regulations to our business as we expand into new jurisdictions. There is a growing body of laws and regulations applicable to access to, or commerce on, the Internet. Moreover, the applicability to the Internet of existing laws is uncertain and may take years to resolve. Due to the increasing popularity and use of the Internet, it is likely that additional laws and regulations will be adopted covering issues such as privacy, pricing, content, copyrights, distribution, taxation, antitrust, characteristics and quality of services and consumer protection. The adoption of any additional laws or regulations may impair the growth of the Internet or online direct marketing, which could, in turn, decrease the demand for our services and prohibit, limit or increase the cost of our doing business.

Internet-related stock prices are especially volatile and this volatility may depress our stock price.

The stock market and specifically the stock prices of Internet-related companies have been very volatile. Because we are an Internet-related company, we expect our stock price to be similarly volatile. As a result of this volatility, the market price of our common stock could significantly decrease. This volatility is often not related to our operating performance and may accordingly reduce the price of our common stock without regard to our operating performance.

If our internal controls are inadequate, there is a greater risk of misstatements in our financial reports, fraud or incomplete disclosures.

In connection with section 404 of Sarbanes-Oxley Act of 2002, the Company's auditors will provide an attestation on the effectiveness of internal controls over financial reporting in either March 2005 or March 2006. The company has never undergone testing under the new standards. If the auditors are not able to attest to the adequacy of controls, this would indicate that there is not high assurance that the company's controls would prevent misstatements in our financial reports, fraud or incomplete disclosures.

Item 2. Properties

Our principal executive offices are located in San Mateo, California, where we lease approximately 36,000 square feet under three leases that expire in dates ranging from 2005 to 2007. Digital Impact also leases office space in New York City and London for local sales and client service personnel, and Santa Monica, California for research and development staff. The Santa Monica office will be closed in June 2004 as part of our restructuring initiated in February 2004.

A summary of our significant leased office and data center facilities is as follows:

Location	Approximate Number of Square Feet Leased(1)	Expiration of Lease
San Mateo, California (headquarters)	36,000	March 2007
New York, New York	12,000	August 2007
Santa Monica, California	7,000	June 2004
London, England	1,200	April 2005

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(1) We currently occupy approximately 36,000 square feet of our San Mateo facility, approximately 9,000 square feet of our New York facility, 4,200 square feet of our Santa Monica facility and 1,200 square feet of our London facility. As of March 31, 2004 the remaining obligations under the San Mateo and New York leases are approximately \$5 million and \$2 million, respectively.

Our datacenter is primarily located at facilities operated by Globix Corporation in Northern California. Our agreement with Globix expires in September 2004. As of March 31, 2004, the remaining obligation under the Globix lease is approximately \$447,000.

We are continually evaluating our facilities requirements. Periodically, we evaluate the expenses likely to be incurred for our facilities, and where appropriate, have exited facilities and taken restructuring charges with respect to these expenses. We cannot assure you that there will not be additional restructuring charges recognized with respect to our excess or idle facilities.

Item 3. *Legal Proceedings*

In June 2001, a series of putative securities class actions were filed in United States District Court for the Southern District of New York against certain investment bank underwriters for the Company's initial public offering (IPO), the Company, and various of the Company's officers and directors. The complaints, which have been consolidated under the caption *In re Digital Impact, Inc. Initial Public Offering Securities Litigation*, Civil Action No. 01-CV-4942, allege undisclosed and improper practices concerning the allocation of the Company's IPO shares, in violation of the federal securities laws, and seek unspecified damages on behalf of persons who purchased the Company's stock during the period from November 22, 1999 to December 6, 2000. The Court has appointed a lead plaintiff for the consolidated cases. On April 19, 2002, plaintiffs filed an amended complaint. Other actions have been filed making similar allegations regarding the IPOs of more than 300 other companies. All of these lawsuits have been coordinated for pretrial purposes as *In re Initial Public Offering Securities Litigation*, Civil Action No. 21-MC-92. Defendants in these cases filed omnibus motions to dismiss on common pleading issues. Oral argument on these omnibus motions to dismiss was held on November 1, 2002. The Company's officers and directors have been dismissed without prejudice in this litigation. On February 19, 2003, the court granted in part and denied in part the omnibus motion to dismiss. The court's order did not dismiss any claims against the Company.

A proposal has been made for the settlement and release of claims against the issuer defendants, including the Company, in exchange for a guaranteed recovery to be paid by the issuer defendants' insurance carriers and an assignment of certain claims. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. If the settlement does not occur, and litigation against the Company continues, the Company believes it has meritorious defenses and intends to defend the case vigorously.

On February 23, 2004, the Company filed a patent infringement lawsuit against Responsys, Inc., a competitor of the Company. The lawsuit, captioned *Digital Impact, Inc. v. Responsys, Inc.*, N. D. Cal., Case No. C04 00734 (SBA), alleges that Responsys has infringed and is continuing to infringe the Company's U.S. Patent No. 6,449,634. The complaint seeks injunctive relief and unspecified damages. Responsys filed an answer and counterclaim on March 15, 2004. The counterclaim seeks a declaration that the patent is invalid or, in the alternative, that Responsys's technology does not infringe the patent. The Company replied to the counterclaim on April 7, 2004, denying all material allegations. Responsys then filed a motion for judgment on the pleadings, which was denied on June 4, 2004.

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

No matters were submitted to a vote of our stockholders during the fourth quarter of the fiscal year ended March 31, 2004.

Table of Contents**PART II****Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.***Market Information*

Our common stock has been quoted on the Nasdaq National Market under the symbol DIGI since our initial public offering on November 23, 1999. The following table sets forth, for the periods indicated, the high and low bid quotations for our common stock as quoted on the Nasdaq National Market.

	<u>High</u>	<u>Low</u>
Fiscal Year 2003:		
First quarter (from 4/01/02 to 6/30/02)	3.25	1.53
Second quarter	1.90	1.25
Third quarter	2.03	1.23
Fourth quarter	2.01	1.26
Fiscal Year 2004:		
First quarter (from 4/01/03 to 6/30/03)	2.56	1.25
Second quarter	3.50	1.80
Third Quarter	3.22	2.18
Fourth Quarter	3.35	2.09

On March 31, 2004, the last sale price of our common stock reported by the Nasdaq National Market was \$2.64 per share. On June 8, 2004 the last sale price of our common stock reported by the Nasdaq National Market was \$1.70 per share. As of June 8, 2004, the approximate number of common stockholders was 4,605.

Digital Impact has never declared or paid any cash dividends on its capital stock. Digital Impact currently intends to retain its future earnings, if any, to fund the development and growth of its business and, therefore, does not anticipate paying any cash dividends in the foreseeable future.

Item 6. Selected Financial Data

The selected consolidated financial data set forth below with respect to Digital Impact's Consolidated Statement of Operations for each of the years ended March 31, 2004, 2003 and 2002 and with respect to Digital Impact's Consolidated Balance Sheets as of March 31, 2004 and 2003 have been derived from the audited financial statements which are included elsewhere herein. The selected consolidated data set forth with respect to Digital Impact's Consolidated Statement of Operations for each of the periods ended March 31, 2001 and 2000 and with respect to Digital Impact's Consolidated Balance Sheet as of March 31, 2002, 2001, and 2000 are derived from the audited financial statements of Digital Impact which are not included herein. The selected financial data set forth below is qualified in its entirety by, and should be read in conjunction with, Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and the notes to those statements included elsewhere herein.

	<u>Fiscal year ended March 31,</u>				
	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Statement of Operations Data					
Revenues	\$43,712	\$44,010	\$ 39,038	\$ 40,153	\$ 12,991
Gross profit	24,186	25,751	20,494	22,317	6,813
Loss from operations	(507)	(3,767)	(19,975)	(59,763)	(23,130)
Net loss	(580)(1)	(3,974)(2)	(19,678)(3)	(56,731)(4)	(21,653)

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Net loss per common share basic and diluted	\$ (0.02)	\$ (0.13)	\$ (0.70)	\$ (2.33)	\$ (2.28)
Weighted average shares used in basic and diluted per share calculation	32,950	30,290	27,960	24,350	9,510

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	March 31,				
	2004	2003	2002	2001	2000
Balance Sheet Data					
Cash, cash equivalents and short-term investments	\$26,158	\$23,767	\$25,588	\$35,038	\$68,073
Total assets	45,361	46,017	49,633	69,019	81,102
Long-term debt and capital lease obligations	80		1,324	2,653	726
Stockholders equity	39,016	36,455	38,889	55,555	73,530

- (1) The 2004 net loss includes restructuring charges and write-off of fixed assets of \$326,000.
- (2) The 2003 net loss includes restructuring charges and write-off of fixed assets of \$546,000.
- (3) The 2002 net loss includes a restructuring charge of \$1.2 million and write-off of fixed assets of \$600,000.
- (4) The 2001 net loss includes a goodwill impairment charge of \$19.0 million and the write-off of acquired in-process research and development and fixed assets of \$4.6 million

QUARTERLY RESULTS OF OPERATIONS

The following table sets forth certain unaudited consolidated quarterly statement of operations data for the eight quarters ended March 31, 2004. This information is unaudited, but in the opinion of management, it has been prepared on substantially the same basis as the audited Consolidated Financial Statements appearing elsewhere in this report, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts stated below to present fairly the unaudited consolidated quarterly results of operation. The consolidated quarterly data should be read in conjunction with our audited Consolidated Financial Statements and the notes to such statements appearing elsewhere in this report. The results of operations for any quarter are not necessarily indicative of the results of operations for any future period.

Fiscal Quarter Ended	Revenues	Gross Profit	Income		Weighted Average Common Shares Basic	Weighted Average Common Shares Diluted	Basic Net	Diluted Net
			(Loss) From Operations	Net Income (Loss)			Loss per Common Share	Loss per Common Share
(In thousands, except per share data)								
2004								
June 30	\$ 10,928	\$ 6,146	\$ (239)	\$ (293)	31,670	31,670	\$(0.01)	\$(0.01)
September 30	10,924	6,183	174	108	32,780	35,662	0.00	0.00
December 31	11,509	6,588	436	489	33,490	36,022	0.01	0.01
March 31	10,351	5,269	(878)	(884)	33,870	33,870	(0.03)	(0.03)
2003								
June 30	\$ 10,518	\$ 6,165	\$(1,139)	\$(1,193)	29,640	29,640	\$(0.04)	\$(0.04)
September 30	11,128	6,626	(1,145)	(1,163)	29,990	29,990	(0.04)	(0.04)
December 31	11,490							