DIGITAL IMPACT INC /DE/
Form 10-Q
February 13, 2001

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

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2000

OR

[ ] 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: 000-27787

DIGITAL IMPACT, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	94-3286913
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(I.R.S. EMPLOYER IDENTIFICATION NO.)

177 BOVET ROAD
SAN MATEO, CALIFORNIA 94402
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

TELEPHONE NUMBER (650) 356-3400
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

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

Yes [X] No [ ]

As of February 6, 2000, there were approximately 27,157,000 shares of the

Registrant's Common Stock outstanding.

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DIGITAL IMPACT, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

DIGITAL IMPACT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(UNAUDITED)

	THREE MONTHS ENDED DECEMBER 31,		NINE MONTHS ENDED DECEMBER 31,	
	2000	1999	2000	1999
Revenues	$12,156	$ 4,011	$ 30,001	$ 7,268
Cost of revenues	5,326	1,944	13,193	3,561

Gross margin	6,830	2,067	16,808	3,707
Operating expenses:				
Research and development	4,934	2,140	12,800	4,658
Sales and marketing	4,935	2,001	13,085	4,545
General and administrative	3,111	1,576	8,178	3,740
Stock-based compensation	595	3,188	4,353	6,483
Amortization of goodwill and purchased intangibles	2,411	--	4,018	--
Nonrecurring charges (Note 3)	--	--	4,563	--
Total operating expenses	15,986	8,905	46,997	19,426
Loss from operations	(9,156)	(6,838)	(30,189)	(15,719)
Interest income, net	664	412	2,500	494
Net loss	$(8,492)	$(6,426)	$(27,689)	$(15,225)
Net loss per common share -- basic and diluted	$ (0.34)	$ (0.60)	$ (1.17)	$ (2.82)
Shares used in net loss per common share calculation -- basic and diluted	25,080	10,650	23,760	5,400

The accompanying notes are an integral part of
these unaudited condensed consolidated financial statements.

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DIGITAL IMPACT, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

ASSETS

	DECEMBER 31, 2000	MARCH 31, 2000
	(UNAUDITED)	
Current assets:		
Cash and cash equivalents	$ 42,011	$ 68,073
Accounts receivable, net	14,332	4,809
Prepaid expenses and other current assets	923	626
Total current assets	57,266	73,508
Property and equipment, net	13,501	7,309
Restricted cash	1,847	108
Goodwill, net	22,624	--
Other assets	4,532	177
Total assets	$ 99,770	$ 81,102
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 6,177	$ 3,066
Deferred revenues	1,588	256
Accrued liabilities	5,564	2,994

Current portion of long term debt	2,852	530
Total current liabilities	16,181	6,846
Long term debt, less current portion	831	726
Total liabilities	17,012	7,572
Stockholders' equity:		
Common Stock	27	24
Additional paid-in capital	140,740	109,866
Accumulated other comprehensive loss	(34)	(15)
Unearned stock-based compensation	(5,290)	(11,349)
Accumulated deficit	(52,685)	(24,996)
Total stockholders' equity	82,758	73,530
Total liabilities and stockholders' equity	$ 99,770	$ 81,102

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

DIGITAL IMPACT, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	NINE MONTHS ENDED DECEMBER 31,	
	2000	1999
Cash flows from operating activities		
Net loss	$(27,689)	$(15,225)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Charge for acquired in-process research and development	4,432	--
Depreciation and amortization	7,262	1,043
Provision for bad debts	1,100	60
Warrants issued for services	--	212
Amortization of unearned stock-based compensation	4,353	6,271
Loss on write-off of fixed assets	131	--
Unrealized loss on cash and cash equivalents	(19)	--
Changes in operating assets and liabilities:		
Accounts receivable	(10,508)	(3,186)
Prepaid expenses and other current assets	(231)	(692)
Restricted cash	(1,739)	--
Other assets	(130)	(71)
Accounts payable	2,132	2,026
Accrued liabilities and deferred revenue	2,116	1,985
Net cash used in operating activities	(18,790)	(7,577)

Cash flows from investing activities		
Acquisition of property and equipment	(8,469)	(2,952)
Cash acquired from acquisition (See Note 3)	264	--
Net cash used in investing activities	(8,205)	(2,952)
Cash flows from financing activities		
Principal payments on long-term debt	(505)	(653)
Proceeds from initial public offering, net of issuance costs	--	70,822
Proceeds from exercise of common stock options and warrants	1,438	128
Proceeds from issuance of convertible preferred stock, net of issuance costs	--	10,644
Repayment of stock subscription	--	1
Net cash provided by financing activities	933	80,942
Net increase (decrease) in cash and cash equivalents	(26,062)	70,413
Cash and cash equivalents at beginning of period	68,073	2,864
Cash and cash equivalents at end of period	$ 42,011	$ 73,277
Supplemental noncash information:		
Fair value of net assets acquired (excluding transaction costs)	$ 31,145	$ --
Assets acquired under capital leases	$ 140	$ 943
Unearned stock-based compensation	$ (1,706)	$ 19,388

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

DIGITAL IMPACT, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. THE COMPANY

Digital Impact, Inc. ("Digital Impact" or the "Company"), a Delaware corporation, is a leading provider of online direct marketing solutions for enterprises. The Company offers comprehensive customer acquisition, retention, and analysis solutions as either a single or bundled service. The Company leverages several proprietary capabilities to deliver superior campaign results and exceptional ROI, including: Mass Personalization Engine(TM), the Company's messaging platform which assembles and delivers personalized content over various digital media such as email and set-top box; Impact 4.0(TM), the Company's web-based campaign management and reporting system; and Adaptive Intelligent Marketing(TM), the Company's consulting and data management methodology for developing and implementing online direct marketing strategies and programs.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited condensed consolidated financial statements of Digital Impact at December 31, 2000 and for the three and nine month periods then ended reflect

all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted in these interim statements under the rules and regulations of the Securities and Exchange Commission ("SEC"). The condensed consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto included in Digital Impact's annual report on Form 10-K for the fiscal year ended March 31, 2000. The results of operations for the three and nine months ended December 31, 2000 are not necessarily indicative of the results for the entire fiscal year ending March 31, 2001.

Comprehensive Income

Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Other comprehensive loss, a component of stockholders' equity, recorded by the Company for the nine months ended December 31, 2000 was attributable to unrealized loss on cash equivalents. The Company did not have any additional transactions that were required to be reported in other comprehensive income during the three and nine months ended December 31, 2000.

NOTE 3. BUSINESS COMBINATION

On July 31, 2000, the Company acquired MineShare, Inc. ("MineShare"), a customer intelligence and analysis company based in Santa Monica, California, in exchange for approximately 1,855,700 shares of the Company's common stock. Additionally, the Company assumed MineShare's outstanding stock options and warrants and reserved approximately 132,700 shares of the Company's common stock for issuance upon exercise of these options and warrants. The acquisition was effected by means of a merger pursuant to which a wholly owned subsidiary of the Company was merged with and into MineShare, with MineShare as the surviving corporation. The acquisition has been accounted for as a purchase.

DIGITAL IMPACT, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The allocation of the $31.9 million purchase price is summarized as follows (amounts in thousands):

Net assets at the date of acquisition	$(3,368)
Goodwill	26,273
In-process technology	4,432
Developed technology	1,930
Other intangibles	2,660
Net assets acquired	$31,927

The amounts allocated to goodwill and other intangible assets will be amortized over a three-year period. The amount allocated to the purchased in-process technology and other items was determined based on an appraisal completed by an independent third party using established valuation techniques. The in-process technology was expensed upon acquisition because technological feasibility had not been established and no future alternative uses existed.

The estimated purchase price was approximately $31.9 million, measured as the average fair market value of Digital Impact's closing stock price from July 12, 2000 to July 26, 2000, five trading days before and after the merger agreement was announced, plus the fair value of the vested options and warrants calculated using the Black-Scholes option pricing model of MineShare assumed by Digital Impact in the merger, and other costs directly related to the merger as follows (in thousands):

Fair market value of Digital Impact's common stock	$30,304
Fair value of options and warrants assumed	841
Acquisition-related costs	782
Total	$31,927

The following unaudited pro forma revenues, net loss, and net loss per share data for the nine months ended December 31, 2000 and 1999 are based on the respective historical financial statements of the Company and MineShare. The pro forma data reflects the consolidated results of operations as if the merger with MineShare had occurred at the beginning of each of the periods indicated and includes the amortization of the resulting goodwill and other intangible assets. The pro forma financial data presented are not necessarily indicative of the Company's results of operations that might have occurred had the transaction been completed at the beginning of the periods specified, and do not purport to represent what the Company's consolidated results of operations might be for any future period.

	(UNAUDITED PRO FORMA) NINE MONTHS ENDED DECEMBER 31,	
	2000	1999
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Revenues	$ 30,263	$ 8,779
Net loss	$(30,242)	$(33,455)
Net loss per common share -- basic and diluted	$ (1.18)	$ (4.61)

DIGITAL IMPACT, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 4. RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 133, or SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS 133 establishes new standards of accounting and reporting for derivative instruments and hedging activities. SFAS 133 requires that all derivatives be recognized at fair value in the statement of financial position, and that the corresponding gains or losses be reported either in the statement of operations or as a component of

comprehensive income, depending on the type of hedging relationship that exists. SFAS 133 will be effective for fiscal years beginning after June 15, 2000. The Company does not currently hold derivative instruments or engage in hedging activities.

In December 1999, the SEC issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," or SAB 101, which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC. SAB 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for disclosures related to revenue recognition policies. The Company adopted the provisions of SAB 101 during the third quarter of the fiscal year ended March 31, 2000, and believes that its adoption has not had a material effect on the Company's financial position or results of operations.

In March 2000, the Financial Accounting Standards Board issued Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation -- an interpretation of APB Opinion No. 25" ("FIN 44"). This Interpretation clarifies the definition of employee for the purposes of applying Accounting Practice Board Opinion No. 25, "Accounting for Stock Issued to Employees", the criteria for determining whether a plan qualifies as a noncompensatory plan, the accounting consequences of various modifications to the terms of a previously fixed stock option or award, and the accounting for an exchange of stock compensation awards in a business combination. This Interpretation is effective July 1, 2000, but certain conclusions in this Interpretation cover specific events that occur after either December 15, 1998, or January 12, 2000. The Company applied FIN 44 in accounting for the options granted to MineShare option holders in the acquisition of MineShare. As a result, the Company recorded $841,000 of deferred compensation relating to the unvested portion of these options at the acquisition date.

NOTE 5. NET LOSS PER SHARE

Basic net loss per share is calculated by dividing net loss by the weighted average number of vested common shares outstanding for the period. Diluted net loss per share is calculated giving effect to all dilutive potential common shares, including options, warrants and preferred stock. Options, warrants, and preferred stock were not included in the calculation of diluted net loss per share for the three and nine month periods ended December 31, 2000 and December 31, 1999 because the effect would be antidilutive. A reconciliation

of the numerators and denominators used in the basic and diluted net loss per share amounts follows (in thousands, except per share data):

	THREE MONTHS ENDED DECEMBER 31,		NINE MONTHS ENDED DECEMBER 31,	
	2000	1999	2000	1999
Numerator:				
Net loss..............................	$(8,492)	$(6,426)	$(27,689)	$(15,225)
Denominator:				

Weighted average common shares outstanding..........................	26,790	14,010	25,810	8,920
Weighted average unvested common shares subject to repurchase................	(1,710)	(3,360)	(2,050)	(3,520)
Denominator for basic and diluted calculation............................	25,080	10,650	23,760	5,400
Net loss per common share -- basic and diluted................................	$ (0.34)	$ (0.60)	$ (1.17)	$ (2.82)

All convertible preferred stock, warrants, outstanding stock options, and shares subject to repurchase by the Company have been excluded from the calculation of diluted net loss per common share because all such securities are antidilutive for all periods presented. As of December 31, 1999, 7,215,000 shares of convertible preferred stock have not been included in the calculation of diluted net loss per share. Warrants to purchase 3,000 shares and 104,000 shares at a weighted average exercise price of $0.21 and $0.85 have been excluded from the computation of diluted net loss per share at December 31, 2000 and 1999, respectively. Options to purchase 5,095,000 shares and 4,299,000 shares of common stock at a weighted average exercise price of $9.66 and $2.37 have been excluded from the calculation of diluted net loss per share at December 31, 2000 and 1999, respectively.

NOTE 6. STOCK-BASED COMPENSATION

During the nine months ended December 31, 2000, the Company reduced unearned stock-based compensation, a component of stockholders' equity, by $6.1 million. This reduction was the result of stock-based compensation of $4.4 million, a reduction of $2.4 million related primarily to stock option cancellations and the revaluation of options granted to consultants, offset by the recording of $0.7 million of deferred compensation relation to unvested options assumed in the MineShare acquisition. Unearned stock-based compensation is amortized to expense over the period during which the options vest, generally four years in accordance with FASB Interpretation No. 28.

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

You should read the following discussion of our financial condition and results of operations in conjunction with our financial statements and related notes. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of factors including those discussed in "Certain Factors Which May Impact Future Operating Results," starting on page 12, as well as factors set forth in Digital Impact's annual report on Form 10-K for the fiscal year ended March 31, 2000. Any forward-looking statements speak only as of the date such statements are made.

OVERVIEW

Digital Impact, Inc., a Delaware corporation, is a leading provider of online direct marketing solutions. Optimized for email, our strategic consulting, data management, market analytics and campaign management offerings yield superior results for corporations seeking to acquire, retain, and understand customers. Our service offerings leverage proprietary capabilities, including: Mass Personalization Engine(TM), our messaging platform which

assembles and delivers personalized content over various digital media such as email and set-top box; Impact 4.0(TM), our web-based campaign management and reporting system; and Adaptive Intelligent Marketing(TM), our consulting and data management methodology for developing and implementing online direct marketing strategies and programs.

On July 31, 2000, we acquired MineShare, Inc. ("MineShare"), a customer intelligence and analysis company based in Santa Monica, California, in exchange for approximately 1,855,700 shares of our common stock. Additionally, we assumed MineShare's outstanding stock options and warrants and reserved approximately 132,700 shares of our common stock for issuance upon exercise of these options and warrants. The acquisition was effected by means of a merger pursuant to which a wholly owned subsidiary of Digital Impact was merged with and into MineShare, with MineShare as the surviving corporation. The acquisition has been accounted for as a purchase.

Of the $31.9 million purchase price, $4.4 million represented the value of in-process research and development that had not yet reached technological feasibility and had no alternative future use, and as such, was expensed during the quarter ended September 30, 2000. Of the remaining purchase price, $26.3 million, $1.9 million, and $2.7 million were allocated to goodwill, developed technology, and other intangible assets, respectively.

Digital Impact generates revenues from the sale of services to businesses that enable them to proactively communicate with both current and prospective customers online. Historically, these services have primarily consisted of the design and execution of online direct marketing campaigns. In accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," revenue is recognized as these eMarketing campaigns are delivered, provided that there are no remaining significant obligations and collection of the resulting receivable is reasonably assured. Revenue is also generated from our acquisition solutions group, which assists clients in growing their email lists through the use of third party list rentals. The cost of renting the lists is passed through to our clients and hence is offset against the corresponding revenue.

Cost of revenues consists primarily of expenses relating to the delivery of online direct marketing services, including personnel costs, primarily consisting of our production services staff, the amortization of equipment and licensed technology, and data center expenses.

Operating expenses are categorized into research and development, sales and marketing, general and administrative, and stock-based compensation.

Research and development expenses consist primarily of personnel and related costs, consultants and outside contractor costs, and software and hardware maintenance costs for our development efforts. To date, all research and development costs have been expensed as incurred.

Sales and marketing expenses consist of personnel and related costs primarily for our direct sales force and marketing staff, in addition to marketing programs which include trade shows, advertisements, promotional activities and media events.

General and administrative expenses consist primarily of personnel and related costs for corporate functions, including information services, finance, accounting, human resources, facilities and legal.

Stock-based compensation related to stock options granted to employees

represents the aggregate difference, at the date of grant, between the respective exercise price of stock options and the deemed fair market value of the underlying stock. Stock-based compensation related to stock options granted to consultants is revalued at each reporting date using the Black-Scholes option pricing model. Stock-based compensation is amortized based on an accelerated vesting method over the vesting period of the underlying options, generally four years.

RESULTS OF OPERATIONS

THREE MONTHS ENDED DECEMBER 31, 2000 AND DECEMBER 31, 1999

Revenues. Revenues increased to $12.2 million for the three months ended December 31, 2000 from $4.0 million for the three months ended December 31, 1999, an increase of $8.2 million or 203%. The increase was primarily due to the addition of new clients from December 1999 through December 2000, increased volume from continuing clients, and expansion of our core service offerings.

Cost of Revenues. Cost of revenues increased from $1.9 million during the quarter ended December 31, 1999 to $5.3 million during the quarter ended December 31, 2000. The increase was primarily due to higher costs of campaign creation and delivery associated with supporting our growing client base, a higher volume of campaigns, and the expansion of our data center infrastructure. Gross margins improved from 52% for the quarter ended December 31, 1999 to 56% for the quarter ended December 31, 2000, largely due to increased productivity, the continued scaling of our operations as volumes increase, and an increase in the number of clients using our professional services.

Research and Development. Research and development expenses increased from $2.1 million for the quarter ended December 31, 1999 to $4.9 million for the quarter ended December 31, 2000. The increase is largely a result of an increase in personnel costs of approximately $1.2 million, largely related to the increase in engineering staff associated with our MineShare acquisition, and an increase in professional fees of $962,000 as we continued to invest in technological capabilities to differentiate our offerings and increase our operating efficiency. We expect to continue to make investments in research and development and anticipate that research and development expenses will continue to increase in absolute dollars in future periods, but will decrease as a percentage of total revenues.

Sales and Marketing. Sales and marketing expenses increased from $2.0 million for the three months ended December 31, 1999 to $4.9 million for the three months ended December 31, 2000. The increase was primarily due to an increase in marketing costs of $541,000 related to expanded advertising and promotional activities and increased personnel costs of $1.4 million associated with the growth of our sales force, client services and marketing staff. We expect our sales and marketing expenses to increase in future periods as we increase our marketing efforts to promote our brand and hire additional personnel. However, we anticipate that these expenses will continue to decrease as a percentage of revenues in future periods.

General and Administrative. General and administrative expenses increased from $1.6 million for the three months ended December 31, 1999 to $3.1 million for the three months ended December 31, 2000. The increase was due primarily to an increase in insurance costs of $200,000 largely related to the increase in liability insurance during the current fiscal year, and an increase in personnel related expenses of $600,000 associated with the expansion of our finance, administration, and information technology departments. We anticipate that general and administrative expenses will increase in absolute dollars in future periods as we incur additional costs related to the expected growth of our business and operations. However, we anticipate that these expenses will continue to decrease as a percentage of revenues in future periods.

Stock-based Compensation. Stock-based compensation recognized during the three months ended December 31, 1999 and 2000 was $3.2 million and $595,000 respectively. Unearned stock based compensation is recognized over the period during which the underlying stock options vest, generally four years.

Amortization of Goodwill and Purchased Intangibles. During the quarter ended December 31, 2000, we recorded amortization of goodwill and purchased intangibles of $2.4 million. The goodwill and purchased intangibles relate to the July 31, 2000 acquisition of MineShare and are being amortized over three years.

Interest Income, Net. Interest income increased from $412,000 for the quarter ended December 31, 1999 to $664,000 for the quarter ended December 31, 2000. The increase is largely due to higher average cash and cash equivalents balances resulting from the $70.8 million in net proceeds raised during the Company's initial public offering in November 1999.

NINE MONTHS ENDED DECEMBER 31, 2000 AND DECEMBER 31, 1999

Revenues. Total revenues increased from $7.3 million for the nine months ended December 31, 1999 to $30.0 million for the nine months ended December 31, 2000. The increase was largely attributable to the growth of our client base, a significant increase in the number of campaigns sent on behalf of our clients, and expansion of our core service offerings.

Cost of Revenues. Cost of revenues increased from $3.6 million for the nine months ended December 31, 1999 to $13.2 million for the nine months ended December 31, 2000. The increase was primarily attributable to increased personnel costs needed to support our growing client base and higher volumes. Gross margins improved from 51% for the nine months ended December 31, 1999 to 56% for the nine months ended December 31, 2000. This increase was primarily due to the scaling of our technology as a result of higher email volumes and increased capacity utilization.

Research and Development. Research and development expenses increased from $4.7 million for the nine months ended December 31, 1999 to $12.8 million for the nine months ended December 31, 2000. The increase was primarily due to increased personnel costs of $4.8 million and an increase in professional fees of $2.0 million.

Sales and Marketing. Sales and marketing expenses increased from $4.5 million for the nine months ended December 31, 1999 to $13.1 million for the nine months ended December 31, 2000. The increase was largely due to growth in our direct sales and marketing staff with personnel related costs increasing by $3.1 million and an increase in promotional spending of $2.6 million related to building our brand and growing sales.

General and administrative. General and administrative expenses increased from $3.7 million for the nine months ended December 31, 1999 to $8.2 million for the nine months ended December 31, 2000. The increase was due primarily to an increase in personnel costs of $1.7 million, increased rent expense of $900,000 and increased insurance costs of $908,000.

Stock-based Compensation. Stock-based compensation recognized during the nine months ended December 31, 1999 and 2000 was $6.5 million and $4.4 million, respectively. Unearned stock based compensation is recognized over the period during which the underlying stock options vest, generally four years.

Amortization of Goodwill and Purchased Intangibles. During the nine months ended December 31, 2000, we recorded amortization of goodwill and purchased intangibles of $4.0 million. The goodwill and purchased intangibles relate to the July 31, 2000 acquisition of MineShare.

Nonrecurring Charges. Nonrecurring charges recorded during the nine months ended December 31, 2000 ($4.6 million) consisted primarily of the write-off of purchased in-process research and development associated with the acquisition of MineShare. See note 3 to the attached condensed consolidated financial statements for further information.

Interest Income, Net. Interest income increased from $494,000 for the nine months ended December 31, 1999 to $2.5 million for the nine months ended December 31, 2000. The increase is largely due to higher average cash and cash equivalents balances resulting from the $70.8 million net proceeds raised during the Company's initial public offering completed in November 1999.

Income Taxes. No provision for federal and state income taxes was recorded as we incurred net operating losses from inception through December 31, 2000. Due to the uncertainty regarding the ultimate utilization of the net operating loss carryforwards, we have not recorded any benefit for losses and a valuation allowance has been recorded for the entire amount of the net deferred tax asset. In addition, sales of our stock, including shares sold in the initial public offering, may further restrict our ability to utilize our net operating loss carryforwards.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was $18.8 million for the nine months ended December 31, 2000, which was due primarily to a net loss of $27.7 million and an increase in accounts receivable of $10.5 million related to higher sales during the period. This was partially offset by noncash charges including the write-off of in-process research and development associated with the MineShare acquisition ($4.4 million), amortization of stock-based compensation ($4.4 million), and depreciation and amortization ($7.3 million). Net cash used in operating activities for the nine months ended December 31, 1999 was $7.6 million.

Our investing activities used $8.2 million during the nine months ended December 31, 2000 attributable primarily to the acquisition of property and equipment related to significant investments in our data center infrastructure and purchases for new office furniture and equipment for our increased staff. Cash used in investing activities for the nine months ended December 31, 1999 was $3.0 million.

Financing activities generated $933,000 during the nine months ended December 31, 2000, consisting primarily of the proceeds from the exercise of stock options and the purchase of shares through our employee stock purchase plan. This was offset by principal payments on our long-term debt. During the nine months ended December 31, 1999, cash provided by financing activities was $80.9 million, due primarily to the proceeds raised during our initial public offering and a preferred stock round, net of issuance costs.

At December 31, 2000, we had $42.0 million in cash and cash equivalents and availability of $160,000 under a leasing line of credit. Amounts borrowed under this agreement of $927,000 at December 31, 2000 bear interest at rates of between 6.2% and 10.1%. We have $44,236 outstanding under a $50,000 revolving line of credit, which is guaranteed by a shareholder and bears interest at prime plus 3 percent (12.5 percent as of December 31, 2000). We also have an equipment

loan facility with a maximum borrowing limit of $800,000, which is secured by the equipment of our MineShare subsidiary and bears interest at 10 percent. As of December 31, 2000, $396,050 was outstanding under this facility. We have a second equipment loan facility with a borrowing limit of $1,000,000, which is secured by the equipment of our MineShare subsidiary, and bears interest at 10 percent. As of December 31, 2000, $275,266 was outstanding under this facility. At December 31, 2000, we also had $2.0 million outstanding under various promissory notes which bear interest at rates between 9% and 12.7%. The promissory notes mature in February 2001.

Our other principal commitments at December 31, 2000 consisted of obligations under operating leases for facilities. We believe that our existing cash and cash equivalents will be sufficient to satisfy both our currently anticipated cash requirements for the next twelve months and our currently anticipated longer-term cash requirements. Longer-term cash requirements are anticipated for the continued investment in the development of our current and future online direct marketing services, the expansion of our sales and marketing activities, investment in our infrastructure, and the acquisition or investment in complementary products, businesses, or technologies.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 133, or SFAS 133, "Accounting for Derivative Instruments and Hedging

Activities." SFAS 133 establishes new standards of accounting and reporting for derivative instruments and hedging activities. SFAS 133 requires that all derivatives be recognized at fair value in the statement of financial position, and that the corresponding gains or losses be reported either in the statement of operations or as a component of comprehensive income, depending on the type of hedging relationship that exists. SFAS 133 will be effective for fiscal years beginning after June 15, 2000. We do not currently hold derivative instruments or engage in hedging activities.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," or SAB 101, which provides guidance on the recognition, presentation, and disclosure of revenue in financial statements filed with the SEC. SAB 101 outlines the basic criteria that must be met to recognize revenue and provides guidance for disclosures related to revenue recognition policies. We adopted the provisions of SAB 101 during the third quarter of fiscal year 2000, and we believe that its adoption has not had a material effect on our financial position or results of operations.

In March 2000, the Financial Accounting Standards Board issued Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation -- an interpretation of APB Opinion No. 25" ("FIN 44"). This Interpretation clarifies the definition of employee for the purposes of applying Accounting Practice Board Opinion No. 25, "Accounting for Stock Issued to Employees", the criteria for determining whether a plan qualifies as a noncompensatory plan, the accounting consequences of various modifications to the terms of a previously fixed stock option or award, and the accounting for an exchange of stock compensation awards in a business combination. This Interpretation is effective July 1, 2000, but certain conclusions in this Interpretation cover specific events that occur after either December 15, 1998 or January 12, 2000. We applied FIN 44 in accounting for the options granted to MineShare option holders in the acquisition of MineShare. As a result, we recorded $841,000 of deferred compensation relating to the unvested portion of

these options at the acquisition date.

CERTAIN FACTORS WHICH MAY IMPACT FUTURE OPERATING RESULTS

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 you could experience losses on your investment.

BECAUSE OF OUR LIMITED OPERATING HISTORY AND THE EMERGING NATURE OF THE EMARKETING 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 eMarketing industry, we cannot determine trends that may emerge in our market or affect our business. The revenue and income potential of the eMarketing 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.

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 may be affected by similar revenue fluctuations, but our limited operating history is insufficient to predict the existence or magnitude of these effects. If we do experience these effects, analysts and investors may not be able to predict our quarterly or annual operating results, and if we fail to meet expectations of analysts and investors, our stock price could decline.

THE LOSS OF A MAJOR CLIENT COULD RESULT IN LOWER THAN EXPECTED REVENUES.

The loss of a major client could harm our business. While no single customer accounted for more than 10 percent of our revenues for the three and nine months ended December 31, 2000, the loss of a major client could have a material adverse effect on our business and results of operations. Additionally, some internet-based businesses have recently been experiencing financial problems. While the majority of our clients are not internet-based businesses, the loss of a number of these clients could have a material adverse effect on our business and results of operations.

THE EMARKETING 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 eMarketing is highly competitive, rapidly evolving and experiences 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 eMarketing solutions such as 24/7 Media Inc. (through its acquisition of Exactis.com), Kana Communications, Inc. Kana Connect product, FloNetwork, MessageMedia, Responsys.com, Netcentives Inc. (through its acquisition of Post Communications, Inc.), and Annuncio Software, Inc., as well as the in-house information technology departments of our existing and prospective 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 such as America Online, DoubleClick, E.piphany, Inc., Yahoo!, ADVO, and the Interpublic Group of Companies. Each of these companies possesses large, existing customer bases, substantial financial resources and established distribution channels and could develop, market or resell a number of eMarketing solutions. These potential competitors may also choose to enter the market for eMarketing by acquiring one of our existing competitors or by forming strategic alliances with these competitors. Any of these occurrences could harm our ability to compete effectively.

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 services and our ability to provide comprehensive eMarketing expertise. Our main offices are located in the San Francisco Bay Area, where competition for personnel with internet-related technology and marketing skills is extremely intense. 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. As a public company we face greater difficulty attracting and retaining personnel than we did as a private company.

WE RELY ON THE SERVICES OF OUR FOUNDERS AND OTHER KEY PERSONNEL, WHOSE KNOWLEDGE OF OUR BUSINESS AND TECHNICAL EXPERTISE WOULD BE EXTREMELY DIFFICULT TO REPLACE.

Our future success depends to a significant degree on the skills, experience and efforts of our senior management. In particular, we depend upon the continued services of William Park, our President, Chief Executive Officer and co-founder and Gerardo Capiel, our Chief Technology Officer and co-founder, whose

vision for our company, knowledge of our business and technical expertise would be extremely difficult to replace. In addition, we have not obtained life insurance benefiting Digital Impact on any of our key employees. If any of our key employees left or was seriously injured and unable to work and we were unable to find a qualified replacement, the level of services we are able to provide could decline or we may be otherwise unable to execute our business strategy.

IF WE ARE UNABLE TO IMPLEMENT APPROPRIATE CONTROLS, SYSTEMS AND PROCEDURES TO MANAGE OUR EXPECTED GROWTH, WE MAY NOT BE ABLE TO SUCCESSFULLY OFFER OUR SERVICES AND IMPLEMENT OUR BUSINESS PLAN.

Our ability to successfully offer services and implement our business plan requires an effective planning and management process. Since we began operations, we have significantly increased the size of our operations. This growth has placed, and we expect that any future growth we experience will continue to place, a significant strain on our management, systems and resources. To manage the anticipated growth of our operations, we will be required to improve existing and implement new operational, financial and management information controls, reporting systems and procedures.

IF THE DELIVERY OF OUR EMAILS IS LIMITED OR BLOCKED, THEN 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 America Online. We do not have, and we are not required to have, an agreement with America Online to deliver emails to their customers. America Online 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, America Online and other internet service providers are able to block unwanted messages to their users. If these companies 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 our clients may discontinue their use of our services.

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' EMARKETING 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, telecommunications failures, and similar events. If any of these events result in damage to our data center or systems, we may be unable to execute our clients' eMarketing campaigns until the damage is repaired, and may accordingly lose clients and revenues. In addition, 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 ADEQUATELY PROTECT OUR INTELLECTUAL PROPERTY, THIRD PARTIES COULD USE OUR INTELLECTUAL PROPERTY WITHOUT OUR CONSENT.

Our ability to successfully compete is substantially dependent upon our internally developed technology and intellectual property, which we protect through a combination of copyright, trade secret and trademark law, and contractual obligations. We have no issued patents and have two U.S. patent applications pending. We have no registered trademarks and have two U.S. trademark applications pending. We may not be able to adequately 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.

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 retain highly confidential customer information in a secure data warehouse. We cannot assure you, 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 substantial 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.

NEW REGULATION OF AND UNCERTAINTIES REGARDING THE APPLICATION OF EXISTING LAWS AND REGULATIONS TO EMARKETING AND THE INTERNET COULD PROHIBIT, LIMIT OR INCREASE THE COST OF OUR BUSINESS.

Legislation has recently been enacted in several states restricting the sending of unsolicited commercial email. We cannot assure you that existing or future legislation regarding commercial email will not harm our business. The federal government, several U.S. states, and foreign governments are considering, or have considered, similar legislation. These provisions generally limit or prohibit both the transmission of unsolicited commercial emails and the use of forged or fraudulent routing and header information. Some states, including California, require that unsolicited commercial emails include opt-out instructions and that senders of these emails honor any opt-out requests.

Our business could be negatively impacted by new laws or regulations applicable to eMarketing or the internet, the application of existing laws and regulations to eMarketing 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 eMarketing, which could, in turn, decrease the demand for our services and prohibit, limit or increase our cost of 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 the operating performance of the companies and may accordingly reduce the price of our common stock without regard to our operating performance.

OUR ACQUISITION OF MINESHARE MAY RESULT IN DISRUPTIONS TO OUR BUSINESS AND MANAGEMENT DUE TO DIFFICULTIES IN ASSIMILATING PERSONNEL AND OPERATIONS.

In July 2000, we completed our acquisition of MineShare. We may not be able to successfully assimilate MineShare's personnel, operations, acquired technology and products into our existing business. Key personnel from MineShare may decide in the future that they want to leave our employment. Additionally, MineShare products will have to be integrated into our existing products, and this may not be easily accomplished. These difficulties could disrupt our ongoing business or distract management and other key personnel. We may also face unexpected costs which could lead to higher than expected expenses, which may adversely affect our future operating results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For the period from our inception through December 31, 2000, we provided our services to clients primarily in the United States. As a result, our financial results have not been directly affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. The majority of our sales are currently denominated in U.S. dollars. During the first quarter of the year ending March 31, 2001, we established a subsidiary in the United Kingdom which has had minimal operations to date. As the operations of this subsidiary expand, our future operating results could be directly impacted by changes in foreign currency exchange rates or economic conditions in this region.

Our exposure to market risk for changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our investment portfolio and on the increase or decrease in the amount of interest expense we must pay on our outstanding debt instruments. The risk associated with fluctuating interest expense is limited, however, to the exposure related to those debt instruments and credit facilities which are tied to market rates. We do not plan to use derivative financial instruments in our investment portfolio. We plan to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We plan to mitigate default risk by investing in high-credit quality securities.

PART II. OTHER INFORMATION

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

On November 23, 1999, we completed our initial public offering of 5,175,000 shares of our common stock, which includes 675,000 shares in connection with the exercise of the underwriters' overallotment option, at $15 per share. The managing underwriters in the offering were Credit Suisse First Boston, Hambrecht & Quist, Donaldson, Lufkin & Jenrette, and U.S. Bancorp Piper Jaffray. The shares of common stock sold in the offering were registered under the Securities Act of 1933, as amended, on a Registration Statement on Form S-1 (Reg. No. 333-87299) that was declared effective by the SEC on November 22, 1999. The aggregate offering amount including the overallotment exercise was approximately $77.6 million. We incurred expenses of approximately $6.8 million, of which approximately $5.4 million represented underwriting discounts and commissions and approximately $1.4 million represented other expenses related to the offering.

Currently, we have placed the net proceeds from the offering in short-term, interest bearing, investment grade securities. During the nine months ended December 31, 2000, we used a portion of the net proceeds to fund our general operations, to purchase new data center equipment and office furniture and equipment, and to begin the integration of the operations of our newly acquired MineShare subsidiary. We expect to use the remaining offering net proceeds for working capital and general corporate purposes, including continued investment in the development of our current and future online direct marketing services, the expansion of our

sales and marketing activities, and investment in our infrastructure. Additionally, we may use a portion of the net proceeds to acquire or invest in complementary products, technologies, or businesses.

On July 31, 2000, we acquired MineShare, Inc. In connection with the acquisition, we issued approximately 1,855,700 shares of our common stock to the shareholders of MineShare in exchange for all of the issued and outstanding capital stock of MineShare. The shares were issued pursuant to exemptions by reason of Section 4(2) of the Securities Act of 1933 and/or Regulation D promulgated under such Act. These sales were made in private transactions without general solicitation or advertising. Also in connection with the acquisition, we assumed options and warrants to purchase 132,700 shares of our common stock. We filed a Registration Statement on Form S-8 with respect to the shares of our common stock issuable upon exercise of all such options.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

Exhibits

None

Reports on Form 8-K

None

SIGNATURES

Pursuant to 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.

Dated: February 12, 2000

DIGITAL IMPACT, INC.
(Registrant)

/s/ WILLIAM PARK

William Park
President, Chief Executive Officer and Chairman of the Board of Directors
(Principal Executive Officer)

/s/ DAVID OPPENHEIMER

David Oppenheimer
Sr. Vice President and Chief Financial Officer, Treasurer and Secretary
(Principal Financial and Accounting Officer)