

DIGI INTERNATIONAL INC  
Form 10-K  
December 13, 2016

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

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

For the fiscal year ended: September 30, 2016  
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: 1-34033

DIGI INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

Delaware 41-1532464  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification Number)

11001 Bren Road East  
Minnetonka, Minnesota 55343  
(Address of principal executive offices) (Zip Code)

(952) 912-3444  
(Registrant's telephone number, including area code)

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

| Title of each class                     | Name of each exchange on which registered |
|---|---|
| Common Stock, par value \$.01 per share | The NASDAQ Global Select Market           |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) 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 the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The aggregate market value of voting stock held by non-affiliates of the Registrant as of the last business day of the Registrant's most recently completed second fiscal quarter was \$240,899,354 based on a closing price of \$9.43 per common share as reported on the NASDAQ Global Select Market. (For purposes of this calculation all of the

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registrant's directors and executive officers are deemed affiliates of the registrant.)

Shares of common stock outstanding as of December 9, 2016: 26,321,953

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's Proxy Statement for its 2017 Annual Meeting of Stockholders are incorporated by reference into Part III hereto.

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PART I.

ITEM 1. BUSINESS

General Background and Product Offerings

Digi International Inc. (“Digi,” “we,” “our,” or “us”) was incorporated in 1985 as a Minnesota corporation. We were reorganized as a Delaware corporation in 1989 in conjunction with our initial public offering. Our common stock is traded on the NASDAQ Global Select Market under the symbol DGII. Our World Headquarters is located at 11001 Bren Road East, Minnetonka, Minnesota 55343. The telephone number at our World Headquarters is (952) 912-3444. We are a leading global provider of business and mission-critical machine-to-machine (M2M) and Internet of Things (IoT) connectivity products and services. We help our customers create next-generation connected products and deploy and manage critical communications infrastructures in demanding environments with high levels of security and reliability. We create secure, easy to implement embedded solutions and services to help customers build IoT connectivity. We also deploy ready to use, complete box solutions to connect remote machinery. In addition, we manage cloud services, offer professional services and complete IoT solutions. Most recently we formed a cold chain solution that offers automated wireless temperature monitoring as well as employee task management services to restaurants, convenience stores, warehouses and other businesses that have perishable or temperature sensitive goods. Our products and services are used by a wide range of businesses and institutions.

Our present portfolio primarily includes:

• Wireless and wired hardware products that have been the historical foundation of our business;

• Services include the following offerings:

Digi Cold Chain Solutions is a wireless end-to-end solution that utilizes sensors, gateways and an easy-to-use software application that enables companies to monitor automatically the temperature of perishable goods effectively and economically. Our Digi Cold Chain Solutions are the result of our acquisition of Bluenica Corporation in October 2015 (see Note 2 to our Consolidated Financial Statements). On November 1, 2016, we acquired Pittsburgh-based FreshTemp, LLC (FreshTemp). This acquisition expands our offerings and customer base in this market space (see Note 19 to our Consolidated Financial Statements). FreshTemp helps organizations track the completion of employee tasks in real time via the use of software applications in which employees log their activities in real-time.

Wireless Design Services provide customers with turn-key wireless networking product design, testing, and certification for a wide range of wireless technology platforms and applications to improve speed to market and reduce risk.

Digi Support Services provides various levels of technical support to customers with programming and implementation challenges related to Digi products. We offer base support up to our highest level of professional support which includes implementation planning, application development, on-site support, installation and customer training. These support services help minimize design risk and ensure optimal performance.

Digi Device Cloud™ and Digi Remote Manager™ Digi Device Cloud™ (Device Cloud) is a platform as-a-service (PaaS) offering that provides a secure environment for customers to aggregate their interaction with a large number of disparate devices and connect enterprise applications to these devices. This allows for devices to be monitored and controlled remotely and permits customers to collect, interpret and utilize data from many devices to operate their businesses efficiently and with greater ease. Digi Remote Manager™ is a complete, centralized remote device management solution that is housed on the Digi Device Cloud™ and allows customers to meet service level commitments and stay compliant with Payment Card Industry (PCI) standards. Digi Remote Manager™ also allows customers to monitor, diagnose and fix remote devices without sending a technician on site.

In October 2015, we sold our Etherios, Inc. CRM consulting services business (“Etherios”), which focused on integration and configuration of enterprise resource management (ERM) systems, including customer relationship management (CRM) systems. This part of our business principally provided integration and configuration of salesforce.com products. As a result of the sale of Etherios, we have accounted for it as a discontinued operation. Accordingly, amounts in the Consolidated Statement of Operations, the Consolidated Balance Sheets and notes thereto, for all periods affected, have been reclassified to reflect discontinued operations accounting for that business.

For more information on this divestiture see Note 3 to the Consolidated Financial Statements.

For more in-depth descriptions of our primary hardware products, please refer to the heading “Listing of Principal Hardware

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Products and Services” at the end of Part I, Item 1 of this Form 10-K.

Our hardware product revenue represented 96.6%, 95.9% and 94.4% of our total revenue in fiscal 2016, 2015 and 2014, respectively. Our service revenue represented 3.4%, 4.1% and 5.6% of our total revenue in fiscal 2016, 2015 and 2014, respectively.

Our corporate website address is [www.digi.com](http://www.digi.com). In the “Company - Investor Relations” section of our website, we make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, our proxy statement and any amendments to these reports available free of charge as soon as reasonably practicable after these reports are filed with or furnished to the United States Securities and Exchange Commission (the “SEC”). Each of these documents can also be obtained free of charge (except for a reasonable charge for duplicating exhibits to our reports on Form 10-K, 10-Q or 8-K) in print by any stockholder who requests them from our investor relations personnel. The Investor Relations email address is [ir@digi.com](mailto:ir@digi.com) and its mailing address is: Investor Relations Administrator, Digi International Inc., 11001 Bren Road East, Minnetonka, Minnesota 55343. These reports can also be accessed via the SEC website, [www.sec.gov](http://www.sec.gov), or via the SEC’s Public Reference Room located at 100 F Street, N.E., Washington, D.C. 20549. Information concerning the operation of the SEC’s Public Reference Room can be obtained by calling 1-800-SEC-0330.

Information on our website is not incorporated by reference into this report or any other report we file with or furnish to the SEC.

Industry and Marketplace Conditions

Current Market Conditions

We believe the marketplace for IoT products and services will continue to expand generally. While we realized significant revenue growth in fiscal 2015, our business stagnated in fiscal 2016 primarily because certain significant customers of our cellular and RF products slowed their purchases of our products. While we generally expect the trend of marketplace growth to continue, it is susceptible to downturns in general economic conditions as well as uncertainty or changes in the regulatory environments. These impacts may be more pronounced in certain industries. For instance, the oil and gas marketplace for IoT networking products has been more challenging in recent years because of lower prices for these natural resources. Further, as demonstrated in fiscal 2016, our own ability to grow our core hardware business can be subject to fluctuation. Sales of many of our products are subject to large non-repeatable customer deployments. If we are unable to identify and commence new deployments with equal or greater significance than completed projects, our growth from period to period may be inconsistent. In turn, if we do not replace significant opportunities as they conclude with similar opportunities of scale, our growth from period to period may be inconsistent.

Strategy

Current Status of Our Business

Since appointing Ronald E. Konezny as our Chief Executive Officer in December, 2014, we have focused on:

- Simplifying our operations;
- Improving our operating expense model and profitability; and
- Exploring ways to drive greater revenue growth.

Among other actions we have taken to advance these aims during that time include:

- We have taken steps to contain our operating expenses and delivered higher levels of profitability despite decreased revenue in fiscal 2016.

We focused our business and improved our operating model by selling our Etherios CRM consulting business in October 2015. We acquired Etherios with the expectation that it would drive engagements with companies that utilize the salesforce.com platform and were looking to deploy solutions within their businesses. We were not, however, rewarded in the marketplace as we had hoped. As a result, we disposed of a consulting business that was losing money and not fully tied to our core hardware expertise.

- We have consolidated and relocated office locations. In the first quarter of fiscal 2016, we moved our Wireless Design Services team from an office in downtown Minneapolis to our World Headquarters in suburban Minnetonka. At first,

this move was disruptive for some employees of the Wireless Design Services team and the revenues of the business

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consequently suffered due to attrition. However, as of the fourth quarter of fiscal 2016 business results have begun to rebound. Additionally, we closed our office location in Dortmund, Germany in the third quarter of fiscal 2016 and moved the corresponding positions to our existing office in Munich, Germany. These moves improved our operating expenses and better positioned our employees to drive positive results in our operations through increased collaboration. We also expect to benefit from closer proximity to certain key customers in the Munich area.

During fiscal 2016, we continued to reduce the number of hardware product stock keeping units (SKUs) we produce. We expect this effort to simplify our operations will have a significant impact on our ability to manage inventory effectively, improve channel stocking strategies and control costs. At present, SKUs have been reduced from close to 5,000 to approximately 2,700.

Our recent acquisitions enhance our opportunity to develop a high-growth hardware enabled service business with significant recurring revenue potential. In October 2015, we acquired Bluenica Corporation, a company focused on automating temperature monitoring of perishable goods in the food industry by using wireless sensors and a web-based application. In November 2016, we also acquired Pittsburgh-based FreshTemp, LLC. See "Acquisitions and Dispositions" below for further discussion. These acquisitions will provide us with an advanced portfolio of products for the cold chain market.

Long Term Strategy

We are focused on creating a high-growth business that leverages our long-term strengths of providing reliable and secure equipment and solutions for the M2M marketplace. We intend to continue to take steps to simplify our operations, improve operating expenses to increase our profit leverage and expand our business in ways that we believe can drive growth. We will continue to seek and evaluate acquisitions that will further enhance Digi Cold Chain Solutions as we believe this marketplace offers a path to a significant base of recurring revenue that can provide both stability and significant growth for us. If opportunities present themselves, we may also seek to acquire hardware or other businesses that we believe can improve our market position in our core IoT hardware business.

Acquisitions and Dispositions

Acquisitions

In October 2015, we acquired Bluenica Corporation, a company focused on temperature monitoring of perishable goods in the food industry by using wireless sensors which are installed in grocery and convenience stores, restaurants, and in products during shipment and storage to ensure that quality, freshness and public health requirements are met (see Note 2 to our Consolidated Financial Statements).

This Company formed the initial basis for Digi Cold Chain Solutions and was purchased for several reasons. First, it provided us with the opportunity to develop a recurring revenue business that is focused on a large addressable market that has not been penetrated significantly. Restaurants, pharmacies, hospitals and other businesses that maintain significant inventories of perishable goods are an enormous market. These businesses by and large presently rely primarily on employees to log the temperature of these goods periodically using pencil and paper. This is not as cost effective or secure as using wireless communications sensors to provide real time alerts at all times. Second, at present this marketplace primarily is served by smaller companies that lack the infrastructure to provide hardware enabled service to customers in as effective and efficient a manner as we are able to do because of our long-standing history as an IoT hardware provider. Third, we believe customers in this marketplace will not require significant customization or development of existing products before they will commit to purchase the solution. This differs from many of our present customers who often ask us to create a highly customized product that cannot be easily sold to other parties. This potential for repeatable sales of an established product suite appeals to us. Fourth, by protecting valuable goods that impact health and safety, the solution provides a clear return on investment for potential customers whose business and reputation is highly reliant on maintaining inventory that is safe for human consumption.

We have further enhanced Digi Cold Chain Solutions with the November 1, 2016 acquisition of Pittsburgh based FreshTemp, LLC (FreshTemp). FreshTemp offers restaurants, convenience stores and other retailers the ability to monitor the temperature of food products automatically through the use of wireless sensors. The company also enables these businesses to track in real time the completion of operational tasks by their employees that could impact human



health and safety - a capability that we believe enhances our product offering.

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### Disposition

On October 23, 2015, we entered into a stock purchase agreement with West Monroe Partners, LLC, pursuant to which they acquired our Etherios CRM consulting services business. We sold Etherios as part of a strategy to focus on providing highly reliable machine connectivity solutions for business and mission-critical application environments (see Note 3 to our Consolidated Financial Statements).

These are the only acquisitions and dispositions we have completed in the past five years. We will continue to evaluate strategic opportunities to acquire businesses as they arise and may seek to divest businesses or assets we no longer consider appropriate to our long-term strategy.

### Sales Channels

We sell our products through a global network of distributors, systems integrators and value added resellers (VARs) which accounted for 66.1%, 61.8% and 63.0% of our total revenue in fiscal 2016, 2015 and 2014, respectively. We also complete sales through our own dedicated sales organization to original equipment manufacturers (OEMs) and other customers which accounted for 33.9%, 38.2% and 37.0% of our total revenue in fiscal 2016, 2015 and 2014, respectively.

### Distributors

Our larger distributors, based on sales we make to them, include Alcom Electronics BV, Anewtech Systems Pte Ltd., Arrow Electronics, Inc., Astone Technologies, Atlantik Elektronik GmbH, Avnet, Codico GmbH, Digi-Key Corporation, Express Systems & Peripherals, Future Electronics, Ingram Micro, Melchoni S.p.A., Miel, Mouser Electronics, Novotech, Sapply Pty. Ltd., Scansource Corporation, Solid State Supplies, Ltd., Sphinx Computer Vertriebs GmbH, Synnex, Tech Data Corporation and Tokyo Electron Device Ltd. We also maintain relationships with many other distributors in the U.S., Canada, Europe, Asia Pacific and Latin America.

### Strategic Sales Relationships

We maintain alliances with other industry leaders to develop and market technology solutions. These include many major communications hardware and software vendors, operating system suppliers, computer hardware manufacturers, enterprise application providers and cellular carriers. Among others, partners include: AT&T, Bell Mobility, Ericsson, NXP, Qualcomm, Telit, Rogers, Silicon Laboratories, Sprint, Telus, Verizon and several other cellular carriers worldwide. Furthermore, we maintain a worldwide network of authorized developers that extends our reach into certain other technology applications and geographical regions.

We have established relationships with equipment vendors in a range of industries such as energy, industrial, retail, transportation, medical, and government that allow the vendors to ship our products and services as component parts of their overall solutions. Our products are used by many of the world's leading telecommunications companies and Internet service providers, including AT&T Inc., Sprint Corporation and Verizon Communications Inc.

No single customer comprised more than 10% of our consolidated revenue for any of the years ended September 30, 2016, 2015 or 2014.

### Competition

We compete primarily in the communications technology industry, which is characterized by rapid technological advances and evolving industry standards. The market can be affected significantly by new product introductions and marketing activities of industry participants. In addition, we may compete with other companies to acquire new businesses or technologies and the competition to secure such assets may be intense. We compete for customers on the basis of existing and planned product features, service and software application capabilities, company reputation, brand recognition, technical support, alliance relationships, quality and reliability, product development capabilities, price and availability. While no competitor offers a comparable range of products and services, various companies do compete with us with respect to one or more of our products or solutions. With respect to many of our product and service offerings, we face competition from companies who dedicate more resources and attention to that particular offering than we are able to do given the breadth of our business. As marketplace for IoT connectivity products and solutions continues to grow, we expect to encounter increased competition. Some of these competitors may have access to significantly more financial and technical resources than we possess.



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### Manufacturing Operations

Our manufacturing operations are conducted through a combination of internal manufacturing and external subcontractors specializing in various parts of the manufacturing process. We rely on third party foundries for our semiconductor devices that are Application Specific Integrated Circuits (ASICs) and we outsource printed circuit board production. This approach allows us to reduce our fixed costs, maintain production flexibility and optimize our profits.

Our products are manufactured to our designs with standard and custom components. Most of the components are available from multiple vendors. We have several single-sourced supplier relationships, either because alternative sources are not available or because the relationship is advantageous to us. If these suppliers are unable to provide a timely and reliable supply of components, we could experience manufacturing delays that could adversely affect our consolidated results of operations in a material way.

### Seasonality

In general, our business is not considered to be highly seasonal, although our first fiscal quarter revenue is often less than other quarters due to holidays and fewer shipping days.

### Working Capital

We fund our business operations through a combination of cash and cash equivalents, marketable securities and cash generated from operations. We believe that our current financial resources, cash generated from operations, and our capacity for debt and/or equity financing will be sufficient to fund our business operations for the next twelve months and beyond.

### Research & Development and Intellectual Property Rights

During fiscal years 2016, 2015 and 2014, our research and development expenditures were \$31.0 million, \$29.9 million and \$28.9 million, respectively.

Due to rapidly changing technology in the communications technology industry, we believe a large part of our success depends upon the product and service development skills of our personnel as well as our ability to integrate any acquired technologies with organically developed technologies. While we dedicate significant resources to research and development, many of our competitors are focused on a smaller set of products than us and are likely able to dedicate more resources than us toward the portions of the market in which we compete.

Our proprietary rights and technology are protected by a combination of copyrights, patents, trade secrets and trademarks.

We have established common law and registered trademark rights on a family of marks for a number of our products. Our products and services primarily are sold under the Digi, Rabbit® and Xbee® brands. We believe that the Digi and Rabbit® brands have established strong identities with our targeted customer base and our customers associate the Digi brand with “reliability” and the Rabbit® brand with “ease of integration.” We believe that our customers associate Xbee® with “ease of use.” Many of our customers choose us because they are building a very complex system solution and they want the highest level in product reliability and ease of integration and use. Our Etherios® brand was sold in connection with the sale of Etherios, Inc. in October 2015.

Our patents are applicable to specific technologies and are valid for varying periods of time based on the date of patent application or patent grant in the U.S. and the legal term of patents in the various foreign countries where patent protection is obtained. We believe our intellectual property has significant value and is an important factor in the marketing of our company and products.

### Backlog

Backlog as of September 30, 2016 and 2015 was \$25.3 million and \$27.2 million, respectively. The majority of the backlog at September 30, 2016 is expected to be shipped in fiscal 2017. Backlog as of any particular date is not necessarily indicative of our future sales trends.

### Employees

We had 515 employees on September 30, 2016. We consider our relations with our employees to be good.



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Geographic Areas and Currency Risks

Our customers are located throughout North America, Europe, Middle East & Africa (EMEA), Asia Pacific and Latin America. We are exposed to foreign currency transaction risk associated with certain sales being denominated in Euros, British Pounds, Japanese Yen and Canadian Dollar and foreign currency translation risk as the financial position and operating results of our foreign subsidiaries are translated into U.S. Dollars for consolidation. We manage our net asset or net liability position for U.S. dollar accounts in our foreign locations to reduce our foreign currency risk. We have not implemented a formal hedging strategy to reduce foreign currency risk.

During 2016, we had approximately \$71.5 million of revenue related to foreign customers including export sales, of which \$22.9 million was denominated in foreign currency, predominantly the Euro and British Pound. During fiscal 2015 and 2014, we had approximately \$76.2 million and \$76.3 million, respectively of revenue to foreign customers including export sales, of which \$21.3 million and \$23.3 million, respectively, were denominated in foreign currency, predominantly the Euro and British Pound. In future periods, we expect a significant portion of sales will continue to be made in Euros and British Pounds.

Financial information about geographic areas appears in Note 5 to our Consolidated Financial Statements in this Form 10-K.

PRINCIPAL HARDWARE PRODUCTS AND SERVICES

Hardware Products

Cellular routers and gateways - Cellular routers provide connectivity for devices over a cellular data network. They can be used as a cost effective alternative to landlines for primary or backup connectivity for remote locations and devices. These products have been certified by the major wireless providers in North America and abroad, including, among others, AT&T®, Verizon Wireless®, Sprint®, Bell Mobility, Rogers and Vodafone. Cellular gateway products enable devices or groups of devices to be networked in locations where there is no existing network or where access to a network is prohibited. All of our cellular products include a unique remote management platform that provides secure management of devices across remote networks and can all use the Device Cloud for remote management. In addition, application connectivity, management and customization are enabled via the Device Cloud platform for many of these products.

Radio Frequency (RF) - Our RF products are small box or module products that utilize a variety of wireless protocols for PC-to-device or device-to-device connectivity, often in locations where deploying a wired network is not possible either because of cost, disruption or impracticality. By supporting ZigBee®, Wi-Fi® and other radio frequency "RF" technologies, we can meet most customer application requirements. In conjunction with one of our gateways, RF products can be connected into the Device Cloud for remote management, application connectivity and customization. Embedded - Our Connect, Rabbit® and ARM-based embedded systems on module, and single board computers are designed and developed with small footprints, low power consumption and software, making them ideal for medical, transportation and industrial device manufacturers. A number of these modules can be connected directly to the Device Cloud or other similar platforms, enabling remote management and remote application connectivity. Also included in our embedded grouping are our chips (or microprocessors) that provides the "brains" and processing power of an intelligent electronic device or communication sub-system. Some of our higher volume customers choose to purchase chips and build their own products. Chips are low cost but require the highest level of development expertise. Chip development is not part of our strategy; instead we use commercial-off-the-shelf technology from companies such as Freescale and Ember for our products.

Network - Our network product category consists of:

• Console servers - Our console servers provide a secure remote graphical access to computer systems and network equipment that can communicate with virtually any server or device.

• Serial servers - Our serial servers (also known as device servers and terminal servers) provide secure, reliable and flexible serial-to-Ethernet integration of most devices into wired Ethernet networks. They are used for a variety of applications such as automation, robotics control, centralized device monitoring and management, data acquisition and point-of-sale applications.

USB - Our Universal Serial Bus (USB) solutions include USB-to-serial converters that offer instant I/O expansion for peripheral device connectivity. We also offer USB over IP products that connect USB and serial devices on a wired or wireless LAN, while eliminating the need for locally-attached host PCs. In addition, we also offer multiport USB hubs that offer a simple solution for adding switched USB ports to a PC, server or thin client.

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Services

Digi Cold Chain Solutions - Our Digi Cold Chain Solutions is an end-to-end, cost-effective system that uses sensors, gateways and a cloud based application to enable customers such as restaurants, groceries and convenience stores to monitor wirelessly the temperature of food and other perishable goods. Our Digi Cold Chain Solutions was introduced as a result of our acquisition of Bluenica Corporation on October 5, 2015 (see Note 2 to our Consolidated Financial Statements). Our acquisition of FreshTemp, LLC in November 2016 further expands our product suite through the addition of software offerings that help customers track the completion of operating tasks in real-time that may impact health and safety.

Wireless Design Services - Our Wireless Design Services provide customers turn-key wireless networking product designs, testing, and certification for a wide range of wireless technology platforms and applications.

Digi Support Services - Our Digi Support Services provides various levels of technical support to customers with programming and implementation challenges related to Digi products. We offer base support up to our highest level of professional support which includes implementation planning, application development, on-site support, installation and customer training. These support services help minimize design risk and ensure optimal performance.

Digi Device Cloud™ and Digi Remote Manager™ - Our Digi Device Cloud™ is a platform as-a-service (PaaS) offering that provides a secure environment for customers to aggregate their interaction with a large number of disparate devices and connect them to enterprise applications. This allows for devices to be monitored and controlled remotely and allows customers to collect, interpret and utilize data from many devices to operate their businesses more easily and efficiently. The Digi Remote Manager™ is a complete centralized remote device management solution that is housed on the Digi Device Cloud™ and allows customers to meet service level commitments and stay compliant with Payment Card Industry (PCI) standards. Digi Remote Manager™ also allows customers to monitor, diagnose and fix remote devices without sending a technician on site.

ITEM 1A. RISK FACTORS

Multiple risk factors exist which could have a material effect on our operations, results of operations, financial position, liquidity, capital resources and common stock.

Risks Relating to Our Business

We face intense competition from established companies that may have significant advantages over us and our products.

The market for our products is intensely competitive. Certain of our competitors and potential competitors have or may develop greater financial, technological, manufacturing, marketing, and personnel resources than us either generally or relative to the product sets they sell in competition to us. Further, there are numerous companies competing with us in various segments of the market for our products, and their products may have advantages over our products in areas such as conformity to existing and emerging industry standards, interoperability with other products, management and security capabilities, performance, price, ease of use, scalability, reliability, flexibility, product features and technical support.

Our current and potential competitors have or may develop one or more of the following significant advantages over us in the product areas where they compete with us:

- tighter focus on an individual product or product category;
- greater financial, technical and marketing resources;
- barriers to transition to our products;
- higher brand recognition across larger geographic regions;
- more comprehensive functionality;
- longer-standing cooperative relationships with OEM and end-user customers;
- superior customer service capacity and quality;
- longer operating history; and
- larger customer base.





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We cannot provide assurance that we will be able to compete successfully with our current and potential competitors. Such competitors may be able to more quickly develop or adapt to new or emerging technologies and changes in customer requirements, or devote greater resources to the development, promotion and sale of their products. Additionally, it is probable that new competitors or new alliances among existing competitors could emerge and rapidly acquire significant market share.

Our dependence on new product development and the rapid technological change that characterizes our industry makes us susceptible to loss of market share resulting from competitors' product introductions and enhancements, service capabilities and similar risks.

Our industry is characterized by rapidly changing technologies, evolving industry standards, frequent new product introductions, short product life cycles in certain instances and rapidly changing customer requirements. The introduction of products and enhancements embodying new technologies and the emergence of new industry standards can render existing products obsolete and unmarketable.

Our future success will depend on our ability to enhance our existing products, to introduce new products to meet changing customer requirements and emerging technologies, and to demonstrate the performance advantages and cost-effectiveness of our products over competing products. Failure by us to modify our products to support new alternative technologies or failure to achieve widespread customer acceptance of such modified products could cause us to lose market share and cause our revenue to decline. Further, if competitors offer better service capabilities associated with the implementation and use of products in communication networks, our business could be impacted negatively.

We may experience delays in developing and marketing product enhancements or new products that respond to technological change, evolving industry standards and changing customer requirements. There can be no assurance that we will not experience difficulties that could delay or prevent the successful development, introduction, and marketing of these products or product enhancements, or that our new products and product enhancements will meet the requirements of the marketplace adequately and achieve any significant or sustainable degree of market acceptance in existing or additional markets. In addition, the future introductions or announcements of products by us or one of our competitors embodying new technologies or changes in industry standards or customer requirements could render our then-existing products obsolete or unmarketable. This risk may become more pronounced as new competitors enter the marketplace, especially if these competitors have more resources than us to develop and market new products and technologies and provide related services. There can be no assurance that the introduction or announcement of new product offerings by us or one or more of our competitors will not cause customers to defer their purchase of our existing products, which could cause our revenue to decline.

We intend to continue to devote significant resources to our research and development, which, if not successful, could cause a decline in our revenue and harm our business.

We intend to continue to devote significant resources to research and development in the coming years to enhance and develop additional products. For fiscal 2016, 2015, and 2014, respectively, our research and development expenses were 15.2%, 14.7% and 15.8% of our revenue. If we are unable to develop new products, applications and services as a result of our research and development efforts, if we encounter delays in deploying these new products, applications and services, or if the products, applications and services we develop are not successful, our business could be harmed. Even if we develop new products, applications and services that are accepted by our target markets, the net revenue from these products, applications and services may not be sufficient to justify our investment in research and development.

Many of our products, applications and services have been developed through a combination of internally developed technologies and acquired technologies. Our ability to continue to develop new products, applications and services could be partially dependent on finding and acquiring new technologies in the marketplace. Even if we identify new technologies that we believe would be complementary to our internally developed technologies, we may not be successful in obtaining those technologies or we may not be able to acquire the technologies at a price that is acceptable to us.

A substantial portion of our development efforts have been directed toward the development of new products targeted to manufacturers of intelligent, network-enabled devices and other embedded systems in various markets, including markets in which networking solutions for embedded systems have not historically been sold, such as markets for industrial automation equipment and medical equipment.

Our participation in a services and solutions model, using hardware and cloud-based services, presents execution and competitive risks.

We are deploying a services and solutions model. Our Digi Cold Chain offering deploys hardware, software and cloud-based hosting. In other parts of our business we also offer our own internally developed hosted services and cloud-based platform,

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software applications, and supporting products and services. We are employing significant human and financial resources to develop and deploy these offerings. As we work to grow and scale these offerings, these investments have impacted our gross margins and profitability adversely in the past and may continue to do so in the future. While we believe we have a strong foundation to compete, it is uncertain whether our strategies will attract the users or generate the revenue required to be successful. We have and will encounter competition from other solutions providers, many of whom may have more significant resources than us with which to compete. Whether we are successful in this business model depends on a number of factors, including:

- our ability to put in place the infrastructure to deploy and evolve our solutions effectively and continuously;
- the features and functionality of our offerings relative to competing offerings as well as our ability to market effectively;
- our ability to engage in successful strategic relationships with third parties such as telecommunications carriers, component makers and systems integrators;
- competing effectively for market share; and
- deploying complete end-to-end solutions that meet the needs of the marketplace generally as well as the particular requirements of our customers more effectively and efficiently than competitive solutions.

Our ability to sustain and grow our business depends in large part on the success of our channel partner distributors and resellers.

A substantial part of our revenue is generated through sales by channel partner distributors and resellers. Sales through our channel partners accounted for 66.1%, 61.8% and 63.0% of our total revenue in fiscal 2016, 2015 and 2014, respectively. Further, in recent years we have been taking steps to expand our relationship with certain distributors who have global reach, an effort that may increase the percent of our revenue driven through channel partners or our reliance on certain channel partners to drive sales. To the extent our channel partners are unsuccessful in selling our products or if we are unable to obtain and retain a sufficient number of high-quality channel partners, our operating results could be materially and adversely affected. In addition, our channel partners may also market, sell and support products and services that are competitive with ours, and may devote more resources to the marketing, sales and support of such products. They also may have incentives to promote our competitors' products in lieu of our products, particularly for our competitors with larger volumes of orders, more diverse product offerings and a longer relationship with our distributors and resellers. In these cases, one or more of our important channel partners may stop selling our products completely. Our channel partner sales structure also could subject us to lawsuits, potential liability and reputational harm if, for example, any of our channel partners misrepresents the functionality of our products or services to customers, or violates laws or our corporate policies. If we fail to manage our existing or future sales channel partners effectively, our business and operating results could be materially and adversely affected. Our gross margins may be subject to decline.

Our gross margins may be subject to decline which could decrease our overall profitability and impact our financial performance adversely. Many of the hardware products we sell are approaching the end of their product life cycles. These mature hardware products typically sell at higher gross margins than our other product and service offerings. In fiscal 2016, sales of mature hardware products represented about 40.9% of our overall revenue. While these products experienced increased sales in fiscal 2016, in general, revenues from the sale of these mature hardware products have been declining for several years at a rate of between 1% and 10%, and we expect this trend to continue. In addition, ongoing cost pressures in our industry create downward pressure on the prices at which we and other manufacturers can sell hardware products. We also have indicated that we would be willing to realize lower levels of gross margins from customers in return for long-term, binding purchase commitments, a strategy that, if successful, could also put downward pressure on our gross margins. While part of our longer term strategy is to sell software applications and IoT solutions such as Digi Cold Chain which can provide recurring revenues at relatively high gross margin, these types of offerings are at early stages of adoption by customers and their sales growth is not necessarily predictable or assured. As such, our gross margins may be subject to decline unless we can implement cost reduction initiatives effectively to offset the impact of these factors.

Our revenue may be subject to fluctuations based on the level of significant one time purchases. No single customer has represented more than 10% of our revenue in any of the last three fiscal years. However, many of our customers make significant one-time hardware purchases for large projects that are not repeated. As a result, our revenue may be subject to significant fluctuations based on whether we are able to close significant sales opportunities. Our failure to

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complete one or a series of significant sales opportunities in a particular fiscal period could have a material adverse effect on our revenue for that period.

Certain of our products are sold into mature markets, which could limit our ability to continue to generate revenue from these products.

Many of our hardware products are sold into mature markets that are characterized by a trend of declining demand. As the overall market for these mature hardware products decreases due to the adoption of new technologies, we expect that our revenue from these products will continue to decline. As a result, our future prospects depend in part on our ability to acquire or develop and successfully market additional products that address growth markets.

Our ability to grow our business is dependent in part on strategic relationships we develop and maintain with third parties as well as our ability to integrate and assure use of our products and services in coordination with the products and services of certain strategic partners in a commercially acceptable manner.

We believe that our ability to increase our sales depends in part on maintaining and strengthening relationships with parties such as telecommunications carriers, systems integrators, enterprise application providers, component providers and other strategic technology companies. Once a relationship is established, we likely will dedicate significant time and resources to it in an effort to advance our business interests and there is no assurance any strategic relationship will generate enough revenue to offset the significant resources we use to advance the relationship. Parties with whom we establish strategic relationships may also work with companies that compete with us. We also have limited, if any, control as to whether these parties devote adequate resources to promoting, selling, and implementing our products. Further, new or emerging technologies, technological trends or changes in customer requirements may result in certain companies with whom we maintain strategic relationships de-emphasizing their dealings with us or becoming potential competitors in the future. We also have limited, if any, control as to other business activities of these parties and we could experience reputational harm because of our association with such parties if they fail to execute on business initiatives, are accused of breaking the law or otherwise suffer reputational harm for other reasons. All of these factors could materially and adversely impact our business and results of operations.

In some cases we expect the establishment of a strategic relationship with a third party to result in integrations of our products or services with those of other parties. Identifying appropriate parties for these relationships as well as negotiating and documenting business agreements with them requires significant time and resources. We expect these agreements typically to be non-exclusive and not to prohibit the other party from working with our competitors or offering competing services. Once the relationship is established we may also encounter difficulties in combining our products and services in a commercially acceptable manner. We expect this type of dynamic, whereby our ability to realize sales opportunities is dependent on how our products and services interact with those sold by third parties, may become more common as the marketplace in our industry evolves. There can be no guarantee in any particular instance that we will be successful in making our products interact with those of other parties in a commercially acceptable manner and, even if we do, we cannot guaranty the resulting products and services will be marketed or sold effectively via the relationship.

Our failure to compete successfully in our highly competitive market could result in reduced prices and loss of market share.

The market in which we operate is characterized by rapid technological advances and evolving industry standards. The market can be affected significantly by new product introductions and marketing activities of industry participants. In addition, the amount of competition we face in the marketplace may change and grow as the market for our industry grows and new entrants enter the marketplace. Present and future competitors may be able to identify new markets and develop products more quickly, which are superior to those developed by us. They may also adapt new technologies faster, devote greater resources to research and development, promote products more aggressively, and price products more competitively than us. Competition may also intensify or we may no longer be able to compete effectively in the markets in which we compete.

Our failure to anticipate or manage product transitions effectively could have a material adverse effect on our revenue and profitability.

From time to time, we or our competitors may announce new products, capabilities, or technologies that may replace or shorten the life cycles of our existing products. Announcements of currently planned or other new products may cause customers to defer or stop purchasing our products until new products become available. Furthermore, the introduction of new or enhanced products requires us to manage the transition from older product inventories and ensure that adequate supplies of new products can be delivered to meet customer demand. Our failure to anticipate the revenue declines associated with older products or manage transitions from older products effectively could result in inventory obsolescence and also have a material adverse effect on our revenue and profitability.

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Acquisitions could disrupt our business and seriously harm our financial condition.

We will continue to consider acquisitions of complementary businesses, products or technologies. In the event of any future acquisitions, we could issue stock that would dilute our current stockholders' percentage ownership, incur debt, assume liabilities, or incur large and immediate write-offs.

Our operation of any acquired business also involves numerous risks, including but not limited to:

- problems combining the purchased operations, technologies, or products;
- unanticipated costs;
- diversion of management's attention from our core business;
- difficulties integrating businesses in different countries and cultures;
- adverse effects on existing business relationships with suppliers and customers;
- risks associated with entering markets in which we have no or limited prior experience; and
- potential loss of key employees, particularly those of the purchased organization.

We cannot assure that we will be able to successfully integrate any businesses, products, technologies, or personnel that we have acquired or that we might acquire in the future and any failure to do so could disrupt our business and have a material adverse effect on our consolidated financial condition and results of operations. Moreover, from time to time, we may enter into negotiations for a proposed acquisition, but be unable or unwilling to consummate the acquisition under consideration. This could cause significant diversion of management's attention and out-of-pocket expenses for us. We could also be exposed to litigation as a result of any consummated or unconsummated acquisition.

We are subject to various cybersecurity risks, which are particularly acute in the cloud-based technologies operated by us and other third parties that form a part of our solutions. These risks may increase our costs and could damage our brand and reputation.

As we continue to direct a substantial portion of our sales and development efforts toward broader based solutions, such as Digi Cold Chain Solutions and the Device Cloud, we expect to store, convey and potentially process significant amounts of data produced by devices. This data may include confidential or proprietary information, intellectual property or personally identifiable information of our customers or other third parties with whom they do business. It is important for us to maintain solutions and related infrastructure that are perceived by our customers and other parties with whom we do business to provide a reasonable level of reliability and security. Despite available security measures and other precautions, the infrastructure and transmission methods used by our products and services may be vulnerable to interception, attack or other disruptive problems. Continued high-profile data breaches at other companies evidence an external environment that is becoming increasingly hostile to information security. Improper disclosure of data or perception that our data security is insufficient could harm our reputation, give rise to legal proceedings, or subject our company to liability under laws that protect data, any of which could result in increased costs and loss of revenue.

If a cyberattack or other security incident were to allow unauthorized access to or modification of our customers' data or our own data, whether due to a failure with our systems or related systems operated by third parties, we could suffer damage to our brand and reputation. The costs we would incur to address and fix these incidents could significantly increase our expenses. These types of security incidents could also lead to lawsuits, regulatory investigations and increased legal liability, including in some cases contractual costs related to customer notification and fraud monitoring. Further, as regulatory focus on privacy and data security issues continues to increase and worldwide laws and regulations concerning the protection of information become more complex, the potential risks and costs of compliance to our business will intensify.



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Digi Cold Chain Solutions is a new business line for us and is subject to the risks faced by a new business.

Digi Cold Chain Solutions was formed through acquisitions of various businesses and represents a new business line for our company. Our management has limited experience in this marketplace. The operation of Digi Cold Chain Solutions will be subject to significant additional risks that are not necessarily related to our legacy products and services. Additional risks that relate to Digi Cold Chain Solutions, include, but are not limited to:

• We have not traditionally sold products or services to restaurants, pharmacies, hospitals and other similar businesses, which are a focus for Digi Cold Chain Solutions.

• Digi Cold Chain Solutions offerings are deployed to help assure perishable goods are safely preserved. This presents a risk of loss in the event of a malfunction or failure of our offerings.

• Although we have retained several key employees with extensive experience in operating companies we have acquired to date, Digi Cold Chain Solutions represents a new line of business in a marketplace that is nascent in its development and has numerous competitors. We cannot provide assurances we will be successful in operating and growing this business.

• Our ability to succeed with the Digi Cold Chain Solutions offerings will depend in large part on our ability to provide customers with hardware and software products that are easy to deploy and offer features and functionality that address the needs of particular businesses. We may face challenges and delays in the development of this business as the marketplace for products and services evolves to meet the needs and desires of customers.

• In light of these risks and uncertainties, we may not be able to establish or maintain Digi Cold Chain Solutions' market share, integrate it successfully into our other operations or take full advantage of businesses we have acquired or may acquire in the future. There can be no assurance that we will recover our investments in this new business, that we will realize a profit from this new business or that diverting our management's attention to this new business will not have a material adverse effect on our existing businesses, any of which may have a material adverse effect on our results of operations, financial condition and prospects.

• We have identified a material weakness in our internal control over financial reporting. If we are unable to sufficiently mitigate the material weakness or if we fail to establish and maintain effective internal control over financial reporting, our ability to accurately report our financial results could be adversely affected.

• In connection with the preparation of our consolidated financial statements as of and for the year ended September 30, 2016, our management conducted an assessment of the effectiveness of our internal control over financial reporting. In connection with that assessment, we concluded there is a material weakness in our internal control over financial reporting with respect to the design of access control reviews for our financial system and related independent reviews of manual journal entry inputs to the system. The Exchange Act Rule 12b-2 and Rule 1-02(p) of Regulation S-X define a material weakness as a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of our annual or interim consolidated financial statements will not be prevented or detected and corrected on a timely basis. The identified material weakness is further described in Part II, Item 9A of this Form 10-K.

• Our remediation efforts with regard to the material weakness are also described in Part II, Item 9A of this Form 10-K. Although we expect to remediate the material weakness by the end of our second fiscal quarter of 2017, we cannot be certain whether or when our remediation initiatives will be successful. If our remedial measures are insufficient to address the material weakness or if additional material weaknesses in our internal control over financial reporting are discovered or occur in the future, our consolidated financial statements may contain material misstatements and we could be required to restate our financial results. Further, regardless of how well designed, operated and evaluated it may be, any system of internal control over financial reporting can provide only reasonable, not absolute, assurance that its objective will be satisfied. We cannot be certain that, in the future, additional material weaknesses will not exist or otherwise be discovered. If we fail to maintain effective internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected by misstatements or restatements of our consolidated financial statements, our business and financial condition could be harmed, investors may lose confidence in our reported financial information and the market price of our securities may decline.

Our consolidated operating results and financial condition may be adversely impacted by worldwide economic conditions and credit tightening.

If worldwide economic conditions experience a significant downturn, these conditions may make it difficult or impossible for our customers and suppliers to accurately forecast and plan future business activities, which may cause them to slow or suspend spending on products and services. Our customers may find it difficult to gain sufficient credit in a timely manner, which could

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result in an impairment of their ability to place orders with us or to make timely payments to us for previous purchases. If this occurs, our revenue may be reduced, thereby having a negative impact on our results of operations. In addition, we may be forced to increase our allowance for doubtful accounts and our days sales outstanding may increase, which would have a negative impact on our cash position, liquidity and financial condition. We cannot predict either the timing or duration of an economic downturn in the economy, should one occur.

The long and variable sales cycle for certain of our products makes it more difficult for us to predict our operating results and manage our business.

The sale of our products and services can involve a significant technical evaluation and commitment of capital and other resources by potential customers and end users, as well as delays frequently associated with end users' internal procedures to deploy new technologies within their products and to test and accept new technologies. For these and other reasons, the sales cycle associated with certain of our products is typically lengthy and is subject to a number of significant risks, such as end users' internal purchasing reviews, that are beyond our control. Because of the lengthy sales cycle and the large size of certain customer orders, if orders forecasted for a specific customer are not realized or delayed, our operating results could be materially adversely affected.

We depend on manufacturing relationships and on limited-source suppliers, and any disruptions in these relationships may cause damage to our customer relationships.

We procure all parts and certain services involved in the production of our products and subcontract most of our product manufacturing to outside firms that specialize in such services. Although most of the components of our products are available from multiple vendors, we have several single-source supplier relationships, either because alternative sources are not available or because the relationship is advantageous to us. There can be no assurance that our suppliers will be able to meet our future requirements for products and components in a timely fashion. In addition, the availability of many of these components to us is dependent in part on our ability to provide our suppliers with accurate forecasts of our future requirements. Delays or lost revenue could be caused by other factors beyond our control, including late deliveries by vendors of components, or force majeure events. For instance, a fire in November 2014 disrupted the operations at one of our contract manufacturers in Thailand. If we are required to identify alternative suppliers for any of our required components, qualification and pre-production periods could be lengthy and may cause an increase in component costs and delays in providing products to customers. Any extended interruption in the supply of any of the key components currently obtained from limited sources could disrupt our operations and have a material adverse effect on our customer relationships and profitability.

Our inability to obtain the appropriate telecommunications carrier certifications or approvals from governmental regulatory bodies could impede our ability to grow revenue in our wireless products.

The sale of our wireless products in certain geographical markets is sometimes dependent on the ability to gain telecommunications carrier certifications and/or approvals by certain governmental bodies. Failure to obtain these approvals, or delays in receiving the approvals, could impact our ability to enter our targeted markets or to compete effectively or at all in these markets and could have an adverse impact on our revenue.

We are dependent on wireless communication networks owned and controlled by others.

Our revenue could decline if we are unable to deliver continued access to digital cellular wireless carriers that we depend on to provide sufficient network capacity, reliability and security to our customers. Our financial condition could be impacted if our wireless carriers were to increase the prices of their services, or to suffer operational or technical failures.

The impact of natural disasters could negatively impact our supply chain and customers resulting in an adverse impact to our revenue and profitability.

Certain of our components and other materials used in producing our products are from regions susceptible to natural disasters. If we are unable to procure necessary materials, we could experience a disruption to our supply chain that would hinder our ability to produce our products in a timely manner, or cause us to seek other sources of supply, which may be more costly or which we may not be able to procure on a timely basis. We also risk damage to any tooling, equipment or inventory at the supplier's facilities. For instance, flooding in October 2011 and a fire in

November 2014 disrupted the operations at one of our contract manufacturers in Thailand. In addition, our customers may not follow their normal purchasing patterns or temporarily cease purchasing from us due to impacts to their businesses in the region, creating unexpected fluctuations or decreases in our revenue and profitability. Natural disasters in other parts of the world on which our operations are reliant also could have material adverse impacts on our business.

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Our use of suppliers in other parts of the world involves risks that could negatively impact us.

We purchase a number of components from suppliers in other parts of the world. Product delivery times may be extended due to the distances involved, requiring more lead time in ordering. In addition, ocean freight delays may occur as a result of labor problems, weather delays or expediting and customs issues. Any extended delay in receipt of the component parts could eliminate anticipated cost savings and have a material adverse effect on our customer relationships and profitability.

Our ability to compete could be jeopardized if we are unable to protect our intellectual property rights.

Our ability to compete depends in part on our proprietary rights and technology. Our proprietary rights and technology are protected by a combination of copyrights, patents, trade secrets and trademarks.

We enter into confidentiality agreements with our employees, and sometimes with our customers, potential customers and other third parties, and limit access to the distribution of our proprietary information. There can be no assurance that the steps taken by us in this regard will be adequate to prevent the misappropriation of our technology. Our pending patent applications may be denied and any patents, once issued, may be circumvented by our competitors.

Furthermore, there can be no assurance that others will not develop technologies that are superior to our technologies. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. There can be no assurance that our means of protecting our proprietary rights in the United States or abroad will be adequate or that competing companies will not independently develop similar technologies. Our failure to adequately protect our proprietary rights could have a material adverse effect on our competitive position and result in loss of revenue.

From time to time, we are subject to claims and litigation regarding intellectual property rights or other claims, which could seriously harm us and require us to incur significant costs.

The communications technology industry is characterized by frequent litigation regarding patent and other intellectual property rights. From time to time, we receive notification of a third-party claim that our products infringe other intellectual property rights. Any litigation to determine the validity of third-party infringement claims, whether or not determined in our favor or settled by us, may be costly and divert the efforts and attention of our management and technical personnel from productive tasks, which could have a material adverse effect on our ability to operate our business and service the needs of our customers. There can be no assurance that any infringement claims by third parties, regardless if they have merit, will not materially adversely affect our business, operating results or financial condition. In the event of an adverse ruling in any such matter, we may be required to pay substantial damages, cease the manufacture, use and sale of infringing products, discontinue the use of certain processes or be required to obtain a license under the intellectual property rights of the third party claiming infringement. There can be no assurance that a license would be available on reasonable terms or at all. Any limitations on our ability to market our products, or delays and costs associated with redesigning our products or payments of license fees to third parties, or any failure by us to develop or license a substitute technology on commercially reasonable terms could have a material adverse effect on our business, operating results and financial condition.

We face risks associated with our international operations and expansion that could impair our ability to grow our revenue abroad as well as our overall financial condition.

We believe that our future growth is dependent in part upon our ability to increase sales in international markets.

These sales are subject to a variety of risks, including fluctuations in currency exchange rates, tariffs, import restrictions and other trade barriers, unexpected changes in regulatory requirements, longer accounts receivable payment cycles, potentially adverse tax consequences, and export license requirements. In addition, we are subject to the risks inherent in conducting business internationally, including political and economic instability and unexpected changes in diplomatic and trade relationships. In many markets where we operate business and cultural norms are different than those in the United States and practices that may violate laws and regulations applicable to us like the Foreign Corrupt Practices Act (FCPA) and the UK Anti-Bribery Act (UKBA) are more commonplace. Although we have implemented policies and procedures with the intention of ensuring compliance with these laws and regulations,

our employees, contractors and agents, as well as channel partners involved in our international sales, may take actions in violation of our policies. Many of our vendors and strategic business allies also have international operations and are subject to the risks described above. Even if we are able to successfully manage the risks of international operations, our business may be adversely affected if one or more of our business partners are not able to successfully manage these risks. There can be no assurance that one or more of these factors will not have a material adverse effect on our business strategy and financial condition.

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Our failure to comply effectively with regulatory laws pertaining to our foreign operations could have a material adverse effect on our revenue and profitability.

We are required to comply with U.S. government export regulations in the sale of our products to foreign customers, including requirements to properly classify and screen our products against a denied parties list prior to shipment. We are also required to comply with the provisions of the FCPA and all other anti-corruption laws, such as UKBA, of all other countries in which we do business, directly or indirectly, including compliance with the anti-bribery prohibitions and the accounting and recordkeeping requirements of this law. Violations of the FCPA or other similar laws could trigger sanctions, including ineligibility for U.S. government insurance and financing, as well as large fines. Failure to comply with the aforementioned regulations could also deter us from selling our products in international jurisdictions, which could have a material adverse effect on our revenue and profitability.

Foreign currency exchange rates may adversely affect our operating results.

We are exposed to a variety of market risks, including the effects of changes in foreign currency exchange rates on transactions that are denominated in foreign currencies. Because our financial statements are denominated in U.S. Dollars and approximately 11% of our revenue is denominated in a currency other than U.S. Dollars, such as Euros, British Pounds, Yen and Canadian Dollars, our revenues and earnings may be adversely impacted if the U.S. dollar strengthens significantly against these foreign currencies.

The loss of key personnel could prevent us from executing our business strategy.

Our business and prospects depend to a significant degree upon the continuing contributions of our executive officers and key technical and other personnel. Competition for such personnel is intense, and there can be no assurance that we will be successful in attracting and retaining qualified personnel. Failure to attract and retain key personnel could result in our failure to execute our business strategy.

Our failure to comply effectively with the requirements of applicable environmental legislation and regulation could have a material adverse effect on our revenue and profitability.

Production and marketing of products in certain states and countries may subject us to environmental and other regulations. In addition, certain states and countries may pass new regulations requiring our products to meet certain requirements to use environmentally friendly components. The European Union has issued two directives relating to chemical substances in electronic products. The Waste Electrical and Electronic Equipment Directive (WEEE) makes producers of certain electrical and electronic equipment financially responsible for collection, reuse, recycling, treatment and disposal of equipment placed in the European Union market. The Restrictions of Hazardous Substances Directive (RoHS) bans the use of certain hazardous materials in electric and electrical equipment which are put on the market in the European Union. In the future, China and other countries including the United States may adopt further environmental compliance programs. If we fail to comply with these regulations, we may not be able to sell our products in jurisdictions where these regulations apply, which could have a material adverse effect on our revenue and profitability.

Negative conditions in the global credit markets may impair a portion of our investment portfolio.

Our investment portfolio consists of certificates of deposit, commercial paper, money market funds, corporate bonds and government municipal bonds. These marketable securities are classified as available-for-sale and are carried at fair market value. Some of our investments could experience reduced liquidity and could result in an impairment charge should the impairment be considered as other-than-temporary. This loss would be recorded in our consolidated statement of operations, which could materially adversely impact our consolidated results of operations and financial condition.

Unanticipated changes in our tax rates could affect our future results.

Our future effective tax rates could be favorably or unfavorably affected by unanticipated changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws or our interpretation of such laws. In addition, we may be subject to the examination of our income tax returns by the Internal Revenue Service and other U.S. and international tax authorities. We regularly assess the potential outcomes resulting from these examinations to determine the adequacy

of our provision for income taxes. There can be no assurance that the outcomes from these examinations will not have an adverse effect on our consolidated operating results and financial condition.



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We may have additional tax liabilities.

We are subject to income taxes in the United States and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income taxes, including our reserves for uncertain tax positions. In the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain. We regularly are under audit by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits could be materially different from our historical income tax provisions and accruals. The results of an audit could have a material effect on our consolidated financial position, results of operations, or cash flows in the period or periods for which that determination is made.

**Risks Related to Our Common Stock**

Unsolicited takeover proposals, governance change proposals, proxy contests and resulting litigation may adversely impact our operations, create uncertainty and affect the market price and volatility of our securities.

We have received an unsolicited takeover proposal and other companies in our industry have been the target of unsolicited takeover proposals in the past. In the event that a third party, such as a competitor, private equity firm or activist investor makes an unsolicited takeover proposal, or proposes to change our governance policies or board of directors, or makes other proposals concerning our ownership structure or operations, our review and consideration of such proposals may be a significant distraction for our management and employees, and could require us to expend significant time and resources. Such proposals may create uncertainty for our employees and this uncertainty may adversely affect our ability to retain key employees, to hire new talent or to complete acquisitions we may desire to make. Similar uncertainty among our customers, suppliers and other business partners could cause them to terminate, or not to renew or enter into, arrangements with us. Certain proposals may result in costly proxy contests or litigation that can disrupt our business operations or result in an adverse effect on our operating results. Management and employee distraction related to any such proposals also may adversely impact our ability to conduct our business optimally and pursue our strategic objectives. Such proposals, or their withdrawal, could create uncertainty among investors and potential investors as to our future direction and affect the market price of our common stock without regard to our operational or financial performance.

Certain provisions of the Delaware General Corporation Law and our charter documents have an anti-takeover effect. There exist certain mechanisms under the Delaware General Corporation Law and our charter documents that may delay, defer or prevent a change of control. For instance, under Delaware law, we are prohibited from engaging in certain business combinations with interested stockholders for a period of three years after the date of the transaction in which the person became an interested stockholder unless certain requirements are met, and majority stockholder approval is required for certain business combination transactions with interested parties.

Our Certificate of Incorporation contains a “fair price” provision requiring majority stockholder approval for certain business combination transactions with interested parties, and this provision may not be changed without the vote of at least 80% of the outstanding shares of our voting stock. Other mechanisms in our charter documents may also delay, defer or prevent a change of control. For instance, our Certificate of Incorporation provides that our Board of Directors has authority to issue series of our preferred stock with such voting rights and other powers as the Board of Directors may determine. Furthermore, we have a classified board of directors, which means that our directors are divided into three classes that are elected to three-year terms on a staggered basis. Since the three-year terms of each class overlap the terms of the other classes of directors, the entire board of directors cannot be replaced in any one year. Under Delaware law, directors serving on a classified board may not be removed by shareholders except for cause. Also, pursuant to the terms of our shareholder rights plan, each outstanding share of common stock has one attached right. The rights will cause substantial dilution of the ownership of a person or group that attempts to acquire us on terms not approved by the Board of Directors and may have the effect of deterring hostile takeover attempts. The effect of these anti-takeover provisions may deter business combination transactions not approved by our Board of Directors, including acquisitions that may offer a premium over the market price to some or all stockholders. The price of our common stock has been volatile and could continue to fluctuate in the future.

The market price of our common stock, like that of many other high-technology companies, has fluctuated significantly and is likely to continue to fluctuate in the future. During fiscal year 2016, the closing price of our common stock on the NASDAQ Global Select Market ranged from \$7.88 to \$13.00 per share. Our closing sale price on December 9, 2016 was \$13.65 per share. Following the announcement of an unsolicited takeover proposal on November 8, 2016, the price of our common stock increased significantly. If this proposal were to be withdrawn, the price of our common stock may move significantly. Further, announcements by us or others regarding the receipt of customer orders, quarterly variations in operating results, departures of key personnel, acquisitions or divestitures, additional equity or debt financings, results of customer field trials, scientific

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discoveries, technological innovations, litigation, product developments, patent or proprietary rights, government regulation and general market conditions and risks may, for example, have a significant impact on the market price of our common stock.

If our stock price declines over a sustained period of time or our profits significantly decrease, we may need to recognize an impairment of our goodwill.

The price of our common stock could decline. If such a decline continued over a sustained period of time, we could have an impairment of our goodwill. Our market value is dependent upon certain factors, including continued future growth of our products and solutions. If such growth does not materialize or our forecasts are not met, our profits could be significantly reduced and our market value may decline, which could result in an impairment of our goodwill. Goodwill is tested for impairment on an annual basis as of June 30, or more frequently if events or circumstances occur which could indicate impairment.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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## ITEM 2. PROPERTIES

The following table contains a listing of our significant property locations as of September 30, 2016:

| Location of Property                       | Use of Facility  | Approximate Square Footage | Ownership or Lease Expiration Date |
|--|--|----------------------------|------------------------------------|
| Minnetonka, MN<br>(Corporate headquarters) | Research & development, sales, sales support, marketing and administration | 130,000                    | Owned                              |
| Eden Prairie, MN                           | Manufacturing and warehousing  | 58,000                     | Owned                              |
| Waltham, MA                                | Research & development, sales and sales support                            | 4,249                      | October 2020                       |
| Rochester, MN                              | Engineering services   | 3,090                      | September 2017                     |
| Lindon, UT                                 | Sales, technical support, research & development and administration        | 11,986                     | December 2020                      |
| Herndon, VA                                | Sales, marketing and technical support                                     | 2,416                      | October 2017                       |
| Hong Kong, China                           | Sales, marketing and administration  | 1,656                      | April 2016                         |
| Beijing, China                             | Sales, marketing and administration  | 1,617                      | October 2019                       |
| Shanghai, China                            | Sales, marketing and administration  | 1,991                      | May 2017                           |
| Ismaning, Germany                          | Sales, sales support and administration                                    | 6,878                      | September 2019                     |
| Neuilly sur Seine, France                  | Sales and marketing  | 2,895                      | January 2018                       |
| Logrono, Spain                             | Sales, research & development and administration                           | 3,228                      | November 2018                      |
| Tokyo, Japan                               | Sales  | 1,371                      | Perpetual                          |
| Singapore                                  | Sales, marketing and administration  | 3,498                      | April 2017                         |

In addition to the above locations, we perform sales activities in various other locations in Europe and Canada that are not deemed to be principal locations and are not listed above. In connection with our sale of the Etherios business in October 2015, we no longer maintain operations in Chicago, IL, Dallas, TX or San Francisco, CA.

We have consolidated and relocated office locations due to a fiscal 2016 restructuring (see Note 10 to our Consolidated Financial Statements). We moved our Wireless Design Services team from an office in downtown Minneapolis to our World Headquarters in suburban Minnetonka. Additionally, we closed our office location in Dortmund, Germany and moved the corresponding positions to our existing office in Ismaning just outside of Munich, Germany.

## ITEM 3. LEGAL PROCEEDINGS

In the normal course of business, we are subject to various claims and litigation, which may include, but are not limited to, patent infringement and intellectual property claims. While we are unable to predict the outcome of any potential claims or litigation due to the inherent unpredictability of these matters, we believe that it is possible that we could, in the future, incur judgments or enter into settlements of claims that could have a material adverse effect on our operations in any particular period.

ITEM 4. MINE SAFETY DISCLOSURES

None.

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## PART II.

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

## Stock Listing

Our common stock trades under the symbol DGII on the NASDAQ Global Select Market tier of The NASDAQ Stock Market LLC. On December 9, 2016 there were 129 stockholders of record.

The high and low sale prices for our common stock for each quarter during the years ended September 30, 2016 and 2015, as reported by The NASDAQ Stock Market, were:

## Stock Prices

| 2016 First   | Second  | Third   | Fourth  |
|--------------|---------|---------|---------|
| High \$13.53 | \$12.23 | \$11.69 | \$12.49 |
| Low \$11.14  | \$7.70  | \$8.37  | \$9.79  |

| 2015 First  | Second  | Third   | Fourth  |
|-------------|---------|---------|---------|
| High \$9.45 | \$10.78 | \$10.69 | \$12.08 |
| Low \$6.90  | \$8.23  | \$8.95  | \$9.39  |

## Dividend Policy

We have never paid cash dividends on our common stock. Our Board of Directors presently intends to retain all earnings for use in our business, except for periodic stock repurchases, and does not anticipate paying cash dividends in the foreseeable future.

## Issuer Repurchases of Equity Securities

On April 26, 2016, our Board of Directors authorized a program to repurchase up to \$15.0 million of our common stock primarily to return capital to shareholders. This authorization expires on May 1, 2017. Shares repurchased under this program may be made through open market and privately negotiated transactions from time to time and in amounts that management deems appropriate. The amount and timing of share repurchases, if any, depends upon market conditions and other corporate considerations. As of the date of this filing, no shares were repurchased under this program.

The following table presents the information with respect to purchases made by or on behalf of Digi International Inc. or any "affiliated purchaser" (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of our common stock during the fourth quarter of fiscal 2016:

| Period                       | Total Number of Shares Purchased (1) | Average Price Paid per Share | Total Number of Shares Purchased as Part of a Publicly Announced Program | Maximum Dollar Value of Shares that May Yet Be Purchased Under the Program |
|------------------------------|--------------------------------------|------------------------------|--|--|
| July 1, 2016 - July 31, 2016 | 292                                  | \$11.32                      | —  |  |