DealerTrack Holdings, Inc.
Form 10-Q
November 14, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the quarterly period ended September 30, 2006
OR

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

Commission File Number 000-51653
DealerTrack Holdings, Inc.
(Exact name of Registrant as specified in its charter)

Delaware	**52-2336218**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
1111 Marcus Ave., Suite M04 **Lake Success, NY**	**11042**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(516) 734-3600**

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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2.)

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer þ

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

As of October 31, 2006, 39,156,710 shares of the registrant s common stock were outstanding.

DEALERTRACK HOLDINGS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006
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PART I. FINANCIAL INFORMATION

Item 1. *Financial Statements*

DEALERTRACK HOLDINGS, INC.
CONSOLIDATED BALANCE SHEETS
(unaudited)

	September 30, 2006	December 31, 2005
	(In thousands, except share and per share amounts)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 29,964	$ 103,264
Short-term investments	60,750	
Accounts receivable related party	5,880	5,386
Accounts receivable, net of allowances of $4,398 and $2,664 at September 30, 2006 and December 31, 2005, respectively	16,422	13,893
Prepaid expenses and other current assets	7,386	3,902
Deferred tax assets	667	910
Total current assets	121,069	127,355
Property and equipment, net	6,330	4,885
Software and website developments costs, net	10,855	8,769
Intangible assets, net	42,915	39,550
Goodwill	51,742	34,200
Restricted cash	540	590
Deferred taxes and other long-term assets	13,483	5,266
Total assets	$ 246,934	$ 220,615
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 994	$ 2,367
Accounts payable related party	118	2,021
Accrued compensation and benefits	8,282	7,589
Accrued other	10,700	8,674
Deferred revenue	3,472	3,267
Deferred taxes	42	42
Due to acquirees	2,220	1,447
Capital leases payable	58	387
Total current liabilities	25,886	25,794
Capital leases payable long-term		7
Due to acquirees long-term	2,932	4,957

Other long-term liabilities	4,969	3,186
Total liabilities	33,787	33,944
Commitment and contingencies (Note 10)		
Stockholders equity		
Preferred stock, $0.01 par value; 10,000,000 shares authorized and no shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively		
Common stock, $0.01 par value; 175,000,000 shares authorized; 36,393,248 and 35,379,717 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	364	354
Additional paid-in capital	224,358	214,471
Deferred stock-based compensation	(4,911)	(7,745)
Accumulated other comprehensive income (foreign currency)	245	157
Accumulated deficit	(6,909)	(20,566)
Total stockholders equity	213,147	186,671
Total liabilities and stockholders equity	$ 246,934	$ 220,615

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

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DEALERTRACK HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
	(In thousands, except share and per share amounts)		(In thousands, except share and per share amounts)	
Revenue				
Net revenue(1)	$ 46,264	$ 34,380	$ 127,613	$ 86,844
Operating costs and expenses				
Cost of revenue(1)(2)	19,128	16,733	51,536	36,922
Product development(2)	2,218	1,498	6,781	3,585
Selling, general and administrative(2)	22,515	14,399	54,957	38,795
Total operating costs and expenses	43,861	32,630	113,274	79,302
Income from operations	2,403	1,750	14,339	7,542
Interest income	934	20	2,681	106
Interest expense	(65)	(633)	(206)	(1,006)
Income before benefit (provision) for income taxes	3,272	1,137	16,814	6,642
Benefit (provision) for income taxes, net(3)	2,294	(488)	(3,157)	(2,856)
Net income	$ 5,566	$ 649	$ 13,657	$ 3,786
Basic net income per share applicable to common stockholders(4)	$ 0.16	$ 0.03	$ 0.39	$ 0.15
Diluted net income per share applicable to common stockholders(4)	$ 0.15	$ 0.01	$ 0.37	$ 0.07
Weighted average shares outstanding	35,547,699	674,217	35,408,425	603,227
Weighted average shares outstanding assuming dilution	36,989,642	1,635,148	36,878,982	1,318,000

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
	(In thousands)		(In thousands)	
(1) Related party revenue	$ 12,500	$ 8,124	$ 32,819	$ 21,495
Related party cost of revenue	$ 26	$ 876	$ 1,835	$ 2,552

(2) Stock-based compensation expense recorded for the three and nine months ended September 30, 2006 and 2005 was classified as follows
(in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Cost of revenue	$ 287	$ 93	$ 811	$ 201
Product development	96	30	264	70
Selling, general and administrative	$ 6,144	$ 529	$ 8,073	$ 1,046

(3) See Note 2 of these consolidated financial statements for further information.

(4) See Note 2 of these consolidated financial statements for earnings per share calculations.

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

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DEALERTRACK HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
	(In thousands)	
Cash flows from operating activities		
Net income	$ 13,657	$ 3,786
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	19,157	17,258
Deferred tax (benefit) provision	(7,282)	797
Amortization of stock-based compensation	9,148	1,317
Provision for doubtful accounts and sales credits	3,566	904
Gain on sale of property and equipment	(47)	(29)
Amortization of deferred interest	133	110
Deferred compensation	154	
Amortization of bank financing costs	94	91
Stock-based compensation windfall tax benefit	(1,485)	
Changes in operating assets and liabilities, net of effects of acquisitions		
Trade accounts receivable	(4,880)	(8,509)
Accounts receivable related party	(494)	(2,572)
Prepaid expenses and other current assets	(3,197)	47
Accounts payable and accrued expenses	908	2,886
Accounts payable related party	(1,903)	281
Deferred revenue and other current liabilities	140	2,812
Other long-term liabilities	35	(122)
Deferred rent	103	216
Other assets	(21)	(444)
Net cash provided by operating activities	27,786	18,829
Cash flows from investing activities		
Capital expenditures	(2,578)	(2,827)
Funds released from escrow and other restricted cash	47	577
Purchase of short term investments	(85,450)	
Sale of short term investments	24,700	
Capitalized software and web site development costs	(2,841)	(4,120)
Proceeds from sale of property and equipment	50	30
Payment for net assets acquired, net of acquired cash	(37,529)	(64,052)
Net cash used in investing activities	(103,601)	(70,392)
Cash flows from financing activities		

Principal payments on capital lease obligations	(336)	(327)
Proceeds from the exercise of employee stock options	1,226	1,431
Proceeds from employee stock purchase plan	596	
Net proceeds from bank indebtedness		48,284
Repayments of bank indebtedness		(5,000)
Principal payments on notes payable	(316)	
Stock-based compensation windfall tax benefit	1,485	
Deferred financing costs	(211)	(1,105)
Net cash provided by financing activities	2,444	43,283
Net decrease in cash and cash equivalents	(73,371)	(8,280)
Effect of exchange rate changes on cash and cash equivalents	71	49
Cash beginning of period	103,264	21,753
Cash end of period	$ 29,964	$ 13,522
Supplemental disclosure		
Cash paid for:		
Income taxes	$ 10,867	$ 1,295
Interest	61	103
Non-cash investing and financing activities:		
Acquisition of capitalized software through note payable	2,608	
Accrued capitalized hardware and software	1,132	
Goodwill adjustment	366	
Deferred financing costs accrued		830
Deferred compensation reversal to equity	264	
Note payable issued in conjunction with net assets acquired		1,800

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

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DEALERTRACK HOLDINGS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Business Description

DealerTrack Holdings, Inc. is a leading provider of on-demand software, network and data solutions for the automotive retail industry in the United States. Utilizing the Internet, we have built a network connecting automotive dealers with banks, finance companies, credit unions and other financing sources, and other service and information providers, such as aftermarket providers and the major credit reporting agencies. We have established a network of active relationships, which as of September 30, 2006, consisted of over 22,000 automotive dealers, including over 89% of all franchised dealers; over 250 financing sources, including the 20 largest independent financing sources in the United States; and a number of other service and information providers to the automotive retail industry. Our credit application processing product enables dealers to automate and accelerate the indirect automotive financing process by increasing the speed of communications between these dealers and their financing sources. We have leveraged our leading market position in credit application processing to address other inefficiencies in the automotive retail industry value chain. We believe our proven network offers a competitive advantage for distribution of our software and data solutions. Our integrated subscription-based software products and services enable our automotive dealer customers to compare various financing and leasing options and programs, sell insurance and other aftermarket products, analyze inventory, document compliance with certain laws and execute financing contracts electronically. We have created efficiencies for financing source customers by providing a comprehensive digital and electronic contracting solution. In addition, we offer data and other products and services to various industry participants, including lease residual value and automobile configuration data.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements as of September 30, 2006 and for the three and nine months ended September 30, 2006 and 2005 have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all information and footnotes required for a complete set of financial statements in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments, consisting only of normal and recurring adjustments, considered necessary for a fair statement have been included in the accompanying unaudited consolidated financial statements. All intercompany transactions and balances have been eliminated in consolidation. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2006. The December 31, 2005 balance sheet information has been derived from the audited 2005 financial statements, but does not include all disclosures required for a complete set of financial statements in accordance with accounting principles generally accepted in the United States of America. For further information, please refer to the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission on March 30, 2006.

Our provision for income taxes for the nine months ended September 30, 2006 includes approximately $206,000 of additional tax expense that relates to prior periods. Our provision for income taxes for the three and nine months ended September 30, 2006 includes a $3.7 million tax benefit. The out of period tax adjustment and the tax benefit both relate to our Canadian subsidiary, dealerAccess Canada, Inc. The reversal of our Canadian subsidiary s $3.7 million deferred tax valuation allowance during the third quarter of 2006 was based on a number of factors, including a history of pre-tax income over a significant period and the level of projected future pre-tax income based on current operations. We believe that it is more likely than not that our Canadian subsidiary will generate sufficient taxable income in the future to utilize the deferred tax asset outstanding as of September 30, 2006. Although these deferred tax assets begin to expire in 2008, we believe that they will be utilized prior to expiration.

Short-term Investments

We account for investments in marketable securities in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities.*

Short-term investments as of September 30, 2006 consist of auction rate securities that are invested in tax-exempt and tax-advantaged securities. We classify investment securities as available for sale, and as a result, report the investments at fair value. There were no unrealized gains (losses) as of September 30, 2006.

Auction rate securities have long-term underlying maturities, but have interest rates that are reset every one year or less. The securities can be purchased or sold at any time, which creates a highly liquid market for these securities. Our intent is not to hold these securities to maturity, but rather to use the interest rate reset feature to provide liquidity as necessary. Our investment in these securities generally provides higher yields than money market and other cash equivalent investments.

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Net Income per Share

For the three and nine months ended September 30, 2006, basic earnings per share is calculated by dividing net income by the weighted average number of common shares outstanding during the quarter. Diluted earnings per share is calculated by dividing net income by the weighted average number of common shares outstanding (including unvested restricted common stock), assuming dilution. The calculation assumes that all stock options that are in the money are exercised at the beginning of the period and the proceeds used by us to purchase shares at the average market price for the period.

For the three and nine months ended September 30, 2005, we computed net income per share in accordance with SFAS No. 128, *Earnings per Share* and EITF No. 03-06, *Participating Securities and the Two-Class Method under FASB Statement No. 128.* Under the provisions of SFAS No. 128, basic earnings per share is computed by dividing the net income applicable to common stockholders by the weighted average number of shares of our common stock outstanding for the period. Diluted earnings per share is calculated based on the weighted average number of shares of common stock plus the diluted effect of potential common shares.

The following table sets forth the computation of basic and diluted net income per share applicable to common stockholders (in thousands, except share and per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Numerator:				
Net income	$ 5,566	$ 649	$ 13,657	$ 3,786
Amount allocated to participating preferred stockholders under two-class method(1)		(629)		(3,696)
Net income applicable to common stockholders	$ 5,566	$ 20	$ 13,657	$ 90
Denominator:				
Weighted average common stock outstanding (basic)	35,547,699	674,217	35,408,425	603,227
Common equivalent shares from options to purchase common stock and restricted common stock	1,441,943	960,931	1,470,557	714,773
Weighted average common stock outstanding (diluted)	36,989,642	1,635,148	36,878,982	1,318,000
Basic net income per share applicable to common stockholders	$ 0.16	$ 0.03	$ 0.39	$ 0.15
Diluted net income per share applicable to common stockholders	$ 0.15	$ 0.01	$ 0.37	$ 0.07

(1) Not applicable for the three and nine months ended September 30, 2006, as all outstanding participating preferred stock was converted into common stock upon our initial public offering in December 2005.

The following is a summary of the securities outstanding during the respective periods that have been excluded from the diluted net income per share calculation because the effect would have been antidilutive:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Stock options	794,439		728,370	74,700
Restricted common stock	1,630		14,060	
Preferred stock		24,765,127		24,765,127
Total	796,069	24,765,127	742,430	24,839,827

Stock-Based Compensation Expense

We maintain several share-based incentive plans. We grant stock options to purchase common stock and grant restricted common stock. In January 2006, we began offering an employee stock purchase plan that allows employees to purchase our common stock at a discount each quarter through payroll deductions. See Note 9 for further disclosure on our share-based incentive plans.

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Prior to the effective date of SFAS No. 123(R), Share-Based Payment , we applied APB No. 25 *Accounting for Stock Issued to Employees* and related interpretations for our stock option and restricted common stock grants. ABP No. 25 provides that the compensation expense is measured based on the intrinsic value of the stock award at the date of grant.

Effective January 1, 2006, we adopted SFAS 123(R), which requires us to measure and recognize the cost of employee services received in exchange for an award of equity instruments. Under the provisions of SFAS 123(R), share-based compensation cost is measured at the grant date, based on the fair value of the award, and recognized as an expense over the requisite service period.

As permitted by SFAS 123(R), we elected the modified prospective transition method. Under this method, prior periods are not revised. We use the Black-Scholes Option Pricing Model, which requires extensive use of accounting judgment and financial estimates, including estimates of the expected term employees will retain their vested stock options before exercising them, the estimated volatility of our stock price over the expected term, and the number of options that will be forfeited prior to the completion of their vesting requirements. Application of alternative assumptions could produce significantly different estimates of the fair value of stock-based compensation and consequently, the related amounts recognized in our consolidated statements of operations. The provisions of SFAS No. 123(R) apply to new awards and awards outstanding, but not yet vested, on the effective date. In March 2005, the SEC issued SAB No. 107 relating to SFAS No. 123(R). We have applied the provisions of SAB No. 107 in our adoption.

On December 13, 2005, we commenced an initial public offering (IPO) of our common stock. Prior to our IPO, we measured awards using the minimum-value method for SFAS 123 pro forma disclosure purposes. SFAS 123(R) requires that a company that measured awards using the minimum-value method for SFAS 123 prior to its IPO filing, but adopts SFAS 123(R) as a public company, should not record any compensation amounts measured using the minimum-value method in its financial statements. As a result, we will continue to account for pre-IPO awards under APB No. 25 unless they are modified after the adoption of SFAS 123(R). For post-IPO awards, compensation expense recognized after the adoption of SFAS 123(R) will be based on fair value of the awards on the date of grant.

In November 2005, the FASB issued FASB Staff Position (FSP) SFAS 123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-based Payment Awards,* which provides an elective alternative transition method of calculating the pool of excess tax benefits available to absorb tax deficiencies recognized subsequent to the adoption of SFAS No. 123(R) to the method otherwise required by paragraph 81 of SFAS No. 123(R). We may take up to the latter of one year from the effective date of the FSP or the adoption of SFAS No. 123(R) to evaluate our available alternatives and make our one-time election. We are currently evaluating the alternative methods.

Stock-based compensation expense recognized under SFAS No. 123(R) for the three and nine months ended September 30, 2006 was $1.0 million and $2.4 million, respectively, which consisted of stock-based compensation expense related to employee stock options, employee stock purchases and restricted common stock awards. For the three and nine months ended September 30, 2006, we recorded stock-based compensation expense of $5.5 million and $6.7 million, respectively, in accordance with APB No. 25, using the intrinsic value approach to measure compensation expense.

The following is the effect of adopting SFAS No. 123(R) as of January 1, 2006 (in thousands, except per share amounts):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Stock options, restricted common stock and employee stock purchase plan compensation expense recognized:		
Cost of revenue	$ 196	$ 539
Product development	69	182
Selling, general and administrative	778	1,715

Total stock-based compensation expense		1,043		2,436
Related deferred income tax benefit		(407)		(950)
Decrease in net income	$	636	$	1,486
Decrease in basic earnings per share	$	0.02	$	0.04
Decrease in diluted earnings per share	$	0.02	$	0.04

Upon the adoption of SFAS No. 123(R), we did not have a cumulative effect of accounting change.

The fair market value of each option grant for all years presented has been estimated on the date of grant using the Black-Scholes Option Pricing Model with the following weighted average assumptions:

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