

DIAMOND HILL INVESTMENT GROUP INC

Form 10QSB

November 14, 2005

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**U.S. Securities and Exchange Commission
Washington, D.C. 20549
Form 10-QSB**

þ **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2005

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
For the transition period from _____ to _____
Commission file number 000-24498
DIAMOND HILL INVESTMENT GROUP, INC
(Name of small business issuer in its charter)

Ohio 65-0190407
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)
375 North Front Street, Suite 300, Columbus, Ohio 43215
(Address of principal executive offices) (Zip Code)
Issuer's telephone number (614) 255-3333

State the number of shares outstanding of each of the issuer's classes of common equity, as of November 9, 2005:
Common Stock: 1,682,390 shares

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

Transitional Small Business Disclosure Format (check one): Yes No

DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES

PART I FINANCIAL INFORMATION

ITEM 1: Financial Statements

The accompanying consolidated financial statements, which should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2004, are unaudited, but have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included.

Operating results for the nine months and three months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2005.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES
 CONSOLIDATED STATEMENT OF FINANCIAL CONDITION

As of September 30, 2005

UNAUDITED

ASSETS

Cash	\$ 1,984,590
Investment portfolio (note 3):	
Mutual fund shares and private limited partnership interests	4,322,913
Accounts receivable:	
Investment management revenue	1,356,254
Property and equipment, net of accumulated depreciation of \$182,913	104,640
Prepaid expenses	420,015
Refundable deposits	10,570
 Total assets	 \$ 8,198,982

LIABILITIES

Unearned fee income	8,365
Accrued expenses	2,829,682
 Total liabilities	 2,838,047

SHAREHOLDERS EQUITY

Common stock: (note 4) No par value, 7,000,000 shares authorized, 1,827,972 shares issued and 1,681,603 shares outstanding	10,812,124
Treasury stock, at cost (146,369 shares)	(837,461)
Deferred compensation	(313,775)
Accumulated deficit	(4,299,953)
 Total shareholders equity	 5,360,935
 Total liabilities and shareholders equity	 \$ 8,198,982

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

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
For the Nine Months and Three Months Ended September 30, 2005 and 2004

UNAUDITED

	9 MONTHS ENDED		3 MONTHS ENDED	
	SEP 2005	SEP 2004	SEP 2005	SEP 2004
INVESTMENT MANAGEMENT REVENUE:				
Mutual funds	\$ 2,120,078	\$ 657,525	\$ 922,618	\$ 252,940
Managed accounts	1,721,687	810,389	787,969	297,020
Private investment partnership	2,034,912	179,205	1,586,728	111,714
Total investment management revenue	5,876,677	1,647,119	3,297,315	661,674
OPERATING EXPENSES:				
Salaries, benefits and payroll taxes	1,949,369	1,480,906	648,925	554,991
Incentive compensation (note 6)	2,500,000		2,500,000	
Legal and audit	77,170	67,255	15,859	8,720
General and administrative	424,947	303,222	162,977	115,630
Sales and marketing	192,456	133,587	82,591	42,780
Total operating expenses	5,143,942	1,984,970	3,410,352	722,121
NET OPERATING INCOME (LOSS)	732,735	(377,851)	(113,037)	(60,447)
Mutual fund administration, net (Note 7)	(126,709)	(139,530)	(9,007)	5,393
Investment return	378,469	316,016	211,718	207,717
INCOME (LOSS) BEFORE TAXES	984,495	(161,365)	89,674	152,663
Income tax provision (Note 8)				
NET INCOME (LOSS)	\$ 984,495	\$ (161,365)	\$ 89,674	\$ 152,663
Basic Earnings (Loss) Per Share	\$ 0.60	\$ (0.10)	\$ 0.05	\$ 0.10
Diluted Earnings (Loss) Per Share	\$ 0.50	\$ (0.10)	\$ 0.04	\$ 0.09

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

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2005 and 2004
UNAUDITED

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ 984,495	\$ (161,365)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	28,989	28,742
Write off of assets	34	762
Amortization of deferred compensation	40,275	12,774
(Increase) decrease in certain assets:		
Accounts receivable:		
Investment management fees	(818,879)	(210,744)
Other		229
Refundable income taxes		(27,000)
Deposits and other	(170,177)	(45,801)
Increase (decrease) in certain liabilities-		
Unearned fee income	8,365	
Accounts payable to broker-dealers and other		(1,465)
Accrued expenses and other	(2,424,888)	9,589
Net cash provided by (used in) operating activities	2,497,990	(394,279)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(20,708)	(19,303)
Unrealized (gain) loss	(316,683)	(317,237)
(Increase) decrease in investment portfolio	(1,880,101)	282,318
Sale of securities	828,125	
Net cash (used in) provided by investing activities	(1,389,367)	(54,222)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Exercise of stock options		
Sale of treasury stock	773,401	508,534
Net cash provided by financing activities	773,401	508,534
NET INCREASE (DECREASE) IN CASH	1,882,024	60,033
CASH, BEGINNING OF PERIOD	102,566	50,985
CASH, END OF PERIOD	\$ 1,984,590	\$ 111,018

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

Cash paid during the period for:

Interest	\$	\$ 1,221
Income taxes		

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

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2005

Note 1 **ORGANIZATION AND NATURE OF BUSINESS**

Diamond Hill Investment Group, Inc. (the Company) is an Ohio corporation incorporated in May 2002, previously a Florida corporation since April 1990. The Company has one operating subsidiary.

Diamond Hill Capital Management, Inc. (DHCM), an Ohio corporation, is a wholly owned subsidiary of the Company and a registered investment advisor. DHCM is the investment adviser to the Diamond Hill Funds, a series of open-end mutual funds. DHCM is also the investment adviser to the Diamond Hill Investment Partners, L.P. (DHIP) and to institutional and individual investors.

Note 2 **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses for the periods. Actual results could differ from those estimates. The following is a summary of the Company's significant accounting policies:

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year financial presentation.

Principles of Consolidation

The accompanying consolidated financial statements include the operations of the Company and DHCM. All material inter-company transactions and balances have been eliminated in consolidation.

Cash

The Company has defined cash as demand deposits, certificate of deposits and money market funds.

Accounts Receivable

Accounts receivable are recorded when they are due and are presented in the statement of financial condition net of any allowance for doubtful accounts. Accounts receivable are written off when they are determined to be uncollectible. Any allowance for doubtful accounts is estimated on the Company's historical losses, existing conditions in the industry, and the financial stability of those individuals that owe the receivable. No allowance for doubtful accounts was deemed necessary at September 30, 2005.

Valuation of Investment Portfolio

Investments in mutual funds are valued at their current net asset value. Investments in DHIP are valued based on readily available market quotations. Realized and unrealized gains and losses are included in investment profits and losses.

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September 30, 2005

Note 2 **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)**Limited Partnership Interests**

DHCM is the managing member of Diamond Hill General Partner, LLC, the General Partner of DHIP, a limited partnership whose underlying assets consist of marketable securities. DHCM's investment in DHIP is accounted for using the equity method, under which DHCM's share of the net earnings or losses from the partnership is reflected in income as earned and distributions received are reflected as reductions from the investment. Several board members, officers and employees of the Company are members in Diamond Hill General Partner, LLC and collectively represent 9.8% of the partnership's total net assets as of September 30, 2005. The capital of Diamond Hill General Partner, LLC is not subject to a management fee or an incentive fee.

Property and Equipment

Property and equipment, consisting of computer equipment, furniture, and fixtures, is carried at cost less accumulated depreciation. Depreciation is calculated using the straight-line method over estimated lives of three to seven years.

Revenues

Securities transactions are accounted for on the trade date basis. Dividend income is recorded on the ex-dividend date and interest income is accrued as earned. Realized gains and losses from sale of securities are determined utilizing the specific identification method.

Earnings Per Share

Basic and diluted earnings per common share are computed in accordance with Statement of Financial Accounting Standards No. 128, Earnings per Share. A reconciliation of the numerators and denominators used in these calculations is shown below:

For the nine months ended September 30, 2005:

	Numerator	Denominator	Amount
Basic Earnings	\$984,495	1,642,623	\$0.60
Diluted Earnings	\$984,495	1,965,743	\$0.50

For the nine months ended September 30, 2004:

	Numerator	Denominator	Amount
Basic Earnings	\$(161,365)	1,551,220	\$(0.10)
Diluted Earnings	\$(161,365)	1,551,220	\$(0.10)

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September 30, 2005

Note 3 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)Earnings Per Share (Continued)

For the three months ended September 30, 2005:

	Numerator	Denominator	Amount
Basic Earnings	\$89,674	1,658,446	\$0.05
Diluted Earnings	\$89,674	1,999,620	\$0.04

For the three months ended September 30, 2004:

	Numerator	Denominator	Amount
Basic Earnings	\$152,663	1,594,014	\$0.10
Diluted Earnings	\$152,663	1,658,440	\$0.09

Stock options and warrants have not been included in the denominator of the diluted per-share computations for those periods with a net loss because the effect of their inclusion would be anti-dilutive.

Fair Value of Financial Instruments

Substantially all of the Company's financial instruments are carried at fair value or amounts approximating fair value. Assets, including accounts receivable and securities owned are carried at amounts that approximate fair value. Similarly, liabilities, including accounts payable and accrued expenses are carried at amounts approximating fair value.

Note 3 INVESTMENT PORTFOLIO

Investment portfolio balances, which consist of securities classified as trading, are comprised of the following at September 30, 2005:

	Market	Cost	Unrealized Gains (Losses)
Diamond Hill Large Cap Fund	\$ 57,674	\$ 50,000	\$ 7,674
Diamond Hill Focus Long-Short Fund	58,442	50,000	8,442
Diamond Hill Focus Small Cap Fund	59,433	50,000	9,433
Diamond Hill Strategic Income Fund	1,028,444	961,768	66,676
DHIP Private Investment Partnership	3,118,920	2,394,927	723,993
Total	4,322,913	3,506,695	816,218

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES
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 September 30, 2005

Note 3 **INVESTMENT PORTFOLIO** (Continued)

DHCM is the managing member of the General Partner of DHIP, whose underlying assets consist primarily of marketable securities. The General Partner is contingently liable for all of the partnership's liabilities.

Summary financial information, including the Company's carrying value and income from this partnership at September 30, 2005 and 2004 and for the nine months then ended, is as follows:

	2005	2004
Total assets	\$ 155,560,086	\$ 31,733,939
Total liabilities	59,440,368	12,860,296
Net assets	96,119,718	18,873,643
Net income	14,299,359	2,859,649

DHCM's portion of net assets	3,118,920	1,744,993
DHCM's portion of net income	2,040,618	155,164

DHCM's income from this partnership includes its pro-rata capital allocation and its share of an incentive allocation from the limited partners. DHCM earned the following management fee and incentive fee from the partnership:

	NINE MONTHS ENDED		THREE MONTHS ENDED	
	SEP 2005	SEP 2004	SEP 2005	SEP 2004
Management fee	\$ 298,266	\$ 72,638	\$ 137,047	\$ 28,135
Incentive fee	1,736,646	106,567	1,449,682	83,579

Note 4 **CAPITAL STOCK****Common Stock**

The Company has only one class of Common Stock.

Treasury Stock

On July 17, 2000, the Company announced a program to repurchase up to 400,000 shares of its Common Stock through open market purchases and privately negotiated transactions. From July 17, 2000 through July 25, 2002 the Company purchased a total of 352,897 shares of its Common Stock at an average price of \$5.69 per share. During the nine months ending September 30, 2005, the Company has issued 68,543 shares of Treasury Stock (15,000 shares to employees in the form a restricted stock grant, 44,000 shares to fulfill the execution of warrants and options, and 9,543 to fulfill the Company's match under the Company's 401k Plan). The Company's total Treasury Stock share balance as of September 30, 2005 is 146,369.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES
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Note 4 CAPITAL STOCK (Continued)Authorization of Preferred Stock

The Company's Articles of Incorporation authorize the issuance of 1,000,000 shares of blank check preferred stock with such designations, rights and preferences, as may be determined from time to time by the Company's Board of Directors. The Board of Directors is empowered, without shareholder approval, to issue preferred stock with dividend, liquidation, conversion, voting, or other rights, which could adversely affect the voting or other rights of the holders of the Common Stock. There were no shares of preferred stock issued or outstanding at September 30, 2005.

Note 5 OPERATING LEASES

The Company leases office space under an operating lease agreement effective May 1, 2002, which terminates on May 31, 2006. Total lease expenses for the nine months and three months ended September 30, 2005 were \$101,000 and \$38,250, respectively. The future minimum lease payments under the operating lease are as follows:

Year Ended	Amount
2005	38,250
2006	63,750

Note 6 EMPLOYEE INCENTIVE PLANSComprehensive Compensation Program

At the Company's annual shareholder meeting on May 12, 2005, shareholders approved the 2005 Employee and Director Equity Incentive Plan (2005 Plan). The 2005 Plan is intended to facilitate the Company's ability to attract and retain staff, provide additional incentive to employees, directors and consultants, and to promote the success of the Company's business. The 2005 Plan is to be administered by the Board of Directors. With the approval of the 2005 Plan, the board has initiated a review of the compensation of all Company staff including base salary, cash incentives and equity incentives. The review will include an assessment of the current compensation structure as compared to other organizations in the investment management industry and the performance of the company's staff, particularly its investment team. The board expects to finalize a new compensation program by November 2005. Performance bonuses, which are expected to be significant, will be finalized by the fourth quarter.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES
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September 30, 2005

Note 6 EMPLOYEE INCENTIVE PLANS (Continued)

Equity Compensation Grants

On May 13, 2004 the Company's shareholders approved terms and conditions of certain equity compensation grants to three key employees. Under the approved terms a total of 75,000 shares of restricted stock and restricted stock units were issued to the key employees on May 31, 2004. The restricted stock and restricted stock units are restricted from sale and do not vest until May 31, 2009.

Equity Incentive Plan

On May 12, 2005 at the Company's annual shareholder meeting, shareholders approved and the Company adopted the 2005 Employee and Director Equity Incentive Plan (the Plan). The Plan authorizes the issuance of up to 500,000 shares of the Company's common stock in various forms of stock or option grants. The Plan provides that the Board of Directors, or a committee appointed by the Board, may grant awards and otherwise administer the Plan. As of September 30, 2005 no shares have been issued under the Plan.

Stock Option Plan

The Company adopted a Non-Qualified and Incentive Stock Option Plan in 1993 that authorized the grant of options to purchase an aggregate of 500,000 shares of the Company's Common Stock. The Plan provides that the Board of Directors, or a committee appointed by the Board, may grant options and otherwise administer the Option Plan. The exercise price of each incentive stock option or non-qualified stock option must be at least 100% of the fair market value of the Common Stock at the date of grant, and no such option may be exercisable for more than ten years after the date of grant. However, the exercise price of each incentive stock option granted to any shareholder possessing more than 10% of the combined voting power of all classes of capital stock of the Company on the date of grant must not be less than 110% of the fair market value on that date, and no such option may be exercisable more than five years after the date of grant. This Plan expired by its terms in November 2003. Options issued under this Plan are not affected by the Plan's expiration.

The Company applies Accounting Principles Board Opinion 25 and related Interpretations (APB 25) in accounting for stock options and warrants issued to employees and Directors. Accordingly, compensation cost is recognized based on the intrinsic value of the stock options or warrants.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2005

Note 6 EMPLOYEE INCENTIVE PLANS (Continued)Stock Option Plan (Continued)

Had compensation cost for all of the Company's stock-based awards been determined in accordance with FAS 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

	Nine Months Ended		Three Months Ended	
	September 30		September 30	
	2005	2004	2005	2004
Net income, as reported	984,495	(161,365)	89,674	152,663
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(35,634)	(87,785)	(8,040)	(15,425)
Pro forma net income	948,861	(249,150)	81,634	137,238
Earnings per share:				
Basic as reported	0.60	(0.10)	0.05	0.10
Basic pro forma	0.58	(0.13)	0.05	0.09
Diluted as reported	0.50	(0.10)	0.04	0.09
Diluted pro forma	0.48	(0.13)	0.04	0.08

To make the computations of pro forma results under FAS 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: no dividend yield for all years and expected lives of ten years. The options and warrants granted under these plans are not registered and, accordingly, there is no quoted market price.

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DIAMOND HILL INVESTMENT GROUP, INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2005

Note 6 EMPLOYEE INCENTIVE PLANS (Continued)

Stock Option Plan (Continued)

A summary of the status of the Company's stock option and warrants plans as of September 30, 2005 and 2004 and changes during the nine months ending on those dates are presented below:

	Options		Warrants	
	Shares	Exercise Price	Shares	Exercise Price
Outstanding December 31, 2003	260,202	\$ 10.581	280,400	\$ 12.897
Granted				
Exercised				
Expired unexercised				
Forfeited				
Outstanding September 30, 2004	260,202	10.581	280,400	12.897