



OSI Geospatial Inc.



OSI Geospatial Inc. - Fourth Quarter 2007 Conference Call Transcription

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Speakers: **Jane Hayward**
Investor Relations

Kenneth Kirkpatrick
President and Chief Executive Officer

John T. Sentjens
Vice President, Finance



OPERATOR: At this time I would like to turn the conference over to Jane Hayward, Investment Relations. Please go ahead.

JANE HAYWARD: Thank you operator. Good afternoon everyone and thank you for joining us to discuss OSI Geospatial's 2007 Fourth Quarter and Year End Results. Our results were issued at 9:40 am on March the 5th, 2008. If you have not been able to obtain a copy of our news release, it is posted on our website at www.osigeospatial.com. We are also broadcasting this event live on our website. Joining me this afternoon on the call are Ken Kirkpatrick, President and CEO and John Sentjens, CFO.

We will begin this afternoon with Ken Kirkpatrick who will review the 2007 Fourth Quarter and Year End Results. John Sentjens will follow with the financial and operating highlights and then we will open the call to analyst's questions.

During the call, we will be making forward looking statements about OSI Geospatial's business. These statements are subject to risks and uncertainties, which could cause actual results to differ materially. These include but are not limited to risks related to the company's reliance on international government contracts, the number of large customer transactions and their related lengthy sales cycles, uncertainties associated with competitive bidding processes and contract negotiations, actions by government authorities, the effects of general economic and political conditions, changing foreign exchange rates and challenges related to the company's ability to develop, introduce and implement new products and/or enhancements to existing products that



respond to customer requirements in a rapidly changing and complex technological market. These and other risks are disclosed in the Management Discussion and Analysis portion of the company's annual reports filed with relevant securities regulators.

Statements made on this call reflect management's analysis as of today and management does not assume any responsibility or obligation to update any forward-looking statements made during this presentation.

During the call, we will make reference to selective non-GAAP financial measures including total backlogs, firm backlog, option backlog, and working capital. We feel these measures provide meaningful information to investors. These non-GAAP measures do not have a standardized meaning and are not likely to be comparable to similar measures presented by other issuers.

Please note that all financial information is stated in US dollars and in accordance with Canadian GAAP. With that I would like turn the call over to Ken Kirkpatrick.

KENNETH KIRKPATRICK: Thank you Jane. Good afternoon everyone and thank you for taking the time to join us for our Fourth Quarter and Year End Conference Call. I will begin by providing an explanation for the delay in filing of the financial statements for the fourth quarter and year ending 2007.

Our auditors, Ernst & Young, informed the company at the year end audit committee meeting on February 25th that they



were concerned with management's progress in responding to an SEC comment letter that the company received on January 9th, 2008. Following the meeting on February 25th, E & Y informed us that they would not authorize the release of our year end financial statements until management had addressed these concerns. This was the first time that management had been informed that our response to the SEC comment letter would impact the release of our year end financial result. We were not provided with clear direction on the E&Y requirements until the morning of February 26th. Management provided the required information to E&Y on February 28th and we are informed that E&Y Senior Management would need to review and approve the response before they could provide us necessary approval. This approval was finally received after the close of business on March 4th 2008. Management is proactively addressing the SEC comments that are primarily related to software revenue recognition. We are confident that our response will be to the satisfaction of the SEC. I will now provide you a high level overview of our financials.

In the fourth quarter, we booked revenue of \$8.3 million, a decrease of approximately 18% over the fourth quarter revenue of \$10 million in 2007. Our 2007 consolidated revenue was \$25.3 million compared to \$24.1 million in 2006, a modest increase of 5%. Our revenue growth in 2007 was negatively impacted by unexpected delays in closing key contracts in the US and the UK.



For the fourth quarter of 2007, the company reported a net loss of \$798,000 compared to net earnings of \$2.8 million for the same quarter in 2006. For the full year of 2007, the net loss of \$2.9 million compares with the net earnings of \$932,000 in 2006. The net loss in 2007 was primarily driven by the decrease in revenue from our high gross margin Marine Systems business, completion of the R&D funding from technology partnership Canada, significant increase in the value of the Canadian dollar, investment in the expansion of our sales and marketing capabilities, investment in the establishing our Layered Security Solutions Division and non-recurring one time expenses related to management changes, and the relocation of our corporate office to Ottawa.

2007 has proven to be a challenging year for the company. While I am disappointed with our financial performance this year, I strongly believe that we are making the necessary investments to position ourselves to take advantage of the significant market opportunities available to our company and we remain committed to our aggressive growth strategy. We have substantially expanded and enhanced our sales and marketing capabilities across the company and this has resulted in a considerable increase in the number of qualified sales opportunities. This investment will greatly reduce our dependency on a few key contracts and will position us to meet our growth objectives in 2008 and in the future.

The majority of our efforts will continue to be on developing opportunities in the Defense and Security markets in the United States, United Kingdom, and Canada. These markets



will drive our future growth and we are aggressively pursuing several projects in each of these markets. To ensure that we are well-positioned to win these projects, we have established a Senior Business Development Team that has extensive experience in developing and closing large defense contracts in all of our focus markets. This team is operating out of our corporate office in Ottawa.

I will now provide you with an update on the progress that we have made towards meeting our established objectives for fiscal year 2007.

We set the goal to achieve revenue in the range of \$28 to \$32 million with positive net earnings. In the third quarter, we confirmed that we would achieve approximately \$26 million in revenue due to delays in closing key contracts. We achieved \$25.3 million in revenue. The small short fall was primarily driven by our mapping operations not being able to complete projects due to poor weather conditions. In 2007, we've signed new contracts worth close to \$28 million and have been awarded contracts worth more than \$26 million that we expect to sign and benefit from in 2008.

During the third quarter conference call, I also reported that the company will not be profitable for the year but expected to generate a profit in the fourth quarter. This was not achieved as the company incurred significant non-reoccurring one time expenses in the fourth quarter. We also established the goal of securing both a significant US Department of Defense and UK Ministry of Defense contract. The US and UK defense markets remain a high priority for our company and the majority of the



contracts signed and awarded to the company in 2007 were from these markets. We expect to close a majority of the awarded contracts in 2008. The Canadian market will be a higher priority for our company in 2008, as the Canadian Government has committed to making significant investments in developing defense and security infrastructure in Canada. We are well-positioned to benefit from these programs and expect to show some solid progress in 2008.

Our investment in building our sales and marketing capabilities has significantly increased our sales funnel and we are well-positioned for success in all these markets in 2008.

Thirdly, we set out to establish the company as a credible supplier in the Global National Security and Homeland Defense market. We've achieved this by signing a contract with the US Department of Homeland Security valued at \$2.1 million and a contract with the Texas Sabine Neches Region Maritime Security Committee valued at \$1.2 million. Both these projects are going very well and will be completed in the second quarter of 2008.

The US Department of Homeland Security is investing significant dollars towards Maritime Security and has established a port security grant program that will provide \$380 million of funding in 2008 to port regions across United States.

Our success in 2007 has positioned us extremely well to benefit from the grant program and we are aggressively pursuing a number of projects. The maritime security market



presents a significant opportunity for our company and we are confident that will achieve considerable success in 2008.

In 2007, we achieved the goal of expanding our customer base and have successfully established the US Department of Homeland Security, the US Naval Expeditionary Combat Command, and the US Marine Corp Training Systems as new customers. We made significant progress in developing partnerships with large defense systems integrators and for the first time we are working with BAE Systems on the UK Navy's, Astute Submarine Program and Sperry Marine Systems on the UK Navy CVF Aircraft Carrier Program. Both of these programs will lead to considerable business for the company in 2008 and will provide us the opportunity to develop further business opportunities with these companies in the UK and around the world.

And lastly, we set out to leverage the company's core technology in the development of new products. We developed a small handheld situational awareness unit for Battlefield Frontline Medical Operations. An Asset Control and Tracking System for Maritime Interdiction Operations, a Digital Maritime Operations Plot System for Advanced Submarine Navigation Operations, and a Handheld Situational Awareness Unit for Military Special Operations and first responders operating in extreme environments.

In addition, we have made excellent progress in developing a command and control solution for the maritime security market that leverages our advanced naval technology. All of these new initiatives have the potential to generate a significant



amount of business for the company in 2008 and beyond. I am very encouraged by the progress that we have made in developing our sales funnel, diversifying our product offering, and entering the higher growth maritime security market. Our investment to expand the company's sales and marketing capabilities has resulted in a significant increase in a number of qualified sales opportunities and this will greatly reduce our dependency on a few key contracts to meet our financial objectives.

2008 is an extremely important year for the company and we are committed to achieving the following objectives:

Secure significant contracts in United States, United Kingdom and Canadian Defense and Security markets. Secure additional US maritime security integrated vulnerability assessment contracts. Close our first project to provide our naval situation awareness technology to the maritime security market.

Establish partnerships with large defense contractors to integrate our technology into their systems to provide the company access to large programs and expand our reach into the international market.

Continue to leverage the company's core technology to develop and enter into adjacent and new markets.

We are confident that our first quarter will be a significant improvement over the first quarter in 2007. And we are committed to achieving all our established objectives for 2008.



With that I will turn the call over to John Sentjens who will take you through our financial and operating highlights for 2007 and the fourth quarter.

JOHN SENTJENS:

Thanks Ken and good afternoon everyone. Please note that all financial information is stated in US dollars and in accordance with Canadian GAAP. Before I discuss the highlights of the fourth quarter and fiscal year 2007, I want to clarify what has been restated for fiscal years 2005 and 2006.

The numbers that have been restated are contained in Note #21 of the Audited Statements for the year-ended November 30th, 2006. The restated numbers are reported in Note #23 of the Audited Statements for the year-ended November 30th, 2007. These notes reconciled the differences between Canadian and US GAAP. The restatements relate to differences between Canadian and US GAAP in the accounting for income taxes and the 2005 preference share financing. This restatement does not relate in any way to the delay in releasing our 2007 fiscal or 2007 financial statements.

Now on to the fiscal 2007, our consolidated revenue of \$25.3 million is an increase of 5% over the \$24.1 million dollars in 2006. As Ken noted earlier, revenue growth for 2007 was adversely affected by contract delays. These contracts are currently expected to close in the second quarter of 2008.

Our marine systems revenue decreased by \$1.1 million or 9% primarily due to the timing of new contract awards. We reported \$10.7 million of land and air systems revenue, an increase of 22% over the \$8.8 million generated in 2006. This



increase was largely attributable to the expansion into the US National Security market. Our mapping operations revenue increased \$300,000 over last year to \$4.4 million. Our mapping operations growth was negatively impacted by poor weather conditions that delayed the execution of booked contracts.

For 2007, we reported a gross profit percentage of 39% compared to 44% for 2006, a decrease of 5%. This lower percentage is primarily due to a decrease in revenue from our high gross margin marine system's business and lower revenues derived from the higher margin software sales. General and Administrative expenses increased 8% to \$6.2 million. This is primarily due to one time costs that were incurred during the year which included the establishment of our corporate headquarters in Ottawa, Ontario, the accrual of potential costs relating to the law suite with Triathlon Limited. Severances paid to departing employees and stock options granted to new management. As a percentage of revenue, G&A expenses were up four tenths of 1% from last year. Engineering Expenses decreased 24% to \$1.4 million as more staff and related costs were charged to cost of sales to support revenue generating projects. Certain development costs met the deferral criteria under Canadian GAAP, so that these expenditures are capitalized and amortized over the estimated lives of the related projects. To date, the company has differed \$97,000 of development costs incurred in fiscal 2007.

Sales and marketing expenses increased 53% to \$3.9 million or 15% of total revenue versus 10% in fiscal 2006. The

increase is primarily due to additional sales and marketing emphasis as we position ourselves to expand into new markets and target new customers.

During the year, we also incurred severance cost related to the relocation of the corporate office to Ottawa. The significant increase in our sales and marketing expenses in 2007 was planned. At November 30th, 2007, total backlogs was \$70 million compared to \$63 million at November 30th, 2006. Firm backlog which consists of firm fixed and signed orders at year-end was \$49 million compared to \$35 million at November 30th, 2006. Option backlog which is unexercised or unfunded contract provisions was \$20 million compared to \$28 million at November 30th, 2006. Of the \$49 million in firm backlog, we expect that \$14 to \$15 million will be executed in fiscal year 2008.

Overall, we reported a net loss of \$2.9 million compared to net earnings of \$932,000 in 2006. This was driven by a decrease in revenue from our high gross margin Marine Systems business, the completion in 2006 of the R&D funding from Technology Partnerships Canada, a significant increase in the value of the Canadian dollar, our investment in the expansion of sales and marketing capabilities, and non-recurring one time expenses related to management changes, and establishing our corporate office in Ottawa.

Net loss attributable to common shareholders was \$3.6 million or \$0.9 cents per share compared to \$82,000 or \$0.0 cent per share in 2006.



I will now summarize the 2007 fourth quarter results. Consolidated revenue for Q4 was \$8.3 million, a decrease of 18% compared to Q4 2006 as contract awards and customer schedules slid into 2008.

Marine Systems revenue decreased to \$4 million or 37%. Land and Air Systems revenue in the fourth quarter of 2007 was \$3.4 million, 35% increase over the \$2.5 million generated in Q4 of 2006, which was largely attributable to the expansion into the US National Security Market. Mapping revenue decreased 23% to \$915,000 from 1.2 million in fiscal 2006. Gross profit percentage was 43% compared to 55% in Q4 2006. Operating expenses were \$4.4 million for Q4 2007 compared to \$3.1 million in the same period of 2006. Net loss was \$798,000 compared to a net income of \$2.8 million for the fourth quarter of 2006.

Factors that affected the Q4 results included lower margins as our business shifted from our high gross margin Marine Systems business, one time severance cost, accrued settlement expenses, and strengthening Canadian dollar against other major currencies.

Now turning to our balance sheet, at November 30th, 2007, current assets were \$14.9 million and current liabilities \$7.1 million. Working capital is \$7.8 million at year end. Our current assets and working capital have remained relatively constant year-over-year. We have \$2.6 million available under revolving credit facilities and at November 30th, 2007, we had borrowed \$822,000 against those facilities. This was not unexpected due to the one time cost and delayed signing of significant



contracts. We have enough cash and credit facilities to manage the business and we are confident cash flow from operations will improve in 2008. We continue to explore options to ensure that we have sufficient capital to finance our growth strategies. Now I would like to turn the call back to Ken.

KENNETH KIRKPATRICK: Thank you John. 2007 has been a challenging year for the company. The delays in closing contracts in the US and UK had a negative impact on our ability to meet our commitments this year. We are confident that our efforts in 2007 will lead to a successful 2008 as we will benefit from the closing of delayed contracts, more control over the execution of current backlog, better insight into the timing of closing awarded contracts, and our investment in sales and marketing that will allow us to pursue and develop large projects in our key markets. With that, I would be happy to take your questions.

OPERATOR: Thank you sir. We will now begin the question and answer session. Anyone who wishes to ask a question may press “*” then “1” on their touchtone telephone. If you wish to remove yourself from the question queue, you may press “*” then “2”. Our first question today comes from Robert Catellier of Clarus Securities.

ROBERT CATELLIER: Hi Ken. Can you quantify the amount of revenue generated from Layered Security Solutions and where it was classified?

KENNETH KIRKPATRICK: It was approximately a million dollars and it was classified under Land and Air Systems.



ROBERT CATELLIER: Yeah. And then can you also quantify your view of the one time items in G&A? You don't have to necessarily itemize them but what was the aggregate amount of one timers?

KENNETH KIRKPATRICK: There was approximately a million dollars of one time expenses incurred in Q4.

ROBERT CATELLIER: Ok. So go forward, G&A rate will be about 6 million?

KENNETH KIRKPATRICK: Yeah. It'll be just under 6 million. Moving forward, we don't see our G&A increasing. We see our sales and marketing expense stabilizing going into '08. And we see our engineering costs staying flat moving forward.

ROBERT CATELLIER: Okay. And then at what revenue potential does Layered have given this current staffing level and your current staffing plans and what are you doing to make sure the company is adequately staffed to address what appears to be an expanding market?

KENNETH KIRKPATRICK Yeah, we have ramped our....we have established our Layered Securities Solutions division based in Norfolk, Virginia. We have a staff base of, I believe just under 20 people at this point. And being in that location and part of the reason we established our operation there is there's access to the expertise that we need in support of development of that business. So, part of our strategy to ensure we have the right resources and access to the right level of resources was key to establishing our operations in Norfolk.



ROBERT CATELLIER: And what with that level of staff? What's your revenue potential?

KENNETH KIRKPATRICK: You're looking at I would say anywhere from 150,000 to 200,000 per head. So if you're looking at about 20 staff you're 3.5 to 4 million.

ROBERT CATELLIER: Ok. And have you been able to quantify the revenue decreased due to currency fluctuations in '07?

KENNETH KIRKPATRICK: The revenue decrease?

ROBERT CATELLIER: Yeah, the impact that currency fluctuations had on your reported revenue.

KENNETH KIRKPATRICK: I don't.....maybe John you can help me out on this. But I guess my view of the revenue is it had some impact on non-US revenue currency contracts. But a lot of our revenue contracts are in US dollars and we report in US dollars. The bigger challenge for us in 2007 was driven around our Canadian cost base because as a lot of our business is under US Currency Contracts, and we report in US dollars, the real challenge was the Canadian cost base. And as the Canadian dollar strengthened, that had an impact on our bottom line that was quite significant.

ROBERT CATELLIER: And what I would characterize '07 is it's kind of ironic that, you know, the contract delays and everything of that nature because, you know, they were pervasive obviously throughout the industry. But the company's actual specific markets appear to have grown and I look at the Port Security Program. That's



up by a factor of 3, and your positioning yourself for some larger initiatives. Can you just walk through how some the larger programs have changed and how you've position yourself there? I'm thinking specifically with Port Security and, you know, how big that addressable market is for you over time and maybe what type of revenue potential is possible out of some of the new Canadian spending?

KENNETH KIRKPATRICK: Yeah. I'd be glad to. If you look at the security market in the US, as I think, most people are well aware is it's obviously one of the largest markets in the world. And on the port security side alone, you know, I reference quite often the Port Security Grant Program, which is in itself significant and when you're talking dollars in the range of 400 million that have to be committed to in 2008, that creates a significant opportunity for the company in itself.

But in addition to that, outside of those grant programs port regions, US coast guard are spending huge amounts of dollars in addressing marine security issues. And we truly outside of our Layered Security Solutions Group as it relates to vulnerability assessments, we have technology on the naval side that can easily be transitioned into that market. And so we see that as a very sizeable market for the company in the US, but also in Canada and in the UK. As it relates to major programs, what we are seeing around the world, but specifically in our three markets that we spend a majority of our time that's Canada, UK and the US, is we're seeing major programs ramping up around a lot of our core technologies.



If we look at the soldier modernization programs. There are 24 of these programs ramping up around the world including our three core markets to modernize the soldier that is at the frontline. We have technology, command control and communications technology that fits that market perfectly. So that is a \$10 billion market. A good component of that is going to be covered by technology that we have. So, we are quite excited about the soldier modernization are small unit situational awareness capabilities.

We are also seeing significant marine programs in the UK as I referenced the CVF Aircraft Carrier Program in the United Kingdom, the Astute Nuclear Submarine Program in the UK. Those are all programs that we are becoming very heavily involved. It's new to our business because most of our business in the past has been focused on what I call the retrofit market, taking our systems and integrating it into an existing platform. So, this is creating some exciting opportunities but also some challenges because it's a different contracting process with different players. Moving into Canada, we see massive programs like the Joint Support Ship Program in Canada where we believe we can provide a significant contribution to that program. There's other programs such as the Arctic Patrol Vessel Program that's ramping up here in Canada. So, we're seeing a lot of large programs ramping up in all of our market spaces that we're well-positioned to pursue.

So we have more, in my assessment, none of our markets are on the decline. They're all on the upswing and we're seeing



more activity and more programs than we've ever seen before. And even more important is, we now have a lot more to offer than we did two years ago.

ROBERT CATELLIER: Right. So, the challenge becomes then trying to predict when some of these new programs are going to head or if delays from '07 are going to cause delays in '08 and try to see when the major mapping revenues coming in? It sounds if I can infer from your comments, the contracting spike might happen in '08 and the revenue recognition benefits might accrue in '09 is that's sort of the way to look at it?

KENNETH KIRKPATRICK: I think what we've done is we have a sizeable backlog that within our control for executing in 2008. We've been awarded a significant amount of contracts in '07 that we've been working through '07 and into '08 to actually close off. So, we have more visibility and insight to how we're going to close and the timing of closing those awarded contracts. In addition to that, the company which we don't put out publicly you know when we close this business we have a fairly stable between \$2 to \$2.5 million of what we call repeat business that comes in every quarter. In addition to that, we've got a significant volume of procurements that we've been developing that are going to come to RFP in 2008 that we're very comfortable that we've a very good chance of winning. So when you put all those things together, I think it positions us well for 2008, but it also positions us very well for 2009.

ROBERT CATELLIER: Very true. So some of those awards will be contracted in '08 and there'll be some revenue benefit in '08 as well as '09?



KENNETH KIRKPATRICK: Yeah, typically we're looking, you know, the contracts as typically spread over one to three years.

ROBERT CATELLIER: Okay. Thank you.

KENNETH KIRKPATRICK: Thank you.

OPERATOR: There are no further questions at this time. I will now turn the call back to Ken for any closing remarks.

KENNETH KIRKPATRICK: Okay. Thanks again for joining us today. I look forward to speaking to you again in April when we release our first quarter results for fiscal year 2008. Thank you.