



OSI Geospatial Inc.

First Quarter 2009 Conference Call Transcript

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Speakers: **Jane Hayward**
Investor Relations

John Sentjens
Chief Financial Officer

Ken Kirkpatrick
President and Chief Executive Officer



OSI Geospatial Inc.

OPERATOR: Hello. This is the conference operator. Welcome to the OSI Geospatial's 2009 first quarter conference call. At this time, I would like to turn the conference over to Jane Hayward, Investor Relations.

JANE HAYWARD: Thank you, Operator. Good afternoon, everyone, and thank you for joining us to discuss OSI Geospatial's 2009 first-quarter results. Our results were issued at 4:05 PM today, April 9, 2009. We are broadcasting this event live on our website. There is a link posted to our Investors page.

Joining me this afternoon on the call are Ken Kirkpatrick, President and CEO, and John Sentjens, VP, Finance. We will begin this afternoon with John Sentjens, who will review the 2009 first-quarter financial and operating results. Ken Kirkpatrick will follow with the first-quarter highlights. We will then open the call to 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 number of large customer transactions and their related lengthy sales cycles; uncertainties associated with the competitive bidding processes and contract negotiations; actions by government authorities; the effects of general economic and political conditions; and changing foreign exchange rates.

These and other risks are disclosed in the Management Discussion and an Analysis portion of the Company's annual reports filed with the relevant securities regulators. Statements made in 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 selected non-GAAP financial measures, including firm 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 Canadian dollars and in accordance with Canadian GAAP.

With that, I will turn the call over to John Sentjens.

JOHN SENTJENS: Thanks, Jane, and good afternoon, everyone. As of December 1, 2008, we are reporting in Canadian dollars. The change was made as the result of the Company's de-registration with the SEC in the US in fiscal 2008, and to adopt a currency that is more appropriate for the Company's investors and other users of the financial statements.

I will begin by providing you a high-level overview of our financials. In the first quarter, we reported revenue of \$5.7 million, a decrease of approximately 2% over the first-quarter revenue of \$5.8 million in 2008. For the first quarter of 2009, the Company reported a net loss before tax of \$844,000 and after tax of \$697,000, compared to a net loss before tax of \$635,000 and after tax of \$541,000 for the same quarter in 2008.

Our Marine Systems revenue decreased by \$408,000 to \$2.1 million, due to the timing of deliveries and installations on existing contracts and of new contracts awarded. We reported \$3.4 million of Land and Air Systems revenue, an increase of 20% from the \$2.8 million generated in Q1 2008. This increase was attributable to the delivery schedules of existing contracts and the timely passage of the US budget in the fall of 2008.



Our Mapping Operations revenue decreased 57% to \$217,000 from \$503,000 in Q1 2008. The decrease was -- is the result of delays in the execution of existing contracts and the timing of new contracts awarded.

We reported a gross profit percentage of 30% compared to 38% for the same quarter in 2008. This lower percentage is primarily due to a decrease in revenue from our high gross margin Marine Software and Systems business; the level of fixed costs, including the cost of sales across all businesses units; and the level of underutilized resources, primarily in the Company's US Systems operations, and to a smaller extent, in our Mapping operations. The underutilization of resources was the result of delays in customer schedules and new contract awards. These issues have been resolved, and we expect revenue to increase in the second quarter.

Overall, operating expenses decreased 4% to \$2.6 million or 45% of revenue. General and administrative expenses remained consistent at \$1.2 million or 21% of revenue. Engineering expenses increased to \$301,000 from \$262,000, but remained consistent at 5% of revenue, as fewer costs were charged to cost of sales this quarter when compared to last year. This is a direct result of the Company's effort to achieve IMO Type Approval for ECPINS 5.3.

Sales and marketing expenses decreased 12% to \$813,000 and were 14% of total revenue. The decrease was the result of lower commissions and a reduction in discretionary spending.

In the first quarter of 2009, we reported a net loss of \$697,000 compared to a net loss of \$541,000 in 2008. Net loss attributable to common shareholders was \$853,000 or \$0.02 per share compared to \$697,000 or \$0.01 per share in 2008.

At February 28, 2009, firm backlog, which consists of firm, fixed and signed orders at quarter-end, was \$53 million, compared to \$42 million at February 28,



2008. Of the \$53 million, \$10 million is expected to be executed in the remainder of fiscal 2009.

Now, turning to our balance sheet. At February 28, 2009, current assets were \$11.1 million and current liabilities \$5.4 million. Working capital was \$5.7 million at quarter-end, a reduction from the \$6.4 million at year-end. We have revolving credit facilities of \$3 million in Canada and \$1.2 million US dollars in the US.

At February 28, 2009, we had borrowed \$1.9 million against these facilities -- a slight reduction from the past year-end balance of \$2 million. We generated cash from operations in Q1 2009, and have continued to generate cash from operations after quarter-end. As a result, we have reduced the utilization of our credit facilities to \$1 million. We have enough cash in the credit facilities to manage the business.

Now I would like to turn the call over to Ken.

KEN KIRKPATRICK: Thank you, John. In the first quarter, we were successful in signing repeat customer contracts valued at approximately \$5 million, and continued negotiations on awarded contracts valued at approximately \$14 million. In addition, we have developed and qualified a sales funnel that is valued well above \$100 million. It is expected that the majority of the projects that make up our sales funnel will be signed or awarded in the next 12 months.

I strongly believe that we have -- that we are very well-positioned to win a number of these projects, and this success will drive our future growth. We are committed to returning the business to a profitable position in 2009, and we remain confident that this will be achieved.



I will now discuss our accomplishments in the first quarter, and the progress that we are making towards our narrowed, strategic direction that was communicated to shareholders during the 2008 fourth-quarter and year-end conference call.

We remain focused on expanding our warship navigation and leadership position, and leveraging this success to drive new market opportunities. I am pleased to report that we are making very good progress. We were successful in closing a \$1.3 million software upgrade and one-year support contract with the Australian Navy. This customer is committed to our technology, and we are confident that we will secure a long-term support contract in 2009. We were selected to provide our warship navigation system to the Turkish Navy MILGEM Corvette new build program that is expected to build six to eight vessels. This is our first opportunity to work with the Turkish Navy, and we look forward to developing a long-term relationship with this customer.

In addition, we are making good progress towards completing negotiations with our seventh fleet-wide naval customer and I look forward to sharing more details with you in the near future.

The majority of the world Navies are still navigating warships with paper charts, and it is no longer if, but when, a Navy will embrace this technology. We are without a doubt the leader in this market, and we are well positioned to leverage and build on this success.

As discussed at the fourth quarter conference call, we are near the completion of our very successful UK Navy Warship Automatic Identification System or Warship AIS project. In the first quarter, we've received yet another contract from this customer to further enhance the capability of our system. This system has been developed with significant input from the Royal Navy to enhance Situational Awareness, or SA capabilities, for mission effectiveness.



Our warship AIS system leverages the information available through the widespread use of AIS, as well as the tactical support functions available in our navigation and operational support software. This combination provides a dynamic means of resolving complex situational awareness picture situations, as well as tactically exploiting AIS capabilities. This system also can be employed to coordinate the operations of multiple warship AIS fitted ships in either an overt or covert manner, as dictated by the tactical situation. This technology presents significant operational benefits for ship and shore-based operations. We strongly believe that there is a significant market opportunity for this technology, and we are aggressively moving forward to develop this market.

In fact, we are currently leading a team that is aggressively pursuing the Canadian Navy Interdepartmental Maritime Integrated Command Control and Communications, or IMIC3 program, that is expected to be awarded in 2009. IMIC3 will provide the Canadian Navy and Coast Guard vessels the capability to securely exchange information in near real-time, and collaborate on a common national Maritime picture that will improve decision making, supported planning, and coordinated response.

These systems will be installed on 12 Navy Kingston class vessels, 44 Coast Guard vessels, and shore-based facilities. This project has a publicly stated budget of \$24 million and the request for proposal is expected in June 2009. Our warship AIS technology and strong team positions us very well for this important program.

In the first quarter, we successfully delivered, installed and sea-tested our small boat command and control systems for the Canadian Navy port security unit. This system consists of one shore-based and 15 small boat systems. To test the overall effectiveness of the system, we participated in Exercise SILVER that was conducted in preparation of the 2010 Vancouver Olympics.



I am pleased to report that this exercise went very well and we have a happy customer. This success provides us the evidence that this technology enhances shore-based port security operations, and presents a large market opportunity for our Company.

Over the last 12 months, we have been aggressively marketing this capability in the United States through our LLS Division in Norfolk, Virginia. We are making very good progress with the U.S. Navy organization that is responsible for port security and force protection operations across 70 US naval bases. We see this as a significant opportunity for our Company.

The US Coast Guard is also a high priority for our Company, as they are responsible for port and coastal security across the United States. The US market presents an exciting opportunity for our Company, and we are pushing hard for success in 2009.

In addition, we are developing opportunities in the Middle East with Navies and Coast Guards that operate hundreds of small boats in support of security operations. In fact, we have a team in the UAE the week of April 20 to conduct extensive sea trials with both the UAE Navy and Coast Guard. These countries are dealing with extreme situations on a daily-basis, and our small boat C2 technology is being received very well. We are excited about the opportunities that this technology presents, and we will achieve further success in 2009.

Our LSS Division has been structured to lead the delivery of our operational solutions in the US market. And in support of this strategy, we will continue to pursue integrated port security in US naval security exercise projects.

We have recently completed the Port of Buffalo project and we are currently executing the Port of Miami project. I am pleased to report that we have recently



been awarded the Port of Cleveland, and that we are currently bidding on several other port security projects.

In March, we successfully completed our first U.S. Navy security exercise project, and I'm pleased to report that we have been awarded our second project. The US government conducts extensive security exercises on an annual basis and spends hundreds of millions of dollars in support of this activity. We see this as an excellent opportunity to further develop the US security market.

In the first quarter of 2009, we have realigned our US R&D Division to focus on research and development exclusively. I am pleased to report that our R&D team was recently selected as a prime contractor and a first-tier subcontractor for the US Program Executive Office for Simulation Training and Instrumentation under the STOC II program. Under this contracting vehicle, we will provide simulation and training, research and development, utilizing our agent-based cognitive skills training capability. This is a ten-year contract with a long-term potential value of more than \$100 million. We are one of approximately 130 approved contractors that would be bidding on \$17.5 billion that has been committed to this program.

We continue to explore opportunities to divest technologies that have been developed through the R&D process that present solid commercialization opportunities, but are not aligned with our strategic direction. This effort will provide us with the capital to pursue growth opportunities that are aligned with our strategy.

This has -- there has been very good progress in maturing an opportunity to divest our trained analysis or TAK technology. We are in discussions with a number of potential buyers and we are confident that this will lead to success in 2009.



The first quarter has been a very active period for our LSS team that is leading the dismounted soldier systems market initiative. We have been awarded a contract to support our prime contractor in the pursuit of the U.S. Army Ground Soldier Ensemble Program or GSE. This is a \$1.5 billion program that will be delivered -- that will deliver approximately 11,500 systems to the US Army. We expect that there will be an initial award to three companies to each build approximately 50 prototype systems. It is expected that one of these companies will then be selected to provide the 11,500 systems. We are pleased to be on a quality team and remain optimistic that we will be one of the teams selected for the prototype phase of the GSE program.

We continue to develop the US Special Operations Forces or SOF market, and in support of this strategy, we successfully completed several product demonstrations and field trials throughout the first quarter. We remain confident that we will achieve substantial success in 2009.

As discussed during our 2008 year-end conference call, we have begun to explore options to divest our mapping operations, but expect this to be a fairly long process, and we will keep you posted, as we make further progress against this initiative. Our mapping operations were awarded approximately \$1.8 million in new contracts in the first quarter, and we expect significant activity to continue throughout our second quarter.

I am pleased to confirm the appointment of Mr. Steve Barnett to the OSI Board of Directors, and Mr. Peter Hunter to the position of CFO. I am confident that both of these individuals will make a significant contribution to the Company.

We remain on track and developing key opportunities in all of our markets, and we are committed to achieving positive results in 2009.

I would now be happy to take your questions.



- OPERATOR: Thank you. We will now begin the question-and-answer session. Our first question is from Mr. Dev Bhangui of Haywood Securities. Please go ahead.
- DEV BHANGUI: Hi, good afternoon gentlemen. Ken, just a, I guess, a housekeeping kind of a question, but not on the financial side. Since Peter Hunter is coming on as a CFO and John continues to be with the Company, and that he has been on a long-term basis, I guess I just wanted you to clarify to the markets that there is going to be no financial restatements or anything of that sort. I mean, I believe that there won't be, but I wanted you to say it.
- KEN KIRKPATRICK: No, absolutely not. There is no issue related to restatement of financials at all. Essentially, John will focus the majority of his time on the financial reporting externally and internally, and will focus his time on cash and finance for the Company. And where Peter will spend more of his time on the financial and operational management strategy, acquisition, divestiture and financing. So he brings a lot of well-rounded business experience to the team.
- DEV BHANGUI: Okay. With that question out of the way, the more meaningful one would be -- just in terms of, I guess, the margins. This time, they came at around 30%. I was just going over the last few quarters there. And the margins have a pretty big range, Ken. They've gone from 30% on the low side to about 48% on the high side. I know it all depends on the mix. But I've seen some of the quarters wherein supposedly the hardware, which has a lower margin, which is the Land and Air systems as well as the Mapping, has contributed significant percentage of the revenues, and still you had 40% and 41% quarters. So, is there anything particular that you would like to tell us in terms of why the margins were lower here, even though the Mapping contributed highly earning to the revenue in terms of percentage-basis, compared to what it has contributed historically in the past?



KEN KIRKPATRICK: Right. Yes, I think -- good question. I think as we look at the margins itself, as you know, our business is very driven by events within specific timeframes, and we can push through a lot of revenue and a lot of margin, depending on the actual mix that we have in backlog or contracts that we've actually signed.

In the first quarter, as you noted on the mapping business, we had an unusual slow ramp-up in the first quarter. The good news is, based on the business booked and the business we're announcing, it's going to ramp up very aggressively in the second quarter.

The other challenge that we had in the first quarter is certain aspects of our US operations had contracts delayed and they also had customer schedule issues. So we had a relatively large cost base that we've kept productive on internal projects, while these projects got sorted out, because it did not make sense to remove those expenses, because we knew the contracts were there. So that was another factor. The good news, again, on that side is those contracts have been brought to a closure and the customer delayed contracts have been resolved. So that's been ramping up very aggressively in the second quarter.

DEV BHANGUI: Great.

KEN KIRKPATRICK: And then the other last factor is, obviously, on our Marine business, Software and Systems is where we typically generate our highest-level margin. That margin -- the revenue level was down quarter-over-quarter, and that had an impact on our gross margins also.

DEV BHANGUI: Okay. Based on your detailed kind of hopper and all the opportunities in the early stage here and late stage and all kinds of projects, the next three quarters appear to be quite promising, if at least half of them catalyze into revenues.



From that point of view, again, going back to the margins, the sense that you are having -- and this is not a guidance, but essentially just a ballpark kind of a range figure, if you land up, in a sense -- I'm just making, I guess, doing this calculation here -- if the Company lands more or less closer to the 30% margin, and we need to have a revenue level of \$32 million plus to break even, and I'm expecting that 2009 will be profitable, based on all the sound bites. If we resort to more of a 40% weighted average margin, then you need to be only \$25 million, which is pretty close to what you guys have done in 2008, and anything above that will be in terms of profitability. So, when you look at 2009, the rest of it, when you see all these projects, all trying to catalyze into revenues, where do you see your margins to be? Are they closer to the 40s or closer to the 30s?

KEN KIRKPATRICK: I'd expect on average our margins will be closer to what it's been historically; so, high 30s. And that's -- obviously, that's an average on the year.

DEV BHANGUI: Yes. Okay. And one last question and I'll stand back in the line. Here -- in terms of Mapping, you said that it's going to be a long drawn process. Is that going to be within this particular fiscal year?

Because right now, it looks like, as you kind of mentioned in your prepared remarks, while the Company really doesn't need to draw on the lines and so on, and you are managing within the working capital, between receivables and payables, for growing really, really in an expedited manner and taking full advantage of all these opportunities, some of them being pretty large, you need some capital on your side.

And so from that point, is the divestment and then bringing of the capital on the balance sheet, is that going to happen most likely by the end of this year or in the second half or --?



- KEN KIRKPATRICK: Yes, I think we're -- as it relates to the mapping business, it was never in our plans to be a priority for us at the start of the year. Essentially, as communicated at the last call, as we had actually somebody approach us, which kind of drove the process forward at a faster pace, and that's still an opportunity. Part of the challenge is management bandwidth, which, bringing in Peter Hunter is going to support moving those initiatives forward at a faster pace.
- DEV BHANGUI: Okay. Thanks, Ken and John, I'll stand back in line. Thanks.
- OPERATOR: Once again, to ask a question please press star and one on your telephone. Our next question is from Mr. Dev Bhangui of Haywood Securities.
- DEV BHANGUI: So, thanks. Just in terms of the OpEx, I guess, would it be okay to say that having given us some kind of guidance last time on -- in terms of the reduction in OpEx, but at the same time knowing that the SNM component is probably the variable part of the equation in terms of ramping up your activity then bidding for new projects, would it be fair to say that OSI could stay within the \$10 million kind of an annualized range in those OpEx? The reason I'm asking is because I guess based on last time, we were looking at the 2008 of \$11.7 million. And based on the savings per quarter, I just kind of annualize it and came to that kind of a conclusion. Is it okay to say that we will take up approximately close to \$2 million out of the equation, compared to 2008?
- KEN KIRKPATRICK: Yes, I would say if we look at our run rate on overhead expenses for Q1, there wouldn't be any significant increase to that moving forward -- based on our core plan.
- DEV BHANGUI: Okay. One last thing from my side would be, when you're looking at the \$63 million backlog, and John said in his prepared remarks that \$10 million out of that would be appointed to operating in the next 12 months.



KEN KIRKPATRICK: No, next nine months.

DEV BHANGUI: Next nine months, sorry. So, just given all this -- all these contracts that are coming through, or would come through, by the Canadian Port Security, the IMIC3 and so on, by when do you expect -- if you at all you win it, when do you expect that those revenues would catalyze? Would it be within this fiscal year?

KEN KIRKPATRICK: Yes, I wouldn't expect on that program that we would see much in 2009, Dev, in the way of revenue.

DEV BHANGUI: Okay. Ken, when you started making your prepared statements, I probably missed out on this, you said something about \$14 million out of -- \$5.1 million in terms of new wins, \$14 million in terms of in the hopper in advance stages of discussions and negotiations; \$100 million in terms of a sales funnel, and then you said something about next few months, if you can just go back to your prepared statement, I missed that particular sentence.

KEN KIRKPATRICK: I'm not sure what -- sorry, one sec.

DEV BHANGUI: I think you were giving some kind of an idea as to what to expect within the next 12 months.

KEN KIRKPATRICK: Yes, what I was saying is that when I speak to our sales funnel, what we do is we work through to try to put together the timing and the profile. So we'd look at our business, typically of what we think we'll actually be awarded or signed within the sales funnel within the next 12 months. That's what the reference was to the \$100 million sales funnel is it consists of projects that we expect to be either awarded or signed within the next 12 months.

DEV BHANGUI: And this \$100 million meaning coming to you, OSI, not awarded to --?



- KEN KIRKPATRICK: Well, no, it's our -- what we call our qualified sales funnel that we are aggressively pursuing and competing for. We're going to win some; we're going to lose some. That is what we've qualified, and think we're well positioned to win. And it's what we expect to see happen in the next 12 months. I think that's an important qualifier for you to understand also. That's not our total sales funnel; that's the sales funnel that we expect to be awarded or be signed in the next 12 months.
- DEV BHANGUI: Okay. And just a quick clarification -- since you said IMIC3, you probably most likely don't expect to happen in 2009?
- KEN KIRKPATRICK: Revenue-wise.
- DEV BHANGUI: Yes, revenue wise.
- KEN KIRKPATRICK: Yes.
- DEV BHANGUI: Which will be the three revenue drivers then, in terms of the next nine months? It will be the AIS? It will be the small boat program, and then the land and air systems in terms of handhelds?
- KEN KIRKPATRICK: A good component of it will come out of our core repeat Navigation business. As you know, we have six fleet customers and two other naval customers using our technologies, so we see a significant amount of repeat business that comes out of those customers. Australia is a perfect example, where Australia just put through \$1.3 million in contracts. And that brings their total value now up to probably over \$12 million now as our relationship with Australia. So that kind of business is a nice significant chunk of our annualized revenue that we can count on.



The other side of that business -- of our business -- is also our US military R&D business, which is also a significant component of our repeat ongoing business. So out of our core business -- and then we see opportunities, obviously, to expand with our warship AIS technology and our small boat command and control technology, and our soldier systems technology. So over and above our core business, we've got three key markets that we're very focused on to support our growth activity.

DEV BHANGUI: Okay. Thanks, Ken and John, for taking my questions and all the best.

KEN KIRKPATRICK: Okay, thank you.

OPERATOR: Thank you, ladies and gentlemen -- I will now turn the call back over to Ken Kirkpatrick for closing comments.

KEN KIRKPATRICK: Thank you for joining us today. I look forward to speaking with you again at our annual and special general meeting on May 28, and our next conference call in July.

OPERATOR: Ladies and gentlemen, the conference is now concluded. You may disconnect your telephones. Thank you for joining and have a pleasant day. Good bye.