OSI Geospatial Inc.

Second Quarter 2009 Conference Call Transcript

Date: Monday, July 13, 2009

Time: 2:00 PM PT / 5:00PM ET

Speakers:

Jane Hayward
Investor Relations

Kenneth Kirkpatrick
President and Chief Executive Officer

Peter Hunter
Chief Financial Officer

OSI Geospatial Inc.

JANE HAYWARD: Good afternoon everyone, and thank you for joining us to discuss OSI Geospatial's 2009 second-quarter results. Our results were issued at 4:05 P.M. today, July 13, 2009. These documents are now available on our website at www.osigeospatial.com. We are also broadcasting this event live on our website. There is a link posted to our Investor's page.

Joining me this afternoon on the call are Ken Kirkpatrick, President and Chief Executive Officer and Peter Hunter, Chief Financial Officer. We will begin this afternoon with Peter Hunter, who will review the 2009 second-quarter financial and operating results. Ken Kirkpatrick will follow with the second-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 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 Analysis portion of the Company's Annual Reports filed with the 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 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 would like to turn the call over to Peter Hunter.

PETER HUNTER: Good afternoon everyone. As of December 1, 2008 we are reporting in Canadian dollars. I will begin by providing you a high-level overview of our financials. In the second quarter we reported revenue of $6.3 million, a decrease of approximately 4% over the second quarter revenue of $6.6 million in 2008.

For the second quarter of 2009 the Company reported a net loss before and after tax of $1 million, compared to a net loss before tax of $1.4 million and after tax of $1.2 million for the same period in 2008.

For the second quarter our Marine Systems revenue decreased by $673,000 to $1.7 million due largely to client delays, delays in contracting, and OSI's decision to focus on a number of new initiatives that are expected to produce significant bookings during the third and fourth quarters of this fiscal year.

We reported Land and Air Systems revenue of $3.2 million, an increase of 30% above the $2.5 million generated in the second quarter of 2008. This increase was attributable to the delivery schedules of existing contracts and the timely passage of the U.S. defense budget.

Our Mapping Operations revenue decreased 19% to $1.4 million from

$1.8 million in Q2 of 2008. The decrease is a result of a continuing competitive marketplace placing downward pressure on contract pricing, and our reluctance to lower prices has led to some contract losses in the bidding process. Further contractions in the U.S. market have had an impact on revenue to date.

Our gross profit percentage of 31% remained unchanged as compared to the same quarter last year. Our increase in revenue from Land and Air Systems yielded sufficient margin to offset gross margin reductions in both Marine and Mapping Systems on a percentage-basis. There was that an underutilization of resources in Marine Systems, which held back improvements in overall margin. We are hopeful that our focus on new initiatives in the Marine segment will contribute to improved margins over the balance of this fiscal year and into 2010.

Overall operating expenses decreased 15% to $2.7 million or 43% of revenue. General and administrative expenses decreased to $1.6 million or 25% of revenue. Engineering expenses increased to $337,000 from $312,000, but remained consistent at 5% of revenue, reflecting the Company's commitment to continued spending on technology and innovation.

Sales and marketing expenses decreased 32% to $813,000 and were 13% of total revenue. This reduction reflects an overall reduction in amounts paid under our commission structure, discretionary spending and an overall reduction in the number of sales positions. These decisions have centered around our commitment to cost reduction and the narrowing of our focus on higher-margin yielding businesses with shorter sales cycles.

In the second quarter of 2009 we reported a net loss of $1 million compared to a net loss of $1.4 million in 2008. The net loss attributable to common shareholders was $1.2 million or $0.02 per share compared to $1.3 million or $0.03 a share in 2008.

At May 31, 2009 firm backlog, which consists of firm, fixed and signed orders at quarter end, was $48.6 million compared to $51 million at May 31, 2008. Of the $48.6 million, $8.3 million is expected to be recognized as revenue in the remainder of fiscal 2009. And $6.1 million is expected to be recognized as revenue in 2010.

As of May 31, 2009 we have been awarded contracts of $17 million, of which we expect to realize $7 million in 2009 and $8 million in 2010.

Now, turning to our balance sheet. At May 31, 2009 current assets were $9.2 million and current liabilities were $4.5 million. Working capital was $4.7 million at quarter end, a reduction from $5.7 million at the end of the first quarter of 2009.

As of May 31, 2009 we have two credit facilities available to the Company. The first is a credit facility with a major Canadian bank in the amount of $3 million. And as of May 31, 2009 the Company had no borrowings against this facility. The Company had a second credit facility with a US bank in the amount of $1.2 million; however, during the month of May the U.S. banker advised the Company that credit under the facility had been frozen at $604,000 and formally requested, in June, that the balance of the loan be retired over a 90-day period. The balance of the loan is to be repaid by August 31, 2009.

As a result, the Company has approached other bankers to replace this facility, and we are hopeful that a replacement facility will be secured, or alternately a consolidated banking facility will be arranged to accommodate the Company's overall requirements for financing.

We generated $2 million of cash from operations in Q2 2009, as compared to a usage of $267,000 in the same period of the previous fiscal year. We continue to generate cash from operations after the quarter end and as a result we continue to hold cash within our Marine and Mapping segments. Although we have generated cash in the Land and Air Systems segments, subsequent to the end of the quarter, we have chosen not to make any reductions in our U.S. banking facility until required.

We continue to be offside with certain covenants contained in our Canadian banking facility; however, we feel we should be able to correct those covenant breaches over the course of the next two quarters.

Moving forward, we feel we have enough cash and credit facilities to manage the business.

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

KEN KIRKPATRICK: Thank you Peter. In the second quarter we were successful in closing contracts valued at approximately $5 million, and made considerable progress towards closing awarded contracts valued at approximately $17 million.

Our qualified sales funnel continues to grow and is now in excess of $130 million, with the majority of these contracts to be signed or awarded within the next 12 to 18-months. We are very, well positioned to win a number of these projects, and we are confident that we will achieve success in 2009.

The first half of the fiscal year has been challenging. We have experienced unexpected delays in closing several awarded contracts due to complex contract negotiations, government procurement processes, and program funding delays due to the economic challenges that many countries are experiencing. These challenges directly impacted our financial results in the first six-months. But we remain committed to returning the business to a profitable position, and we are working hard to achieve this in 2009.

I would now like to tell you about our key accomplishments in the second quarter and the progress that we are making towards achieving our objectives. We continue to build on our leadership position in the WEDCIS market by leveraging our flagship product ECPINS, or Electronic Chart Precise Integrated Navigation System.

I am pleased to report that we closed a contract to provide warship navigation systems to the Turkish Navy Corvette newbuild program. This is our first contract with the Turkish Navy, and we believe that this contract will provide us the opportunity to build on this success.

We have now completed the final contract negotiations for our seventh fleetwide WEDCIS customer and expect to sign and announce the details of this contract before the end of our third quarter.

The Australian Navy has decided to extend their in-service support contract to three years, and we expect to finalize this contract by the end of July. In-service support contracts are now in place with the U.K., Canadian, New Zealand and Australian navies. This provides the Company a steady stream of revenue. And we believe our other customers will embrace this approach in the near future.

Over the last two years we've invested some of our resources in the development of business in select Middle Eastern and Asian-Pacific countries, and we are very excited about the opportunities that we have uncovered. As the NATO WEDCIS market leader we are well-positioned to leverage our success to enter these new growth markets. I look forward to sharing more information about these opportunities as we make more progress in the coming months.

Our WASE System and ACT System that we delivered to the Royal U.K. and Canadian navies, respectively, provide a tactical advantage and directly enhance the operational performance, security and safety of their critical assets, people and equipment.

The primary focus of our sales and technical teams to date has been on marketing our new technologies to navies around the world that support a ship-based operations. This process unfortunately takes considerable time to introduce new technologies and educate naval operational requirements and procurement teams of the benefits that can be obtained from these new technologies. We have been working through this process for the last 18-months and we are making considerable progress.

In addition to ship-based operations, we've identified a market opportunity to provide these technologies to organizations responsible for port and coastal security operations. These security operations are generally managed from shore-based command centers and control significantly more small boats than ship-based operations.

These new technologies can be sold as a standalone system or an integrated solution. We strongly believe that these new technologies present a significant growth opportunity for the Company, and we expect to provide more evidence of this leading to the end of 2009 and into 2010.

Historically, our business focus has been on developing the NATO market and delivering systems primarily for naval, major combatants. Over the last several years countries around the world have been investing significant resources in national security and critical infrastructure protection. In support of port and coastal security and critical infrastructure protection, these countries are ramping up programs to build thousands of small, fast, and armed patrol vessels.

There are many Middle Eastern and Asian Pacific countries that are in regions where there are extreme security risks, and they're responding to these risks by building small and fast patrol vessels that are armed and designed for littoral operations.

To respond to the significant market opportunity, we have designed and developed a system that provides unparalleled capability for military and security patrol-vessel littoral operations. Our INTS, or Integrated Navigation and Tactical System, is the direct result of the integration of ECPINS, WASE and ACT. This system can be easily integrated into a patrol vessel's navigation sensors, weapon system and combat management system.

We are very excited about this new market opportunity as it has a shorter sell cycle and it will position our Company to increase our average revenue per vessel fivefold. In addition, this market offers a much higher number of platforms when compared to major combatants, our traditional target market.

This new market opportunity is not under development; it has been developed and is immediately addressable. We have the best solution in the world and it is ready to be delivered. We are actively bidding on a number of programs, and we are very confident that we will achieve significant success in the third quarter of 2009.

In the second quarter we announced a partnership with the Raytheon Company to pursue the soldier modernization program market, and that our team was selected for the initial phase of the U.S. Army Program. There were three companies selected for the initial phase and one of these companies will be selected for the deployment phase of 11,500 systems. This initial phase will be executed over an 18 to 24-month period, and each of the three teams will be required to deliver 60 prototype systems. The systems built by each team will be evaluated and the best solution will be selected for the development phase.

The first ten prototype systems will be delivered in September 2009 and will be followed by the delivery of 50 systems in late 2010. OSI will be contributing components of our DC4S, or Dismounted Close Combat System software, and engineering services for which we will receive contracts totaling approximately $1.5 million.

In addition, we will be working with the Raytheon team to pursue other soldier modernization programs, which we expect to ramp up in 2010.

We are also aggressively marketing our DC4S system to the SOF, or Special Operations Forces, in the U.S., U.K. and Canada. We are making significant progress in developing opportunities in these markets, especially in the U.S., but do not expect to achieve substantial results until 2010. We remain confident that the SOF market and soldier modernization programs' market through the Raytheon Company and other potential primes presents a significant opportunity for our Company.

Our Advanced Technology Research and Development division continues to sign significant U.S. Army contracts to further develop our land-based command-and-control and training simulation technologies. This statement is supported by the announcement of more than $3 million of U.S. Army contracts in the second quarter.

Our R&D team has been working on a U.S. Army classified program for the last three years, and we are pleased to report that this program will be transitioned to a program of record that will deploy this technology operationally. This success will lead to a multiyear, multimillion-dollar contract in the fourth quarter to continue to support and enhance this capability.

In addition, our R&D group, under a three-year multimillion-dollar U.S. Army contract has developed advanced GPS-deny capability that we strongly believe will be deployed operationally in 2010. This capability enables the tracking of the position of a soldier or soldiers in environments such as caves, tunnels and buildings in which GPS signals cannot be obtained. We expect that this success will lead to additional contracts in 2010.

In support of our effort to expand our markets for our U.S. R&D group, I am pleased to report that we have secured our first Canadian R&D contract to develop a counter IED training solution. And in the U.K. we are working on a Joint Force training with BAE Systems utilizing our simulation-based training capabilities.

We have identified the opportunity to explore the possibility of divesting non-core IP that has been developed by our R&D team. This process has been slow to move forward, but we believe that this does present an opportunity that is worth developing. We will provide more details as these activities progress to more serious opportunities.

Our Mapping business has been negatively impacted by the severe economic downturn in the United States. This business is primarily focused on the county and city government market. These governments have experienced a significant decline in property and other tax revenue. This has directly impacted their ability to fund projects and it has resulted in the delay and cancellation of a number of planned projects.

The reduction in the number of projects has put added pressure on an already price competitive industry. We expect our Mapping business to experience continued topline pressure during the balance of 2009. These market conditions are making the divestiture strategy more challenging, but we are continuing discussions with a number of potential buyers.

We believe that the U.S. stimulus package that has been established in 2009 will benefit the mapping industry and we will see an increase in projects leading into 2010.

The first half of our fiscal year has been extremely challenging, and I'm very disappointed with our year-to-date financial performance. However, I am pleased with the progress that we have made on a number of fronts, and we're working hard to bring several exciting projects to closure. I look forward to sharing the positive news with you over the next few months, and we will work hard to ensure the last half of the year yields significant positive results.

I am pleased to confirm the election of Dr. Adam Chowaniec to the OSI Board of Directors. Adam has had a very successful career in high-tech, in the high-tech industry, and we very much look forward to his involvement. I am confident that he will make a significant contribution to the Company.

I would now be happy to take your questions.

OPERATOR: Our first question today comes from Dev Bhangui, of Haywood Securities.

DEV BHANGUI: Hi, good afternoon. Ken, I just wanted to find out, given that the first half has been soft, and based on your commentary as well as Peter's commentary it looks like that the Company is baking in a significantly up, backend loaded second half, both in terms of revenues as well is in terms of margins.

Can you give us any kind of ballpark figure as to what you are looking at, because you kind of alluded to it indirectly by saying that in the second half it is going to be more the Marine Systems business, so I guess hardware and implementation will land higher margins.

And then, you were also talking about two different multimillion, multiyear contracts, one starting in Q4 2009, another one possibly starting in the early part of 2010 and then going several years. So, if you can give us some kind of color around what that translates into the kind of numbers for the rest of 2009 and then the early part of 2010, that would really clarify things.

KEN KIRKPATRICK: I think if you, from the information provided we have $12 million in revenues behind us. We have fixed backlog of $8.3 million for 2009. And we have awarded contracts of about $7 million that we expect to be able to burn in '09.

In addition to that, we have several other programs that we are pursuing that we believe will provide significant growth opportunities for the Company leading into 2010. Some of those programs are related to the

U.S. multiyear programs, but also the programs related to our Integrated Navigation and Tactical System technology that we hope to be able to share some news with the market in the short term.

DEV BHANGUI: Okay, and then you also, when you were making some commentary early on, you said that when you think about the delineation of awarded $17 million and signed $5 million in this particular quarter that just went by. Then you said next 12 to 18-months you would give a figure which was a figure of so many contracts in millions to be awarded. Can you just tell me what the figure was? I probably missed it.

KEN KIRKPATRICK: We had stated that we have built a qualified sales funnel now that exceeds $130 million, of which, it is made up of programs and projects that we believe will be closed off in the next 12 to 18-months.

DEV BHANGUI: Okay, so when you are talking $130 million being sales funnel, it is as good as you guys don't have any competitors. It is going to come to you. It is only going to go to various processes or process stages in terms of the sales funnel being converted, a portion of that being converted into awarded contracts and then -- sorry, awards, and then awards turning into contracts and then contracts turning into revenue. Is that correct?

KEN KIRKPATRICK: No, the $130 million in our sales funnel, qualified sales funnel, those are programs that we have spent a lot of effort in qualifying and positioning the Company to win, but a good component of them are going to be competitive contracts, some of which we can win and some that we won't win.

The awarded contracts of $17 million that I referenced, those are contracts that the only unknown primarily is time. Those are contracts where we know the contract will be coming to us. And following contract negotiations, and related activities, that will turn into signed contracts and will turn into revenues for the Company.

DEV BHANGUI: Okay, and I guess the one component of my earlier question was in terms of margins. For this particular half of the year that has gone by, you are essentially looking at 30%, 30.5% for the six months. And if you compare the previous year, 2008, we had, I guess for the overall year we are looking at about 6 points up 6, 7 points up margin. So it seems to be that given the mix in the second half, you're confident you will be either there or probably a little bit higher than that, given the visibility of whatever is out there?

KEN KIRKPATRICK: We see the last six months of the year having a significantly higher revenue base from our Marine business, which tends to generate higher gross margins. And based on that we believe that our average gross margins in the last six months will actually go up, obviously from the first six months.

DEV BHANGUI: One last question and then I will step down and come back in the queue. Is in terms of the board program or this kind of special vessels program that you're talking about, you said that your revenue per vessel is going up like fivefold, and also the number of vessels that you can target are higher and the sales cycle is shorter. And you, I think, alluded to one potential Middle East customer.

How many such customers are there following this Middle East customer in close proximity in terms of time? And what is the order of addressable market? If you can put some -- if you can wrap some arms around it and size it for us that will be great.

KEN KIRKPATRICK: I would say if you looked at the market, to answer the first part of the question is; the reason we are confident that we will be able to increase our revenue per platform is because we have developed a system that integrates three separate capabilities that meets a very demanding requirement. And we are seeing clear evidence in business that we are pursuing that we can achieve that.

As it relates to the number of vessels, the historical focus of the Company was selling systems into major platforms. What is happening now around the world is because of the type of threat, national security countries are going forward and they are building thousands of these smaller patrol vessels to support more coastal and port security related activities. So what that creates is an opportunity for us to step into that space, and there is a significant increase in the number of platforms now available.

These are also well-established programs. This, I think, is an important point to make, is with some of our other technologies we go through a cycle of introducing disruptive technologies that is convincing a customer that it would add tremendous value. We work through that process and it gets there, but it takes a little longer.

In this market -- in this market opportunity, you have preplanned budgets and programs that are ramping up to build X number of patrol vessels. They have a requirement today for an integrated navigation system. We are stepping into that market with a much more advanced military capability at a competitive price to what they are currently paying today for a basic, what I would call, a commercial grade integrated navigation system.

So again these are well-established programs that are funded, that are ramping up, that we actually can step in and offer a superior solution for a competitive price. That is becoming very clear to us that it is being received very well in that marketplace. And hence our confidence that we are going to show some significant success in the short term.

DEV BHANGUI: Thanks. I will fall back in line.

OPERATOR: We have a follow-up question from Dev Bhangui, of Haywood Securities.

DEV BHANGUI: Just in terms of -- I guess a question for Peter in terms of this commentary that the Company had in terms of the Canadian revolving facility and the current facility in the U.S. and so on, how much amount needs to be paid?

And I guess, I just missed the exact number in terms of a cash flow that was generated in this particular quarter. Peter, you said it was worth about $2 million, right?

PETER HUNTER: You're asking how much is outstanding on the U.S. banking facility?

DEV BHANGUI: Yes, and why -- I mean, you guys seem confident that you will be able to amalgamate the two facilities and have, I guess, a new facility which can pay back the U.S. bank and then still you will have some kind of cushion in terms of operating flexibility going forward. If you can just detail a little bit about that, that would be great.

PETER HUNTER: Currently we have in Canada a $3 million credit facility that is not being used. And in the U.S. we owe the bank $604,000 that has been frozen on that line of credit, and they would like to be repaid by the end of August.

In the simplest of approaches to this situation, we can just write a check from our Canadian facility and retire the U.S. facility and it's finished with at that point. What we are trying to do at this point is negotiate a consolidated facility with our Canadian banker that would en-franchise the security in the U.S. as well. That would seem to be pretty straightforward, but when you get into cross-border security situations it gets a little tricky in the administration of that, and that's taking a little time to work out.

We are also approaching a number of U.S. banks about securing separate and maintaining a separate banking facility down there for our U.S. subsidiary. The U.S. banking market right now is really difficult, and that is proving to be a bit of a challenge, but we still have a number of prospects down there. So that is still one of the possibilities.

As we sit right now I think we can manage with our Canadian facility. And we are still hopeful that we will be able to replace the U.S. facility with an alternate U.S. facility.

DEV BHANGUI: Peter, you don't expect any kind of issues coming from the Canadian financial institution in terms of the fact that, as you mentioned, you are offside in terms of covenants?

PETER HUNTER: I don't think there is going to be anything material on that front developing. I met with the banks last week, and while obviously they would like us to improve that, our covenants, the forecast we've got with them shows that actually happening. I think one of the consequences could be that we could see a slight reduction in our operating line for the next two quarters. But based on our current forecast that doesn't present us any kind of significant problem for us in cash flow.

DEV BHANGUI: Okay. Then one last quick question to Ken, I guess. Ken, given the backend loading in terms of revenues for fiscal '09 what is in store for 2010?

KEN KIRKPATRICK: I think with some of the new market opportunities and the transition of some of our new technologies to actually revenue-generating projects, I think the outlook for 2010 is looking very positive. Where, as you know, we don't provide guidance, but I think we have everything in place to move into 2010 in a very positive, upward direction.

DEV BHANGUI: Okay. But just in terms of talking conceptually, do you think you will be able to be in 2010 -- I am not saying that it's a guidance -- but is there an expectation given the ramp and given the multimillion dollar contracts that you talked about, that you guys will be over your breakeven point?

KEN KIRKPATRICK: Oh, yes, yes, absolutely.

DEV BHANGUI: Thank you for taking my questions. All the best.

OPERATOR: That concludes today's question-and-answer period. I will now turn the call over to Mr. Kirkpatrick for any closing comments.

KEN KIRKPATRICK: Thank you for joining us today. We look forward to speaking with you again at our third-quarter conference call.