STRATESEC INC
Form 10-Q
November 14, 2001

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended September 30, 2001

Commission File Number: 1-13427

STRATESEC INCORPORATED

State of Incorporation: Delaware I.R.S. Employer I.D.: 22-2817302

7544 Fullerton Court
Springfield, Virginia 22153
(703) 912-8704

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days.

Yes X No

There were 10,279,964 shares of Common Stock, par value $0.01 per share, outstanding at November 9, 2001.

STRATESEC INCORPORATED

Quarter ended September 30, 2001

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Part I. Financial information

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

STRATESEC INCORPORATED
BALANCE SHEETS

	December 31, 2000*
ASSETS	
Current assets:	
Cash and cash equivalents	$ 887,214
Accounts receivable, net of allowance for doubtful accounts of $350,000 in 2000 and $545,000 in 2001	3,925,536
Costs and estimated earnings in excess of billings of uncompleted contracts	4,615,240
Inventory, net of allowance of $70,000 in 2000 and 2001	370,882
Other receivables	28,124
Prepaid expenses	45,150
Total currents assets	9,872,146
Property and equipment, net	675,913
Note Receivable from Stockholder	327,277
Other assets	124,068
	$ 10,999,404

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities:	
Accounts payable	$ 3,120,396
Accrued expenses and other	1,020,746
Income taxes payable	1,245,000
Bank and other lines of credit	2,331,555
Billings in excess of costs and estimated earnings on uncompleted contracts	137,309
Capital lease obligations	69,642
Total current liabilities	$ 7,924,648
Long-term liabilities:	
Capital lease obligations, less current maturities	22,616
Shareholders' equity:	
Common stock, $0.01 par value per share; authorized 20,000,000 shares; 10,280,043 issued and 10,279,964 outstanding shares in 2000 and 2001	102,800
Treasury stock 79 shares in 2001	(164)
Additional paid-in capital	24,279,914
Accumulated deficit	(21,330,410)
Total shareholders' equity	3,052,140
Total liabilities & shareholders' equity	$ 10,999,404

* Derived from audited financial statements as of December 31, 2000.

STRATESEC INCORPORATED
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended September 30,		Nine Mont[hs Ended] Septemb[er 30,]
	2000	2001	2000
Earned Revenue	$ 7,812,346	$ 1,694,650	$ 18,665,550
Cost of earned revenue	5,127,337	1,025,430	11,661,441
Gross profit	2,685,009	669,220	7,004,109
Reserve-bad debt expense	281,171	(200,000)	281,171
Selling, general and administrative expenses	2,502,588	1,452,527	5,044,706
Operating income (loss)	(98,750)	(583,307)	1,678,232
Interest and financing fees	(120,145)	(52,613)	(321,097)

Interest and other income	45,615	204,956	74,266
Net income (loss)	$ (173,280)	$ (430,961)	$ 1,431,401
Net income (loss) per share--basic	$ (0.02)	$ (0.04)	$ 0.14
Net income per share--diluted	--	$ --	$ 0.14
Weighted average common shares Outstanding-basic	10,279,131	10,279,964	9,941,397
Weighted average common shares Outstanding-diluted	--	--	10,198,783

STRATESEC INCORPORATED
STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Month Septemb 2000
Cash flows from operating activities:	
Net income (loss)	$ 1,431,401
Adjustments to reconcile net income (loss) to net cash used in operating activities:	
Depreciation and amortization	206,688
Bad debt expense	281,171
Changes in operating assets and liabilities:	
Accounts receivable	(3,049,586)
Costs and estimated earnings in excess of billings on uncompleted contracts	(878,368)
Inventory	(739,792)
Other receivables	--
Other current assets	(23,702)
Other assets	(3,485)
Accounts payable	(203,756)
Accrued expenses and other	404,353
Income taxes payable	750,000
Billings in excess of costs and estimated earnings on uncompleted contracts	(2,952,086)
Total adjustments	(6,208,563)
Net cash provided (used) by operating activities	(4,777,162)

Cash flows from investing activities:		
Acquisition of plant and equipment	(147,163)	
Net cash provided (used) by investing activities	(147,163)	
Cash flows from financing activities:		
Proceeds from line of credit	1,082,560	
Proceeds from private placement of common stock	2,610,405	
Dividends paid	(1,277,069)	
Principal payments on capital lease obligations	(58,915)	
Purchase of treasury stock	(203,250)	
Net cash provided (used) by financing activities	2,153,731	
Net increase (decrease) in cash and cash equivalents	(2,770,594)	
Cash and cash equivalents at beginning of period	3,084,443	
Cash and cash equivalents at end of period	$ 313,849	$
Supplemental Disclosures of Cash Flow Information:		
Cash paid for:		
Interest expense	$ 305,024	$
Income tax	$ --	$

NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

The unaudited balance sheet as of September 30, 2001 and unaudited statement of operations and statement of cash flows for the nine months ended September 30, 2000 and 2001 are condensed financial statements prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Accordingly, they omit certain information included in complete financial statements and should be read in conjunction with the financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000 filed with the Securities and Exchange Commission on March 30, 2001.

In the opinion of the Company, the unaudited financial statements at September 30, 2001 and for the three and nine months ended September 30, 2000 and 2001 include all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation of the financial position and results of operations for such periods. Results of operations for the three and nine months ended September 30, 2001 are not necessarily indicative of results to be expected for the full year.

On November 30, 2000, the Company acquired Security Systems Integration, Inc. (SSI) in a business combination accounted for as a pooling of interests. In the transaction, SSI merged with a wholly owned subsidiary of the Company, which then merged into the Company. The Company exchanged 1,650,000 in newly issued shares and 350,000 in treasury shares of its common stock for all of the outstanding stock of SSI.

2. Cost and Estimated Earnings on Uncompleted Contracts and Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts

Cost and estimated earnings in excess of billings on uncompleted contracts, as well as the related billings in excess of costs and estimated earnings on uncompleted contracts, represent revenue recognized on long-term fixed-price contracts based on the percentage-of-completion method less the related billings to date. Revenue recognized in excess of billing is included in the asset balance and billings in excess of recognized revenue is included in the liability balance.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This discussion and analysis of the Company's financial condition and historical results of operations should be read in conjunction with the condensed financial statements and the related notes included elsewhere in this report.

Overview

The Company is a single-source provider of comprehensive, technology-based security solutions for medium and large commercial and government facilities in the United States and abroad. The Company offers a broad range of services, including: (i) consulting and planning; (ii) engineering and design; (iii) systems integration; and (iv) maintenance and technical support.

The Company attributes its recent poor financial results to continuing poor economic conditions, particularly the reduction in capital expenditures by business. Additionally, the Company's government business continued to be significantly lower than the previous year as a result of a change in mission of the Company's principal government customer. The Customer moved to a research and development mission instead of a system procurement mission. As a result of the continuing reduction in capital spending by the commercial customers and the need to replace the principal government customer, the Company's revenue was less than 25% of the revenue of the third quarter in 2000. The Company was able to improve gross margins to 39% by using its credit facility to purchase material directly from the manufacturer at significant discounts to the prices charged by distributors. The Company can continue to generate gross margins in excess of 35% so long as the bank provides a sufficient line to allow purchases of material from the manufacturer. The Company was also able to invoice its customers for $200,000 of the amounts reserved in the previous quarter. The Company will continue to recover the amounts reserved for bad debt.

During the third quarter selling, general and administrative expenses before extraordinary items was $384,000 per month. The Company incurred additional expenses during the quarter as it continued to terminate employees. In addition, the Company expanded its presence in California to begin replacing the lost revenue from its existing customer base. The expansion in California was funded through overhead expenses for two months in the quarter at a rate of $40,000 per month until sufficient revenue in the region could be generated to cover the expansion. In addition, a one-time expense of $300,000 was booked to record consulting fees associated with the government business.

The Company is continuing to reduce overhead costs to adjust to the level of revenue. The revenue stabilized in the third quarter and based on the events of September 11, the Company expects revenue to begin to increase during the fourth quarter. The Company's goal is to reduce overhead costs sufficiently to be break-even at a monthly revenue rate of $600,000 and then control the costs to insure profitability as the Company's revenue increases beyond $600,000 per month.

The Company is also continuing to search for additional working capital to allow it to address old debt and to provide capital required to support growth. The Company's sales force have identified a significant number of sales opportunities that are expected to be awarded in the fourth quarter of 2001 and the first quarter of 2002. If the working capital is in place to allow the Company to close these opportunities and efficiently execute the projects, the Company expects to return to profitability as the revenue increases beyond $600,000 per month.

The Company derives its revenues primarily from long-term, fixed-price contracts. Earnings are recognized based upon the Company's estimates of the cost and percentage of completion of individual contracts. Earned revenues equal the project's total contract amount multiplied by the proportion that direct project costs incurred on a project bear to estimated total direct project costs. Project costs include direct labor and benefits, direct material, subcontract costs, project related travel and other direct expenses.

Clients are invoiced based upon negotiated payment terms for each individual contract. Terms usually include a 25% down payment and the balance as stages of the work are completed. Maintenance contracts are billed either in advance, monthly, or quarterly. As a result, the Company records as an asset, costs and estimated earnings in excess of billings, and as a liability, billings in excess of costs and estimated earnings.

Results of Operations

The following table sets forth the percentages of earned revenues represented by certain items reflected in the Company's statements of operations:

	Three Months Ended September 30,		Nine Mo Septe
	2000	2001	2000
Earned revenues	100.0%	100.0%	100.0%
Cost of earned revenues	65.6	60.5	62.5
Gross profit	34.4	39.5	37.5
Reserve for bad debt	3.6	(11.8)	1.5
Selling general and administrative expenses	32.0	85.7	27.0
Operating income (loss)	(1.3)	(34.4)	9.0
Interest and financing fees	(1.5)	(3.1)	(1.7)

Interest and other income................................	0.6	12.1	0.4
Net income (loss).....................................	(2.2)%	(25.4)%	7.7%

Three Months Ended September 30, 2001 Compared With Three Months Ended September 30, 2000

Revenues decreased by 78% from $7.8 million in the three months ended September 30, 2000 to $1.7 million in the three months ended September 30, 2001. The decrease was due primarily to capital spending reductions by existing customers and the lack of working capital to execute existing contracts.

Cost of earned revenues decreased from $5.1 million in the three months ended September 30, 2000 to $1.0 million in the three months ended September 30, 2001, primarily due to the decrease in revenues. Gross margin increased from 34.3% in the 2000 period to 39.4% in 2001. Third quarter revenue had a larger proportionate number of price-competitive contracts than the historical average. As the ratio of non-competitive contracts to price-competitive contracts moves back to the norm, margins should increase. In addition, the lack of sufficient working capital caused inefficiencies in the execution of contracts. [Margin seems to have improved yet discussion explains why it is low]

Selling, general and administrative expenses decreased 42% from $2.50 million in the three months ended September 30, 2000 to $1.45 million in the three months ended September 30, 2001. The decrease was primarily due to costs associated with the reduction of the workforce.

Interest expense and financing fees decreased from $0.12 million in the three months ended September 30, 2000 to $0.05 million in the three months ended September 30, 2001.

Net income decreased from a net loss of $0.1 million in 2000 to net income of $6.4 million in 2001. The decrease was due to the decrease in revenue and gross margins.

Nine Months Ended September 30, 2001 Compared With Nine Months Ended September 30, 2000

Revenues decreased by 58% from $18.7 million in the nine months ended September 30, 2000 to $7.8 million in the nine months ended September 30, 2001. The decrease was due primarily to capital spending reductions by existing customers and lack of working capital to execute existing contracts.

Cost of earned revenues decreased from $11.7 million in the nine months ended September 30, 2000 to $5.1 million in the nine months ended September 30, 2001, primarily due to the decrease in revenues. Gross margin decreased from 37.6% in the 2000 period to 35.0% in 2001. The lack of sufficient working capital caused inefficience in the execution of contracts.

Selling, general and administrative expenses decreased from $5.0 million in the nine months ended September 30, 2000 to $4.1 million in the nine months ended September 30, 2001. The decrease was primarily due to cost associated with reduction of the workforce.

Interest expense and financing fees increased from $0.32 million in the nine months ended September 30, 2000 to $0.30 million in the nine months ended September 30, 2001. The growth in interest was due to increased use of line of credit as compared to 2000 when private equity funds were used.

Net income decreased from a net income of $1.4 million in 2000 to net loss of $3.6 million in 2001. The decrease was due to the decrease in revenue and gross margins.

Liquidity and Capital Resources

The Company's principal capital requirements are increased working capital needed to support its business and reduce outstanding accounts payable. The Company currently is funding its working capital requirements with cash generated by operations and a receivables factoring facility with a financial institution. During the three months ended September 30, 2001, operations used cash of $2.3 million, primarily due to the Company's loss. As of September 1, 2001 the Company had $0.2 million in unrestricted cash. During the quarter the Company used its credit line as well as extending payables with vendors to provide the working capital required. As a result of extending payables, the Company has moved to a cash basis with several major vendors which will constrain revenue recognition until additional working capital is in place. The cash balances going forward will be reduced by the need to immediately fund the acquisition of material from vendors until outstanding payables can be reduced as a result of obtaining additional working capital. The Company is seeking additional financing to reduce outstanding aged accounts payable and to provide the working capital to fund the increase in sales projected for the fourth quarter of 2001. In addition, the Company has contracted with F&H Financial to renegotiate amounts owned to vendors and expects working capital requirements to be reduced as a result.

This Form 10-Q includes certain statements that may be deemed to be "forward-looking statements" within the meaning of Section 27A of the Securities Act. All statements, other than statements of historical fact, included in this Form 10-Q that addresses activities, events, or developments that the Company expects, projects, believes, or anticipates will or may occur in the future, including matters having to do with existing or future contracts, the Company's ability to fund its operations and repay debt, business strategies, expansion and growth of operations and other such matters, are forward-looking statements. These statements are based on certain assumptions and analyses made by our management in light of its experience and its perception of historical trends, current conditions, expected future developments, and other factors it believes are appropriate in the circumstances. These statements are subject to a number of assumptions, risks and uncertainties, including general economic and business conditions, the business opportunities (or lack thereof) that may be presented to and pursued by the Company, the Company's performance on its current contracts and its success in obtaining new contracts, the Company's ability to attract and retain qualified employees, and other factors, many of which are beyond the Company's control. You are cautioned that these forward-looking statements are not guarantees of future performance and that actual results or developments may differ materially from those projected in such statements.

PART II. OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

a. Exhibits

11.1 Calculation of Net Income (Loss) Per Share

b. Reports on Form 8-K.

None

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

STRATESEC INCORPORATED

/s/BARRY MCDANIEL

Barry McDaniel
Chief Operating Officer

November 14, 2001