STRATESEC INC
Form 10-Q
August 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 June 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 August 7, 2001.

2

STRATESEC INCORPORATED

Quarter ended June 30, 2001

Index

Page

4

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 $46,000 in 2001	3,953,660
Costs and estimated earnings in excess of billings on uncompleted contracts	4,615,240
Inventory, net of allowance of $70,000 in 2000 and 2001	370,882
Advance to officer	--
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 STOCKHOLDERS' DEFICIT	
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
Commitments and contingencies	
Stockholders' Deficit	
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 stockholders' deficit	3,052,140
Total liabilities and stockholders' deficit	$ 10,999,404

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

STRATESEC INCORPORATED
STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30, 2000	Three Months Ended June 30, 2001	Six Month June 2000
Earned Revenues	$ 6,511,291	$ 1,688,322	$ 10,853,204
Cost of earned revenue	3,847,303	1,397,257	6,534,104
Gross profit	2,663,988	291,065	4,319,100
Reserve - bad debt expense		2,200,000	
Selling, general and administrative expenses	1,145,280	1,195,240	2,542,118
Operating income (loss)	1,518,708	(3,104,175)	1,776,982

Interest and financing fees	(115,527)	(191,909)	(200,952)
Interest and other income	7,611	3,234	28,651
Net income (loss)	$ 1,410,792	$ (3,292,850)	$ 1,604,681
Net income (loss) per share--basic	$ 0.14	$ (0.32)	$ 0.16
Net income per share--diluted	$ 0.13	$ N/A	$ 0.16
Weighted average common shares outstanding-basic	10,300,488	10,279,964	9,770,675
Weighted average common shares outstanding-diluted	10,766,842	N/A	10,064,197

STRATESEC INCORPORATED
STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months June 2000
Cash Flows from Operating Activities:	
Net income (loss)	$ 1,604,681
Adjustments to reconcile net income (loss) to net cash used in operating activities:	
Depreciation and amortization	101,234
Reserve - bad debt expense	--
Changes in operating assets and liabilities	
Accounts receivable	(2,090,917)
Costs and estimated earnings in excess of billings on uncompleted contracts	(661,790)
Inventory	(461,086)
Advance to officer	--
Other current assets	(22,839)
Other assets	(3,550)
Accounts payable	487,442
Accrued expenses and other	26,205
Income taxes payable	--
Billings in excess of costs and estimated earnings on uncompleted contracts	23,481
Total adjustments	(2,601,820)

Net cash used in operating activities	(997,139)	
Cash Flows from Investing Activities:		
Acquisition of plant and equipment	(111,889)	
Net cash used in by investing activities	(111,889)	
Cash Flows from Financing Activities:		
Proceeds from line of credit	649,703	
Proceeds from private placement of common stock	2,607,282	
Dividends paid	(2,119,488)	
Principal payments on capital lease obligations	(42,004)	
Purchase of treasury stock	(203,250)	
Net cash provided by financing activities	892,243	
Net increase (decrease) in cash and cash equivalents	(216,785)	
Cash and cash equivalents at beginning of period	3,084,443	
Cash and cash equivalents at end of period	$ 2,867,658	$
Supplemental Disclosures of Cash Flow Information:		
Cash paid for:		
Interest expense	$ 200,952	$
Income tax	$ --	$

NOTES TO FINANCIAL STATEMENTS

1. Basis of Presentation

The unaudited balance sheet as of June 30, 2001 and unaudited statement of operations and statement of cash flows for the three months ended June 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 June 30, 2001 and for the three and six months ended June 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 six months ended June 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 poor financial results to overall economic conditions, particularly the decline in capital expenditures by business and the distressful conditions of the telecom sector, the Company's major client base. Furthermore, the Company wrote off $591,000 of amounts owed due to renegotiated contracts with four customers that reduced the amounts to be paid on completed contracts. The Company also reserved $1,609,000 to bring the total of write offs and reserves to $2,200,000. The additional $1,609,000 accounts for all amounts that the Company expects to potentially have difficulty collecting. The potential difficulties relate to possible additional contract reductions, and payment disputes with certain customers. The Company chose to be conservative and reserve an amount sufficient to address the most pessimistic outcome of all potential disputes. Additionally, the Company was inhibited from further developing new commercial and government business due to insufficient available working capital.

The Company has continued to reduce overhead costs, renewed its asset-based bank credit line, and has made certain adjustments in its business model. These adjustments include new policies regarding the payment, by clients, for procured material and equipment. Additionally, the Company will focus heavily on building its maintenance and technical support business, which provides recurring revenue and is less affected by overall economic conditions.

By the end of the second quarter, the Company had reduced its selling, general and administration expenses before extraordinary items to $341,000 per month. Based upon the 33% average gross margin for the first six months, the

Company estimates that its annual break-even revenue amount is $12,400,000. The Company is continuing to reduce overhead costs and expects to reduce its selling, general and administration expenses by an additional 10% in the third quarter, those reductions will lower the annual break-even another $1,000,000 to $11,400,000.

The Company has implemented the following additional initiatives to improve future performance:

1) It has renewed its asset-based credit line with its bank.
2) It is working with vendors to negotiate terms for continued material purchases for new contracts.
3) It has continued discussions with investor groups that are interested in providing the necessary working capital.
4) It has negotiated more favorable terms with some key customers regarding payment for high dollar-value material purchases.

The Company has a very senior sales force, which has identified a significant number of near-term sales opportunities. With the cost reductions and initiatives described above in place, the Company is positioned to be more profitable, require less working capital and have much lower break-even point. If sufficient working capital is obtained to address outstanding debt with current vendors, the Company believes that it can generate sufficient operating cash flow to execute enough additional business to achieve profitability going forward.

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 June 30,		Six Mon Jun
	2000	2001	2000

Earned revenues	100.0%	100.0%	100.0%
Cost of earned revenues	59.1	82.8	60.2
Gross profit	40.9	17.2	39.8
Bad debt expense	--	130.3	--
Selling general and administrative expenses	17.6	70.8	23.4
Operating income (loss)	23.3	(183.9)	16.4
Interest and financing fees	(1.8)	(11.4)	(1.9)
Interest and other income	0.1	0.2	0.3
Net income (loss)	21.6%	(195.1)%	14.8%

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

Revenues decreased by 74% from $6.5 million in the three months ended June 30, 2000 to $1.7 million in the three months ended June 30, 2001. The decrease was due primarily due to capital spending reductions by existing customers and the lack of working capital to execute existing contracts.

Cost of earned revenues decreased from $3.8 million in the three months ended June 30, 2000 to $1.4 million in the three months ended June 30, 2001, primarily due to the decrease in revenues. Gross margin decreased from 40.9% in the 2000 period to 17.2% in 2001. Second 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 will increase. In addition, the lack of sufficient working capital caused inefficiencies in the execution of contracts.

Selling, general and administrative expenses increased 4.4% from $1.14 million in the three months ended June 30, 2000 to $1.19 million in the three months ended June 30, 2001. The increase was primarily due to costs associated with the reduction of the workforce.

The $2.2 million item reflects write offs and reserves for negotiated reductions with certain customers for reductions in the amount to be paid on existing contracts. This line also includes a reserve for all potential additional reductions in contracts and payment disputes, as a result of the severe reduction in capital spending budgets with key customers and contract execution issues caused by lack of sufficient working capital by the Company.

Interest expense and financing fees increased from $0.12 million in the three months ended June 30, 2000 to $0.19 million in the three months ended June 30, 2001. The growth in interest was due to increased use of the 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 $3.3 million in 2001. The decrease was due to the decrease in revenue and gross margins.

Six Months Ended June 30, 2001 Compared With Six Months Ended June 30, 2000

Revenues decreased by 43% from $10.9 million in the six months ended June 30, 2000 to $6.2 million in the six months ended June 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 $6.5 million in the six months ended June 30, 2000 to $4.1 million in the six months ended June 30, 2001, primarily due to the decrease in revenues. Gross margin decreased from 39.8% in the 2000 period to 33.3% in 2001. The lack of sufficient working capital caused inefficience in the execution of contracts.

Selling, general and administrative expenses increased 8% from $2.5 million in the six months ended June 30, 2000 to $2.7 million in the six months ended June 30, 2001. The increase was primarily due to cost associated with reduction of the workforce.

Interest expense and financing fees increased from $0.20 million in the six months ended June 30, 2000 to $0.30 million in the six months ended June 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 $1.6 million in 2000 to net loss of $3.1 million in 2001. The decrease was due to the decrease in revenue and gross margins.

Liquidity and Capital Resources

Through 1997, the Company funded its capital requirements with cash generated by operations, private equity offerings, and its initial public offering in October 1997. During April 1998, the Board of Directors approved the issuance of up to $2.0 million of convertible subordinated debentures to provide additional working capital. As of May 13, 1998, the Company had issued and sold $1,450,000 of debentures. The Company sold an additional $400,000 of debentures as of August 25, 1998. The debentures have an interest rate of 10%, are due on December 31, 1999 and are convertible into common stock of the Company at $8.50 per share. In addition, the holders were issued 100 warrants for each $1,000 of investment with an exercise price of $2.50 and a term of three years.

During February 1999, the $1.9 million the Company was required to post as collateral for a bond pending its appeal of a law suit was released when the trial court's judgment was reversed. The Company paid off $0.9 million of the convertible subordinated debentures during the first quarter 1999. In September 1999 all of the holders of the remaining subordinated debentures agreed to exchange their notes for the Company's common stock valued at $1.50 per share. Additionally, to support the significant increase in business, the Board approved a private placement of 500,000 shares at $1.50 per share, which was subsequently increased to 1,204,855 shares. The Board also approved the sale of up to 21% equity in the Company to a minority partner. NetCom Solutions International subsequently purchased approximately 8% or 700,000 shares of the Company at $1.50 per share. As of March 2000, $930,000 of debt was converted to equity, $1.8 million was received by the private placement and $1.05 million in the form of cash and a short-term note was received from the sale of a minority interests.

The Company's principal capital requirements are increased working capital needed to support its growth 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. As of June 1, 2001 the Company had $0.8 million in unrestricted cash and working capital of $0.3 million. 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 2001. In addition, the Company has contracted with F&H Financial to renegotiate amounts owed 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 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

27.1 Financial Data Schedule

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

EXHIBIT 11
Calculation of Weighted Average Shares
Outstanding for Net Income (Loss) Per Share

	Six Months June 3
	2000
Earnings:	
Net Income (Loss)..	$ 1,604,681
Shares:	
Weighted Average Number of Common Shares Outstanding..	9,770,675
Average Common Shares Outstanding and Equivalents.........................	10,064,197
EPS:	
Net Income (Loss) Per Share-Basic..	$ 0.16
Net Income (Loss) Per Share-Diluted..	$ 0.16

n/a-- Calculation would be anti-dilutive for 2001.