STRATESEC INC
Form 10-Q
May 14, 2002

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2002

Commission File Number: 1-13427

STRATESEC INCORPORATED

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

14360 Sullyfield Circle Ste. B
Chantilly, Virginia 20151
(703) 631-5163

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 10,401,472 shares of Common Stock, par value $0.01 per share, outstanding at May 14, 2002.

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STRATESEC INCORPORATED

QUARTER ENDED MARCH 31, 2002

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STRATESEC INCORPORATED
BALANCE SHEETS

	December 31, 2001*	March 31, 2002 (Unaudited)
ASSETS		
Current Assets		
Cash and cash equivalents	$ 238,201	$ 102,400
Accounts receivable, net of allowance for doubtful accounts of $750,000 in 2001 and 2002	4,108,692	4,267,787
Costs and estimated earnings in excess of billings on uncompleted contracts	582,698	198,355
Inventory, net of allowance of $400,000 in 2001 and 2002	190,606	234,018
Other current assets	70,728	70,558
TOTAL CURRENT ASSETS	5,190,925	4,873,098
Property and Equipment, net	483,904	435,034
Other Assets	121,764	121,764
	$ 5,796,593	$ 5,429,896
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	$ 2,287,718	$ 1,787,447
Accrued expenses and other	304,961	713,160
Income taxes payable	955,954	955,954
Bank and other lines of credit	6,325,490	7,520,540
Billings in excess of costs and estimated earnings on uncompleted contracts	276,984	169,984
Capital lease obligations	22,615	6,004
TOTAL CURRENT LIABILITIES	10,173,722	11,153,089
Long-Term Liabilities		
Capital lease obligations, less current maturities		
Commitments and Contingencies	-	-
Shareholders' Equity		
Common stock, $0.01 par value per share; authorized		

20,000,000 shares; 10,401,471 issued and 10,392,550 outstanding shares in 2001 and 2002	104,015	104,015
Treasury stock, 8,891 shares in 2001and 2002	(18,533)	(18,533)
Additional paid-in capital	24,363,700	24,363,700
Accumulated deficit	(28,826,311)	(30,172,375)
	(4,377,129)	(5,723,193)
	$ 5,796,593	$ 5,429,896

* Derived from audited financial statements as of December 31, 2001.

The accompanying notes are an integral part of these statements.

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STRATESEC INCORPORATED
STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended March 31, 2001	2002
Earned revenues	$ 4,461,804	$ 646,922
Cost of earned revenues	2,705,468	583,831
Gross profit	1,756,336	63,091
Selling, general and administrative expenses	1,496,152	1,070,842
Operating income (loss)	260,184	(1,007,751)
Other income (expense)	(104,701)	(338,313)
Net income before income tax provision	155,483	(1,346,064)
Income tax provision		
Net income (loss)	$ 155,483	$ (1,346,064)
Net income (loss) per share - basic	$ 0.02	$ (0.13)
Net income per share - diluted	$ 0.01	$ n/a
Weighted average common shares outstanding - basic	10,279,780	10,392,550
Weighted average common shares outstanding - diluted	10,514,364	n/a

The accompanying notes are an integral part of these statements.

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STRATESEC INCORPORATED
STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three Months Ended March 31, 2001	Three Months Ended March 31, 2002
Cash Flows from Operating Activities:		
Net income (loss)	$ 155,483	$ (1,346,064)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	54,619	52,690
Changes in operating assets and liabilities:		
Accounts receivable	(403,811)	(159,095)
Costs and estimated earnings in excess of billings on uncompleted contracts	(809,601)	384,363
Inventory	(443,200)	(43,412)
Other current assets	(166,332)	170
Other assets	(1,519)	
Accounts payable	125,086	(500,271)
Accrued expenses and other	510,861	408,199
Billings in excess of costs and estimated earnings on uncompleted contracts		(107,000)
Total adjustments	(1,133,357)	35,644
Net cash provided (used) by operating activities	(977,874)	(1,310,420)
Cash Flows from Investing Activities:		
Acquisition of plant and equipment	(54,760)	(3,820)
Net cash provided (used) by investing activities	(54,760)	(3,820)
Cash Flows from Financing Activities:		
Proceeds from line of credit	1,038,005	1,195,050
Principal payments on capital lease obligations		(16,611) -
Net cash provided (used) by financing activities	1,038,005	1,178,439
Net increase (decrease) in cash and cash equivalents	5,371	(135,801)
Cash and cash equivalents at beginning of period	887,214	238,201
Cash and cash equivalents at end of period	$ 892,585	$ 102,400
Supplemental Disclosures of Cash Flow Information:		
Cash paid for:		
Interest expense	$ 104,873	$ 338,476
Income taxes	$ -	$ -

The accompanying notes are an integral part of these statements.

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NOTES TO FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The unaudited balance sheet as of March 31, 2002 and unaudited statement of operations and statement of cash flows for the three months ended March 31, 2001 and 2002 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, 2001 filed with the Securities and Exchange Commission on March 30, 2002.

In the opinion of the Company, the unaudited financial statements at March 31, 2002 and for the three months ended March 31, 2001 and 2002 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 months ended March 31, 2002 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 of 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 following plan addresses management's approach to improving the financial condition of the Company.

Sales remained slow through the first quarter, averaging slightly over $200,000 per month. This was below the $300,000 to $500,000 per month that the Company expected. The reduction was due to a slower restart than anticipated in Texas and continued delays in contract awards. The second quarter will start very slow, but based on sales projections, the Company expects revenue to improve by the end of the second quarter to $800,000 per month. The Company projects sales per month of $1 million by the end of the third quarter and $1.2 million per month by the end of the fourth quarter. To achieve this improvement in sales, the Company has added several major accounts to replace the accounts that froze their capital budgets. For example, we have added Hewitt and Associates, EMC Corporation, Kaiser Permanente, Veritas Software, Clarion Realty, The Washington Metropolitan Transit Authority, Guinette County in Georgia, CMT Construction, San Jose Construction Group, Devcon Construction and American University. In addition, we have restarted projects with EDS, Trammel Crow, Amtrak and several other prior customers.

As of May 15, there are $3 million in projects on which the Company has been informed that it is the vendor of choice, and there are $5.8 million more in high probability proposals outstanding. The Company has contracts on $1.2 million of the $3 million, and has been verbally notified on the other $1.8 million of projects. The Company believes that all of the remaining $1.8 million will be awarded to the Company over the next 60 days but even if 80% of the amount is awarded, there will be $.72 million dollars of new business awarded in June and July. If the company merely maintains that rate of new business, it will significantly improve operating profits.

The Company has also obtained the commitment from its finance company, E.S. Bankest, to finance the material and the cash flow necessary to work as much business as the Company can win; as a result the Company's financial condition should not prevent execution of its projects.

In order to expand its offering and add higher margin revenue, the Company has also added the capability to provide software security products and services to its customers. The Company has software in evaluation at the U.S. Postal Service now for a potential major sale. The Company will add more security software products and services and expects to expand its customer base significantly in this area. The fixed overhead required to support these products and services is very low and the profitability is very high. We expect that the overall Company profitability will be significantly improved as software sales are recorded.

The Company is also in the process of adding products for sale to the federal government to its GSA schedule. Since the Company has its headquarters in the Washington, D.C. suburbs, we expect the business with the federal government to grow over the next 12 months. Security funding for federal government buildings has been increased tremendously since September 11, 2001. The federal government recently allocated the fiscal year 2002 budget, but through March had operated under a condition of no new projects since September 2001. Contacts inside the federal government have informed us that the budgets have now been allocated and we expect sales to the federal government to increase..

The Company has also implemented the following initiatives to reduce its overhead expenses so that break-even revenue will be $600,000 per month:

- Reduced full-time and temporary corporate staff
- Reduced executive management
- Relocated headquarters to shared facilities with Netcom Solutions, a privately held IT company and shareholder of STRATESEC
- Restructured salaries of sales force to lower base and higher commissions
- Consolidated costs (telephones, utilities, etc.) with Netcom Solutions
- Restructured operations to increase use of subcontractors on a fixed price basis

Based on the projected increase in monthly sales and the decrease in overhead, the Company expects to be profitable on a monthly operating basis by the end of June. In order to improve the equity position on its balance sheet, the Company is aggressively exploring mergers and acquisitions with other physical and software security firms as well as pursuing external equity funding. In addition, to reduce the liabilities on its balance sheet, the Company has prepared an offer in compromise to the IRS that will eliminate $930,000 of tax liability, if accepted. The Company also intends to attempt to convert a significant amount of the line of credit debt to equity.

RESULTS OF OPERATIONS

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

	Three Months Ended March 31, 2001	Three Months Ended March 31, 2002
Earned revenues	100.0%	100.0%
Cost of earned revenues	60.6	90.2
Gross profit	39.4	9.8
Selling, general and administrative expenses	33.5	165.5
Operating income (loss)	5.8	(155.8)
Other income (expense)	(2.3)	(52.3)
Net income (loss)	3.5%	(208.1)%

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THREE MONTHS ENDED MARCH 31, 2002 COMPARED WITH THREE MONTHS ENDED MARCH 31, 2001

Revenue decreased by 86% from 4.4 million in 2001 to $.6 million in 2002. The decrease was due to a severe decrease in revenue from existing commercial customers as a result of a freeze or reduction in capital spending in the telecom and information technology (IT) sectors. In addition, ramp up of new commercial customers in other business sectors was slow due to economic conditions. The Government sector revenue from existing customers also declined dramatically and no new Government customers were added.

Cost of revenue decreased from $2.7 million in 2001 to $.5 million in 2002, primarily due to the decrease in revenue. Gross margin decreased from 39.3% in 2001 to 10% in 2002. The gross margin was adversely affected by the trailing costs associated with completion of 2 large Government and one commercial contract.

Selling, general and administrative expenses decreased by 28.4% from $1.5 million in 2001 to $1.0 million in 2002.

Interest expense and financing fees increased from $0.1 million in 2001 to $ 0.4million in 2002. The increase was due to the increased use of line of credit.

Net income decreased from a net income of $0.1 million in 2001 to a net loss of $1.3 million in 2002. This decrease in net income was primarily due to the significant decrease in revenue.

LIQUIDITY AND CAPITAL RESOURCES

During February 1999, the $1.9 million the Company was required to post as collateral for a bond pending its appeal of a lawsuit 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, the private placement and $1.05 million in the form of cash received $1.8 million and a short-term note was received from the sale of a minority interest.

The Company's principal capital requirements are increased working capital needed to support the rebuild of the company.The Company currently is funding its working capital requirements with cash generated by operations and a receivables factoring facility with a financial institution. The Company is seeking additional financing to reduce outstanding aged accounts payable and to provide the working capital to fund the sales projected for 2002. If it is unable to obtain additional financing, its ability to obtain new business and increase revenue may be limited.

PART II. OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits

11.1 Calculation of Net Income 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
President and Chief Executive Officer

May 14, 2002