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Magal Security Systems Ltd.

Fourth Quarter and Year End 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Mike Distler, *Amnx Holdings*

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PRESENTATION

Operator

Greetings and welcome to the Magal Security Systems Fourth Quarter and Year End 2020 Earnings Conference Call.

It is now my pleasure to introduce your host, Brett Maas, of Hayden IR. Thank you, sir. You may begin.

Brett Maas

Thank you, Operator. I'd like to welcome all of you to the conference call and thank Magal's Management for hosting this call. With us on the call today is Dror Sharon, CEO of Magal; and Kobi Vinokur, CFO. Dror will summarize key financial and business highlights, followed by Kobi who will review Magal's financial performance of the fourth quarter and full year. We will then open the call to questions and answers.

Before we start, I would like to point out that this conference call may contain projections or other forward-looking statements regarding future events or future performance of the Company. These statements are only predictions and Magal cannot guarantee that they will in fact occur. Magal does not assume any obligation to update that information. Actual results or events may differ materially from those projected, including as a result of changing market trends, reduced demand and the competitive nature of the security systems industry, the unanticipated and unknown effect of the coronavirus, including on our operations and our clients as well as other risks identified in the documents filed with the Company with the Securities Exchange Commission.

In addition, during the course of this conference call, we will describe certain non-GAAP financial measures, which should be considered in addition to, and not in lieu of comparable GAAP financial measures. Please note that in our press release, we have reconciled our non-GAAP financial measures to the most directly comparable GAAP measures in accordance with Reg G requirements. You can also refer to our website at magalsecurity.com for the most directly comparable financial measures and related reconciliations.

With that, I'd like to turn the call over to Dror. Dror, please go ahead.

Dror Sharon

Okay. Thank you, Brett. I'd like to welcome everyone to our call and thank you for joining us today. I hope that your families and friends are all well and healthy.

Magal Security finished 2020 with a solid fourth quarter that delivered 23% revenue growth, a strong balance sheet and record backlog of $64.3 million. The Company's performance in 2020, a year where we faced challenges due to the COVID-19 pandemic, reflects the strength of our global leadership team and their ability to pivot to productive and successful customer engagement across our vertical markets. The Magal Integrated Solutions sales led the revenue increase in the quarter due to the fulfillment of delayed orders.

Fourth quarter gross margin was 40% and operating income increased 22%, helped by the higher gross margin and slightly lower operating expenses in the quarter. As a result, we delivered 14% EBITDA margin, on par with the fourth quarter last year.

Senstar's fourth quarter revenue was $9.6 million, with 63% gross margin. The segment delivered 22% EBITDA, which demonstrates the operational strength of this business segment. Senstar backlog was $14.3 million in the quarter, up from $8.6 million at this time last year. Senstar's business pipeline has historically been short cycle from purchase order to product of solution delivery; meaning we have begun the year with a lot of momentum.

For the full year, we maintained EBITDA on par with last year at 9%, primarily due to the tight expense control throughout the year. After a one-time cash distribution to shareholders totaling $25 million in December 2020, we ended 2020 with $27 million of cash and cash equivalents and no debt.

Shifting to an overview of the business, despite the COVID-19 challenges and disruptions in 2020, we saw success on numerous fronts. Last March, we appointed new division heads for the Magal Integration Solution or Project division, Mr. Arnon Bram; and for Senstar, our Product division, Mr. Fabian Haubert. The new division heads did a great job leading their teams and delivering new businesses evidenced by the sustained business and new accounts lending during the year.

We have a strong team in place. In 2020, these executives showed their capabilities in a difficult environment. With our global footprint, streamlined management structure and team members on the ground in strategic markets, we were able to pivot and continue our momentum. We saw good traction in our four focus verticals where we received many new purchase orders in the pipeline.

By mid-2020, the Project team had closed new sizable contracts for European and African Turnkey Seaport project. Africa was a productive territory for projects in 2020 with new critical infrastructure contracts awarded for security system design and installation in strategic locations. Magal Integrated Solutions rendered significant contract last fall to install a state-of-the-art integrated security system for the government's principal sites located in one of the largest and most economically developed countries in Africa. In addition, the team landed a three-year maintenance contract for a major African seaport from a recurring customer.

Senstar and Magal Integrated Solutions won a turnkey project for a Mexican VIP resident that features Senstar Symphony, the VMS, and the Magal's FORTIS command control. Our system was chosen for the technical capabilities and flexibility to provide robust solutions that allow security personnel to make effective real-time decisions.

Last August, Senstar was awarded a large military contract to provide equipment to secure deployable military assets used throughout the world. Key to winning this contract was Senstar technology differentiation and the scope of Senstar's offering. Technology was a key differentiator that allows Senstar to continue winning new transactional business with high-profile customers in the logistics, energy and critical infrastructure and correctional sectors throughout 2020.

In February 2021, we announced the divestiture of our Integrated Solutions division. The deal is anticipated to close by the end of the second quarter of 2021. The Project operation divesture will improve the visibility of our business and further strengthen our already strong balance sheet to support the execution of our long-term growth strategy. Senstar's rich customer base and business model with attractive gross margin contribution and the operational efficiency, is highly scalable to deliver long-term shareholder value as a standalone entity.

The Senstar team is working continuously to improve our product line and develop new products that sets an industry standard for quality, innovation and availability. We are committed to focusing our efforts and resources on developing Senstar's industry-leading security technology and expanding its market share, particularly in our four focus verticals. In each of our verticals, Senstar provides unique solutions beyond security. Our goal is to expand sales with tailored security solution features, Senstar's technical (phon) products and software for physical security solution and sell new adjacent solutions that deliver Senstar's core capabilities into each vertical. In 2021, we are implementing key performance indicators, KPIs, and incentivizing our Senstar team on performance in each vertical.

Management has set KPIs to measure sales activity per vertical to develop the sales pipelines and they create personal targets in the vertical. The intent is to improve sales growth while maximizing resources dedicated to the channels. Senstar revenue stream come from three sources: product software and recurring revenue related to services and maintenance. Product is the largest contributor, but we continue to invest in software as well. We are defining solutions to selling hardware and software together to provide effective and efficient solution for our customers and system indicators. An example would be a Perimeter Intrusion Detection System, or PIDS, with Senstar that are designed for easy integration with a wide variety of security systems. This could be simple alarm panel or complex full features VMS with video software analytics or full security management system. By offering APIs and STKs, the software design kit, Senstar solutions are easy to install and work well with existing solutions and hardware. Our technology and the flexibility are key differentiators and a competitive edge we will continue to invest in.

Twenty twenty was a crucial year for the upcoming release of our next-generation of Symphony, Symphony 8, common operation platform with access control that is an all-in-one video security information management solution. Symphony is an open, highly scalable video management system with built-in analytics. The key differentiator for Symphony is its sensor fusion engine, which intelligently combines low level sensor data with video analytics. The system incorporates event algorithm and role-based actions that are unmatched in capability and performance, another expertise that we are working to either develop in-house or acquire a technology that would improve real-time intelligence to optimize decision-making. These features reduced risk and increased operational efficiency with decision ready data for our customers. This would include testing technology and software. We continued to invest in R&D and are currently working on closing an M&A deal. However, the timing of this acquisition is hard to pin down at this time as we wait for legal issues to be resolved.

Post divestiture, we anticipate our business will continue to grow organically and have a stronger balance sheet. We plan to leverage Senstar industry-leading position in the security sector as a technology platform to optimize future strategic acquisition and achieve incremental growth in our global markets.

The Magal brand will remain associated with the Integration Solutions division once it moves over to Aeronautics. After the close of the transaction, we will rebrand our Company under a new name and logo.

In summary, I would like to thank the entire Magal team for their exceptional performance in 2020. I value the dedication and hard work of our global team and appreciate their commitment to our strategy. With our strategic initiatives, strong leadership and enhanced offering combined with some strategic M&A, Senstar is well positioned to continue its growth and improve profitability.

Now I would like to hand the microphone over to Kobi to summarize the financial results. Kobi, please go ahead.

Kobi Vinokur

Thank you, Dror.

Revenue for the fourth quarter of 2020 increased 23% to $29.2 million compared with revenue of $23.8 million in the fourth quarter of 2019. The increase in revenue was primarily due to the timing of the fulfillment of delayed orders from prior quarters. The geographic breakdown as a percentage of revenue for the fourth quarter was as following: Israel, 31% versus 18%; North America, 18% versus 24%; Latin America, 6% versus 4%; Europe, 23% versus 27%; Africa 15% versus 12%; Asia and the rest of the world, 7% versus 15%.

The breakout between Magal's Integrated Solutions and Senstar's Product revenue was 33% product and 67% projects in the quarter. As I mentioned, this quarter, the Projects revenue included some catch-up order fulfillments from previous quarters. As a result, the Product versus Project revenue mix was unusually biased towards projects. Revenue from Magal's Integrated Solutions projects increased by 57% related while the Senstar Product division decreased by 15% compared to the fourth quarter of 2019, primarily due to the weakness in COVID affected APAC and the EMEA regions.

Fourth quarter gross profit was $11.7 million, or 40% gross margin, versus gross profit of $11.4 million, or 48% of revenue in the fourth quarter of 2019. The lower gross margin in the quarter was due to the sales mix with a larger percentage of revenue coming from the Integrated Solutions division.

Our operating expenses were $8.2 million, a 3.6% reduction from the prior year's fourth quarter operating expenses of $8.5 million. The reduction in operating expenses is attributable primarily to a lower R&D and selling and marketing expenses in the current period, which also benefited from governmental subsidies.

Operating income was $3.5 million compared to $2.9 million in the fourth quarter of 2019. Operating income improved compared to the fourth quarter of 2019 due to the impact of the higher revenue and gross profit, coupled with some improved operational efficiencies, primarily related to lower R&D and selling and marketing expenses in the current period.

Financial expenses were $1.5 million compared to zero in the fourth quarter of 2019. This expense is primarily due to the depreciation of the U.S. dollar against the new Israeli shekel in the fourth quarter of 2020, which impacted the valuation of the USD denominated monetary assets held by the Company.

Fourth quarter taxes on income were $2 million compared to $0.6 million in 2019. The increase in tax expenses was driven by a combination of effective blended tax rate related to the various operating jurisdictions and several one-time provisions.

Net loss attributable to Magal's shareholders in the quarter was $648,000, or $0.02 loss per share, versus a net income of $1.8 million, or $0.05 per share in the fourth quarter of the last year.

EBITDA was $4 million, representing an EBITDA margin of 13.6% compared with $3.4 million, representing an EBITDA margin of 14.1% in the fourth quarter of 2019.

For the full year 2020 results, the revenue for the year ended December 31, 2020, was $80.6 million compared with revenue of $86.8 million in the prior year. The 7% decline year-over-year was primarily due to the lower Integrated Solutions division and Senstar Product division revenue throughout the year, mainly related to business disruptions and challenges due to the COVID-19 pandemic. The geographic breakdown as a percentage of revenue for 2020 compared to 2019 is as follows: Israel, 26% versus 22%; North America, 23% versus 23%; Latin America, 6% versus 9%; Europe, 19% versus 22%; Africa, 16% versus 13%; Asia and the rest of the world, 10% versus 11%.

The revenue breakdown between Magal Integrated Solutions division and Senstar Product division was 59% projects and 41% for products. Revenue from Magal's Integrated Solutions division decreased by 5%, while the Senstar Product division decreased by 8%, respectively, year-over-year.

The full year gross profit was $34.6 million, representing gross margin of 42.5%, versus $38.8 million or gross margin of 44.6% last year. The lower gross margin was due to the increased revenue contribution from Magal's Integrated Solutions division, which carries a lower gross margin.

Our 2020 operating expense was $29.2 million, a 10.8% reduction from the $32.7 million last year. Operating income was $5.4 million compared with $6 million in 2019. The decrease in operating income was due to lower revenue and lower gross margin contribution, largely offset by lower operating expenses.

Net income attributable to Magal's shareholders for 2020 was $0.6 million, or $0.06 per share, compared with $2.3 million, or $0.07 per share in 2019. The decline in the net income was primarily attributable to the non-cash financial expenses described above, and tax expense of $3 million compared to a tax expense of $1.6 million in 2019. The higher tax expense is related to a combination of effective blended tax rate related to various operating jurisdictions and several one-time provisions.

In 2020, our EBITDA was $7.3 million, representing an EBITDA margin of 9% compared with $8.1 million, representing an EBITDA margin of 9.4% in 2019.

Cash, short-term deposits and restricted deposits, net of bank debt as of December 31, 2020 was $27.1 million, or $1.18 per share, compared with cash and short-term deposits of $51.6 million, or $2.23 per share as of December 31, 2019. The decrease in the cash balance was primarily due to the payment of cash distribution to shareholders totaling $25 million in December 2020.

Before we move on to the Q&A, I would like to remind listeners of the profile of the Company, which we discussed on the February 10 conference call. We anticipate that the Company, which, upon closing of the integration business sales transaction will be based primarily on Senstar's revenue. It will continue to have a high gross margin contribution and is anticipated to continue growing organically in line with prior years. The Product division represented approximately 41% of the consolidated revenue, yet the segment delivered approximately two-third of the consolidated gross profit.

Historically, Senstar has had a high EBITDA contribution despite carrying a higher percentage of the operating expenses. The operating expenses as a percentage of revenue carried by the Company following the divesture of the Project revenue will be initially higher due to the following reasons. First, the current corporate structure and the public company costs will be borne by Senstar Product division only, while currently they are shared between the two divisions. Secondly, we will see a higher percentage of R&D and sales and marketing expenses out of revenue as compared to the consolidated company. This is in line with the financial characteristic of the growing and scalable tech business operating higher gross margin.

Looking specifically at the R&D expense level, Senstar's R&D budget is supported by a broad portfolio of technology-rich products and has been crucial to its revenue growth. Senstar's R&D during the last 12 months represented 11% of its revenue as compared to 7% of the consolidated company. As Dror mentioned, we continue prioritizing R&D investment because it is an essential differentiator for Senstar. As a result, we anticipate increase in operating expenses as a percentage of revenue for the Company, following the divesture of the Project revenue and with the revenue coming only from Senstar. Although EBITDA margin for 2021 could experience a potential slight and temporary decline, Senstar's EBITDA margin, excluding the corporate expenses, will continue to be in the range of mid to high teens.

In parallel, as the business scales, we expect a continuous improvement in the overall Company's profitability primarily due to Senstar's high gross margin contribution and the operational leverage of the Company, allowing us to grow revenue and gross profit on the basis of the current operating expense. Due to the high gross margin and assuming continued organic growth, up to 55% of the gross margin contribution is expected to fall to the bottom line. With this level of operating leverage, we anticipate in the next couple of years that EBITDA margin for the overall Company, including the corporate structure, will improve and exceed the prior year levels, which have historically been in the range of 8% to 9% for the consolidated company that included the Project business.

Given the low cap ex for Senstar, we also anticipate positive cash flow for the Company. In addition, we plan to augment our growth with strategic acquisitions. For illustrative comparison purposes, would the Project division be divested in the past, our financial metrics for the last two years would look as follows: revenue of $35 million and $37.7 million in 2020 and 2019, respectively; gross margin of 66% and 62%; EBITDA contribution to the public platform of $7.6 million and $5.7 million, and the Company's EBITDA after public company platform costs $4.4 million and $2.8 million in 2020 and 2019, respectively.

We remain focused on deriving the greatest shareholder value from our cash. We continue to prioritize the use of cash on retaining our experienced team critical to supporting our growth. Throughout 2020, our employee headcount remained mostly unchanged; continuing our R&D investments, which I discussed earlier; M&A, our current M&A pipeline targets; technology that leverages existing capabilities, while bringing innovation and new expertise; and finally, evaluating the benefits of dividends to shareholders.

Turning to the balance sheet, immediately post divestiture, the Company will maintain a strong balance sheet with a high net cash position. The transaction strengthens our balance sheet and gives us sufficient capital to execute our long-term growth strategy.

When we report Q1 2021 financial results, Magal Integrated Solutions will be reported as discontinued operations, even though the transaction is expected to close by the end of the second quarter.

That concludes my remarks. We are happy to take your questions now. Operator?

Operator

Thank you. Gentlemen, it appears we have no questions at this time. I would now like to turn the floor—I'm sorry, we did get a question.

Our question is from Mike Disler with Amnax Holdings. Please proceed with your question.

Mike Disler

Yes. Good afternoon, gentlemen. Thanks for taking the call again. Just a couple of quick questions. First, since Q1 seems to be in the books, I was just wondering if you can just comment, provide any comment on how first quarter looked?

Dror Sharon

Hi, Mike, it's Dror. It's a little bit too early to report anything about the quarter at this stage.

Mike Disler

Okay. No problem there. I understand the timing issue. Number two, I think, Kobi, you said something about keeping the large cash on the books, part of it as—obviously, for acquisition, part for dividends, which is the third item, which you've already done quite enough in December. But regarding the use of cash to hold your key employees, I think that was what you said two to three minutes ago. My question, wouldn't it be at least more prudent use of capital in terms of the balance sheet to incentivize those long-term key personnel that you wish to retain with options based on the performance of the price of the future Senstar spin out, whatever we call it, NewCo in the interim, rather than just a pure cash outlay to those folks so that they have the same incentive as the shareholders do?

Kobi Vinokur

Hi, Mike. It's a combination. We do have an ESOP program, ESOP plan in the Company. After the divestiture of the Project division, Magal, obviously, remains a public company, and we definitely have this tool to incentivize certain employees, our leadership to deliver results and benefit from the increase in the stock value. (Multiple Speakers)

Mike Disler

No, go ahead. Sorry. No, I was aware of the plan. Just on a go-forward basis, it seems to me that just further aligning those key personnel. I'm not talking necessarily C-suite, but the R&D folks, which are clearly going to be instrumental in driving revenue growth over the next three to five years. They are aligning their interest so that they remain and are captivated by the allure of building something bigger, better, stronger. That was the only thought there in terms of it's great to put some cash on the table, but the next guy can just put up more cash, and if they have an incentive to stay by investing those options over time and therefore work hard to achieve those goals and accumulate personal satisfaction through a long-term mechanism in addition to the ESOP program that exists. That's all I was getting at. I think you're on the right page there, so…

Kobi Vinokur

Mike, your point is very valid. Actually, my reference in my comments also related to 2020 when as a company that does have cash on the balance sheet, we could actually afford to plan our actions during the pandemic and during the entire crisis, especially if you remember, of course, Q1 2020 with lots of uncertainty about the impact of the COVID-19 crisis, we could afford a reaction, managerial action that first of all, targeted retaining our key technology, commercial, marketing, human capabilities, right? Unlike probably other companies, our R&D teams, commercial teams basically remained unchanged. We didn't take any—we could afford to do different stuff rather than say touching our employees, and we are very proud of it.

Mike Disler

Yes, and I think you should be. My closing comment was going to be that I thought the two of you and the entire team have done a superior job navigating a year and a quarter of potential decimation for a company the size of Magal, but the fact that you were able to not just stay afloat but aggressively move forward, I think, is a real testament to your capabilities, and I'm proud to be a shareholder. I just thought I'd throw that out there as well.

Finally, I look forward to some information, the update on your acquisition trials and tribulations. I'll await the next conference call. Hopefully, there will be some positive news and keep up the good work. I thank you very much for your time.

Dror Sharon

Thanks. Thank you very much, Mike.

Mike Disler

Okay.

Operator

Our next question comes from the line of Sal DeTurris, a Private Investor. Please proceed with your question.

Sal DeTurris

Good morning, gentlemen. Thanks for taking my call. Hey, I just had a quick question on the foreign tax that was withheld on the Magal dividend in December 2020. It was noted that there would be an instruction letter posted on the Magal website to see if one could qualify for an exemption or a lower tax rate. Can you give us an update on the status of that instruction letter?

Kobi Vinokur

Yes. Unfortunately, we are running some delay on this. Basically this instruction letter is subject to a ruling that is to be issued by the Israeli tax authorities with regards to the split of the distribution between dividends or profit distribution and capital reduction. Unfortunately, there were lots of delays on the Israeli tax authority side due to the—first it was multiple closures related to COVID and the holidays. We are pushing this very hard with our EY tax advisers. We really hope that within the next month or so, we'll have some direction there, and we could publish the letter to the shareholders with regards to the remaining part of the distribution.

Sal DeTurris

Thank you very much.

Dror Sharon

You're welcome.

Operator

We have no further questions at this time. I would now like to turn the floor back over to Management for closing comments.

Dror Sharon

Thank you, Operator. On behalf of the Management of Magal, we'd like to thank you for your continued interest and long-term support of our business. I look forward to updating you next quarter. Have a good day, and stay healthy. Bye.

Operator

Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.