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Magal Security Systems Ltd.

First Quarter 2021 Earnings Call

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CORPORATE PARTICIPANTS

Brett Maas*, Investor Relations, Hayden IR*

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CONFERENCE CALL PARTICIPANTS

Mike Distler, *Amanax Holdings*

Sal Deturris, *Private Investor*

PRESENTATION

Operator

Greetings, and welcome to the Magal Security Systems Limited First Quarter 2021 Earnings Call.

I would now like to turn the call over to your host, Mr. Brett Maas of Hayden IR. Thank you. You may begin.

Brett Maas

Thank you, Operator. I would like to welcome all of you to the conference call and thank Magal's Management for hosting this call.

With us today on the call 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 for the first quarter. We will then open the call for question-and-answer session.

Before we start, I would like to point out that this conference call may contain projections and 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 if actual results or results 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 by the Company with the SEC, 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 turn the call over to Dror. Dror, the floor is yours.

Dror Sharon

Thank you, Brett. Thank you, all, for joining us today.

The first quarter results were expectable given that many regions we're operating continue to be impacted by COVID restriction that limit business activities. Despite those limitations, we approached 2020 prior quarter's performance on revenue and gross margins. This quarter we reported Magal Integrated Solutions as a discontinued operation. Since the Company is still controlled, the Magal segment it is considered a related party. As a result, the reported revenue of $6.5 million excludes Senstar sales to Magal Integrated Solution of $0.6 million. After completion of the divestiture, Senstar would include Magal's ongoing sales in reported revenue.

For that reason, my comments to follow will speak to the Company's result, including sales to Magal. On this basis, Senstar sales in the first quarter, including Magal Integrated revenue was $7.5 million, a decrease of 9% from the first quarter Senstar revenue in Q1 2020. The decline is due to the impact of COVID on our target verticals in the U.S., APAC and Latin America. In the first quarter of 2021, we started to see business activities begin returning to normal, in particularly, in Europe, but we are still not 100% recovered.

The outlook for Q2 and the remainder of the year, based on our pipeline and closing ratio, looks very positive. Hopefully, increased vaccination and reducing incidence of COVID-19 infection will result in the reporting—in the reopening of borders and the return of people to places of work. This will remove many of the limitation that have impacted our results for the past 14 months.

Senstar gross margin in the first quarter was 65%, on par with last year's first quarter, including the gross profit from sales to Magal Integrated Solution. This year we have increased our hardware sales relative to software. Hardware tends to have a low margin compared with software license sales. However, hardware is an important enabler for selling software. Our model will always be a balance between the two components.

For the remainder of 2021, we see the cost of some material increasing, particularly of semiconductors. We are working on long-term procurement agreements to secure supply and mitigate further price increase. However, we anticipate the supply chain issue to pressure gross margin in 2021 modestly and maybe even into the first half of 2022. For the remainder of the year, we are targeting Senstar gross margin for the year in the low 60% range.

Senstar EBITDA margin in the first quarter was 12%, slightly higher than Q1 2020. Typically, the first quarter is our seasonally weakest quarter. Looking out into the remainder quarters of 2021, we anticipate our normal revenue cadence during the year with higher revenue in Q2-Q3, and the last one Q4 being the strongest quarter of the year. We also expect operating expense to remain stable throughout the year and as a result EBITDA shows improved performance.

We expect Public Company expense and amortization to be stable or lower for the corporate entity each quarter, resulting in improving reported operating performance by the second half of 2021 with positive net income by year end.

Let's shift gears to talk about Senstar's growth strategy. For 2021, the drivers for our growth are increasing sales from our key verticals, establishing sales and sales distribution, conversion of the R&D investment into sales, technology acquisition to bring differentiated products and software.

First, on increasing sales from key verticals. We intend to keep increasing our percentage of revenue from our key verticals: energy, production, logistics, and critical infrastructure. For 2021, we implemented KPIs across the entire Company to align priorities and outcome, to increase revenue from the four verticals. New Management teams were installed in all our regions for increased focus on customers and support, especially in key geographies. The outcome is that round 50% of our employees are now facing customers.

Next, expanding our presence and adding new sales distribution to drive growth. We see the opportunity to make our current sales process more efficient and have better initiative to grow our pipeline. Post-divesture, Senstar plans to expand into new geographic regions. We are currently evaluating territories we could penetrate and how we would enter those regions. We are also considering adding additional distribution channels like resellers that could support us in areas where we do not have a person, so connect us with the customers' relationship that would be difficult for us to access. Security is a large global and fragmented market. Adding distribution partners is a logical way to grow sales and increase awareness of Senstar capabilities.

The remaining two growth drivers, R&D and M&A tie back to our capital allocation priorities. We remain very mindful about how we allocate and invest our cash. Well, firstly to have a strong balance sheet and the business that generates free cash flow, we prioritize our uses of cash, one, internal investment R&D that can future growth. Two, target technology acquisition. Three, returning cash to Shareholders when we have excess cash after investments in number one and two.

Let me talk about how we plan to convert the R&D investments into sales. We invested over $10 million in R&D, on UPI ESPs (phon) and software products and solution in the past three years. Increasing our hardware offering is one outcome of this investment. In the past year, we introduced several new products including a new version of our Fire Patrol and the Safe Spaces Solution to ease the return of companies to normal life after the COVID. We expect to release prototype of a multi-sensor project by the end of this year. In the early 2022, we plan to release a new Fire Patrol Short Range and Optimization Solution.

Well, we also intend to increase sales for software, which is a critical part of our plan to improve gross margin in the long-term. We are releasing version 8 of our Symphony common operating platform in Q2 with continuous release occurring during the year. Symphony 8 is an SMS, meaning a security management system providing functionality beyond the traditional VMS platform. Symphony 8 will include analytics, access control, video integration, and input from our PIDS product.

Senstar Fusion is a critical part of this system and we anticipate delivering this to the market in the next few months. Senstar Fusion combines input from our traditional PIDS product into a solution that brings the end user an increased intelligence from the perimeter status. We intend to leverage this improved platform to move up the food chain to a solution provider by combining the SMS capabilities with first-in-class PIDS to system integrators and end users. This strategy will bring new customers higher contract value and higher revenue streams.

Our fourth growth driver, M&A, is focused on adding differentiated technology. We continue to look for additional technology or products we can acquire to increase our offering in the key verticals. Ideally, this acquisition would allow us to expand into adjacent capabilities to increase sales with existing clients and attract new ones.

Closing now the conversation on capital allocation and comments on the dividend policy. We anticipate completing the divestiture of Magal Integrated Solution before the end of June. When the transaction is completed, we will have approximately $60 million in cash. We have earmarked funds for R&D investments and M&A. If the Board decides that the dividend policy makes sense for Senstar, we will share the decision with the Shareholders. We anticipate updating Shareholders on this topic sometime in the second half of 2021.

Senstar, post-divesture, what we want to achieve? As I mentioned, we will have a laser-focus on growth in the key verticals and have developed a tactical plan to achieve this. The plan includes streamlining the range of solution with a deep focus on selling. We will also look to reset the Company's image and leverage our leadership position with enhanced technology offering. In addition, we plan to cross-sell and upsell to our existing customer base.

Lastly, we plan to increase the business pipeline with new channel distribution by leveraging OEM, system integrators, and end level (phon). We will continue to be innovators on the products front and have a (inaudible) and vision to execute this plan. We plan to use our product technologies and scalable cost platform analytics as a building block with engine that leverage database on our Symphony 8 common operating platform as a solid foundation. Currently, we are developing products to increase our differentiation. One example is the multi-sensor. This device collects information through different sensors. This device is targeted to be given (phon) existing sites with infrastructure in it.

Another innovative product we are bringing to the market is a target control for long and short distances. We will have a unique advantage in the market with this product short range capabilities. This product delivers performance above and beyond current offerings. We are also doing some work with data fusion to correlate activities between sensors for comprehensive security solution.

Senstar brand is tied to differentiation and innovation. We plan to design vertical solution and to increase our offering outside of security. We want to be a leader and we leverage our technology, our people, and our brand to expand our business. The foundation of our offering, which we are very excited about is Symphony 8. This improvement enhanced common operating platform should open doors and bring new business and enhance our brands.

An essential asset of Senstar is our people. In 2020, during the global pandemic, we retained almost our entire global employee base, while delivering positive EBITDA every quarter. Keeping most of our employee base on board allows us to support customers in all our regions with sales and technical support staff. We also kept the R&D team in place and remain committed to delivering on the R&D goals despite the business slowdown last year. As a result, we will exit the COVID-19 environment stronger than we entered it, and we are well-positioned to accelerate our growth and profitability.

We remain confident that we can achieve the revenue goals we have set for Senstar in 2021. To support our growth goal, we have built an employee base that is now 50% customer base facing, dedicated to sales, marketing, and technical support and 26% dedicated to R&D. In other words, half of our employee base is committed to delivering and supporting current sales, with one quarter of all employees are committed to developing future sales.

In closing, I'd like to thank all of our employees worldwide for their commitment and excellent work. Collectively, we are working to deliver growth, improve our profitability, and ultimately, deliver Shareholders' value.

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

Kobi Vinokur

Thank you, Dror.

As Dror mentioned, we are reporting this quarter the results of continuing operations, based primarily on Senstar's standalone revenue and on the Corporate entity containing costs of public platform. In addition, we show in a separate line on our P&L the net result of Magal Integrated Solutions, defined as net loss from discontinued operations.

Until the divesture is formally completed, which is aimed for the end of Q2, the Integrated Solutions or project division is still a controlled operation, and therefore, is considered a related party. This means that the Senstar sales to Magal project division and the total project division sales are eliminated from the top line in this quarter. This will affect how Senstar's revenue will be reported until the closing of the divestiture transaction. Following the completion of the sale of the project division and for the remaining period of 2021, Senstar sales to Magal as an unrelated party external customer will be included in the reported revenue and gross margin.

For clarity and consistency, I will cover the reported first quarter's results and then provide an explanation on Senstar's revenue, gross profit, gross margin, and EBITDA including the portion of sales to Magal's Projects. Since we expect Magal Integration division to continue as Senstar's customer in similar volumes, also after the divestiture, the pro forma revenues and profitability that include the sales to the project division better represent the potential revenue levels of the Company post-divesture.

I remind you that our results from continued operations include two components. First, are the results of Senstar's operations on a standalone basis. Second, are the operating costs of the public platform, which include corporate HQ costs, legal and financial advisor fees related to the public activity, the NASDAQ listing fees and expenses. I will review later on the split of both components of the results from continuing operations.

Our reported revenue for the first quarter of 2021 was $6.5 million, a decline of 14% compared with reported revenue of $7.6 million in the first quarter of 2020. The decline in first quarter revenue was primarily due to the impact of COVID-19 in regions that still have strict limitations on traveling, gathering in groups, and social distancing, while the first quarter of 2020 was not materially impacted by the pandemic yet. I would also remind you that the first quarter is our seasonally weakest quarter.

The geographic breakdown as a percentage of reported revenue for the first quarter was as following, North America 50% versus 54%, Europe 35% versus 23%, APAC 13% versus 20%, Latin America 2% versus 3%. First quarter reported gross margin was 62.1% of revenue versus 64.8% last year. The decline in gross margin was primarily due to the mix of Senstar hardware and software product sold during the quarter. Our reported operating expenses were $4.7 million, an 8% reduction from the prior year's first quarter operating expenses of $5.2 million. The reduction in operating expenses is attributable primarily to the reduction in business and sales expenses, such as travel and marketing, as well as due to a contribution of the payroll subsidies granted by the Canadian government.

Our reported operating loss for the first quarter was $681,000 compared to an operating loss of $214,000 in the year ago period. The overall Company's reported EBITDA loss for continuing operations for the first quarter was $369,000 versus EBITDA of $80,000 in the first quarter of the last year. Financial income was $19,000 compared to financial income of $744,000 in the first quarter last year. This is an accounting effect we regularly experience due to adjustment of our monetary assets and liabilities, denominated in currencies other than the functional currency of the operational entities in the Group.

As Dror mentioned, thanks to our operating leverage with the anticipated ramp in quarterly revenue, we expect to report improving operating performance for each quarter. We anticipate producing positive net income from continuing operations for the year end.

Net loss attributable to Magal Shareholders in the quarter was $2 million or $0.09 per share versus net income of $438,000 or $0.02 per share in the first quarter of last year. The reported net loss includes $1.2 million loss from discontinued operations versus $35,000 of income in the same period last year. The net results from discontinued operations include the net loss of the Integration division in the quarter, as well as certain transactional expenses.

I mentioned earlier the two components that contribute to the results of operations, Senstar's standalone contribution and corporate expenses. I will refer to this result as pro forma. Senstar's first quarter pro forma revenue includes sales to Magal's project division, was $7.1 million versus $7.8 million in the first quarter of 2020. The decline in revenue of 9% was primarily due to COVID-related business restrictions in our key geographies.

Pro forma gross profit was $4.6 million or gross margin of 65% for Q1 2021 versus $5.1 million or gross margin of 66% for the prior year period. Senstar's pro forma Q1 2021 operating income was $705,000 compared to $689,000 last year. Senstar's pro forma Q1 2021 EBITDA was $822,000 versus $789,000 in the same period last year, 12% versus 10% of revenue respectively. The second component added to Senstar's operational contribution is the public platform expenses and amortization of intangible assets from historical acquisitions.

The corporate expenses in the first quarter of 2021 were $0.8 million and amortization expenses were $0.2 million as compared to $0.7 million and $0.2 million, respectively in the parallel quarter of 2020. As a result, the pro forma operating loss from continuing operations for the first quarter of 2021 was $0.3 million as compared to an operating loss of $0.2 million in the prior year period. This resulted in Group EBITDA of the first quarter of 2021 of $32,000 versus $125,000 in the same quarter last year.

Looking ahead to the impact of the Magal Integrated Solutions division sale transaction on our P&L and balance sheet, I would like to point out that the sale will result in capital gain. Senstar's cash and cash equivalents and short-term deposits and restricted cash and deposits as of March 31, 2021 were $25.9 million or $1.12 per share.

Our working capital increased by $0.7 million at March 31, 2021 in comparison to the end of the last year. In the first quarter, assets attributed to discontinued operations were $42.6 million with liabilities attributed to our discontinued operations of $21.1 million as compared to assets attributed to discontinued operations of $50.5 million and liabilities attributed to discontinued operations of $25.41 million as of December 31, 2020. We delivered positive cash flow from operations of $0.3 million for the quarter.

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

Operator

Our first question comes from the line of Mike Distler with Amanax Holdings. Please proceed with your question.

Mike Distler

Yes, good afternoon, gentlemen. How are you? As you know, I'm a long time Shareholder. Hope all is well.

I appreciate the depth of your conversation with Shareholders this morning. I know it was not easy to get through all that. My only question just regarding the go forward is, is there an expiration date or a time limit when Magal no longer seeks to purchase Senstar material, Senstar software, Senstar products, et cetera? Related to that, do you think the ongoing concern will be renamed Senstar? Seems appropriate enough, but I was just—you may have some update on that. It's really a two-part question. Thank you very much for your time.

Dror Sharon

Hi Mike, thank you. First, Magal hopefully will remain a customer of Senstar for many years to come. There's no reason to—as long as the products are in good quality and good price, I feel Magal will continue to purchase those solutions from Senstar. There's nothing in the agreement that prohibit them from using Senstar as a product supplier.

About your second question, we will have to update the name. We are currently discussing it internally and once it will be approved by the Board of Directors, then we'll share it with the market.

Mike Distler

Okay, I assume you're on board with all that. Finally, just in closing, I just want to make sure that you bring along all of your many Shareholders. I don't mean the 44% holder, but that you bring along all of the Shareholders who've been with you for a very long time and just keep them in the loop as you did today, and as you have been doing, both of you, for the last, couple of years kind of thing. I just—make sure because communication is the bond because information is power. Thank you for updating us today and I look forward to three months from now. Continued success.

Dror Sharon

Thank you, Mike.

Mike Distler

Thank you.

Operator

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

Sal Deturris

Good afternoon, gentlemen.

Yes, I had a question last conference call and I had the same question again. On the foreign tax withheld on the Magal dividend in December of 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 me an update to the status of that instruction letter?

Kobi Vinokur

Yes, Sal. Unfortunately, it's been delayed and delayed. It's beyond our control in a way because the entire activity is done with the Israeli tax authorities. We're assisted by our tax consultants in this matter. The tax authorities in Israel, unfortunately, they have their own pace. There were delays due to the COVID lockdowns and limitations. Recently we also had some political issues in Israel. We get promised on a daily and weekly basis to finalize this. It's very extraordinary given the, I would say, relative non-complexity of the matter. I hope that for the next—during the next month or so, we'll be able to issue this letter. We are on it.

Sal Deturris

Okay. Thank you very much.

Dror Sharon

Thank you.

Operator

Thank you. Ladies and gentlemen, there are no further questions at this time. I'll turn the floor back to Mr. Sharon for any final comments.

Dror Sharon

Okay, thank you, Operator. On behalf of the Management of Magal, I would like to thank you for your continued interest in long-term support of our business. I look forward to updating you next quarter. Have a safe and good day.

Operator

Thank you. This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.