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FARMSTEAD TELEPHONE GROUP INC
Form 10-K
March 26, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

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

For the fiscal year ended December 31, 2003

Commission file number 0-15938

FARMSTEAD TELEPHONE GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

06-1205743
(I.R.S. Employer Identification No.)

22 Prestige Park Circle, East Hartford, CT
(Address of principal executive offices)

06108-3728
(Zip Code)

Registrant's telephone number, including area code: (860) 610-6000

Securities registered under Section 12(b) of the Act:

| Title of each class Common Stock, \$.001 par value | Name of each Exchange on which registered American Stock Exchange |
|---|--|
|---|--|

Securities registered pursuant to Section 12(g) of the Act: None

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 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the closing price on the last business day of the registrant's most recently completed second fiscal quarter, was \$1,822,159.

As of February 29, 2004, the registrant had 3,311,601 shares of \$0.001 par value Common Stock outstanding.

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DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the Annual Meeting of Stockholders to be held June 10, 2004 are incorporated by reference into Part III, Items 10 through 14 hereof. Certain exhibits filed with this registrant's prior registration statements and forms 10-K are incorporated by reference into Part IV of this Report.

TABLE OF CONTENTS TO FORM 10-K

| | Page |
|---|------|
| | ---- |
| PART I | |
| ITEM 1. BUSINESS | 3 |
| ITEM 2. PROPERTIES | 7 |
| ITEM 3. LEGAL PROCEEDINGS | 7 |
| ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS | 7 |
| PART II | |
| ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS | 7 |
| ITEM 6. SELECTED FINANCIAL DATA | 9 |
| ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS | 9 |
| ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK | 19 |
| ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA | 19 |
| ITEM 9A. CONTROLS AND PROCEDURES | 19 |
| PART III | |
| ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT | 19 |
| ITEM 11. EXECUTIVE COMPENSATION | 19 |
| ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS | 20 |
| ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS | 20 |
| ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES | 20 |
| PART IV | |
| ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K | 20 |
| SIGNATURES | 21 |

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GENERAL

Farmstead Telephone Group, Inc. ("Farmstead", the "Company", "we", or "our") was incorporated in Delaware in 1986. We are principally engaged as a provider of new and used Avaya, Inc. ("Avaya") business telecommunications parts, complete systems, and services. We provide used "Classic Avaya(TM) " telecommunications equipment pursuant to an "Authorized Remarketing Supplier Program" with Avaya, under which we are one of only five companies nationwide so authorized. We also offer Avaya's full-line of new telecommunications parts and complete systems as an Avaya-certified "Gold Dealer". Our service revenues are under the aegis of our "2 Star" Avaya Services Agreement. Our product offerings are primarily customer premises-based private switching systems and peripheral products, including voice messaging products. We also provide telecommunications equipment installation, repair and refurbishing, short-term rental, inventory management, and related value-added services. A portion of our revenues is also derived from the sale of Avaya maintenance contracts. We sell our products and services to large and mid-size, multi-location businesses, as well as to small businesses, government agencies, and other equipment resellers.

Effective February 1, 2001, we entered into a joint venture agreement with TriNET Business Trust ("TriNET"), forming a limited liability corporation operating under the name of InfiNet Systems, LLC ("InfiNet"). Under the agreement, we had a 50.1% ownership interest, and TriNET had a 49.9% ownership interest. Based in East Hartford, Connecticut, InfiNet was organized for the purpose of selling new Avaya telecommunications systems primarily to customers within the State of Connecticut and various counties in the State of New York. Effective January 1, 2002, we acquired TriNET's 49.9% ownership interest in InfiNet. During 2002, however, we changed our business strategy concerning the use of InfiNet, downsizing its operating activities by eliminating its entire workforce and fulfilling systems sales orders directly through Farmstead, which acquired its own systems dealer license in 2002. As a result, InfiNet has since been inactive.

Our revenue has declined significantly over the past three years. Revenue for the years ended December 31, 2003, 2002 and 2001 was \$14.68 million, \$19.15 million and \$33.34 million, respectively. The decline in revenue is attributable primarily to the effect of general economic conditions prevailing in the United States and resulting reduced business spending on enterprise communications equipment. The decline in revenue has also been the prime contributor to our net losses for the years ended December 31, 2003, 2002 and 2001 of \$709,000, \$2,530,000 and \$1,708,000, respectively. Accordingly, we have tried to reduce our losses and return to profitability through cost reductions and by broadening our product offerings. Our current strategy is to become less dependent on parts sales, and become more of a systems and applications solutions provider. We will expand our product offerings beyond traditional voice communications products by offering Internet Protocol, or IP, telephony products and unified communications products including voice messaging. Because we believe that business capital spending on enterprise communications equipment will not significantly improve over the short-term, we expect to have continued pressure on our ability to increase revenues over current levels.

PRODUCTS

EQUIPMENT

We sell a wide range of Avaya's traditional voice telephony parts and

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systems, including Avaya's most advanced enterprise voice communications system marketed under the DEFINITY(R) and MultiVantage product lines. These server based product lines provide reliable voice communication and offer integration with an enterprise's data networks. They support a wide variety of voice and data applications such as call and customer contact centers, messaging and interactive voice response. This product also facilitates the ongoing transition at many enterprises from traditional voice telephony systems to advanced systems that integrate voice and data traffic and deploy increasingly sophisticated communications applications, including "voice over internet protocol (VOIP)", popularized with Avaya's IP Office product family. For smaller enterprises or small locations of larger ones, we offer Avaya's, medium to small user voice communications products, marketed under the MERLIN MAGIX(TM), SPIRIT(R) and PARTNER(R) Communications Systems product families. We also offer Avaya voice messaging and unified messaging products such as OCTEL(R) Messaging and INTUITY(tm) AUDIX(R) Messaging, as well as the latest messaging release called Modular Messaging.

3

Equipment sales consist of both sales of complete systems and software applications, and sales of new and refurbished parts (commonly referred to as "aftermarket" sales). Refurbished products are primarily sold under the Classic Avaya(TM) label pursuant to a licensing agreement with Avaya. Aftermarket parts primarily consist of telephone sets and circuit packs, and other system accessories such as headsets, consoles, speakerphones and paging systems. Equipment sales revenues accounted for approximately 88%, 90% and 93% of total revenues in 2003, 2002 and 2001, respectively.

SERVICES AND OTHER REVENUE

We are committed to respond to our customers' service or project-oriented telecommunications needs, and believe these services help differentiate us from our competitors, as well as contribute to longer-lasting customer relationships and incremental equipment sales. Services include:

Installation Services: We use Avaya and, to a lesser degree, other equipment installation companies on a subcontract basis to install telecommunication parts and systems nation-wide, as well as to perform equipment moves, adds and changes.

Repair and Refurbishing: We perform fee-based telecommunications equipment repair and refurbishing services. Until 2003, these services were provided through a combination of our in-house refurbishing center and the use of subcontract repair shops. The in-house work primarily consisted of cleaning, buffing and minor repairs, while major repairs of equipment, including repair of circuit boards, was outsourced. By the end of 2003, we had outsourced all equipment repair and refurbishing services to outside repair shops.

Equipment Rentals: We provide rentals of equipment on a month-to-month basis, servicing those customers that have temporary, short-term equipment needs.

Other Services: Our technical staff currently provides system engineering and configuration, project management, and technical "hot line" telephone support services.

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Other Revenue: A portion of our revenues is derived from the sale of Avaya communications equipment maintenance contracts. In these transactions we act as a sales agent of Avaya, and the service obligations are borne entirely by Avaya.

Our combined service and other revenues accounted for 12%, 10% and 7% of total revenues in 2003, 2002 and 2001, respectively. The largest individual component, installation services, accounted for 9%, 8% and 6% of total revenues in 2003, 2002 and 2001, respectively.

RELATIONSHIP WITH AVAYA INC.

Avaya is one of the leading providers of communications products in the United States. Avaya provides support to the telecommunications equipment aftermarket by offering installation and maintenance services for its products purchased by end-users through equipment resellers. Equipment resellers like us may also, with various restrictions, utilize Avaya documentation, technical information and software. Avaya also generally provides up to a one-year warranty on its products. Avaya generally provides maintenance of Avaya equipment sold by us.

Our relationship with Avaya is on three main fronts. First, we are a part of Avaya's Authorized Remarketing Supplier ("ARS") aftermarket program as an ARS Dealer (the "ARS Agreement"), selling Classic Avaya(TM) products to end-users nationwide. The ARS Agreement expires December 31, 2004; however it shall automatically renew for an additional one-year term unless written notice is given by either party of its intent not to renew thirty days in advance of the termination date. Classic Avaya(TM) products are defined as used Avaya PBX system and key system parts that have been refurbished under Avaya quality standards, and sold with a Classic Avaya label. We are currently one of only five appointed ARS Dealers, none of whom has been granted an exclusive territory. The ARS Agreement also allows us to sell certain new Avaya PBX products and voice processing products to end-users, including government agencies. Second, we are an Avaya-certified Gold Dealer, authorized to sell new voice and data systems and applications. And third, Farmstead is a "2 Star" Services partner selling Avaya installation, maintenance, and moves, adds and changes (MAC) products.

4

Under the ARS Agreement with Avaya, we are required to pay fees to Avaya based upon a percentage (currently 6.5%) of the sales price of Classic Avaya(TM) products sold by us. We also required to pay fees to Avaya based upon a percentage (currently 15%) of the sales price of Classic Avaya(TM) products sold through the Company's call center. The Company recorded in cost of revenues approximately \$323,000, \$507,000 and \$1,341,000 of fee expense in 2003, 2002 and 2001, respectively.

We believe that our relationship with Avaya is satisfactory. Avaya is currently considering replacing the ARS program with a successor program which would allow the ARS companies, as well as non-ARS companies, to purchase refurbished "Classic Avaya" equipment directly from Avaya. We cannot predict whether the ARS program will continue throughout 2004 or what the terms and conditions of any successor program might be or how it might impact us. We believe that should the ARS program not be renewed, it will not have a material adverse impact on our ability to sell refurbished equipment.

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MARKETING AND CUSTOMERS

We market our product offerings nationally through a direct sales staff, which includes salespersons located along the Eastern seaboard, and other areas of the country. Since 1999, we have also marketed Avaya products through a call center operation. Our customers range from large and mid-sized, multi-location corporations, to small companies, and to equipment wholesalers, dealers, and government agencies and municipalities. End-user customers accounted for approximately 91%, 83% and 86% of our total revenues in 2003, 2002 and 2001, respectively, while sales to dealers and other resellers accounted for approximately 9%, 17% and 14% of revenues during the same respective periods. We have thousands of customers and, during the years ended December 31, 2003, 2002 and 2001, no single customer accounted for more than 10% of revenues. We do not consider our business to be seasonal.

COMPETITION

We operate in a highly competitive marketplace. Over the years, our marketplace has become subject to more rapid technological change as communications systems have been evolving from stand-alone voice systems to more highly integrated, software-driven systems. Since we principally sell Avaya products, our competitive position in the marketplace is highly dependent upon Avaya's ability to continue to be a market leader in the product lines that we sell. Our competitors principally include Avaya and other new equipment manufacturers that similarly compete against Avaya products, including Nortel Networks Corporation, Siemens Aktiengesellschaft, Alcatel S.A. and NEC Corporation along with their local and regional dealers, and other Avaya business partners. In the sale of Classic Avaya(TM) products, we compete with the other Avaya-designated ARS Dealers. We believe that key competitive factors in our market are price, timeliness of delivery, service and product quality and reliability. Due to the reduction in business capital spending on telecommunications products, which has developed in the U.S. over the past few years, competitive pressures have intensified. We also anticipate intensified competition from larger companies having substantially greater technical, financial and marketing resources, as well as larger customer bases and name recognition. As the industry further develops voice and data converged products, we anticipate encountering a broader variety of competitors, including new entrants from related computer and communication industries.

SUPPLIERS

Our agreement with Avaya requires us to purchase new equipment from a designated "master distributor", and accordingly we have used Catalyst Telecom ("Catalyst") as our primary supplier over the last several years. The performance of this distributor in meeting our product and delivery demands has been satisfactory to date. Should there be an adverse change in Catalyst's performance, we would have the ability to contract with another "master distributor" to supply us with new Avaya telecommunications equipment.

We acquire used equipment from a variety of sources, depending upon price and availability at the time of purchase. These sources include other secondary market equipment dealers, leasing companies and end-users. The equipment so acquired may be in a refurbished state and ready for resale, or it may be purchased "as-is", requiring repair and/or refurbishing prior to its resale. We are not dependent upon any single supplier for used equipment. The Company believes that the availability of used equipment in the marketplace is presently sufficient to enable the Company to meet its customers' used equipment delivery requirements.

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5

PATENTS, LICENSES AND TRADEMARKS

No patent is considered material to our continuing operations. Pursuant to agreements in effect with Avaya, we may utilize, during the term of these agreements, certain Avaya designated trademarks, insignia and symbols in our advertising and promotion of Avaya products. We operate under a license agreement with Avaya, in which we were granted a non-exclusive license to use the Classic Avaya(TM) trademark in connection with the refurbishing, marketing and sale of Avaya products sold under the ARS Agreement. Under this agreement, we are required to pay fees to Avaya based upon a percentage of the sales price of Classic Avaya(TM) products that we sell. For more information on these fees, refer to the above section "Relationship With Avaya Inc." The license agreement expires December 31, 2004; however it shall automatically renew for an additional one-year term unless written notice is given by either party of its intent not to renew thirty days in advance of the termination date.

RESEARCH AND DEVELOPMENT

We did not incur any research and development expenses during the three years ended December 31, 2003, and research and development activities are not material to our business.

BACKLOG

The backlog of unshipped orders believed to be firm was approximately \$397,000 at December 31, 2003, compared to \$1,010,000 at December 31, 2002. We expect this entire backlog to ship and be recognized as revenue during the current fiscal year.

EMPLOYEES

At December 31, 2003, we had 60 full-time employees. Our employees are not represented by any organized labor union and are not covered by any collective bargaining agreements.

WEBSITE ACCESS TO SEC FILINGS

We maintain an Internet website at www.farmstead.com. We make available free of charge through our Internet website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

EXECUTIVE OFFICERS OF THE REGISTRANT

| Name | Age (1) | First Became An Executive Officer in | Position(s) Held |
|-----------------------|---------|--------------------------------------|---|
| George J. Taylor, Jr. | 61 | 1984 | Chairman of the Board, President, Chief Executive |

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Officer

Michael R. Johnson

57

2001

Executive Vice President

Robert G. LaVigne

52

1988

Executive Vice President, Chief Financial Officer,
Secretary, Treasurer