

OSI SYSTEMS INC
Form 10-Q
January 27, 2015
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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2014

OR

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

For the transition period from _____ to _____

Commission File Number 000-23125

OSI SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

33-0238801
(I.R.S. Employer
Identification No.)

12525 Chadron Avenue

Hawthorne, California 90250

(Address of principal executive offices) (Zip Code)

(310) 978-0516

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of January 26, 2015, there were 19,804,943 shares of the registrant's common stock outstanding.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****OSI SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

(amounts in thousands, except share amounts)

	June 30, 2014	(Unaudited) December 31, 2014
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 38,831	\$ 44,780
Accounts receivable, net	185,773	184,228
Inventories	234,138	263,901
Deferred taxes	73,510	73,293
Prepaid expenses and other current assets	46,978	53,131
Total current assets	579,230	619,333
Property and equipment, net	260,479	240,369
Goodwill	92,607	98,410
Intangible assets, net	43,615	48,865
Other assets	48,255	49,681
Total assets	\$ 1,024,186	\$ 1,056,658
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Bank lines of credit	\$ 24,000	\$ 23,000
Current portion of long-term debt	2,819	2,816
Accounts payable	74,460	96,513
Accrued payroll and related expenses	32,997	29,681
Advances from customers	38,493	42,486
Deferred revenue	60,677	51,742
Income taxes payable	20,556	30,872
Other accrued expenses and current liabilities	55,977	61,473
Total current liabilities	309,979	338,583
Long-term debt	10,436	9,399
Advances from customers	50,000	37,500
Deferred income taxes	73,161	73,933
Other long-term liabilities	48,397	55,920
Total liabilities	491,973	515,335
Commitments and contingencies (Note 7)		
Stockholders Equity:		
Preferred stock, \$0.001 par value, 10,000,000 shares authorized; no shares issued or outstanding		
Common stock, \$0.001 par value authorized, 100,000,000 shares; issued and outstanding, 19,942,923 shares at June 30, 2014 and 19,788,531 shares at December 31, 2014	287,434	271,988

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Retained earnings	247,680	277,170
Accumulated other comprehensive loss	(2,901)	(7,835)
Total stockholders' equity	532,213	541,323
Total liabilities and stockholders' equity	\$ 1,024,186	\$ 1,056,658

See accompanying notes to condensed consolidated financial statements.

Table of Contents**OSI SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(amounts in thousands, except per share data)

(Unaudited)

	For the Three Months Ended		For the Six Months Ended	
	December 31,		December 31,	
	2013	2014	2013	2014
Net revenues:				
Products	\$ 173,974	\$ 190,821	\$ 317,450	\$ 347,309
Services	62,434	67,008	125,232	128,917
Total net revenues	236,408	257,829	442,682	476,226
Cost of goods sold:				
Products	118,781	126,366	222,374	233,790
Services	36,688	42,189	71,423	78,920
Total cost of goods sold	155,469	168,555	293,797	312,710
Gross profit	80,939	89,274	148,885	163,516
Operating expenses:				
Selling, general and administrative	45,556	47,894	87,770	92,076
Research and development	11,175	13,240	22,195	25,910
Restructuring and other charges	2,179	2,079	6,418	2,805
Total operating expenses	58,910	63,213	116,383	120,791
Income from operations	22,029	26,061	32,502	42,725
Interest and other expense, net	(1,503)	(832)	(2,973)	(1,696)
Income before income taxes	20,526	25,229	29,529	41,029
Provision for income taxes	5,953	6,988	8,562	11,539
Net income	\$ 14,573	\$ 18,241	\$ 20,967	\$ 29,490
Net income per share:				
Basic	\$ 0.73	\$ 0.92	\$ 1.05	\$ 1.49
Diluted	\$ 0.71	\$ 0.89	\$ 1.02	\$ 1.44
Shares used in per share calculation:				
Basic	19,961	19,811	19,966	19,815
Diluted	20,589	20,487	20,604	20,506

See accompanying notes to condensed consolidated financial statements.

Table of Contents**OSI SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(amounts in thousands)****(Unaudited)**

	For the Three Months Ended December 31,		For the Six Months Ended December 31,	
	2013	2014	2013	2014
Net income	\$ 14,573	\$ 18,241	\$ 20,967	\$ 29,490
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustment	471	(2,433)	1,779	(5,133)
Other	30	71	122	199
Other comprehensive income (loss)	501	(2,362)	1,901	(4,934)
Comprehensive income	\$ 15,074	\$ 15,879	\$ 22,868	\$ 24,556

See accompanying notes to condensed consolidated financial statements.

Table of Contents**OSI SYSTEMS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(amounts in thousands)

(Unaudited)

	For the Six Months Ended December 31,	
	2013	2014
Cash flows from operating activities:		
Net income	\$ 20,967	\$ 29,490
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	26,417	32,082
Stock based compensation expense	10,721	12,078
Provision for losses on accounts receivable	977	647
Other	39	215
Changes in operating assets and liabilities net of business acquisitions:		
Accounts receivable	46,781	456
Inventories	(8,768)	(29,164)
Prepaid expenses and other assets	(5,649)	4,186
Accounts payable	(32,798)	19,201
Advances from customers	(10,648)	(8,465)
Deferred revenue	27,542	(7,557)
Other	(608)	7,781
Net cash provided by operating activities	74,973	60,950
Cash flows from investing activities:		
Acquisition of property and equipment	(41,702)	(6,447)
Acquisition of businesses, net of cash acquired	(10,087)	(14,687)
Acquisition of intangible and other assets	(2,467)	(3,376)
Net cash used in investing activities	(54,256)	(24,510)
Cash flows from financing activities:		
Net borrowings (repayments) on bank lines of credit	1,000	(1,000)
Proceeds from long-term debt	2,841	653
Payments on long-term debt	(1,562)	(1,470)
Proceeds from exercise of stock options and employee stock purchase plan	1,501	1,941
Repurchase of common shares	(12,056)	(22,617)
Taxes paid related to net share settlements of equity awards	(8,230)	(6,847)
Net cash used in financing activities	(16,506)	(29,340)
Effect of exchange rate changes on cash	991	(1,151)
Net increase in cash and cash equivalents	5,202	5,949
Cash and cash equivalents-beginning of period	34,697	38,831
Cash and cash equivalents-end of period	\$ 39,899	\$ 44,780
Supplemental disclosure of cash flow information:		
Cash paid, net during the period for:		
Interest	\$ 2,878	\$ 1,347
Income taxes	\$ 8,716	\$ 6,559

See accompanying notes to condensed consolidated financial statements.

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OSI SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

Description of Business

OSI Systems, Inc., together with its subsidiaries (the Company), is a vertically integrated designer and manufacturer of specialized electronic systems and components for critical applications. The Company sells its products and provides related services in diversified markets, including homeland security, healthcare, defense and aerospace.

The Company has three reporting segments: (i) Security, providing security inspection systems, turnkey security screening solutions and related services; (ii) Healthcare, providing patient monitoring, cardiology and anesthesia systems, and related services and (iii) Optoelectronics and Manufacturing, providing specialized electronic components and electronic manufacturing services for the Security and Healthcare divisions as well as to external original equipment manufacturing clients for applications in the defense, aerospace, medical and industrial markets, among others.

Through its Security division, the Company provides security screening, threat detection and non-intrusive inspection products and related services globally. These products fall into the following categories: baggage and parcel inspection systems; cargo and vehicle inspection systems; hold (checked) baggage screening systems; people screening; radiation detection; and trace detection. In addition to these products, the Company provides site design, installation, training and technical support services to its customers. The Company also provides turnkey security screening solutions, which can include the construction, staffing and long-term operation of security screening checkpoints for its customers.

Through its Healthcare division, the Company designs, manufactures, markets and services patient monitoring, cardiology and anesthesia delivery and ventilation systems, and related supplies and accessories worldwide. These products are used by care providers in critical care, emergency and perioperative areas within hospitals as well as physicians' offices, medical clinics and ambulatory surgery centers amongst others.

Through its Optoelectronics and Manufacturing division, the Company designs, manufactures and markets optoelectronic devices and provides electronics manufacturing services worldwide for use in a broad range of applications, including aerospace and defense electronics, security and inspection systems, medical imaging and diagnostic products, telecommunications, computer peripherals, industrial automation systems, automotive diagnostic systems, gaming systems and consumer products. This division provides products and services to original equipment manufacturers and end users as well as to the Company's own Security and Healthcare divisions.

Basis of Presentation

The condensed consolidated financial statements include the accounts of OSI Systems, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. The condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to interim financial reporting guidelines. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of the Company's management, the condensed consolidated financial statements include all adjustments, consisting of only normal and recurring adjustments, necessary for a fair presentation of the financial position and the results of operations for the periods presented. These condensed consolidated financial statements and the accompanying notes should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2014. The results of operations for the three and six months ended December 31, 2014 are not necessarily indicative of the operating results to be expected for the full 2015 fiscal year or any future periods.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and costs of sales during the reporting period. The most significant of these estimates and assumptions for the Company relate to contract revenue, profit and loss recognition, fair values of assets acquired and liabilities assumed in business combinations, market values for inventories reported at lower of cost or market, stock-based employee compensation expense, income taxes, accrued product warranty costs, and the recoverability, useful lives and valuation of recorded amounts of long-lived assets, identifiable intangible assets and goodwill. Changes in estimates are reflected in the periods during which they become known. Actual amounts will differ from these estimates and could differ materially.

Per Share Computations

The Company computes basic earnings per share by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. The Company computes diluted earnings per share by dividing net income available to common stockholders by the sum of the weighted average number of common and dilutive potential common shares outstanding. Potential common shares consist of the shares issuable upon the exercise of stock options and restricted stock or unit awards under the treasury stock method. During the three and six months ended December 31, 2013 and 2014, the number of stock options and stock awards or units excluded from the calculations because they were antidilutive was de minimis.

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The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2013	2014	2013	2014
Net income for diluted earnings per share calculation	\$ 14,573	\$ 18,241	\$ 20,967	\$ 29,490
Weighted average shares outstanding for basic earnings per share calculation	19,961	19,811	19,966	19,815
Dilutive effect of stock awards	628	676	638	691
Weighted average shares outstanding for diluted earnings per share calculation	20,589	20,487	20,604	20,506
Basic net income per share	\$ 0.73	\$ 0.92	\$ 1.05	\$ 1.49
Diluted net income per share	\$ 0.71	\$ 0.89	\$ 1.02	\$ 1.44

Reclassifications

Certain reclassifications have been made to prior year amounts within the condensed consolidated balance sheet and condensed consolidated statement of cash flows to conform to the current year's presentation.

Cash Equivalents

The Company considers all highly liquid investments purchased with maturities of approximately three months or less as of the acquisition date to be cash equivalents.

Fair Value of Financial Instruments

The Company's financial instruments consist primarily of cash, marketable securities, derivative instruments, accounts receivable, accounts payable and debt instruments. The carrying values of financial instruments, other than long-term debt instruments, are representative of their fair values due to their short-term maturities. The carrying values of the Company's long-term debt instruments are considered to approximate their fair values because the interest rates of these instruments are variable or comparable to current rates offered to the Company.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Level 1 category includes assets and liabilities at the quoted prices in active markets for identical assets and liabilities.

Level 2 category includes assets and liabilities from observable inputs other than quoted market prices. Level 3 category includes assets and liabilities whose valuation techniques are unobservable and significant to the fair value measurement. There were no assets or liabilities where

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Level 3 valuation techniques were used, and there were no assets and liabilities measured at fair value on a non-recurring basis.

The following is a summary of the inputs used in valuing investments carried at fair value (in thousands):

	Level 1		Level 2		June 30, 2014		Level 1		Level 2		December 31, 2014	
Equity securities	414		500		914		326		1,600		1,926	
Insurance company contracts			17,383		17,383				18,176		18,176	
Interest rate contract			28		28				36		36	
Total	\$	414	\$	17,911	\$	18,325	\$	326	\$	19,812	\$	20,138

Derivative Instruments and Hedging Activity

The Company's use of derivatives consists of an interest rate swap agreement. The interest rate swap agreement was entered into to improve the predictability of cash flows from interest payments related to variable, LIBOR-based debt for the duration of the term loan. The interest rate swap matures in October 2019. The interest rate swap is considered an effective cash flow hedge, and, as a result, the net gains or losses on such instrument were reported as a component of Other comprehensive income in the condensed consolidated financial statements and are reclassified as net income when the hedge transaction settles.

Revenue Recognition

The Company recognizes revenue from sales of products upon shipment when title and risk of loss passes, and when terms are fixed and collection is probable. Revenue from services includes after-market services, installation and implementation of products, and turnkey security screening services. The portion of revenue for the sale attributable to installation is deferred and recognized when the installation service is provided. In an instance where terms of sale include subjective customer acceptance criteria, revenue is deferred until the Company has achieved the acceptance criteria. Concurrent with the shipment of the product, the Company accrues estimated product return reserves and warranty expenses. Critical judgments made by management related to revenue recognition include the determination of whether or not customer acceptance criteria are perfunctory or inconsequential. The determination of whether or not customer acceptance terms are perfunctory or inconsequential impacts the amount and timing of revenue recognized. Critical judgments also include estimates of warranty reserves, which are established based on historical experience and knowledge of the product under warranty.

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Revenue from turnkey services agreements is included in revenue from services. In certain agreements, revenue is recognized based upon proportional performance, measured by the actual number of hours incurred divided by the total estimated number of hours for the project. The impact of changes in the estimated hours to service the agreement is reflected in the period during which the change becomes known. Deferred revenue for such agreements arises when payments from customers are received in advance of revenue recognition.

Revenues from out of warranty service maintenance contracts are recognized ratably over the term of such contract. For services not derived from specific maintenance contracts, revenues are recognized as the services are performed. Deferred revenue for such services arises from payments received from customers for services not yet performed. On occasion, the Company receives advances from customers that are amortized against future customer payments pursuant to the underlying agreements. Such advances are classified in the condensed consolidated balance sheets as either a current or long term liability dependent upon when the Company estimates the corresponding amortization to occur.

Business Combinations

During the normal course of business the Company makes acquisitions. In the event that an individual acquisition (or an aggregate of acquisitions) is material, appropriate disclosure of such acquisition activity is provided. During the six months ended December 31, 2014, the Company completed acquisitions that were not material both individually and in aggregate.

Recent Accounting Updates Not Yet Adopted

In May 2014, the Financial Accounting Standards Board issued an accounting standards update amending revenue recognition requirements for multiple deliverable revenue arrangements. This update provides guidance on how revenue is recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for the goods or services. This determination is made in five steps: (i) identify the contract with the customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The update is effective for annual reporting periods after December 15, 2016 and for interim reporting periods within that reporting period. Early adoption is not permitted. The Company has not yet adopted this update and is currently evaluating the impact it may have on its financial condition and results of operations.

2. Balance Sheet Details

The following tables provide details of selected balance sheet accounts (in thousands):

	June 30, 2014	December 31, 2014
Accounts receivable		
Billed receivables	\$ 189,489	\$ 188,351
Unbilled receivables	1,975	2,727

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Less allowance for doubtful accounts		(5,691)		(6,850)
Total	\$	185,773	\$	184,228

		June 30, 2014		December 31, 2014
Inventories				
Raw materials	\$	117,945	\$	154,948
Work-in-process		33,394		52,909
Finished goods		82,799		56,044
Total	\$	234,138	\$	263,901

		June 30, 2014		December 31, 2014
Property and equipment				
Buildings and improvements	\$	163,952	\$	166,453
Leasehold improvements		9,744		10,318
Equipment and tooling		154,367		155,642
Furniture and fixtures		4,017		4,093
Computer equipment		17,466		18,276
Computer software		15,670		16,185
		365,216		370,967
Less: accumulated depreciation and amortization		(131,038)		(155,344)
		234,178		215,623
Land		13,651		13,651
Construction in process				