



Magal Security Systems Ltd.

Second Quarter 2020 Earnings Conference Call

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C O R P O R A T E P A R T I C I P A N T S

Brett Maas, *Hayden IR*

Dror Sharon, *Chief Executive Officer*

Kobi Vinokur, *Chief Financial Officer*

C O N F E R E N C E C A L L P A R T I C I P A N T S

Sam Rebotsky, *SER Asset Management*

Ken Liddy, *Oppenheimer*

Bruce Tuchman, *Private Investor*

Craig Roth, *Private Investor*

P R E S E N T A T I O N

Operator

Greetings, and welcome to the Magal Security Systems Limited Second Quarter 2020 Earnings Call.

At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad.

As a reminder, this conference is being recorded.

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

Brett Maas

Thank you, Operator. Welcome to Magal's second quarter 2020 earnings conference call. I would like to welcome you to all of 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 results for the second quarter. We will then open the call for a questions-and-answer session.

Before we start, I'd like to point out that this conference call may contain projections and other forward-looking statements regarding future events or the 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 events or results 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 on our clients, as well as other risks identified in the documents filed by the Company with the Securities and Exchange Commission.

In addition, during the 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 reconciliation.

And with that, I'd like to now hand the call over Dror. Dror, please go ahead.

Dror Sharon

Thank you, Brett.

I'd like to welcome all of you to our call, and thank you for joining us today. I hope that everyone's families and friends are safe and healthy.

In my comments, all compares are year-over-year referring to the second quarter of 2019. I'm pleased that during this time of economic uncertainty, we continue to achieve our statistic goals, while managing costs and maintaining profitability.

For the second quarter of 2020, we delivered positive net income and grew EBITDA by 78%, on revenue decrease of 17%. Gross margin rose to 47% of reported revenue due to the increase in sensor sales and cost reduction in the quarter.

With the onset of COVID, we shifted our focus to managing our costs with the goal of maintaining annual profitability, while positioning the Company for recovery and growth longer term.

This action provided flexibility to management—to manage operation expenses for the remaining of the year, without jeopardizing our sales and R&D capabilities and efforts.

In the second quarter, we reduced operating expenses by 22% through cost management, delaying new hires, and incurring low sales and marketing expenses. As a result, operating income increases to \$796,000, to \$195,000 in the second quarter of last year.

We improved net—year-over-year we improved net income to \$154,000 from a net loss of \$302,000, and delivered an EBITDA margin of 7.8%, or a 78% increase in EBITDA.

We also had another quarter of positive cash flow generating \$1.1 million in cash from operations.

Our two business segments, Magal Integration Solutions and the Senstar product division have been impacted quite differently in the quarter by the COVID. Project delays, along with the travel limitations, the restrictions on face-to-face meetings, which was affecting the client (inaudible) to closing new business, affected our division differently.

Magal Integrated Solutions division was more affected than the Senstar product division this quarter. Closing large project deals is dependent on face-to-face meeting and the repeated in-person interaction with the various teams.

Although government and large entities, particularly in some of our targets vertical are delaying new projects to conserve cash in the period of economic uncertainty, as a result, Magal Integration Solutions' second quarter revenue reduced by 26% year-over-year.

The COVID-19 impacted our Senstar product division to a lesser degree, due to the high geographical and product line diversity. As a result, Senstar revenue declined only 40% year-over-year. We continue diversifying our revenue streams across vertical and territories during the global COVID outbreak. As a result, Magal project revenue was more conventional, coming from smaller contracts and deals, rather than large contracts as in prior years.

In the second quarter, we landed several turnkey projects, including a VIP resident in Mexico, and an African seaport, and an extension to our turnkey project with the Port of Tarragona in Spain.

Shifting to an update on our four key verticals: the Oil and Gas, Correctional Facilities, Critical Infrastructures, and Logistics. In the second quarter, the Oil and Gas sector continued to be affected by oil price fluctuations related to the uneven global economic recovery and large projects remaining on hold. We expect this vertical to begin to improve next year and remain engaged with those customers very closely.

The Correctional vertical, particularly in Canada, experienced delays in project execution due to the COVID-19-related limitation on facilities they access. We do expect Corrections to recover in Canada in (audio interference).

Brett Maas

Hello, Kobi?

Kobi Vinokur

Yes.

Brett Maas

Do you want to continue reading for him?

Kobi Vinokur

Yes, for now, and apologies for the technical issue.

We do expect Corrections to recover in Canada in 2020, where this vertical has grown nicely over the last few years. A new solution developed for Corrections is our recently launched anti-drone system. This system can be used for the detection, tracking and neutralizing of drones that bring (inaudible) or prohibited materials into facilities.

We also intend to target Homeland Security and public safety with the anti-drone system. This system operates in a unique distributed solution based on our proprietary Magal (inaudible) command and control capabilities, and electro-optics solution.

The Critical Infrastructure vertical has been active for our teams this quarter, but outcomes vary depending on the region. As mentioned earlier, we closed several infrastructure contracts in Europe and Africa during the quarter.

We continue to invest in the Logistics vertical.

(Audio interference).

Operator

Excuse me, are we connecting Dror Sharon? (Audio interference)

Brett Maas

Yes.

Dror Sharon

This is Dror Sharon.

Kobi Vinokur

Okay, he's here, okay.

Dror Sharon

So sorry about that, I'm just—I was disconnected. Kobi, where did you stop?

Kobi Vinokur

We just started discussing the Logistics vertical.

Dror Sharon

Logistics vertical to continue—okay, we continue to invest in the Logistics vertical. Logistical requirements are going worldwide due to the COVID-19. This has generated an upsurge in online shopping, and increased focus on improving the expanded distribution capability. These larger, more complex Logistics facilities have greater security and operation needs.

To expand our scope of services in the vertical, we are diverting our (inaudible), (inaudible), the VMS software and the dedicated analytics to provide specialized solutions for securing the facility, as well as tracking and managing parts of movement.

Another new innovative product we just launched is the Safe Spaces in response to the COVID requirements. This new video analytic solution is camera and VMS platform agnostic to enable businesses to reopen while maintaining COVID-related public safety requirements. Safe Spaces (inaudible) identifies individuals not wearing masks and monitors social distancing, occupancy limited, enhanced sanitation stands in public facilities and buildings.

Currently, we have distribution channel partners and their potential clients testing the system. They are closing new business with prior customers (inaudible) the new contract announced yesterday to secure military assets (inaudible) inter-governmental align. The \$6.5 million contract will provide physical

security, (inaudible) metal detection, video surveillance, access controlled, public address and associated command and control (inaudible) globally.

This key contract awards recognized technology differentiation and the scope of sensor product offering for deployable security solutions.

The other key was very competitive acquiring robust modular equipment, the technology sophistications capable of being mounted, connected and dismounted rapidly and easily integrated with existing asset. This (inaudible) is an endorsement for sensor technology, experience and customer support.

Shifting to an overview of our performance per region, North America saw growth in our product operation during the second quarter. Deliveries have mostly continued in this region, as security for critical site is considered an essential service.

The Canadian territory was primarily affected by the slow-down in the Correctional sector. We have a backlog of orders which we will fulfil as restrictions in the country are lifted.

In the EMEA region where people are considered essential services, Spain has been active territory for our European team. In this world, the impact of the crisis is mixed, with (inaudible) still active while other sectors have slowed down.

Africa is also mixed, but we are winning new business there as well. We landed a seaport security system design and installation in Djibouti, and new territories where we see future opportunities.

The APAC region has been impacted the longest by the COVID. We closed down as the restrictions begin in early 2020, and still continue in many regions that we sell into.

We began to see some activity in the APAC region in July, but large areas including the Philippines and Indonesia are still under lockdown.

Another region still managing COVID outbreaks that are severely impacted economic activity is Latin America. Since there are large countries in Central America are fighting to control the rate of outbreaks. These dynamics has impacted our businesses in this region, though we have add some small contract wins there recently.

Magal's strong financial standings with net cash and related-cash (inaudible) gives me confidence in our ability to respond to the challenges and opportunities ahead. We will prioritize our use of capital in these areas, investing in R&D to increase our competitive advantages, maintaining our book of talented experienced people critical to our future growth, and M&A specific opportunities to add synergies product in growth markets and leverage existing platform.

I have already discussed some example of investment in our R&D roadmap and the innovation it has delivered.

Another element essential for the Company post crisis recovery is employee retention. We believe that keeping our teams onboard will provide support to our customers, close new business, and continue to improve our product solutions and software (inaudible) competitive advantage that enable us to preserve the strategic direction of Magal.

The M&A targets in our pipeline would add technology to leverage our existing capabilities and bring innovation and expertise.

We hope to close at least one to two deals in 2020. We will resume dialogue with the targets put on hold at the end of the first quarter, and just a week ago we submitted a non-binding LOI to one of the interesting targets that we are working on.

I want to thank the global Magal team for their dedication and spirit in dealing with all the diverse challenges we are facing, both have (inaudible) and their personal lives.

I'm confident that with our strong balance sheet, our backlog of business and our skilled team, we will emerge from the crisis strong and positioned for growth.

And now, I would like to hand the call over to Kobi to summarize the financial result. Kobi, please go ahead.

Kobi Vinokur

Thank you, Dror.

Revenue for the second quarter of 2020 was \$16.4 million, a decline of 17% compared with the (audio interference) in the second quarter of 2019.

The geographic breakdown as a percentage of revenue for the second quarter was as follows: Israel 24% versus 23%; North America 26% versus 23%; Latin America 3% versus 9%; Europe 17% versus 19%; Africa 15% versus 16%; Asia and the rest of the world 15% versus 10%.

The breakout between Magal Integrated Solutions and Senstar's product revenue was 47% product, and 53% projects.

Magal Integrations Solutions division revenue declined by 26% year-over-year, and Senstar product division revenue declined by 4% year-over-year.

Second quarter blended gross margin was 44.2% of revenue versus 42.6% last year. The gross margin increase was primarily due to the higher gross profit contribution related to the increase of Senstar sensor product sales, as well as cost savings in the quarter.

Our operating expenses were \$6.4 million, a 22% reduction from the prior year second quarter operating expenses of \$8.2 million. The reduction in operating expenses is attributable primarily to payroll-related actions, such as delays in hiring and reduction in vacation liability, as well as the reduction in other expenses such as travel and marketing.

We deliver these reductions while maintaining our continuous investments in R&D and sales personnel.

Operating income was \$796,000 in second quarter of 2020, compared to \$195,000 in the second quarter of 2019.

Financial expense was \$457,000, compared to financial expense of \$363,000 in the second quarter of the last year. This is a non-cash expense as a result of the end-of-period valuation of monetary assets and liabilities.

At the end of each period, the change in currency valuation of monetary assets and liabilities is recorded as a non-cash financial expense to our income, therefore we use EBITDA and non-GAAP metrics to even out the variable influx of foreign exchange fluctuations, and other non-cash factors, and believe that EBITDA is a better gauge of the Company's performance.

EBITDA for the second quarter was \$1.3 million, versus EBITDA of \$716,000 in the second quarter of the last year.

Net income attributable to Magal's shareholders in the quarter was \$153,000, or \$0.01 per share versus a net loss of \$236,000, or \$0.01 share in the second quarter of the prior year.

Cash and cash equivalent, short-term deposits and restricted cash and deposits net of short-term debt and credit as of June 30, 2020 were \$56.4 million, or \$2.44 per share, compared with cash and short-term deposits of \$51.6 million, or \$2.23 per share as of December 31, 2019, and \$54.4 million, or \$2.35 per share as of March 31, 2020.

Our working capital decreased by almost \$5 million at June 30, 2020, in comparison to the end of the last year. A majority of the decrease is driven by the trade receivables collections related to high-billing level in Q4 2019.

We delivered positive cash flow from operations of \$1.1 million in the quarter. We are pleased with the Company's ability to generate cash in such a tough environment.

That concludes my remarks.

We are happy to take your questions now. Operator, please?

Operator

Thank you.

Thank you. Ladies and gentlemen, at this time, we will be conducting a question-and-answer session. If you'd like to ask a question, you may please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, you may need to pick up your handset before pressing the star key.

Our first question comes from the line of Sam Rebotsky with SER Asset Management. Please proceed with your question.

Sam Rebotsky

Good morning, Dror, and good morning, Kobi, or afternoon in Israel.

The \$6.5 million contract, in the language it says the contract has a value of \$6.5 million with final acceptance expected in second half of 2021. Does that mean you started working on the contract and they will complete it? When do you start working on it, and when do you get the money?

Dror Sharon

The idea, again, we signed it just last week, so we booked it last week in our backlogs, starting to operator immediately. I assume that up to 20% will be done during 2020, and the rest should be finished by the end of 2021.

Sam Rebotsky

Well, that sounds very good.

Your profit on the—even though the sales went down for the quarter, you managed to show a small profit. I assume with all the—with the additional contracts, if you increase sales, your profit will increase proportionally going forward.

Kobi Vinokur

In this—hi, Sam, this is Kobi. In this respect we should remember that currently in this quarter, we are not at our quarterly opex run-rate, so the reduction in operational expenses is a reaction, it's a reaction basically to the specific situation related to COVID-19 impact. Obviously elements like travel and other expenses will get back, at least partially, as the overall situation and the economy is getting back to normal, so it's not—I wouldn't say it will a pure increase or improvement, EBITDA is a bit more complex than that, but definitely this contract is accretive to our profitability.

Sam Rebotsky

Okay. I'm going to say something which—you recall—Thurman Willis, who was on the call and had always asked for activity in investor relations, unfortunately, he passed and I would appreciate in his name that you would do as much as you can in investor relations in memory of Thurman Willis, and hopefully you have—your story improves and your earnings improve, and he would appreciate knowing that Magal has improved, and thank you.

Dror Sharon

Thank you, Sam.

Kobi Vinokur

Thank you, Sam. Thurman did believe very much in the Company, and we do join your wishes.

Sam Rebotsky

Thank you.

Operator

As a reminder, ladies and gentlemen, it is star, one to ask a question.

Our next question comes from the line of Ken Liddy with Oppenheimer. Please proceed with your question.

Ken Liddy

Hi, good afternoon.

Just two questions, first, have you had any additional feedback on your Safe Spaces video analytics at this point yet?

Dror Sharon

So, with Safe Spaces we are now introducing it to several customers and distributors. They are now evaluating the solution. I assume that in the next few weeks or a month, we will start to secure all those, but again, something left to see in the (inaudible), but we see lots of attraction and enthusiasm about this solution.

Ken Liddy

And, given COVID-19, do you see any new verticals that will provide growth or have things changed at this point that you can discuss?

Dror Sharon

As I mentioned in my script, the logistics looks very promising. The amount of logistics warehouses and centers is growing, people are buying more and more online, and logistics providers and suppliers are looking for solutions in two levels. One is to secure the logistics centers themselves, and we started to provide them also with project management, we did already the first project in Newark, and the (inaudible) was pretty pleased. And, by using our VMS software, we are managing the movement of the parcels by unique analytics solution developed for this system. So, logistics looks very promising. For some reason also the Correctional facilities, especially in North America, is a growing market.

Ken Liddy

Good to hear.

And, just one last question, what was your cash flow for the quarter?

Kobi Vinokur

So, we had positive cash flow from operations of just about \$1 million.

Ken Liddy

Okay, great. Congratulations on maintaining the profit. I appreciate it. Take care.

Kobi Vinokur

Thank you, Ken.

Ken Liddy

Thank you.

Operator

As a reminder, ladies and gentlemen, it is (audio interference).

Dror Sharon

Hello?

Operator

As a reminder, ladies and gentlemen, it is star, one to ask a question.

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

Dror Sharon

Bruce?

Bruce Tuchman

(Audio interference) both aware, at least Kobi I know is aware, it's been a disappointing run and I know that in the past, people have said to emphasize investor relations and get the word out, but it's really a matter of increasing sales. If you guys can get either a better salesforce or a kick-in-the-butt to the current salesforce, in this environment in the past 10 years with terrorism, with everything else going on in the world, you folks should be doing a much better job of getting your product out there. I keep hearing the good news on this contract and that contract, but the stock at \$3.35 this morning, is not reflecting a growing company, and I had hoped that you folks would be growing a lot better, and increasing sales. So, it's really not a question, it's a comment, and I've been a dedicated shareholder and hope to be longer because I believe in the product, I believe in the Company, and I believe in the need for the product. So, if you could comment, that would be great, but otherwise, I wish you all a great day.

Dror Sharon

One—maybe one comment, Bruce. The Company for the last two years '18/'19 grew very nice. We grew the sales in between 30% to 50% year-over-year, and the plans for 2020 was pretty much to keep this trend. (Inaudible) we have to speak more with the investors, but revenue-wise, and also profit-wise, the Company grew very nice in those two-years. (Inaudible) rest of the world in beginning of the year with the COVID situation, it slowed us down. Hopefully in the next—within six months or so, once COVID will be controlled in a better manner, worldwide we'll be able to go back on track and grow the Company, because we see lots of traction. I assume that security will grow even more than what it will grow in the last year, and so I still believe that the security is a good place to be.

There is some kind of slowed down during 2020 because of the COVID, but other than that, the Company grew very nice in the previous two-years.

Bruce Tuchman

Okay, thank you, keep it up.

Dror Sharon

Okay, thank you.

Operator

Our next question is a follow-up question from the line of Sam Rebotsky of SER Asset Management. Please proceed with your question.

Sam Rebotsky

Yes, Dror, you spoke of acquisitions previously, what is the status of the acquisitions we're looking at, and as prices come down on a potential acquisition.

Dror Sharon

We are looking in two directions. We have a few prospect in front of us, with one also actually two we are (inaudible) analyzed outside. I cannot say that prices went down, but at least there are some good opportunities in front of us. Anyhow we'll proceed exploring those companies. Hopefully once we'll be able to move out of Israel and meet them face-to-face, we'll be able to try and close at least one if not two during the next few months.

Sam Rebotsky

Okay. And could you sort of comment relative to the tender offer for stock which was unsuccessful by the officer—by the major stockholder that owns about 40%, and what is the Company's position on that, they're a member of the Board of Directors, and what has been the recommendation of this type of procedure, and what did that accomplish? If this was not successful, but the stock managed to move up after that, and based on this contract, sort of would you comment something on that?

Kobi Vinokur

The tender offer is basically between the shareholders, so from that perspective and with his company's management, we are kind of outside of this transaction of course, which eventually did not happen. The Board of Directors did convene twice as required by the law to discuss and provide a recommendation, eventually decided to be neutral in terms of the recommendation, and I think this is how we see it from the management team perspective.

Sam Rebotsky

From my point of view, the stock is under-valued and you've hired a new IR firm, and they will do whatever they think and recommend to you to get exposure as best they can with the COVID, but there is all the security needs, and hopefully the contracts that you've just signed, it is decently profitable, and that we can get the stock to trade on a regular basis at a higher price.

Good luck. Thank you very much.

Dror Sharon

Thank you, Sam.

Kobi Vinokur

Thank you, Sam. Just to add that we are going to attempt—from the IR perspective, we work very closely with Hayden IR, and Brett and Kim were very pleased with their service. We are going to attend the LB (inaudible) in beginning of September, hoping to market successfully the stock. We also have the scheduled calls almost every week with new potential investors. We also extended some very nicely our IR work in Israel, in our home country, and we also conduct here almost weekly meetings with potential investors base, so we hope that eventually our story gets out of there and gets understood, and we will see some traction in the stock price.

Operator

Once again, it is star, one to ask a question.

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

Craig Roth

Good afternoon. I just had a question about cash, just to confirm that cash per share is US\$2.44, and regarding the changes in expenses to follow on the proportional comment earlier, as business increases again and your expenses rise, do you anticipate using cash. The reason I have the question is that even with this, you increased your cash on-hand, so how should I understand that going forward, please?

Kobi Vinokur

In terms of the calculation, it's indeed the number that you mentioned. We have around \$66 million in cash, and we are around \$23 million of shares out there.

Dror Sharon

Twenty-two million.

Kobi Vinokur

Twenty-two million, so this is the situation. We do generate—we show positive EBITDA, we generate cash, we generate cash from operations, and this is the result of cash increase. We had—we finished basically in 2018 and 2019 with positive EBITDA, and basically the cash increased during 2020, obviously it's also related to the collection of income that was earned in Q4 in 2019.

From our perspective, the cash—the use of the cash is for the M&A activity, and, as we mentioned, our target list gets longer, actually in the last few months, and we are in quite intense stage with at least two targets, and on top of that, there is working capital provisional use of cash.

I hope that I addressed your question.

Craig Roth

Yes, I think so. Thank you, and congratulations.

Dror Sharon

You're welcome.

Operator

There are no further questions in the queue. I'd like to hand the call back to management for closing remarks.

Dror Sharon

Okay, thank you, Operator.

On behalf of the management of Magal, I would like to thank you for your continuing interest and long-term support to our business.

I look forward to updating you next quarter.

Have a good day, all of you. Thank you.

Operator

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