FARMSTEAD TELEPHONE GROUP INC
Form 10-Q
May 11, 2001

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)
[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended March 31, 2001
or
[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Commission File Number: 0-15938

Farmstead Telephone Group, Inc.
(Exact name of registrant as specified in its charter)

Delaware	06-1205743
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
22 Prestige Park Circle East Hartford, CT	06108
(Address of principal executive offices)	(Zip Code)

(860) 610-6000
(Registrant's telephone number)

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 past 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 [ ]

As of April 28, 2001, the registrant had 3,272,579 shares of its $0.001 par value Common Stock outstanding.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

(In thousands)	March 31, 2001	December 31, 2000
	(Unaudited)	

ASSETS		
Current assets:		
Cash and cash equivalents	$ 694	$ 374
Accounts receivable, less allowance for doubtful accounts	4,937	6,527
Inventories	8,550	7,181
Deferred income taxes	107	107
Other current assets	175	90
Total Current Assets	14,463	14,279
Property and equipment, net	584	632
Non-current deferred income taxes	348	348
Other assets	278	235
Total Assets	$15,673	$15,494
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,613	$ 3,789
Debt maturing within one year (Note 2)	102	102
Accrued expenses and other current liabilities (Note 3)	644	1,493
Total Current Liabilities	4,359	5,384
Long-term debt (Note 2)	2,630	1,726
Other liabilities	201	182
Total Liabilities	7,190	7,292
Minority Interest in Subsidiary (Note 4)	117	-
Stockholders' Equity:		
Preferred stock, $0.001 par value; 2,000,000 shares authorized; no shares issued and outstanding	-	-
Common stock, $0.001 par value; 30,000,000 shares authorized; 3,272,579 shares issued and outstanding at March 31, 2001 and December 31, 2000, respectively	3	3
Additional paid-in capital	12,258	12,248
Accumulated deficit	(3,895)	(4,049)
Total Stockholders' Equity	8,366	8,202
Total Liabilities and Stockholders' Equity	$15,673	$15,494

See accompanying notes to consolidated financial statements.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
Three Months Ended March 31, 2001 and 2000

(In thousands, except per share amounts)	2001	2000

Revenues	$9,294	$9,449
Cost of revenues	6,869	7,497
Gross profit	2,425	1,952
Selling, general and administrative expenses	2,131	1,822
Operating income	294	130
Interest expense	(41)	(115)
Other income	11	10
Income before income taxes and minority interest in income of subsidiary	264	25
Provision for income taxes	18	2
Income before minority interest in income of subsidiary	246	23
Minority interest in income of subsidiary	92	-
Net income	$ 154	$ 23
Basic and diluted net income per common share	$ .05	$ .01
Weighted average common shares outstanding:		
Basic	3,273	3,273
Diluted	3,357	3,276

See accompanying notes to consolidated financial statements.

FARMSTEAD TELEPHONE GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
Three Months Ended March 31, 2001 and 2000

(In thousands)	2001	2000
Cash flows from operating activities:		
Net income	$ 154	$ 23
Adjustments to reconcile net income to net cash flows (used in) provided by operating activities:		
Depreciation and amortization	62	88
Minority interest in income of subsidiary	92	-
Value of compensatory stock options issued	10	-
Changes in operating assets and liabilities:		
Decrease in accounts receivable	1,590	407
(Increase) decrease in inventories	(1,369)	817
Increase in other assets	(128)	(138)
(Decrease) increase in accounts payable	(176)	503
(Decrease) increase in accrued expenses and other current liabilities	(849)	996
Increase in other liabilities	19	18
Net cash (used in) provided by operating activities	(595)	2,714

Cash flows from investing activities:		
Purchases of property and equipment	(14)	(18)
Net cash used in investing activities	(14)	(18)
Cash flows from financing activities:		
Repayments of inventory finance borrowings	-	(1,159)
Borrowings (repayments) under revolving credit line	930	(1,472)
Repayments of capital lease obligation	(26)	(32)
Capital contribution from minority interest partner	25	-
Net cash provided by (used in) financing activities	929	(2,663)
Net increase in cash and cash equivalents	320	33
Cash and cash equivalents at beginning of period	374	446
Cash and cash equivalents at end of period	$ 694	$ 479
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 41	$ 115
Income taxes	77	5

See accompanying notes to consolidated financial statements.

FARMSTEAD TELEPHONE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Note 1. Basis of Presentation

The interim financial statements are presented on a consolidated basis, consisting of the accounts of Farmstead Telephone Group, Inc., its wholly owned subsidiary, FTG Venture Corporation (inactive) and InfiNet Systems, LLC, a subsidiary in which the company has a 50.1% ownership interest (the "Company"). See Note 4 for further information on InfiNet. The interim financial statements presented herein are unaudited, however in the opinion of management these statements reflect all adjustments, consisting of adjustments that are of a normal recurring nature, which are necessary for a fair statement of results for the interim periods presented. This Form 10-Q should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2000.

Note 2. Debt Obligations

Long-term Debt

Long-term debt obligations consisted of the following (in thousands):

	March 31, 2001	December 31, 2000

Revolving credit agreement	$2,619	$1,689
Obligation under capital lease	113	139
	2,732	1,828
Less current portion	(102)	(102)
Long-term debt	$2,630	$1,726

As of March 31, 2001, the unused portion of the revolving credit facility was approximately $5,381,000, of which approximately $1,728,000 was available under various borrowing formulas. The average and highest amounts borrowed during the three months ended March 31, 2001 were approximately $1.9 million and $2.6 million, respectively. The Company was in compliance with its loan covenants as of March 31, 2001.

Note 3. Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consisted of the following (in thousands):

	March 31, 2001	December 31, 2000
Salaries, commissions and benefits	$433	$1,137
License fees payable to Avaya	92	210
Other	119	146
Accrued expenses and other current liabilities	$644	$1,493

Note 4. Formation of Subsidiary

Effective February 1, 2001, the Company 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, the Company has a 50.1% ownership interest, and TriNet has a 49.9% ownership interest. Incorporated under the laws of the State of Delaware, and with operations currently based in East Hartford, CT, 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. InfiNet was initially funded by an aggregate capital contribution of $50,000. InfiNet recorded revenues of $949,000 and net income of $183,000 from its inception to March 31, 2001. InfiNet's total assets at March 31, 2001 were $1,074,000.

Since the Company owns greater than a 50% interest in, and exercises significant control over, InfiNet, the financial statements of InfiNet have been consolidated herein. All intercompany balances and transactions have been eliminated.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations

Net Income

Net income for the three months ended March 31, 2001 was $154,000, compared with $23,000 for the three months ended March 31, 2000. Net income for the current year period includes $92,000 representing the Company's 50.1% interest in the net income of InfiNet, which was organized in February 2001. In its first months of operations, InfiNet recorded net income of $183,000 on revenues of $949,000. See the notes to consolidated financial statements contained elsewhere herein, for further information on InfiNet.

Revenues

Revenues for the three months ended March 31, 2001 were $9,294,000, a decrease of $155,000 or 1.6% from the three months ended March 31, 2000. End-user equipment sales revenues in the current year amounted to $7,540,000, a decrease of $32,000 or .4% from the comparable 2000 period. Equipment sales to other resellers in the current year amounted to $1,090,000, a decrease of $16,000 or 1.4% from the comparable 2000 period, while service revenues amounted to $664,000, a decrease of $107,000 or 13.9% from the comparable 2000 period. Revenues for the three months ended March 31, 2001 included $949,000 of end-user system sales and installation revenues generated by InfiNet. Excluding revenues generated by InfiNet, revenues were 11.7% below the comparable period of 2000. The Company believes this is primarily a reflection of current economic conditions and the resulting slowdown in capital spending for technology products, and to some extent the result of a reduction in the Company's sales force due to turnover.

Gross Profit

Total cost of revenues for the three months ended March 31, 2001 were $6,869,000, a decrease of $628,000 or 8.4% from the three months ended March 31, 2000. The gross profit for the three months ended March 31, 2001 was $2,425,000, an increase of $473,000 or 24.2% over the comparable 2000 period. As a percentage of revenue, the gross profit margin increased to 26.1% in the current year period, from 20.7% for the prior year period. The improvement in the gross profit margin was attributable to several factors including a shift in product mix (higher percentage of the more profitable used equipment vs. new equipment); lower labor and overhead costs as a percent of revenues; an improvement in product pricing; and the discontinuance of an unprofitable equipment repair contract in the prior year.

Selling, General and Administrative ("SG&A") Expenses

SG&A expenses for the three months ended March 31, 2001 were $2,131,000, an increase of $309,000 or 17.0% over the three months ended March 31, 2000. As a percentage of revenues, SG&A expenses were 22.9% and 19.3%, respectively, for the three months ended March 31, 2001 and 2000. The increase in SG&A expenses in the current year period was primarily attributable to higher compensation levels, expenses incurred in locating and hiring new personnel, increased business and employee insurance costs, and higher bank charges from increased credit card sales volume, offset by lower fixed asset depreciation expense. The Company also incurred higher than normal legal fees during the current year period, principally in connection with amending the Company's By-laws and Certificate of Incorporation, establishing a proposed employee stock purchase plan for approval at the June 14, 2001 annual stockholders meeting, and in various other corporate governance matters. Also included in the increase in SG&A

expenses for the current year period, are $35,000 of salary, commission and other overhead expenses incurred by InfiNet.

Interest Expense, Other Income and Minority Interest

Interest expense for the three months ended March 31, 2001 was $41,000, as compared to $115,000 for the three months ended March 31, 2000. The decrease in interest expense in the current year period was attributable to both lower average bank borrowings, and lower borrowing costs. During the current year period, average borrowings approximated $1,900,000 at an average borrowing rate of 8%, compared with average borrowings approximating $4,500,000 at an average borrowing rate of 9.5% for the same period of 2000.

Other income for the three months ended March 31, 2001 and 2000 consisted primarily of interest earned on invested cash.

Minority interest of $92,000 for the three months ended March 31, 2001 represents the 49.9% share of the net income of InfiNet accruing to its minority partner.

Liquidity and Capital Resources

Working capital was $10,104,000 at March 31, 2001, an increase of $1,209,000 or 13.6% from $8,895,000 at December 31, 2000. The working capital ratio was 3.3 to 1 at March 31, 2001, compared with 2.7 to 1 at December 31, 2000.

Operating activities used $595,000 during the three months ended March 31, 2001, principally as a result of an increase in inventory and a reduction in accrued expenses, partially offset by a decrease in accounts receivable. Investing activities used $14,000 in the purchase of property and equipment.

Financing activities provided $929,000, principally from an increase in bank borrowings. The Company's loan agreement with its bank contains certain financial covenants, and the Company was in compliance with these covenants at March 31, 2001. As of March 31, 2001, the unused portion of the credit facility was approximately $5,381,000 of which approximately $1,728,000 was available under various borrowing formulas. The average and highest amounts borrowed during the three months ended March 31, 2001 were approximately $1.9 million and $2.6 million, respectively. Financing activities also included a $25,000 capital contribution to InfiNet from its minority partner.

The Company is currently dependent upon its existing credit agreements and accounts receivable collection experience to provide cash to satisfy its working capital requirements. Material changes in its credit agreements, or a slowdown in the collection of accounts receivable, could negatively impact the Company. No assurances can be given that the Company will have sufficient cash resources to finance future growth, and it may become necessary to seek additional financing for such purpose. There are currently no material commitments for capital expenditures.

Safe Harbor Forward-Looking Statements

The Company's prospects are subject to certain uncertainties and risks. The discussions set forth in this Form 10-Q report contain certain statements, based on current expectations, estimates, forecasts and projections about the industry in which the Company operates and management's beliefs and assumptions, which are not historical facts and are considered forward-looking statements within the meaning of the Private

Securities Litigation Reform Act of 1995 ("the Act"). Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate, or imply future results, performance, or achievements, and may contain the words "believe," "will be," "will continue," "will likely result," "anticipates," "seeks to," "estimates," "expects," "intends," "plans," "predicts," "projects," and similar words, expressions or phrases of similar meaning. The Company's actual results could differ materially from those projected in the forward-looking statements as a result of certain risks, uncertainties and assumptions which are difficult to predict. The risks and uncertainties are detailed from time to time in reports filed by the Company with the Securities and Exchange Commission ("SEC") including Forms 8-K, 10-Q, and 10-K, and include, among other factors, general economic conditions and growth in the telecommunications industry, competitive factors and pricing pressures, changes in product mix, product demand, risk of dependence on third party suppliers, the ability of the Company to sustain, manage or forecast its growth and inventories, performance and reliability of products, customer service, adverse publicity, business disruptions; increased costs of freight and transportation to meet delivery deadlines, changes in business strategy or development plans, turnover of key employees, and other risk factors detailed in this report, described from time to time in the Company's other SEC filings, or discussed in the Company's press releases. In addition, other written or oral statements made or incorporated by reference from time to time by the Company or its representatives in this report, other reports, filings with the Securities and Exchange Commission, press releases, conferences, or otherwise are forward-looking statements within the meaning of the Act. All forward-looking statements included in this document are based upon information available to the Company on the date hereof. The Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

The risks included here are not exhaustive. Other sections of this report may include additional factors which could adversely affect the Company's business and financial performance. Moreover, the Company operates in a very competitive and rapidly changing environment. New risk factors emerge from time to time and it is not possible for management to predict all such risk factors, nor can it assess the impact of all such risk factors on its business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements as a prediction of actual results.

Investors should also be aware that while the Company does, from time to time, communicate with securities analysts, it is against the Company's policy to disclose to them any material information unless such information shall have been previously or is simultaneously disclosed in a manner intended to provide broad, nonexclusionary distribution of the information to the public. Accordingly, shareholders should not assume that the Company agrees with any statement or report issued by any analyst irrespective of the content of the statement or report. Furthermore, the Company has a policy against issuing or confirming financial forecasts or projections issued by others. Thus, to the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are not the responsibility of the Company.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Market risks which have the potential to affect the Company's earnings and cash flows result primarily from changes in interest rates. The Company's cash equivalents, which consist of an investment in a money market fund consisting of high quality short term instruments, principally US government and agency issues and commercial paper, are subject to fluctuating interest rates. A 10 percent change in such current interest rates would not have a material effect on the Company's results of operations or cash flow.

The Company is also exposed to market risk from changes in the interest rate related to its revolving credit facility, which is based upon a 30-day average LIBOR rate. Assuming an average borrowing level of $1.9 million (which amount represented the average amount borrowed under the revolving credit facility during the three months ended March 31, 2001), each 1 percentage point increase in the bank's lending rate would result in $19,000 of additional annual interest charges. Under its current policies, the Company does not use interest rate derivative instruments to manage exposure to interest rate changes.

PART II. OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

On February 28, 2001, the Board of Directors of the Company amended and restated the By-laws of the Company in order to, among other things, (i) adopt an advanced notice provision for nominations or other business to be properly brought before an annual meeting by Stockholders; (ii) eliminate the right of Stockholders to call special meetings; (iii) provide that a quorum is a majority of shares entitled to vote, present, in person, or represented by a proxy; (iv) amend the section pertaining to indemnification of officers, directors, and employees; (v) require a super majority vote of Stockholders to further amend the Amended and Restated By-laws, in certain instances. A copy of the Amended and Restated By-laws of the Company was filed as Exhibit 3(d) to the Annual Report on Form 10-K for the period ending December 31, 2000.

Item 6. Exhibits and Reports on Form 8-K:

(a) Exhibits: None.

(b) Reports on Form 8-K: None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FARMSTEAD TELEPHONE GROUP, INC.

Dated: May 11, 2001

/s/ George J. Taylor, Jr.

George J. Taylor, Jr.
Chief Executive Officer, President

Dated: May 11, 2001

/s/ Robert G. LaVigne

Robert G. LaVigne
Executive Vice President,
Chief Financial Officer