SYSTEMONE TECHNOLOGIES INC
Form 10QSB
November 12, 2004

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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended September 30, 2004

Commission File No. 000-21325

SYSTEMONE TECHNOLOGIES INC.

(Exact Name of Small Business Issuer as Specified in its Charter)

Florida	**65-0226813**
(State or Other Jurisdiction of Incorporation or organization)	**(I.R.S. Employer Identification No.)**

**8305 N.W. 27th Street, Suite 107
Miami, Florida 33122**

(Address of Principal Executive Offices)

(305) 593-8015

(Issuer s Telephone Number, Including Area Code)

The registrant had an aggregate of 4,960,087 shares of its common stock, par value $.001 per share, outstanding as of the close of business on November 8, 2004.

Transitional Small Business Disclosure Format (check one): YES [ ] NO [X]

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PART I. FINANCIAL INFORMATION
ITEM 1. CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

SYSTEMONE TECHNOLOGIES INC.

CONDENSED BALANCE SHEETS

(In thousands, except share and per share data)

	September 30, 2004 (Unaudited)	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,534	$ 8,359
Receivables, net of allowance of $4 and $0	430	7
Inventories, net of obsolescence reserve of $193 and $183	2,231	1,745
Prepaid and other assets	107	386
Assets held for sale	39	39
Total current assets	7,341	10,536
Property and equipment, net	420	540
Other assets	63	197
Total assets	$ 7,824	$ 11,273
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable and accrued expenses	$ 999	$ 1,165
Warranty accrual	199	241
Deferred revenue	24	64
Current installments of long-term debt and obligations under capital leases	101	31
Total current liabilities	1,323	1,501
Long-term debt	15,117	29,150
Warranty accrual, non-current	70	176
Total liabilities	16,510	30,827

Commitments and contingencies		
Redeemable convertible preferred stock, $1.00 par value per share. Authorized 1,500,000 shares, 209,569 issued and outstanding (197,376 in 2003), at liquidation value	20,957	19,738
Less unamortized discount		(283)
Net redeemable convertible preferred stock	20,957	19,455
Stockholders deficit:		
Common stock, $0.001 par value per share. Authorized 25,000,000 shares, issued and outstanding 4,960,087	5	5
Additional paid-in capital	20,723	20,723
Deficit	(50,371)	(59,737)
Total stockholders deficit	(29,643)	(39,009)
Total liabilities, redeemable convertible preferred stock and stockholders deficit	$ 7,824	$ 11,273

See accompanying notes to condensed financial statements (unaudited).

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SYSTEMONE TECHNOLOGIES INC.

CONDENSED STATEMENTS OF OPERATIONS
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003
(Unaudited)
(In thousands, except share and per share data)

	Three Months Ended		Nine Months Ended	
	September 30, 2004	**September 30, 2003**	**September 30, 2004**	**September 30, 2003**
Revenue	$ 817	$ 5,519	$ 1,659	$ 16,829
Cost of goods sold	647	3,470	1,470	10,347
Gross profit	170	2,049	189	6,482
Operating expenses:				
Selling, general and administrative	577	863	2,115	2,306
Research and development	75	84	278	275
Total operating expenses	652	947	2,393	2,581
Operating (loss) income	(482)	1,102	(2,204)	3,901
Other (expense) income:				
Safety-Kleen termination fee income			4,000	
Gain on Notes repurchase			10,217	
Interest expense	(350)	(754)	(1,047)	(2,324)
Interest income	17	139	42	389
Other (expense) income, net	(333)	(615)	13,212	(1,935)
(Loss) income before income tax provision	(815)	487	11,008	1,966
Income tax benefit (provision)	20	(7)	(140)	(40)
Net (loss) income	(795)	480	10,868	1,926

Dividends and accretion of discount on redeemable convertible preferred stock	(417)	(566)	(1,502)	(1,669)
Net (loss) income available to common shares	$(1,212)	$ (86)	$ 9,366	$ 257
Basic net (loss) income per common share	$ (.24)	$ (.02)	$ 1.89	$ .05
Diluted net (loss) income per common share	$ (.24)	$ (.02)	$ .98	$ .04

See accompanying notes to condensed financial statements (unaudited).

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SYSTEMONE TECHNOLOGIES INC.

CONDENSED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004 AND 2003
(Unaudited)
(In thousands)

	September 30, 2004	September 30, 2003
Cash flows provided by operating activities:		
Net income	$ 10,868	$ 1,926
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	124	321
Amortization of debt issue costs	50	94
Interest accrued on convertible debt and amortization of note discounts	785	1,419
Gain on Notes repurchase, net of debt issue costs	(10,217)	
Changes in operating assets and liabilities:		
Receivables	(423)	(1,369)
Inventories	(486)	(294)
Prepaid and other assets	193	177
Accounts payable and accrued expenses	(166)	519
Warranty accrual	(148)	(148)
Deferred revenue	(40)	(29)
Net cash provided by operating activities	540	2,616
Cash flows used in investing activities:		
Purchase of equipment	(11)	(32)
Return of equipment	7	
Net cash used in investing activities	(4)	(32)
Cash flows used in financing activities:		
Repayments of Subordinated Convertible Notes	(2,916)	
Repayments of revolving credit loan	(1,435)	(1,735)
Repayments of capital lease obligations	(10)	(137)
Net cash used in financing activities	(4,361)	(1,872)

Net (decrease) increase in cash and cash equivalents	(3,825)	712
Cash and cash equivalents at beginning of period	8,359	505
Cash and cash equivalents at end of period	$ 4,534	$ 1,217
Supplemental disclosures:		
Cash paid for interest	$ 194	$ 822
Non-cash financing and investing activities:		
Acquisition of equipment through a capital lease	$	$ 23

See accompanying notes to condensed financial statements (unaudited).

SYSTEMONE TECHNOLOGIES INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NEW ACCOUNTING PRONOUNCEMENTS

The Company designs, manufactures and sells a full line of patented, self-contained, recycling industrial parts washers (the SystemOne® Washers), for use in the automotive, aviation, marine and general industrial repair markets. The Company has been awarded eleven patents for its products, which incorporate innovative, proprietary resource recovery and waste minimization technologies to distill contaminated solvents and yield pure solvent allowing cleaning solvents to be used, recycled and re-used perpetually, thus eliminating the need for costly and dangerous storage, transportation, and off-site processing of hazardous waste.

The Company was incorporated as Mansur Industries Inc. in November 1990 and, as a development stage company, devoted substantially all of its resources to research and development programs related to its full line of self-contained, recycling industrial parts washers until June 1996. The Company commenced its planned principal operations in July 1996 and began to generate significant revenue from product sales commencing in 1997. Between 1997 and 2000, the Company developed a national direct marketing and distribution organization, including the establishment of regional distribution centers and a service fleet, to market its products directly to customers.

Shifting its strategy in late 2000, the Company appointed Safety-Kleen Systems, Inc., a wholly-owned subsidiary of Safety-Kleen Corp. (collectively, Safety-Kleen), the exclusive distributor for SystemOne® parts washers in the United States, Puerto Rico, Canada and Mexico (the Territory) under the Marketing and Distribution Agreement, dated November 14, 2000, as amended and restated as of March 8, 2001 (the Exclusive Marketing Agreement). This strategic shift allowed the Company to eliminate its entire national direct sales and service infrastructure permitting a significant reduction in the Company s operating expenses. Also, during 2000 the Company s operating subsidiary was merged with and into the Company and the Company changed its name to SystemOne Technologies Inc.

On September 30, 2003, the Company entered into a Comprehensive Settlement Agreement (the Settlement Agreement) with Safety-Kleen that, among other things, terminated the Exclusive Marketing Agreement. For more information regarding the termination of the Exclusive Marketing Agreement, its potential effect on the Company s financial position, and management s plans for the future see note 2 below. Because Safety-Kleen was the Company s only customer, the Company must establish new distribution channels for its products and continues such efforts.

(1) BASIS OF PRESENTATION

The accompanying unaudited condensed interim financial statements have been prepared pursuant to the federal securities rules and regulations promulgated by the Securities and

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Exchange Commission for reporting on a Quarterly Report on Form 10-QSB. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America for complete financial statements are not included herein. The interim statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-KSB for the year ended December 31, 2003 as filed with the Securities and Exchange Commission.

Management acknowledges its responsibility for the preparation of the accompanying interim financial statements, which reflect all adjustments considered necessary, in the opinion of management, for a fair presentation. The results of operations for the interim periods are not necessarily indicative of the results of operations for the entire year.

(2) LIQUIDITY AND OUTLOOK

On September 30, 2003, the Company entered into the Settlement Agreement with Safety-Kleen to terminate the Exclusive Marketing Agreement. The Settlement Agreement provided for a total payment of $14 million to the Company, consisting of a termination fee and a lump sum payment of the accumulated deferred price on the approximately 30,000 parts washer units shipped to Safety-Kleen under the Exclusive Marketing Agreement prior to its termination. Of this amount, the Company received $10 million during the fourth quarter of 2003 and the balance during the first quarter of 2004. In addition, the Settlement Agreement (i) canceled all remaining purchase commitments under the Exclusive Marketing Agreement, effective as of October 1, 2003, (ii) settled all disputes regarding the Exclusive Marketing Agreement, and (iii) released the parties from any and all claims that each may have against the other. Safety-Kleen was also given the right (but not the obligation) in 2005 to purchase the lesser of up to 3,000 parts washer units or one-sixth of the Company s then annual production capacity. (Approximately 3,750 units would have been shipped every quarter of 2004 under the Exclusive Marketing Agreement.)

Because Safety-Kleen was the Company s only customer, the Company continues its efforts to develop new third party distribution channels for its products. To date the Company has identified and communicated with 416 potential distributors nationwide from which the Company anticipates appointing approximately 40-50 distributors. Approximately 22 distributors have been appointed to date and the Company expects to continue with the appointment of new distributors through the end of the year and beyond. Although there can be no assurance, the Company believes that sales should trend upward in successive quarters as its new distribution channels continue to ramp up and mature.

During March 2004, the Company repurchased and retired $13.5 million principal amount of its 8.25% Subordinated Convertible Note due December 31, 2005 (the Notes) for an aggregate purchase price of $2.9 million. The Company recognized a pre-tax gain of approximately $10.2 million in the first quarter of 2004 on the repurchase and retirement of these Notes. See note 8 for further discussion.

During June 2004 the Company laid off seven employees and reduced the salaries of several others, including executive management, in order to conserve cash and streamline corporate operations and administration. The Company recognized an expense of approximately $65,000

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in the three months ended June 30, 2004 in relation to the severance and benefits continuation granted to the seven employees. In addition, manufacturing labor hours were reduced by 20% pending improvement in the level of unit sales. The savings resulting from these cost reduction efforts is estimated at $700,000 annually. However, should the Company s sales increase, there might be the need to replace certain of these individuals. Further, management expects consulting expenses to increase in 2005 as a result of the implementation of Section 404 of the Sarbanes-Oxley Act.

The Company believes that it has sufficient cash reserves to meet its operating cash requirements through 2005 prior to the scheduled maturity of long-term debt at December 31, 2005, in addition to the potential for additional borrowings under the Senior Revolver. However, if none of the outstanding convertible debt and convertible preferred stock is converted to common stock or purchased at a discount, significant amounts of cash would be required to repay long-term debt, accrued interest and redeemable preferred stock as follows:

	DEBT PLUS INTEREST	PREFERRED STOCK	TOTAL
2004	194,459		194,459
2005	16,712,316		16,712,316
2006		23,618,000*	23,618,000
Total	$16,906,775	$23,618,000	$40,524,775

* Assuming no pre-payment in full of the Notes (as defined herein).

Based on current plans and projections, it is highly unlikely that the Company will generate sufficient internal cash flow to repay its long-term debt and redeem its preferred stock prior to their scheduled maturities at December 31, 2005 and March 31, 2006, respectively. Accordingly, the Company anticipates that it will be necessary to refinance such obligations through additional debt or restructuring. There can be no assurance that the Company s current efforts to rebuild its distribution system will generate a sufficient level of financial performance and cash flow necessary to permit such refinancing on acceptable terms nor can there be any assurance that any such refinancing would be available at all. In addition, if the Company s efforts to increase its sales is unsuccessful or requires more time and expense than currently anticipated, the Company could be required to further reduce its operating costs.

As a result of the Company s termination of its relationship with Safety-Kleen, its significant indebtedness and stockholder s deficiency, the audit report accompanying its financial statements as of and for the year ended December 31, 2003 notes that there is substantial doubt about the Company s ability to continue as a going concern.

(3) STOCK BASED COMPENSATION

The Company accounts for stock options issued using the intrinsic value method and, accordingly, no compensation cost has been recognized for stock options granted as such options granted had an exercise price greater than or equal to the market value of the underlying common stock on the date of the grant. For options granted under variable accounting, compensation cost

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is recognized for the difference between the exercise price and the market price of the common shares until such options are exercised, expired or forfeited. No compensation cost has been recognized for options under the variable accounting provision because performance criteria have not yet been met. Compensation cost will be recognized if and when the performance criteria are met, based on the excess of the market price over the exercise price at that date.

Per share weighted-average fair value on the date of grant of stock options granted during 2003 ranged from $.28 to $.47 using the Black-Scholes option pricing model with the following assumptions: 2003-expected dividend yield of zero percent, risk-free interest rate of 5.07 percent, expected life of seven years and a volatility ranging from 58.6 to 166.1 percent.

If the Company determined compensation cost based on the fair value of the options at the grant date, the Company s net income (loss) to common shares and basic and diluted net loss per common share would have reflected the pro forma amounts shown below:

FOR THE THREE MONTHS ENDED SEPTEMBER 30,	**2004**	**2003**
Net (loss) income available to common shares:		
As reported	$(1,212)	$ (86)
Incremental compensation expense	(6)	(21)
As adjusted	$(1,218)	(107)
Basic (loss) earnings per share:		
As reported	$ (.24)	$ (.02)
As adjusted	$ (.25)	$ (.02)
Diluted (loss) earnings per share		
As reported	$ (.24)	$ (.02)
As adjusted	$ (.25)	$ (.02)

FOR THE NINE MONTHS ENDED SEPTEMBER 30,	**2004**	**2003**
Net income available to common shares:		
As reported	$9,366	$257
Incremental compensation expense	(34)	(64)
As adjusted	$9,332	$193
Basic earnings per share:		
As reported	$ 1.89	$ .05
As adjusted	$ 1.88	$ .04
Diluted earnings per share		

As reported	$ .98	$ .04
As adjusted	$ .98	$ .03

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(4) REVENUE RECOGNITION

The Company currently recognizes revenue at the time of shipment (F.O.B. plant) for the total sales price of each unit shipped.

Pursuant to the Exclusive Marketing Agreement, which was terminated in 2003, the price charged to Safety-Kleen was determined annually based on the actual manufacturing costs incurred during a specified three-month period of the previous year. Under the Exclusive Marketing Agreement, the price for each unit purchased by Safety-Kleen consisted of two components: a standard price payable on net 30-day terms from the date of shipment and a deferred price (approximately 12% of the total price) payable in equal installments over a 12-quarter period. The Company recognized revenue at the time of shipment (F.O.B. plant) for the total sales price, but applied a discount to reflect the present value of the 12 quarterly deferred price payments utilizing a discount rate of 14% which was the interest rate then paid on the Company s Senior Revolver. In addition, the Company recognized imputed interest income over the discount period as the deferred portion of the purchase price was amortized over the scheduled payment period. The receivable related to the deferred portion of the purchase price and interest income recognized through September 30, 2003 was paid pursuant to the Settlement Agreement.

The collectability of receivables is evaluated routinely and, if deemed necessary, the Company records an allowance for doubtful accounts. The allowance for doubtful accounts was $4,000 at September 30, 2004 and $0 at December 31, 2003. The Company wrote off all uncollectible receivables against the reserve in fiscal year 2003.

Deferred revenue on the balance sheet relates to extended two-year warranty contracts purchased by customers and is recognized in income on the straight-line basis over the term of each contract.

(5) BASIC AND DILUTED INCOME PER SHARE

In accordance with the requirements of SFAS No. 128, *Earnings Per Share* (SFAS No. 128), basic earnings per share is computed by dividing net income or loss by the weighted average number of shares outstanding. Diluted income per share is calculated using the weighted average number of shares outstanding during the period plus the additional dilutive effect of common share equivalents. Options and warrants are accounted for under the treasury stock method while convertible securities are accounted for under the if-converted method. Under the if-converted method, securities are assumed to be converted at the beginning of the period if the conversion of those shares would be dilutive.

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The following reconciles the components of the earnings per share (EPS) computation (in thousands) for the three months ended September 30:

	2004			2003		
(In thousands, except per share data)	Income (Numerator)	Shares (Denominator)	Per-Share Amount	Income (Loss) (Numerator)	Shares (Denominator)	Per-Share Amount
Earnings per common share:						
Net (loss) income	$ (795)	4,960		$ 480	4,960	
Dividends on Redeemable Convertible Preferred Stock	(417)			(566)		
Net (loss) income applicable to common shareholders	$(1,212)	4,960	$(.24)	$ (86)	4,960	$(.02)
Effect of dilutive securities:						
Net (loss) income applicable to common shareholders plus assumed conversions	$(1,212)	4,960	$(.24)	$ (86)	4,960	$(.02)

The following reconciles the components of the earnings per share (EPS) computation (in thousands) for the nine months ended September 30:

	2004			2003		
(In thousands, except per share data)	Income (Numerator)	Shares (Denominator)	Per-Share Amount	Income (Loss) (Numerator)	Shares (Denominator)	Per-Share Amount
Earnings per common share:						
Net income	$10,868	4,960		$ 1,926	4,929	
Dividends on Redeemable Convertible Preferred Stock	(1,502)			(1,669)		
Net income applicable to common shareholders	$ 9,366	4,960	$1.89	$ 257	4,929	$.05
Effect of dilutive securities:						
Warrants		736			797	
Preferred Stock C	637	2,943				

Preferred Stock B	495	1,666				
Preferred Stock D	370	817				
Subordinated Convertible Notes	605	592				
Net income applicable to common shareholders plus assumed conversions	$11,473	11,714	$ .98	$ 257	5,726	$.04

For the three months ended September 30, 2004, the following were outstanding, but were not included in the computation of diluted income per share because they are antidilutive due to the Company s loss: (i) warrants to purchase 29,750, 1,250, 942,858, 571,428 and 736,371 shares of common stock at exercise prices of $19.50, $11.50, $3.50, $3.50 and $0.01 per share, respectively, (ii) Series B, C and D convertible preferred stock and the Notes (including accrued payment-in-kind interest) convertible into 1,666,301, 2,943,021, 816,587 and 592,355 shares of

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common stock at conversion prices of $4.68, $3.50, $3.50 and $17.00, respectively, and (iii) options to purchase 362,536 shares of common stock at exercise prices ranging from $1.00 to $19.50.

For the three months ended September 30, 2003, the following were outstanding, but were not included in the computation of diluted income per share because they are antidilutive due to the Company s loss: (i) warrants to purchase 29,750, 1,250, 942,858, 571,428 and 779,687 shares of common stock at exercise prices of $19.50, $11.50, $3.50, $3.50 and $0.01 per share, respectively, (ii) Series B, C and D convertible preferred stock and the Notes (including accrued payment-in-kind interest) convertible into 1,536,891, 2,720,981, 753,163 and 1,361,533 shares of common stock at conversion prices of $4.68, $3.50, $3.50 and $17.00, respectively, and (iii) options to purchase 533,716 shares of common stock at exercise prices ranging from $2.50 to $19.50.

For the nine months ended September 30, 2004, the following were outstanding, but were not included in the computation of diluted income per share because the exercise prices were greater than the average market price of the common shares: warrants to purchase 29,750, 1,250, 942,858 and 571,428 shares of common stock at exercise prices of $19.50, $11.50, $3.50 and $3.50 per share, respectively and options to purchase 362,536 shares of common stock at exercise prices ranging from $1.00 to $19.50.

For the nine months ended September 30, 2003, the following were outstanding, but were not included in the computation of diluted income per share because the exercise prices were greater than the average market price of the common shares: (i) warrants to purchase 29,750, 1,250, 942,858 and 571,428 shares of common stock at exercise prices of $19.50, $11.50, $3.50 and $3.50 per share, respectively, (ii) Series B, C and D convertible preferred stock and the Notes (including accrued payment-in-kind interest) convertible 1,536,891, 2,720,981, 753,163 and 1,361,533 shares of common stock at conversion prices of $4.68, $3.50, $3.50 and $17.00, respectively, and (iii) options to purchase 533,716 shares of common stock at exercise prices ranging from $2.50 to $19.50.

(6) INCOME TAXES

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Realization of deferred tax assets associated with federal and state net operating loss carry-forwards (NOLs) is dependent upon generating sufficient taxable income prior to their expiration. The Company believes that there is a risk that these NOLs may expire unused and accordingly, has established a valuation reserve against them in full. The current income tax provision of $140,000 represents the Company s estimated federal Alternative Minimum Tax (AMT) liability on pre-tax income for the first nine months ended September 30, 2004, after considering the utilization of NOL s. The Company recognized a pre-tax loss for the three months ended September 30, 2004 and the decreased income tax provision reflects the benefit recognized during this period.

(7) PRODUCT WARRANTY

Prior to 2004, the Company generally warranted that its products would be free of material defects during a three-year warranty period. Pursuant to the Exclusive Marketing Agreement, Safety-Kleen assumed all service, maintenance and repair responsibilities for the Company s installed base of SystemOne® parts washers including units sold prior to the Exclusive Marketing Agreement and units sold pursuant to the Exclusive Marketing Agreement. The Company is responsible solely for the cost of parts required for warranty repairs during the warranty period for all units sold. For units sold prior to the Exclusive Marketing Agreement, the Company agreed to pay Safety-Kleen a total one-time fee of $500,000 for all warranty service to be performed by Safety-Kleen on these units, which amount was fully paid as of December 31, 2003. For units sold pursuant to the Exclusive Marketing Agreement, Safety-Kleen is responsible for the labor cost of all service, maintenance and repair during the warranty period. The Company accrues estimated warranty costs as the parts washers are sold to customers. Such accrued warranty costs consist of the estimated cost of parts projected to be consumed during the remaining warranty period based on actual parts used during the previous 28-month period. Under the Settlement Agreement, the Company is required to continue to supply any warranty related parts free of charge in accordance with, and for the balance of, the three-year warranty period applicable to units sold to Safety-Kleen. The Company will also continue to provide repair and replacement parts for the items not covered by warranty at Safety-Kleen s expense. Effective January 1, 2004, all of the Company s products are offered with a one-year parts only limited warranty.

The table below sets forth warranty accrual activity during the nine month periods ended September 30:

	2004	2003
Beginning balance	$ 417,000	$ 674,000
Warranty provision	10,000	489,000
Warranty payments	(158,000)	(637,000)
Ending balance	$ 269,000	$ 526,000

(8) REPURCHASE OF SUBORDINATED CONVERTIBLE NOTES

Early in the first quarter, based on then existing plans and estimates and taking into account the expected investment necessary to rebuild the Company s marketing and sales distribution system, management allocated approximately $5 million of available cash to reduce and retire certain indebtedness of the Company, which as of December 31, 2003, included $23