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FARMSTEAD TELEPHONE GROUP INC
Form 10-K
April 07, 2005

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

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

For the fiscal year ended December 31, 2004

Commission file number 0-15938

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

Delaware
(State or other jurisdiction of
incorporation or organization)

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

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

06108-3728
(Zip Code)

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

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

Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates, computed by reference to the closing price on the last business day of the registrant's most recently completed second fiscal quarter, was \$1,276,624.

As of March 31, 2005, the registrant had 3,322,182 shares of \$0.001 par value Common Stock outstanding.

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DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the Annual Meeting of Stockholders to be held July 14, 2005 are incorporated by reference into Part III, Items 10 through 14 hereof. Certain exhibits filed with this registrant's prior registration statements and forms 10-K are incorporated by reference into Part IV of this Report.

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GENERAL

Farmstead Telephone Group, Inc. ("Farmstead", the "Company", "we", or "our") was incorporated in Delaware in 1986. We are principally engaged as a provider of new and used Avaya, Inc. ("Avaya") business telecommunications parts, complete systems, and services. From December 1998 to the program's termination in July 2004, we provided refurbished "Classic Lucent(TM) " and "Classic Avaya(TM) " telecommunications equipment pursuant to an "Authorized Remarketing Supplier Program" with Lucent Technologies and Avaya. Since the termination of this program we have continued to supply refurbished equipment to our customers. We also offer Avaya's full-line of new telecommunications parts and complete systems as an Avaya-certified "Gold Dealer". Our service revenues are under the aegis of our "2 Star" Avaya Services Agreement. Our product offerings are primarily customer premises-based private switching systems and peripheral products, including voice messaging products. We also provide telecommunications equipment installation, repair and refurbishing, short-term rental, inventory management, and related value-added services. A portion of our revenues is also derived from the sale of Avaya maintenance contracts. We sell our products and services to large and mid-size, multi-location businesses, as well as to small businesses, government agencies, and other equipment resellers.

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

Our revenue has declined significantly over the past several years. Revenue for the years ended December 31, 2004, 2003, and 2002 was \$12.34 million, \$14.9 million, and \$19.46 million, respectively. The decline in revenue and profit margins has been primarily attributable to reduced business spending by our larger customers on enterprise communications equipment coupled with intense competition between the Company and other telecommunications equipment dealers and aftermarket resellers. The decline in revenue and profit margins has also been the prime contributor to our net losses for the years ended December 31, 2004, 2003, and 2002 of \$1,424,000, \$709,000, and \$2,530,000, respectively. Accordingly, we tried to reduce our losses and return to profitability through cost reductions and by broadening our product offerings. Cost reductions alone, however, were not enough to offset the impact of continued revenue declines.

Business Reorganization. During the third and fourth quarters of 2004, we engaged the services of two independent business consultants to evaluate our current business model and operating performance, and assist in developing and implementing a strategic redirection. Effective October 1, 2004, we hired the first of these individuals, Mr. Jean-Marc Stiegemeier, as our new President and Chief Executive Officer. On January 15, 2005, we hired the second consultant, Mr. Alfred Stein, as an Executive Vice President, responsible for sales operations. On March 1, 2005 we hired Mr. Nevelle Johnson as an Executive Vice President, responsible for the implementation of our SMB Program as further described below. Refer to Item

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1, "Executive Officers and Significant Employees of the Registrant" for information on these persons' qualifications.

In the fourth quarter of 2004 we began implementing a strategic redirection, which is principally based upon building a larger and more highly qualified sales force, and diversifying the Company's product offerings and targeted customers. The business strategy is to transition to a full communications solutions provider, becoming less dependent on parts sales, and developing more sources of recurring revenues, such as through installation and maintenance services. We plan to expand our product offerings beyond traditional voice communications products by offering Internet Protocol, or IP, telephony products and unified communications products including voice messaging, and we plan to expand our customer base and revenues by targeting the small to medium-sized (under 200 employees) business market ("SMB"). As further described in the "Overview" section of Item 7, and in the "Relationship with Avaya Inc." section of Item 1, in March 2005 we entered into a pilot program with Avaya designed to generate incremental SMB revenues. We believe that this is the fastest growing segment of the

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telecommunications systems business. On March 1, 2005 we launched an SMB program that is targeting this customer base and, in March 2005 we hired an additional 23 experienced sales professionals that have been deployed in 12 states and 22 cities nationally. We intend to hire additional sales professionals during 2005 to meet our 2005 SMB revenue expectations.

PRODUCTS

EQUIPMENT

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

Equipment sales consist of both new and refurbished parts (commonly referred to as "aftermarket" sales), complete systems and software applications. Aftermarket parts primarily consist of telephone sets and circuit packs, and other system accessories such as headsets, consoles, speakerphones and paging systems. Equipment sales revenues accounted for approximately 89%, 87%, and 89% of total revenues in 2004, 2003, and 2002 respectively.

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SERVICES AND OTHER REVENUE

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

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

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

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

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

Other Revenue: A portion of our revenues is derived from commissions received on the sale of Avaya communications equipment maintenance contracts. In these transactions, once the contract is executed, we receive a one-time commission, and all future service obligations are borne entirely by Avaya.

Service revenues accounted for 8%, 10% and 9% of total revenues in 2004, 2003 and 2002, respectively, primarily attributable to installation services. Other revenues accounted for 3%, 3% and 2% of revenues in 2004, 2003 and 2002, respectively.

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RELATIONSHIP WITH AVAYA INC.

Avaya is one of the leading providers of communications products in the United States. Avaya provides support to its dealer network and to the telecommunications equipment aftermarket by providing installation and maintenance services, technical and marketing support. Avaya also provides up to a one-year warranty on its products.

We are currently one of several hundred independent companies in the United States who are authorized "Dealers" of Avaya products and services. We are an Avaya-certified Gold Dealer, selling new voice and data systems and applications nationwide. Gold Dealer status also allows us certain product purchasing discounts, and participation in incentive rebate programs based upon purchasing volume and other cash incentive programs connected with eligible business development and marketing initiatives. We are also a "2 Star" Services partner selling Avaya installation,

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maintenance, and moves, adds and changes (MAC) products. Our various dealer agreements with Avaya principally contain language governing the products we are authorized to sell, the territories in which we can sell these products, our price structure under which we are charged for purchases of their products for resale, the level of technical product knowledge we are required to maintain, and product warranty and support provisions. No agency relationship has been created in these agreements. These provisions apply to the sale of both new and used products.

Until July 2004, we also had separate agreements with Avaya which granted us a license to sell used equipment branded with a "Classic Avaya" label. Under these agreements, we refurbished equipment to "like new" condition under their quality standards, remarketing the finished product as "Classic Avaya" equipment. This process was under the umbrella of an "Authorized Remarketing Supplier" aftermarket program (initiated by Avaya's predecessor, Lucent Technologies several years ago), in which we were one of only five other companies nationwide authorized to refurbish and resell Avaya product under their "Classic" trademark. As consideration for this right, we paid Lucent/Avaya a license fee, calculated as a percentage (which varied over the term of the agreement) of the sales price of equipment sold with the "Classic" label. Effective July 30, 2004, Avaya terminated this program, and we discontinued affixing their label to the used equipment that we sell. We recorded in cost of revenues approximately \$110,000, \$323,000, and \$507,000 of fee expense in 2004, 2003 and 2002, respectively. The revenues generated and subject to these license fees approximated 11% (21% at the time of contract termination), 29% and 33% of total revenues for 2004, 2003 and 2002, respectively. We do not believe that the termination of this program has had, or will have, a material adverse impact on our operations. Since the beginning of 2004, in anticipation of this program winding down, we started selling refurbished equipment branded with our own "Farmstead Certified" label for which we have received widespread customer acceptance since Avaya will maintain and service this equipment. In addition, we expect to enter into other revenue-generating programs with Avaya, as further noted below.

Since the beginning of 2005, we have been working with Avaya to structure a "strategic alliance" that would allow us to launch a nationwide effort to sell Avaya SMB products and services. Effective March 1, 2005 we concluded a non-binding agreement to commence a "pilot program", obtaining authorization to market SMB products and services nationally. The purpose of the program is to enable Avaya, and our Company, to increase market share of SMB products and services. Under this trial agreement, Avaya will provide marketing leads and other marketing and technical support, and we will provide the direct sales team to generate sales in the authorized territory. To this end, in March 2005 we hired 23 former Avaya sales and support professionals and launched our SMB program. The pilot program agreement may be terminated by either party upon 30 days prior notice.

MARKETING AND CUSTOMERS

We market our product offerings nationally through a direct sales staff, which includes salespersons located along the Eastern seaboard, and other areas of the country. Since 1999, we have also marketed Avaya products through a call center operation. Our customers range from large and mid-sized, multi-location corporations, to small companies, and to equipment wholesalers, dealers, and government agencies and municipalities. End-user customers accounted for approximately 87%, 91% and 83% of our total revenues in 2004, 2003 and 2002, respectively, while sales to dealers and other resellers accounted for approximately 13%, 9% and 17% of revenues during the same respective periods. During the years ended December 31, 2004, 2003 and 2002, no single customer accounted for more than 10% of revenues. We do not consider our business to be seasonal.

COMPETITION

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

SUPPLIERS

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

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

PATENTS, LICENSES AND TRADEMARKS

No patent is considered material to our continuing operations. In connection with the termination of the ARS program in July 2004 as previously described, we are no longer licensed to utilize the Classic Avaya(TM) trademark on the refurbished products that we sell. We presently use a "Farmstead Certified" label on our used equipment, but this has not been trademarked or registered

RESEARCH AND DEVELOPMENT

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We did not incur any research and development expenses during the three years ended December 31, 2004, and research and development activities are not material to our business.

BACKLOG

The backlog of unshipped orders believed to be firm was approximately \$182,000 at December 31, 2004, compared to \$397,000 at December 31, 2003. We expect this entire backlog to ship and be recognized as revenue during the current fiscal year.

EMPLOYEES

At December 31, 2004, we had 42 employees. Our employees are not represented by any organized labor union and are not covered by any collective bargaining agreements.

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WEBSITE ACCESS TO SEC FILINGS

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

EXECUTIVE OFFICERS AND SIGNIFICANT EMPLOYEES OF THE REGISTRANT

| Name and age (1) ----- | Position(s) Held ----- |
|---------------------------------------|---|
| Jean-Marc Stiegemeier Age 59 | President, Chief Executive Officer and Director |
| George J. Taylor, Jr. Age 62 | Chairman of the Board of Directors, President and Chief Executive Officer (until October 1, 2004) |
| Robert G. LaVigne Age 53 | Executive Vice President, Chief Financial Officer, Secretary, Treasurer |
| Alfred G. Stein Age 60 | Executive Vice President (hired January 15, 2005) |
| Nevelle R. Johnson Age 47 | Executive Vice President (hired March 1, 2005) |
| Frederick E. Robertson, Jr. Age 46 | Vice President - Operations |