MAI SYSTEMS CORP
Form 10-Q
November 22, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

ý	**Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

For the period ended September 30, 2004 or

o	**Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

For the transition period from to .

Commission file number: 1-9158

MAI Systems Corporation

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**22-2554549** **(IRS Employer Identification No.)**

26110 Enterprise Way, Lake Forest, CA 92630
Address of principal executive offices
Registrant s telephone number including area code (949) 598-6000

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 ý No o

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

Yes ý No o

The aggregate market value of the common stock held by non-affiliates of the registrant, based upon the last sale price of the Common Stock reported on the National Association of Securities Dealers Automated Quotation National Market System on November 18, 2004 was $1,648,000

The number of shares of common stock issued, outstanding and subscribed as of November 18, 2004 was 57,847,862.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

MAI SYSTEMS CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	(in thousands, except share data) As of December 31, 2003	As of September 30, 2004
ASSETS		
Current assets:		
Cash	$ 664	$ 555
Receivables, less allowance for doubtful accounts of $335 in 2003 and $311 in 2004	1,313	2,130
Inventories	47	74
Prepaids and other assets	814	659
Total current assets	2,838	3,418
Furniture, fixtures and equipment, net	758	501
Intangibles, net	2,876	3,697
Other assets	58	14
Total assets	$ 6,530	$ 7,630
LIABILITIES AND STOCKHOLDERS DEFICIENCY		
Current liabilities:		
Current portion of long-term debt	$ 3,646	$ 983
Accounts payable	904	1,078
Customer deposits	2,334	2,243
Accrued liabilities	3,059	2,725
Income taxes payable	85	111
Unearned revenue	3,209	3,415
Total current liabilities	13,237	10,555
Long-term debt	7,135	9,982
Other liabilities	744	505
Total liabilities	21,116	21,042

Commitments and contingencies				
Stockholders deficiency:				
Preferred Stock, par value $0.01 per share; 1,000,000 shares authorized, none issued and outstanding				
Common Stock, par value $0.01 per share; authorized 99,000,000 shares; 14,875,752 and 14,675,752 shares issued,outstanding and subscribed at December 31, 2003 and September 30, 2004, respectively.		152		152
Additional paid-in capital		218,112		218,112
Common stock subscribed				1,000
Accumulated other comprehensive loss				
Minimum pension liability		(1,005)		(1,005)
Foreign currency translation		(2)		(47)
Unearned Compensation		(53)		(25)
Accumulated deficit		(231,790)		(231,599)
Total stockholders deficiency		(14,586)		(13,412)
Total liabilities and stockholders deficiency	$	6,530	$	7,630

The accompanying notes are an integral part of these condensed consolidated financial statements.

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MAI SYSTEMS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	(Unaudited) For the Three Months Ended September 30, (in thousands, except per share data) 2003	2004	(Unaudited) For the Nine Months Ended September 30, (in thousands, except per share data) 2003	2004
Revenue:				
Software	$ 842	$ 842	$ 3,098	$ 2,945
Network and computer equipment	104	118	339	329
Services	3,868	3,923	11,315	11,683
Total revenue	4,814	4,883	14,752	14,957
Direct costs:				
Software	167	40	425	369
Network and computer equipment	73	103	238	272
Services	1,109	1,264	3,384	3,446
Total direct costs	1,349	1,407	4,047	4,087
Gross profit	3,465	3,476	10,705	10,870
Selling, general and administrative expenses	2,307	2,200	7,277	6,900
Research and development costs	764	956	2,104	2,756
Other expense(income)	(134)	48	(181)	67
Operating income	528	272	1,505	1,147
Interest income			1	1
Interest expense	(286)	(303)	(928)	(882)
Other non-operating expense	(98)	(22)	(309)	(60)
Income (loss) before income taxes	144	(53)	269	206
Income tax benefit (expense)	(12)	(5)	41	(15)
Net income (loss)	$ 132	$ (58)	$ 310	$ 191
Income (loss) per share:				
Net income (loss) per share:				
Basic income (loss) per share	$ 0.01	$ 0.00	$ 0.02	$ 0.01
Diluted income (loss) per share	$ 0.01	$ 0.00	$ 0.02	$ 0.01
Weighted average common shares used in determining income (loss) per share:				
Basic	14,575	14,676	14,525	14,676
Diluted	14,875	14,676	14,825	14,676

The accompanying notes are an integral part of these condensed consolidated financial statements.

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MAI Systems Corporation

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Nine Months Ended September 30, (in thousands) 2003	2004
Net cash provided by operating activities:	$ 619	$ 405
Cash flows used in investing activities:		
Proceeds from note receivable	250	
Capital Expenditures	(240)	(98)
Acquisition of unconsolidated subsidiary	(79)	
Capitalized software development costs	(619)	(821)
Net cash used in investing activities	(688)	(919)
Cash flows used in financing activities:		
Proceeds for common stock subscribed		1,000
Repayments on long-term debt	(312)	(594)
Net cash used in financing activities	(312)	406
Net cash used in operations	(381)	(108)
Effect of exchange rate changes on cash	(3)	(1)
Net change in cash	(384)	(109)
Cash at beginning of period	545	664
Cash at end of period	$ 161	$ 555

The accompanying notes are an integral part of these condensed consolidated financial statements.

MAI Systems Corporation

Notes to Condensed Consolidated Financial Statements

Three and Nine Months ended September 30, 2004

(Unaudited)

1. **Basis of Presentation**

Companies for which this report is filed are MAI Systems Corporation and its wholly owned subsidiaries (the Company). The information contained herein is unaudited, but gives effect to all adjustments (which are normal recurring accruals) necessary, in the opinion of Company management, to present fairly the condensed consolidated financial statements for the interim period. All significant intercompany transactions and accounts have been eliminated in consolidation.

Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC), and these financial statements should be read in conjunction with the financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2003, which is on file with the SEC.

2. **Liquidity**

Although the Company has a net stockholders deficiency of $13,412,000 and a working capital deficit of $7,137,000 at September 30, 2004, the Company expects to generate positive cash flow from its operations during 2004 and 2005 from shipping out products and services from its current backlog as of September 30, 2004 as well as new orders to meet its operating and capital requirements. In the event that the Company cannot generate positive cash flow from its operations, the Company can substantially reduce its research and development efforts to mitigate cash outflow to help sustain its operations. There can be no assurance that the Company will be able to sustain profitability or generate positive cash flow from operations. These financial statements have been prepared assuming the Company will continue to operate as a going concern. If the Company is unsuccessful in the aforementioned efforts, the Company could be forced to liquidate certain of its assets, reorganize its capital structure and, if necessary, seek other remedies available to the Company, including protection under the bankruptcy laws. The restructured debt, pursuant to the original inter-creditor agreement between Canyon Capital and Coast, which was sold to Wamco on May 15, 2003, contains various restrictions and covenants. In the event that the Company were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance, the term debt would be immediately due and payable. The Company is in compliance with the amended debt covenants as of and for the period ended September 30, 2004. There is no guaranty that the Company will meet its debt covenants in the future. In the event that the Company were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance, the term loan would be immediately due and payable.

3. **Inventory**

Inventories are summarized as follows:

	(dollars in thousands) December 31, 2003		September 30, 2004	
Finished goods	$	39	$	67
Replacement parts		8		7
	$	47	$	74

4. **Business Acquisitions**

Hospitality Services & Solutions

On June 23, 2002, the Company acquired substantially all of the assets and assumed certain liabilities of Hospitality Services & Solutions (HSS) including a 35% ownership in AMDB HIS (AMDB) pursuant to a stock purchase agreement for 100,000 shares of common stock valued at $32,000 (the quoted market price of the common stock at the time the terms were agreed), and $75,000 in cash. Additionally, the shareholders of HSS received a 20% minority interest in the Company s combined operations in Asia. HSS was acquired for the Company to expand its operations in the Asian marketplace, strengthen its management team in the territory and create new opportunities for its new enterprise capable suite of products. The net assets acquired from HSS are used in the business of software design, engineering and service relating to hotel information systems. The net assets also include subsidiaries of HSS in Malaysia, Singapore and Thailand. The Company recorded $297,000 of goodwill (deductible for tax purposes) in connection with the acquisition of HSS. Pro forma results of operations as if this acquisition had occurred at the beginning of 2001 and 2002 are not shown because its impact would have been immaterial.

Included in the acquired assets of HSS was a 35% interest in AMDB, an online reservation service, originally purchased by HSS for $66,000. On February 20, 2003, the Company entered into an agreement whereby it acquired the remaining 65% for $79,000 payable over 6 month installments. The net liabilities of $15,000 acquired are used to support an online reservation service related to hotel information systems. The Company recorded $159,000 of goodwill in connection with the acquisition of AMDB. Pro forma results of operations as if this acquisition had occurred at the beginning of 2003 are not shown because its impact would have been immaterial.

5. Long-Term Debt

Wamco 32 Ltd.

On January 13, 2003, the Company re-negotiated the terms of its credit facility with Coast Business Credit (Coast) whereby the outstanding balance of $1,828,000 was converted to a term loan which accrues interest at 9.25% per annum and requires monthly payments of $58,000 over a 36 months period commencing March 1, 2003. On February 7, 2003, the Federal Deposit Insurance Corporation (FDIC) put Coast and its parent company, Southern Pacific Bank, into receivership and held all of Coast s assets for sale to third parties. On May 15, 2003, the loan was sold to Wamco 32, Ltd. (Wamco). This sale of the loan by the FDIC did not change any of the terms of the Company s loan agreement. The Company is required to pay Wamco additional principal payments on a quarterly basis based upon an EBITDA-based formula commencing March 31, 2003. For the period ended September 30, 2004, there are no additional principal payments required under the EBITDA-based formula.

On April 9, 2004, the Company successfully re-negotiated the terms of its loan whereby the maturity date was extended to February 28, 2006. In addition, various restrictions and covenants, pursuant to the inter-creditor agreement between Canyon and Wamco, were amended to modify the financial covenants to a minimum quick ratio of 0.20 to 1.00 and a minimum debt coverage ratio of 0.50 to 1.00 effective for the three month period ended March 31, 2004 and for each and every fiscal quarter ending thereafter. The Company was in compliance with the amended debt covenants as of and for the period ending September 30, 2004. There is no guaranty that the Company will meet its debt covenants in the future. In the event that the Company were not in compliance with the various restrictions and covenants and were unable to receive waivers for non-compliance, the term loan would be immediately due and payable. As of December 31, 2003 and September 30, 2004, the balance of the term loan was $1,366,000 and $907,000, respectively.

Canyon Capital Management LP

On January 13, 2003, the Company modified its 11% subordinated notes payable agreement with Canyon Capital Management LP (Canyon), whereby the Company is required to make monthly interest payments of $52,000 until the Wamco term loan is paid off in full at which time the note payable will be converted into a three-year amortizing loan which will accrue interest at 11% per annum and requires equal monthly payments of principal and interest such that the subordinated debt will be paid in full at the end of the amended term. Upon the repayment of the Wamco debt in full, the Company will also be required to pay Canyon additional principal payments on a quarterly basis based upon an EBITDA-based formula. Additionally, the Company issued to Canyon 200,000 shares of its common stock valued at $20,000 (the quoted market price of the common stock at the time the terms were agreed) and agreed to issue one million warrants at an exercise price of $0.40 per share valued at $42,000 (using the Black-Scholes option-pricing model with the following weighted-average assumptions: risk-free interest rate of 6.5%, volatility of 80% and an expected life of 5 years). The $62,000 is being amortized to interest expense over the term of the modified note. The principal balance outstanding on the subordinate notes payable to Canyon was approximately $5,662,000 and $5,660,000 respectively at December 31, 2003 and September 30, 2004, respectively.

CSA Private Limited

In connection with a settlement agreement in February 2001 with CSA Private Limited (CSA), the Company issued

$2.8 million of subordinated debt to CSA. The $2.8 million of debt was secured by all of the Company s assets, which was subordinate to Wamco and Canyon, accrued interest at 10% per annum and required payments of $37,500 from March 1, 2002 through September 1, 2002 and monthly payments of $107,500 commencing on October 1, 2002 until October 2003 when all remaining unpaid principal and accrued interest was to be paid in full.

The agreement with CSA was amended whereby the Company was required to make payments under the subordinated note unless and until it paid $1 million by December 31, 2002. Upon payment of the $1 million, contractual payments under the subordinated note would have ceased until a final payment in the amount of $400,000 is paid by February 28, 2003. If the Company did not make all of the modified payments to CSA, the subordinated note would revert back to its original terms. The Company did not make the modified payment and have not made any payments since September 2002. CSA did not formally notify the Company of its default.

On April 9, 2004, the Company successfully amended its agreement with CSA whereby the principal balance and accrued interest through March 31, 2004, totaling $3,633,000, were converted to two new notes. The first note for $500,000 accrues interest at 10% per annum and provides for monthly payments of $10,000 until the Wamco and Canyon debt is paid in full. Thereafter, the note provides for monthly payments in an amount equal to the greater of i) $10,000 or ii) the amount required to fully amortize all remaining principal and interest in 24 equal monthly payments. The second note for $3,133,000 (Other Note) also accrues interest at 10% per annum and provides for monthly payments of $7,500, or such other interest amount, not to exceed $10,000 per month, that Wamco and Canyon will allow. As of September 30, the Company accrued and unpaid interest relating to the Other Note was $160,000. Under the terms of the amended subordination agreement between Wamco, Canyon and CSA, all payments under the new notes are subordinated to the payment in full of the Wamco and Canyon loan agreements. The Company has not made any payments on the two new notes as of September 30, 2004. The Company is currently in default of the first note. The interest rate has been increased to 12.5% in line with the terms of that note until the Company becomes current on its contractual payments.

On April 9, 2004, an investor group, consisting of Canyon, the Company s Chairman of the Board, Chief Executive Officer and Chief Financial and Operating Officer (Investor Group), acquired 2,433,333 shares of the Company s common stock held by CSA and the Other Note for $1 million in cash.

On September 22, 2004, the Company received approval from its shareholders for the Investor Group to convert the Company indebtedness acquired from CSA plus any accrued interest through the date of conversion for shares of the Company s common stock based upon a conversion price of $0.10 per share. Additionally, the shareholders also approved for the Investor Group to invest $1,000,000 of new cash proceeds into the Company, which the Company received on September 24, 2004, in a private placement at $0.10 per share (The Management Equity/Conversion Transaction). As of September 30, 2004, the private placement funds were classified as a Common Stock Subscribed in the accompanying condensed consolidated balance sheet (See Note 13). The Company issued common stock in connection with the Management Equity/Conversion Transaction on November 1, 2004 (See Note 13) and such stock is subject to certain terms and conditions, including the fact that it will initially be restricted stock, not available for sale. The Company has also received a fairness opinion from Marshall Stevens which concluded that the transaction was fair to the shareholders.

Tax Claim

On September 30, 2003, the Company entered into a settlement agreement with the United States Internal Revenue Service (the Service) on a tax claim which resulted from the Company s 1993 Chapter 11 proceedings whereby it agreed to pay $489,000 in equal monthly installments of $7,438 over a period of six (6) years at an interest rate of 6%. The $489,000 settlement is reflected as debt in the financial statements and resulted in a one-time gain of $262,000 which was included in income tax benefit in the fourth quarter of 2003. In the event that the Company fails to pay the Service any payment, and such payment failure continues for sixty days after written notice of such failure, $1,832,100, plus accrued interest thereon, less any payments made by the Company will be immediately due and payable to the Service. As of December 31, 2003 and September 30, 2004, the debt balance was $428,000 and $379,000, respectively.

In connection with the settlement agreement with the Service, the Company s 1993 Chapter 11 proceedings were officially closed pursuant to Court order effective as of September 30, 2003.

6. <u>Restricted Stock Plan</u>

In May 2001, the Board of Directors adopted the 2001 Restricted Stock Plan. Under the plan, 1,250,000 authorized shares of the Company s Common Stock are reserved for issuance to officers and directors of the Company. The shares will be issued as Restricted Stock within the meaning of Rule 144 of the Securities Act of 1933, as amended. The

Compensation Committee of the Board of Directors shall have the discretion to determine what terms and conditions shall apply, including the imposition of a vesting schedule.

In May 2002, the Company issued 612,500 shares of restricted common stock to its members of the board of directors and certain of its corporate officers which vest equally over a four-year period. Recipients are not required to provide consideration to the Company other than rendering the service and have the right to vote the shares. Under APB 25, compensation cost is recognized for the fair value of the restricted stock awarded, which is its quoted market price at the date of grant, which was $0.25 per share. The total market value of the shares of $153,000 was treated as unearned compensation and is being amortized to expense in proportion to the vesting schedule. The unamortized balance as of September 30, 2004 is $25,000 and is included in accumulated other comprehensive loss in the accompanying consolidated balance sheet.

7. Preferred Stock

On May 20, 1997, the Company authorized the issuance of up to 1,000,000 shares of $0.01 par value preferred stock. The Board of Directors has the authority to issue the preferred stock, in one or more series, and to fix the rights, preferences, privileges and restrictions thereof without any further vote by the holders of Common Stock.

8. Intangible Assets

Intangible assets consist primarily of goodwill and capitalized software. Intangible assets other than goodwill are amortized on a straight-line basis over their estimated useful lives. Prior to 2002, goodwill, representing the excess of the purchase price over the estimated fair value of the net assets of the acquired business, was amortized over the period of expected benefit of five to seven years. However, effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, (SFAS No. 142) which requires that the Company cease amortization of all goodwill and intangible assets having indefinite useful economic lives. The Company determined that there was no impairment upon adoption. Such assets are not to be amortized until their lives are determined to be finite. However, a recognized intangible asset with an indefinite useful life should be tested for impairment annually or on an interim basis if events or circumstances indicate that the fair value of the asset has decreased below its carrying value. At September 30, 2004, the Company evaluated its goodwill and determined that fair value had not decreased below carrying value and no adjustment to impair goodwill was necessary in accordance with SFAS No. 142.

Goodwill and capitalized software as of December 31, 2003 and September 30, 2004 are as follows:

	(dollars in thousands)	
	December 31, 2003	September 30, 2004
Goodwill	$ 1,121	$ 1,121
Accumulated amortization		
Goodwill, net	1,121	1,121
Capitalized software	1,755	2,576
Accumulated amortization		

Capitalized software, net		1,755		2,576
Total	$	2,876	$	3,697

Net goodwill is comprised of $665,000 on the purchase of Hotel Information Systems Inc. (HIS) in 1996, $297,000 on the purchase of HSS in 2002 and $159,000 on the purchase of AMDB in 2003 (see Note 4).

The Company s weighted average amortization period for capitalized software is expected to be three years. The Company expects that certain of our new products will be available for general release during the first quarter of 2005 at which time amortization of such costs shall commence. The following table shows the estimated amortization expense for these assets for each of the five succeeding years:

Year Ending December 31, (in thousands)		
2004	$	
2005		859
2006		859
2007		858
2008		
	$	2,576

9. **Income (Loss) Per Share**

Basic and diluted income or loss per share is computed using the weighted average shares of common stock outstanding during the period. Consideration is also given in the diluted income per share calculation for the dilutive effect of stock options and warrants.

The following table illustrates the computation of basic and diluted earnings (loss) per share under the provisions of SFAS 128:

	For the Three Months Ended September 30, 2003	For the Three Months Ended September 30, 2004	For the Nine Months Ended September 30, 2003	For the Nine Months Ended September 30, 2004
	(in thousands except per share data)		(in thousands except per share data)	
Numerator:				
Numerator for basic and diluted earnings (loss) per share net income (loss)	$ 132	$ (58)	$ 310	$ 191
Denominator:				
Denominator for basic income (loss) per share weighted average number of Common shares outstanding during the period	14,575	14,676	14,525	14,676
Incremental common shares attributable to exercise of outstanding shares	300		300	
Denominator for diluted income (loss) per per share	14,875	14,676	14,825	14,676