PORTA SYSTEMS CORP
Form 10-K
March 30, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

(Mark One)

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [FEE REQUIRED]**
For the fiscal year ended December 31, 2005

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**
Commission file number 1-8191

PORTA SYSTEMS CORP.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**11-2203988** (IRS Employer Identification No.)
6851 Jericho Turnpike, Syosset, New York (Address of principal executive offices)	**11791** (Zip Code)
Registrant's telephone number, including area code:	**(516) 364-9300**

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $.01 per share
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 x No o

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 10K or any amendment to this Form 10K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. Check one: Large accelerated filer o Accelerated filer o Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act. o Yes x No

State aggregate market value of the voting stock held by non-affiliates of the registrant: $1,558,314 as of June 30, 2005.

Indicate the number of shares outstanding of each of the registrant's class of common stock, as of the latest practicable date: 10,053,638 shares of Common Stock, par value $.01 per share, as of March 15, 2006.

DOCUMENTS INCORPORATED BY REFERENCE

None

Part I

Item 1. Business

Porta Systems Corp. develops designs, manufactures and markets a range of standard and proprietary telecommunications equipment for sale domestically and internationally. Our core products, focused on ensuring communications for service providers worldwide, fall principally into two categories:

Telecommunications connection and protection equipment. These systems are used to connect copper-wired telecommunications networks and to protect telecommunications equipment from voltage surges. We market our copper connection equipment and systems to telephone operating companies and customer premise systems providers in the United States and foreign countries.

Signal processing equipment. These products, which we sell principally for use in defense and aerospace applications, support copper wire-based communications systems.

Through 2004, we offered a third category of products - operations support systems, which we call OSS. During 2003 we began to scale back our OSS operations and we continued to scale back these operations through 2005. We now limit our OSS operations to the performance of maintenance on existing systems and the performance of warranty services. We are also seeking to sell our existing OSS inventory; however, such sales were not significant in 2005, and we do not plan to add additional inventory. OSS systems focus on the access loop and are components of telephone companies' service assurance and service delivery initiatives. The systems primarily focus on trouble management, line testing, network provisioning, inventory and assignment, and automatic activation, and most currently single ended line qualification for the delivery of xDSL high bandwidth services.

We are a Delaware corporation incorporated in 1972 as the successor to a New York corporation of the same name incorporated in 1969. Our principal offices are located at 6851 Jericho Turnpike, Syosset, New York 11791; telephone number, 516-364-9300. References to "we," "us," "our," and words of like import refer to Porta Systems Corp. and its subsidiaries, unless the context indicates otherwise.

Forward-Looking Statements

Statements in this Form 10-K annual report may be "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to, statements that express our intentions, beliefs, expectations, strategies, predictions or any other statements relating to our future activities or other future events or conditions. These statements are based on current expectations, estimates and projections about our business based, in part, on assumptions made by management. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may, and probably will, differ materially from what is expressed or forecasted in the forward-looking statements due to numerous factors, including those risks discussed from time to time in this Form 10-K annual report, including the risks described under "Risk Factors" and the matters described under "Management's Discussion and Analysis of Financial Condition and Results of Operations," and in other documents which we file with the Securities and Exchange Commission. In addition, such statements could be affected by risks and uncertainties related to our financial conditions, our relationship with the holder of our senior debt, factors which affect the telecommunications industry, market and customer acceptance, competition, government regulations and requirements and pricing, as well as general industry and market conditions and growth rates, and general economic conditions. Any forward-looking statements speak only as of the date on which they are made, and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this Form 10-K.

Products

Telecommunications Connection Equipment. Our copper connection/protection equipment is used by domestic and international telephone operating companies, by owners of private telecommunications equipment and manufacturers and suppliers of telephone central office and customer premises equipment. Products of the types comprising our telecommunications connection equipment are included as integral parts of all domestic and foreign telephone and telecommunications systems.

Our connection equipment consists of connection/protection blocks, building entrance terminals and protection modules. These products are used by telephone companies and installers of communications and data transmission equipment to interconnect copper-based subscriber lines to switching equipment lines. The protector modules protect central office and customer premises personnel and equipment from electrical surges. The need for protection products has increased as a result of the worldwide move to digital technology, which is extremely sensitive to damage by electrical overloads, and private owners of telecommunications equipment now have the responsibility to protect their equipment, personnel and buildings from damage caused by electrical surges. Line connection/protection equipment usually incorporates protector modules to safeguard equipment and personnel from injury due to power surges. Currently, these products include a variety of connector blocks, protector modules, building entrance terminals and frames used in telephone central switching offices, PBX installations, multiple user facilities and customer premise applications.

We also have developed a range of frames for use in conjunction with our traditional line of connecting/protecting products. Frames for the interconnection of copper circuits are specially designed structures which, when equipped with connector blocks and protectors, interconnect and protect telephone lines and distribute them in an orderly fashion allowing access for repairs and changes in line connections. One of our frame products, the CAM frame, is designed for the optimum placement of connections for telephone lines and connector blocks mounted on the frame.

Our copper connection/protection products are used by many of the regional Bell and international operating companies as well as independent telephone operating companies in the United States, and owners of private telecommunications equipment providing communications and data transmission facilities and equipment. These products are also purchased by equipment manufacturers for integration with their systems. In addition, our telecommunications connection products have been sold to telephone operating companies in various foreign countries. This equipment is compatible with existing telephone systems both within and outside the United States and can generally be used without modification, although we do custom-design modifications to accommodate the specific needs of our customers.

Signal Processing Products. Our signal processing products include data bus systems and wideband transformers. Data bus systems, which are the communication standard for military and aerospace systems, require an extremely high level of reliability and performance. Wideband transformers are required for ground noise elimination in video imaging systems and are used in the television and broadcast, medical imaging and industrial process control industries.

Operations Support Systems. Through 2004, we sold our OSS systems primarily to telephone operating companies in established and developing countries in Asia, South and Central America and Europe. Because of continuing losses in this division, combined with difficulties in marketing OSS products in view of our financial condition, we limited our OSS activities in 2005 to the performance of maintenance and warranty services. In addition, we are trying to sell our remaining OSS inventory, although such sales were not significant and we can give no assurance that we will be able to sell the remaining OSS inventory. We expect our OSS business to continue to decline in future years.

The table below shows, for the last three fiscal years, the contribution made to our sales by each of our major categories of the telecommunications industry:

Sales by Product Category

	Years Ended December 31,					
	2005		2004		2003	
	(Dollars in thousands)					
Line Connecting/Protecting Equipment	$ 21,982	77%	$ 21,545	74%	$ 11,334	58%
Signal Processing	5,710	20%	5,551	19%	4,253	21%
OSS Systems	785	3%	2,003	7%	3,249	17%
Other	127	0%	69	0%	754	4%
Total	$ 28,604	100%	$ 29,168	100%	$ 19,590	100%

Markets

As a telephone company expands the number of its subscriber lines, it may require additional connection equipment to interconnect and protect those lines in its central offices. We provide a line of copper connection equipment for this purpose. Recent trends towards the transmission of high frequency signals on copper lines are sustaining this market. Less developed countries, such as those with emerging telecommunications networks or those upgrading to digital switching systems, provide a growing market for copper connection and protection equipment.

The increased sensitivity of the newer digital switches to small amounts of voltage requires the telephone company which is upgrading its systems to digital switching systems to also upgrade its central office connection/protection systems in order to meet these more stringent protection requirements. We supply central office connection/protection systems to meet these needs.

During 2005, approximately 77% of our sales were made to customers in this category.

Our line of signal processing products is supplied to customers in the military and aerospace industry as well as manufacturers of medical equipment and video systems. The primary communication standard in new military and aerospace systems is the MIL-STD-1553 Command Response Data Bus, an application which requires an extremely high level of reliability and performance. Our wideband transformers are required for ground noise elimination in video imaging systems and are used in the television and broadcast, medical imaging and industrial process control industries. If not eliminated, ground noise caused by poor electrical system wiring or power supplies, results in significant deterioration in system performance, including poor picture quality and process failures in instrumentation. The wideband transformers provide a cost-effective and quick solution to the problem without the need of redesign of the rest of the system. Products are designed to satisfy the specific requirements of each military or aerospace customer.

During 2005, signal processing equipment accounted for approximately 20% of our sales.

During 2005, approximately 3% of our sales consisted principally of maintenance services and, to a lesser extent, of the sale of existing OSS inventory. None of our current maintenance agreements extend beyond 2007, and we do not expect to enter into new maintenance agreements. As a result, we anticipate that the OSS sales will represent a declining percentage of total sales.

Marketing and Sales

We operate principally through two business units, which are organized by product line, and with each having responsibility for the sales and marketing of its products. We also continue to employ a modest staff of personnel to perform maintenance and warranty services on OSS systems.

When appropriate to obtain sales in foreign countries, we may enter into business arrangements and technology transfer agreements covering our products with local manufacturers and participate in manufacturing and licensing arrangements with local telephone equipment suppliers.

In the United States and throughout the world, we use independent distributors in the marketing of all copper based products to the regional Bell operating companies and the customer premises equipment market. All distributors marketing copper-based products also market directly competing products. In addition, we continue to promote the direct marketing relationships we developed in the past with telephone operating companies.

British Telecommunications purchased line connecting/protecting products of $5,641,000 (20% of sales) in 2005, $2,259,000 (8% of sales) in 2004, and $867,000 (4% of sales) in 2003. During these years, we also sold our products to unaffiliated suppliers for resale to British Telecommunications, the most significant of which was Fujitsu, a systems integrator for British Telecommunications, to whom we sold $3,170,000 in 2005, $4,772,000 in 2004, and $3,150,000 in 2003. We have an agreement with British Telecommunications which, in effect, enables British Telecommunications to use certain of our proprietary information to modify or enhance products provided to British Telecommunications and permits British Telecommunications to manufacture or engage others to manufacture those products.

Our signal processing products are sold primarily to United States military and aerospace prime contractors, and domestic original equipment manufacturers and end users.

The following table sets forth, for the last three fiscal years, our sales to customers by geographic region:

Sales to Customers by Geographic Region (1)

	Year Ended December 31,					
	2005		2004		2003	
	(Dollars in thousands)					
North America	$ 13,277	46%	$ 12,948	45%	$ 9,647	49%
United Kingdom	14,998	53%	14,911	51%	7,523	38%
Asia/Pacific	10	0%	694	2%	954	6%
Other Europe	319	1%	457	2%	1,228	6%
Latin America	0	0%	158	1%	238	1%
Total Sales	$ 28,604	100%	$ 29,168	100%	$ 19,590	100%

(1) For information regarding the amount of sales, operating profit or loss and identifiable assets attributable to each of our divisions and geographic areas, see Note 19 of Notes to the Consolidated Financial Statements.

In selling to customers in foreign countries, we face inherent risks not normally present in the case of sales to United States customers, including risks associated with currency devaluation, inability to convert local currency into dollars, as well as local tax regulations and political instability.

Manufacturing

At present, our manufacturing and assembly operations are conducted at facilities located in Syosset, New York and Matamoros, Mexico. From time to time we also use subcontractors to augment various aspects of our production activities and periodically explore the feasibility of conducting operations at lower cost manufacturing facilities located abroad. We are no longer manufacturing or purchasing new inventory for OSS products.

Source and Availability of Components

We generally purchase the standard components used in the manufacture of our products from a number of suppliers. We attempt to assure ourselves that the components are available from more than one source.

Significant Customers

Total sales for British Telecommunications, consisting of direct sales and sales to systems integrators for British Telecommunications (including Fujitsu) were $14,339,000 (50% of sales) for 2005, $14,055,000 (48%) for 2004 and $7,077,000 (36%) for 2003. During 2005, sales to Telmex accounted for $3,157,000, or approximately 11% of sales and $3,139,000 or approximately 11% of sales for 2004. No other customers account for 10% or more of our sales in 2005, 2004 or 2003.

Our five largest customers, consisting of British Telecommunications, Fujitsu and two other systems integrators for British Telecommunications, and Telmex, accounted for sales of $17,431,000, or approximately 61% of sales, for 2005; $15,443,000, or approximately 53% of sales, for 2004; and $8,507,000, or approximately 43% of sales, for 2003. British Telecommunications was our largest customer for 2005, accounting for sales of $5,933,000, or approximately 21% of our revenue, and Fujitsu was our largest customer for 2004, accounting for sales of $4,772,000, or approximately 16%. Direct sales to British Telecommunications were $5,933,000, or 21% of sales for 2005; $2,652,000, or 9% of sales, for 2004; and $1,480,000, or 8% of sales, for 2003. Almost all of these sales were sales of connection/protection products, with the balance being revenue for OSS maintenance contracts.

Distributors of our customer premise equipment are the ultimate purchasers of a significant portion of our products sold in the United States, while sales to foreign telephone operating companies constitute the major portion of our foreign sales. Our contracts with these customers require no minimum purchases by such customers. Significant customers for the signal processing products include major United States aerospace companies, the Department of Defense and original equipment manufacturers in the medical imaging and process control equipment industries. We sell both catalog and custom designed products to these customers. Some contracts are multi-year procurements.

Backlog

At December 31, 2005, our backlog was approximately $4,188,000 compared with approximately $5,265,000 at December 31, 2004. The decrease in the backlog reflects our ability to manufacture and ship inventory during 2005 in a more timely manner than in 2004 because of our improved cash flow and a reduced level, as of December 31, 2005, of signal processing orders. Of the December 31, 2005 backlog, approximately $2,700,000 represented orders from foreign telephone operating companies. We expect to ship substantially all of our December 31, 2005 backlog during 2006.

Intellectual Property Rights

We own a number of domestic utility and design patents and have pending patent applications for these pr