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OSI Systems: Lost Credibility

OSIS's response to our December 6, 2017 report in no way changes our opinion that OSIS is rotten to the core. We see the Albania issue as important for three reasons – first, it's illustrative of our view of the rot; second, it begs the question of how viable the turnkey model is without corruption, particularly in jurisdictions where corruption is a major issue; and third, OSIS's response goes to what we see is a complete lack of management credibility.

In this update, we address OSIS's response to Albania. OSIS's "partnership" with ICMS, a company purportedly "with civil works construction capabilities in Albania", appears to us a conduit for corruption for five additional reasons.[1]

- First, OSIS's statement that "…ICMS made significant capital investments toward the implementation of the program in a value well beyond the par value of shares" is greatly misleading because it appears from the various entities' financials that OSIS has provided virtually all funding to, and investment in, S2 Albania.

- Second, OSIS appears to have sought to conceal its joint venture with ICMS from its investors, which we see no reason to do if this arrangement were legitimate.

- Third, even if ICMS were the greatest construction company in the world, how would it be entitled to half of the economics of the concession for pouring concrete when OSIS is providing the key equipment, technology, knowhow, and financing?

- Fourth, we are fairly certain that ICMS is not the greatest construction company in the world – or even in Albania. ICMS's construction affiliate was formed only eight months before OSIS was awarded the concession – its capitalization was only ~US$850, and it was then sold to ICMS's physician shareholder also for ~US$850. Moreover, it has virtually no tangible assets. If it's really this easy and cheap to get a nine-figure construction contract, then we at Muddy Waters are wondering why we're in the relatively impoverished world of hedge funds.

- Fifth, the timeline of this "partnership" is beyond suspicious – with the requisite approval of the transfer of shares taking place on the day the outgoing Minister of Finance left and the new one was seated.

OSIS's response seems greatly misleading when it implies that ICMS has made capital contributions that are on par with those of OSIS (and thus somehow justifying half of the concession). Calendar year financials for S2 Albania, ICMS, and its affiliate ICMS Construction are available in person from the companies' registry. We have posted them here. Note that as of December 2017, S2 Albania had not met its statutory obligation to file CY2016 financials. To promote transparency, we call upon OSIS to have the 2016 S2 Albania financials filed immediately if it has not already done so.

[1] http://investors.osi-systems.com/releasedetail.cfm?ReleaseID=1050967

That said, we can assume that based on OSIS's January 27, 2016 statement OSIS expected "Albania to be fully operational within [that] quarter", substantially all of the assets S2 Albania needed were on the balance sheet as of the end of CY2015.[2] We are calling B.S. on OSIS's claim that ICMS earned its 49% stake through capital investments for the following reasons:

- **We see no S2 Albania assets to which ICMS could conceivably have contributed**. As of December 31, 2015, S2 Albania had total assets of US$10.8 million.[3] Virtually all of the assets – US$9.6 million – were PP&E.[4] According to the footnotes, 98.5% of PP&E (US$9.6 million) were machines (i.e., likely equipment from OSIS) – with no construction or buildings disclosed at all.

- **We see no financial contribution from ICMS to S2 Albania**. S2 Albania's December 31, 2015 liabilities confirm that substantially all of S2 Albania's capitalization came from OSIS. The financials show US$11.7 million in payables to OSIS.[5] (Note that S2 Albania had negative shareholders' equity of US$-1.1 million.)

- **We see no account evidencing investment in S2 Albania by ICMS or ICMS Construction**. We see nothing on ICMS's CY2016 balance sheet that could resemble a meaningful investment in S2 Albania. Of its US$3.06 million in assets as of December 31, 2016, US$2.97 million are current assets.[6] (US$1.8 million – 59.6% – is prepaid expenses; the balance is substantially all cash and receivables.) Of the US$80,000 of non-current assets, 99.99% is PP&E.

  We also see nothing on the CY2016 balance sheet of ICMS Construction, which is an affiliate of ICMS, that evidences investment in S2 Albania. (Note that ICMS Construction does not own the equity in S2 Albania.) ICMS Construction has a total of US$704,000 of assets, of which US$647,000 are receivables. There is no meaningful PP&E or investments. ICMS Construction had $627 million of revenue in 2015, which means it undertook no significant construction prior to 2016.

OSIS appears to have taken pains to keep its "partnership" hidden from investors. We see this as affirmation that the relationship is a conduit for corruption. When OSIS trumpeted the award of the Albania concession as potentially worth $150 million to $250 million, it would have been an opportune time to mention that it would only be entitled to half of the profits. When Ajay Mehra patted OSIS management on the back by saying the deal "reinforces the attractiveness and compelling value of our turnkey service model", the lack of any mention of the supposedly critical role their construction company was playing would seem a material omission.[7] When the new government sought to renegotiate the concession agreement against a backdrop of news stories calling the concession award and the transfer of S2 Albania shares corrupt, OSIS chose not to publicly discuss this controversy or its partner. When OSIS investor relations was asked

[2] Source: Bloomberg Q2 FY16 earnings call transcript.
[3] All December 31, 2015 conversions use USD/ALL: 126.1.
[4] There were ~US$1.2 million in cash and receivables.
[5] Including OSIS's UK Rapiscan subsidiary.
[6] All December 31, 2016 conversions use USD/ALL: 128.27.
[7] http://investors.osi-systems.com/releasedetail.cfm?releaseid=786552

before the publication of our initial report to provide details on turnkey contract partnerships in Puerto Rico and Albania, OSIS refused to provide any information. A former key executive of OSIS told our investigators he was unaware that OSIS had sold half of S2 Albania for $4.50. Regardless of whether he was telling the truth, his professed lack of awareness is telling. ICMS clearly seems to be a joint venture partner OSIS wanted to keep hidden.

We struggle to understand how OSIS can justify a construction contractor having half of the concession economics. Note that the approximately $1.55 million in revenue at an at least 46.3% operating margin ICMS recorded in 2016 **could mean that ICMS's economics even exceed half the concession value**.[8] The following is how OSIS previously described its role in the concession:

> "Under the program, Rapiscan Systems intends to provide a comprehensive X-ray screening program, which will incorporate technology, staffing, systems integration, and maintenance support at sites throughout Albania."[9]
>
> "The Company will provide a comprehensive X-ray screening program, including staffing, training, systems integration, operations and maintenance utilizing Rapiscan's high energy X-ray screening equipment at sites throughout Albania."[10]

OSIS seems to state this is because construction is commoditized and is not nearly as important as the scanners and services. Given our above analysis on S2 Albania's assets and capitalization, we strongly agree with this proposition. We therefore conclude that ICMS's 49% share of S2 Albania was entirely unjustified, and is a conduit for corruption.

ICMS was not an established construction company in Albania, and its construction affiliate, ICMS Construction (100% owned by the doctor who owns ICMS) was formed by a single shareholder on January 29, 2013, only eight months before the award of the concession. When formed, it was called Bledi Construction and had capital of $850. Approximately one and one-half months after formation (March 11, 2013), it changed its registration status from "active" to "suspended", during which time it would not have been permitted to conduct business. On June 21, 2013, Bledi changed its status back to "active". The next day – only two months before the award of the concession – it was sold to ICMS…for $850. A few days after that, the name was changed to ICMS Construction. (In 2016, the shares were transferred from ICMS to Dr. Olti Peçini again for $850.)

[8] CY2016 revenue and expenses converted at USD/ALL 124.1.
[9] http://investors.osi-systems.com/releasedetail.cfm?releaseid=786552
[10] https://www.businesswire.com/news/home/20151013005793/en/OSI-Systems-Commences-Operations-Albania-Turnkey-Screening

It is inconceivable that a legitimate structure would give ICMS a 49% stake in the concession. To show how much of a farce ICMS Construction is, as of the end of 2016, it had:[11]

- $1,300 cash,
- zero inventory,
- $20,000 in plant and machinery, and
- our favorite ICMS Construction factoid though is that this construction powerhouse had office equipment of just $514 – AT COST! So the biggest question we have is whether ICMS Construction is run off a typewriter or an iPhone.

ICMS Construction seems to essentially be a company on paper only that has no substance.

For the foregoing reasons, the company's response to our report in no way changes our opinion that OSIS is rotten to the core.

[11] ALL:USD .0078