FARMSTEAD TELEPHONE GROUP INC
Form 10-K
March 26, 2003

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, 2002

Commission file number 0-15938

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

Delaware	06-1205743
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
22 Prestige Park Circle, East Hartford, CT	06108-3728
(Address of principal executive offices)	(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 report), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] 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. [X]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

The aggregate market value of the Common Stock held by non-affiliates of the registrant, computed by reference to the last sale price on June 28, 2002, the last business day of the registrant's most recently completed second fiscal quarter, was $2,115,485.

As of February 28, 2003, the registrant had 3,298,958 shares of $0.001 par value Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the registrant's definitive proxy statement for the

Annual Meeting of Stockholders to be held on June 12, 2003 are incorporated by reference in Items 10 through 13 of Part III of this Annual Report on Form 10-K.

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PART I

ITEM 1. BUSINESS

GENERAL

Farmstead Telephone Group, Inc. ("Farmstead", the "Company", "we", or "our") was incorporated in Delaware in 1986 and has been a publicly held company since May 1987. Our main offices are located at 22 Prestige Park Circle, East Hartford, CT 06108, and our telephone number is (860) 610-6000. We are principally engaged as a provider of new and used Avaya, Inc. ("Avaya") business telecommunications parts and complete systems. We provide used "Classic Avaya(TM) " telecommunications equipment pursuant to an " Authorized Remarketing Supplier Program" with Avaya, under which we are one of only five companies nationwide so authorized. We also offer the full-line of new telecommunications parts and complete systems as an Avaya "Diamond Dealer". Our product offerings are primarily customer premises-based private switching systems and peripheral products, including voice processing systems. We also provide telecommunications equipment installation, repair and refurbishing, short-term rental, inventory management, and related value-added services. We sell our products and services to large and mid-sized, multi-location businesses as well as to small businesses, government agencies, and other equipment resellers.

Effective February 1, 2001, Farmstead 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, Farmstead had a 50.1% ownership interest, and TriNET had a 49.9% ownership interest. Formed under the laws of the State of Delaware, and with operations 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, Farmstead acquired TriNET's 49.9% ownership interest in InfiNet. During 2002, however, Farmstead changed its 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 was inactive for most of 2002.

PRODUCT OFFERINGS

EQUIPMENT

We sell a wide range of Avaya product offerings, including Avaya's most advanced enterprise voice communications system marketed under the DEFINITY(R) product line. The DEFINITY product line provides reliable voice communications and offers integration with an enterprise's data network. DEFINITY servers 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. 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 market Avaya voice messaging products such as OCTEL(R) Messaging and INTUITY(TM) AUDIX(R) Messaging, and network support products such as Avaya Cajun(R).

Equipment sales consist of both sales of complete systems and software applications, and sales of new and refurbished parts (commonly referred to as "aftermarket" sales). Refurbished products are primarily sold under the Classic Avaya(TM) label pursuant to a licensing agreement with Avaya.

Equipment sales revenues accounted for approximately 91% of total revenues in 2002 and 93% of total revenues in both 2001 and 2000.

SERVICES

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:

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

Repair and Refurbishing: We perform fee-based repair and refurbishing services for our customers through our in-house facilities and use of subcontract repair shops. The in-house work primarily consists of cleaning, buffing and minor repairs. The Company outsources major repairs of equipment.

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 provide system engineering and configuration, and technical "hot line" telephone support services.

Our combined service revenues accounted for 9% of revenues in 2002 and 7% of revenues in 2001 and 2000. Installation Services accounted for 8% of total revenues in 2002. No individual service category accounted for more than 5% of revenues during 2001 and 2000.

RELATIONSHIP WITH AVAYA INC. (PREVIOUSLY A BUSINESS SEGMENT OF LUCENT TECHNOLOGIES)

Lucent Technologies ("Lucent") was formed in 1995 from the systems and technology units that were formerly a part of AT&T Corp., including the research and development capabilities of Bell Laboratories. In April 1996, Lucent completed the initial public offering of its common stock and on September 30, 1996, became independent of AT&T when AT&T distributed to its shareholders all of its Lucent shares. On September 30, 2000, Lucent completed the spin-off of its Enterprise Networks Group business segment (essentially its PBX business, and within which market segment we participate), as well as its SYSTIMAX(R) cabling and LAN-based data businesses to Lucent shareholders, forming Avaya which focuses directly and independently on the enterprise networking market. Avaya is a leading provider of telecommunications products in the U.S.

Since 1985, AT&T, Lucent, and now Avaya, have provided support to the aftermarket by offering installation and maintenance services for its products purchased by end-users through equipment resellers. Equipment resellers such as the Company may also, with various restrictions, utilize Avaya documentation, technical information and software. Avaya also generally provides up to a one-year warranty on its products. Maintenance of Avaya equipment sold by us is generally provided by Avaya. We use either Avaya, authorized Avaya subcontractors, or the Company's own network of subcontract installers throughout the U.S. to handle our customers' equipment installation needs.

We operate in an Avaya-sponsored Authorized Remarketing Supplier ("ARS") aftermarket program as an ARS Dealer (the "ARS Agreement"), selling Classic Avaya(TM) products to end-users nationwide. The ARS Agreement expires December 31, 2003. Classic Avaya(TM) products are defined as used Avaya PBX system and key system parts that have been refurbished by us under Avaya quality standards, and sold with a Classic Avaya label. We are currently one of only five appointed ARS Dealers, none of whom has been granted an exclusive territory. The ARS Agreement also allows us to sell certain new Avaya PBX products and voice processing products to end-users, including government agencies. In January, 2002, we additionally became a Diamond Dealer, authorized by Avaya to sell complete voice and data systems and applications.

Under a license agreement with Avaya that expires December 31, 2003, we are required to pay fees to Avaya based upon a percentage of the sales price of Classic Avaya(TM) products that we sell. Over the period of the agreement, these fees have ranged from 10% to 6.5% (currently). We are also required to pay fees to Avaya based upon a percentage of the sales price of Avaya products sold through our call center. These fees have ranged from 25% to 15% (currently). We recorded in cost of revenues approximately $507,000, $1,341,000, and $2,097,000 of fee expense in 2002, 2001 and 2000, respectively.

We believe that our relationship with Avaya is satisfactory and we have received no indication that Avaya has any intention of terminating or not renewing the ARS Agreement, or any other agreement, with us. We would be materially adversely affected should Avaya decide to terminate or not renew these agreements.

MARKETING AND CUSTOMERS

We market our product offerings nationally through a direct sales staff, which includes salespersons located throughout the Eastern seaboard, Indiana, Texas and California. In February 2002, we opened a sales office in New York City. 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 83% of our total revenues in 2002, 86% of revenues in 2001and 91% of revenues in 2000, while sales to dealers and other resellers accounted for approximately 17%, 14% and 9% of revenues during the same respective periods. We have thousands of customers and, during the years ended December 31, 2002, 2001and 2000, 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 currently include Avaya and other new equipment manufacturers, other new telecommunications equipment distributors, as well as other telecommunications equipment resellers. In the sale of Classic Avaya(TM) products, we compete with the other Avaya-designated ARS Dealers. We believe that key competitive factors in our market are price, timeliness of delivery, service and product reliability. Due to economic conditions, and the reduction in capital spending on telecommunications products, which have developed in the U.S. over the past two 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 convergence 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 secondary market 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, therefore, dependent upon any single supplier for used equipment. The Company believes that the availability of used equipment in the marketplace is presently sufficient to allow the Company to meet its customers' used equipment delivery requirements.

PATENTS, LICENSES AND TRADEMARKS

No patent is considered material to our continuing operations. Pursuant to agreements in effect with Avaya, we may utilize, during the term of these agreements, certain Avaya designated trademarks, insignia and symbols in our advertising and promotion of Avaya products. We operate under a license agreement with Avaya, in which we were granted a non-exclusive license to use the Classic Avaya(TM) trademark in connection with the refurbishing, marketing and sale of Avaya products sold under the ARS Agreement. Under this agreement, we are required to pay fees to Avaya based upon a percentage of the sales price of Classic Avaya(TM) products that we sell. Over the period of the agreement, these fees have ranged from 10% to 6.5% (currently). We are also required to pay fees to Avaya based upon a percentage of the sales price of Avaya products sold through our call center. These fees have ranged from 25% to 15% (currently). We recorded in cost of revenues approximately $507,000, $1,341,000, and $2,097,000 of fee expense in 2002, 2001 and 2000, respectively. The license agreement expires December 31, 2003. We have

received no indication that Avaya has any intention of terminating or non-renewing the license agreement. We would be materially adversely affected should Avaya decide to terminate or not renew the license agreement.

RESEARCH AND DEVELOPMENT

We did not incur any research and development expenses during the three years ended December 31, 2002, and research and development activities are not material to our business.

BACKLOG

The backlog of unshipped orders believed to be firm was approximately $1,010,000 at December 31, 2002 and $1,732,000 at December 31, 2001.

EMPLOYEES

At December 31, 2002, we had 64 full-time employees. Our employees are not represented by any organized labor union and are not covered by any collective bargaining agreements.

EXECUTIVE OFFICERS OF THE REGISTRANT

Name	Age (1)	First Became An Executive Officer in	Position(s) Held
George Taylor, Jr.	60	1984	Chairman of the Board, President, Chief Executive Officer
Michael R. Johnson	56	2001	Executive Vice President
Robert G. LaVigne	51	1988	Executive Vice President, Chief Financial Officer, Secretary, Treasurer