Sharps Compliance, Inc.
Second Quarter Fiscal 2009 Results
February 10, 2009

Operator: Greetings and welcome to the Sharps Compliance Corp., Second Quarter Fiscal 2009 Earnings Conference Call. It is now my pleasure to introduce your host, Ms. Deborah Pawlowski, IR for Sharp Compliance, Inc. Thank you, Ms. Pawlowski, you may begin.

Deborah Pawlowski: Thank you, Shay. Good afternoon, everyone. We appreciate your participation in our Second Quarter Fiscal Year 2009 Earnings Conference Call. You should have a copy of the news release detailing Sharp's financial results that was put out earlier this morning, and if not, you can obtain it from the company's website at www.sharpsinc.com. On this site you'll also find the announcement that we put out last week regarding the $40 million government contract that the company was awarded. I have with me here today on the line, Sharps Chairman and CEO, Dr. Burt Kunik, as well as Randy Grow, the President and Chief Operating Officer, and David Tusa, Chief Financial Officer. Burt and David are going to provide their planned comments and then we will open it up for questions. If you are listening via the webcast, you also have the ability to submit questions online.

As you are aware, we may make forward-looking statements, both during the call, and in the following question and answer session. These forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties, as well as other factors that could cause the actual results to differ materially from what we discuss here. These risks and uncertainties are available for you in the press release itself as well as with the company's filings with the Securities and Exchange Commission. So with that, let me turn the call over to Dr. Kunik to begin the review and discussion.

Burt Kunik: Thank you, Debbie. I'd like to welcome everyone to our Fiscal Year 2009 Second Quarter Earnings Teleconference Call.

On February 2, 2009, we announced that we had been awarded a contract to provide our Sharps Medical Waste Management System to an agency of the United States Government. The total contract is valued at approximately $40 million, and it is expected to be executed over a five-year period. We have now received a purchase order for $28.5 million of the contract which represents products and services that will be provided during the first contract year. The contract does provide for an additional $11 million to be earned over the following four option years and represents payment for program maintenance.

Our strategy has been to develop the systems and tools to safely and cost-effectively handle medical waste for alternate health care sites and other generators of medical waste. That is to say, anywhere medical waste is generated outside of a hospital or a large health care setting. For many years, I've been working with government regulatory bodies to convey the significance of the amount of waste generated outside of the hospital setting, and more importantly, helping them to understand that placing your sharps and other medical waste in a red Sharps container does not constitute proper handling of medical waste. If the red Sharps container is not properly disposed of, we have not addressed the issues of contamination of our environment and danger to individuals and communities.

We believe there will be many additional opportunities to sell the Sharps Medical Waste Management System to prospective government and commercial customers. This could include an expansion of our existing government contract as well as selling the Medical Waste Management System to many additional agencies within the Federal government. Additionally, we look to target major cities and states that would also benefit from the service offering. Finally, we'll market the Medical Waste Management System to large corporations and industrial facilities who we believe will also see the value of our service offering.

The pipeline of pharmaceutical manufacturer opportunities continues to be strong. We are currently working with several manufacturers to design a program that best fits their patients, as well as their needs for data. We are confident that our continued sales efforts in this market will result in the launching of additional patient support programs in calendar year 2009.

We have been building our infrastructure over the past six months in anticipation of the U.S. Government contract and other sales opportunities in many markets. The infrastructure includes people, systems, facilities and other related expenditures that we believe are necessary for the company to execute on the expected significant increase in volume and activity. We are confident we have the resources in place to successfully deliver high quality products and services to our customers.

With that overview, I'd like to turn the call over to David for review of our financial performance, the earnings release and the U.S. Government contract.

David Tusa: Thank you, Burt, and good afternoon everyone. Thank you for participating in the call. First I will cover the second quarter financial results, and then talk a bit more about the new U.S. Government contract, its effect on the organization, infrastructure and our prospective financials. I also want to mention that we're limited in the amount of information that we can disclose about the new U.S. Government contract, therefore, I would request that you respect the confidentiality surrounding the contract when you ask your questions later in the conference call.

As you see from a review of the earnings release, our second quarter revenue was down about $380 thousand to $3.4 million, when compared with the same period of the prior fiscal year. The decrease in revenue for the quarter was primarily due to timing associated with billing in one of our largest vendor-managed inventory programs for pharmaceutical manufacturers. We had billings in a prior year and did not have corresponding billings in the current quarter. That's not true for the six-month period. The decrease on the pharmaceutical manufacturing side was partially offset by strength in the retail markets and in the professional markets.

For the six-month period ended December 31, 2008, revenue was up $500 thousand, to $7.6 million, compared with the first six months of fiscal 2008. The six-month year-over-year increase was attributable to the recently announced renewal of our first vendor-managed inventory program for a top ten pharmaceutical manufacturer's patient-support program as well as about $300 thousand in billings from two other pharmaceutical manufacturers and a major mail-order pharmacy. The six-month period also showed growth in the retail and professional markets. The increase in the retail market is a result of demand for the Sharps Disposal by Mail Systems®, as pharmacies and clinics administer flu shots in the retail setting.

Gross margins were down in both the second quarter and the six-month period ended December 31, 2008. The reduction in gross margin in the second quarter was due to the effect of lower revenue, higher infrastructure costs and the mix in product sold. The higher infrastructure cost is associated with a ramp-up in the planned increase in volume and activity as the Company executes on the U.S. Government contract, as well as other core business opportunities. The reduction in the gross margin for the six-month period was primarily due to the $200 thousand in excess air freight shipping costs that we incurred in the first quarter of fiscal year 2009 to address supplier and manufacturing issues associated with the Company's Pitch-It™ IV Poles. The supplier issues have been resolved, and as you'll see from our balance sheet, we have increased our safety stock of inventory to mitigate potential supplier issues in the future.

SG&A expense was up in both the second quarter and fiscal year-to-date periods. The increases are due to the non-cash 123R stock-based compensation expense, compensation-related expenses, and professional and recruiting fees. These increases in SG&A are a result of increased infrastructure costs that we believe are necessary to put in place in light of the Government contract and other expected increase in activity, as well as costs associated with the recent hiring of the Company's new President and Chief Operating Officer.

For the six-month period, we generated $377 thousand of operating income. As a result of the decrease in revenue and increased costs in the second quarter, the Company generated an operating loss of $233 thousand for the second quarter of fiscal year 2009.

When you review the numbers, you will see a tax entry. This was the company evaluating its deferred tax asset valuation allowance. As a result, we've decided to eliminate that valuation allowance. In layman's terms, that means the Company which has approximately $8 million in Net Operating Losses (NOL) that has been generated since inception, is now confident that we're going to be able to generate future taxable income sufficient to offset this NOL. Under the accounting rules, we eliminate the valuation allowance, and record a deferred tax asset of $3.1 million, which is about 35% of the tax-affected number on the $8 million NOL. We also recorded $1.8 million credit to tax expense and a credit to additional paid-in capital of about $1.3 million. The $9.5 million of total assets and $6.7 million in stockholders' equity represents a significant increase over that shown in prior quarters.

From an earnings standpoint, we generated $1.6 million in earnings, or $0.11 per diluted share, for the quarter, and $2.2 million in earnings, or $0.16 per diluted share for the six-month period. The majority of those earnings are related to the $1.8 million tax credit that the company recorded during the second quarter.

As Burt mentioned, the U.S. Government contract is valued at $40 million, of which about $29 million is expected to be earned in the first contract year (versus fiscal year). That is on a contract-year basis. The contract year starts February 1, 2009. The remaining $11.0 million is scheduled to be earned over the following four contract years in conjunction with the program maintenance.

From a GAAP revenue standpoint, and these numbers could shift between periods depending upon our actual production schedules, we expect about $6 million of GAAP revenue in the fourth quarter of fiscal year 2009, quarter ending June 30, 2009. We expect about $23 million in revenue for fiscal year 2010, year-ended June 30, 2010, and about $2 to $3 million in each of the next four fiscal years, 2011 through 2014, for the total $40 million contract. These are estimates and they could shift between periods.

In conjunction with this growth and expansion, we've also recently executed operating leases for two additional warehouse and production facilities totaling about 90,000 square feet. This brings our total facility square footage, both leased and owned, to about 135,000 square feet. We expect this number could increase by another 30,000 square feet by the end of calendar year 2009.

With this contract, we've been working with our bankers, JP Morgan Chase, on increasing our line-of-credit. We do have a term sheet from JP Morgan Chase to take our line-of-credit from $2.5 to $4.5 million. We have a traditional line-of-credit with a borrowing base and interest at prime, or 3.25%. We've got an excellent banking relationship with Chase, and we look forward to expanding our business with them. We expect, over the next 30 days, to be able to announce the final details. We have cash on the balance sheet, plus we have a term sheet on the line-of-credit that we will need to finance the working capital of the business as we execute on the Government contract as well as the Company's other business.

We're in the process of completing our application listing for NASDAQ. Based upon our strengthened balance sheet, we now meet all the listing requirements other than the $4.00 stock price. The closing bid stock price has to be $4.00 to qualify for listing, but we meet all the other requirements, including corporate governance requirements and balance sheet requirements. We will complete the application process after we issue the 10-Q. The process takes about eight weeks and is designed to remain active until we meet that $4.00 threshold. So, we want to get moving on the process to move the company toward the NASDAQ listing.

As many of you are aware, our business model is one of significant operating leverage. You've heard me talking in prior quarters about our revenue increasing by 18% to 20%, but our earnings doubled. That is because of the significant operating leverage we have. Typically our SG&A and our cost structure don't grow anywhere nearly as much as the revenue. Now, as we execute on this U.S. Government contract and other business, the operating leverage is really going to become apparent. As a matter of fact, by the fourth fiscal quarter, which is the quarter ended June 30, 2009, we think we'll start to see gross margins exceeding 50%. And we will also see significant expansion of the operating margin, as a percentage of the revenue.

You've also seen over the last couple of quarters an increase on our SG&A and cost structure, which is really contrary to what we've done in prior years. We think we've done a great job in keeping costs under control. We've been increasing our infrastructure costs in anticipation of not only the U.S. Government contract, but also the growth in the business. We think this was prudent, and in light of the contract that we have in hand, we were very smart to put all this in place and spend the extra money, whether it is systems, facility expansions, or people.

In closing, it's an exciting time for the company. Our employees are very excited. Our shareholders are excited about this award and the expected growth that we should experience here over the next 12 to 18 months. Unlike many companies in the country, we are growing, hiring employees and expanding our facilities. We welcome the opportunity that this contract and others present to us, and we look forward to executing on these contracts. With that, I think we can open it up to questions.

Operator: Thank you. Our first question is coming from Ben Lichtenberg from Noble Financial Group.

Ben Lichtenberg: Good afternoon gentlemen. Given some guidance on your margins with regards to the ramping up of the government contract, are you done building out your infrastructure for the government contract? Will there be additional costs, and if so, how much?

David Tusa: Ben, this is David. We pretty much put most of the infrastructure in place with the recent signing of these leases. We are hiring some more people, as we speak. But as I mentioned earlier, we think from a gross margin standpoint, we could see exceeding the 50% level, beginning with the fourth quarter. From an SG&A standpoint, there will be some, it won't be overly significant. It could be 10% to 15%, but the SG&A is going to grow at a rate much lower than the rate that revenue will be increasing and the gross margin will be expanding.

Ben Lictenberg: So, if you did the math, historically, your run rate's about $15 million. Assuming that core business stays intact and your costs against that $15 million were about, just to use a round number, $10 million, and you've been a relatively break-even company, which means your G&A has been about $5 million. If you go from a $15 million company to a $40 million company, you don't get the $29 million of revs, you come in with $25 million over the next 18 months and you have 50% margins. You're going to have $20 million of operating margin before overhead. Overhead has annually been about $5 million. If you don't ramp that up too much from here you get to stay at the $6 or $7 million level. So if you do $20 million of operating margin on $40 million of revenues with annually about $6, $7 or $8 million against, it that works out to be some pretty sizable net income.

David Tusa: Well that's right. Again, that's the beauty of the business model. You're right, if you use $15 million for the base business and throw in the $23 on top of that for the government business, you're approaching $40 million, and you have 50% gross margin. You're right, and if you increase 10% to 15%, even 20% on the overhead, the operating margins expand quite a bit. Again, that's the beauty of the business model, and that's why we have been building out the infrastructure and hiring the people necessary to make this thing profitable. I don't think your math is unreasonable.

Ben Lichtenberg: Okay, thank you very much.

Operator: Our next question comes from Walter Young from Thomas Davis & Co.

Walter Young: Hi, good afternoon. My question is what's your best estimate of the size of the market opportunities for other government agencies in this area on an annual basis?

Burt Kunik: It's Burt Kunik. I think we really shouldn't put a number to the size. I think what we're really excited about is the fact that we now have delivery solutions that meet the needs of the various markets that we serve, and being a solutions provider, that opportunity should be really outstanding for us. You just have to look at the size of contracts going forward. I don't think that we've peaked the market in terms of what a size could be, and I think going forward our opportunities should be tremendous. We'll just be heading out to the markets from there, and we've asked the sales force to address this particular market. I think our opportunities should be really tremendous without putting a number to it.

Operator: Thank you. Our next question is coming from Mathew Kantrowitz from RedChip Companies.

Mathew Kantrowitz: Hi, Burt, David. Good to speak with you. How many accounts in total does Sharps have right now?

David Tusa: How many accounts in total? Well, we have probably thousands. Matt, we have 10 to 20 large, significant high-dollar accounts. Other than that, we have thousands of smaller day-to-day type of accounts.

Mathew Kantrowitz: I'm wondering what the pipeline's looking like in terms of sales for the next couple of quarters?

Burt Kunik: We have to look at our existing business and our future business in the new markets that we're going into. I think our existing business has some tremendous opportunities. When you just look at the markets that we're addressing; a pharmaceutical market, which we already mentioned we have tremendous opportunity in, and the home-infusion market, which is a rapidly growing market today. It is where we've received so much of our revenue over the years. We have excellent products and services in that marketplace, and in today's times, that's going to be a rapidly growing market. So, the various markets that we're in all have tremendous opportunity, in addition to the new markets that we're going into with the government, whether it be state, local, federal government opportunities, along with offering our new delivery system into large commercial operations. I think that the opportunities going forward are really tremendous, and I hope by the next quarter we'll be able to talk about where we've been.

Deborah Pawlowski: Randy, maybe you could talk to, strategically, what are the top three markets, how do we go to market, and then how do we address the multitudes of thousands of client markets.

Randy Grow: When we talk about some of the new markets that we are entering into, I think that the paradigm shift we see ourselves in the midst of is that, as Burt mentioned, we are really now offering solutions to problems that perhaps didn't exist when this company was founded years ago.

When we look at the manufacturing opportunities that we have, we are finding a great amount of interest from our manufacturing partners that we have and those that we are speaking to, to address their needs, not only around safe and effective waste management of their products, but also the ability to track when our products go out, when they come back. It gives strong indication about how that manufacturer's product is being used, because we can track when the waste was generated and when it came back, what it weighed and the timing of the whole thing. So, it starts to border on compliance information that most manufacturers would really like to have.

We're starting to see interest from some of the specialty pharmacy providers around the same kind of information, and many of these specialty pharmacy providers are owned by Managed Care Systems. I can go on for a long time, but I think really what we're saying is that there is now a much stronger acknowledgement of the solutions that are out there to solve some of the problems that are beginning to become much more clear. The last thing, and I don't mean to minimize it, but there is much more acknowledgement now, just in terms of social conscientiousness, of manufacturers and the insurance or specialty pharmacy community around the whole green initiative. People are now recognizing that there is a tremendous amount of waste that is created that finds itself into the public, and now there are solutions that will address these issues that exist. I think, in summary, the market is much more aware, in tune and willing to look at solutions today than they ever have been, historically. I think that speaks volumes about what our opportunities look like for us in the future.

Mathew Kantrowitz: Randy, picking up on that, you talked about the regulatory environment a bit. How do you see the new administration and the new EPA putting out the regulations, and how will that affect the business going forward here?

Randy Grow: Burt has far more experience in this. He has direct responsibility for the regulatory side, so I'm going to ask him to address that question. Thank you.

Burt Kunik: I think the new administration will definitely foster a greener environment. You're seeing now, as well, States are addressing the issue of sharps disposal. Combined with that, you're seeing a lot of new initiatives take place on the regulatory front. We're also very involved in the disposal of unused medications. That is taking a forefront in so much of the news today. We have one of the best solutions in the marketplace for helping the consumers with the management of unused medications. The current regulatory environment, be it State or Federal, is very conducive to our growing our business and filling the needs in the marketplace.

Mathew Kantrowitz: David, do you have any numbers on that prescription take-away that Burt was just referring to?

David Tusa: No, we're literally right in the middle of the launch. Matt, let me answer the bigger question a little bit differently than Burt or Randy spoke of it. Fifteen plus years ago, when Burt started this company and sold the Sharps Disposal by Mail System®, providing a great product to the home health care industry, that's what the focus of the company was. Starting four or five years ago, we really moved more to a service offering with the pharmaceutical manufacturers. The pharmaceutical manufacturers were providing a better managed-inventory program. Now, with the medical waste management solution, it truly is a comprehensive solution offering, and it is just as much or more services than products. It is a much more robust service offering combined with a product. That's from a big-picture standpoint; that's kind of the evolution of the company over the last 15 years.

Mathew Kantrowitz: I think the government contract is really a great "get" and testament to that. Thank you and I'll take my questions offline. Thanks.

Operator: Thank you. Our next question is coming from Hinda Mizrahi, from SSM Investment Corp.

Hinda Mizrahi: Is this government agency a main or parent agency that has other branches and this contract includes the other branches or right now includes the main parent and is there room to expand into the other local agencies or you know the child agencies?

David Tusa: We're prohibited from talking more about that, but as Burt mentioned, we think we have many opportunities within a number of government agencies in addition to the one that we're dealing with.

Hinda Mizrahi: Is it because this agency opens up the doors? Or, because once you're in it you can make your pitch and they'll listen more?

David Tusa: I think all of the above.

Hinda Mizrahi: And the $28 million is that for the first year to set up the system for them and then later on it's just the maintenance?

David Tusa: The remaining four years are primarily maintenance and the first year is the build up.

Operator: Thank you. Our next question is coming from Michael Alexander who is a private investor.

Michael Alexander: I joined late so I'm sorry if this was already covered, but regarding the government contract, do you have a timeframe you expect that to roll out and how fast do you expect it to ramp up?

David Tusa: Sure, Michael, let me cover that for you. We did talk about it earlier. We expect about $6 million in the fourth quarter of fiscal year 2009; that's the quarter-ended June 30, 2009; about $23 million in GAAP revenue in fiscal year 2010, that's the fiscal year ended June 30, 2010; and about $2 to $3 million in each of the fiscal years following, which are 2011 through 2014. Now, those are estimates; those could shift between the periods a bit, but that's our current estimate.

Michael Alexander: That makes sense. Based on your comments on margins, it sounds like this contract probably has a similar margin to your other businesses, is that correct?

David Tusa: We don't talk about any margins on any particular contract, but what we have said is that we think because of the growth of the business and the increased revenue and product offerings, we think that we'll be able to get our gross margins over 50% starting with the June 30, 2009, quarter.

Michael Alexander: Great job, thanks.

Operator: Our next question is a follow-up from Walter Young, from Thompson Davis & Company.

Walter Young: Could you describe the service a little better and address whether the facility expansion has to occur, if you were to get other contracts or can you efficiently use this extra warehouse space for other contracts? Are these expansions strictly for the contract that you've signed for $40 million?

David Tusa: Walter, we're expanding. If you step back just a bit, I don't think it was more than 6 or 7 years ago that we only had 5,000 or 6000 square feet. We're over 130,000 square feet right now. So, the build-out that we're putting in place is a combination of expected growth in the existing businesses and growth that will facilitate this contract. We are trying to build out, while being prudent, but build out as we see the demand in the business moving us there.

Walter Young: The contract doesn't require a specific square footage for that particular customer?

David Tusa: We're providing a service offering, and as part of that service offering, we're going to provide the infrastructure to make sure that service can be offered. There are no restrictions on what we're doing and our using it for our core business. We are consistent with the service offerings that we make right now. So, yes, we can use it for whatever parts of the business that we feel are prudent.

Operator: Thank you. At this time, we have no further questions.

Burt Kunik: I want to thank everybody and tell you that our efforts to move from being a provider of products and services, to a comprehensive solutions provider of medical waste management systems is being realized by our recent pharmaceutical and government contracts. We are confident that we have the experience, expertise, personnel and infrastructure to transform into a comprehensive provider of medical waste management services for alternate site health care customers and other generators of medical waste.

Thanks, again, for joining us today on our Fiscal Year 2009 Second Quarter Earnings Teleconference Call.