

**Lattice Incorporated**  
**2010 Financial Results Conference Call**  
**March 31, 2011**

**Operator:** Good day ladies and gentlemen. Thank you for standing by and welcome to the Lattice Incorporated 2010 Financial Results Conference Call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference will be opened for questions. If you have a question, please press the star followed by the one on your touch-tone phone. Please press star zero for operator assistance at any time and for participants using speaker equipment it will be necessary for you to lift your handset before making your selection. This conference is being recorded today, Thursday, March the 31<sup>st</sup> of 2011, and I'd now like to turn the conference over to Mr. Frank Hawkins of Hawk Associates. Please go ahead, sir.

**Frank Hawkins:** Thank you, Operator, and good afternoon everyone. Thanks for joining us on Lattice Incorporated's Year-End 2010 Earnings Conference Call. With us today are Lattice's Chief Executive Officer, Paul Burgess and the Chief Financial Officer, Joe Noto.

Before I hand the call over to Paul, may I remind our listeners that on this call management's prepared remarks contain forward-looking statements which are subject to risks and uncertainties, and management may make additional forward-looking statements in response to your questions. Therefore the company claims the protection of the safe harbor for forward-looking statements that is contained in the Private Securities Litigation Reform Act of 1995. Actual results may differ from those discussed today and therefore we refer you to a more detailed discussion of the risks and uncertainties in the company's filings with the Securities and Exchange Commission.

In addition, any projections as to the company's future performance represent management's estimates as of today, March 31<sup>st</sup>, 2011. Lattice assumes no obligation to update these projections in the future as market conditions change. The supplement, its financial results presented in accordance with U.S. GAAP, management will make reference to certain non-GAAP financial measures which the company believes provides meaningful additional information to understand the company's operating performance. A table reconciling non-GAAP measures to the nearest GAAP equivalent may be found in the earnings release.

It's now my pleasure to turn the call over to CEO, Paul Burgess.

**Paul Burgess:** Thanks, Frank and welcome to everyone joining us on the call today. I will make a few opening remarks and then pass the call over to our CFO, Joe Noto for a more in depth discussion of our financials. Our strategy for expanding the communications business in 2010 enabled us to increase revenues in that division by approximately 220% to \$3.5 million in 2010. With the proven success of the new communications model, we have arranged additional financing in the first quarter to facilitate the continued growth of the company. Although the government contracting business has seen some pressure due to the budget delays, we are currently working on closing an acquisition which should put us on a path to stronger growth in this division moving forward. I'll go into a more in depth analysis of our operations, but before I do so I'll pass the call over to Joe Noto for a more in depth discussion of our financials.

**Joe Noto:** Thanks, Paul. Good afternoon everyone. Looking at the P&L for the year, our total revenue for the year ended December 2010 decreased 13.2% to \$13.5 million from prior year. The total percentage decrease of 13.2% included a decrease in our government segment of 31% which was partially offset by an increase of 220% in our telecom business. The decrease in government revenues was mainly due to a decrease in lower margin subcontracted or pass-through revenue as opposed to inhouse and direct labor revenues, and that was due to certain programs ending under our state work contract vehicles. That decrease in sub-revenue accounted for 25% of the year-on-year decrease.

The strong growth of our telecom business is mainly attributable to the direct service model launched late in 2009 which we anticipate will continue into 2011. Our gross margin increased to 37% from 34%. The increase in percentage was primarily due to an increase in margin in our government segment due to decline of lower margin pass-through subcontracted revenues relative to higher margin inhouse or direct labor. Our adjusted operating income, a non-GAAP metric, for the year was \$357,000 positive which adds back non-cash items to a reported operating loss of \$907,000. Non-cash items included \$753,000 of depreciation and amortization and \$511,000 in share-based compensation. You can see our press release for a reconciliation to reported operating loss.

Turning to our cash flows, we ended the year with \$324,000 in cash compared to \$213,000 in cash at December 2009. Our operating cash flow, OCF, for 2010 was \$700,000 positive which compared to a negative OCF of \$119,000 in the prior year. The increase was mainly driven by a decrease in gov receivables attributable to the decrease in subcontractor billings from the fourth quarter 2009 year-end levels. During 2010, as Paul had mentioned, we closed on financing generating proceeds of \$1.35 million which was used to pay a \$1.3 million patent licensing fee supporting our strategy in moving towards a direct services model in our telecom segment.

With that, I'll turn the call back to Paul for some closing remarks.

**Paul Burgess:** Thanks, Joe. For this portion of the call, I'll divide the call into two sections. The first being our federal government contracting business and the second being our communications business. Starting with the federal business, we've been able to increase our gross margins primarily by reducing the amount of revenue we were generating via subcontractors which have a much smaller gross margin. Our strategy moving forward continues to be focused on increasing revenue with direct labor and minimizing the amount of subcontractors we utilize to provide services to the federal government.

Although our sales pipeline continues to be strong, the ongoing budget issues at the federal level have delayed many awards and even stagnated funding on some existing contracts. To help counterbalance these issues, we are negotiating an acquisition that would bring enough contract backlog to add approximately \$4 million in annualized revenue. Should we be successful, we anticipate being able to close and announce the transaction in the next 30 days. We anticipate with the close of the transaction we should be able to generate revenues of \$12 to \$14 million from the government services division.

Moving to the communications division, the communications business as previously discussed, we went through a transition to becoming not only a technology company, but also providing communication services to correctional facilities. The new model enabled us to increase our revenues by 220% within this division. We generate revenues in this business from three primary sources; providing secure telecommunication services directly to the facility, wholesaling our services to other providers who provide the same service via our technology, and selling our technology and engineering and transaction services. We anticipate strong growth in all three areas in 2011.

To facilitate our direct sale strategy, we have increased our sales force from two to nine in the first quarter of this year. In addition, we have signed on a number of facilities in Q1 that we will begin announcing early next week. We have also been awarded a trial for our new facility in the UK which will begin in May of this year. If successful, the services will be implemented in the facility which is approximately 1,500 beds. This should lead to further expansion in the region as our partner, we anticipate, would implement the services in other facilities that they currently have under management and our bidding line.

We have also been selected by a large Canadian telecommunications company to be their partner on bidding for provincial and federal correctional facilities in Canada. Our first bid is taking place now and we anticipate it being awarded in late Q2. We also feel very strongly that we'll

probably win that bid as it was sole-sourced to this one telecommunication company. We have also partnered with a large technology company in Israel to bid on all the Israeli correctional facilities. If successful, we anticipate this being awarded in Q3 of this year. For some of the large state bids which we're not able to currently bid on at this point in our growth, we have partnered with a US-based communications company to joint bid on some of the state facilities. We currently have one bid in process and we anticipate that being awarded in Q2 or Q3 of this year as well.

The company will also be introducing two new product lines this year. The first will be video visitation and the second will be a kiosk system for use both by visitors and inmates in correctional facilities. Both technologies will enable us to expand our revenue base and facilitate a strong margin growth. With everything in front of us, I anticipate this division generating over \$8 million in revenue and the company as a whole generating between \$20 and \$22 million in revenue for the year 2011. In Q1, we also closed an additional financing that brought in approximately \$1.6 million of which management contributed approximately \$200,000 of that financing. The financing is primarily being used to facilitate the growth of our telecommunications division primarily in sales, marketing, and product development.

With that, I open the call to questions. Operator?

**Operator:** Ladies and gentlemen, we will begin the question and answer session at this time. If you would like to ask a question, please press the star followed by the one on your touch-tone phone. If you'd like to withdraw your question, please press the star followed by the two, and if you're using speaker equipment you will need to lift the handset before making your selection. One moment please for our first question

Our first question comes from the line of Peter D'Agostino with AMI Research. Please go ahead.

**Peter D'Agostino:** Good morning, Paul. Congrats on a great quarter. I have a couple of questions. One, I wondered about, can we expect a sustained positive cash flow from operations going forward this year and next?

**Paul Burgess:** Yes. I mean just to kind of answer that at a higher level too, you know, with the additional revenue we plan on investing as much as we can in the expansion of the company through sales and marketing. So I anticipate the company will remain EBITDA positive in 2011, but we do plan on reinvesting a substantial amount of money that we have back into the business, especially in product development and in the continued growth of the company.

**Peter D'Agostino:** Okay, good. Nice job on expanding the gross margin. Where do you see that leveling out?

**Paul Burgess:** As far as gross margin, Joe, you can comment on this as well. You know, I think right now in the communications business you're going to see a bit of a fluctuation in that you may see the margins for initial entry into some markets be a little pressured, but as we expand in those markets they tend to grow. The other thing that grows them as well is introduction of new product lines. So a lot of times product lines are introduced and they allow us to give a larger share of the revenue contribution that we get coming out of the facility which is really a gross margin to us rather than just going in and selling a specific type of technology. So that can add to increased gross margin as well. So we do see gross margin in the communications business being able to expand a little. On the federal government side, it's more a formula of how much direct labor you have versus subcontract labor. Subcontract labor usually comes in at 68% gross margin. Direct labor as you know, 35 to 50% depending on the contract.

**Peter D'Agostino:** Great and I have a couple more questions. You were able to raise \$1 million in this current quarter and you mentioned how you were going to expand, but I was curious, do you plan on using that \$1 million or any part of it to fund any non-organic growth?

**Paul Burgess:** Not really and here's why. I think, you know, we are going to be doing potential acquisitions going-forward. We have this one that we're working on on the government side, but that financing specifically is focused on the current operations and expanding the current operations of the company. We've got a lot of good opportunities ahead of us right now and where we really see strong growth is being able to develop our product and get it into the various markets. That's why when I mentioned previously, some of the big partners we're working with, in that instance, we're almost paid to develop our products because they'll come in and say, I like what you're doing, we want you to be part of this bid, but we need your product to also do A, B, and C. So as we go in on these bids and we win them, they pay us, we redevelop the product, and launch future services that we can take elsewhere, so that's almost a second source of financing for us.

**Peter D'Agostino:** I see, thank you. I have one more question Paul. I think it was 26% of your 2010 income revenue was the telecom business segment. How is that looking forward for this current year?

**Paul Burgess:** For the current year, out of the – if you look at an estimate of about 22 million, about 8 million –

**Peter D'Agostino:** We're looking at around like 36% for '11 projected.

**Paul Burgess:** Yes, what I anticipate seeing forward going through '11 and into '12 is expansion on both sides. So the telecom group, we've got a

lot of great bids out in front of us - we're really ramping. The federal business was – it tailed off a little last year. We have a new acquisition coming in with some exciting contracts in front of us, so we should see expansion in that as well. But the fastest growth of the company is coming from the telecom side.

**Peter D'Agostino:** Great, Paul. I'm going to jump back in the queue. Thanks so much.

**Paul Burgess:** Okay.

**Operator:** So once again ladies and gentlemen, if you'd like to ask a question, please press the star followed by the one on your touch-tone phone. If you're using speaker equipment, you will need to lift the handset before making your selection.

Our next question comes from the line of Kevin Ood with Barron Partners. Please go ahead.

**Kevin Ood:** Hi, guys. Great progress. You've given us an earful already. Most of my questions are answered from the previous caller, but a couple of things. To make sure I heard correctly, you're suggesting that for the full-year this year you'll be \$20 to 22 million in revenues of which \$12 to 14 will be on the government side and the balance on the telecom side, right?

**Paul Burgess:** Correct.

**Kevin Ood:** Okay, I wanted to make sure I had that right. In terms of the acquisition that you've mentioned, you just indicated that you're really not using any of the capital raised for that, so presumably that's a stock deal, or can you tell us anything about how that'll be put together or what kind of bid?

**Paul Burgess:** Yes, this deal is actually put together by an executive we have been working with for the last year. So he finalized this transaction, put a great deal together. Now we're just rolling the deal into our company. So there will be a stock component. The stock component will be done in the mid \$0.20 range, not anything below that.

**Kevin Ood:** I see, okay. Good, good. And then I guess on the margin side you really can't see clearly where overall numbers are likely to be this year up or down versus last year. I know I understand in the telecom side, you know, there's more upfront costs before the revenue starts to catch up with it. But I mean generally can that go a lot higher on a company-wide basis than what we're seeing, or should somewhere in that 35, 40% gross margin be about the best we could ever look for?

**Paul Burgess:** Well, I wouldn't say it's the best we could ever look for, but you have to remember two things. When you're getting into a new area and breaking into new markets there might be some price pressuring to get into that market, some discounting we do to get into those certain markets, so that could put margin pressure on you and then that will trend higher as we go further out, so it's really a blend. So I think you're going to see higher margin in some areas, but you're going to see margin pressures in others, so that's why I think the blended rate that you quoted is fairly accurate going-forward.

**Kevin Ood:** Okay, great, great. That's helpful. I think the only other question would be in terms of looking forward towards IR efforts getting this story out now that it's really becoming an exciting story and you're past the pickup period in the last few years, what are you planning in that area and are you looking at it at what you might do to uplist your stock, get a little more exposure and greater participation?

**Paul Burgess:** Yes, the first thing we're doing and we started this at the end of last year. We kind of got interrupted because of this financing that we did. We started negotiating the financing probably in December, January timeframe and really moved forward with it in January, and at that time we kind of put the breaks on flowing any of the information out to the market, so now we actually have a backlog of press releases that we're going to start sending out.

But the first key for us is we have to get consistent communications out, so in other words we have to be putting news out into the market at least every couple of weeks, which we do have a strong backlog of information, and a lot of things I discussed on the call today will go out in subsequent press releases as well. So that's going to be the first step and the second step is obviously spending more time in front of the investor community. That's myself being in New York and talking to the investment community and now that we've closed the financing, we've started to do that as well. I've got a whole backlog of appointments here for the next couple of months that I'll be working on and then the third piece of that obviously is really ramping up the whole IR communications piece and we've started to do that as well.

**Kevin Ood:** Great, great. Okay, that's all I have. Everything sounds great. We'll look forward to hearing lots more from you soon.

**Paul Burgess:** All right, thanks.

**Operator:** And once again ladies and gentlemen, if you have a question, please press the star followed by the one on your touch-tone phone. To withdraw your question, press the star followed by the two and if you're using speaker equipment, please lift the handset before making your selection. One moment please for our next question.

Our next question comes from the line of Bill Lee, private investor. Please go ahead.

**Bill Lee:** Hey, Paul.

**Paul Burgess:** Hey, Bill. How are you doing?

**Bill Lee:** I'm doing good. How are you?

**Paul Burgess:** I'm doing well.

**Bill Lee:** Good. A couple of questions. Revenues are looking very good starting this year. With the company that you're acquiring, you said that they would give you approximately \$4 million in revenue this year and that's on the government side, correct?

**Paul Burgess:** Correct.

**Bill Lee:** Does this company give you any additional capabilities other than what you have right now?

**Paul Burgess:** Yes, actually, interesting enough, they really supplement our abilities in the federal government as far as enterprise architecture, but they also have a contract that they're working on with Siemens where they do a lot of higher end telecommunications installations around the world for them and they're just in the midst of renegotiating that contract which is good. But those skill sets can actually be used for our installations around the world as well. So they bring some skill sets that we are going to have to ramp anyway in the telecommunications side, so it's a really nice fit from that side of the business and a nice fit in the essence that, you know, these people are used to traveling and doing installations in remote areas which is what we require and at a very professional level working with a larger company like Siemens, so that's a really nice fit for us and to really help supplement our operations on the communications side as we build it up.

**Bill Lee:** Okay, and as far as in the communications area, you mentioned Canada, the UK, Israel, and these that you're looking to open up during the year as you go along?

**Paul Burgess:** Well, yes. For example, the UK is – we currently have an installation in the UK, and that was used as really a template of something that we could showcase, and that's what got us in with this other company that actually does jail management in the UK, and actually they have even more facilities around the world. Their model is a little different in that they really see telecommunications as a way to help incorporate prisoners back into society, so they want them communicating more with their families. And in this

instance, what they're doing with the technology is they want it very accessible to the inmate. They want it accessible from the inmate's cell which is something, you know, obviously we don't do here. Now what that does is it probably creates much more telecommunications usage, and they're going to be looking at some other unique systems as well.

The deal in Canada is also very interesting in that the products that will come out of that will completely displace what we know as the phone today. Two years from now they expect that they won't even have the phones in the prison, they'll have tablets. They want the prisoners to be able to communicate electronically, for people to be able to do video visitation from their homes. They want to be able to leave video clips for the prisoner. So it's a tool more used to help incorporate people back with their families. And in that model it also helps from the law enforcement perspective in that everything is VOIP-based. It goes over in an IP-based system and the data is much easier to analyze. When you're dealing with an analog phone you're listening to a recording. That's much more difficult to analyze. When you're putting things over IP it's completely digital and the analysis, the electronic analysis of it is a lot more accessible. So from that perspective you're going to see a lot more innovation coming out of these product lines and a lot of that innovation comes from these deals we have outside of the US.

**Bill Lee:** You also mentioned that you have, what is it nine salespeople right now in the communications area?

**Paul Burgess:** Yes, looking at the direct sales within the US market, there's nine people currently working on that.

**Bill Lee:** Okay, you have nobody internationally right now?

**Paul Burgess:** Yes, we do.

**Bill Lee:** You do?

**Paul Burgess:** Yes, well, the Canadian stuff is managed by myself and Terry Whiteside. The international stuff is also supplemented by an individual that we have in the US and we also have an individual in the UK.

**Bill Lee:** Okay. What's your backlog right now, roughly?

**Paul Burgess:** Well, our contract backlog is most of our contracts are coming into their final year, so the backlog is, you know, probably down more in the 30 million range, but as those contracts come up for re-compete and we win them then that backlog goes back up.

**Bill Lee:** And that's primarily the government you're talking about?

**Paul Burgess:** Yes. Yes. As far as that telecommunications, we've got – I think we have a backlog of installations that are currently at about 12 to 1,500 beds, and that's ramping as we speak, so.

**Bill Lee:** Okay. Projections for this year, you mentioned \$20 to 22 million in revenue?

**Paul Burgess:** Yes.

**Bill Lee:** Would you like to venture something for 2012?

**Paul Burgess:** Well, 2012 is a little bit different animal in that, you know, if you look at where we are in the communications business we have some key small regional partners that we have. So they use our telecommunications services, they use our technology, and they may be a great consolidation place for us. There's only a small handful of them because the customer then would be using a lot of technology, nothing would change for them.

In this model, you find a lot of disruption when companies acquire another company in this similar technology and customers don't like that. In our case, it's quite easy. Same people, same technology, nothing changes. So I anticipate in 2012 we may start some of that integration, and our numbers are going to be dependant on that, so we'd have to do a little further analysis. We have some internal projections, but I really want to stick to 2011 right now because that's what we know and are sort of focused on right now.

**Bill Lee:** Mm-hmm. Okay, and what you're projecting for this year percentage-wise is a big increase, so it sounds good.

**Paul Burgess:** Yes, you know, they're numbers, now we have to execute on them.

**Bill Lee:** That's right. Okay, that's really all I have for now.

**Paul Burgess:** All right, thanks Bill.

**Bill Lee:** Thanks, Paul.

**Operator:** And I show no further questions at this time. Please continue.

**Paul Burgess:** On behalf of Lattice, I just wanted to thank everyone for your interest and participation in this call. If you have any interest in visiting with us, please let me know and again thanks for joining us on the call. We look forward to speaking with you again in May.

**Operator:** Ladies and gentlemen, that concludes our conference for today. Thank you for your participation. You may now disconnect.