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OSIS: Rotten to the Core

<table>
<thead>
<tr>
<th>Report Date:</th>
<th>December 6, 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company:</td>
<td>OSI Systems, Inc.</td>
</tr>
<tr>
<td>Ticker:</td>
<td>OSIS (NASDAQ: OSIS)</td>
</tr>
<tr>
<td>Industry:</td>
<td>Electronic Equipment and Instruments, Security</td>
</tr>
<tr>
<td>Stock Price:</td>
<td>$84.07</td>
</tr>
<tr>
<td>Market Cap:</td>
<td>$1.6 billion</td>
</tr>
<tr>
<td>Float:</td>
<td>95%</td>
</tr>
<tr>
<td>Average Daily Volume (90-day):</td>
<td>$13.5 million</td>
</tr>
</tbody>
</table>

We are short OSI Systems, Inc. (OSIS.US) because we think it is rotten to the core. We believe it obtained a major turnkey contract in Albania through corruption. It is likely that OSIS’s accounts are misstated as a result. We believe the pricing of its Mexico turnkey contract does not stand up to scrutiny. We estimate that the contract is so rich, it accounted for more than 50% of OSIS’s FY2017 EBITDA, despite being only 15% of revenue. Put another way, we estimate the Mexico contract’s EBITDA margin is approximately 55%, which would mean the rest of OSIS has an EBITDA margin of a paltry 7.5%. This contract is up for renewal in 2018, and non-renewal would seemingly have an enormous impact on OSIS’s profits. It also implies that there is significant room for price adjustment downward, which could have a material impact on profits. Former employees’ statements support our view that OSIS is rotting from the inside.

Corruption in the 2013 award of OSIS’s Albania concession is more obvious than a three-liter bottle of shampoo in your carry-on luggage. The concession has an estimated top line lifetime value of $150 million to $250 million. However, OSIS either appears to value the total concession at $9.00 (yes, nine dollars), or they likely bribed somebody by giving half of it away for $4.50. There was an unannounced transfer of 49% of OSIS’s project company, S2 Albania SHPK, to a holding company owned by an Albanian doctor, for consideration of less than $5.00. To be clear, this company (S2 Albania SHPK) is the company to which all rights and obligations under the turnkey contract award belong, so 49% of the company is presumably worth many millions of dollars. It appears to us that OSIS’s accounts do not reflect the transfer – there are no deductions for non-controlling interests in the income statement, and February 2017 bond offering documents appear to show the subsidiary as 100% owned by OSIS.

There have been numerous news reports in Albania accusing OSIS of corruptly obtaining the concession, and a senior member of parliament has called the award corrupt on the record. Amazingly, U.S. investors appear to have no inkling of these allegations.

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Turnkey contracts seem particularly well-suited to corruption. If a government is only purchasing scanning equipment, it is relatively easy for an internal auditor to spot an overpayment because the equipment is somewhat commoditized. However, when bundling in various bespoke services, the pricing suddenly becomes much more opaque. Given this reality, it is perhaps not surprising that the turnkey contracts to date are in jurisdictions not known for their strong governance.

Beyond the turnkey contracts, investigators’ interviews with former employees yielded numerous anecdotes indicating OSIS is rotten to the core. Former employees alleged a list of rot they experienced at Rapiscan, including their concern about possibly going to prison, knowledge of improper sales, cash payments to government officials, fraud in a significant contract, and that OSIS had narrowly avoided being debarred from doing business with the U.S. government.

This corrupt behavior puts at significant risk OSIS’s Security Division contracts with U.S. and European government agencies. The only former employee who, in our view, made unreservedly positive comments about OSIS’s compliance admitted that OSIS could lose significant government business if it engaged in corruption. Although this senior executive was at OSIS when the transfer of 49% of S2 Albania occurred, he professed no knowledge of the transaction. Either way, his professed lack of knowledge is telling – he was kept out of the loop, which we would not have expected given his role; or, he was not responding truthfully to the question.

In addition, OSIS could face liability under the Foreign Corrupt Practices Act (“FCPA”), which could be in the many hundreds of millions of dollars. The U.S. Department of Justice has been aggressive in prosecuting FCPA violations in both Republican and Democratic administrations. (FCPA settlements generate meaningful revenue generators for the federal government.) In October 2015, we announced we were short Telia Company (TELIA SS) because we believed the corruption issues in its business were significantly larger than had been disclosed, and that it would likely settle at $1 billion or more. Just three months ago (September 2017), Telia agreed to settle with the DOJ and assisting regulators for $966 million. At these levels, there is room for a FCPA settlement that would equal a significant chunk of OSIS’s market cap.

We have published a website at www.RapiscanRevealed.com (with a Spanish site at www.InvestigacionRapiscan.com) to connect with whistleblowers, and publish additional information about OSIS. In addition, we have published a video report available on those sites.

Albania – “Theft of the Century” & Transfer of Almost Half of the Concession for $4.50!

Corruption in the award of OSIS’s Albania concession is an open secret. The documents evidencing a giveaway of many millions of dollars to a highly suspicious counterparty are available online – and free of charge. Media and at least one high profile Albanian politician have openly accused the former government and OSIS of engaging in corruption. It appears OSIS’s accounts are misstated because they likely do not reflect the transfer of almost half of its Albanian subsidiary, S2 Albania SHPK.
Substantially all of the documents evidencing these acts is available at the Albanian government portal: http://www.qkr.gov.al/home/

Albania awarded OSIS the concession for cargo scanning under a turnkey contract in August 2013. The Albanian government required OSIS to form an Albanian subsidiary to own all rights and obligations of the concession. OSIS formed S2 Albania SHPK on March 19, 2013. OSIS used its wholly-owned subsidiary Rapiscan Systems, Inc. to hold its shares in S2 Albania SHPK.

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Heche: Why Albania?
De Niro: Why not?
Heche: What have they done to us?
De Niro: What have they done FOR us? What do you know about them?
Heche: Nothing.
De Niro: See? They keep to themselves. Shifty. Untrustable.

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2 http://investors.osi-systems.com/releasedetail.cfm?releaseid=786552
3 S2 Albania SHPK Historical Register
4 100% ownership source: S&P CapitalIQ
5 S2 Albania SHPK Historical Register
6 Per the Historical Register, Rapiscan Systems, Inc. remains the shareholder for OSIS’s 51% entity in S2 Albania SHPK.
On September 19, 2013, OSIS completed the transfer of 49% of its ownership in S2 Albania:⁷

The purchase price for the 49% stake was at the par value of the shares, ALL 490 – or only approximately US$4.50 (four dollars and fifty cents). Below is the first page of the Purchase and Sale Agreement filed with the Commercial Registry:

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The share capital of S2 Albania SHPK is ALL 1,000, of which OSIS transferred ALL 490.
QUOTA PURCHASE AND SALE CONTRACT

THIS CONTRACT (the "Contract") dated 11.03.2013 is made among:
Rapiscan Systems Inc, with its registered seat at 2805 Columbia Street, Torrance, California 90503 (the “Seller”), represented through Power of Attorney by Endrit Shijaku; and

Inspection Control & Measuring Systems Sh.p.k., a company organized under the laws of Albania with registration number K81902014E with offices located at R. Kongresi Lushnjes, Tirane, Albania ("ICMS") represented by its administrator (the "Purchaser").

ARTICLE I - DEFINITIONS

Section 1.01. Definitions

Wherever used in this Contract, unless stated otherwise or the context otherwise requires, the following terms shall have the following meanings:

"Quota" means each of the quotas of the Company with a nominal value of ALL 1 each.

"Company" means S2 Albania shpk a company established under the laws of the Republic of Albania registered with the commercial register held by the National Registration Centre under NIPT: L31722010Q.

"Leks" or "ALL" means the lawful currency of the Republic of Albania.

"Purchase Price" means ALL 490 (four hundred ninety leke).

ARTICLE II - PURCHASE AND SALE OF THE QUOTAS

Section 2.01. Purchase Price

The Seller hereby sells to the Purchaser and the Purchaser hereby purchases from the Seller 490 Quota in the Company with a total nominal value of ALL 490 representing 49% of the entire registered capital of the Company in consideration for the Purchase Price ("Target Quotas").

For the avoidance of doubt, the Seller shall – upon registration of the above sale - continue to hold the 510 quotas in the Company with a nominal value of ALL 510 representing 51% of the Quotas of the Company.
The Agreement was signed on behalf of OSIS / Rapiscan Systems, Inc. by an Albanian attorney named Endrit Shijaku under a power of attorney. The POA was executed in Los Angeles on September 10, 2013, and was signed by OSIS director and then-president of Rapiscan Systems, Ajay Mehra.8 (We understand that Mr. Mehra is a family member of OSIS chairman and CEO Deepak Chopra.) The POA expressly states that the sale price is ALL 490 (approximately US$4.50):9

Below is Mr. Mehra’s signature on the POA:

The recipient of the 49% of S2 Albania SHPK was a company owned by a doctor named Olti Peçini. As shown in the Commercial Register, Mr. Peçini is the Administrator and owns 100% of the company with registration number K81902014E – which is the same registration number referenced on the first page of the Purchase and Sale Agreement shown above.

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8 Sources: FY2013 and FY2014 10-K  
9 The POA was obtained through an in-person visit to the Commercial Registry.
Albanian media reports that Mr. Peçini is a doctor (the below is a Google translation of just one of the headlines).


Mafia of scanning concession / How did the doctor Olti Pecini bought 49% of the shares of a concession worth 316 million USD for 490 lekë. Who is hiding behind the ICMS and the Salus hospital?!
We could find little about Dr. Peçini other than he founded a hospital in Tirana:

Troubled History of the Concession Award

Early in OSIS’s bid for the concession (late 2011), former Prime Minister Berisha added a bonus of eight percentage points to OSIS’s bid, which obviously advantaged OSIS vis-à-vis competitors (translation by Google).\(^{11}\)

OSIS was awarded the concession in August 2013. At the time Berisha was still prime minister, and his party (the Democratic Party), controlled government although his term was about to end. In June of that year, the opposition party (the Socialists) had won the largest share of seats in parliament. The Socialists and their partners selected a new prime minister, and the old government left office in September 2013. The approval of the transfer of 49% of S2 Albania’s

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\(^{11}\) Official Notebook of the Republic of Albania, December 1, 2011.
shares occurred on the day Berisha’s finance minister left office (and the new one took office), September 13, 2013.\textsuperscript{12}

The concession appears to have been more lucrative than OSIS had originally proposed to make it. OSIS reportedly initially proposed a scanning fee of US$32; however, when the concession was approved, the fee to be charged was €39 (or approximately US$50).\textsuperscript{13,14} There was significant backlash in the Albanian business community to the fees and the breadth of their imposition – the €39 was to be levied on all customs declarations – including on electricity, and goods transiting Albania.\textsuperscript{15} (In other words, the fee was levied regardless of whether the goods actually underwent scanning.) Some referred to this as a “Super Tax”.\textsuperscript{16}

Upon taking power, the Socialists refused to implement the concession agreement, and urged OSIS to renegotiate it. In 2014, OSIS filed for arbitration, calling for US$359 million in compensation.

In Albania, there was ultimately a media firestorm over the controversial concession, with various media referring to the concession as a “theft”, the collusion behind the concession award a “mafia”, and repeatedly calling the award “corrupt”.

\textbf{Suspicions for the scan monopoly, "Rapiscan" sold 49% of the shares for 490 Lek}

\textit{Posted on: 07 July 2015 18:29}

\begin{quote}
\texttt{Rapiscan-secure-1000 sp-1\_large} The overwhelming concession of scanning is wrapped up with other questions. The chairman of the Parliamentary Commission of Economy, Erion Brace, revealed that it included another company besides "Rapiscan".

"Rapiscan and ICMS company have entered into an agreement where 49 percent of the shares are transferred. On September 16, 2013, the day before he left office (referring to the departure of the government "Berisha"), said the chairman of the Economy Commission, Erion Brace.

\textit{10/4/2017} Mafia scanning concession / As a doctor Olti Pezzini bought 49% stake in a concession worth USD 316 million to 490 leks. Who is hiding b

\texttt{Mafia scanning concession / As a doctor Olti Pezzini bought 49% stake in a concession worth USD 316 million to 490 leks. Who is hiding behind the ICMS and the Salus hospital ?!}

\textit{July 1, 2015}
\end{quote}

\textsuperscript{12} The new finance minister’s appointment became official upon publication of his appointment in the official gazette, which occurred on September 13, 2013.


\textsuperscript{14} Assuming EUR/USD 1.32.


The below TV news program calls the S2 Albania concession the “Theft of the Century”:

Brace: Berisha laments, the energy price will not be over 10 ALL

25 NOV 2014

“This man (Sali Berisha) has decided at the end of his term with these five concessions that we have to pay for the next 15 years. They are money that does not go to the state budget but in the pockets of the concessionaires, Sali Berisha and the ministers who signed these contracts, he declared.

Brace insists on revising these concessions, specifically the contract of former Berisha government with the Rapiscan container company. The latter seeks indemnity at Vienna’s international arbitration for demolition of the concession contract by the Albanian government in the amount of $ 359 million.

Yet, when asked about the delay in implementing the contract in Albania, management never spoke of the 49% share transfer for approximately $4.50; nor of the additional eight points former PM Berisha awarded; nor of the company’s physician joint venture partner; nor of the excessive scanning fees and the breadth of their imposition; and, they never attempted any explanation for what was fueling the new government’s challenge to the concession agreement. Instead, in the midst of all of this movement and chaos in Albania, management’s discussion of the problem evoked stillness:

“Last year, we announced a 15-year contract that we received from the government of Albania to provide turnkey cargo and vehicle screening services at various sites throughout the country of Albania. Unfortunately, we recently learned that the customer, the Albanian newly elected government, has halted further progress on the contract and put into doubt the continuation of the program. The program had been proceeding smoothly and ahead of schedule. We intend to strongly enforce our contractual rights and hope to reach an amicable outcome... You can understand that, under the circumstances, we cannot comment further at this time.”

OSIS obviously could have commented further, but simply chose not to because these transactions are, in our view, unjustifiable. In 2015, the government and OSIS reached a settlement. Interestingly, the Democrats (as an opposition party) voiced opposition to the settlement, which appears to be less lucrative for OSIS (and its joint venture partner). Head of parliament’s economics commission Erion Brace gave a scathing critique of the award of the concession in parliament in 2015.

OSIS management still told the market nothing of the facts underlying this controversy – it was apparently back to business. In recent conversations between an investor and OSIS, when asked, the company refused to provide details on any joint ventures it has in Albania. OSIS’s failure at that time to disclose even the scantest fact that’s freely available on the Albanian corporate registry bolsters our opinion that these facts evidence corruption.

S2 Albania Transfer Off the Books?

OSIS’s accounts are likely misstated because they appear not to reflect the transfer of the stake in S2 Albania. S2 Albania has not filed its required CY 2016 financial statements, so we are unsure of its profit; however, we assume that it is large enough that the portion of profits belonging to ICMS / Dr. Peçini (or their backers) should be deducted on the income statement in a line item called “Noncontrolling Interests” (or “Minority Interests”), which would be in between Net Income and Net Income to Common Shareholders. Yet, there is no such line.

Offering documents for OSIS’s 1.25% convertible senior notes due 2022 support our suspicion that the transfer has been kept off OSIS’s books. In the Purchase Agreement with the

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17 “In the midst of movement and chaos, keep stillness inside of you” – the other Deepak Chopra
underwriters, OSIS warrants that except as disclosed in the General Disclosure Package and the Final Offering Memorandum, it owns all of the shares of each Subsidiary:

OSIS then includes S2 Albania SHPK in its list of Subsidiaries in Schedule D of the Agreement (see below). We have found no documents other than on the Albanian corporate registry that disclose the minority interest.

SCHEDULE D

Subsidiaries

American Science and Engineering, Inc. (Massachusetts)
Rapiscan Systems Mexico, S. de R.L. de C.V. (Mexico)
Rapiscan System Limited (UK)
OSI Optoelectronics, Inc. (California)
Spacelabs Healthcare LLC (Washington)
OSI Electronics Pte Ltd (Singapore)
S2 Albania (Albania)
S2 Services Puerto Rico, LLC (Puerto Rico)

The Albanians are Getting Paid Though

While it could be unclear to an OSIS shareholder whether you own all, or part, of S2 Albania, it seems pretty clear in Albania that someone else owns 49%. On December 7, 2013 – prior to ICMS even formally receiving its interest in S2 Albania – ICMS entered into a pledge agreement with National Commercial Bank for a €1.9 million loan. Under the agreement, Dr. Peçini pledged his shares of ICMS as collateral for the loan. However, we believe that ICMS’s only material asset is its ownership in S2 Albania. In ICMS’s corporate registry file reads that “ICMS approves the obligation imposed by the Bank for the obtainment of the prior approval of the Bank in case ICMS decided to transfer its shares in S2 Albania.” Rather than pledging the S2 Albania shares, which it did not yet formally own and which would need Ministry of Finance approval to pledge, ICMS agreed to encumber any transfer in exchange for the loan. It appears from ICMS’s financials that it has not received any dividends from S2 Albania through December 31, 2016; however, it was able to extract some initial value.

20 OSIS February 15, 2017 8-K, Exhibit 1.1, p. 5.
**Mexico – Inflated Pricing, Potentially at Risk Contract**

The original contract in Mexico appears to have been substantially overpriced and oversold in terms of capabilities. We base these conclusions on i) an analysis showing the seemingly outsized profitability of the contract, and ii) conversations our investigators spoke with a former senior SAT official who had extensive knowledge of the contract, the machines, and their capabilities. In the former official’s view, the contract price is greatly inflated, and was based on a false promise about the machines’ capabilities that he calls “a lie”.

If our understanding of the overpricing is correct, it could have profound implications for OSIS’s attempt to renew the contract – possibly leading to less favorable terms or non-renewal. Based on the assumptions and analysis that follows, we estimate that OSIS’s turnkey contract in Mexico generated approximately $65 million to $70 million of EBITDA in FY2017, which would have been more than 50% of total company EBITDA. Given our estimate of the materiality of this contract, a non-renewal or a sizable downward adjustment in pricing would seemingly have a significant impact on OSIS’s financials.

**Mexico Turnkey EBITDA Estimate**

We estimate that the Mexico S2 turnkey contract generates about $65 million to $70 million of EBITDA annually, which is an EBITDA margin of approximately 55% to 59% (compared to that of the rest of the business, which would seem to generate an EBITDA margin of only about 7.5%). The Mexico turnkey contract therefore likely generates over half of OSIS’s total company EBITDA. When an investor recently asked OSIS investor relations to comment on whether the estimate of EBITDA composition is reasonably accurate, the company refused to comment.

Below is the Mexico segment by year from FY2012-FY2017. We assume substantially all Mexico revenue is from the turnkey contract.

<table>
<thead>
<tr>
<th>Mexico Turnkey Contract Revenue by Year (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>16,866</td>
</tr>
</tbody>
</table>

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The key to our estimate methodology is looking at changes between FY2012 (when the Mexico contract was negligible) to FY2014 (when the contract appears to have fully ramped). As shown above, the company disclosed the Mexico segment revenue; but, we need to estimate its corresponding operating profit. As shown below, we see that the security division operating profit margin was approximately 8%, which is roughly consistent with what it had been in FY2010 and 2011. However, in FY2014, we see a jump in segment operating profit margin to 13.5%, which we assume is due to the Mexico turnkey contract.

<table>
<thead>
<tr>
<th>Security Division Revenue and OP by Year (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY2102</td>
</tr>
<tr>
<td>Revenue</td>
</tr>
<tr>
<td>Oper Profit</td>
</tr>
<tr>
<td>OP Margin</td>
</tr>
</tbody>
</table>

The final task is to solve for the margin associated with the incremental revenue from Mexico. First, we note that outside of the Mexico turnkey contract, Security Division revenue declined between FY2012 and FY2013. We use the decrease in comp revenue to estimate the incremental operating profit from Mexico in 2013.

\[
\begin{align*}
\text{Security Div FY2013 Revenue} & = 372,164 \\
- \text{FY2013 Mexico Revenue} & = 78,695 \\
= \text{FY2013 Comparable Revenue} & = 293,469 \\
\text{Security Div FY2012 Revenue} & = 391,808 \\
- \text{FY2012 Mexico Revenue} & = 16,866 \\
= \text{FY2012 Comparable Revenue} & = 374,942 \\
\Delta \text{FY2012-2013 Comp Revenue} & = (81,473)
\end{align*}
\]

We assume that the lost $81.5 million of comp revenue in FY2013 had an operating profit margin of 8.0%. Taking that, we estimate how much operating profit the Security Division lost with the decrease of comp revenue ($6.5 million). The increase in FY2013 Security Division operating profit should therefore be due to the incremental revenue under the Mexico turnkey contract. Once we calculate the incremental operating profit from the Mexico turnkey contract, we divide it by the incremental revenue from the contract. The result is an operating profit margin of 31.9%:

\[
\begin{align*}
\text{Security FY2013 Oper Profit} & = 43,748 \\
- \text{Security FY2012 Oper Profit} & = 30,552 \\
+ \text{OP from } \Delta \text{Security Rev @8.0% OPM} & = (6,518) \\
= \Delta \text{FY2013-2012 OP from Mexico} & = 19,714 \\
\Delta \text{FY2013-2012 Mexico Revenue} & = 61,829 \\
\text{OP Margin} & = 31.9%
\end{align*}
\]
The same methodology in FY2014 produces an operating profit margin of 27.9%:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security FY2014 Oper Profit</td>
<td>59,501</td>
</tr>
<tr>
<td>- Security FY2013 Oper Profit</td>
<td>43,748</td>
</tr>
<tr>
<td>- OP from Δ Security Rev @8.0% OPM</td>
<td>1,331</td>
</tr>
<tr>
<td>= Δ FY2014-2013 OP from Mexico</td>
<td>14,422</td>
</tr>
<tr>
<td>Δ FY2014-2013 Mexico Revenue</td>
<td>51,635</td>
</tr>
<tr>
<td>OP Margin</td>
<td>27.9%</td>
</tr>
</tbody>
</table>

Comparing the change between FY2012 and FY2014, we estimate a Mexico operating profit margin of 30.1%:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security FY2014 Oper Profit</td>
<td>59,501</td>
</tr>
<tr>
<td>- Security FY2012 Oper Profit</td>
<td>30,552</td>
</tr>
<tr>
<td>- OP from Δ Security Rev @8.0% OPM</td>
<td>(5,187)</td>
</tr>
<tr>
<td>= Δ FY2014-2012 OP from Mexico</td>
<td>34,316</td>
</tr>
<tr>
<td>Δ FY2014-2012 Mexico Revenue</td>
<td>113,464</td>
</tr>
<tr>
<td>OP Margin</td>
<td>30.1%</td>
</tr>
</tbody>
</table>

Applying a 30.0% operating profit margin to FY2017 Mexico revenue of $119.9 million yields an estimated operating profit of $36.0 million (excluding the impairment, which has no impact on the EBITDA calculation). We believe a depreciation and amortization estimate of $30.0 million to $35.0 million per year is reasonable for Mexico, which is based on:

- Security Division D&A increased by $32.8 million between FY2012 and FY2014, which is the year after Mexico fixed assets should reached their peak values.
- If we assume that YoY changes in Mexico long lived assets beginning in FY2015 are due to depreciation, we get respective annual depreciation expense in FY2015-FY2016 of $36.6 million and $38.9 million (including impairments).
- Mexico turnkey capex appears to total approximately $225 million. If we assume a 10% residual value and a six-year depreciation schedule (to match the contract life), annual depreciation would have averaged $33.8 million.

In this way, we estimate that FY2017 EBITDA from Mexico was approximately $66 million to $71 million. We use an EBITDA denominator of $128.4 million, as we do not add back restructuring and M&A charges (which seem to be a recurring expense for OSIS). Using these estimates and assumptions produces a range of contribution to FY2017 overall company EBITDA of 51.4% to 55.3%.

The outsize profitability of the Mexico turnkey contract supports our assessment that contract pricing is greatly inflated. It seems SAT could have saved a great deal of money by purchasing only the machines. While OSIS might trumpet the value of the “services” that come with the contract, there is good reason to doubt there is much value in those.
Our investigators spoke with a former senior SAT official who had in-depth knowledge of OSIS’s contract with SAT and the machines’ capabilities. Below are some of his relevant quotes:

“This last contract with Rapiscan was a big kind of fallacy…They were selling something that this equipment can’t do. They were supposed to substitute what a man should do on the field. That is identifying quantities, country of origin and many other things that these machines can’t do. That’s why they set a pretty high-priced service, which is unreal. This is one of the main reasons that I’m pretty sure this Rapiscan contract with the Mexican government will not be renewed in any way.”

“They are selling that they will tell the government if the goods that are passing through customs are legal or not, if they paid the correct duties or not, a lot of things that these machines can’t do.”

“[The Rapiscan scanners] are just an average machine like any other on the market. The only thing that they are selling is this big, fat contract and that they’re supposed to give a service that has nothing to do with these x-ray machines and they are actually not giving. This has nothing to do with the machine’s capabilities. These machines can do one thing: scan goods or scan vehicles. That’s all that they do and there are so many other brands on the market that do exactly the same. What they are selling is like a complete service with infrastructure that connects these machines to the systems of the Mexican government and gives you, in an automated way, the image and they have a previous filter that tells you if that scan complies with all of the legislation and all of the foreign trade rules that Mexico has. This supposed added value that they are selling is something that no one can do. There is no way that you could know if those goods are paying the correct taxes, if they are of the country of origin that they are saying on papers, but there’s no way that this x-ray machine could complete the job of the humans that actually works on custom houses. And this is what they sell, not just the x-ray machine service. They sell the x-ray machine service with all the other components that the Mexican government needs to verify everything about goods on custom houses. They say ‘You don’t need humans anymore. With my machines, you will not have to have people there. I will give you the answers and I will give you if everything is correct or if there is something incorrect,’ and that’s a lie. This is the red point on this contract.”

“They just scan. They give you an image, but you don’t know exactly the composition of the goods that are in there. You just can’t imagine if there is something that is out of the pattern and then physically, you need to open the container and look at what is there. Actually, it doesn’t even tell you if that thing that doesn’t match with the pattern of all the goods is an illegal good, if they are guns or if they are drugs. These machines don’t tell you that. They just give you an image, just like an x-ray shows you the bone but it doesn’t tell you anymore. You just see the image of the bone and you can see if there is a fracture or not. It doesn’t tell you more details. These guys are selling that. There is no technology in the world that could give you what they sell. This was the main reason for the cost increase because they are selling this unbelievable high. It’s a contract that
doesn’t have any reason for being that high.”

Former Employees Paint a Picture of Thorough Internal Rot

Our investigators spoke with former employees of the Rapiscan business. Several of their comments are enlightening about the extent of rot at the company.

- One former employee stated that s/he brought significant accounting problems in a contract in Iraq to the attention of senior management, but that his concerns were dismissed. The source said s/he “found two things that could put me in prison if I had not done anything about it.” The source also reported being told to withdraw cash from a company account to be put into brown envelopes for visiting foreign government officials to use as walking around money.

- One former employee refused to speak with our investigators stating only “I would rather not discuss this business as I felt I had to resign to avoid future risks to my professional credibility and future as a company director.”

- Another source described an important overseas Rapiscan distributor as “shady” and stated it was assumed within Rapiscan the distributor was tied to organized crime. This source indicated s/he also had concerns at times while at Rapiscan about whether s/he was being forced to break the law.

- One former employee stated that Rapiscan shipped machines out regardless of whether they were finished or not in order to meet monthly sales quotas. The source refereed to these machines as “half-built”.

- Two sources said Rapiscan had almost been debarred from doing business from the U.S. government. One of those sources stated that had actually been the case twice.

One former senior employee spoke in glowing terms about OSIS’s culture of compliance:

“Let me put it this way. The entire time I was there, one of my roles at OSI was [redacted]. And OSI was doctrinaire, exceedingly exacting, for all of its subsidiaries including Rapiscan and S2 and everyone else about compliance with the anti-bribery act in the U.K., the EU bribery rules, and of course the Foreign Corrupt Practices Act in the United States being that it’s a U.S. corporation with subsidiaries around the world. It has never had any instance, question, violation – primarily because not only is it morally wrong, but from a corporate governance standpoint, any violation of those, even minimal violation of those acts are criminal for the executives, so executives can go to jail. But you also potentially ruin your U.S. government business and European government business, and a huge portion of the revenues of Rapiscan and OSI are with government business.”

However, when he was asked to comment on the transfer of 49% of S2 Albania for $4, which occurred while he was there, he replied “I don’t know anything about that.” Given his senior roles at OSIS, we are surprised that he does not know about the Albanian joint venture partner – either way, the transfer was kept tellingly close to the vest, or the source lied about his knowledge of the transfer.
Conclusion

It is ironic that a company integral to enforcing the most ticky-tack of rules at security checkpoints seems to pay so little heed to the rules (ahem...laws) governing its conduct of business. We believe the Albania contract resulted from a massive bribe of half the concession value. We believe OSIS’s accounts are misstated as a result of this apparent bribe. Mexico looks to be egregiously priced, which certainly raises questions. Former employees painted a reasonably consistent picture of a company operating with disregard for the law. We are therefore short because this way of doing business just doesn’t seem sustainable.