

GSE SYSTEMS INC
Form S-3/A
August 31, 2006

As filed with the Securities and Exchange Commission on August 31, 2006 Registration No. 333-134569

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Amendment No. 2

to

FORM S-3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

GSE SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

52-1868008

(I.R.S. Employer Identification Number)

7133 Rutherford Road, Suite 200

Baltimore, MD 21244

(410) 277-3740

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

John V. Moran

Chief Executive Officer

GSE Systems, Inc.

7133 Rutherford Road, Suite 200

Baltimore, MD 21244

Tel: (410) 277-3740

Fax: (410) 277-5287

(Name and address, including zip code, and telephone number, including area code, of agent for service)

Copy to:

James R. Hagerty, Esq.

888 17th Street, N.W., Suite 1000

Washington, DC 20006

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Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. ()

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. (x)

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ()

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ()

If this form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the commission pursuant Rule 462(e) under the Securities Act, check the following box: ()

If this form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box: ()

CALCULATION OF REGISTRATION FEE

Title of each class of securities to be registered	Amount to be Registered	Proposed maximum offering price per share	Proposed maximum aggregate offering price (5)	Amount of registration fee
Common stock, par value \$0.01 per share, issuable upon conversion of the Company's Series A 8% cumulative convertible preferred stock	2,401,133 (1)	\$3.68	\$8,836,169	\$945
Common stock, par value \$0.01 per share, issuable upon exercise of warrants	480,226 (1)	\$3.68	\$1,767,232	\$189
Common stock, par value \$0.01 per share, issuable upon exercise of warrants	150,000 (2)	\$3.68	\$552,000	\$59
Common stock, par value \$0.01 per share, issuable upon exercise of warrants	900,000 (3)	\$3.68	\$3,312,000	\$354
Common stock, par value \$0.01 per share, issuable upon exercise of warrants	367,647 (4)	\$3.68	\$1,352,941	\$145
				\$1,692.00

(1) Represents shares of our Common Stock issuable upon conversion of the Series A 8% Cumulative Convertible Preferred Stock or upon exercise of Warrants issued in connection with our private placement offering, which closed as of February 28, 2006. The securities being registered hereby do not consist of such indeterminate number of additional shares of common stock as may become issuable upon conversion of such convertible preferred stock or exercise of such warrants to prevent dilution resulting from stock splits, stock dividends or similar transactions, nor do they include such number of additional common stock that may be issued from time to time as a result of anti-dilution adjustments or missed dividend payments pursuant to the terms of the Convertible Preferred Stock and Warrants. The Company shall register such additional shares of Common Stock as necessary.

(2) Represents shares of our Common Stock issuable upon exercise of a warrant issued to Northeast Securities, Inc. as a placement agent fee in connection with the private placement offering, which closed as of February 28, 2006.

(3) Represents shares of our Common Stock issuable upon exercise of a warrant issued to Dolphin Direct Equity Partners, LP in connection with that certain Cancellation and Warrant Exchange Agreement, dated as of February 28, 2006.

(4) Represents shares of our Common Stock issuable upon exercise of a warrant issued to Laurus Master Fund, Ltd. in connection with the Company's new two-year revolving line of credit.

(5) Estimated solely for purposes of calculating the registration fee pursuant to Rule 457(c) of Regulation C under the Securities Act, on the basis of \$3.68 per share, the average of the high and low prices for the Common Stock on May

22, 2006 as reported on the American Stock Exchange..

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933, AS AMENDED, OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE SECURITIES AND EXCHANGE COMMISSION ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.

The information in this Prospectus is not complete and may be changed. The selling shareholders may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED AUGUST 31, 2006

PROSPECTUS

GSE SYSTEMS, INC.

**Shares of Common Stock Issuable upon Conversion of Units Consisting of up to \$4,250,000 of
8% Cumulative Convertible Preferred Stock and Warrants
and
Shares of Common Stock Issuable upon Exercise of Warrants**

This prospectus relates to the disposition by the selling stockholders of up to 4,299,006 shares of our Common Stock issuable upon the conversion of Preferred Stock and the exercise of warrants issued for the account of the stockholders named in this prospectus.

Investing in our securities involves a significant degree of risk. You should carefully read this prospectus and consider the matters described in "Risk Factors" before you decide to invest in these securities.

Our common stock is listed on the American Stock Exchange under the symbol "GVP." For a more detailed description of our securities, see "Description of Our Share Capital" section of this prospectus. On February 28, 2006, the closing sale price of the common stock on the American Stock Exchange was \$1.61. These securities have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this Prospectus. Any representation to the contrary is a criminal offense.

This Prospectus does not constitute an offer to sell or the solicitation of an offer to buy any securities. Changes may occur after the date of this Prospectus and GSE Systems will not update the information contained herein except in the normal course of their respective public disclosures.

The selling stockholders may sell the shares of common stock described in this prospectus in a number of different ways and at varying prices. We provide more information about how the selling stockholders may sell their shares of common stock in the section entitled "Plan of Distribution". We will not be paying any underwriting discounts or commissions in this offering.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense.

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The date of this prospectus is August , 2006.

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PROSPECTUS SUMMARY

This section contains a general summary of the information contained in this prospectus and highlights selected information described in greater detail elsewhere or incorporated by reference in this prospectus. You should carefully read this entire prospectus, including the risk factors beginning on page 6, and the documents incorporated by reference in this prospectus to fully understand it and our business, results of operations and financial condition. The information in this prospectus is not complete and may be changed. The selling stockholders named in this prospectus may not sell these securities until the registration statement filed with the Securities and Exchange Commission becomes effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted. Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy and accuracy of this prospectus. Any representation to the contrary is a criminal offense.

This prospectus relates to the sale by the selling stockholders of up to 4,299,006 shares of our Common Stock issuable upon the conversion of Preferred Stock and the exercise of warrants issued in three separate transactions (summarized below) for the account of the stockholders named in this prospectus. The selling stockholders may sell the Common Stock from time to time in the principal market on which the stock is traded at the prevailing market price or in negotiated transactions. We will pay the expense of registering these shares.

The three transactions are summarized here and are more fully explained in separate sections below:

1. On February 28, 2006, we sold units consisting of up to \$4,250,000 of Series A 8% Cumulative Convertible Preferred Stock (the "Preferred Stock") and Warrants (the "Warrants") in a private offering exempt from registration under the Securities Act of 1933. Northeast Securities, Inc. ("Northeast Securities") acted as placement agent for this offering. We entered into a registration rights agreement with the individual investors and with the placement agent in the offering in which we agreed, for the benefit of the holders of the Preferred Stock and Warrants, to file a registration statement with the U.S. Securities and Exchange Commission (the "SEC"), with respect to the resale of the Common Stock issuable upon conversion of the Preferred Stock and upon exercise of the Warrants. The exercise price for the Preferred Stock and Warrants is \$1.77 per share. See the section captioned "Description of the February 27, 2006 Offering."
2. On February 28, 2006, we entered into a Cancellation and Warrant Exchange Agreement with Dolphin Direct Equity Partners, LP (the "Cancellation Agreement"). Pursuant to that Cancellation Agreement, we issued Dolphin a warrant to purchase 900,000 shares of our Common Stock at an exercise price equal to \$0.67 per share. See the section captioned "Description of the Cancellation and Warrant Exchange Agreement."
3. On March 7, 2006, we entered into a new two-year revolving credit facility with Laurus Master Fund, Ltd. ("LMF"), a limited liability company organized under the laws of the Cayman Islands, in an amount up to \$5.0 million (the "New Facility"). The exact amount of the New Facility that the Company is permitted to draw will be based on the Company's accounts receivable at an advance rate equal to 90% of eligible billed receivables and 40% of unbilled receivables (subject to a cap of \$1.0 million on unbilled receivables) at the time of such draw. In consideration of the New Facility, we issued LMF a warrant to purchase 367,647 shares of our Common Stock at an exercise price of \$0.01 per share. See the section captioned "Description of the New Two-Year Revolving Credit Facility."

The Company

General

GSE Systems, Inc. (the “Company,” “GSE” or “GSE Systems” or “we” or “us”) is organized under the laws of the State of Delaware and is a leader in real-time, high fidelity simulation. The Company provides simulation solutions and services to the nuclear and fossil electric utility industry, the chemical and petrochemical industries and to the U.S. Military Complex. In addition, the Company provides plant monitoring and signal analysis monitoring and optimization software primarily to the power industry. GSE Systems, Inc.’s executive offices are located at 7133 Rutherford Road, Suite 200, Baltimore, Maryland 21244. The Company’s telephone number is (410) 277-3740 and its facsimile number is (410) 277-5287. GSE maintains a Web site at <http://www.gses.com>. Nothing contained in such Web site should be deemed a part of this prospectus.

Recent Developments

For the six months ended June 30, 2006, the Company has incurred operating income of \$651,000, but has incurred a net loss of \$1.2 million. The Company’s backlog has increased from \$12.3 million at December 31, 2005 to \$28.5 million at June 30, 2006.

In the fourth quarter 2005, the Company announced the formation of the Emirates Simulation Academy, LLC (ESA), a United Arab Emirates company, to build and operate simulation training academies in the Arab Gulf Region. GSE is a 10% owner of ESA. These simulation training centers will be designed to train and certify indigenous workers for deployment to a nation’s critical infrastructure facilities including power plants, oil refineries, petrochemical plants, desalination units and other industrial facilities. In January 2006, the Company announced the award of a contract valued at over \$15 million from ESA to supply five simulators and an integrated training program. ESA accounted for 12.6% of the Company’s consolidated revenue for the six months ended June 30, 2006. Under the terms of the contract, the Company provided a \$2.1 million performance bond to ESA that will remain outstanding until the end of the warranty period on October 31, 2008.

In order to ensure that the Company would have sufficient working capital in 2006, the Company completed several financing transactions in early 2006 which are fully described below in the sections entitled “Description of the February 27, 2006 Offering”, “Description of the Cancellation and Warrant Exchange Agreement” and “Description of the New Two-Year Revolving Credit Facility”. In conjunction with the cancellation of the Company’s 2.0 million Senior Subordinated Secured Convertible Promissory Note and warrant payable to Dolphin Direct Equity Partners, LP described below, the Company incurred a \$1.4 million loss on extinguishment of debt. This loss was comprised of a \$1.1 million charge from the write off of the remaining unamortized Original Issue Discount, a \$185,000 charge from the write off of the remaining unamortized deferred financing charges, and a \$868,000 charge for the value of the new warrants issued to Dolphin which charges were partially offset by a \$698,000 credit from the write off of the remaining liabilities related to the Dolphin Note conversion feature and the related warrants. After the completion of these financing transactions, the Company believes that it has sufficient liquidity and working capital for its operations in 2006.

In October 2005, the Company signed an “Assignment of Lease and Amendment to Lease” that assigns and transfers to another tenant (the “assignee”) the Company’s rights, title and interest in its Columbia, Maryland facility lease. The assignee’s obligation to pay rent under the lease began on February 1, 2006. The Company remains fully liable for the payment of all rent and for the performance of all obligations under the lease through the scheduled expiration of the lease, May 31, 2008, should the assignee default on its obligations. In October 2005, the Company relocated its Maryland operations from its facility in Columbia to the Baltimore facility.

Description of the February 27, 2006 Offering

The Company offered Units consisting of up to \$4.25 million of shares of Preferred Stock and Warrants. The minimum investment was \$50,000 and the price per share of Preferred Stock was \$100 (or 500 shares per the minimum investment). The Preferred Stock is convertible at any time into a total of 2,401,133 shares of GSE Common Stock at a conversion price of \$1.77 per share. The conversion price was equal to 110% of the closing price of the Company's Common Stock on February 28, 2006, the date the sale of the Convertible Preferred Stock was completed. In addition to Preferred Stock, each investor received a five-year Warrant to purchase GSE Common Stock equal to 20% of the shares they would receive from the conversion of the Convertible Preferred Stock, at an exercise price of \$1.77. In aggregate, the Company issued Warrants to purchase a total of 480,226 shares of GSE Common Stock.

The Preferred Stock holders are entitled to an 8% cumulative dividend, payable on a semiannual basis every June 30 and December 30. If the Company does not make two consecutive dividend payments on the dates such payments are due, there will be an additional 30% warrant coverage of five-year warrants at a conversion price of \$1.77 per share. At any time after March 1, 2007, the Company has the right to convert the Preferred Stock into shares of GSE common stock when the average of the current stock price during the twenty trading days immediately prior to the date of such conversion exceeds 200% of the Series A Conversion Price. The holders of the Preferred Stock are entitled to vote on all matters submitted to the stockholders for a vote, together with the holders of the voting common stock, all voting together as a single class. The holders of the Convertible Preferred Stock are entitled to the number of votes equal to the number of GSE Common Stock that they would receive upon conversion of their Preferred Stock.

The Company paid the placement agent 6% of the gross proceeds received by the Company from the offering (\$255,000) plus five-year warrants to purchase 150,000 shares of the Company's Common Stock at an exercise price of \$1.77 per share (the "NESC Warrant"). On March 5, 2006, counsel for the placement agent notified the Company that the placement agent had assigned a portion of the NESC Warrant to certain of the selling stockholders identified in the "Selling Security Holders" section of this Prospectus (See also Footnote 18).

This offering was made on an "any and all" basis. That is, funds tendered for payment of the subscription purchase price were not maintained in an escrow or other account until a minimum number of units had been sold. Rather, as acceptable subscriptions were received by the Company, they were accepted in whatever order the Company determined. Upon acceptance of each subscription, the accompanying payment became the property of the Company and may have been applied by the Company to any of its business purposes and uses. Subscriptions were submitted and received on an irrevocable basis.

This offering was made only to "accredited investors," as that term is used in rules and regulations of the SEC.

The proceeds of the private placement offering were used to pay off the Dolphin Note and the Company's line of credit balance and for other working capital purposes.

Description of the Cancellation and Warrant Exchange Agreement

On February 28, 2006, the Company and Dolphin Direct Equity Partners, LP, a Delaware limited partnership ("Dolphin"), entered into a Cancellation and Warrant Exchange Agreement (the "Cancellation Agreement"). Pursuant to the terms of the Cancellation Agreement, Dolphin agreed to cancel its senior subordinated secured convertible promissory note issued by the Company to Dolphin on May 26, 2005 in the aggregate principal amount of \$2,000,000 (the "Note"), all as further provided for in the Senior Subordinated Secured Convertible Note and Warrant Purchase Agreement dated as of May 26, 2005 (the "Purchase Agreement") wherein the Company agreed to issue to Dolphin a warrant to purchase an aggregate of 380,952 shares of common stock, par value \$0.01 per share (the "Exchange Warrant") in addition to the Note.

In exchange for Dolphin's agreement to enter into the Cancellation Agreement and for the participation of Dolphin Offshore Partners, L.P. in the private placement offering, the Company paid off the Note and exchanged the warrant issued pursuant to the Purchase Agreement for the Exchange Warrant. Upon exercise of the Exchange Warrant, Dolphin will acquire 900,000 shares of the Company's common stock at a price per share (the "Exercise Price") equal to \$0.67 cents. Dolphin must exercise the Exchange Warrant promptly after the Company certifies to Dolphin on or after May 30, 2006 (the "Mandatory Exercise Date") that (i) the Company has filed a registration statement with respect to the resale of the Common Stock issuable upon exercise of the Exchange Warrant and such registration statement shall have been declared effective by the Commission, (ii) the Common Stock has been listed on the American Stock Exchange and the Company has not received any communication from such exchange regarding the Company's failure to meet listing qualifications or the institution of any delisting proceeding at any time up to and including the Mandatory Exercise Date, (iii) the Current Stock Price shall not be less than \$1.25 on the Mandatory Exercise Date

and (iv) the average of the Current Stock Prices for each trading day of the 30 calendar day period up to and including the Mandatory Exercise Date shall not be less than \$1.25. The Company also agreed to use its best efforts to file a registration statement with respect to the resale of the Common Stock issuable upon exercise of the Exchange Warrant with the Commission within 30 days after the original issuance of the Preferred Stock and Warrants as set forth in the Registration Rights Agreement.

The Company also agreed to pay to Dolphin Advisors, L.L.C. a transaction fee in the amount of \$3,000 in respect of services it rendered to Dolphin related to the Cancellation Agreement transaction. Furthermore, Dolphin Offshore Partners, L.P., an affiliate of Dolphin, agreed to invest in the Company's private placement offering.

Description of the New Two-Year Revolving Credit Facility

On March 7, 2006, GSE entered into the New Facility with LMF in an amount up to \$5.0 million (all as further described in the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein). The exact amount of the New Facility that the Company is permitted to draw will be based on the Company's accounts receivable at an advance rate equal to 90% of eligible billed receivables and 40% of unbilled receivables (subject to a cap of \$1.0 million on unbilled receivables) at the time of such draw. The interest rate on the New Facility is the Prime Rate (as reported in the *Wall Street Journal*) plus 2.0%, provided that the minimum interest rate is 8.0%.

The New Facility is secured by a first lien on certain assets and receivables of the Company as set out more fully in that certain Security Agreement dated as of March 7, 2006 (attached as an Exhibit to the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein), including but not limited to: (i) a security interest in the patents and trademarks of the Company and GSE Power Systems, Inc. ("GSE Power"), a Delaware corporation and wholly owned subsidiary of GSE Systems, Inc.; (ii) a security interest in favor of LMF in all of the right, title and interest of the Company in and to any and all equity interests (including, without limitation, limited liability company interests and membership interests) from time to time issued by GSE Services, LLC ("GSE Services"), a Delaware limited liability company owned and controlled by the Company; and (iii) a security interest in certain defined collateral of (a) MSHI, Inc. ("MSHI"), a Virginia corporation and wholly owned subsidiary of the Company, (b) GSE Power, (c) GSE Erudite Software, Inc. ("GSE Erudite"), a Delaware corporation and wholly owned subsidiary of the Company, (d) GSE Process Solutions, Inc. ("GSE Process"), a Delaware corporation and wholly owned subsidiary of the Company, and (e) GSE Government & Military Simulation Systems, Inc. ("GSE Military" and together with MSHI, GSE Power, GSE Erudite, GSE Process, GSE Military and GSE Services, the "Subsidiaries"), a Delaware corporation and wholly owned subsidiary of the Company.

In connection with entering into the New Facility, the Company also issued to LMF a Warrant to purchase up to 367,647 shares of the Company's Common Stock, at a price per share equal to \$0.01 (the "LMF Warrant"). The Company paid LMF \$15,000 in due diligence fees and \$30,000 in structuring fees associated with the New Facility. On July 31, 2006, LMF exercised its warrant in a cashless exercise transaction and received 366,666 shares of the Company's restricted Common Stock.

The Company agreed that it would use its best efforts to prepare and file a registration statement with the Securities and Exchange Commission (the "Commission") and the American Stock Exchange within 60 days of LMF funding the New Facility and use reasonable best efforts to have such Registration Statement declared effective within 120 days thereafter.

The key agreements underlying the New Facility are more fully described below and were attached as exhibits to the Form 8-K filed with the SEC on March 13, 2006:

Subsidiary Guaranty: In consideration of the Company and LMF entering into the New Facility, the Subsidiaries unconditionally guaranteed all present and future obligations and liabilities of any and all kinds of each Company to LMF. The Guaranty is a guaranty of payment and not of collection. LMF has no obligation to take any action against any company, person or entity liable with respect to any of the obligations or resort to any collateral security held by it to secure any of the obligations as a condition precedent to the Subsidiaries being obligated to perform. Each Subsidiary waived any and all statutory or common law rights which would require LMF to seek redress first from any liable person or entity before seeking redress from the Subsidiary. LMF is also under no obligation to marshal any assets in favor of Subsidiaries, or against or in payment of any or all of the obligations. Each of the Subsidiaries also waived all suretyship defenses and any rights to interpose any defense, counterclaim or offset of any nature and

description which any company may assert on the underlying debt. A complete copy of the Subsidiary Guaranty is contained in the Form 8-K filed with the Commission on March 13, 2006 and is incorporated by reference herein.

Security Agreements and Interests: Capitalized terms used herein have the same meaning as indicated in the Security Agreement, a complete copy of which is attached hereto as an Exhibit to the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein.

Pursuant to a Security Agreement by and among the Company, GSE Power and LMF dated as of March 7, 2006, the Company and GSE Power are jointly and severally liable for payment of interest at the Contract Rate (all as further defined in the Security Agreement filed as an Exhibit to the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein) on the unpaid principal balance of each Loan made by LMF under the Security Agreement with interest and payments being computed on the basis of actual days elapsed in a year of 360 days, with interest chargeable to the Company or GSE Power's accounts at LMF's option. Upon the occurrence or continuation of any Event of Default, the Contract Rate shall automatically be increased and all outstanding Obligations, including unpaid interest, shall continue to accrue interest from the date of such Event of Default at the Default Rate applicable to such Obligations. In the event any Company fails to deliver to LMF financial information required by the Security Agreement as specified therein, all Companies shall jointly and severally pay LMF an aggregate fee in the amount of \$250.00 per week (or portion thereof) for each such failure until such failure is cured or waived in writing by Laurus.

In addition, upon execution of the Security Agreement, the Company agreed to pay Laurus Capital Management, LLC ("LCM") a closing payment in an amount equal to three and three-fifths (3.60%) of the Capital Availability Amount which would be deemed fully earned on the Closing Date and not be subject to rebate or pro-ration. In the event the Loans exceed the Formula Amount (each such event, an "Overadvance"), all such Overadvances shall bear additional interest at a rate equal to one and one half percent (1.5%) per month of the amount of such Overadvances. All amounts Overadvances incurred are due and payable by the Companies monthly, in arrears, on the first business day of each calendar month and upon expiration of the Term. All amounts that are incurred are due and payable by the Company monthly, in arrears, on the first business of each calendar month and upon expiration of the Term. Furthermore, the Company paid LMF \$15,000 in due diligence fees and \$30,000 in structuring fees associated with the New Facility.

Pursuant to the terms of that certain Grant of Security Interest in Patents and Trademarks by and among GSE Systems, GSE Power and LMF dated March 7, 2006 (attached hereto as an Exhibit to the Form 8-K filed with the Commission on March 13, 2006 and incorporated by reference herein), LMF was granted a security interest that extends to all right, title and interest in and to the Trademarks and Patents, and all proceeds thereof, together with the business as well as the goodwill of the business symbolized by, or related or pertaining to, the Trademarks, and the customer lists and records related to the Trademarks and Patents and all causes of action which may exist by reason of infringement of any of the Trademarks and Patents (collectively, the "T&P Collateral").

Stock Pledge Agreement: Pursuant to a Stock Pledge Agreement by and among GSE Services, MSHI, GSE Power and GSE Process and LMF dated as of March 7, 2006, each of which pledged and granted a security interest to LMF in certain collateral (the "Collateral") to include certain shares of stock together with (i) any additional shares of stock or other equity interests acquired by any Pledgor, the "Pledged Stock"; (ii) the certificates representing the Pledged Stock and all dividends, cash, instruments and other property or proceeds from time to time received, receivable or otherwise distributed in respect of or in exchange for any or all of the Pledged Stock; (iii) all additional shares of stock of any issuer (each, an "Issuer") of the Pledged Stock acquired by any Pledgor in any manner, including stock dividends or a distribution (in connection with any increase or reduction of capital, reclassification, merger, consolidation, sale of assets, combination of shares, stock split, spin-off or split-off); (iv) the certificates representing such additional shares, and (v) all dividends, cash, instruments and other property or proceeds received, receivable or otherwise distributed in respect of or in exchange for any or all of such shares; (vi) and all options and rights to any shares of any Pledged Stock and all dividends, cash, instruments and other property or proceeds received, receivable or otherwise distributed in respect of or in exchange for any or all such options and rights.

Registration Rights

In connection with each of the above described transactions, the Company agreed that it would use its best efforts to prepare and file a registration statement with the Securities and Exchange Commission (the "Commission") and the American Stock Exchange within 60 days of the completion of the foregoing transactions to cover resales of the Common Stock underlying the securities.

Other Information

Our common stock trades on the American Stock Exchange under the symbol "GVP."

Our principal executive offices are located at 7133 Rutherford Road, Suite 200, Baltimore, Maryland 21244. Our telephone number is (410) 277-3740.

Our website address is www.gses.com. Except for any documents that are incorporated by reference into this prospectus that may be accessed from our website, the information available on or through our website is not part of this prospectus.

RISK FACTORS

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below may not be the only ones we will face. Additional risks and uncertainties not presently known to us or that we currently deem not material may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In such case, the trading price of our common stock could decline, and you may lose all or part of your investment.

The Company has limited cash resources. If the Company is unable to generate adequate cash flow from operations, it will need additional capital to fund its operations.

In 2005, the Company incurred a net loss of \$4.8 million. The Company's revenue and profitability were impacted by the low volume of orders logged in 2004 and 2005 and the Company's backlog decreased from \$19.6 million at December 31, 2004 to \$12.3 million at December 31, 2005. In addition, the Company continued to spend heavily on business development activities in order to expand the Company's simulation business into new sectors, such as integrating its simulation capabilities with broader training and educational programs. Accordingly, the Company's cash position weakened during the year, with total cash used in operating activities of \$1.9 million. Although the Company took actions that will reduce its operating expenses in 2006, including the termination of a number of employees and by restructuring two facility leases, our ability to meet our debt obligations and to reduce our debt level depends on our future performance which is affected by general economic conditions and financial, business and other factors, and there can be no assurance the Company will continue to be able to reduce its operating expenses.

Although the Company believes that, as a result of the transactions described in this prospectus, it has sufficient liquidity and working capital for its operations in 2006, the Company may be required to look for additional capital to fund its operations if the Company is unable to operate profitably and generate sufficient cash from operations. There can be no assurance that the Company would be successful in raising such additional funds.

The Company's expense levels are based upon its expectations as to future revenues, so it may be unable to adjust spending to compensate for a revenue shortfall. Accordingly, any revenue shortfall would likely have a disproportionate effect on the Company's operating results.

The Company's revenue was \$22.0 million, \$29.5 million and \$25.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. The Company's operating income (loss) was (\$4.7 million), \$2,000 and (\$1.0 million) in 2005, 2004 and 2003, respectively. The Company's operating results have fluctuated in the past and may fluctuate significantly in the future as a result of a variety of factors, including purchasing patterns, timing of new products and enhancements by the Company and its competitors, and fluctuating foreign economic conditions. Since the Company's expense levels are based in part on its expectations as to future revenues and includes certain fixed costs, the Company may be unable to adjust spending in a timely manner to compensate for any revenue shortfall and such revenue shortfalls would likely have a disproportionate adverse effect on operating results. The Company believes that these factors may cause the market price for its common stock to fluctuate, perhaps significantly. In addition, in recent years the stock market in general, and the shares of technology companies in particular, have experienced extreme price fluctuations. The Company's common stock has also experienced a relatively low trading volume, making it further susceptible to extreme price fluctuations.

Risk of International Sales and Operations

Sales of products and the provision of services to end users outside the United States accounted for approximately 65% of the Company's consolidated revenue in 2004 and 63% of the Company's consolidated revenue in 2005. As a result, the Company may be subject to certain risks, including risks associated with the application and imposition of protective legislation and regulations relating to import or export (including export of high technology products) or otherwise resulting from trade or foreign policy and risks associated with exchange rate fluctuations. Additional risks include potentially adverse tax consequences, tariffs, quotas and other barriers, potential difficulties involving the Company's strategic alliances and managing foreign sales agents or representatives and potential difficulties in accounts receivable collection. The Company currently sells products and provides services to customers in emerging market economies such as Russia, Ukraine, Bulgaria, and the Czech Republic. Although end users in the Ukraine accounted for 18%, 21%, and 29% of the Company's consolidated revenue in 2005, 2004, and 2003, respectively, GSE's customer for these projects was Battelle's Pacific Northwest National Laboratory, which is the purchasing agent for the U.S. Department of Energy ("DOE"). The DOE provides funding for various projects in Eastern and Central Europe. Accordingly, the Company is not subject to the political and financial risks that are normally faced when doing business in the Ukraine. The Company has taken steps designed to reduce the additional risks associated with doing business in these countries, but the Company believes that such risks may still exist and include, among others, general political and economic instability, lack of currency convertibility, as well as uncertainty with respect to the efficacy of applicable legal systems. There can be no assurance that these and other factors will not have a material adverse effect on the Company's business, financial condition or results of operations.

The Company relies on one customer for a substantial portion of its revenue. The loss of this customer could have a material adverse effect upon the Company's revenues and results of operations.

For the years ended December 31, 2005, 2004, and 2003, one customer (Battelle's Pacific Northwest National Laboratory) accounted for approximately 25%, 24%, and 29%, respectively, of the Company's consolidated revenue. The Pacific Northwest National Laboratory is the purchasing agent for the DOE and the numerous projects the Company performs in Eastern and Central Europe. If the Company lost this customer, the Company's revenue and results of operations would be materially and adversely affected.

The Company's business is substantially dependent on sales to the nuclear power industry. Any disruption in this industry would have a material adverse effect upon the Company's revenue.

In 2005, 83% of GSE's revenue was from customers in the nuclear power industry. The Company will continue to derive a significant portion of its revenue from customers in the nuclear power industry for the foreseeable future. The Company's ability to supply nuclear power plant simulators and related products and services is dependent on the continued operation of nuclear power plants and, to a lesser extent, on the construction of new nuclear power plants. A wide range of factors affect the continued operation and construction of nuclear power plants, including the political and regulatory environment, the availability and cost of alternative means of power generation, the occurrence of future nuclear incidents, and general economic conditions.