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ENGINEERED SUPPORT SYSTEMS INC

Form 10-K

January 28, 2002

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

For the year ended October 31, 2001

Commission file number 0-13880

ENGINEERED SUPPORT SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

Missouri
(State of Incorporation)

43-1313242
(IRS Employer Identification No.)

201 Evans Lane, St. Louis, Missouri
(Address of principal executive offices)

63121
(Zip Code)

Registrant's telephone number including area code: (314) 553-4000

Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of each class

Name of each exchange on
which registered

Common stock, \$.01 par value

Over the counter
National Market System
National Association of
Security Dealers

No securities are registered pursuant to Section 12(g) of the Securities Exchange Act of 1934.

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirement for the past 90 days.

Yes ☒ No ☐ .

Based on the closing price on January 17, 2002, the aggregate market value of the voting stock held by non-affiliates of the Registrant was approximately \$289,654,000.

The number of shares of the Registrant's common stock, \$.01 par value, outstanding at January 17, 2002 was 10,233,407.

DOCUMENTS INCORPORATED BY REFERENCE

Parts I and II incorporate by reference portions of the Engineered Support Systems, Inc. Annual Report to Shareholders (the Annual Report) for

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the year ended October 31, 2001. Part III incorporates by reference portions of the Engineered Support Systems, Inc. Proxy Statement for the Annual Shareholders Meeting to be held on March 5, 2002 (the Definitive Proxy Statement) to be filed within 120 days after the close of the year ended October 31, 2001.

PART I

ITEM 1. BUSINESS

Engineered Support Systems, Inc. is a holding company for six wholly-owned subsidiaries: Systems & Electronics Inc. (SEI), Engineered Air Systems, Inc. (Engineered Air), Keco Industries, Inc. (Keco), Engineered Coil Company, d/b/a Marlo Coil (Marlo Coil), Engineered Electric Company, d/b/a Fermont (Fermont) and Engineered Specialty Plastics, Inc. (ESP). Engineered Support Systems, Inc. and its subsidiaries (Company) are a leading designer and manufacturer of military support equipment and electronics for the United States armed forces. The Company also engineers and manufactures air handling and heat transfer equipment, material handling equipment and custom molded plastic products for commercial and industrial users.

Engineered Air was incorporated under the laws of the State of Missouri on December 24, 1981 and acquired the assets of the Defense Systems Division of Allis-Chalmers Corporation on March 30, 1982. The Company was incorporated under the laws of the State of Missouri in December 1983, and exchanged all of its outstanding common stock for two-thirds of the common stock of Engineered Air held by the Company's founders. The Company purchased the remaining one-third of the common stock of Engineered Air in January 1984, effective as of November 1, 1983. The Company became a publicly owned corporation on August 21, 1985. On March 9, 1993, the Company purchased all of the outstanding stock of Associated Products, Inc. (subsequently changed to Engineered Specialty Plastics, Inc.). Effective February 1, 1998, Engineered Coil Company acquired substantially all of the net assets of Nuclear Cooling, Inc., d/b/a Marlo Coil. On June 24, 1998, the Company acquired all of the outstanding common stock of Keco. On February 22, 1999, Engineered Electric Company acquired substantially all of the net assets of the Fermont Division of Dynamics Corporation of America, d/b/a Fermont. On September 30, 1999, the Company acquired all of the outstanding common stock of SEI.

PRODUCTS

Products are manufactured by the Company within four operating segments: heavy military support equipment, electronics and automation systems, light military support equipment and plastic products. The heavy military support equipment segment engineers and manufactures load management and transport systems primarily for the U.S. Department of Defense (DoD). Segment products include aircraft load management equipment, tank transport systems and bridging systems. The electronics and automation systems segment engineers and manufactures radar and electronic warfare systems, fire support systems and avionics test equipment primarily for the DoD. The segment also engineers and manufactures material handling equipment primarily for the U.S. Postal Service and for the pharmaceutical industry throughout the United States. The light military support equipment segment engineers and manufactures a broad range of military support equipment primarily for the DoD, as well as related heat transfer and air handling

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equipment for domestic commercial and industrial users. Segment products include environmental control systems, generator sets, petroleum and water systems, chemical and biological protection systems and other multipurpose military support equipment. The plastic products segment manufactures injection molded resin products, as well as a proprietary line of plastic faucets, primarily for commercial customers in the south-central United States.

See pages 6 through 20 of the 2001 Annual Report which are incorporated herein by reference.

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ENGINEERING AND DESIGN

The Company employs 396 people engaged in the design and development of new products and the improvement of existing products. The majority of these development activities are conducted pursuant to, and funded by, DoD contracts in response to designated performance specifications. The Company's expenditures on research and development were approximately \$1.1 million, \$0.8 million and \$0.2 million for the years ended October 31, 2001, 2000 and 1999. The Company anticipates that unfunded internal research and development will exceed \$1.0 million in fiscal year 2002. The Company believes that its engineering expertise gives it a significant competitive advantage.

The Company's engineering capabilities are in the areas of systems, electro-mechanics, electro-chemical, mechanics, electrical systems and electronics, and acoustics, as well as expertise in thermodynamics, air flow, liquid pumping, stress analysis, liquid fuel combustion, dynamic and climatic environmental engineering, biological and chemical decontamination, non-pyrotechnic smoke generation, and filtration of chemically and biologically contaminated air.

The Company's design and development of support equipment is enhanced by computer-aided design and manufacturing (CAD/CAM) systems used by engineers and draftsmen to design complex products and component parts in three-dimensional view. The Company's engineering technologies and expertise provide it with the ability to adapt its production process to new product needs on a timely basis. The Company also has the capability to provide complete technical data support for the products it manufactures. This includes integrated logistics support, spare parts provisioning and preparation of technical manuals.

MARKETING

The Company's marketing of military equipment and services focuses, in part, on determining the current and future needs of the DoD. To identify those needs, the Company gathers information from primary sources such as the DoD budget and its supporting documents, and military requirement documents such as the Air Force's Statement of Need, the Navy's Operational Requirements and the Army's Required Operational Capability, along with direct interface with its customers. The Company analyzes this data through an established new business opportunity procedure and then determines whether or not to bid on specific projects based upon determinations of potential profitability and the likelihood of being awarded the contract.

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For its defense products, the Company maintains a domestic field marketing/sales network with offices located in the Washington, D.C. area and at several major U.S. Government defense procurement centers. The Washington, D.C. office carries out legislative activities, and conducts customer liaison activities with all branches of the U.S. armed services and with foreign government offices in the Washington, D.C. area. The primary responsibility for individual products or programs is handled within the product line organizations, with the field organization providing closely coordinated assistance.

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In addition, the Company supplies electronic sorting and material handling equipment to the U.S. Postal Service and other customers. Sales of custom commercial, industrial and marine air handling units and coils are effected both directly and through sales representatives located primarily in the United States, parts of Canada, and Puerto Rico, with the pharmaceutical, telecommunications and healthcare industries representing a significant portion of current sales volume. Principal customers for injection molded custom and specialty plastic products include large, well-established producers of consumer and industrial products. Sales of injection molded plastic products are effected both directly and through sales representatives. The Company's sales of its proprietary line of kitchen and lavatory faucets are effected primarily through sales representatives.

PURCHASED COMPONENTS AND RAW MATERIALS

The Company's products require a wide variety of components and materials. Although the Company has multiple sources of supply for most of its material requirements, sole-source vendors supply certain components, and the Company's ability to perform certain contracts depends on their performance. In the past, these required raw materials and various purchased components generally have been available in sufficient quantities.

GOVERNMENT CONTRACTING

The Company's government contracts are obtained through the DoD procurement process as governed by the Federal Acquisition Regulations and related agency supplements, and are typically fixed-price contracts. This means that the price is agreed upon before the contract is awarded and the Company assumes complete responsibility for any difference between estimated and actual costs.

Under the Truth in Negotiations Act of 1962 (Negotiations Act), the U.S. government has the right for three years after final payment on certain negotiated contracts, subcontracts and modifications thereto, to determine whether the Company furnished the U.S. government with complete, accurate and current cost or pricing data as defined by the Negotiations Act. In the event the Company fails to satisfy this requirement, the U.S. government has the right to adjust a contract or subcontract price by the amount of any overstatement as defined by the Negotiations Act.

U.S. government contracts typically contain terms permitting the contract to be terminated at the convenience of the U.S. government. In the event of such termination, the Company is entitled to reimbursement for certain expenditures and overhead as provided for in applicable U.S. government procurement regulations. Generally, this results in the

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contractor being reasonably compensated for work actually done, but not for anticipated profits. The U.S. government may also terminate contracts for cause if the Company fails to perform in strict accordance with contract terms. The Company has never had a contract terminated by the U.S. government for failure to perform in accordance with contract terms. Termination of, or elimination of appropriation for, a significant government contract could have a material adverse effect on the Company's business, financial condition and results of operations in subsequent periods. Similarly, U.S. government contracts typically permit the U.S. government to change, alter or modify the contract at its discretion. If the U.S. government were to exercise this right, the Company would be entitled to reimbursement of all allowable and allocable costs incurred in making the change plus a reasonable profit.

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The U.S. government typically finances a substantial portion of the Company's contract costs through progress payments. The Company receives progress payments in accordance with DoD contract terms which provide progress payments at 75% to 90% of costs incurred.

INTELLECTUAL PROPERTY

The Company owns various patents and other forms of intellectual property. From time to time, the Company develops proprietary information and trade secrets regarding the design and manufacture of various products. The Company considers its proprietary information and intellectual property to be valuable assets. However, the Company's business is not materially dependent on their protection.

COMPETITION

The markets for all of the Company's products are highly competitive. In order to obtain U.S. government contracts, the Company must comply with detailed and complex procurement procedures adopted by the DoD pursuant to regulations promulgated by the U.S. government. The regulations and procurement procedures are adopted to promote competitive bidding. In addition, the Company competes with a number of businesses with plastic injection molding capabilities and competes with a large number of suppliers to commercial and industrial air handling customers. In all phases of its operations, the Company competes in both performance and price with companies, some of which are considerably larger, more diversified and have greater financial resources than the Company.

BACKLOG

The Company records its backlog as either funded or unfunded backlog. The Company's funded backlog as of October 31, 2001 was approximately \$291.7 million. The Company's funded backlog is subject to fluctuations and is not necessarily indicative of future sales. Funded backlog represents products the customer has committed by contract to purchase from the Company. Unfunded backlog includes products the customer has the option to purchase under contract with the Company, including, with respect to contracts which include a maximum amount purchasable by the customer thereunder, such maximum amount, and with respect to contracts without a specified maximum amount, the Company's estimate of the amount it expects the customer to purchase using the Best Estimated Quantity (BEQ) as a guide where a BEQ is specified. There are no commitments by the customer

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to purchase products included in unfunded backlog and there can be no assurance that any or all amounts included therein will generate revenue for the Company. Moreover, cancellations of purchase orders or reductions of product quantities in existing contracts could substantially reduce the Company's funded backlog and, consequently, future net revenues. Failure of the Company to replace canceled or reduced backlog, whether funded or unfunded, could have a material adverse effect on the Company's business, financial condition and results of operations in subsequent periods.

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The following table summarizes funded and unfunded defense backlog (in millions) as of the indicated dates:

	Funded Defense Backlog -----	Unfunded Defense Backlog -----
October 31, 2001	\$291.7	\$681.8
October 31, 2000	307.3	598.1
October 31, 1999	286.8	850.5
October 31, 1998	85.8	319.6
October 31, 1997	44.1	155.0

EMPLOYEES

As of October 31, 2001, the Company employed 2,174 persons, of which 1,305 were engaged in manufacturing activities, 396 in engineering activities, and 473 in office administration and management functions. District No. 9 of the International Association of Machinists and Aerospace Workers (AFL-CIO) represents approximately 346 employees under a collective bargaining agreement, which expires March 18, 2003. Lodge 1012 of the International Brotherhood of Boilermakers, Iron Ship Builders, Blacksmiths, Forgers and Helpers (AFL-CIO) represents approximately 90 employees under a collective bargaining agreement, which expires January 31, 2002. The Company believes it will be able to negotiate a new collective bargaining agreement with this union.

The Company considers its overall employee relations to be satisfactory.

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ITEM 2. PROPERTIES

The Company conducts its business from 11 manufacturing and office facilities. All owned facilities are owned by the Company and are subject to deeds of trust in favor of the Company's lender.

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Location -----	Description -----	Square Feet -----	Leased Owned -----
St. Louis County, Missouri	Manufacturing/Office	171,000	Owned
Hot Springs, Arkansas	Manufacturing/Office	110,000	Owned
Bossier City, Louisiana	Manufacturing	80,000	Owned
High Ridge, Missouri	Manufacturing/Office	185,000	Owned
Florence, Kentucky	Manufacturing/Office	174,000	Lease
Blue Ash, Ohio	Manufacturing	132,000	Owned
West Plains, Missouri	Manufacturing	405,000	Owned
St. Louis County, Missouri	Office	260,000	Owned
Sanford, Florida	Manufacturing	177,000	Owned
Bridgeport, Connecticut	Manufacturing/Office	109,000	Owned
Bridgeport, Connecticut	Manufacturing	26,000	Lease

The Company believes that its current facilities are sufficient for the conduct of its current level of operations.

ITEM 3. LEGAL PROCEEDINGS

The Company and its subsidiaries are from time to time parties to various legal proceedings arising out of their business. Management believes that there are no such proceedings pending or threatened against them which, if determined adversely, would have a material adverse effect on the business or financial condition of the Company.

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ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SHAREHOLDERS

There were no matters submitted to a vote of shareholders during the fourth quarter of the year ended October 31, 2001.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED

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SHAREHOLDER MATTERS

Information concerning the principal market on which the Company's common stock is traded and the high and low sales prices for such stock during 2001 is shown in Supplemental Information on page 40 of the 2001 Annual Report, incorporated herein by reference. The Company currently pays a semi-annual dividend. The most recently declared dividend was in the amount of \$.018 per share payable January 31, 2002 to shareholders of record as of December 31, 2001.

ITEM 6. SELECTED FINANCIAL DATA

Financial data required under this section is shown in the Summary of Selected Financial Data on page 2 of the 2001 Annual Report, incorporated herein by reference.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis of Financial Condition and Results of Operations, shown on pages 22 through 26 of the 2001 Annual Report, is incorporated herein by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following consolidated financial statements of Engineered Support Systems, Inc. included in the Annual Report for the year ended October 31, 2001 at the pages indicated, are incorporated herein by reference:

Consolidated Balance Sheets, October 31, 2001 and 2000, page 27.

Consolidated Statements of Income, years ended October 31, 2001, 2000 and 1999, page 28.

Consolidated Statements of Shareholders' Equity, years ended October 31, 2001, 2000 and 1999, page 28.

Consolidated Statements of Cash Flows, years ended October 31, 2001, 2000 and 1999, page 29.

Notes to Consolidated Financial Statements, pages 30 through 38.

The quarterly financial information included in Supplementary Information on page 40 of the 2001 Annual Report is incorporated herein by reference.

All other schedules are omitted because they are not applicable or the required information is included in the consolidated financial statements or the notes thereto.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The directors, executive officers and key employees of the Company as of January 17, 2002 are as follows:

Name ----	Age ---	Pos ---
Michael F. Shanahan, Sr. (1)	62	Chairman, Chief Executive Officer and Director
Gerald A. Potthoff (1)	61	President, Chief Executive Officer and Director
Gary C. Gerhardt (1)	56	Vice Chairman - Audit Committee and Chief Financial Officer
William H. T. Bush (2)	63	Director
General Michael P. C. Carns (2)	64	Director
MG George E. Friel (2)	59	Director
Thomas J. Guilfoil (3)	82	Director
S. Lee Kling (2)	73	Director
LTG Kenneth E. Lewi (3)	71	Director
General Charles T. Robertson, Jr.	55	Director
General Crosbie E. Saint	65	Director
Michael F. Shanahan, Jr. (1) (3)	35	Director
Earl W. Wims (3)	62	Director
Ronald W. Davis	55	Vice President - Business Development
Larry K. Brewer	59	Senior Vice President - Business Development
Dan D. Jura	49	Vice President - Business Development
Allan K. Kaste	55	Vice President - Business Development
Robert L. Klautzer	57	Vice President - Business Development Systems
Steven J. Landmann	42	Vice President - Business Development

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David D. Mattern	43	Secretary and Gen
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John R. Wootton	54	Vice President -
John E. Capeless	56	President (ESP)
Thomas G. Cornwell	46	President (Engine
Gerald A. Nicholson	55	President (Marlo
Daniel A. Rodrigues	46	President (SEI)
Thomas C. Santoro	48	President (Fermon
Marvin L. Smith	64	President (Keco)