ENGINEERED SUPPORT SYSTEMS INC
Form 10-K
January 09, 2006

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, 2005 Commission file number 0-13880

ENGINEERED SUPPORT SYSTEMS, INC.
(Exact name of Registrant as specified in its charter)

Missouri	43-1313242
(State of Incorporation)	(IRS Employer Identification No.)
201 Evans Lane, St. Louis, Missouri	63121
(Address of principal executive offices)	(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: None

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

Title of each class
Common stock, $.01 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ]. No [X].

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ]. No [X].

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 [X]. No [ ].

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes [X]. No [ ].

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ]. No [X].

Based on the closing price on April 30, 2005, the aggregate market value of the voting stock held by non-affiliates of the Registrant was approximately $1,420,768,494.

The number of shares of the Registrant's common stock, $.01 par value, outstanding at December 20, 2005 was 41,960,035.

DOCUMENTS INCORPORATED BY REFERENCE

None.

PART I

ITEM 1. BUSINESS

Engineered Support Systems, Inc. (ESSI) is a holding company for 14 wholly-owned operating subsidiaries. These subsidiaries are organized within ESSI's two business segments: Support Systems and Support Services. The Support Systems segment includes the operations of Systems & Electronics Inc. (SEI), Keco Industries, Inc. (Keco), Engineered Air Systems, Inc. (Engineered Air), Engineered Coil Company, d/b/a Marlo Coil (Marlo Coil), Engineered Electric Company, d/b/a Fermont (Fermont), Universal Power Systems, Inc. (UPSI), Engineered Environments, Inc. (EEi), Pivotal Power Inc. (Pivotal Power), Prospective Computer Analysts Incorporated (PCA) and Mobilized Systems, Inc. (Mobilized Systems). The Support Services segment includes the operations of Technical and Management Services Corporation (TAMSCO), Radian, Inc. (Radian), Spacelink International, LLC (Spacelink) and ESSIbuy.com, Inc. (ESSIbuy). Substantially all revenues within these two segments are directly or indirectly derived from contracts with the U.S. Department of Defense (DoD) and certain foreign militaries.

Engineered Air was incorporated under the laws of the State of Missouri in December 1981 and acquired the assets of the Defense Systems Division of Allis-Chalmers Corporation in March 1982. ESSI 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 ESSI's founders. ESSI purchased the remaining one-third of the common stock of Engineered Air in January 1984. ESSI effected its initial public offering in August 1985. In March 1993, ESSI purchased all of the outstanding stock of Associated Products, Inc. (subsequently changed to Engineered Specialty Plastics, Inc. (ESP)). Effective February 1998, Engineered Coil Company acquired substantially all of the net assets of Nuclear Cooling, Inc., d/b/a Marlo Coil. In June 1998, ESSI acquired all of the outstanding common stock of Keco. In February 1999, Engineered Electric Company acquired substantially all of the net assets of the Fermont Division of Dynamics Corporation of America, d/b/a Fermont. In September 1999, ESSI acquired all of the outstanding common stock of SEI. In May 2002, ESSI acquired all the outstanding common stock of Radian. In June 2002, ESSI acquired all the outstanding stock of UPSI. In May 2003, ESSI acquired all of the outstanding stock of TAMSCO. In September 2003, ESSI acquired all of the outstanding stock of EEi. In December 2003, ESSI acquired all of the outstanding stock of Pivotal Power. In January 2005, ESSI acquired all of the outstanding stock of PCA. In February 2005, ESSI acquired all the outstanding membership interests of Spacelink. In May 2005, ESSI acquired all the outstanding equity of Mobilized Systems.

On September 21, 2005, ESSI and DRS Technologies, Inc. (DRS) entered into a definitive agreement which provides for the acquisition by DRS of all the outstanding common stock of ESSI for approximately $1.9 billion, or $43.00 per share (subject to possible adjustment), through a combination of cash and DRS common stock. Pending customary regulatory approvals and other closing conditions, including approval by ESSI and DRS shareholders, the transaction is expected to close on or about January 31, 2006.

PRODUCTS AND SERVICES

As described above, ESSI's operations currently are organized into two business segments: Support Systems and Support Services. The Support Systems segment designs, engineers and manufactures integrated military electronics and other military support equipment primarily for the DoD, as well as related heat transfer and air handling equipment for domestic commercial and industrial users. The Support Services segment provides engineering services, logistics and training services, advanced technology services, asset protection systems and services, telecommunication systems integration and information technology services primarily for the DoD. The Support Services segment also provides certain power generation and distribution equipment and vehicle armor installation to the DoD.

For financial information regarding ESSI's business segments, see "Management Discussion and Analysis of Financial Condition and Results of Operations," and Note L to the Consolidated Financial Statements for the year ended October 31, 2005 included elsewhere within this Annual Report on Form 10-K.

3

ENGINEERING AND DESIGN

As ESSI has grown both internally and through acquisition, it significantly has increased its engineering capabilities. As of October 31, 2005, ESSI has 1,165 people engaged in engineering activities that encompass advanced development, engineering research and development, product improvement and evolution, new product development, productionization, logistic and life-cycle support, product re-engineering and support services. ESSI believes its depth of engineering capabilities allows it to cover all phases of a project from conception to full-life cycle support.

The majority of ESSI's development activities are conducted under, and funded directly or indirectly through, DoD contracts in response to designated performance specifications. ESSI's expenditures on internal research and development (IRAD) were approximately $4.6 million, $4.3 million and $2.9 million for the years ended October 31, 2005, 2004 and 2003, respectively.

ESSI's engineering expertise is complementary to the military markets it serves, primarily the environmental control, power, electronics, heavy mechanical and material handling, security, communications, service and logistical support markets. ESSI has engineering capabilities in the areas of system design and analysis, electronic signal processing, power electronics, software, firmware, mechanical design, control, electro-mechanical, electro-optical, electro-chemical, acoustics, thermodynamics, fluid and air flow, fluid pumping, HVAC, liquid fuel combustion, chemical and biological hardened environmental control, filtration and decontamination, power system analysis, environmental control system analysis, stress analysis, water treatment analysis, water purification technology, radar, target acquisition systems, automatic test equipment, communication system analysis and all the logistic support disciplines to include reliability, maintainability, embedded diagnostics and prognostics, training and the development of web-based interactive electronic technical manuals. ESSI's subsidiaries within the Support Services segment have engineering expertise in fields such as re-engineering obsolete mechanical and electronic products, nano-hardened products, security system design, fuel cells and super critical reformation. ESSI's engineering expertise has significant overlap throughout its operating subsidiaries, allowing it to leverage engineering personnel and technologies, and to function as an integrated team.

ESSI's design and development of new products is enhanced by a number of computer-aided design and manufacturing (CAD/CAM) systems as well as a number of automated system design and analysis tools. CAD/CAM tools are used by both engineers and draftsmen to design and validate complex products and component parts. ESSI utilizes both two- and three-dimensional CAD/CAM tools, providing both design and production engineers an interactive environment with which to view the final product and all the relevant interfaces. These tools are compatible across all of ESSI's operating subsidiaries, allowing for virtual design and development without regard to geographical location. ESSI's engineering technologies and expertise provide it with the ability to adapt its production processes to new product needs on a timely basis. ESSI also has the capability to provide complete technical data support for the products it manufactures to include integrated logistics support, spare parts provisioning and preparation of technical manuals.

ESSI intends to leverage its engineering and design capabilities to continue to develop and evolve differentiated products and services that address both the current and future needs of the DoD for rapid deployment, smaller, lighter and more efficient equipment, and for innovative, value-added service offerings.

MARKETING AND BUSINESS DEVELOPMENT

ESSI's business development efforts are undertaken at two functional levels. ESSI's corporate operation focuses on long-term strategic planning, policy development, best practice identification and dissemination, and on major programs which require the bundling of products and services across traditional subsidiary lines. In addition, ESSI's corporate Washington D.C. operations interface with service staffs within the Pentagon and liaisons with key

4

Congressional delegations. At the subsidiary level, a sales force is engaged to identify and pursue programs with specific customers in a variety of markets. With increased emphasis on ESSI's vision for the future, efforts have begun to strengthen the long-term strategic planning process. Market-based peer groups enable experts throughout ESSI to share knowledge and collectively recommend direction and strategy. These peer groups also evaluate market intelligence, customer knowledge and core competencies to refine ESSI's growth strategies.

ESSI's Business Development Organization meets on a regular basis to identify and disseminate best practices in the areas of proposal development and market presence. The sales force shares customer and market intelligence, identifies key opportunities and assesses campaign strategies. ESSI gathers information from primary sources such as the DoD budget and its supporting documents, and military requirements documents such as Initial Capabilities Documents, along with direct interface with its customers. ESSI analyzes this data and then determines whether or not to bid on specific projects based upon determinations of potential profitability and the likelihood of award.

PURCHASED COMPONENTS AND RAW MATERIALS

ESSI's products require a wide variety of components and materials. Although ESSI has multiple sources of supply for most of its material requirements, sole-source vendors supply certain components, and ESSI'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

ESSI's government contracts are obtained through the DoD procurement process as governed by the Federal Acquisition Regulations and related regulations and agency supplements, and are typically fixed-price contracts. This means that the price is agreed upon before the contract is awarded and ESSI assumes complete responsibility for any difference between estimated and actual costs. For the fiscal year ended October 31, 2005, approximately 64% of ESSI's revenues were derived from fixed-price contracts.

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, to determine whether ESSI furnished the U.S. government with complete, accurate and current cost or pricing data as defined by the Negotiations Act. If ESSI 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 permit the U.S. government to unilaterally terminate these contracts at its convenience. In the event of such termination, ESSI is entitled to reimbursement for certain expenditures and overhead as provided for in applicable U.S. government procurement regulations. Generally, this results in the contractor being reasonably compensated for work actually done, but not for anticipated profits. The U.S. government also may terminate contracts for cause if ESSI fails to perform in strict accordance with contract terms. Termination of, or elimination of appropriation for, a significant government contract could have a material adverse effect on ESSI'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, ESSI could be entitled to reimbursement of all allowable and allocable costs incurred in making the change plus a reasonable profit.

For manufactured items, the U.S. government typically finances a substantial portion of ESSI's contract costs through progress payments. In each such case, ESSI receives progress payments in accordance with DoD contract terms which provide progress payments at 75% to 90% of costs incurred.

INTELLECTUAL PROPERTY

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

COMPETITION

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

BACKLOG

ESSI records its backlog as either funded or unfunded backlog. ESSI's funded backlog was $689.8 million and $588.1 million as of October 31, 2005 and 2004, respectively. ESSI's funded backlog is subject to fluctuations and is not necessarily indicative of future revenues. Funded backlog represents products or services that the customer has committed by contract to purchase from ESSI. Unfunded backlog includes products or services that the customer has the option to purchase under contract with ESSI, 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, ESSI'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 to purchase products or services included in unfunded backlog and there can be no assurance that any or all amounts included therein will generate revenue for ESSI. Moreover, cancellations of purchase orders or reductions of product quantities or levels of service to be provided in existing contracts could substantially reduce ESSI's funded backlog and, consequently, future net revenues. Failure of ESSI to replace canceled or reduced backlog, whether funded or unfunded, could have a material adverse effect on ESSI's business, financial condition and results of operations in subsequent periods.

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

	Funded Defense Backlog	Unfunded Defense Backlog
October 31, 2005	$689.8	$1,487.1
October 31, 2004	588.1	849.2
October 31, 2003	533.4	922.8
October 31, 2002	350.1	868.6
October 31, 2001	291.7	681.8

EMPLOYEES

As of October 31, 2005, ESSI employed 3,673 persons, of which 1,196 were engaged in manufacturing activities, 1,165 in engineering activities and 1,312 in services activities, office administration and management functions. District No. 9 of the International Association of Machinists and Aerospace Workers (AFL-CIO) represents 287 employees under a collective bargaining agreement, which expires March 21, 2008.

ESSI considers its overall employee relations to be satisfactory.

GEOGRAPHIC AREAS

The following table summarizes (in thousands) ESSI's net revenues attributed to the United States and to foreign countries:

Year Ended October 31	United States	Foreign Countries	Total Revenues
2005	$993,288	$25,085	$1,018,373
2004	853,286	30,344	883,630
2003	556,809	15,892	572,701

ESSI attributes foreign net revenues based on the domicile of the purchaser of the product or service.

Of the $702.2 million of ESSI's total assets as of October 31, 2005, $13.9 million were located in countries other than the United States.

FILING OF PERIODIC REPORTS

ESSI regularly files periodic reports with the Securities and Exchange Commission (SEC), including annual reports on Form 10-K and quarterly reports on Form 10-Q, as well as, from time to time, current reports on Form 8-K and amendments to those reports. These filings are available free of charge on ESSI's website at www.engineeredsupport.com, as soon as reasonably practicable after their electronic filing with the SEC.

ITEM 1A   RISK FACTORS

In addition to historical information, this Annual Report on Form 10-K contains or may contain certain forward-looking statements, within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Generally, the words "will," "may," "should," "continue," "believes," "expects," "intends," "anticipates," "estimates" or similar expressions identify forward-looking statements, These forward-looking statements involve certain risks and uncertainties. Factors that could cause actual results to differ materially from those contemplated by the forward-looking statements include, among others, the risks and uncertainties identified below.

THE OBLIGATIONS OF ESSI AND DRS TO COMPLETE THE PROPOSED MERGER ARE SUBJECT TO THE SATISFACTION OR WAIVER OF CERTAIN CONDITIONS. THE FAILURE TO SATISFY THESE CONDITIONS COULD RESULT IN TERMINATION OF THE MERGER AGREEMENT, WHICH WOULD HAVE A MATERIAL ADVERSE EFFECT ON ESSI.

A number of conditions must be satisfied before the proposed merger between ESSI and DRS will be completed. These include among others:

- the receipt of the approval of the issuance of shares of DRS common stock in the merger by DRS stockholders and the approval of the merger agreement and the transactions contemplated by the merger agreement by ESSI shareholders;

- the absence of any legal restraints or prohibitions preventing the completion of the merger, or making such completion illegal;

- the receipt of all governmental and regulatory authorizations, consents, waivers, orders, approvals, or declarations required to consummate the merger, except as would not be reasonably expected to result in a material adverse effect on ESSI;

- the representations and warranties of each party contained in the merger agreement being true and correct in all material respects;

- each party must have performed, in all material respects, all of its obligations under the merger agreement at or prior to the effective time of the merger agreement; and

- the absence of events or developments since the date of the merger agreement that would reasonably be expected to have a material adverse effect with respect to either party.

ESSI can give no assurance that all of the conditions to the merger will be either satisfied or waived or that the merger will occur. The failure to satisfy these conditions could result in termination of the merger agreement, which would have a material adverse effect on ESSI. The proposed merger between DRS and ESSI is discussed in Note P to the Consolidated Financial Statements included elsewhere in this Annual Report on Form 10-K.

THE MERGER AGREEMENT MAY BE TERMINATED PRIOR TO COMPLETION OF THE MERGER, WHICH WOULD HAVE A MATERIAL ADVERSE EFFECT ON ESSI.

DRS and ESSI mutually may agree in writing, at any time before the effective time of the merger, to terminate the merger agreement. Also, either DRS or ESSI may terminate the merger agreement in a number of circumstances, including if:

- the merger is not consummated by June 30, 2006 through no fault of the party seeking to terminate the merger agreement;

- there is a final, non-appealable injunction, judgment or other order, or law which prohibits the merger;

- the ESSI board of directors authorizes ESSI to enter into an agreement with respect to a superior proposal;

- ESSI shareholders fail to approve the merger agreement and the transactions contemplated by the merger agreement at the ESSI special meeting or at an adjournment of that meeting;

- DRS stockholders fail to approve the issuance of shares of DRS common stock in the merger at the DRS special meeting or at an adjournment of that meeting; or

- the party seeking termination is not in material breach of the merger agreement and the other party has materially breached a representation, warranty, covenant or agreement of that party contained in the merger agreement and such breach has not been cured within 15 days of notice of the breach.

ESSI may terminate the merger agreement to accept an acquisition proposal that is more favorable to ESSI and ESSI's shareholders from a financial point of view than the proposed merger with DRS. ESSI must pay DRS a termination fee of $60.0 million, plus up to $10.0 million in costs and expenses of DRS in connection with the transactions contemplated by the merger agreement, if the merger agreement is terminated due to ESSI's board of directors authorizing ESSI to enter into an acquisition agreement with a third party or if DRS terminates the merger agreement due to ESSI's board of directors withdrawing its approval or recommendation of the proposed merger, modifying its recommendation of the merger agreement in a manner adverse to DRS or failing to recommend against any tender or exchange offer that constitutes an alternative proposal. ESSI also must pay these fees and expenses if ESSI or DRS terminates the merger agreement because the merger has not been completed by the outside date or ESSI shareholders fail to approve the merger agreement, an alternative proposal with respect to ESSI shall have been publicly announced prior to such termination and ESSI enters into or completes any merger or extraordinary transaction within twelve months of the termination.

DRS may terminate the merger agreement if the financing contemplated by the merger agreement is not available on substantially the terms and conditions identified in DRS's financing commitment letter, or on other

8

terms or pursuant to other financing arrangements reasonably acceptable to DRS, but DRS will not have the right to terminate for this reason if its failure to fulfill its obligations to obtain financing is the cause of the failure of financing to become available. ESSI may terminate the merger agreement if DRS's financing contemplated in the merger agreement is not available and DRS fails to enter into a substitute commitment letter or alternate arrangements with other financing sources within 20 business days of advising ESSI of the unavailability of such financing or substitute financing. Under the merger agreement, DRS must pay ESSI $20.0 million in liquidated damages upon such termination by DRS or ESSI.

ESSI can give no assurance that the merger agreement will not be terminated prior to completion of the merger or that the merger will occur. Termination of the merger agreement, other than in respect of a superior transaction that actually closes, would have a material adverse effect on ESSI operations.

DRS MAY NOT BE ABLE TO OBTAIN FINANCING TO PAY THE CASH PORTION OF THE MERGER CONSIDERATION.

In addition to the issuance of common stock, DRS intends to finance the merger using a portion of available cash on hand, borrowings provided for under the commitment letter issued by Bear, Stearns & Co. Inc. and its affiliates (Bear Stearns) and Wachovia Capital Markets, LLC and its affiliates (Wachovia) for a $706.9 million senior secured credit facility consisting of a $356.9 million seven-year term loan and a $350.0 million six-year revolving credit facility and through the issuance of a combination of senior fixed-rate notes, senior floating-rate notes, senior subordinated notes and/or convertible notes in an aggregate principal amount of $950.0 million. DRS has entered into a commitment with Bear Stearns and Wachovia for the term loan and revolving credit facility. DRS also has entered into a separate commitment letter with each of Bear Stearns and Wachovia for up to a $950.0 million interim credit facility, if the placement of the permanent debt financing cannot be consummated by the effective time of the merger.

Each of the commitment letters and the availability of the term loan, revolving credit facility and interim facility, if necessary, is subject to certain conditions precedent, including, among other things, that there be no material adverse effect on ESSI. Therefore, ESSI can give no assurance that the financing pursuant to the commitment letters will be available. DRS's proposed offerings of notes pursuant to the permanent debt financing is subject to market and other customary conditions, including, but not limited to, general global and U.S. economic conditions, the market for similar securities, and delivery of customary documents, officer certifications and representations prior to, or at the time of, the closing of the notes offering. There can be no assurance that DRS will be able to complete the notes offering or enter into the term loan, the revolving credit facility or the interim facility, if necessary, on commercially reasonable terms, or at all.

As of September 30, 2005, DRS's cash and cash equivalents were approximately $257.3 million. DRS will not be able to complete the merger if it is unable to obtain financing. DRS may terminate the merger agreement if funding to consummate the merger pursuant to financing arrangements on substantially the terms expected or other terms reasonably acceptable to DRS shall not have become available. However, DRS will not have this termination right if the failure to fulfill its obligations under the merger agreement to obtain such financing is the cause of such financing not becoming available. ESSI may terminate the merger agreement if DRS's financing contemplated in the merger agreement is not available and DRS fails to obtain substitute financing within 20 business days of advising ESSI of the unavailability of such financing or substitute financing. Under certain circumstances pursuant to the merger agreement, DRS must pay ESSI $20.0 million in liquidated damages upon such termination by DRS or ESSI.

ESSI CURRENTLY IS SUBJECT TO AN SEC INVESTIGATION THAT COULD REQUIRE SIGNIFICANT MANAGEMENT ATTENTION AND LEGAL RESOURCES AND COULD HAVE A MATERIAL ADVERSE EFFECT ON ESSI OR THE COMBINED COMPANY.

In December 2004, ESSI was notified by the Enforcement Division of the SEC of the issuance of a formal order directing a private investigation captioned In the Matter of Engineered Support Systems, Inc. and in September 2005, ESSI received notice that the SEC staff had expanded the scope of its investigation. The investigation is discussed in greater detail under "Item 3--Legal Proceedings" of this Annual Report on Form 10-K. In connection with the investigation, ESSI and certain of its directors and officers have received subpoenas and provided information and testimony to the SEC and one former director and officer who currently is a consultant has received a so-called Wells notice. ESSI continues to furnish information required by the SEC and otherwise to cooperate in connection with the

investigation. ESSI is unable to determine at this time the impact, if any, which the investigation could have on ESSI or the combined company following ESSI's proposed merger with DRS as discussed in Note P to the Consolidated Financial Statements included elsewhere in this Annual Report on Form 10-K. If ESSI is unable to resolve the SEC investigation before completion of the merger, it could require significant management attention and legal resources and could have a material adverse effect on the combined company.

THE VALUE OF THE STOCK COMPONENT OF THE MERGER CONSIDERATION COULD VARY BASED UPON THE PRICE OF DRS COMMON STOCK.

The merger consideration to be received by ESSI's shareholders in exchange for each share of ESSI common stock includes $30.10 in cash and a fraction of a share of DRS common stock to be determined based upon the average closing sale price of DRS common stock for the ten consecutive trading day period ending with the second complete trading day before the closing of the merger. The merger agreement provides that such fraction will be fixed at 0.2255 if the average price is $57.20 or greater and 0.2756 if the average price is $46.80 or less. If such average price is less than $57.20 and greater than $46.80, such fraction will be equal to $12.90 divided by the average price. If the average price is between $57.20 and $46.80 per share, the total consideration per share of ESSI common stock as of the date will be valued at $43.00; if the average price is less than $46.80, the value of the per-share consideration will be less than $43.00, and if the average price is greater than $57.20, the value of the consideration per share of ESSI common stock will be greater than $43.00. Accordingly, ESSI shareholders will not know the value of the stock component of the merger consideration until after the closing date.

THE REVENUES OF THE COMBINED COMPANY DEPEND ON DRS'S AND ESSI'S ABILITY TO MAINTAIN LEVELS OF GOVERNMENT BUSINESS. THE LOSS OF CONTRACTS WITH DOMESTIC AND NON-U.S. GOVERNMENT AGENCIES COULD ADVERSELY AFFECT THE COMBINED COMPANY'S REVENUES.

Both DRS and ESSI derive the substantial majority of their revenues from contracts or subcontracts with domestic and non-U.S. government agencies. A significant reduction in the purchase of products by these agencies would have a material adverse effect on the businesses of DRS and ESSI. For fiscal years ended October 31, 2005, 2004 and 2003, approximately 96%, 94% and 95%, respectively, of ESSI's revenues were derived directly or indirectly from defense industry contracts with the U.S. government and its agencies. In addition, in each of the fiscal years ended October 31, 2005, 2004 and 2003, approximately 3% of ESSI's revenues were derived directly or indirectly from sales to foreign governments. Additionally, for fiscal years ended March 31, 2005, 2004 and 2003, approximately 84%, 85% and 81%, respectively, of DRS's revenues were derived directly or indirectly from defense-industry contracts with the U.S. government and its agencies. In addition, in each of the fiscal years ended March 31, 2005, 2004 and 2003, less than 14% of DRS's revenues were derived directly or indirectly from sales to foreign governments. Therefore, the development of the combined company's business in the future will depend upon the continued willingness of the U.S. government and its prime contractors to commit substantial resources to defense programs and, in particular, upon the continued purchase of ESSI's and DRS's products and other products which incorporate their respective products, by the U.S. government. In particular, the current funding demands on the U.S. government combined with a potential reduction of forces in Iraq, may lead to lower levels of government defense spending.

The risk that governmental purchases of products may decline stems from the nature of ESSI's and DRS's business with the U.S. government, in which the U.S. government may:

- terminate contracts at its convenience;
- terminate, reduce or modify contracts or subcontracts if its requirements or budgetary constraints change;
- cancel multi-year contracts and related orders if funds become unavailable;
- shift its spending priorities;

- adjust contract costs and fees on the basis of audits done by its agencies; and

- inquire about and investigate business practices and audit compliance with applicable rules and regulations.

In addition, as defense businesses, DRS and ESSI are subject to the following risks in connection with government contracts:

- the frequent need to bid on programs prior to completing the necessary design, which may result in unforeseen technological difficulties and/or cost overruns;

- the difficulty in forecasting long-term costs and schedules and the potential obsolescence of products related to long-term fixed-price contracts;

- the risk of fluctuations or a decline in government expenditures due to any changes in the DoD budget or appropriation of funds;

- when DRS or ESSI acts as a subcontractor, the failure or inability of the primary contractor to perform its prime contract may result in an inability to obtain payment of fees and contract costs;

- restriction or potential prohibition on the export of products based on licensing requirements; and

- government contract wins can be contested by other contractors.

THE PRICE OF DRS COMMON STOCK MAY BE AFFECTED BY FACTORS DIFFERENT FROM THOSE AFFECTING THE PRICE OF ESSI COMMON STOCK.

Holders of ESSI common stock will be entitled to receive cash and DRS common stock in the merger and thus will become holders of DRS common stock. DRS's business is different in certain ways from that of ESSI, and DRS's results of operations, as well as the price of DRS common stock, may be affected by factors different from those affecting ESSI's results of operations and the price of ESSI common stock. The price of DRS common stock may fluctuate significantly following the merger, including as a result of factors over which DRS has no control. For a discussion of ESSI's businesses and certain factors to consider in connection with such businesses, see "Business" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Factors affecting DRS's business include:

- DRS's revenues are dependent on its ability to maintain its government business;

- DRS's revenues will be adversely affected if it fails to receive renewal of follow-on contracts;

- DRS's failure to anticipate technical problems, estimate costs accurately or control costs with respect to the performance of fixed-price contracts may reduce its profit or cause a loss;

- DRS may experience production delays if its suppliers fail to deliver materials to it;

- DRS's backlog is subject to reduction and cancellation;
- competition;
- military conflict, war or terrorism;
- government regulation;

- technological change; and
- DRS's ability to use and safeguard intellectual property.

THE MARKET PRICE OF DRS COMMON STOCK MAY DECREASE AS A RESULT OF THE MERGER.

In the merger, ESSI shareholders will receive consideration that includes DRS common stock. A number of factors may cause the market price of such DRS common stock to fluctuate significantly after the merger, including:

- the success of the integration of DRS's and ESSI's operations;
- DRS's realization of expected business opportunities and growth prospects from the merger;
- short-term selling pressure on the market price of DRS common stock resulting from sales of DRS shares received by ESSI's shareholders in the merger;
- DRS's operating results and those of defense companies in general;
- the public's reaction to DRS's press releases, announcements and filings with the SEC;
- changes in earnings estimates or recommendations by research analysts;
- DRS's ability to reduce the indebtedness undertaken in connection with the acquisition of ESSI;
- changes in general conditions in the U.S. economy, financial markets, global climate or defense industry;
- natural disasters, terrorist attacks or acts of war;
- other developments affecting DRS or its competitors; and
- additional issuances of DRS common stock.

INTEGRATION OF DRS'S AND ESSI'S OPERATIONS WILL BE COMPLEX, TIME-CONSUMING AND EXPENSIVE AND MAY ADVERSELY AFFECT THE RESULTS OF OPERATIONS OF DRS AFTER THE MERGER.

The anticipated benefits of the merger will depend in part on whether DRS and ESSI can integrate their operations in an efficient, timely and effective manner. Integrating DRS and ESSI will be a complex, time-consuming and expensive process. ESSI will represent DRS's largest and most significant acquisition to date. Successful integration will require, among other things, combining the companies':

- o business development efforts;
- o key personnel;
- o geographically separate facilities; and
- o business and executive cultures.

DRS and ESSI may not accomplish this integration successfully and may not realize the benefits contemplated by combining the operations of both companies. The diversion of management's attention to the integration effort and any difficulty encountered in combining operations could cause the interruption of, or a loss of momentum in, the activities of either or both of the companies' businesses.

IF DRS IS UNABLE TO SUCCESSFULLY INTEGRATE ESSI INTO DRS'S OPERATIONS ON A TIMELY BASIS, DRS'S PROFITABILITY COULD BE NEGATIVELY AFFECTED.

DRS expects that the acquisition of ESSI will result in certain business opportunities and growth prospects. DRS, however, may never realize these expected business opportunities and growth prospects. DRS may experience increased competition that limits its ability to expand its business, DRS's assumptions underlying estimates of expected cost savings may be inaccurate or general industry and business conditions may deteriorate. The acquisition involves numerous risks, including, but not limited to:

- o difficulties in assimilating and integrating the operations, technologies and products of ESSI;
- o the diversion of DRS's management's attention from other business concerns;
- o DRS's current operating and financial systems and controls may be inadequate to deal with the combined company's operations;
- o the risk that the combined company will be unable to maintain or renew any of ESSI's government contracts;
- o the risks of DRS entering markets in which it has limited or no experience; and
- o the loss of key employees.

If these factors limit DRS's ability to integrate the operations of ESSI successfully or on a timely basis, DRS's expectations of future results of operations may not be met. In addition, DRS's growth and operating strategies for ESSI's business may be different from the strategies that ESSI currently is pursuing. If DRS's strategies are not the proper strategies for ESSI, it could have a material adverse effect on the business, financial condition and results of operations of the combined company. Further, there can be no assurance that DRS will be able to maintain or enhance the profitability of ESSI or consolidate the combined company's operations to achieve cost savings.

DRS'S LEVEL OF INDEBTEDNESS FOLLOWING THE MERGER COULD LIMIT CASH FLOW AVAILABLE AND COULD ADVERSELY AFFECT ITS OPERATIONS OR ITS ABILITY TO OBTAIN ADDITIONAL FINANCING, IF NECESSARY. DRS MAY INCUR SUBSTANTIAL ADDITIONAL INDEBTEDNESS IN THE FUTURE.

DRS's total debt outstanding as of September 30, 2005 was approximately $708.4 million. DRS's pro forma indebtedness as of September 30, 2005, after giving effect to the merger and related financing would have been approximately $1.9 billion. As a result of the increase in debt, demands on the cash resources of DRS will increase after the merger, which could have important effects on an investment in DRS common stock. For example, increased levels of indebtedness could, among other things:

- limit the ability of the combined company to obtain additional financing for working capital, capital expenditures, acquisitions and general corporate purposes or make such financing more costly;
- require the combined company to dedicate all or a substantial portion of its cash flow to service debt, which will reduce funds available for other business purposes, such as capital expenditures, research and development, dividends or acquisitions;
- limit flexibility in planning for or reacting to changes in the markets in which the combined company will compete;
- place the combined company at a competitive disadvantage relative to its competitors with less indebtedness;
- render the combined company more vulnerable to general adverse economic and industry conditions; and
- make it more difficult to satisfy financial obligations, including those relating to the financing of the merger.

The terms of DRS's new financing agreements will include covenants restricting the activities of DRS and will require repayment of the debt in certain circumstances. In addition, following the merger, DRS may not be able to incur substantial additional indebtedness in the future. If DRS adds new debt, the related risks that it currently faces could intensify.

If DRS is unable to consummate permanent debt financing of at least $950.0 million, DRS may enter into a new interim credit facility of up to $950.0 million that is likely to be on terms substantially more restrictive and is likely to be more costly than the terms of the contemplated permanent financing. If any interim loan under the interim facility is not repaid within one year of the closing of the interim facility, the principal amount of such loan and any interest on the loan automatically will be exchanged for senior exchange notes which will bear a higher rate of interest and may contain other more restrictive terms than the interim credit facility. Additionally, if the interim facility has not been repaid within 90 days of the closing of the interim facility, Bear Stearns, in consultation with Wachovia, may demand that DRS issue and sell senior notes or senior subordinated notes in an amount sufficient to refinance the interim loans.

THE MERGER MAY ADVERSELY AFFECT THE COMBINED COMPANY'S ABILITY TO ATTRACT AND RETAIN KEY ESSI EMPLOYEES.

ESSI employees may experience uncertainty about their future roles after the merger. In addition, ESSI employees, including key executives and members of ESSI's senior management, may determine that they do not desire to work for DRS for a variety of reasons and may seek early retirement or other employment opportunities. These factors may adversely affect the combined company's ability to attract and retain key management, engineering, sales, marketing and other personnel. There is a continuing demand for qualified technical personnel and DRS's future growth and success will depend in part upon its ability to attract, train and retain such personnel. Competition for personnel in the defense industry is intense. An inability to attract and maintain a sufficient number of technical personnel, including ESSI personnel, could have a material adverse effect on DRS's contract performance and ability to capitalize on market opportunities.

A number of senior executive officers of ESSI have agreements requiring payments in the event of a change in control of ESSI. (See "Item 11 --Executive Compensation--Employment Agreements" and "Item 11--Executive Compensation--Consulting Agreements"). Moreover, several of these executives have indicated their desire to retire from ESSI upon completion of the merger. Departing key employees may be difficult to replace, and their loss may have a material adverse effect on the combined company's operations.

ITEM 2. PROPERTIES

ESSI conducts its business from 45 manufacturing, warehouse and office facilities.

Location	Description	Squar
West Plains, Missouri (1)	Manufacturing/Office	3
Florence, Kentucky (1)	Manufacturing/Office	2
St. Louis County, Missouri (1)	Subassembly/Office	2
High Ridge, Missouri (1)	Manufacturing/Office	2
Bridgeport, Connecticut (1)	Manufacturing/Office	1
Cincinnati, Ohio (2)	Manufacturing/Office	1
Elizabeth City, North Carolina (1)	Hangar - under construction	
Bridgeport, Connecticut (2)	Warehouse	
Alexandria, Virginia (2)	Office	
Halifax, Nova Scotia, Canada (1)	Manufacturing/Office	
Cincinnati, Ohio (1)	Manufacturing/Office	
Elizabeth City, North Carolina (2)	Office	
Polson, Montana (2)	Manufacturing/Office	
Troy, Michigan (2)	Office	
Calverton, Maryland (2)	Office	
Chantilly, Virginia (2)	Office	
Melbourne, Florida (2)	Manufacturing/Office	
Tinton Falls, New Jersey (2)	Manufacturing/Office	
Dulles, Virginia (2)	Office	
St. Louis County, Missouri (2)	Manufacturing	
St. Louis County, Missouri (2)	Warehouse	
Warner Robins, Georgia (2)	Office	
Fairborn, Ohio (2)	Office	
West Plains, Missouri (2)	Warehouse	

Willoughby, Ohio (2)	Office
Bridgeton, Missouri (2)	Manufacturing/Office
Warner Robins, Georgia (1)	Office
Warner Robins, Georgia (2)	Manufacturing/Office
Polson, Montana (2)	Manufacturing/Office
West Long, New Jersey (2)	Office
Huntsville, Alabama (2)	Office
Lorton, Virginia (2)	Office
Cincinnati, Ohio (2)	Warehouse
Petersburg, Virginia (2)	Office
Augusta, Georgia (2)	Manufacturing/Office
Arlington, Virginia (2)	Office
Garden City, New York (2)	Office
Abington, Maryland (2)	Office
Coronado, California (2)	Office
Layton, Utah (2)	Office
San Diego, California (2)	Office
Shrewsbury, New Jersey (2)	Office
Anchorage, Alaska (2)	Office
Oklahoma City, Oklahoma (2)	Office
Fredericksburg, Virginia (2)	Office