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ENGINEERED SUPPORT SYSTEMS INC
Form 10-Q
March 17, 2003

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

Quarterly Report under Section 13 or 15 (d)

of the Securities Exchange Act of 1934

For the three months ended January 31, 2003 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 Number)

201 Evans Lane, St. Louis, Missouri 63121
(Address of principal executive offices) (Zip Code)

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

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 requirements for the past 90 days. Yes No
--- ---

The number of shares of the Registrant's common stock, \$.01 par value, outstanding at February 28, 2003 was 16,056,115.

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ENGINEERED SUPPORT SYSTEMS, INC.

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ENGINEERED SUPPORT SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)

	January 31 2003 ----- (Unaudited)
ASSETS	
Current Assets	
Cash and cash equivalents	\$ 1,071
Accounts receivable	48,422
Contracts in process and inventories	40,909
Deferred income taxes	6,660
Other current assets	8,015
Current assets of discontinued operations	8,194
Total Current Assets	----- 113,271
Property, plant and equipment, less accumulated depreciation of \$26,712 and \$25,464	44,659
Goodwill	108,452
Deferred income taxes	6,772
Other assets	18,485
Long-term assets of discontinued operations	1,308
Total Assets	----- \$ 292,947 =====

LIABILITIES AND SHAREHOLDERS' EQUITY

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Current Liabilities	
Notes payable	\$
Current maturities of long-term debt	21,000
Accounts payable	31,324
Other current liabilities	36,956
Current liabilities of discontinued operations	2,297

Total Current Liabilities	91,577
Long-term debt	15,750
Additional minimum pension liability	20,334
Other liabilities	14,919
Shareholders' Equity	
Common stock, par value \$.01 per share; 30,000	
shares authorized; 17,022 and 16,991 shares issued	170
Additional paid-in capital	100,248
Retained earnings	93,250
Accumulated other comprehensive loss	(14,098)

	179,570
Less treasury stock at cost, 967 and 1,171 shares	29,203

	150,367

Total Liabilities and Shareholders' Equity	\$ 292,947
	=====

See notes to condensed consolidated financial statements.

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ENGINEERED SUPPORT SYSTEMS, INC. CONDENSED CONSOLIDATED STATEMENTS OF INCOME (in thousands, except per share amounts)

	Three Months Ended January 31	
	2003	2002
	-----	-----
Net revenues	\$ 121,663	\$ 91,286
Cost of revenues	94,517	71,373
	-----	-----
Gross profit	27,146	19,913
Selling, general and administrative expense	12,907	9,396
	-----	-----
Operating income from continuing operations	14,239	10,517
Interest expense	(456)	(859)

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Interest income	49	22
Gain on sale of assets	6	3
	-----	-----
Income from continuing operations	13,838	9,683
Income tax provision	5,397	3,777
	-----	-----
Net income from continuing operations	8,441	5,906
Income (loss) from discontinued operations, net of income tax	137	(382)
	-----	-----
Net income	\$ 8,578	\$ 5,524
	=====	=====
Basic earnings per share:		
Continuing operations	\$ 0.53	\$ 0.38
Discontinued operations	0.01	(0.02)
	-----	-----
Total	\$ 0.54	\$ 0.36
	=====	=====
Diluted earnings per share:		
Continuing operations	\$ 0.50	\$ 0.37
Discontinued operations	0.01	(0.02)
	-----	-----
Total	\$ 0.51	\$ 0.35
	=====	=====

See notes to condensed consolidated financial statements.

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ENGINEERED SUPPORT SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(UNAUDITED)

	Three Months January
	----- 2003 -----
From operating activities:	
Net income from continuing operations	\$ 8,441
Depreciation and amortization	2,177
Gain on sale of assets	(6)

Cash provided before changes in operating assets and liabilities	10,612
Net (increase) decrease in non-cash current assets	(4,655)

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Net increase (decrease) in non-cash current liabilities	4,371
Decrease in other assets	1,913

Net cash provided by continuing operations	12,241
Net cash provided by discontinued operations	525

Net cash provided by operating activities	12,766

From investing activities:	
Additions to property, plant and equipment	(2,831)
Proceeds from sale of property, plant and equipment	10

Net cash used in continuing operations	(2,821)
Net cash used in discontinued operations	

Net cash used in investing activities	(2,821)

From financing activities:	
Net payments under line-of-credit agreement	(13,000)
Payments of long-term debt	(5,250)
Purchase of treasury stock	(266)
Exercise of stock options	5,137
Cash dividends	(288)

Net cash used in continuing operations	(13,667)
Net cash used in discontinued operations	

Net cash used in financing activities	(13,667)

Net increase (decrease) in cash and cash equivalents	(3,722)
Cash and cash equivalents at beginning of period	4,793

Cash and cash equivalents at end of period	\$ 1,071
	=====

See notes to condensed consolidated financial statements.

ENGINEERED SUPPORT SYSTEMS, INC
NOTES TO CONDENSED CONSOLIDATED
FINANCIAL STATEMENTS (UNAUDITED)
(in thousands, except per share amounts)
JANUARY 31, 2003

NOTE A - BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements have been

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prepared by the Company without audit. In the opinion of management, all adjustments (including normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month period ended January 31, 2003 are not necessarily indicative of the results to be expected for the entire fiscal year.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial statements and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report to shareholders for the year ended October 31, 2002.

NOTE B - EARNINGS PER SHARE

Average diluted common shares outstanding include common stock equivalents, which represent common stock options as computed based on the treasury stock method.

Basic earnings per share for the three months ended January 31, 2003 and 2002 is based on average basic common shares outstanding of 15,915 and 15,342, respectively. Diluted earnings per share for the three months ended January 31, 2003 and 2002 is based on average diluted common shares outstanding of 16,845 and 15,929, respectively.

NOTE C - STOCK-BASED COMPENSATION

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for all stock option plans. Accordingly, no compensation expense has been recognized for stock option awards. The following table illustrates the effect on net income from continuing operations and earnings per share had the Company applied the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation," to stock option awards.

	Three Months Ended January 31	
	2003	2002
Reported net income from continuing operations	\$8,441	\$5,906
Total stock-based employee compensation expense determined under the fair value method for all stock option awards, net of income tax	5	-----
Pro forma net income from continuing operations	\$8,436	\$5,906
Earnings per share from continuing operations:		
Basic - as reported	\$ 0.53	\$ 0.38

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Basic - pro forma	\$ 0.53	\$ 0.38
	=====	=====
Diluted - as reported	\$ 0.50	\$ 0.37
	=====	=====
Diluted - pro forma	\$ 0.50	\$ 0.37
	=====	=====

The fair value of options at the grant date was estimated using the Black-Scholes model with the following weighted average assumptions for the three months ended January 31, 2003: an expected life of 1.5 years, volatility of 51%, a dividend yield of 0.16% and a risk-free interest rate of 3.74%. The weighted average fair value of options granted in the three months ended January 31, 2003 was \$7.66. There were no stock option awards in the three months ended January 31, 2002.

NOTE D - ACQUISITIONS

On May 10, 2002, the Company acquired all of the outstanding common stock of Radian, Inc., a supplier of engineering, logistics support and systems integration services to the U.S. Department of Defense. The purchase price was approximately \$42.0 million, which included consideration of \$2.0 million in the common stock of the Company. The purchase price is net of \$0.4 million of cash acquired. The fair value of the assets acquired, including goodwill of \$26.6 million and customer-related intangibles of \$15.3 million, was \$58.3 million and liabilities assumed totaled \$16.3 million. (Acquired customer-related intangibles, less \$2.1 million of amortization to date, are included on the January 31, 2003 Condensed Consolidated Balance Sheet in Other Assets.) The cash portion of the purchase price was financed with available cash resources and short-term borrowings under the Company's revolving credit facility.

On June 27, 2002, the Company acquired all of the outstanding common stock of Universal Power Systems, Inc. (UPSI), a provider of uninterruptible power supply systems for the U.S. Department of Defense, intelligence agencies and commercial customers. The purchase price was approximately \$5.5 million plus certain contingent cash consideration based upon UPSI's net revenue levels through two measurement dates, December 31, 2002 and October 31, 2003. Based upon UPSI's net revenue through the December 31, 2002 measurement date, \$5.0 million of cash consideration was added to the purchase price and is included on the January 31, 2003 Condensed Consolidated Balance Sheet in Other Current Liabilities. (The Company estimates the maximum amount of contingent cash consideration related to the October 31, 2003 measurement date to be \$0.6 million). The fair value of the

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assets acquired, including goodwill of \$10.4 million, was \$11.6 million and liabilities assumed totaled \$1.2 million. The purchased price was financed with short-term borrowings under the Company's revolving credit facility.

Both companies are included in the Light Military Support Equipment segment.

NOTE E - OTHER COMPREHENSIVE INCOME (LOSS)

The Company's other comprehensive income (loss) for the three months ended January 31, 2003 and 2002 was \$177 and \$150, respectively. The components

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of other comprehensive income (loss) include a minimum pension liability adjustment and an adjustment to the fair value of derivatives.

NOTE F - GOODWILL AND INTANGIBLE ASSETS

In June 2001, the Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Standards No. 141 (SFAS 141), "Business Combinations," and No. 142 (SFAS 142), "Goodwill and Other Intangible Assets." Under SFAS 142, goodwill and other acquired intangible assets deemed to have indefinite lives are no longer amortized but are subject to periodic impairment tests. All other acquired intangible assets are amortized over their useful lives. In addition, SFAS 141 eliminates the pooling-of-interests method of accounting for business combinations.

The Company adopted SFAS 141 and SFAS 142 as of November 1, 2001. The Company has identified its reporting units to be its operating subsidiaries with the exception of Systems & Electronics Inc., which comprises two reporting units: the Heavy Military Support Equipment and the Electronics and Automation Systems segments of the Company. The carrying value of each reporting unit as of November 1, 2001 was determined by assigning assets and liabilities, including existing goodwill and acquired intangible assets, to the reporting units. Upon adoption of SFAS 142, amortization of goodwill ceased. The Company performed a transitional goodwill impairment assessment as of November 1, 2001 and a goodwill impairment assessment as of October 31, 2002. Neither assessment resulted in impairment of goodwill.

As a result of the adoption of SFAS 142 effective November 1, 2001, the Company recorded no goodwill amortization in the three month periods ended January 31, 2003 and 2002, respectively.

The following disclosure presents certain information on the Company's acquired intangible assets as of January 31, 2003 and October 31, 2002. All acquired intangible assets are being amortized over their estimated useful lives with no estimated residual values. These amounts are included in Other Assets in the Condensed Consolidated Balance Sheets.

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	Weighted Average Amortization Period	Gross Amount	Accumulated Amortization
	-----	-----	-----
Customer-related intangibles:			
January 31, 2003	5.4 years	\$ 15,300	\$ 2,130
October 31, 2002	5.4 years	15,300	1,420

The amortization expense related to acquired intangible assets was \$710 for the three months ended January 31, 2003. Related estimated amortization expense is \$2,840 annually through the year ended October 31, 2006, and \$2,520 for the year ended October 31, 2007. There was no amortization expense related to acquired intangible assets for the three months ended January 31, 2002.

NOTE G - OPERATIONAL RESTRUCTURING

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During the year ended October 31, 2002, the Company announced a restructuring plan to improve both plant utilization and long-term profitability. Under the plan, the Company's Blue Ash, Ohio and Olivette, Missouri manufacturing locations will be closed during the year ending October 31, 2003 with related production efforts being relocated to other existing Company facilities. Emerging Issues Task Force (EITF) No. 94-3 provides specific requirements as to the appropriate recognition of restructuring costs associated with employee termination benefits and other exit costs. Employee termination costs are recognized when benefit arrangements are communicated to affected employees in sufficient detail to enable the employees to determine the amount of benefits to be received upon termination. Other costs resulting from the restructuring plan that are not associated with or that do not benefit activities that will be continued are recognized at the date of commitment to the plan subject to certain conditions. For the cost to be accrued, it must not be associated with or incurred to generate revenues after the commitment date, and must be either incremental to other costs incurred prior to the commitment date or represent amounts under a contractual obligation that existed prior to the commitment date that will either continue after the plan is completed with no economic benefit or which will result in a penalty to cancel the obligation. Other costs directly related to the restructuring plan which are not eligible for recognition at the commitment date, such as relocation and other integration costs, are expensed as incurred. The plan will involve terminating 113 employees, none of which had been terminated as of January 31, 2003.

During the three months ended January 31, 2003, the Company recorded the following costs in connection with the restructuring plan.

	Accrued at October 31, 2002	Expensed	Utilized	Accrued January 2003
	-----	-----	-----	-----
Severance and related benefits	\$ 789			\$ 78
Other cash restructuring costs	153			15
	-----	-----	-----	-----
Restructuring costs, excluding non-cash items	\$ 942			\$ 94
	=====	=====	=====	=====

NOTE H - DISCONTINUED OPERATIONS

During the second quarter of 2002, the Company formally adopted a plan to dispose of Engineered Specialty Plastics, Inc. (ESP), a wholly-owned subsidiary representing the entirety of the Plastic Products business segment. The Company expects that the disposition through sale of ESP will be completed by April 30, 2003. In conjunction with this plan, the Company has recorded an estimated loss on disposal of discontinued operations of \$4.2 million as of January 31, 2003 to reduce the carrying value of ESP's net assets to their estimated fair value less estimated selling costs. Accordingly, the Company has reported the results of operations of ESP as discontinued operations for the three months ended January 31, 2003 and 2002 in the Condensed Consolidated Statements of Income. All assets and liabilities associated with ESP have been reclassified as assets and liabilities of discontinued operations on the January

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31, 2003 and October 31, 2002 Condensed Consolidated Balance Sheets. Certain information with respect to the discontinued operations of ESP for the three month periods ended January 31, 2003 and 2002 is as follows:

	Three Months Ended January 31	
	2003	2002
	-----	-----
Net revenues	\$ 5,125	\$ 2,830
	=====	=====
Income (loss) from operations, net of income tax	\$ 137	\$ (382)
Estimated loss on disposal, net of income tax		
	-----	-----
Income (loss) on discontinued operations, net of income tax	\$ 137	\$ (382)
	=====	=====

Certain information with respect to the assets and liabilities of ESP is summarized as follows:

	January 31 2003	October 31 2002
	-----	-----
Accounts receivable	\$ 3,325	\$ 4,750
Inventories	4,869	5,329
Property, plant and equipment	1,308	1,308
	-----	-----
Assets of Discontinued Operations	\$ 9,502	\$11,387
	=====	=====
Accounts payable	\$ 1,801	\$ 3,354
Accrued expenses and other liabilities	496	439
	-----	-----
Liabilities of Discontinued Operations	\$ 2,297	\$ 3,793
	=====	=====

NOTE I - CONTRACTS IN PROCESS AND INVENTORIES

Contracts in process and inventories of certain of the Company's operating subsidiaries (Systems & Electronics Inc., Engineered Air Systems, Inc., Keco Industries, Inc., Engineered Electric Company and Radian, Inc.) represent accumulated contract costs, estimated earnings

thereon based upon the percentage of completion method and contract inventories reduced by the contract value of delivered items. Inventories of Engineered Coil

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Company and Universal Power Systems, Inc. are valued at the lower of cost or market using the first-in, first-out method. Contracts in process and inventories are comprised of the following:

	January 31, 2003 -----	October 31, 2002 -----
Raw materials	\$ 2,599	\$ 3,662
Work-in-process	1,827	2,368
Finished goods	115	178
Inventories substantially applicable to government contracts in process, less Progress payments of \$51,308 and \$55,809	36,368 -----	35,974 -----
	\$ 40,909 =====	\$ 42,182 =====

NOTE J - SEGMENT INFORMATION

The Company operates in three business segments: Light Military Support Equipment, Heavy Military Support Equipment, and Electronics and Automation Systems. 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 equipment for domestic commercial and industrial users. The segment also provides engineering services and asset protection / security systems to the DoD and other government customers. Segment products include environmental control systems, generator sets and related power generation and distribution systems, chemical and biological protection systems, petroleum and water systems and other multipurpose military support equipment. The Heavy Military Support Equipment segment engineers and manufactures load management and transport systems primarily for the DoD. The Electronics and Automation Systems segment engineers and manufactures airborne radar systems, reconnaissance, surveillance and target acquisition 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. Inter-segment revenues for the three months ended January 31, 2003 and 2002, respectively, were not significant. Total assets by segment as disclosed in the Company's annual report for the year ended October 31, 2002 have not changed materially since that date. Goodwill by segment as of October 31, 2002 totaled \$53,725 for Light Military Support Equipment, \$23,086 for Heavy Military Support Equipment and \$26,633 for Electronics and Automation Systems. Goodwill by segment as of January 31, 2003 totaled \$58,733 for Light Military Support Equipment, \$23,086 for Heavy Military Support Equipment and \$26,633 for Electronics and Automation Systems. In addition, there have been no changes in either the basis of segmentation or the measurement of segment income since October 31, 2002. Information by segment is as follows:

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	2003 -----	2002 -----
Net revenues:		
Light military support equipment	\$ 68,937	\$ 39,583
Heavy military support equipment	31,149	31,024
Electronics and automation systems	21,577	20,679
	-----	-----
Total	\$121,663	\$ 91,286
	=====	=====
Operating income from continuing operations:		
Light military support equipment	\$ 6,118	\$ 5,352
Heavy military support equipment	5,337	3,287
Electronics and automation systems	2,784	1,878
	-----	-----
	14,239	10,517
Interest expense	(456)	(859)
Interest income	49	22
Gain on sale of assets	6	3
	-----	-----
Income from continuing operations before income taxes	\$ 13,838	\$ 9,683
	=====	=====

NOTE K - SUBSEQUENT EVENT

On March 4, 2003, the Company announced that it had entered into a non-binding letter of intent to acquire all of the outstanding stock of Technical and Management Services Corporation (TAMSCO), a provider of information technology logistics and digitization services and a designer and integrator of telecommunications systems primarily for the DoD, in exchange for approximately \$66.5 million in cash. TAMSCO's revenues for the year ended December 31, 2002 were approximately \$116 million.

Neither the Company or TAMSCO is obligated to complete the transaction under the non-binding letter of intent. The proposed transaction is subject to the completion of satisfactory due diligence and the negotiation and execution of a definitive agreement.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS.

CRITICAL ACCOUNTING POLICIES

Revenues on long-term contracts performed within the Company's Light Military Support Equipment, Heavy Military Support Equipment and Electronics and Automation Systems segments, substantially all of which are with the U.S. Government, are recognized under the percentage of completion method and include a proportion of the earnings that are expected to be realized on the contract in the ratio that production measures, primarily labor, incurred bear to the estimated production measures for the contract. Earnings expectations are based

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upon estimates of contract values and costs at completion. Contracts in process are reviewed on a periodic basis. Adjustments to revenues and earnings are made in the current accounting period based upon revisions in contract values and estimated costs at completion. Provisions for estimated losses on contracts are recorded when identified.

During the second quarter of 2002, the Company formally adopted a plan to dispose of Engineered Specialty Plastics, Inc. (ESP), a wholly-owned subsidiary representing the entirety of the Plastic Products business segment. In conjunction with this plan, the Company recorded an estimated loss on disposal to reduce the carrying value of ESP's net assets to their estimated fair value less estimated selling costs. Accordingly, the Company has reported the results of operations of ESP as discontinued operations for the three months ended January 31, 2003 and 2002 in the Condensed Consolidated Statements of Income. Additionally, all depreciation on the property, plant and equipment of ESP was suspended as of the end of the second quarter of 2002.

During the third quarter of 2002, the Company announced a restructuring plan to improve both plant utilization and long-term profitability. Under the plan, the Company's Blue Ash, Ohio and Olivette, Missouri manufacturing locations will be closed during the year ending October 31, 2003 with related production efforts being relocated to other existing Company facilities. Emerging Issues Task Force (EITF) No. 94-3 provides specific requirements as to the appropriate recognition of restructuring costs associated with employee termination benefits and other exit costs. Employee termination costs are recognized when benefit arrangements are communicated to affected employees in sufficient detail to enable the employees to determine the amount of benefits to be received upon termination. Other costs resulting from the restructuring plan that are not associated with or that do not benefit activities that will be continued are recognized at the date of commitment to the plan subject to certain conditions. For the cost to be accrued, it must not be associated with or incurred to generate revenues after the commitment date and must be either incremental to other costs incurred prior to the commitment date, or represent amounts under a contractual obligation that existed prior to the commitment date that will either continue after the plan is completed with no economic benefit or which will result in a penalty to cancel the obligation. Other costs directly related to the restructuring plan which are not eligible for recognition at the commitment date, such as relocation and other integration costs, are expensed as incurred.

The following analysis should be read in this context.

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RESULTS OF OPERATIONS

Consolidated net revenues from continuing operations increased \$30.4 million, or 33.3%, to \$121.7 million in the first quarter of 2003 compared to \$91.3 million in the first quarter of 2002. The increase was primarily the result of \$28.9 million of net revenues from Radian, Inc. (Radian), which was acquired May 10, 2002, and from Universal Power Systems, Inc. (UPSI), which was acquired June 27, 2002. Radian's most significant contract, the Deployable Power Generation and Distribution System (DPGDS) for the U.S. Air Force and U.S. Army contributed \$15.8 million in revenues during the quarter ended January 31, 2003. Gross profit from continuing operations for the three months ended January 31, 2003 increased \$7.2 million, or 36.3%, to \$27.1 million (22.3% of consolidated net revenues) from \$19.9 million (21.8% of consolidated net revenues) in the comparable

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2002 period. The increase in gross profit was a result of a significant increase in revenues, offset by a lower margin contract mix, in the Light Military Support Equipment segment and improved operating performance in the other two business segments. Selling, general and administrative expense from continuing operations increased \$3.5 million, or 37.4%, in the first quarter of 2003 to \$12.9 million (10.6% of consolidated net revenues) from \$9.4 million (10.3% of consolidated net revenues) in the first quarter of 2002. As a result of the above, income from continuing operations increased \$4.1 million, or 42.9%, in the quarter ended January 31, 2003 to \$13.8 million from \$9.7 million in the first quarter of 2002.

LIGHT MILITARY SUPPORT EQUIPMENT. Net revenues for the Light Military Support Equipment segment increased by \$29.4 million, or 74.2%, to \$68.9 million in the first quarter of 2003 from \$39.5 million in the first quarter of 2002 due to the addition of Radian and UPSI to the segment. Gross profit for the segment increased by \$4.7 million, or 51.5%, in the first quarter of 2003 to \$13.9 million (20.1% of segment net revenues) from \$9.2 million (23.1% of segment net revenues) in the first quarter of 2002. The significant increase in revenues, offset by a lower margin contract mix, resulted in the gross profit increase. Income from operations increased by \$0.8 million, or 14.3%, in the first quarter of 2003 to \$6.1 million from \$5.3 million in the first quarter of 2002 as a result of the additions of Radian and UPSI.

HEAVY MILITARY SUPPORT EQUIPMENT. Net revenues for the Heavy Military Support Equipment segment increased by \$0.1 million, or 0.4%, to \$31.1 million in the first quarter of 2003 from \$31.0 million in the first quarter of 2002. Gross profit for the segment increased by \$1.8 million, or 26.9%, in the first quarter of 2003 to \$8.4 million (27.1% of segment net revenues) from \$6.6 million (21.5% of segment net revenues) in the first quarter of 2002. The significant gross profit increase was due to improved margins on the M1000 Heavy Equipment Transporter and other segment programs, stemming from production efficiencies and resultant cost reductions. Income from operations increased by \$2.0 million, or 62.4%, in the first quarter of 2003 to \$5.3 million from \$3.3 million in the first quarter of 2002, as a result of the gross profit gains noted above.

ELECTRONICS AND AUTOMATION SYSTEMS. Net revenues for the Electronics and Automation Systems segment increased by \$0.9 million, or 4.3%, to \$21.6 million in the first quarter of 2003 from \$20.7 million in the first quarter of 2002. The Knight (formerly Striker) and MSTAR programs remained the most significant contributors to segment net revenues, along

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with several aircraft-based radar programs. Gross profit for the segment increased by \$0.7 million, or 17.9%, in the first quarter of 2003 to \$4.8 million (22.4% of segment net revenues) from \$4.1 million (19.9% of segment net revenues) in the first quarter of 2002. Income from operations increased by \$0.9 million, or 48.2%, in the first quarter of 2003 to \$2.8 million from \$1.9 million in the first quarter of 2002 as a result of the above.

Net interest expense decreased by \$0.4 million to \$0.4 million in the first quarter of 2003. This decrease was a result of lower outstanding borrowings on the Company's revolving and term-debt credit facilities, as well as the impact of lower interest rates. The effective income tax rate was 39.0% for the three months ended January 31, 2003 and 2002. As a result of the foregoing, net income from continuing operations increased 42.9% to \$8.4 million

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(6.9% of consolidated net revenues) in the quarter ended January 31, 2003 as compared to \$5.9 million (6.5% of consolidated net revenues) in the first quarter of 2002.

During the second quarter of 2002, the Company formally adopted a plan to dispose of ESP. In conjunction with this plan, the Company has recorded an estimated loss, net of income tax, of \$4.2 million as of January 31, 2003 related to the disposal of ESP. In addition, the Company realized income (loss) from ESP operations, net of income tax, of \$0.1 million and \$(0.4) million in the first quarter of 2003 and 2002, respectively.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". SFAS 144 addresses the financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS 121. The Company adopted SFAS 144 effective November 1, 2001. The Company has accounted for the planned disposition through sale of ESP as discontinued operations in accordance with SFAS 144.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities". SFAS 146 provides direction for accounting and disclosure regarding specific costs related to an exit or disposal activity. These include, but are not limited to, costs to terminate a contract that is not a capital lease, costs to consolidate facilities or relocate employees, and certain termination benefits provided to employees that are involuntarily terminated under the terms of a one-time benefit arrangement. The Company is required to adopt SFAS 146 for any disposal activities initiated after December 31, 2002. The Company is currently reviewing the impact of the adoption of SFAS 146 on its financial statements.

In December 2002, the FASB issued SFAS 148, "Accounting for Stock Based Compensation - Transition and Disclosure - an Amendment of SFAS 123." SFAS 148 provides additional transition guidance for those entities that elect to voluntarily adopt the provisions of SFAS 123, "Accounting for Stock Based Compensation." Furthermore, SFAS 148 mandates new disclosures in both interim and year-end financial statements within the Company's Significant Accounting Policies footnote. The Company adopted these disclosure requirements for the year ended October 31, 2002 and will apply them to its interim financial statements in 2003.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 clarifies disclosures regarding certain guarantees to be made by a guarantor in its interim and annual financial statements. FIN 45 also clarifies that a guarantor is required to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee, but does not prescribe a specific approach for subsequently measuring the liability over its life. Recognition provisions of FIN 45 are to be applied prospectively for guarantees issued or modified after December 31, 2002. The related disclosure requirements are effective for periods ending after December 15, 2002. The Company adopted FIN 45 as of the current quarter, which did not have a material effect on its financial statements.

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LIQUIDITY AND CAPITAL RESOURCES

In conjunction with the acquisition of SEI in September 1999, the Company entered into a credit agreement which provided for a \$90 million term loan and a \$55 million revolving credit facility. The Company's primary sources of short-term financing are from cost reimbursements under contracts with the U.S. government via receipt of progress payments, billings for delivered products and borrowings under the revolving line of credit. As of January 31, 2003, the Company had no borrowings against the revolving line of credit, remaining availability under the line of credit of \$52.8 million and a cash balance of \$1.1 million.

At January 31, 2003, the Company's working capital and ratio of current assets to current liabilities were \$21.7 million and 1.24 to 1 as compared with \$17.6 million and 1.18 to 1 at October 31, 2002. The Company generated cash flow from continuing operations of \$12.2 million in the three months ended January 31, 2003 as compared to \$14.6 million in the first three months of 2002. Investment in property, plant and equipment totaled \$2.8 million and \$0.8 million for the first three months of 2003 and 2002, respectively. \$1.9 million of total capital expenditures for the three months ended January 31, 2003 were incurred at the Company's Keco Industries, Inc. subsidiary and relate to the Company's previously discussed restructuring plan. The Company anticipates that capital expenditures in 2003 should not exceed \$7.0 million. Management believes that cash flow generated from operations, together with the available line of credit, will provide the necessary resources to meet the needs of the Company in the foreseeable future.

There have been no material changes in the total contractual and contingent obligations included in the Company's annual report to shareholders for the year ended October 31, 2002.

BUSINESS AND MARKET CONSIDERATIONS

Approximately 95% of consolidated net revenues from continuing operations for the three months ended January 31, 2003 were directly or indirectly derived from defense orders by the U.S. government and its agencies. As of January 31, 2003, the Company's funded backlog of orders totaled \$340.5 million, with related customer options of an additional \$727.4 million.

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Management continues to pursue potential acquisitions, primarily of those companies providing strategic consolidation within the defense industry.

FORWARD-LOOKING STATEMENTS

In addition to historical information, this report includes certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which are intended to be covered by the safe harbors created thereby. The forward-looking statements involve certain risks and uncertainties, including, but not limited to acquisitions, additional financing requirements, the decision of any of the Company's key customers (including the U.S. government) to reduce or terminate orders with the Company, cutbacks in defense spending by the U.S. government and increased competition in the Company's markets, which could cause the Company's actual results to differ materially from those projected in, or inferred by, the forward-looking statements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

At October 31, 2002, the Company's derivative contracts consisted only of interest rate swaps used by the Company to convert a portion of its variable rate long-term debt to fixed rates. These contracts expired in November 2002. At January 31, 2003, the Company had no derivative contracts.

ITEM 4. CONTROLS AND PROCEDURES.

Within the 90 days prior to the filing date of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon the evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect those controls subsequent to the date this evaluation was carried out, including any corrective actions with regard to significant deficiencies and material weaknesses.

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PART II OTHER INFORMATION

Items 1-5 Not applicable.

Item 6 Exhibits and Reports on Form 8-K.

- (a) Exhibits
 - 11. Statement Re: Computation of Earnings Per Share
 - 99.1 Certification of Chief Executive Officer
 - 99.2 Certification of Chief Financial Officer
- (b) No reports on Form 8-K were filed during the three months ended January 31, 2003.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the

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undersigned thereunto duly authorized.

ENGINEERED SUPPORT SYSTEMS, INC.

Date: March 17, 2003

By: /s/ Michael F. Shanahan, Sr.

Michael F. Shanahan, Sr.
Chairman of the Board and
Chief Executive Officer

Date: March 17, 2003

By: /s/ Gary C. Gerhardt

Gary C. Gerhardt
Vice Chairman - Administration
and Chief Financial Officer

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CERTIFICATIONS

I, Michael F. Shanahan, Sr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Engineered Support Systems, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statements of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a. Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b. Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and,
 - c. Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our

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evaluation as of the Evaluation Date;

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit and finance committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and,
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and,
6. The registrant's other certifying officer and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 17, 2003

/s/ Michael F. Shanahan, Sr.

Michael F. Shanahan, Sr.
Chairman and Chief Executive Officer

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CERTIFICATIONS

I, Gary C. Gerhardt, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Engineered Support Systems, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statements of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a. Designed such disclosure controls and procedures to ensure that

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material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

- b. Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and,
 - c. Presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit and finance committee of the registrant's board of directors (or persons performing the equivalent functions):
- a. All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and,
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and,
6. The registrant's other certifying officer and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 17, 2003

/s/ Gary C. Gerhardt

Gary C. Gerhardt
Vice Chairman - Administration and
Chief Executive Officer