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ENGINEERED SUPPORT SYSTEMS INC
Form 10-K
January 30, 2004

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, 2003

Commission file number 0-13880

ENGINEERED SUPPORT SYSTEMS, INC.

(Exact name of Registrant as specified in its charter)

Missouri
(State of Incorporation)

43-1313242
(IRS Employer Identification No.)

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

63121
(Zip Code)

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

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

Title of each class -----	Name of each exchange on which registered -----
Common stock, \$.01 par value	Over the counter National Market System National Association of Security Dealers

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirement for the past 90 days. Yes X No .
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Registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).

Based on the closing price on January 16, 2004, the aggregate market value of the voting stock held by non-affiliates of the Registrant was approximately \$1,233,645,000.

The number of shares of the Registrant's common stock, \$.01 par value, outstanding at January 16, 2004 was 25,864,074.

DOCUMENTS INCORPORATED BY REFERENCE

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Parts I and II incorporate by reference portions of the Engineered Support Systems, Inc. Annual Report to Shareholders (the Annual Report) for the year ended October 31, 2003. Part III incorporates by reference portions of the Engineered Support Systems, Inc. Proxy Statement for the Annual Shareholders Meeting to be held on March 2, 2004 (the Definitive Proxy Statement) to be filed within 120 days after the close of the year ended October 31, 2003.

PART I

ITEM 1. BUSINESS

Engineered Support Systems, Inc. is a holding company for eleven wholly-owned subsidiaries. These subsidiaries are organized within the Company'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. (EASI), 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) and Pivotal Power Inc. (Pivotal Power). The Support Services segment includes the operations of Technical and Management Services Corporation (TAMSCO), Radian, Inc. (Radian) and ESSIbuy.com, Inc. (ESSIbuy). The Company's Support Systems segment designs, engineers and manufactures integrated military electronics and other support equipment. The Company's Support Services segment provides engineering, logistics support and systems integration services. 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 on December 24, 1981 and acquired the assets of the Defense Systems Division of Allis-Chalmers Corporation on March 30, 1982. The Company was incorporated under the laws of the State of Missouri in December 1983, and exchanged all of its outstanding common stock for two-thirds of the common stock of Engineered Air held by the Company's founders. The Company purchased the remaining one-third of the common stock of Engineered Air in January 1984, effective as of November 1, 1983. The Company became a publicly owned corporation on August 21, 1985. On March 9, 1993, the Company purchased all of the outstanding stock of Associated Products, Inc. (subsequently changed to Engineered Specialty Plastics, Inc.). Effective February 1, 1998, Engineered Coil Company acquired substantially all of the net assets of Nuclear Cooling, Inc., d/b/a Marlo Coil. On June 24, 1998, the Company acquired all of the outstanding common stock of Keco. On February 22, 1999, Engineered Electric Company acquired substantially all of the net assets of the Fermont Division of Dynamics Corporation of America, d/b/a Fermont. On September 30, 1999, the Company acquired all of the outstanding common stock of SEI. On May 10, 2002, the Company acquired all the outstanding common stock of Radian. On June 27, 2002, the Company acquired all the outstanding stock of UPSI. On May 1, 2003, the Company acquired all of the outstanding stock of TAMSCO. On September 24, 2003, the Company acquired all of the outstanding stock of EEi. On December 5, 2003, the Company acquired all of the outstanding stock of Pivotal Power.

PRODUCTS

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Products within the Company's Support Systems segment include environmental control systems, load management and transport systems, power generation, distribution and conditioning systems, airborne radar systems, reconnaissance, surveillance and target acquisition systems, chemical and biological protection systems, petroleum and water distribution systems and other multipurpose military support equipment. 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 to the DoD.

See pages 12 through 24 of the 2003 Annual Report which are incorporated herein by reference.

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ENGINEERING AND DESIGN

As the Company has grown both internally and through acquisition, it has significantly increased its engineering capabilities. The Company currently has 821 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. The Company's depth of engineering capabilities allows it to cover all phases of a project from conception to full-life cycle support.

The majority of development activities are conducted pursuant to, and funded directly or indirectly through, DoD contracts in response to designated performance specifications. The Company's expenditures on internal research and development (IRAD) were approximately \$2.9 million, \$1.8 million and \$1.1 million for the years ended October 31, 2003, 2002 and 2001, respectively. The Company anticipates that IRAD will approximate \$4 million in fiscal year 2004. The Company also anticipates a significant increase in DoD contracted research and development (CRAD) in fiscal 2004 and beyond. The Company believes that its engineering expertise gives it a significant competitive advantage in the development of differentiated products.

The Company's engineering expertise is complimentary to the military markets it serves, primarily the environmental control, power, electronics, heavy mechanical and material handling, security, communications, service and logistical support markets. The Company 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 (IETM). Company subsidiaries within the Support Services segment have engineering expertise in such diverse fields as re-engineering obsolete mechanical and electronic

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products, nano-hardened products, security system design, fuel cells and super critical reformation. The Company'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.

The Company'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. The Company 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 the Company's operating subsidiaries, allowing for virtual design and development without regard to geographical location. The Company's engineering technologies and expertise provide it with the ability to adapt its production processes to new product needs on a timely basis. The Company also has the capability to provide complete technical data support for the products it manufactures to include integrated logistics support, spare parts provisioning and preparation of technical manuals.

The Company 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.

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MARKETING AND BUSINESS DEVELOPMENT

The Company's business development efforts are undertaken at two functional levels. The Company'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, the Company's corporate Washington D.C. operations interface with Service staffs within the Pentagon and liaisons with key 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 the Company's vision for the future, efforts have begun to strengthen the long-term strategic planning process. Market-based peer groups enable experts throughout the Company to share knowledge and collectively recommend direction and strategy. These peer groups also evaluate market intelligence, customer knowledge and core competencies to refine the Company's growth strategies.

The Company'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. The Company 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. The Company analyzes this data through an established business opportunity procedure and then determines whether or not to bid on specific projects based upon determinations of potential profitability and the likelihood of award.

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Major marketing and business development efforts in fiscal 2004 can be segmented into four areas. The first will be increasing the Company's relationship with prime contractors. With continued emphasis from DoD for Lead System Integrators (LSI) and few companies qualifying for that role, the Company has developed marketing efforts to support specific companies in their LSI roles. Secondly, the Company is engaging in new efforts with non-traditional military customers, including the Coast Guard and Homeland Security. Significant resources are also being devoted to opportunities from the bundling of products and services for system solutions, and for reset needs for military assets that have been 'in theatre'.

PURCHASED COMPONENTS AND RAW MATERIALS

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

GOVERNMENT CONTRACTING

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

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

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

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

INTELLECTUAL PROPERTY

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

COMPETITION

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

BACKLOG

The Company records its backlog as either funded or unfunded backlog. The Company's funded backlog as of October 31, 2003 was approximately \$533.4 million. The Company'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 the Company. Unfunded backlog includes products or services that the customer has the option to purchase under contract with the Company, including, with respect to contracts which include a maximum amount purchasable by the customer thereunder, such maximum amount, and with respect to contracts without a specified maximum amount, the Company's estimate of the amount it expects the customer to purchase using the Best Estimated Quantity (BEQ) as a guide where a BEQ is specified. There are no commitments by the customer 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 the Company. Moreover, cancellations of purchase orders or reductions of product quantities or levels of service to be provided in existing contracts could substantially reduce the Company's funded backlog and, consequently, future net revenues. Failure of the Company to replace canceled or reduced backlog, whether funded or unfunded, could have a material adverse effect on the Company's business, financial condition and results of operations in subsequent periods.

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

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	Funded Defense Backlog -----	Unfunded Defense Backlog -----
October 31, 2003	\$533.4	\$922.8
October 31, 2002	350.1	868.6
October 31, 2001	291.7	681.8
October 31, 2000	307.3	598.1
October 31, 1999	286.8	850.5

EMPLOYEES

As of October 31, 2003, the Company employed 2,950 persons, of which 1,056 were engaged in manufacturing activities, 821 in engineering activities and 1,072 in services activities, office administration and management functions. District No. 9 of the International Association of Machinists and Aerospace Workers (AFL-CIO) represents 264 employees under a collective bargaining agreement, which expires March 21, 2008.

The Company considers its overall employee relations to be satisfactory.

FILING OF PERIODIC REPORTS

The Company 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 the Company's website at www.engineeredsupport.com, as soon as reasonably practicable after their electronic filing with the SEC.

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ITEM 2. PROPERTIES

The Company conducts its business from 17 manufacturing and office facilities. All owned facilities are owned by the Company and are subject to deeds of trust in favor of the Company's lender.

Location -----	Description -----	Square Fo -----
West Plains, Missouri (1)	Manufacturing/Office	445,00
Florence, Kentucky (1)	Manufacturing/Office	265,00
St. Louis County, Missouri (1)	Subassembly/Office	264,00
High Ridge, Missouri (1)	Manufacturing/Office	185,00

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Bridgeport, Connecticut (1)	Manufacturing/Office	109,00
Alexandria, Virginia (2)	Office	34,00
Cincinnati, Ohio (1)	Manufacturing/Office	31,00
Bridgeport, Connecticut (2)	Manufacturing	26,00
St. Louis County, Missouri (1)	Manufacturing	25,00
Polson, Montana (2)	Manufacturing/Office	24,00
Troy, Michigan (2)	Office	20,00
Calverton, Maryland (2)	Office	16,00
Chantilly, Virginia (2)	Office	16,00
Tinton Falls, New Jersey (2)	Office	15,00
Warner Robins, Georgia (2)	Office	13,00
Warner Robins, Georgia (1)	Office	11,00
Newington, Virginia (2)	Office	10,20