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ENGINEERED SUPPORT SYSTEMS INC

Form 10-Q

September 14, 2004

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 nine months ended July 31, 2004

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 Number)

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

63121
(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

Indicate by check mark whether the Registrant is an accelerated filer (as defined by Rule 12b-2 of the Exchange Act). Yes ☒ No

The number of shares of the Registrant's common stock, \$.01 par value, outstanding at August 31, 2004 was 26,619,042.

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ENGINEERED SUPPORT SYSTEMS, INC.

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Part I - Financial Information

Item 1. Financial Statements

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

	July 31 2004	October 31 2003
	(Unaudited)	
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 14,273	\$ 14,273
Accounts receivable	110,743	110,743
Contracts in process and inventories	76,793	76,793
Deferred income taxes	5,939	5,939
Other current assets	5,061	5,061
	-----	-----
Total Current Assets	212,809	212,809
Property, plant and equipment, less accumulated depreciation of \$27,853 and \$28,800	46,386	46,386
Goodwill	172,200	172,200
Acquired customer-related intangibles	36,123	36,123
Deferred income taxes	4,030	4,030
Other assets	13,401	13,401
	-----	-----
Total Assets	\$484,949	\$484,949
	=====	=====

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LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities		
Notes payable	\$ 27,000	\$
Current maturities of long-term debt	317	
Accounts payable	61,396	
Other current liabilities	43,777	

Total Current Liabilities	132,490	
Long-term debt	799	
Additional minimum pension liability	25,751	
Other liabilities	13,424	
Shareholders' Equity		
Common stock, par value \$.01 per share; 30,000 shares authorized; 26,617 and 25,263 shares issued	266	
Additional paid-in capital	147,024	
Retained earnings	181,393	
Accumulated other comprehensive loss	(16,198)	

	312,485	
Less treasury stock at cost, 0 and 561 shares	-----	
	312,485	

Total Liabilities and Shareholders' Equity	\$484,949	\$
	=====	

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) (UNAUDITED)

	Three Months Ended July 31		Nine Months July 3
	2004	2003	2004
	-----	-----	-----
Net revenues:			
Products	\$155,179	\$112,383	\$419,317
Services	66,812	43,286	207,940
	-----	-----	-----
	221,991	155,669	627,257
	-----	-----	-----
Cost of revenues:			
Products	107,526	81,538	288,025
Services	57,649	35,970	182,720
	-----	-----	-----
	165,175	117,508	470,745
	-----	-----	-----
Gross profit	56,816	38,161	156,512

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Selling, general and administrative expense	22,133	16,850	65,519
Restructuring expense	(5)	449	61
Gain (loss) on sale of assets	(1,285)	11	(1,290)
	-----	-----	-----
Operating income from continuing operations	33,403	20,873	89,642
Interest expense	(156)	(632)	(1,159)
Interest income	95	117	251
	-----	-----	-----
Income from continuing operations	33,342	20,358	88,734
Income tax provision	12,836	7,942	34,162
	-----	-----	-----
Net income from continuing operations	20,506	12,416	54,572
Income from discontinued operations, net of income tax			
	-----	-----	-----
Net income	\$ 20,506	\$ 12,416	\$ 54,572
	=====	=====	=====
Basic earnings per share:			
Continuing operations	\$ 0.78	\$ 0.51	\$ 2.12
Discontinued operations			
	-----	-----	-----
Total	\$ 0.78	\$ 0.51	\$ 2.12
	=====	=====	=====
Diluted earnings per share:			
Continuing operations	\$ 0.73	\$ 0.48	\$ 1.96
Discontinued operations			
	-----	-----	-----
Total	\$ 0.73	\$ 0.48	\$ 1.96
	=====	=====	=====

See notes to condensed consolidated financial statements.

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

		Nine M J

		2004

From operating activities:		
Net income from continuing operations		\$ 54,572
Depreciation and amortization		9,534
(Gain) loss on sale of assets		1,290

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Cash provided before changes in operating assets and liabilities	65,396
Net (increase) decrease in non-cash current assets	(42,105)
Net increase in non-cash current liabilities	397
Increase (decrease) in other assets	(4,702)

Net cash provided by continuing operations	18,986
Net cash provided by discontinued operations	

Net cash provided by operating activities	18,986

From investing activities:	
Purchase of TAMSCO, net of cash acquired	(7,440)
Purchase of Pivotal, net of cash acquired	(10,064)
Purchase of UPSI, net of cash acquired	(2,026)
Purchase of EEI, net of cash acquired	(99)
Additions to property, plant and equipment	(6,228)
Proceeds from sale of property, plant and equipment	5,674

Net cash used in continuing operations	(20,183)
Net cash provided by discontinued operations	

Net cash used in investing activities	(20,183)

From financing activities:	
Net borrowings (payments) under line-of-credit agreement	(46,100)
Payments of long-term debt	(182)
Proceeds of long-term debt	378
Purchase of treasury stock	
Exercise of stock options	56,331
Issuance of common stock to employee stock purchase plan	3,076
Cash dividends	(932)

Net cash provided by continuing operations	12,571
Net cash used in discontinued operations	

Net cash provided by financing activities	12,571

Effect of exchange rate changes on cash	19

Net increase in cash and cash equivalents	11,393
Cash and cash equivalents at beginning of period	2,880

Cash and cash equivalents at end of period	\$ 14,273
	=====
See notes to condensed consolidated financial statements.	

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NOTES TO CONDENSED CONSOLIDATED
FINANCIAL STATEMENTS (UNAUDITED)
(in thousands, except per share amounts)
JULY 31, 2004

NOTE A - BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements have been prepared by Engineered Support Systems, Inc. (the Company) without audit and include the accounts of the Company and its 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. (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), 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). 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 and nine month periods ended July 31, 2004 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, 2003.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2003, the FASB issued a revision to Interpretation 46 (FIN 46R) to clarify some of the provisions of FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," and to exempt certain entities from its requirements. The adoption of FIN 46R has not had a material impact on the Company's financial statements as it does not maintain any of the interests governed by this pronouncement.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) became law in the U.S. The act introduces a prescription drug benefit under Medicare, as well as a federal subsidy to sponsors of retiree health care benefit plans that provide retiree benefits in certain circumstances. It is not yet clear what impact, if any, the new legislation will have on the Company's postretirement health care plans. The accumulated postretirement benefit obligation

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(APBO) reflected in the other liabilities section of the accompanying consolidated balance sheet, and the net periodic postretirement benefit cost (NPPBC) reflected in the accompanying consolidated statement of earnings do not reflect the effects, if any, of the Act.

NOTE B - EARNINGS PER SHARE

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Average diluted common shares outstanding include common stock equivalents, which represent common stock options as computed based on the treasury stock method. Average basic and diluted common shares outstanding have been restated to reflect a three-for-two stock split effected by the Company on October 31, 2003 in the form of a stock dividend.

Basic earnings per share for the three months ended July 31, 2004 and 2003 is based on average basic common shares outstanding of 26,345 and 24,257, respectively. Diluted earnings per share for the three months ended July 31, 2004 and 2003 is based on average diluted common shares outstanding of 28,066 and 25,791, respectively.

Basic earnings per share for the nine months ended July 31, 2004 and 2003 is based on average basic common shares outstanding of 25,777 and 24,081, respectively. Diluted earnings per share for the nine months ended July 31, 2004 and 2003 is based on average diluted common shares outstanding of 27,819 and 25,524, 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 July 31		Ni
	2004	2003	
	-----	-----	----
Reported net income from continuing operations	\$20,506	\$12,416	\$54
Total stock-based employee compensation expense determined under the fair value method for all stock option awards, net of income tax	1,936		2
	-----	-----	----
Pro forma net income from continuing operations	\$18,570	\$12,416	\$52
	=====	=====	=====
Earnings per share from continuing operations:			
Basic - as reported	\$ 0.78	\$ 0.51	\$
	=====	=====	=====
Basic - pro forma	\$ 0.70	\$ 0.51	\$
	=====	=====	=====
Diluted - as reported	\$ 0.73	\$ 0.48	\$
	=====	=====	=====
Diluted - pro forma	\$ 0.66	\$ 0.48	\$
	=====	=====	=====

Historically, options granted have been fully vested at grant date. 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 and nine months ended July 31, 2004 and 2003: an expected life of 1.5 years, volatility of 36% and 51%, a dividend yield of 0.12% and 0.16% and a

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risk-free interest rate of 3.25% and 3.74%, respectively. The weighted average fair value of options granted in the three and nine months ended July 31, 2004 and 2003 was \$7.55 and \$5.11, respectively.

NOTE D - ACQUISITIONS

On May 1, 2003, the Company acquired all of the outstanding common stock of TAMSCO, a provider of information technology logistics and digitization services and a designer and integrator of telecommunication systems primarily for the U.S. Department of Defense (DoD). The purchase price was approximately \$71.1 million, which is net of \$0.1 million of cash acquired. Approximately \$1.1 million of the purchase price has not yet been paid subject to final collection of accounts receivable. In connection with this transaction, the Company also assumed and paid \$14.9 million of TAMSCO indebtedness. The purchase of TAMSCO, net of cash acquired, totals \$84.9 million, which represents the \$71.1 million purchase price plus assumed indebtedness of \$14.9 million and less \$1.1 million of purchase price not yet paid. (\$84.9 million of purchase price paid through July 31, 2004 represents \$77.4 million paid during the Company's year ended October 31, 2003 plus an additional \$7.5 million related to tax adjustments and accounts receivable collection, paid during the nine months ended July 31, 2004).

The initial purchase price allocation for TAMSCO was based on preliminary information, which was subject to adjustment upon obtaining complete valuation information. During the second quarter of 2004, the Company obtained the final valuation report from an independent third party valuation firm of the assets acquired and liabilities assumed. As a result, the Company reclassified \$29.9 million from goodwill, as recorded in the preliminary allocation, to acquired customer-related intangibles and recorded a \$2.2 million non-cash charge in the quarter ended April 30, 2004 to reflect the related amortization expense from acquisition date. The fair value of assets acquired, including goodwill of \$36.1 million and acquired customer-related intangibles of \$29.9 million, was \$103.9 million and liabilities assumed totaled \$32.8 million.

The following unaudited pro forma summary presents the combined historical results of operations for the nine month period ended July 31, 2003 as adjusted to reflect the TAMSCO purchase transaction assuming the acquisition had occurred at November 1, 2002. These pro forma results are not necessarily indicative of the combined results that would have occurred had the acquisition actually taken place on November 1, 2002, nor are they necessarily indicative of the combined results that may occur in the future.

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	Nine Months Ended July 31, 2003 -----
Net revenues	\$482,343 =====
Net income from continuing operations	\$ 32,197 =====
Basic earnings per share from continuing operations	\$ 1.34 =====

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Diluted earnings per share from continuing operations	\$ 1.26
	=====

On December 5, 2003, the Company acquired all of the outstanding stock of Pivotal Power, a supplier of high-performance static power conversion equipment primarily to military customers. The purchase price was approximately \$10.1 million, net of cash acquired. The purchase price was financed with short-term borrowings under the Company's revolving credit facility. The fair value of assets acquired, including goodwill of \$6.0 million, was \$11.6 million and liabilities assumed totaled \$1.5 million. This allocation is preliminary and subject to final valuation and adjustment.

On September 24, 2003, the Company acquired all of the outstanding common stock of EEI, a designer and manufacturer of specialized environmental control units and heat transfer systems for defense and industrial markets. The purchase price was approximately \$15.6 million. The purchase price was financed with short-term borrowings under the Company's revolving credit facility. The purchase of EEI, net of cash acquired, totaled \$16.7 million, which represents the \$15.6 million purchase price plus assumed indebtedness of \$1.1 million. The fair value of assets acquired, including goodwill of \$14.4 million, was \$19.8 million and liabilities assumed totaled \$4.3 million. This allocation is preliminary and subject to final valuation and adjustment.

On June 27, 2002, the Company acquired all of the outstanding common stock of UPSI, a provider of uninterruptible power supply systems for the DoD, 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 purchase price and paid during the year ended October 31, 2003. Based upon UPSI's net revenue through the October 31, 2003 measurement date, \$2.0 million of cash consideration was added to purchase price and paid in December 2003. The fair value of the assets acquired, including goodwill of \$12.5 million, was \$13.6 million and liabilities assumed totaled \$1.1 million. The purchase price was financed with short-term borrowings under the Company's revolving credit facility.

TAMSCO is included in the Support Services segment. Pivotal Power, EEI and UPSI are included in the Support Systems segment. The operating results of each are included in consolidated operations since their respective dates of acquisition.

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NOTE E - OTHER COMPREHENSIVE INCOME

A reconciliation of net income to other comprehensive income for the three and nine month periods ended July 31, 2004 and 2003 is as follows:

Three Months Ended July 31	Nine Months Ended July 31
-----	-----

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	2004 ----	2003 ----	2004 ----
Net income	\$20,506	\$12,416	\$54,572
Other components of comprehensive income, net of tax:			
Currency translation adjustments	166		(56)
Adjustments to fair value of derivatives	-----	-----	-----
Total comprehensive income	\$20,672 =====	\$12,416 =====	\$54,516 =====

NOTE F - INTANGIBLE ASSETS

The following disclosure presents certain information on the Company's acquired intangible assets. All acquired intangible assets are being amortized over their estimated useful lives with no estimated residual values.

	Weighted Average Amortization Period -----	Gross Amount -----	Accumulated Amortization -----
Customer-related intangibles:			
July 31, 2004	12.1 years	\$45,159	\$ 9,036
October 31, 2003	5.4 years	15,300	4,251

The amortization expense related to acquired intangible assets was \$1,205 for the three months ended July 31, 2004 and \$4,785 for the nine months ended July 31, 2004. Amortization expense related to acquired intangible assets totaled \$710 for the three months ended July 31, 2003 and \$2,130 for the nine months ended July 31, 2003. Related estimated amortization expense is \$5,982 for the year ending October 31, 2004, \$4,821 for the years ending October 31, 2005 and 2006, \$4,453 for the year ending October 31, 2007 and approximately \$1,800 for the years ending October 31, 2008 through October 31, 2018.

NOTE G - OPERATIONAL RESTRUCTURING

During the quarter ended April 30, 2003, the Company announced a restructuring plan under which the electronics assembly work performed at the Company's Sanford, Florida facility of its SEI subsidiary would be relocated to alternate SEI facilities. Statement of Financial Accounting Standards No. 146 (SFAS 146), "Accounting for Costs Associated with Exit or Disposal Activities", applies to all disposal activities initiated after December 31, 2002 and prospectively nullifies EITF 94-3. SFAS 146 requires that a liability for employee termination costs associated with an exit or disposal activity be recognized when the liability is incurred. (EITF 94-3

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had previously required that a liability for such costs be recognized at the date of the Company's commitment to an exit or disposal plan). The Company recorded expense related to this plan of \$2.1 million during the year ended October 31, 2003, consisting of \$1.2 million for severance and related benefits and \$0.9 million for non-cash costs. The Company anticipates that it will record no additional restructuring expense related to this plan for periods ending after July 31, 2004. The plan involved the termination of 106 employees, all of which were terminated as of July 31, 2004.

During the nine months ended July 31, 2004, the Company recorded the following costs in connection with this restructuring plan.

	Accrued at October 31 2003 ----	Expensed -----	Utilized -----
Severance and related benefits	\$ 983 =====	\$ 61 =====	\$ 1,041 =====

NOTE H - DISCONTINUED OPERATIONS

During the quarter ended April 30, 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 completed the sale of ESP in the quarter ended April 30, 2003 to a private equity group. Consideration received by the Company included \$4.1 million of cash, a \$3.3 million two-year note from the buyers secured by the real property of ESP, and contingent consideration based upon ESP's future revenues, net of a \$0.8 million working capital adjustment paid by the Company. In conjunction with the intended disposition of ESP, the Company had previously recorded an estimated loss on disposal of discontinued operations of \$4.2 million during the year ended October 31, 2002 to reduce the carrying value of ESP's net assets to their estimated fair value less estimated selling costs. The completion of the sale resulted in an additional \$0.2 million loss on disposal during the year ended October 31, 2003. The Company has reported the results of operations of ESP as discontinued operations for the nine month period ended July 31, 2003 in the Condensed Consolidated Statements of Income.

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Certain information with respect to the discontinued operations of ESP is as follows:

	Nine Months Ended July 31, 2003 -----
Net revenues	\$ 9,136 =====
Income from discontinued operations, net of income tax	\$ 294

=====

NOTE I - NOTES PAYABLE

Effective April 23, 2003, the Company retired all borrowings under its existing credit facility and entered into a new bank agreement which provided a \$125 million unsecured, revolving credit facility. Borrowings under the new agreement, which expires April 23, 2007, are subject to interest, at the Company's option, at either the Eurodollar rate plus an applicable margin or at the prime rate plus an applicable margin. The margin applicable to the Eurodollar rate varies from 0.875% to 1.625% and the margin applicable to the prime rate varies from 0.0% to 0.25% depending upon the Company's ratio of total indebtedness to earnings before interest, taxes, depreciation and amortization (leverage ratio). As of July 31, 2004, the Company had borrowings of \$27.0 million against the revolving credit facility at an average annual interest rate of 2.285%.

NOTE J - CONTRACTS IN PROCESS AND INVENTORIES

Contracts in process and inventories of certain of the Company's operating subsidiaries (SEI, Engineered Air, Keco, Fermont, Radian, TAMSCO and Pivotal Power) 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 Marlo Coil, UPSI and EEI 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:

	July 31, 2004	Oct
	-----	---
Raw materials	\$ 2,072	
Work-in-process	4,375	
Finished goods	512	
Inventories substantially applicable to government contracts in process, less progress payments of \$77,375 and \$55,010	69,834	

	\$76,793	
	=====	

NOTE K - SEGMENT INFORMATION

The Company operates in 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, and material handling equipment primarily for the U.S. Postal Service. Segment products 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

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distribution systems and other multipurpose military support equipment. The Support Services group 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.

The Company previously defined its business segments as Light Military Support Equipment, Heavy Military Support Equipment and Electronics and Automation Systems. With the Company's entry into the services area through the acquisitions of Radian on May 10, 2002 and TAMSCO on May 1, 2003, the growth of the Company's logistics support capabilities and the continuing rationalization of its operations, the Company has reorganized into the Support Systems and Support Services segments from the previous three segments. The new reporting structure reflects how the Company manages operations, reports results and allocates resources.

Total assets at July 31, 2004, by segment were \$279,774 for Support Systems and \$205,175 for Support Services. Goodwill by segment as of July 31, 2004 totaled \$104,374 for Support Systems and \$67,826 for Support Services.

The differences in net revenues between the accompanying condensed consolidated statements of income and the reporting segment information as presented below are due to certain reclassifications made to categorize net revenues by their functional nature, as required, on the face of the financial statements.

	Three Months Ended July 31		Nine
	2004	2003	2004
	----	----	----
Net Revenues:			
Support Systems	\$134,907	\$ 92,143	\$376,73
Support Services	96,064	65,601	271,72
Intersegment Revenues	(8,980)	(2,075)	(21,19
	-----	-----	-----
Total	\$221,991	\$155,669	\$627,25
	=====	=====	=====
Operating Income from Continuing Operations:			
Support Systems	\$ 24,317	\$ 12,801	\$ 71,63
Support Services	9,086	8,072	18,00
	-----	-----	-----
	33,403	20,873	89,64
Interest expense, net	(61)	(515)	(90
	-----	-----	-----
Income from continuing operations before income taxes	\$ 33,342	\$ 20,358	\$ 88,73
	=====	=====	=====

NOTE L - SHAREHOLDERS' EQUITY

The following summary presents a reconciliation of total

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shareholders' equity from October 31, 2003 to July 31, 2004:

Balance at October 31, 2003	\$197,167
Comprehensive income:	
Net income	54,572
Currency translation adjustments	(56)

Total comprehensive income	54,516

Cash dividends	(932)
Exercise of stock options	56,331
Issuance of common stock	3,705
Issuance of treasury stock	1,698

Balance at July 31, 2004	\$312,485
	=====

NOTE M - PENSION AND OTHER POSTRETIREMENT BENEFITS

The following tables detail the amount of net periodic benefit cost recognized related to the Company's pension and other postretirement benefits for the three and nine month periods ended July 31, 2004 and 2003.

	Three Months Ended July 31		
	Pension Benefits		Other Postretirement Benefits
	2004	2003	2004
	----	----	----
Service cost	\$ 706	\$ 639	\$ 71
Interest cost	1,743	1,443	169
Expected return on plan assets	(1,823)	(1,433)	
Amortization of prior service cost	78	77	
Actuarial loss	641	314	110
Other		8	
	-----	-----	-----
	\$ 1,345	\$ 1,048	\$ 350
	=====	=====	=====

	Nine Months Ended July 31		
	Pension Benefits		Other Postretirement Benefits
	2004	2003	2004
	----	----	----

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Service cost	\$ 2,119	\$ 1,728	\$ 212
Interest cost	5,228	3,951	507
Expected return on plan assets	(5,470)	(3,947)	
Amortization of prior service cost	375	252	
Actuarial loss	1,923	850	331
Other		23	
	-----	-----	-----
	\$ 4,175	\$ 2,857	\$ 1,050
	=====	=====	=====

As of July 31, 2004, \$6,179 of contributions have been made to pension and other postretirement benefit plans. The Company anticipates contributing an additional \$1,950 to fund the pension and other postretirement benefit plans in 2004 for a total of \$8,129.

NOTE N - CONTINGENCIES

As discussed in Note H, the Company completed the sale of ESP, a wholly-owned subsidiary representing the entirety of the Plastic Products business segment, in the quarter ended April 30, 2003 to a private equity group (the Buyers). The Buyers subsequently alleged that the Company breached certain representations made under the related Stock Purchase Agreement (the Agreement) and are seeking \$6.0 million in damages from the Company. Under the terms of the Agreement, this claim is subject to binding arbitration which the Company believes will be completed by April 30, 2005. The Company believes that this claim is without merit and that awarded damages, if any, will not have a material effect on the consolidated financial position, results of operations or cash flows of the Company.

NOTE O - SUBSEQUENT EVENT

In the quarter ending October 31, 2004, the Company recorded a charge of \$5.0 million (\$3.1 million on an after-tax basis) for severance and related benefit costs incurred in connection with the resignation of the Company's former Chief Executive Officer. Of this amount, approximately \$4.2 million (\$2.6 million on an after-tax basis) represents a non-cash charge associated with the extension of the exercise period of vested non-qualified stock options in accordance with FASB Interpretation No. 44 (FIN 44), "Accounting for Certain Transactions Involving Stock Compensation".

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

CRITICAL ACCOUNTING POLICIES

Refer to Management's Discussion and Analysis of Financial Condition and Results of Operations from the Company's 2003 Annual Report to Shareholders into the Company's Annual Report on Form 10-K for the period ended October 31, 2003 for a discussion of the critical accounting policies which we believe are most difficult, subjective or complex.

The following analysis should be read in this context.

RESULTS OF OPERATIONS

Consolidated net revenues from continuing operations increased \$66.3

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million, or 42.6%, to \$222.0 million in the third quarter of 2004 compared to \$155.7 million in the third quarter of 2003. The increase was primarily due to the inclusion of the results of the Company's most recent acquisitions combined with solid organic revenue growth. Engineered Environments, Inc. (EEI) and Pivotal Power Inc. (Pivotal Power), each acquired within the past twelve months, generated net revenues (prior to the exclusion of intersegment revenues) of \$3.0 million and \$2.5 million, respectively, during the third quarter of 2004. All other operating subsidiaries contributed a combined 39.1% increase in net revenues during the quarter. Gross profit from continuing operations for the three months ended July 31, 2004 increased \$18.6 million, or 48.9%, to \$56.8 million (25.6% of consolidated net revenues) from \$38.2 million (24.5% of consolidated net revenues) in the comparable 2003 period. Gross profit from the above recent acquisitions totaled \$2.2

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million. Revenue growth of \$60.8 million at previously existing operations, coupled with improved gross margins at these existing operations, primarily within the Support Systems segment, drove the additional \$16.4 million increase in gross profit. Selling, general and administrative expense from continuing operations increased \$5.2 million, or 30.8%, in the third quarter of 2004 to \$22.1 million (10.0% of consolidated net revenues) from \$16.9 million (10.8% of consolidated net revenues) in the third quarter of 2003. Selling, general and administrative expense for EEI and Pivotal Power accounted for \$1.5 million of the \$5.2 million increase. Primarily as a result of the sale of its Blue Ash, Ohio and Sanford, Florida facilities, the Company realized a loss on sale of assets of \$1.3 million in the third quarter of 2004. As a result of the above, operating income from continuing operations increased \$12.5 million, or 60.0%, in the quarter ended July 31, 2004 to \$33.4 million from \$20.9 million in the third quarter of 2003.

Consolidated net revenues from continuing operations increased \$224.9 million, or 55.9%, to \$627.3 million in the nine months ended July 31, 2004 compared to \$402.4 million in the first three quarters of 2003. This increase was primarily due to the inclusion of the results of the Company's most recent acquisitions combined with solid organic revenue growth. TAMSCO (acquired May 1, 2003) contributed incremental net revenues of \$114.6 (prior to the exclusion of intersegment revenues) while EEI and Pivotal Power generated net revenues (prior to the exclusion of intersegment revenues) of \$10.0 million and \$5.7 million, respectively, during the nine months ended July 31, 2004. All other operating subsidiaries contributed a combined 23.5% increase in net revenues during the first three quarters of 2004. Gross profit from continuing operations for the nine months ended July 31, 2004 increased \$61.4 million, or 64.6%, to \$156.5 million (25.0% of consolidated net revenues) from \$95.1 million (23.6% of consolidated net revenues) in the comparable 2003 period. Gross profit from the acquisitions of

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TAMSCO, EEI and Pivotal Power totaled \$18.1 million. Revenue growth of \$94.6 million at previously existing operations, coupled with improved gross margins at these existing operations, primarily within the Support Systems segment, drove the additional \$43.3 million increase in gross profit. Selling, general and administrative expense from continuing operations increased \$21.3 million, or 48.2%, in the nine months ended July 31, 2004 to \$65.5 million (10.4% of consolidated net revenues) from \$44.2 million (11.0% of consolidated net revenues) in the first nine months of 2003. Selling, general and administrative expense for TAMSCO, EEI and Pivotal Power accounted for \$11.1 million of the \$21.3 million increase. During the first

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three quarters of 2003, the Company recorded a restructuring expense of \$1.6 million related to its plan to relocate electronics assembly work performed at the Company's Sanford, Florida facility of its Systems & Electronics Inc. (SEI) subsidiary to alternate SEI facilities. Primarily as a result of the sale of its Blue Ash, Ohio and Sanford, Florida facilities, the Company realized a loss on sale of assets of \$1.3 million for the nine months ended July 31, 2004. As a result of the above, operating income from continuing operations increased \$40.4 million, or 82.0%, in the nine months ended July 31, 2004 to \$89.6 million from \$49.2 million in the first nine months of 2003.

SUPPORT SYSTEMS. Net revenues in the third quarter of 2004 for the Support Systems segment totaled \$134.9 million compared to \$92.1 million (prior to the elimination of intersegment revenues in each period) for the same period in the prior year, a 46.4% increase. The improved results reflect the inclusion of a combined \$5.5 million in net revenues from EEI and Pivotal Power during the third quarter and net organic revenue growth for existing operations within the Support Systems segment of \$37.3 million, an increase of 40.5%. The programs with the largest revenue gains during

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the quarter include \$21.0 million from the Manportable Surveillance and Target Acquisition Radar (MSTAR), which is serving a wide range of defense applications including base perimeter security and \$3.9 million from the M1000 Heavy Equipment Transporters which are being refurbished after their recent battlefield deployment, as well as a variety of other military support equipment. Gross profit for the segment increased by \$15.0 million, or 60.4%, in the three months ended July 31, 2004 to \$39.9 million (29.6% of segment revenues) from \$24.9 million (27.0% of segment revenues) primarily on the strength of significant revenue increases. Primarily as a result of the sale of its Blue Ash, Ohio and Sanford, Florida facilities, the Company realized a loss on sale of assets of \$1.3 million for the quarter ended July 31, 2004. Quarterly operating income for the segment climbed to \$24.3 million (18.0% of segment revenues) compared to \$12.8 million (13.9% of segment revenues) last year. Incremental gross profit contributions, cost savings realized under the Company's facility rationalization initiatives and the absorption of corporate overhead costs by the Support Services business segment led to the improved results for the Support Systems segment.

Net revenues in the nine months ended July 31, 2004 for the Support Systems segment totaled \$376.7 million compared to \$289.9 million (prior to the elimination of intersegment revenues in each period) for the first nine months of 2003. The improved results reflect the inclusion of a combined \$15.7 million in net revenues from EEI and Pivotal Power during the nine months ended July 31, 2004 and overall higher revenues at existing business units. Net organic revenue growth for the Support Systems segment during the first nine months of 2004 totaled \$71.1 million, an increase of 24.5%. Significant revenue gains from the MSTAR (\$51.8 million) and the Field Deployable Environmental Control Unit (FDECU) (\$14.9 million) programs were prime contributors to this increase. Comparatively lower revenue levels on the Tunner 60K Aircraft Cargo

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Loader / Transporter of \$11.6 million partially offset these increases for the nine month period. Gross profit for the segment increased by \$43.1, or 60.9%, in the nine months ended July 31, 2004 to \$113.8 million (30.2% of segment revenues) compared to \$70.7 million (24.4% of segment revenues) last

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year primarily on the strength of significant revenue increases. Both the MSTAR and FDECU programs discussed above carry higher gross margins than the overall Support Systems segment product portfolio. Primarily as a result of the sale of its Blue Ash, Ohio and Sanford, Florida facilities, the Company realized a loss on sale of assets of \$1.3 million for the nine months ended July 31, 2004. Quarterly operating income for the segment increased to \$71.6 million (19.0% of segment revenues) compared to \$36.1 million (12.4% of segment revenues) in the prior year. Again, incremental gross profit contributions, cost savings realized under the Company's facility rationalization initiatives and an increased allocation of corporate overhead costs to the Support Services business segment, as a result of the TAMSCO acquisition, led to the improved results for the Support Systems segment.

SUPPORT SERVICES. Net revenues for the Support Services segment increased to \$96.1 million, an increase of \$30.5 million, or 46.4%, compared to \$65.6 million (prior to the elimination of intersegment revenues in each period) for the third quarter of 2003, due to the emergence of significant internal growth opportunities in several business areas. In particular, satellite telecommunications support for deployed forces remained robust, several security system integration projects were ongoing and work on vehicle uparmor kits commenced during the third quarter. Net organic revenue growth for the Support Services segment was 46.4% during the third quarter. Gross profit for the segment increased by \$3.6 million, or 27.4%, in the three months ended July 31, 2004 to \$16.9 million (17.6% of segment revenues) from \$13.3 million (20.2% of segment revenues). Task orders awarded under the R2 contract for goods and services typically

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carry a lower fee, or mark-up, than those projects that contain a high level of labor content. Segment operating income for the third quarter of 2004 totaled \$9.1 million (9.5% of segment revenues) compared to \$8.1 million (12.3% of segment revenues) in the same period last year.

Net revenues for the Support Services segment increased to \$271.7 million, an increase of \$155.9 million, or 134.6%, compared to \$115.8 million (prior to the elimination of intersegment revenues in each period) for the first nine months of 2003, principally due to the inclusion of results from TAMSCO (\$114.6 million in incremental revenues). TAMSCO's revenues for the nine months ended July 31, 2004 were above Company forecasts primarily due to additional activity under the R2 contract. Net organic revenue growth for the Support Services segment was 135.7% during the first nine months of 2004, primarily as a result of Radian's Up-Armor contract (\$12.8 million), as well as its security and asset protection service offerings, and a \$7.3 million increase in ESSIBuy revenues. Gross profit for the segment increased by \$18.3 million, or 75.2%, in the nine months ended July 31, 2004 to \$42.7 million (15.7% of segment revenues) from \$24.4 million (21.1% of segment revenues) in the prior year. Task orders awarded under the R2 contract typically carry a lower fee, or mark-up, than those projects that contain a high level of labor content. The initial purchase price allocation for TAMSCO was based on preliminary information, which was subject to adjustment upon obtaining complete valuation information. During the second quarter of 2004, the Company obtained the final valuation report from an independent third party valuation firm of the assets acquired and adjustments assumed. As a result, the Company reclassified \$29.9 million from goodwill, as recorded in the preliminary allocation, to acquired

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customer-related intangibles and recorded a \$2.2 million non-cash charge in the quarter ended April 30, 2004 to reflect amortization expense from acquisition date and \$0.5 million in the quarter ended July 31, 2004. Segment operating income for the first nine months of 2004 totaled \$18.0 million (6.6% of segment revenues) compared to \$13.2 million (11.4% of segment revenues) in the same period last year.

CONSOLIDATED RESULTS OF OPERATIONS. Net interest expense decreased by \$0.4 million to \$0.1 million in the third quarter of 2004, and decreased by \$0.2 million to \$0.9 million in the nine months ended July 31, 2004, reflecting slightly higher average borrowing levels in 2004 offset by decreased interest rates in the credit facility. The effective income tax rate was 38.5% for the three and nine month periods ended July 31, 2004 and was 39% for the three and nine month periods ended July 31, 2003. This reduction is primarily a result of the Company's ongoing state income tax reduction initiatives. As a result of the foregoing, net income from continuing operations increased 63.8 % to \$33.3 million (15.0% of consolidated net revenues) in the quarter ended July 31, 2004 as compared to \$20.4 million (13.1% of consolidated net revenues) in the third quarter of 2003. For the nine months ended July 31, 2004, net income from continuing operations increased 84.5% to \$88.7 million (14.1% of consolidated net revenues) from \$48.1 million (12.0% of consolidated net revenues) for the first nine months of 2003.

During the second quarter of 2002, the Company formally adopted a plan to dispose of ESP. The Company completed the sale of ESP in the quarter ended April 30, 2003 to a private equity group. In conjunction with this plan, the Company recorded an estimated loss, net of income tax, of \$4.2 million during the year ended October 31, 2002. The completion of the sale resulted in an additional \$0.2 million loss on disposal during the year ended October 31, 2003.

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Based on third quarter results, existing backlog and anticipated orders, the Company anticipates that 2004 revenues will approximate \$840 million, and that earnings per share will approximate between \$2.65 and \$2.70. These forecasts include the fourth quarter impact of a charge of \$5.0 million (\$3.1 million on an after-tax basis) for severance and related benefit costs incurred in connection with the resignation of the Company's former Chief Executive Officer. Of this amount, approximately \$4.2 million (\$2.6 million on an after-tax basis) represents a non-cash charge associated with the extension of the exercise period of vested non-qualified stock options in accordance with FASB Interpretation No. 44 (FIN 44), "Accounting for Certain Transactions Involving Stock Compensation."

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2003, the FASB issued a revision to Interpretation 46 (FIN 46R) to clarify some of the provisions of FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," and to exempt certain entities from its requirements. The adoption of FIN 46R has not had a material impact on the Company's financial statements as it does not maintain any of the interests governed by this pronouncement.

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In December 2003, the Medicare Prescription Drug, Improvement and

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Modernization Act of 2003 (the Act) became law in the U.S. The act introduces a prescription drug benefit under Medicare, as well as a federal subsidy to sponsors of retiree health care benefit plans that provide retiree benefits in certain circumstances. It is not yet clear what impact, if any, the new legislation will have on the Company's postretirement health care plans. The accumulated postretirement benefit obligation (APBO) reflected in the other liabilities section of the accompanying consolidated balance sheet, and the net periodic postretirement benefit cost (NPPBC) reflected in the accompanying consolidated statement of earnings do not reflect the effects, if any, of the Act.

LIQUIDITY AND CAPITAL RESOURCES

On April 16, 2003, the Company completed the sale of ESP to a private equity group. Consideration received by the Company included \$4.1 million of cash, a \$3.3 million two-year note from the buyers secured by the real property of ESP, and contingent consideration based upon ESP's future revenues, net of a \$0.8 million working capital adjustment paid by the Company.

Effective April 23, 2003, the Company retired all borrowings under its existing credit facility and entered into a new bank agreement which provided a \$125 million unsecured, revolving credit facility. Borrowings under the new agreement, which expires April 23, 2007, are subject to interest, at the Company's option, at either the Eurodollar rate plus an applicable margin or at the prime rate plus an applicable margin. The margin applicable to the Eurodollar rate varies from 0.875% to 1.625% and the margin applicable to the prime rate varies from 0.0% to 0.25% depending upon the Company's ratio of total indebtedness to earnings before interest, taxes, depreciation and amortization (leverage ratio). As of July 31, 2004, the Company had borrowings of \$27 million against the revolving credit facility, at an average annual interest rate of 2.285%, and a cash balance of \$14.3 million.

Effective December 5, 2003, the Company acquired all of the outstanding stock of Pivotal Power, Inc. (Pivotal Power), a supplier of high performance static power conversion equipment primarily to military customers. The purchase price of Pivotal Power, net of cash acquired, required \$10.1 million in cash which the Company financed with short-term borrowings under its revolving credit facility.

At July 31, 2004, the Company's working capital and ratio of current assets to current liabilities were \$80.3 million and 1.61 to 1 as compared with \$(30.1) million and 0.84 to 1 at October 31, 2003. The Company generated cash from continuing operations of \$19.0 million in the nine months ended July 31, 2004 as compared to generating \$60.2 million of cash flow from continuing operations in the first nine months of 2003. This decrease in operating cash flows was a result of a significant growth in accounts receivable and contract inventories relating to the Company's increasing revenue base and to the contractual requirements of certain programs. Investment in property, plant and equipment totaled \$6.2 million and \$8.4 million for the first nine months of 2004 and 2003, respectively. The Company anticipates that capital expenditures in 2004 should not exceed \$10.0 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.

During the nine months ended July 31, 2004 and 2003, the Company received proceeds of \$56.3 million and \$10.0 million related to the exercise

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of stock options.

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, 2003, except as follows. The Company completed the sale of ESP, a wholly-owned subsidiary representing the entirety of the Plastic Products business segment, in the quarter ended April 30, 2003 to a private equity group (the Buyers). The Buyers subsequently alleged that the Company breached certain representations made under the related Stock Purchase Agreement (the Agreement) and are seeking \$6.0 million in damages from the Company. Under the terms of the Agreement, this claim is subject to binding arbitration which the Company believes will be completed by April 30, 2005. The Company believes that this claim is without merit and that awarded damages, if any, will not have a material effect on the consolidated financial position, results of operations or cash flows of the Company.

BUSINESS AND MARKET CONSIDERATIONS

Approximately 98% of consolidated net revenues from continuing operations for the nine months ended July 31, 2004 were directly or indirectly derived from defense orders by the U.S. government and its agencies. As of July 31, 2004, the Company's funded backlog of orders totaled \$658.4 million, with related customer options of an additional \$643.5 million. These amounts compare to funded backlog of \$533.4 million and related customer options of an additional \$922.7 million as of October 31, 2003.

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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Market risks relating to the Company's operations result primarily from changes in interest rates. In order to manage this risk, the Company periodically converts its variable-rate debt to fixed rates via interest rate swaps. In November 2002, Company interest rate swaps on \$23.6 million of variable-rate debt, matured. Given outstanding debt levels, significant cash flows and anticipated expenditures during fiscal years 2003 and 2004, Company management has not utilized interest rate swaps or other derivative contracts to hedge this risk since November 2002. Management does not believe its exposure to interest rate fluctuations has had, or will have, a significant impact on the Company's operations.

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ITEM 4. CONTROLS AND PROCEDURES.

As of July 31, 2004, 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 changes in the Company's internal controls over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

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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
 - 31.1 Certification of Chief Executive Officer
 - 31.2 Certification of Chief Financial Officer
 - 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
 - 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- (b) During the quarter ended July 31, 2004, the Company filed the following reports on Form 8-K:
 - (1) Form 8-K dated May 27, 2004 regarding release of the Company's financial results for the three months ended April 30, 2004

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SIGNATURES

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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 undersigned thereunto duly authorized.

ENGINEERED SUPPORT SYSTEMS, INC.

Date: September 14, 2004

By: /s/ Gerald A. Potthoff

Gerald A. Potthoff
Vice Chairman, Chief Executive
Officer and President

Date: September 14, 2004

By: /s/ Gary C. Gerhardt

Gary C. Gerhardt
Vice Chairman and Chief
Financial Officer