

SUNTRON CORP  
Form 10-Q  
May 17, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549**

**FORM 10-Q**

**Quarterly report pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the fiscal quarter ended April 2, 2006, or**

**Transition report pursuant section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 0-49651**

**SUNTRON CORPORATION**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

(State of Incorporation)

**86-1038668**

(I.R.S. Employer Identification No.)

**2401 West Grandview Road, Phoenix, Arizona**

(Address of Principal Executive Offices)

**85023**

(Zip Code)

**(602) 789-6600**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer as defined in Exchange Act Rule 12b-2.

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Indicate by check mark if the Registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes  No

As of **April 30, 2006**, there were outstanding **27,510,779** shares of the Registrant's Common Stock, \$0.01 par value.

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

**As of December 31, 2005 and April 2, 2006**

**(In Thousands, Except Per Share Amounts)**

	<b>2005</b>	<b>2006</b>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and equivalents	\$ 59	\$ 90
Trade receivables, net of allowance for doubtful accounts of \$1,678 and \$1,737, respectively	51,377	53,789
Inventories	61,985	62,752
Land, building and improvements held for sale, net	18,772	1,198
Prepaid expenses and other	1,430	1,541
Total Current Assets	133,623	119,370
<b>Property and Equipment:</b>		
Leasehold improvements	7,338	7,311
Manufacturing machinery and equipment	48,050	45,886
Furniture, computer equipment and software	34,327	33,641
Total	89,715	86,838
Less accumulated depreciation and amortization	(81,348)	(79,566)
Net Property and Equipment	8,367	7,272
<b>Intangible and Other Assets:</b>		
Goodwill	10,918	10,918
Deposits and other	180	1,719
Debt issuance costs, net	1,586	860
Identifiable intangible assets, net of accumulated amortization of \$1,325 and \$1,375, respectively	675	625
Total Intangible and Other Assets	13,359	14,122
Total Assets	\$ 155,349	\$ 140,764

The Accompanying Notes Are an Integral Part of These Condensed Consolidated Financial Statements.

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS, Continued**  
**As of December 31, 2005 and April 2, 2006**  
**(In Thousands, Except Per Share Amounts)**

	2005	2006
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities:</b>		
Accounts payable	\$ 38,605	\$ 40,717
Outstanding checks in excess of cash balances	1,039	1,021
Borrowings under revolving credit agreement	47,000	23,106
Accrued compensation and benefits	6,181	7,213
Current portion of accrued exit costs related to facility closures	494	402
Payable to affiliates	501	218
Other accrued liabilities	5,934	2,867
Total Current Liabilities	99,754	75,544
<b>Long-term Liabilities:</b>		
Subordinated debt payable to affiliate		10,000
Accrued exit costs related to facility closures	122	62
Other	905	1,519
Total Liabilities	100,781	87,125
<b>Commitments and Contingencies (Notes 5 and 7)</b>		
<b>Stockholders Equity:</b>		
Preferred stock, \$.01 par value. Authorized 10,000 shares, none issued		
Common stock, \$.01 par value. Authorized 50,000 shares; issued and outstanding 27,415 shares and 27,490 shares, respectively	274	275
Additional paid-in capital	380,744	380,675
Deferred stock compensation	(276)	
Accumulated deficit	(326,174)	(327,311)
Total Stockholders Equity	54,568	53,639
Total Liabilities and Stockholders Equity	\$ 155,349	\$ 140,764

The Accompanying Notes Are an Integral Part of These Condensed Consolidated Financial Statements.

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**For The Quarters Ended April 3, 2005 and April 2, 2006**  
**(In Thousands, Except Per Share Amounts)**

	<b>2005</b>	<b>2006</b>
<b>Net Sales</b>	\$ 82,736	\$ 95,795
<b>Cost of Goods Sold</b>	82,264	87,781
Gross profit	472	8,014
<b>Operating Expenses:</b>		
Selling, general and administrative expenses	5,618	6,051
Severance, retention, and lease exit costs	26	122
Related party management and consulting fees	188	188
Total operating expenses	5,832	6,361
Operating income (loss)	(5,360)	1,653
<b>Other Income (Expense):</b>		
Interest expense	(1,090)	(2,825)
Gain on sale of assets	241	20
Unrealized loss on marketable equity securities	(144)	
Interest and other income	164	15
Total other income (expense)	(829)	(2,790)
Net loss	\$ (6,189)	\$ (1,137)
<b>Loss Per Share (Basic and Diluted)</b>	\$ (0.23)	\$ (0.04)
<b>Weighed Average Shares Outstanding (Basic and Diluted)</b>	27,415	27,456

The Accompanying Notes Are an Integral Part of These Condensed Consolidated Financial Statements.

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**For The Quarters Ended April 3, 2005 and April 2, 2006**  
**(In Thousands)**

	<b>2005</b>	<b>2006</b>
<b>Cash Flows from Operating Activities:</b>		
Net loss	\$ (6,189)	\$ (1,137)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,116	1,654
Amortization of debt issuance costs	209	1,711
Gain on sale of assets	(241)	(20)
Stock-based compensation expense	62	207
Unrealized loss on marketable equity securities	144	
Changes in operating assets and liabilities, net of effects of purchase of businesses:		
Decrease (increase) in:		
Trade receivables, net	3,506	(2,412)
Inventories	10,120	(767)
Prepaid expenses and other	160	(150)
Increase (decrease) in:		
Accounts payable	(5,320)	1,900
Accrued compensation and benefits	1,728	1,032
Other accrued liabilities	(876)	(3,155)
Net cash provided by (used in) operating activities	5,419	(1,137)
<b>Cash Flows from Investing Activities:</b>		
Proceeds from sale of property, plant and equipment	1,891	16,716
Payments for acquisition of businesses	(1,383)	
Payments for property and equipment	(852)	(700)
Net cash provided by (used in) in investing activities	(344)	16,016
<b>Cash Flows from Financing Activities:</b>		
Proceeds from borrowings under debt agreements	87,484	123,365
Principal payments under debt agreements	(91,884)	(137,416)
Payments for debt issuance costs	(72)	(780)
Increase (decrease) in outstanding checks in excess of cash balances	(594)	(18)
Proceeds from exercise of stock options		1
Net cash used in financing activities	(5,066)	(14,848)
Net increase in cash and equivalents	9	31

**Cash and Equivalents:**



Beginning of period		14		59
End of period		\$	23	\$ 90

The Accompanying Notes Are an Integral Part of These Condensed Consolidated Financial Statements.

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**SUNTRON CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
For The Quarters Ended April 3, 2005 and April 2, 2006  
(In Thousands)**

	<b>2005</b>	<b>2006</b>
<b>Supplemental Disclosure of Cash Flow Information:</b>		
Cash paid for interest	\$ 879	\$ 2,319
 Cash paid for income taxes	 \$	 \$
<b>Supplemental Schedule of Non-cash Investing and Financing Activities:</b>		
Deposit retained by purchaser of real estate to secure obligations related to partial leaseback of building	\$	\$ 1,500

The Accompanying Notes Are an Integral Part of These Condensed Consolidated Financial Statements.

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(In Thousands, Except Per Share Amounts)**

***1. Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U. S. generally accepted accounting principles for interim financial information and in conformity with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U. S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain prior period amounts have been reclassified to conform to the current period presentation. Operating results for the fiscal quarter ended April 2, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in Suntron's Annual Report on Form 10-K for the year ended December 31, 2005.

***2. Loss Per Share***

Basic loss per share excludes dilution for potential common shares and is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Diluted loss per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Basic and diluted loss per share are the same for the quarters ended April 3, 2005 and April 2, 2006, as all potential common shares were antidilutive. For the quarter ended April 3, 2005, common stock options that were excluded from the calculation of loss per share amounted to an aggregate of 2,008 shares at exercise prices ranging from \$0.01 to \$57.24 per share. For the quarter ended April 2, 2006, common stock options that were excluded from the calculation of loss per share amounted to an aggregate of 2,600 shares at exercise prices ranging from \$0.01 to \$57.24 per share.

***3. Stock-Based Compensation***

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*. This statement is a revision to Statement of Financial Accounting Standards No. 123 ( SFAS 123 ), *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Statement No. 123R establishes standards of accounting for transactions in which an entity exchanges its equity instruments for goods or services, primarily focusing on the accounting for transactions in which an entity obtains employee services in share-based payment transactions. This standard generally requires companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost is then recognized over the period during which an employee is required to provide service (usually the vesting period) in exchange for the award. The grant-date fair value of employee stock options and similar instruments is estimated using an option-pricing model. If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.

Upon adoption, the Company transitioned to Statement No. 123R using the modified-prospective transition method. Under the modified-prospective method, the Company recognizes

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compensation cost for share-based awards to employees based on their grant-date fair value from the beginning of the fiscal period in which the recognition provisions are first applied, as well as compensation cost for awards that were granted prior to, but not vested as of the date of adoption. Accordingly, beginning January 1, 2006 compensation cost associated with stock options now includes (i) attribution of stock compensation expense for the remaining unvested portion of all stock option awards granted prior to 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (ii) attribution of stock compensation cost associated with stock options granted subsequent to 2005 based on the grant date fair value estimated in accordance with SFAS No. 123R. The Company evaluated the need to record a cumulative effect adjustment for estimated forfeitures upon the adoption of SFAS No. 123R related to previously recognized compensation expense and determined the amount to be immaterial. The Company also evaluated the excess tax benefits in additional paid-in capital as of January 1, 2006, and determined that amount to be immaterial. As a result of the adoption of SFAS No. 123R, the Company recognized \$207 of compensation expense associated with stock options for the first quarter of 2006. As of April 2, 2006, there was \$2,165 of total unrecognized compensation costs related to unvested stock options. These costs are expected to be recognized over a weighted average period of 3.6 years.

The modified prospective transition method of Statement No. 123R requires the presentation of pro forma information for periods presented prior to the adoption of SFAS No. 123R. If compensation cost had been determined for all options granted to employees under the fair value method using an option pricing model, the Company's pro forma net loss and net loss per share (EPS) for the quarter ended April 3, 2005, would have been as follows:

	<b>Net Loss</b>	<b>EPS</b>
Amounts reported	\$ (6,189)	\$ (0.23)
Add stock-based employee compensation recorded under the intrinsic value method	62	
Less stock-based employee compensation under the fair value method	(303)	
Pro forma under fair value method	\$ (6,430)	\$ (0.23)

**Fair Value Method.** The weighted average fair value of options granted for the quarters ended April 3, 2005 and April 2, 2006 was \$1.79 and \$1.60, respectively. In estimating the fair value of stock options, the Company used the Black-Scholes option-pricing model with the following weighted average assumptions:

	<b>April 3, 2005</b>	<b>April 2, 2006</b>
Dividend yield		
Expected volatility	106.5%	95.4%
Risk-free interest rate	4.3%	4.9%
Expected term (years)	6.0	4.0

The dividend yield reflects the fact that the Company has not paid any cash dividends since inception and does not intend to pay any cash dividends in the foreseeable future. The expected

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volatility is based upon the historical volatility of the Company's common stock for the period of time prior to the grant date that is equivalent to the expected term of the related stock option. The risk free interest rate is based on the implied yield on a U.S. Treasury zero-coupon issue with a remaining term equal to the expected term of the related stock option. The expected term is based on observed historical exercise patterns. Groups of employees that have similar historical exercise patterns have been considered separately for valuation purposes.

**Stock Option Summary.** In June 2002, stockholders approved the Amended and Restated 2002 Stock Option Plan (the Plan), which provides that options for 5,000 shares of common stock may be granted under the Plan. The Plan provides for the grant of incentive and non-qualified options to employees, directors and consultants of the Company. At April 2, 2006, approximately 2,320 shares were available for grant under the Plan.

The following table summarizes share activity and the weighted average exercise price related to all stock options granted under the Plan for the quarter ended April 2, 2006:

	Shares	Price
Outstanding, beginning of period	2,264	\$ 5.94
Granted	922	2.42
Canceled	(512)	9.09
Exercised	(74)	0.01
Outstanding, end of period	2,600	\$ 4.24

No stock options were exercised during the quarter ended April 3, 2005. The total intrinsic value of stock options exercised during the quarter ended April 2, 2006 was \$126. The following table summarizes information about stock options outstanding at April 2, 2006:

Stock Options Outstanding				Stock Options Exercisable		
Exercise Prices		Weighted	Remaining	Number	Weighted	Number
Range	Average					
Low	High	Average	Term	Shares	Price	Shares
\$0.01	\$ 0.01	\$ 0.01	1.9	170	\$ 0.01	
1.04	2.15	1.70	9.2	952	1.21	3
2.25	3.41	2.52	9.9	817	3.19	11
3.74	5.77	4.26	7.5	176	4.29	166
7.36	11.00	10.43	6.1	266	10.43	266
11.64	16.00	14.71	4.5	170	14.71	170
18.00	57.24	27.48	2.5	49	27.48	49
\$0.01	\$ 57.24	\$ 4.24	8.1	2,600	\$ 11.06	665

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**4. Inventories**

Inventories at December 31, 2005 and April 2, 2006 are summarized as follows:

	<b>2005</b>	<b>2006</b>
Purchased parts and completed sub-assemblies	\$ 41,798	\$ 41,032
Work-in-process	10,622	10,499
Finished goods	9,565	11,221
Total	\$ 61,985	\$ 62,752

For the quarters ended April 3, 2005 and April 2, 2006, the Company recognized write-downs of excess and obsolete inventories resulting in charges to cost of goods sold of \$1,944 and \$1,149, respectively.

**5. Debt Financing**

At December 31, 2005, the Company had a \$75,000 revolving credit facility with two financial institutions. In January 2006, the Company entered into an amendment to this credit agreement that provided for a more favorable customer concentration limit for receivables from a significant customer and also delayed certain scheduled reductions in advance rates for real estate and equipment. Additionally, an affiliate of the Company's largest stockholder agreed in January 2006 to amend a participation agreement entered into in August 2005 to provide for an additional \$5,000 to the financial institutions in exchange for an immediate increase in borrowing availability of \$5,000.

Although this credit agreement would not have expired until July 2008, customer concentration limits and future scheduled reductions in the advance rates for machinery, equipment and real estate made this facility unattractive to fund the Company's planned activities through the maturity date. Accordingly, on March 30, 2006, the Company terminated this credit agreement and entered into new debt financing agreements as discussed below. Due to the early termination of this credit agreement, the Company recognized a charge to interest expense of \$1,447 to write-off the remaining unamortized debt issuance costs in the first quarter of 2006.

On March 30, 2006, the Company entered into a three-year credit agreement with US Bank National Association (US Bank). The US Bank credit agreement provides for a \$50,000 commitment under a revolving credit facility that matures in March 2009. The Company has the option to terminate the credit agreement before the maturity date with a prepayment penalty of 1.0% of the commitment amount if the prepayment occurs before November 30, 2008. Under the terms of the US Bank credit agreement, the Company can initially elect to incur interest at a rate equal to either (a) the Prime Rate plus 0.50% or (b) the LIBOR Rate plus 3.00%. These rates can be reduced in the future by up to 0.50% for Prime Rate borrowings and 0.75% for LIBOR Rate borrowings depending on the Company's adjusted fixed charge coverage (FCC) ratio, as defined in the credit agreement. As of April 2, 2006, the interest rate for Prime Rate borrowings was 8.25% and no LIBOR Rate borrowings were outstanding. In addition, the Company is obligated to pay a commitment fee of 0.25% per annum for the unused portion of the credit agreement.

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Substantially all of the Company's assets are pledged as collateral for outstanding borrowings under the US Bank credit agreement. The credit agreement also limits or prohibits the Company from paying dividends, incurring additional debt, selling significant assets, acquiring other businesses, or merging with other entities without the consent of the lenders. The credit agreement requires compliance with certain financial and non-financial covenants, including a quarterly adjusted FCC ratio beginning in the second quarter of 2006.

Similar to the previous credit agreement, the US Bank credit agreement includes a lockbox arrangement that requires the Company to direct its customers to remit payments to restricted bank accounts, whereby all available funds are used to pay down the outstanding principal balance under the credit agreement. Accordingly, the entire outstanding principal balance under both credit agreements is classified as a current liability in our condensed consolidated balance sheets.

Total borrowings under the US Bank credit agreement are subject to limitation based on a percentage of eligible accounts receivable and inventories. Accordingly, the Company's borrowing availability generally decreases as our net receivables and inventories decline. As of April 2, 2006, the borrowing base calculation permitted total borrowings of \$49,980. After deducting the outstanding principal balance of \$23,106 and outstanding letters of credit of \$2,000, the Company had borrowing availability of \$24,874 as of April 2, 2006.

On March 30, 2006, the Company also entered into a \$10,000 subordinated Note Purchase Agreement (the "Second Lien Note") with an affiliate of the Company's majority stockholder. The Second Lien Note is collateralized by a second priority interest in substantially all of the collateral under the US Bank credit agreement. The Second Lien Note is subordinated in right of payment to the obligations under the US Bank credit agreement and provides for a maturity date that is 45 days after the maturity date of the US Bank credit agreement. The Second Lien Note provides for an interest rate of 16.0%, payable quarterly in kind (or payable in cash with written approval from US Bank). The Company has the option to prepay the Second Lien Note with a redemption penalty up to 3.0% of the then outstanding principal balance. If the note is paid on the maturity date, a fee equal to 2% of the then outstanding principal balance is due. Accordingly, the Company is recording interest expense related to this 2.0% fee using the effective interest method.

In connection with the US Bank credit agreement, an affiliate of the Company's majority stockholder also agreed to enter into a FCC maintenance agreement that requires the affiliate to make up to \$5,000 of additional subordinated loans to the Company if the FCC is below a prescribed level. Loans pursuant to the FCC maintenance agreement would have similar terms as the Second Lien Note; however, the interest rate on such additional loans can not exceed 18.0%.

The Company incurred debt issuance costs of \$0.9 million in connection with the US Bank credit agreement and the Second Lien Note. These costs are being amortized to interest expense over the term of the financing arrangement.

***6. Restructuring Activities***

The Company periodically takes actions to reduce costs and increase capacity utilization through the closure of facilities and reductions in workforce. The results of operations related to these activities for the quarters ended April 3, 2005 and April 2, 2006, are summarized as follows:

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
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	2005	2006
<b>Amounts related to manufacturing activities and included in cost of goods sold:</b>		
Severance and retention costs	\$ 239	\$ 62
Lease exit costs	142	7
Moving and relocation costs		7
Total included in cost of goods sold	381	76
<b>Amounts unrelated to manufacturing activities and excluded from cost of goods sold:</b>		
Severance and retention costs	7	107
Lease exit costs	12	10
Moving, relocation and other costs	7	5
Total severance, retention and lease exit costs	26	122
Total Restructuring Expense	\$ 407	\$ 198

Presented below is a description of the principal activities that resulted in the charges shown in the table above:

For the quarter ended April 3, 2005, the Company exited a warehouse in Austin, Texas. The Company entered into an agreement with the landlord whereby the Company paid \$160 as consideration for the early termination of the lease.

For the quarters ended April 3, 2005 and April 2, 2006, the Company incurred severance and retention costs of \$246 and \$169, respectively. These severance costs primarily related to the termination of executive officers of the Company and other reductions in the manufacturing workforce.

**Summary of Restructuring Liabilities.** Presented below is a summary of changes in liabilities for lease exit costs and severance and retention obligations for the quarter ended April 2, 2006:

	<b>Accrued Lease Exit Costs</b>	<b>Accrued Severance &amp; Retention</b>
Balance, December 31, 2005	\$ 616	\$ 316
Accrued expense for restructuring activities		169
Cash payments	(169)	(218)
Accretion of interest	17	
Balance, April 2, 2006	\$ 464	\$ 267



Accrued lease exit costs are expected to be paid through July 2007. As shown in the accompanying condensed consolidated balance sheet as of April 2, 2006, \$402 of this obligation is included in current liabilities and \$62 is included in long-term liabilities. The obligation for accrued severance and retention is included in accrued compensation and benefits in the Company's condensed consolidated balance sheet and is expected to be paid over the next five months.

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
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***7. Legal Proceedings***

Applied Materials, Inc. was a customer of the Company and its predecessors for over ten years. During 2003 and 2004, the Company intensified its efforts to recover costs incurred for excess and obsolete inventories for which the Company believes Applied Materials is responsible. In October 2004, Applied Materials notified the Company that it intended to transition substantially all of its business to alternative contract manufacturers and by January 2005 the business relationship with Applied Materials had substantially terminated.

In December 2004, the Company initiated litigation in Fort Bend County, Texas, seeking monetary damages against Applied Materials for expenses relating to raw materials, inventory, and capital and human resources that the Company expended in reliance upon Applied Materials' representations, in addition to other business losses. On January 14, 2005, Applied Materials filed a Complaint for Declaratory Relief in the Superior Court of the State of California. This Complaint seeks to establish that the dispute should be resolved in California and that Applied Materials is not liable for the Company's inventory costs. Applied Materials seeks recovery of its attorneys' fees but is not seeking any other claim for monetary damages. The California litigation has been stayed indefinitely, pending resolution of the Texas proceedings. On May 5, 2006, the Texas Supreme Court issued an order in favor of the Company, allowing the litigation to proceed in Fort Bend County, Texas (the location of the Company's Sugar Land, Texas facility). The trial court has ordered that discovery will proceed and a trial date will be set.

This dispute involves a potential loss contingency if the outcome of the litigation does not result in a settlement that is adequate to recover the net carrying value of the Company's inventories. Management believes that Applied Materials is responsible for the net carrying value of inventories that were purchased on behalf of Applied Materials and the Company intends to vigorously prosecute all of its claims against Applied Materials. No assurances can be made as to the final timing or outcome of this litigation. If the Company is not able to obtain a sufficient award to recover the carrying value of these inventories, the Company's financial position and results of operations could be adversely impacted.

The Company is subject to other litigation, claims and assessments that may arise in the ordinary course of its business activities. Such matters include contractual matters, employment-related issues and regulatory proceedings. Although occasional adverse decisions or settlements may occur, the Company believes that the final disposition of such matters will not have a material adverse effect on the Company's financial position, results of operations or liquidity.

***8. Assets Held for Sale***

In July 2005, the Company began seeking a buyer for its facility and adjoining land in Sugar Land, Texas. This facility consisted of a 488,000 square foot building on approximately 32 acres of land. On March 30, 2006, the Company completed the sale of the building resulting in a net selling price of \$18,238. The transaction for the sale of an adjacent land parcel closed on April 11, 2006, for an additional net selling price of \$1,433. Accordingly, the net carrying value of assets held for sale are classified as current assets in the accompanying condensed consolidated balance sheets at December 31, 2005 and April 2, 2006, respectively. Presented below is a summary of the assets that were held for sale as of December 31, 2005 and April 2, 2006:

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(In Thousands, Except Per Share Amounts)

	2005	2006
Vacant land held for sale	\$ 1,798	\$ 1,198
Building and improvements	18,477	
Land associated with building	2,350	
Total	22,625	1,198
Accumulated depreciation	(3,853)	
Net Carrying Value	\$ 18,772	\$ 1,198

***9. New Accounting Standards***

In November 2004, the Financial Accounting Standards Board issued Statement No. 151, *Inventory Costs*, an amendment of ARB No.43, Chapter 4. This statement requires that abnormal amounts of idle facility expense, freight, handling costs, and wasted material be recognized as current period charges. In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company was required to adopt this statement in the first quarter of 2006. The adoption of SFAS 151 did not have a material impact on the Company's financial position, results of operations or cash flows.

In June 2005, the Financial Accounting Standards Board issued Statement No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard applies to all voluntary changes in accounting principle and changes the requirements for the accounting and reporting of a change in accounting principle. The Company was required to adopt this statement in the first quarter of 2006. The Company's results of operations and financial condition will only be impacted if the Company implements changes in accounting principles that are addressed by this standard.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and the related notes, and the other financial information included in this report, as well as the information in our Annual Report on Form 10-K for the year ended December 31, 2005.*

**Statement Regarding Forward-Looking Statements**

*This report on Form 10-Q contains forward-looking statements regarding future events, including our future financial and operational performance. Forward-looking statements include statements regarding markets for our products; trends in net sales, gross profits, and estimated expense levels; liquidity, anticipated cash needs and borrowing availability; and any statement that contains the words anticipate, believe, plan, estimate, expect, seek, and other similar expressions. The forward-looking statements included in this report reflect our current expectations and beliefs, and we do not undertake publicly to update or revise these statements, even if experience or future changes make it clear that any projected results expressed in this report, annual or quarterly reports to stockholders, press releases, or company statements will not be realized. In addition, the inclusion of any statement in this report does not constitute an admission by us that the events or circumstances described in such statement are material. Furthermore, we wish to caution and advise readers that these statements are based on assumptions that may not materialize and may involve risks and uncertainties, many of which are beyond our control, that could cause actual events or performance to differ materially from those contained or implied in these forward-looking statements. These risks and uncertainties include, but are not limited to, risks related to the realization of anticipated revenue and profitability; the ability to meet cost estimates and achieve the expected benefits associated with recent restructuring activities; trends affecting our growth; the final timing or outcome of the Applied Materials litigation and the precise amount of Suntron's recovery, if any, from this litigation; and the business and economic risks described in Item 1A of Part II herein under the caption Risk Factors.*

**Overview**

Our net sales for the first quarter of 2006 totaled \$95.8 million which reflects an increase of 15.8% over the first quarter of 2005, and 14.2% over the fourth quarter of 2005. The increase was primarily due to an expected one-time spike in sales from an industrial sector customer and strong demand from customers in our semiconductor capital equipment sector.

Our gross profit for the first quarter of 2006 improved to \$8.0 million compared to \$0.5 million in the first quarter of 2005 and \$7.0 million in the fourth quarter of 2005. Gross profit as a percentage of net sales improved to 8.4% for the first quarter of 2006, compared to 0.6% on net sales of \$82.7 million in the first quarter of 2005 and 8.3% on net sales of \$83.9 million in the fourth quarter of 2005. The improvement in gross profit for the first quarter of 2006 compared with the first quarter of 2005 was primarily attributable to the cumulative impact of restructuring and cost containment actions that were initiated throughout 2005 and supplemented by higher net sales.

Our operating income for the first quarter of 2006 was \$1.7 million, an improvement of \$7.1 million as compared to an operating loss of \$5.4 million for the first quarter of 2005. This is the second consecutive quarter of positive operating income and the fourth consecutive quarter of improvement in our operating income.

Due to the repayment of our previous credit facility, a non-cash charge to interest expense of \$1.4 million was incurred in the first quarter of 2006 for the write-off of unamortized

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debt issuance costs associated with the previous credit agreement. For the first quarter of 2006, we incurred restructuring costs of \$0.2 million, legal fees and expenses of \$0.6 million associated with ongoing litigation against Applied Materials, and we also adopted a new accounting standard for stock based compensation which resulted in a charge of \$0.2 million. Despite these significant charges, our net loss for the first quarter of 2006 improved by \$5.1 million to a net loss of \$1.1 million, compared to a net loss of \$6.2 million for the first quarter of 2005.

During the first quarter of 2006, we completed the following actions that resulted in a significant reduction in our existing debt as well as a significant step in our ongoing efforts to right-size our business:

On March 30, 2006, we sold a building and land in Sugar Land, Texas, which generated net proceeds of approximately \$16.7 million that we used to repay outstanding debt. We leased back approximately half of the building under a seven-year lease to continue our manufacturing operations at that location. In addition to the expected benefit from eliminating future interest cost due to the repayment of debt, we also expect to eliminate fixed overhead costs for real estate taxes, insurance and utilities related to the portion of the building that was not leased back.

On March 30, 2006, we entered into a \$10.0 million subordinated Note Purchase Agreement with an affiliate of our majority stockholder. In addition, the affiliate agreed to make additional subordinated loans up to \$5.0 million if we fail to comply with the financial covenants in our new credit facility. The outstanding principal balance plus all accrued interest is due in May 2009.

On March 30, 2006, we entered into a new three-year credit facility with US Bank that permits borrowings of up to \$50.0 million and matures in March 2009. As of March 30, 2006, the principal balance was approximately \$23.1 million and we had unused borrowing availability of approximately \$24.9 million.

We believe the financing actions taken in the first quarter of 2006 will provide adequate liquidity to carry out our planned activities for the next year.

We are continuing to invest in our sales and marketing efforts, and we have already begun to see benefits as evidenced by the addition of six new customers in the first quarter of 2006. In addition, we are continuing to review alternatives to further improve the utilization of our assets as we continue to execute our strategy to right-size our U.S. manufacturing footprint, and we are evaluating other actions that will reduce costs and drive sustainable improvement in our future financial performance.

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Following is an overview of the information included under each section of Management's Discussion and Analysis of Financial Condition and Results of Operations:

<b>Caption</b>	<b>Overview</b>
<b>Information About Our Business</b>	Under this section we provide information to help understand our industry conditions and information unique to our business and customer relationships.
<b>Critical Accounting Policies and Estimates</b>	This section provides details about some of the critical estimates and accounting policies that must be applied in the preparation of our financial statements. It is important to understand the nature of key uncertainties and estimates that may not be apparent solely from reading our financial statements and the related footnotes.
<b>Overview of Statement of Operations</b>	This section includes a description of the types of transactions that are included in each significant category included in our statement of operations.
<b>Results of Operations</b>	This section includes a discussion and analysis of our operating results for the first quarter of 2005 compared to the first quarter of 2006.
<b>Liquidity and Capital Resources</b>	There are several sub-captions under this section, including a discussion of our cash flows for the first quarter of 2006 and other liquidity measures that we consider important to our business. Under the sub-caption for Contractual Obligations, we discuss on- and off-balance-sheet obligations and the expected impact on our liquidity. Under the sub-caption for Capital Resources, we have included a discussion of our debt agreements, including details about interest rates charged, calculation of the borrowing base and unused availability, the potential impact of litigation with Applied Materials on our liquidity and capital resources, compliance with the financial covenant in our debt agreement, and the impact of recent actions to sell assets and enter into new debt agreements.

**Information About Our Business**

Suntron delivers complete manufacturing services and solutions to support the entire life cycle of complex products in the aerospace and defense, industrial, semiconductor capital equipment, networking and telecommunications, and medical equipment market sectors of the electronic manufacturing services (EMS) industry. We provide design and engineering services, quick-turn prototype, materials management, printed circuit board assembly and testing, electronic interconnect assemblies, subassemblies, and full systems integration (known as box-build), after-market repair and warranty services. We believe our competitive niche—low volume, high mix and complex system integration—is a direct result of our ability to provide unique solutions tailored to match each of our customer's specific requirements, while meeting the highest quality standards in the industry.

Our largest single expenditure is for the purchase of electronic components and our expertise in electronics manufacturing techniques is critical to our ability to provide competitive, quality services. However, in order to fully comprehend our business, it is also important to understand that our customers are engaged in aerospace and defense, industrial, semiconductor capital equipment, networking and telecommunications, medical equipment products, and many other industries. While our ability to compete with other companies in the EMS industry is important to our long-term success, short-term fluctuations in the demand for our manufacturing services are primarily affected by the economic conditions in the end-market sectors served by our customers. Since more than half of our customers are currently concentrated in three market

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sectors (aerospace and defense, industrial, and semiconductor capital equipment), the quarterly fluctuations in our net sales can be extremely volatile when these sectors are experiencing either rapid growth or contraction.

Many of our customers are OEMs that have designed their own products. Our customers request proposals that include key terms such as quality, delivery, and the price to purchase the materials and perform the manufacturing services to make one or more components or assemblies. Generally, the component or assembly that we manufacture is delivered to the customer where it is then integrated into their final product. We determine prices for new business with our customers by obtaining raw material quotes from our suppliers and then estimating the amount of labor and overhead that will be required to make the products.

Before we begin a customer relationship, we typically enter into arrangements that are intended to protect us in case a customer cancels an order after we purchase the raw materials to fill that order. In these circumstances, the customer is generally required to purchase the materials or reimburse us if we incur a loss from liquidating the raw materials.

The EMS industry is extremely dynamic and our customers make frequent changes to their orders. The magnitude and frequency of these changes make it difficult to predict revenues beyond the next quarter, and even relatively short-term forecasts may prove inaccurate depending on changes in economic, political, and military factors, as well as unexpected customer requests to delay shipments near the end of our fiscal quarters. These changes in customer orders also cause substantial difficulties in managing inventories, which often leads to excess inventories and the need to recognize losses on inventories. However, from time to time, we may also have difficulties obtaining certain electronic components that are in short supply. In addition, our inventories consist of over 150,000 different parts and many of these parts have limited alternative uses or markets beyond the products that we manufacture for our customers. When we liquidate excess materials through an inventory broker or auction, we often realize less than the original cost of the materials, and in some cases we determine that there is no market for the excess materials.

The most common reasons we incur losses related to inventories are due to purchasing more materials than are necessary to meet a customer's requirements or failing to act promptly to minimize losses once the customer communicates a cancellation. Occasionally, it is not clear what action caused an inventory loss and there is a shared responsibility whereby our customers agree to negotiate a settlement with us. In some cases, our customers may deny responsibility for excess inventories despite the existence of persuasive evidence that the customer was at fault; in these cases we must weigh all alternatives to resolve the dispute, including the possibility of litigation or arbitration. Accordingly, management continually evaluates inventory on-hand, forecasted demand, contractual protections, and net realizable values in order to determine whether an adjustment to the carrying amount of inventory is necessary. When the relationship with a customer terminates, we tend to be more vulnerable to inventory losses because the customer may be reluctant to accept responsibility for the remaining inventory if a product is at the end of its life cycle. We can also incur inventory losses if a customer becomes insolvent and the materials do not have alternative uses or markets into which we can sell them.

**Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these



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financial statements requires that we make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures. On an on-going basis, we evaluate our estimates, including those related to bad debts, inventories, property, plant and equipment, intangible assets, income taxes, warranty obligations, restructuring-related obligations, and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. We cannot assure you that actual results will not differ from those estimates. We believe the following critical accounting policies affect our most significant judgments and estimates used in the preparation of our condensed consolidated financial statements.

**Revenue Recognition.** We recognize revenue from manufacturing services and product sales upon shipment and transfer of title of the manufactured product, whereby our customers assume the risks and rewards of ownership of the product. Occasionally, we enter into arrangements where services are bundled and completed in multiple stages. In these cases, we follow the guidance in Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*, to determine the amount of revenue allocable to each deliverable.

Generally, there are no formal customer acceptance requirements or further obligations related to manufacturing services after shipment; however, if such requirements or obligations exist, then revenue is recognized at the point when the requirements are completed and the obligations fulfilled. If uncertainties exist about whether the customer has assumed the risks and rewards of ownership or if continuing performance obligations exist, we expand our written communications with the customer to ensure that our understanding of the arrangement is consistent with that of the customer before revenue is recognized. In limited circumstances, our customers agree to purchase products but they request that we store the physical product in our facilities. In these circumstances, revenue is only recognized when the terms of the arrangement comply with the guidance in SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*. Revenue from design, engineering, and other services is recognized as the services are performed.

**Write-Downs for Obsolete and Slow-Moving Inventories.** Our judgments about excess and obsolete inventories are especially difficult because (i) hundreds of different components may be associated with a single product we manufacture for a customer, (ii) we make numerous products for most of our customers, (iii) our customers are engaged in diverse industries, (iv) a significant amount of the parts we purchase are unique to a particular customer's orders and there are limited alternative markets if that customer's order is canceled, and (v) our customers experience dynamic business environments affected by a wide variety of economic, political, and regulatory factors. This complex environment results in positive and negative events that can change daily and which affect judgments about future demand for our manufacturing services and the amounts we can realize when it is not possible to liquidate inventories through production of finished products.

We frequently review customer demand to determine if we have excess raw materials that will not be consumed in production. In determining demand we consider firm purchase orders and forecasts of demand submitted by our customers. If we determine that excess inventories exist and that the customer is not contractually obligated for the excess inventories, we make judgments about whether unforecasted demand for those materials is likely to occur or the amount we would likely realize in the sale of this material through a broker or auction. If we

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determine that future demand from the customer is unlikely, we write down our inventories to the extent that the cost of the inventory exceeds the estimated market value. If we record a write-down to reduce the cost of inventories to market, such write-down is not subsequently reversed.

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required in future periods. Likewise, if we underestimate contractual recoveries from customers or future demand, recognition of additional gross profit may be reported as the related goods are sold. Therefore, although we make every effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand or the outcome of customer negotiations with respect to the enforcement of contractual provisions could have a significant impact on the value of our inventory and our reported operating results.

***Allowance for Doubtful Accounts Receivable.*** We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments, as well as to provide for adjustments related to pricing and quantity differences. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances would be required. When our customers experience difficulty in paying us, we estimate how much of our receivable will not be collected. These judgments are often difficult because the customer may not divulge complete and accurate information. Even if we are fully aware of the customer's financial condition it can be difficult to estimate the expected recovery and there is often a wide range of potential outcomes. Sometimes we collect receivables that we reserved for in prior periods and these recoveries are reflected as a credit to operations in the periods in which the recovery occurs. Over the past few years, we have diversified our concentration of business with our major customers and have added smaller customers that generally have higher credit risk. Accordingly, we may experience higher bad debt losses in the future.

***Restructuring Activities and Asset Impairments.*** When we undertake restructuring activities and decide to close a plant that we occupy under a non-cancelable operating lease, we are required to estimate how long it will take to locate a new tenant to sublease the facility and to estimate the rate that we are likely to receive when a tenant is located. Accordingly, we will incur additional lease exit charges in future periods if our estimates of the rate or timing of sublease payments turns out to be less favorable than our current expectations. We also consider the estimated cost of building improvements, brokerage commissions, and any other costs we believe will be incurred in connection with the subleasing process. The precise outcome of most of these factors is difficult to predict. We review our estimates at least quarterly, including consultation with our commercial real estate advisors to assess changes in market conditions, feedback from parties that have expressed interest, and other information that we believe is relevant to most accurately reflect the expected outcome of obtaining a subtenant to lease the facility. Commercial real estate conditions are currently weak in the area in which we are attempting to sublease a closed facility, and we believe our estimates have appropriately considered these conditions.

When we undergo changes in our business, including the closure or relocation of facilities, we often have equipment and other long-lived assets that are no longer needed in continuing operations. When this occurs, we are required to estimate future cash flows and if such undiscounted cash flows are less than the carrying value of the assets (or asset group, as applicable), we recognize impairment charges to reduce the carrying value to estimated fair value. The determination of future cash flows and fair value tend to be highly subjective estimates. When assets are held for sale and the actual market conditions deteriorate, or are less

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favorable than those projected by management, additional impairment charges may be required in subsequent periods.

**Contingencies.** We are subject to loss contingencies arising in the ordinary course of business. These contingencies often involve legal proceedings where the outcome is not determinable with precision until all of the facts surrounding the dispute are known to both parties and legal counsel has had the opportunity to evaluate the merits of the case. An estimated loss from contingencies such as a legal proceedings and claims brought against us is required to be accrued by a charge to income if it is probable that an asset has been impaired or a liability has been incurred and the amount of the loss can be reasonably estimated. In determining whether a loss should be accrued we evaluate, among other factors, the degree of probability of an unfavorable outcome and the ability to make a reasonable estimate of the amount of loss. Revisions in estimates related to the potential outcome of loss contingencies could have a material impact on our condensed consolidated results of operations and financial position.

From time to time, we are also subject to gain contingencies in the ordinary course of our business. Generally, it is not appropriate to record the expected outcome of a gain contingency in our financial statements until it is realized in cash.

For a detailed discussion on the application of these and other accounting policies, see Note 1 in our audited consolidated financial statements for the year ended December 31, 2005, included in our Annual Report on Form 10-K.

**Overview of Statement of Operations**

*Net sales* are recognized when title is transferred to our customers, which generally occurs upon shipment from our facilities. Net sales from design, engineering, and other services are generally recognized as the services are performed. Our sales are recorded net of customer discounts and credits taken or expected to be taken.

*Cost of goods sold* includes materials, labor, and overhead expenses incurred in the manufacture of our products. Cost of goods sold also includes charges and credits related to manufacturing operations for lease exit costs, severance and retention costs, impairment of long-lived assets, and obsolete and slow moving inventories. Many factors affect our gross profit, including fixed costs associated with plant and equipment capacity utilization, manufacturing efficiencies, changes in product mix, and production volume.

*Selling, general, and administrative expenses* primarily include the salaries for executive, finance, accounting, and human resources personnel; salaries and commissions paid to our internal sales force and external sales representatives and marketing costs; insurance expense; depreciation expense related to assets not used in manufacturing activities; bad debt charges and recoveries; professional fees for auditing and legal assistance; and general corporate expenses.

*Severance, retention, and lease exit costs* primarily relate to costs associated with the closure of administrative facilities and reductions in our administrative workforce. Severance, retention, and lease exit costs that relate to manufacturing activities are included in cost of goods sold.

*Related party management and consulting fees* consist of fees paid to affiliates of our majority stockholder. The services provided under these arrangements consist of management

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fees related to corporate development activities and consulting services for strategic and operational matters

*Interest expense* relates to our senior credit facility and other debt obligations. Interest expense also includes the amortization of debt issuance costs and unused commitment fees that are charged for the portion of our credit facility that is not used from time to time.

*Gain (Loss) on sale of assets* results from the sale of property, plant, and equipment for net proceeds that are more (less) than the net carrying value of such assets.

**Results of Operations**

Our results of operations are affected by several factors, primarily the level and timing of customer orders (especially orders from our major customers). The level and timing of orders placed by a customer vary due to the customer's attempts to balance its inventory, changes in the customer's manufacturing strategy, and variation in demand for its products due to, among other things, product life cycles, competitive conditions, and general economic conditions. In the past, changes in orders from customers have had a significant effect on our results of operations. The following table sets forth certain operating data as a percentage of net sales for the quarters ended April 3, 2005 and April 2, 2006:

	<b>2005</b>	<b>2006</b>
Net sales	100.0%	100.0%
Cost of goods sold	99.4%	91.6%
Gross profit	0.6%	8.4%
Operating expenses:		
Selling, general, and administrative expenses	6.8%	6.3%
Severance, retention, and lease exit costs	0.0%	0.2%
Related party management and consulting fees	0.2%	0.2%
Operating income (loss)	(6.4)%	1.7%

**Comparison of Quarters Ended April 3, 2005 and April 2, 2006**

**Net Sales.** Net sales increased \$13.1 million, or 15.8%, to \$95.8 million for the first quarter of 2006 from \$82.7 million for the first quarter of 2005. The increase in first quarter of 2006 net sales was primarily attributable to an increase of \$19.8 million in our net sales to customers engaged in the industrial sector (including an expected one-time spike in sales to a single customer in this sector) and \$8.1 million in net sales to customers in the semiconductor capital equipment sector. The increase in net sales was partially offset by an aggregate decrease of \$14.9 million in net sales to customers engaged in our other market sectors.

Net sales for the first quarter of 2005 and 2006 include approximately \$4.1 million and \$0.7 million, respectively, of excess inventories that were sold back to customers pursuant to provisions of our customer agreements.

For the first quarter of 2005, Honeywell accounted for 29% of our net sales. For the first quarter of 2006, Honeywell accounted for 14% of our net sales, an industrial sector customer accounted for 16% of our net sales, and a customer in our semiconductor capital equipment sector accounted for 11% of our net sales. No other customer accounted for more than 10% of our revenue for the first quarter of 2005 and 2006.

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**Gross Profit (Loss).** Our gross profit increased \$7.5 million from a profit of \$0.5 million in the first quarter of 2005 to a profit of \$8.0 million in the first quarter of 2006. Similarly, gross profit as a percentage of net sales increased from a profit of 0.6% of net sales in the first quarter of 2005 to a profit of 8.4% of net sales in the first quarter of 2006. The increase in gross profit in the first quarter of 2006 is primarily attributable to the realization of the benefits from restructuring and cost-cutting actions initiated in 2005 to reduce operating costs and supplemented by higher net sales.

For the first quarter of 2005, we incurred restructuring costs of \$0.4 million, consisting of \$0.2 million for severance costs related to terminated employees, and \$0.2 million for lease exit costs associated with the early termination of the Austin warehouse lease. For the first quarter of 2006, restructuring costs related to our manufacturing activities were insignificant.

Through the first quarter of 2006 a significant amount of equipment became fully depreciated, although many of these assets are still in service. Accordingly, depreciation expense for the first quarter of 2006 declined by approximately \$0.5 million compared to the first quarter of 2005.

Inventory write-downs decreased \$0.8 million from \$1.9 million, or 2.3% of net sales, in the first quarter of 2005 to \$1.1 million, or 1.2% of net sales, in the first quarter of 2006. In both 2005 and 2006, write-downs of excess inventories are related to a variety of customers for which we do not expect to realize the carrying value through production or other means of liquidation.

**Selling, General, and Administrative Expenses.** Selling, general, and administrative expenses ( SG & A ) increased \$0.5 million from \$5.6 million in the first quarter of 2005 to \$6.1 million in the first quarter of 2006. However, SG&A as a percentage of net sales decreased from 6.8% in the first quarter of 2005 to 6.3% in the first quarter of 2006. The increase in SG&A was primarily attributable to increases in legal and professional fees of \$0.2 million (primarily related to our lawsuit against Applied Materials), \$0.1 million in stock compensation expense (primarily due to the implementation of FAS123R), and \$0.1 million in other salaries and benefits.

**Interest Expense.** Interest expense increased approximately \$1.7 million, from \$1.1 million in the first quarter of 2005 to \$2.8 million in the first quarter of 2006, primarily due to a charge of approximately \$1.4 million to eliminate the unamortized debt issuance costs associated with the early termination of our previous credit agreement. The increase in interest expense was also attributable to higher interest rates, which was partially offset by a decrease in our weighted average borrowings. Our weighted average interest rate increased from 5.5% in the first quarter of 2005 to 9.3% in the first quarter of 2006, primarily reflecting increases in short term interest rates in the U.S. and scheduled rate increases under our previous credit agreement over the past year. Our weighted average borrowings decreased from \$60.6 million for the first quarter of 2005 to \$47.5 million for the first quarter of 2006.

**Liquidity and Capital Resources**

**Cash Flows from Operating Activities.** Net cash used by operating activities in the first quarter of 2006 was \$1.1 million, compared with net cash provided by operating activities of \$5.4 million in the first quarter of 2005. Our net loss for the first quarter of 2006 was equal to our negative operating cash flow. The principal reconciling items between our net loss and net cash used in operating activities include an increase in trade receivables of \$2.4 million, an increase in

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inventories of \$0.8 million, and a decrease in other accrued liabilities of \$3.2 million, offset by \$3.4 million of depreciation and amortization expense, an increase in accounts payable of \$1.9 million, and an increase in accrued compensation and benefits of \$1.0 million. Trade receivables increased in the first quarter of 2006 primarily due to higher net sales for the first quarter. For the first quarter of 2005, operating activities provided \$5.4 million of cash, primarily due to lower inventories and receivables associated with a significant decrease in our net sales compared to the fourth quarter of 2004 due to the loss of business with Applied Materials.

Days sales outstanding (based on annualized net sales for the quarter and net trade receivables outstanding at the end of the quarter) decreased to 51 days for the first quarter of 2006, compared to 52 days for the first quarter of 2005.

Inventories increased 1.2% to \$62.8 million at April 2, 2006, compared to \$62.0 million at December 31, 2005. For the first quarter of 2006, inventory turns (annualized cost of goods sold excluding restructuring charges of \$0.4 million for the first quarter of 2005 and \$0.1 million for the first quarter of 2006, divided by quarter-end inventories) amounted to 5.6 times per year compared to 4.7 times per year for the comparable period in 2005. The improvement in inventory turns is primarily due to our continuing focus on asset management; however, we have inventories that are subject to legal proceedings with Applied Materials and our business relationship with Applied Materials has been terminated. Due to this ongoing dispute, we expect that our inventory turns will continue to be at relatively low levels until the litigation is resolved.

***Cash Flows from Investing Activities.*** Net cash provided by investing activities for the first quarter of 2006 was \$16.0 million compared with net cash used by investing activities of \$0.3 million in the first quarter of 2005. Investing cash flows for the first quarter of 2006 included \$16.7 million of net proceeds received from the sale of our building and land in Sugar Land, Texas. In arriving at the net cash proceeds, the net selling price of \$18.2 million was reduced by a \$1.5 million cash deposit and \$0.1 million for accrued property taxes that were retained by the purchaser. We leased back approximately 50% of the building for a period of seven years. The gain on the sale of \$0.8 million was deferred and will be treated as a reduction of rent expense over the seven-year term of the lease agreement. Our cash inflows for investing activities were partially offset by payments of \$0.7 million primarily for manufacturing equipment and leasehold improvements.

The cash deposit of \$1.5 million discussed above was withheld from the building sale proceeds to secure the Company's obligations under the lease. The lease also required the issuance of letters of credit for \$1.5 million and \$0.5 million. The \$1.5 million cash deposit is required to be refunded and the letters of credit are required to be canceled upon expiration of the primary lease term. However, if we achieve any one of three quarterly financial tests beginning in the second quarter of 2007, the cash deposit is refundable at the rate of \$0.2 million each quarter that one of the tests is achieved until the cash deposit (plus interest) is fully refunded. At such time that the cash deposit is fully refunded, the \$1.5 million letter of credit shall be reduced by \$0.2 million for each succeeding quarter that one of the financial tests is achieved.

Investing cash flows for the first quarter of 2005 totaled \$2.2 million of cash outflows, consisting of the payment of \$1.4 million of contingent consideration related to the 2004 earn-out associated with the acquisition of Trilogic Systems and payments of \$0.9 million primarily for manufacturing equipment and leasehold improvements for our new facility in Mexico. Our cash outflows for investing activities were partially offset by \$1.9 million of proceeds from the sale of certain equipment used for plastic injection molding and sheet metal fabrication.

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**Cash Flows from Financing Activities.** Net cash used by financing activities in the first quarter of 2006 was \$14.8 million, compared with net cash used by financing activities of \$5.1 million in the first quarter of 2005. Financing cash flows in the first quarter of 2006 reflect the net repayment of debt of \$14.1 million and payment of \$0.8 million of debt issuance costs associated with the new credit agreement with US Bank and the Second Lien Note with an affiliate of our majority stockholder.

Financing cash flows in the first quarter of 2005 reflect the net repayment of debt of \$4.4 million, payment of \$0.1 million of debt issuance costs, and a decrease in outstanding checks in excess of cash balances of \$0.6 million.

**Contractual Obligations.** The following table summarizes our contractual obligations as of April 2, 2006:

	Debt Agreements(1)	Operating Leases (2)	Purchase Obligations (3)	Other (4)	Total
(Dollars in Table are in Millions)					
Year ending March 31:					
2007	\$ 25.1	\$ 5.9	\$ 39.7	\$ 0.3	\$ 71.0
2008		4.2	0.1		4.3
2009		3.2			3.2
2010	10.0	2.9			12.9
2011		2.7	0.3		3.0
After 2012		4.0			4.0
	\$ 35.1	\$ 22.9	\$ 40.1	\$ 0.3	\$ 98.4

(1) Includes outstanding letters of credit of \$2.0 million and outstanding borrowings under our US Bank revolving credit agreement of \$23.1 million. The US Bank credit agreement expires in March 2009 but all borrowings are classified as current liabilities due to the lenders requirement for a lockbox arrangement. Also includes \$10.0 million under a subordinated Note Purchase Agreement with an affiliate of our majority stockholder that is due in May 2009.

(2) Includes an aggregate of \$0.8 million, which has been included in the determination of our liability for lease exit costs that is recorded on our condensed consolidated balance sheet at April 2, 2006. U.S. generally accepted accounting principles require that we record a liability for future lease payments, net of estimated sublease rentals, for facilities that we have closed.

(3) Consists of obligations under outstanding purchase orders. Approximately 86% of the deliveries under outstanding purchase orders are expected to be received in the second quarter of 2006. We often have the ability to cancel these obligations if we provide sufficient notice to our suppliers.

(4) Consists of \$0.3 million payable under agreements for the acquisition of manufacturing equipment.

**Capital Resources.** Our working capital at April 2, 2006 totaled \$43.8 million compared to \$33.9 million at December 31, 2005. At December 31, 2005, we had a \$75.0 million revolving credit facility with two financial institutions. In January 2006, we entered into an amendment to this credit agreement that provided for a more favorable customer concentration limit for receivables from a significant customer and also delayed certain scheduled reductions in advance rates for real estate and equipment. Additionally, an affiliate of our largest stockholder agreed to

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amend the participation agreement entered into in August 2005 to provide an additional \$5.0 million to the lenders on January 31, 2006 in exchange for an immediate increase in our borrowing availability of \$5.0 million.

Although this credit agreement did not expire until July 2008, customer concentration limits and future scheduled reductions in the advance rates for machinery, equipment and real estate made this facility unattractive to fund our planned activities through the maturity date. Accordingly, on March 30, 2006, we terminated this credit agreement and, as discussed below, we entered into new debt agreements with US Bank and with an affiliate of our majority stockholder. Due to the early termination of the previous credit agreement, we recognized a charge to interest expense of approximately \$1.4 million to write-off the remaining unamortized debt issuance costs in the first quarter of 2006.

In January 2006, we obtained approval from our board of directors and lenders to enter into two separate agreements to sell our building and adjoining land in Sugar Land, Texas. We were able to structure the sale of the building with a concurrent agreement to leaseback approximately 50% of the building, which permits our current business operations in Sugar Land to continue without interruption. The sale of the building was completed on March 30, 2006 and resulted in a net selling price of \$18.2 million and a gain on the sale of approximately \$0.8 million.

Concurrent with the building sale, we leased back approximately 50% of the building for a period of seven years. The annual rental payments under this lease are approximately \$1.5 million. The gain on the sale was deferred and is being accounted for as a reduction of rent expense over the seven-year term of the lease agreement. A cash deposit of \$1.5 million was withheld from the building sale proceeds to secure our obligations under the lease. The lease also required the issuance of letters of credit for \$1.5 million and \$0.5 million. The \$1.5 million cash deposit is required to be refunded and the letters of credit are required to be canceled upon expiration of the primary lease term. However, if we achieve any one of three quarterly financial tests beginning in the second quarter of 2007, the cash deposit is refundable at the rate of \$0.2 million each quarter that one of the tests is achieved until the cash deposit (plus interest) is fully refunded. At such time that the cash deposit is fully refunded, the \$1.5 million letter of credit shall be reduced by \$0.2 million for each succeeding quarter that one of the financial tests is achieved .

On March 30, 2006, we entered into a three-year credit agreement with US Bank National Association ( US Bank ). The US Bank credit agreement provides for a \$50.0 million commitment under a revolving credit facility that matures in March 2009. We have the option to terminate the credit agreement before the maturity date with a prepayment penalty of 1.0% of the commitment amount if the prepayment occurs before November 30, 2008. Under the terms of the US Bank credit agreement, we can initially elect to incur interest at a rate equal to either (a) the Prime Rate plus 0.50% or (b) the LIBOR Rate plus 3.00%. These rates can be reduced in the future by up to 0.50% for Prime Rate borrowings and 0.75% for LIBOR Rate borrowings depending on our adjusted fixed charge coverage ( FCC ) ratio, as defined in the credit agreement. As of April 2, 2006, the interest rate for Prime Rate borrowings was 8.25% and no LIBOR Rate borrowings were outstanding. In addition, we are obligated to pay a commitment fee of 0.25% per annum for the unused portion of the credit agreement.

Substantially all of our assets are pledged as collateral for outstanding borrowings under the US Bank credit agreement. The credit agreement also limits or prohibits the Company from paying dividends, incurring additional debt, selling significant assets, acquiring other businesses, or merging with other entities without the consent of the lenders. The credit agreement requires



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compliance with certain financial and non-financial covenants, including a quarterly adjusted FCC ratio beginning in the second quarter of 2006.

Similar to our previous credit agreement, the US Bank credit agreement includes a lockbox arrangement that requires us to direct our customers to remit payments to restricted bank accounts, whereby all available funds are used to pay down the outstanding principal balance under the amended credit agreement. Accordingly, the entire outstanding principal balance under both credit agreements is classified as a current liability in our condensed consolidated balance sheets.

Total borrowings under the US Bank credit agreement are subject to limitation based on a percentage of eligible accounts receivable and inventories. Accordingly, our borrowing availability generally decreases as our net receivables and inventories decline. As of April 2, 2006, the borrowing base calculation permitted total borrowings of \$50.0 million. After deducting the outstanding principal balance of \$23.1 million and outstanding letters of credit of \$2.0 million, we had borrowing availability of \$24.9 million as of April 2, 2006.

On March 30, 2006, we also entered into a \$10.0 million subordinated Note Purchase Agreement (the Second Lien Note ) with an affiliate of our majority stockholder. The Second Lien Note is collateralized by a second priority interest in substantially all of the collateral under the US Bank credit agreement. The Second Lien Note is subordinated in right of payment to the obligations under the US Bank credit agreement and provides for a maturity date that is 45 days after the maturity date of the US Bank credit agreement. The Second Lien Note provides for an interest rate of 16.0%, payable quarterly in kind (or payable in cash with written approval from US Bank). We have the option to prepay the Second Lien Note with a prepayment penalty up to 3.0% of the then outstanding principal balance. If the note is paid on the maturity date, a fee equal to 2.0% of the then outstanding principal balance is due. Accordingly, we are recording interest expense related to this 2.0% fee using the effective interest method.

In connection with the US Bank credit agreement, an affiliate of our majority stockholder also agreed to enter into an FCC maintenance agreement that requires the affiliate to make up to an additional \$5.0 million of subordinated loans to us if the FCC is below a prescribed level. Loans pursuant to the FCC maintenance agreement would have similar terms as the Second Lien Note; however, the interest rate on such additional loans can not exceed 18.0%.

We incurred debt issuance costs of \$0.9 million in connection with the US Bank credit agreement and the Second Lien Note. These costs are being amortized to interest expense over the term of the financing arrangement.

During 2002, 2003 and 2004, we exercised our rights to require our customers (including Applied Materials) to purchase excess inventories totaling \$24.2 million, \$8.2 million and \$9.2 million, respectively, under relevant provisions of our customer agreements. Applied Materials was a customer of Suntron and its predecessors for over ten years. During 2003 and 2004 we intensified our efforts to recover costs incurred for excess and obsolete inventories. In October 2004, Applied Materials notified us that it intended to transition substantially all of its business to alternative contract manufacturers and by January 2005 our business relationship with Applied Materials had substantially terminated. In December 2004, we initiated litigation in Fort Bend County, Texas, seeking monetary damages against Applied Materials for expenses relating to raw materials, inventory, and capital and human resources that we expended in reliance upon Applied Materials' representations, in addition to other business losses. On January 14, 2005, Applied Materials filed a Complaint for Declaratory Relief in the Superior Court of the State of

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California. Applied Materials' Complaint seeks to establish that the dispute should be resolved in California and that it is not liable for Suntron's inventory costs. Applied Materials seeks recovery of its attorneys' fees but is not seeking any other claim for monetary damages. The California litigation has been stayed indefinitely, pending resolution of the Texas proceedings. On May 5, 2006, the Texas Supreme Court issued an order in favor of the Company, allowing the litigation to proceed in Fort Bend County, Texas (the location of our Sugar Land, Texas facility). The trial court has ordered that discovery will proceed and a trial date will be set.

Our dispute involves a potential loss contingency if the outcome of the litigation does not result in a settlement that is adequate to recover the net carrying value of our inventories. Similar to the process employed for all of our customers, we evaluated excess inventories for Applied Materials on a quarterly basis and write-downs were recognized in the period when we determined that recovery was not appropriate based on the applicable written agreements. We believe that Applied Materials is responsible for the net carrying value of inventories that we purchased on its behalf and we intend to vigorously prosecute all of our claims. No assurances can be made as to the final timing or outcome of the litigation. In connection with this litigation, we currently expect to incur attorneys' fees and related costs of up to \$1.5 million during the remainder of 2006.

***EBITDA Financial Covenant.*** The primary measure of our operating performance is net income (loss). However, our lenders and many investment analysts believe that other measures of operating performance are relevant. One of these alternative measures is Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Management emphasizes that EBITDA is a non-GAAP measurement that excludes many significant items that are also important to understanding and assessing Suntron's financial performance. Additionally, in evaluating alternative measures of operating performance, it is important to understand that there are no standards for these calculations. Accordingly, the lack of standards can result in subjective determinations by management about which items may be excluded from the calculations, as well as the potential for inconsistencies between different companies that have similarly titled alternative measures. In order to illustrate our EBITDA calculations, we have provided the details below of the calculations for the quarters ended April 3, 2005 and April 2, 2006 using a traditional definition, as well as the calculation pursuant to the definition in our revolving credit agreement. Our lenders modified the traditional definition of EBITDA to exclude certain operating charges that may be considered unlikely to recur in the future or that may be excluded due to a variety of other reasons. As shown below, the measure of EBITDA under a traditional definition differs materially from the calculation of EBITDA under our revolving credit agreement:

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	<b>For the Quarter Ended:</b>	
	<b>April 3, 2005</b>	<b>April 2, 2006</b>
	<b>(Dollars in Millions)</b>	
Net loss	\$ (6.2)	\$ (1.1)
Income tax expense		
Interest expense	1.1	2.8
Depreciation and amortization	2.1	1.6
EBITDA per traditional definition	(3.0)	3.3
Restructuring costs <b>(A)</b>	0.4	0.2
Other charges <b>(B)</b>	1.0	0.8
EBITDA per credit agreement definition	\$ (1.6)	\$ 4.3

**(A)** Restructuring costs include lease exit costs, and severance, retention, and moving costs related to facility closures and other reductions in workforce.

**(B)** Includes stock-based compensation expense, net gains from disposition of capital assets, and charges related to outstanding litigation related to termination of our business relationship with Applied Materials.

**Impact of Recently Issued Accounting Standards**

In November 2004, the Financial Accounting Standards Board issued Statement No. 151, *Inventory Costs*, an amendment of ARB No.43, Chapter 4. This statement requires that abnormal amounts of idle facility expense, freight, handling costs, and wasted material be recognized as current period charges. In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. We were required to adopt this statement in the first quarter of 2006. The adoption of SFAS 151 did not have a material impact on our financial position, results of operations or cash flows.

In June 2005, the Financial Accounting Standards Board issued Statement No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20 and FASB Statement No. 3. This standard applies to all voluntary changes in accounting principle and changes the requirements for the accounting and reporting of a change in accounting principle. We were required to adopt this statement in the first quarter of 2006. Our results of operations and financial condition will only be impacted if we implement changes in accounting principles that are addressed by this standard.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

As of April 2, 2006, we have a revolving line of credit that provides for total borrowings of up to \$50.0 million. The interest rate under this agreement is based on the prime rate and LIBOR rates, plus applicable margins. Therefore, as interest rates fluctuate, we will experience changes in interest expense that will impact financial results. We have not entered into any interest rate swap agreements, or similar instruments, to protect against the risk of interest rate fluctuations. Assuming outstanding borrowings of \$50.0 million, if interest rates were to increase or decrease by one percentage point, the result would be an increase or decrease in annual interest expense of \$0.5 million. Accordingly, significant increases in interest rates could have a material adverse effect on the Company's future results of operations.

**Item 4. Controls and Procedures**

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we have evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15 as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended April 2, 2006, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Disclosure controls and procedures are designed to ensure that information required to be disclosed in our 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. Disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information reported under Item 3, Legal Proceedings, of our 2005 Annual Report on Form 10-K is incorporated herein by reference. In addition, on May 5, 2006, the Texas Supreme Court issued an order in favor of the Company, allowing the litigation to proceed in Fort Bend County, Texas (the location of our Sugar Land, Texas facility). The trial court has ordered that discovery will proceed and a trial date will be set.

There are no other legal proceedings to which we are a party or to which any of our properties are subject, that we expect to have a material adverse effect on our Company.

**Item 1A. Risk Factors**

*An investment in our common stock involves a high degree of risk. You should carefully consider the factors described below, in addition to those discussed elsewhere in this report, in analyzing an investment in our common stock. If any of the events described below occur, our business, financial condition, and results of operations could likely deteriorate, the trading price of our common stock could fall, and you could lose all or part of the money you paid for our common stock. In addition, the following factors could cause our actual results to differ materially from those projected in our forward-looking statements, whether made in this Form 10-Q, our annual or quarterly reports to stockholders, future press releases, other SEC filings, or orally, whether in presentations, responses to questions, or otherwise. See Statement Regarding Forward-Looking Statements.*

**Our level of indebtedness could adversely affect our financial viability, and the restrictions imposed by the terms of our debt instruments may severely limit our ability to plan for or respond to changes in our business.**

As of April 2, 2006, we had outstanding bank debt of approximately \$23.1 million, outstanding letters of credit of \$2.0 million, and subordinated debt payable to an affiliate of our majority stockholder of \$10.0 million. In addition, subject to the restrictions under our debt agreements, we may incur significant additional indebtedness from time to time to finance capital expenditures, business acquisitions, or for other purposes.

Significant levels of debt could have negative consequences. For example, it could:

require us to dedicate a substantial portion of our cash flow from operations to service interest and principal repayment requirements, limiting the availability of cash for other purposes;

increase our vulnerability to adverse general economic conditions by making it more difficult to borrow additional funds to maintain our operations if our revenues decrease;

limit our ability to attract new customers if we do not have sufficient liquidity to meet working capital needs; and

hinder our flexibility in planning for, or reacting to, changes in our business and industry if we are unable to borrow additional funds to upgrade our equipment or facilities.

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**We may need additional capital in the future and it may not be available on acceptable terms, or at all.**

We may need to raise additional funds for the following purposes:

to fund working capital requirements for future growth that we may experience;

to enhance or expand the range of services we offer, including required capital equipment needs;

to increase our promotional and marketing activities; or

to respond to competitive pressures or perceived opportunities, such as investment, acquisition, and international expansion activities.

If such funds are not available when required or on acceptable terms, our business and financial results could deteriorate.

**We experience significant volatility in our net sales, which leads to significant operating inefficiencies and the potential for significant charges.**

Over the past five fiscal years, our quarterly net sales have fluctuated from a low of \$74.8 million in the second quarter of 2003 to a high of \$197.9 million in the first quarter of 2001. During periods of rapidly declining net sales, we generally take actions to eliminate variable and fixed costs, which often results in significant restructuring charges. When our net sales decline significantly, it is difficult to operate our plants profitably because it is not possible to eliminate most of our fixed costs. If we believe that the decline in sales is unlikely to be followed by a rapid recovery, we may determine that there are significant benefits to reducing our cost structure by closing plants and transferring existing business to other plants that are also operating below optimal capacity levels. However, there can be no assurance that customers impacted by a restructuring will agree to transition their business to another Suntron location. In order to realize the long-term benefits of these actions, we usually incur substantial charges for impairment of assets, lease exit costs, and the payment of severance and retention benefits to affected employees. In addition to the up-front costs associated with these actions, the transition of inventory and manufacturing services to a different facility can result in: 1) quality and delivery issues that may have an adverse impact in retaining customers that are affected by the plant closure and 2) ramp-up costs and manufacturing inefficiencies that could impact our gross profit levels. Our results of operations could also be materially and adversely affected by our inability to timely sell or sublet closed facilities on expected terms, or otherwise achieve the expected benefits of our restructuring activities.

During periods of rapidly increasing net sales, we often experience inefficiencies related to hiring and training workers, as well as incremental costs incurred to expedite the purchase and delivery of raw materials and overtime costs related to our workforce. Periods of rapid growth tend to stress our resources and we may not have sufficient capacity to meet our customers' delivery requirements. Significant increases in net sales are typically accompanied by corresponding increases in inventories and receivables that must be financed with borrowings under our revolving credit agreement.

**We are dependent upon the highly competitive electronics industry, and excess capacity or decreased demand for products produced by this industry could result in increased price competition as well as a decrease in our gross margins and unit volume sales.**

Our business is heavily dependent on the EMS industry, which is extremely competitive and includes hundreds of companies. The contract manufacturing services we provide are

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available from many independent sources, and we compete with numerous domestic and foreign EMS firms, including Benchmark Electronics, Inc.; Celestica Inc; Flextronics International Ltd.; Jabil Circuit, Inc.; Pemstar, Inc.; Plexus Corp.; Sanmina-SCI Corporation; SMTC Corporation; Solectron Corporation; Sypris Electronics, LLC; and others. Many of such competitors are more established in the industry and have greater financial, manufacturing, or marketing resources than we do. We may be operating at a cost disadvantage as compared to our competitors that have greater direct buying power from component suppliers, distributors, and raw material suppliers and have lower cost structures. In addition, many of our competitors have a broader geographic presence, including manufacturing facilities in Asia, Europe, and South America.

We believe that the principal competitive factors in our targeted market are quality, reliability, the ability to meet delivery schedules, technological sophistication, geographic location, and price. We also face competition from our current and potential customers, who are continually evaluating the relative merits of internal manufacturing versus contract manufacturing for various products. As stated above, the price of our services is often one of many factors that may be considered by prospective customers in awarding new business. We believe existing and prospective customers are placing greater emphasis on contract manufacturers that can offer manufacturing services in low cost regions of the world, such as certain countries in Asia. Accordingly, in situations where the price of our services is a primary driver in prospective customers' decision to award new business, we currently believe we may have a competitive disadvantage in these circumstances.

Our net sales are generated from the aerospace and defense, industrial, semiconductor capital equipment, networking and telecommunications, and medical sectors of the EMS industry, which is characterized by intense competition and significant fluctuations in product demand. Furthermore, these sectors are subject to economic cycles and have experienced in the past, and are likely to experience in the future, recessionary economic cycles. A recession or any other event leading to excess capacity or a downturn in these sectors of the EMS industry typically results in intensified price competition as well as a decrease in our unit volume sales and our gross margins.

**We are dependent upon a small number of customers for a large portion of our net sales, and a decline in sales to major customers could harm our results of operations.**

A small number of customers are responsible for a significant portion of our net sales. For the year ended December 31, 2005, Honeywell accounted for 25% of our net sales. For the first quarter of 2006, Honeywell accounted for 14% of our net sales, an industrial sector customer accounted for 16% of our net sales, and a customer in our semiconductor capital equipment sector accounted for 11% of our net sales.

Our customer concentration could increase or decrease depending on future customer requirements, which will depend in large part on business conditions in the market sectors in which our customers participate. The loss of one or more major customers or a decline in sales to our major customers could significantly harm our business and results of operations. If we are not able to expand our customer base, we will continue to depend upon a small number of customers for a significant percentage of our sales. There can be no assurance that current customers will not terminate their manufacturing arrangements with us or significantly change, reduce, or delay the amount of manufacturing services ordered from us.

In addition, we generate significant accounts receivable in connection with providing manufacturing services to our customers. From time to time we agree to accept orders from

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smaller, less creditworthy customers. While losses due to credit risk have not been a significant factor in the past, this trend may not continue in the future as we continue to diversify our major customer concentration with orders from smaller customers. If delinquencies related to our receivables increase in the future, this could adversely affect our borrowing capacity because accounts that are aged more than 90 days from the invoice date are ineligible for the borrowing base calculation under our credit agreement. Finally, if one or more of our significant customers were to become insolvent or were otherwise unable to pay for our services, our results of operations could deteriorate substantially.

**Our financial condition could suffer if we fail to obtain a sufficient award in pending litigation.**

In December 2004 and February 2005, we filed lawsuits in Texas and California that seek, through the enforcement of contractual provisions or based upon tort theories, to recover in excess of \$20 million of costs incurred for excess and obsolete inventories; additional charges for carrying costs, warehousing costs, cancellation charges, and employee termination costs; plus punitive damages, interest and legal fees. Although we are vigorously pursuing our claims, this litigation is in a very early stage and we cannot predict the outcome. If we are not able to obtain a sufficient award to recover the carrying value of these inventories, our business, operating results, and financial condition could be adversely impacted.

**Our customers may cancel their orders, change production quantities, or delay production.**

EMS providers must provide increasingly rapid product turnaround for their customers. We generally do not obtain firm, long-term purchase commitments from our customers, and we expect to continue to experience reduced lead-times for customer orders. Customers may cancel their orders, change production quantities, or delay production for a number of reasons. Cancellations, reductions, or delays by a significant customer or by a group of customers could seriously harm our results of operations. When customer orders are changed or cancelled, we may be forced to hold excess inventories and incur carrying costs as a result of delays, cancellations, or reductions in orders or poor forecasting by our key customers.

In addition, we make significant decisions, including determining the levels of business that we seek and accept, production schedules, component procurement commitments, personnel needs, and other resource requirements based on estimates of customer production requirements. The short-term nature of our customers' commitments to us, combined with the possibility of rapid changes in demand for their products, reduces our ability to accurately estimate future customer orders. In addition, because many of our costs and operating expenses are relatively fixed, a reduction in customer demand generally harms our operating results.

**If we are unable to respond to rapid technological change and process development, we may not be able to compete effectively.**

The market for our products and services is characterized by rapidly changing technology and continual implementation of new production processes. The future success of our business will depend in large part upon our ability to maintain and enhance our technological capabilities, to develop and market products that meet changing customer needs, and to successfully anticipate or respond to technological changes on a cost-effective and timely basis. We expect that the investment necessary to maintain our technological position will increase as customers make demands for products and services requiring more advanced technology on a quicker turnaround basis.



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In addition, the EMS industry could encounter competition from new or revised manufacturing and production technologies that render existing manufacturing and production technology less competitive or obsolete. We may not be able to respond effectively to the technological requirements of the changing market. If we need new technologies and equipment to remain competitive, the development, acquisition and implementation of those technologies may require us to make significant capital investments.

**Operating in foreign countries exposes us to increased risks that could adversely affect our results of operations.**

We have had operations in Mexico since 1999 and we may in the future expand into other foreign countries. Because of the scope of our international operations, we are subject to the following risks, which could adversely impact our results of operations:

economic or political instability;

transportation delays and interruptions;

increased employee turnover and labor unrest;

incompatibility of systems and equipment used in foreign operations;

foreign currency exposure;

difficulties in staffing and managing foreign personnel and diverse cultures; and

less developed infrastructures.

In addition, changes in policies by the United States or foreign governments could negatively affect our operating results due to increased duties, increased regulatory requirements, higher taxation, currency conversion limitations, restrictions on the transfer of funds, the imposition of or increase in tariffs, and limitations on imports or exports. Also, we could be adversely affected if our host countries revise their policies away from encouraging foreign investment or foreign trade, including tax holidays.

**If we are unsuccessful in managing future opportunities for growth, our results of operations could be harmed.**

Our future results of operations will be affected by our ability to successfully manage future opportunities for growth. Rapid growth, such as that experienced for 2004, is likely to place a significant strain on our managerial, operational, financial, and other resources. If this growth continues, it may require us to implement additional management information systems, to further develop our operating, administrative, financial, and accounting systems and controls and to maintain close coordination among our accounting, finance, sales and marketing, and customer service and support departments. In addition, we may be required to retain additional personnel to adequately support our growth. If we cannot effectively manage periods of rapid growth in our operations, we may not be able to continue to grow, or we may grow at a slower pace. Any failure to successfully manage growth and to develop financial controls and accounting and operating systems or to add and retain personnel that adequately support growth could harm our business and financial results.

**Our results of operations are affected by a variety of factors, which could cause our results of operations to fail to meet expectations.**

We have experienced large variations in our quarterly results of operations, and we may continue to experience significant fluctuations from quarter to quarter. Our results of operations are affected by a number of factors, including:

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timing of orders from and shipments to major customers;

mix of products ordered by major customers;

volume of orders as related to our capacity at individual locations;

pricing and other competitive pressures;

component shortages, which could cause us to be unable to meet customer delivery schedules;

our ability to minimize excess and obsolete inventory exposure;

our ability to manage the risks associated with uncollectible accounts receivable;

our ability to manage effectively inventory and fixed asset levels; and

timing and level of goodwill and other long-lived asset impairments.

**We are dependent on limited and sole source suppliers for electronic components and may experience component shortages, which could cause us to delay shipments to customers.**

We are dependent on certain suppliers, including limited and sole source suppliers, to provide critical electronic components and other materials for our operations. At various times, there have been shortages of some of the electronic components we use, and suppliers of some components have lacked sufficient capacity to meet the demand for these components. For example, from time to time, some components we use, including semiconductors, capacitors, and resistors, have been subject to shortages, and suppliers have been forced to allocate available quantities among their customers. Such shortages have disrupted our operations in the past, which resulted in incomplete or late shipments of products to our customers. Our inability to obtain any needed components during future periods of allocations could cause delays in shipments to our customers. The inability to make scheduled shipments could in turn cause us to experience a shortfall in revenue. Component shortages may also increase our cost of goods sold due to premium charges we may pay to purchase components in short supply. Accordingly, even though component shortages have not had a lasting negative impact on our business, component shortages could harm our results of operations for a particular fiscal period due to the resulting revenue shortfall or cost increases and could also damage customer relationships over a longer-term period.

**We depend on our key personnel and may have difficulty attracting and retaining skilled employees.**

Our future success will depend to a significant degree upon the continued contributions of our key management, marketing, technical, financial, accounting, and operational personnel. The loss of the services of one or more key employees could have a material adverse effect on our results of operations. We also believe that our future success will depend in large part upon our ability to attract and retain additional highly skilled managerial and technical resources. Competition for such personnel is intense. There can be no assurance that we will be successful in attracting and retaining such personnel. In addition, recent and potential future facility shutdowns and workforce reductions may have a negative impact on employee recruiting and retention.

**Our manufacturing processes depend on the collective EMS industry experience of our employees. If these employees were to leave and take this knowledge with them, our manufacturing processes may suffer and we may not be able to compete effectively.**

We have no patent or trade secret protection for our manufacturing processes and we generally do not enter into non-compete agreements with our employees. We rely on the

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collective experience of our employees to ensure that we continuously evaluate and adopt new technologies in our industry. Although we are not dependent on any one employee or a small number of employees, if a significant number of employees involved in our business were to leave our employment and we are not able to replace these people with new employees with comparable experience, our results of operations may deteriorate. As a result, we may not be able to continue to compete effectively.

**Our failure to comply with the requirements of environmental laws could result in fines and revocation of permits necessary to our manufacturing processes.**

Our operations are regulated under a number of federal, state, and foreign environmental and safety laws and regulations that govern, among other things, the discharge of hazardous materials into the air and water, as well as the handling, storage, and disposal of such materials. These laws and regulations include the Clean Air Act; the Clean Water Act; the Resource Conservation and Recovery Act; and the Comprehensive Environmental Response, Compensation, and Liability Act; as well as analogous state and foreign laws. Compliance with these environmental laws is a major consideration for us because our manufacturing processes use and generate materials classified as hazardous, such as ammoniacal etching solutions, copper, and nickel. In addition, because we use hazardous materials and generate hazardous wastes in our manufacturing processes, we may be subject to potential financial liability for costs associated with the investigation and remediation of our own sites or sites at which we have arranged for the disposal of hazardous wastes, if such sites become contaminated. Even if we fully comply with applicable environmental laws and are not directly at fault for the contamination, we may still be liable. The wastes we generate include spent ammoniacal etching solutions, solder stripping solutions, and hydrochloric acid solutions containing palladium; waste water that contains heavy metals, acids, cleaners, and conditioners; and filter cake from equipment used for on-site waste treatment. We have not incurred significant costs related to compliance with environmental laws and regulations, and we believe that our operations comply with all applicable environmental laws. However, any material violations of environmental laws by us could subject us to revocation of our effluent discharge and other environmental permits. Any such revocations could require us to cease or limit production at one or more of our facilities. Even if we ultimately prevail, environmental lawsuits against us could be time consuming and costly to defend.

Environmental laws could also become more stringent over time, imposing greater compliance costs and increasing risks and penalties associated with violation. We operate in environmentally sensitive locations and are subject to potentially conflicting and changing regulatory agendas of political, business, and environmental groups. Changes or restrictions on discharge limits; emissions levels; or material storage, handling, or disposal might require a high level of unplanned capital investment or relocation. It is possible that environmental compliance costs and penalties from new or existing regulations may harm our business, financial condition, and results of operations.

**We may be subject to risks associated with acquisitions, and these risks could harm our results of operations.**

We completed two business combinations in 2002 and one each in 2003 and 2004, and we anticipate that we will seek to identify and acquire additional suitable businesses in the EMS industry. The long-term success of business combinations depends upon our ability to unite the business strategies, human resources, and information technology systems of previously separate companies. The difficulties of combining operations include the necessity of coordinating

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geographically separated organizations and integrating personnel with diverse business backgrounds. Combining management resources could result in changes affecting all employees and operations. Differences in management approach and corporate culture may strain employee relations.

Future business combinations could cause certain customers to either seek alternative sources of product supply or service, or delay or change orders for products due to uncertainty over the integration of the two companies or the strategic position of the combined company. As a result, we may experience some customer attrition.

Acquisitions of companies and businesses and expansion of operations involve certain risks, including the following:

the business fails to achieve anticipated revenue and profit expectations;

the potential inability to successfully integrate acquired operations and businesses or to realize anticipated synergies, economies of scale, or other value;

diversion of management's attention;

difficulties in scaling up production and coordinating management of operations at new sites;

the possible need to restructure, modify, or terminate customer relationships of the acquired business;

loss of key employees of acquired operations; and

the potential liabilities of the acquired businesses.

Accordingly, we may experience problems in integrating the operations associated with any future acquisition. We therefore cannot provide assurance that any future acquisition will result in a positive contribution to our results of operations. In particular, the successful combination with any businesses we acquire will require substantial effort from each company, including the integration and coordination of sales and marketing efforts. The diversion of the attention of management and any difficulties encountered in the transition process, including the interruption of, or a loss of momentum in, the activities of any business acquired, problems associated with integration of management information and reporting systems, and delays in implementation of consolidation plans, could harm our ability to realize the anticipated benefits of any future acquisition. In addition, future acquisitions may result in dilutive issuances of equity securities, the incurrence of additional debt, significant inventory write-offs, and the creation of goodwill or other intangible assets that could result in increased impairment or amortization expense.

**Failure to maintain an effective system of internal controls in accordance with Section 404 of the Sarbanes-Oxley Act could inhibit our ability to accurately report our financial results and have a material adverse impact on our business and stock price.**

Effective internal controls are necessary for us to provide reliable financial reports. We have in the past discovered, and may in the future discover, areas of our internal controls that need improvement. We have commenced documentation of our internal control procedures in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, which requires annual management assessments of the effectiveness of our internal control over financial reporting. Effective December 31, 2007, we will be required to provide a report that contains an assessment by management of the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm must attest to and

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report on both management's assessment as to whether we maintained effective internal control over financial reporting and on the effectiveness of our internal control over financial reporting. During the course of our testing we may identify deficiencies which we may not be able to remediate in time to meet the December 31, 2007 deadline imposed by the Sarbanes-Oxley Act of 2002 for compliance with the requirements of Section 404. Failure to achieve and maintain effective internal control over financial reporting could have a material adverse effect on our stock price.

**Our stock is traded on the Nasdaq SmallCap Market and if we are unable to sustain compliance with their listing requirements this could adversely impact our ability to use the capital markets to raise additional capital and our stockholders may be unable to efficiently sell their shares of our common stock.**

Our stock is currently being traded on the Nasdaq SmallCap Market. There can be no assurance that we will continue to meet the listing requirements of the Nasdaq SmallCap market, including the requirement to maintain a minimum bid price of \$1.00 per share. If we are unable to sustain compliance with their listing requirements this could adversely impact our ability to use the capital markets to raise additional capital and our stockholders may be unable to efficiently sell their shares of our common stock.

**Our stock price may be volatile, and our stock is thinly traded, which could cause investors to lose all or part of their investments in our common stock.**

The stock market may experience volatility that has often been unrelated to the operating performance of any particular company or companies. If market sector or industry-based fluctuations continue, our stock price could decline regardless of our actual operating performance, and investors could lose a substantial part of their investments. Moreover, if an active public market for our stock is not sustained in the future, it may be difficult to resell our stock.

Since March 2002 when Suntron shares began trading, the average number of shares of our common stock that traded on the Nasdaq National and SmallCap markets has been approximately 8,000 shares per day compared to 27,490,000 issued and outstanding shares as of April 2, 2006. When trading volumes are this low, a relatively small buy or sell order can result in a large percentage change in the trading price of our common stock, which may be unrelated to changes in our stock price that are associated with our operating performance.

The market price of our common stock will likely fluctuate in response to a number of factors, including the following:

- announcements about the financial performance and prospects of the industries and customers we serve;
- announcements about the financial performance of our competitors in the EMS industry;
- the timing of announcements by us or our competitors of significant contracts or acquisitions;
- failure to meet the performance estimates of securities analysts;
- changes in estimates of our results of operations by securities analysts; and
- general stock market conditions.

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**Our major stockholder controls us and our stock price could be influenced by actions taken by this stockholder. Additionally, this stockholder could prevent a change of control or other business combination, or could effect a short form merger without the approval of other stockholders.**

Thayer-Blum owns approximately 90% of our common stock, and six of our ten directors are representatives of Thayer-Blum. In addition, we recently borrowed \$10.0 million from an affiliate of Thayer-Blum. The interests of Thayer-Blum may not always coincide with those of our other stockholders, particularly if Thayer-Blum decides to sell its controlling interest. In addition, Thayer-Blum will have sufficient voting power (without the approval of Suntron's other stockholders) to elect the entire Board of Directors of Suntron and, in general, to determine the outcome of various matters submitted to stockholders for approval, including fundamental corporate transactions. Thayer-Blum could cause us to take actions that we would not consider absent Thayer-Blum's influence, or could delay, deter, or prevent a change of control or other business combination that might otherwise be beneficial to our other stockholders.

In addition, Thayer-Blum could contribute its Suntron stock to a subsidiary corporation that, as a 90% stockholder, then would have the ability under Delaware law to merge with or into Suntron without the approval of the other Suntron stockholders. In the event of such a short-form merger, Suntron stockholders would have the right to assert appraisal/dissenters' rights to receive cash in the amount of the fair market value of their shares in lieu of the consideration they would have otherwise received from the transaction.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not Applicable.

**Item 3. Defaults Upon Senior Securities**

Not Applicable.

**Item 4. Submission Of Matters To A Vote Of Security Holders**

Not Applicable

**Item 5. Other Information**

*Executive Compensation Arrangements.* On May 16, 2006, the Company entered into an Amended and Restated Employment Agreement with Hargopal Singh, the Company's President and Chief Executive Officer, pursuant to which his existing employment agreement was amended to (i) increase his base salary to \$400,000; (ii) provide for a potential 2006 performance bonus of up to \$480,000, based on achieving certain revenue, EBITDA and operational objectives established by the Compensation Committee of the Company's Board of Directors; and (iii) provide for a severance payment equal to three times the sum of his base salary and the maximum bonus payable to him by the Company for the fiscal year in which his employment is terminated, in the event that his employment is terminated within 12 months following a Change of Control (as defined in the agreement) by either (1) the Company without Cause (as defined in the agreement) or (2) Mr. Singh for Good Reason (as defined in the agreement).

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On May 16, 2006, the Company also entered into Change of Control Severance Agreements with James A. Doran and Oscar Hager, the Company's Chief Accounting Officer and Vice President of Information Technology and Administration, respectively. The Change of Control Severance Agreements provide that, in the event the executive is terminated within 12 months following a Change of Control (as defined in the Change of Control Agreement) by either (1) the Company without Cause (as defined in the Change of Control Agreement) or (2) the executive for Good Reason (as defined in the Change of Control Agreement), the executive will be entitled to receive as severance a payment equal to two times the sum of his base salary and the maximum bonus payable to him by the Company for the fiscal year in which the executive's employment was terminated.

**Item 6. Exhibits**

The following exhibits are filed with this report:

- Exhibit 10.12 Form of Change of Control Severance Agreement between Suntron Corporation and certain executives
- Exhibit 10.13 Earnest Money Contract dated effective as of December 27, 2005 by and between Suntron GCO, LP and GSL Industrial Partners, L.P.
- Exhibit 10.14 First Letter Agreement to Earnest Money Contract dated as February 2, 2006
- Exhibit 10.15 Second Letter Agreement to Earnest Money Contract dated as of March 8, 2006
- Exhibit 10.16 Third Letter Agreement to Earnest Money Contract dated as of March 17, 2006
- Exhibit 10.17 Fourth Letter Agreement to Earnest Money Contract dated as of March 22, 2006
- Exhibit 10.18 Assignment of Earnest Money Contract dated as of March 21, 2006 between Suntron GCO, LP and GSL Industrial Partners, L.P.
- Exhibit 10.19 Triple Net Industrial Lease dated effective as of March 30, 2006 by and between Suntron GCO, LP and GSL 16/VIF Gillingham, L.P.
- Exhibit 10.20 Financing Agreement dated as of March 28, 2006 by and between Suntron Corporation and U.S. Bank National Association.
- Exhibit 10.21 Note Purchase Agreement dated as of March 28, 2006 by and between Suntron Corporation and Thayer Equity Investors IV, L.P.
- Exhibit 10.22 Maintenance Agreement dated as of March 28, 2006 by and between Suntron Corporation and Thayer Equity Investors IV, L.P.

Exhibit 31.1 Certification of Chief Executive Officer pursuant to  
Section 302 of the Sarbanes- Oxley Act of 2002

Exhibit 31.2 Certification of Chief Financial Officer pursuant to  
Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32.1 Certification of Chief Executive Officer pursuant to  
Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit 32.2 Certification of Chief Financial Officer pursuant to  
Section 906 of the Sarbanes-Oxley Act of 2002

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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 undersigned, thereunto duly authorized.

**SUNTRON CORPORATION**

(Registrant)

Date: May 17, 2006

/s/ Hargopal Singh

Hargopal Singh  
*Chief Executive Officer*

Date: May 17, 2006

/s/ Thomas B. Sabol

Thomas B. Sabol  
*Chief Financial Officer*

Date: May 17, 2006

/s/ James A. Doran

James A. Doran  
*Chief Accounting Officer*

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