ENGINEERED SUPPORT SYSTEMS INC
Form 10-Q
June 14, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

Quarterly Report under Section 13 or 15 (d)
of the Securities Exchange Act of 1934

For the six months ended April 30, 2004 Commission file number 0-13880

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

Missouri	43-1313242
(State of Incorporation)	(IRS Employer Identification Number)
201 Evans Lane, St. Louis, Missouri	63121
(Address of principal executive offices)	(Zip Code)

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No

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

The number of shares of the Registrant's common stock, $.01 par value, outstanding at May 31, 2004 was 26,045,915.

ENGINEERED SUPPORT SYSTEMS, INC.

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

	April 30 2004 (Unaudited)	Oc
ASSETS		
Current Assets		
Cash and cash equivalents	$ 21,745	$
Accounts receivable	107,582	
Contracts in process and inventories	65,847	
Deferred income taxes	5,939	
Other current assets	4,735	
Total Current Assets	205,848	
Property, plant and equipment, less accumulated depreciation of $28,187 and $28,800	52,541	
Goodwill	172,200	
Acquired customer-related intangibles	37,328	
Deferred income taxes	3,897	
Other assets	12,708	
Total Assets	$484,522	$
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable	$ 56,000	$

Current maturities of long-term debt	411
Accounts payable	66,678
Other current liabilities	49,704
Total Current Liabilities	172,793
Long-term debt	754
Additional minimum pension liability	25,751
Other liabilities	13,622
Shareholders' Equity	
Common stock, par value $.01 per share; 30,000 shares authorized; 25,944 and 25,263 shares issued	259
Additional paid-in capital	126,342
Retained earnings	161,365
Accumulated other comprehensive loss	(16,364)
	271,602
Less treasury stock at cost, 0 and 561 shares	
	271,602
Total Liabilities and Shareholders' Equity	$484,522

See notes to condensed consolidated financial statements.

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

	Three Months Ended April 30		Six Months E April 30
	2004	2003	2004
Net revenues:			
Products	$137,612	$113,639	$263,199
Services	72,524	11,418	142,067
	210,136	125,057	405,266
Cost of revenues:			
Products	91,755	86,431	179,597
Services	64,956	8,843	125,973
	156,711	95,274	305,570
Gross profit	53,425	29,783	99,696
Selling, general and administrative expense	23,389	14,467	43,386
Restructuring expense	39	1,193	66

Operating income from continuing operations	29,997	14,123	56,244
Interest expense	(305)	(271)	(1,003)
Interest income	102	48	156
Gain (loss) on sale of assets	(1)		(5)
Income from continuing operations	29,793	13,900	55,392
Income tax provision	11,470	5,421	21,326
Net income from continuing operations	18,323	8,479	34,066
Income from discontinued operations, net of income tax		157	
Net income	$ 18,323	$ 8,636	$ 34,066
Basic earnings per share:			
Continuing operations	$ 0.71	$ 0.35	$ 1.34
Discontinued operations		0.01	
Total	$ 0.71	$ 0.36	$ 1.34
Diluted earnings per share:			
Continuing operations	$ 0.66	$ 0.33	$ 1.23
Discontinued operations		0.01	
Total	$ 0.66	$ 0.34	$ 1.23

See notes to condensed consolidated financial statements.

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

	Six Months End April 30
	2004
From operating activities:	
Net income from continuing operations	$ 34,066
Depreciation and amortization	6,701
(Gain) loss on sale of assets	5

Cash provided before changes in operating assets and liabilities	40,772
Net (increase) decrease in non-cash current assets	(31,732)
Net increase (decrease) in non-cash current liabilities	7,915
Decrease in other assets	3,713
Net cash provided by (used in) continuing operations	20,668
Net cash provided by discontinued operations	
Net cash provided by (used in) operating activities	20,668
From investing activities:	
Purchase of TAMSCO, net of cash acquired	(7,440)
Purchase of Pivotal, net of cash acquired	(10,064)
Purchase of UPSI, net of cash acquired	(2,026)
Purchase of EEI, net of cash acquired	(99)
Additions to property, plant and equipment	(4,124)
Proceeds from sale of property, plant and equipment	128
Net cash used in continuing operations	(23,625)
Net cash used in discontinued operations	
Net cash used in investing activities	(23,625)
From financing activities:	
Net borrowings (payments) under line-of-credit agreement	(17,100)
Payments of long-term debt	(103)
Proceeds of long-term debt	381
Purchase of treasury stock	
Exercise of stock options	37,826
Issuance of common stock to employee stock purchase plan	1,282
Cash dividends	(453)
Net cash provided by (used in) continuing operations	21,833
Net cash used in discontinued operations	
Net cash provided by (used in) financing activities	21,833
Effect of exchange rate changes on cash	(11)
Net increase in cash and cash equivalents	18,865
Cash and cash equivalents at beginning of period	2,880
Cash and cash equivalents at end of period	$ 21,745

See notes to condensed consolidated financial statements.

ENGINEERED SUPPORT SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED
FINANCIAL STATEMENTS (UNAUDITED)
(in thousands, except per share amounts)
APRIL 30, 2004

NOTE A - BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements have been prepared by Engineered Support Systems, Inc. (the Company) without audit and include the accounts of the Company and its wholly-owned subsidiaries. These subsidiaries are organized within the Company's two business segments: Support Systems and Support Services. The Support Systems segment includes the operations of Systems & Electronics Inc. (SEI), Keco Industries, Inc. (Keco), Engineered Air Systems, Inc. (Engineered Air), Engineered Coil Company, d/b/a Marlo Coil (Marlo Coil), Engineered Electric Company d/b/a Fermont (Fermont), Universal Power Systems, Inc. (UPSI), Engineered Environments, Inc. (EEI), and Pivotal Power Inc. (Pivotal Power). The Support Services segment includes the operations of Technical and Management Services Corporation (TAMSCO), Radian, Inc. (Radian) and ESSIbuy.com, Inc. (ESSIbuy). In the opinion of management, all adjustments (including normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended April 30, 2004 are not necessarily indicative of the results to be expected for the entire fiscal year.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial statements and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report to shareholders for the year ended October 31, 2003.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

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

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

(APBO) reflected in the other liabilities section of the accompanying consolidated balance sheet, and the net periodic postretirement benefit cost

(NPPBC) reflected in the accompanying consolidated statement of earnings do not reflect the effects, if any, of the Act.

NOTE B - EARNINGS PER SHARE

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

Basic earnings per share for the three months ended April 30, 2004 and 2003 is based on average basic common shares outstanding of 25,922 and 24,117, respectively. Diluted earnings per share for the three months ended April 30, 2004 and 2003 is based on average diluted common shares outstanding of 27,858 and 25,515, respectively.

Basic earnings per share for the six months ended April 30, 2004 and 2003 is based on average basic common shares outstanding of 25,489 and 23,993, respectively. Diluted earnings per share for the six months ended April 30, 2004 and 2003 is based on average diluted common shares outstanding of 27,704 and 25,389, respectively.

NOTE C - STOCK-BASED COMPENSATION

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

	Three Months Ended April 30		Six
	2004	2003	200
Reported net income from continuing operations	$18,323	$8,479	$34,0
Total stock-based employee compensation expense determined under the fair value method for all stock option awards, net of income tax	517	648	5
Pro forma net income from continuing operations	$17,806	$7,831	$33,5
Earnings per share from continuing operations:			
Basic - as reported	$ 0.71	$ 0.35	$ 1.
Basic - pro forma	$ 0.69	$ 0.32	$ 1.
Diluted - as reported	$ 0.66	$ 0.33	$ 1.
Diluted - pro forma	$ 0.64	$ 0.31	$ 1.

Historically, options granted have been fully vested at grant date.

The fair value of

options at the grant date was estimated using the Black-Scholes model with the following weighted average assumptions for the three and six months ended April 30, 2004 and 2003: an expected life of 1.5 years, volatility of 36% and 51%, a dividend yield of 0.12% and 0.16% and a risk-free interest rate of 3.25% and 3.74%, respectively. The weighted average fair value of options granted in the three and six months ended April 30, 2004 and 2003 was $7.55 and $5.11, respectively.

NOTE D - ACQUISITIONS

On May 1, 2003, the Company acquired all of the outstanding common stock of TAMSCO, a provider of information technology logistics and digitization services and a designer and integrator of telecommunication systems primarily for the U.S. Department of Defense (DoD). The purchase price was approximately $71.1 million, which is net of $0.1 million of cash acquired. Approximately $1.1 million of the purchase price has not yet been paid subject to final collection of accounts receivable. In connection with this transaction, the Company also assumed and paid $14.9 million of TAMSCO indebtedness. The purchase of TAMSCO, net of cash acquired, totals $84.9 million, which represents the $71.1 million purchase price plus assumed indebtedness of $14.9 million and less $1.1 million of purchase price not yet paid. ($84.9 million of purchase price paid through April 30, 2004 represents $77.4 million paid during the Company's year ended October 31, 2003 plus an additional $7.5 million, related to tax adjustments and accounts receivable collection, paid during the six months ended April 30, 2004).

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

The following unaudited pro forma summary presents the combined historical results of operations for the three and six month periods ended April 30, 2003 as adjusted to reflect the TAMSCO purchase transaction assuming the acquisition had occurred at November 1, 2002. These pro forma results are not necessarily indicative of the combined results that would have occurred had the acquisition actually taken place on November 1, 2002, nor are they necessarily indicative of the combined results that may occur in the future.

	Three Months Ended April 30, 2003
Net revenues	$166,150
Net income from continuing operations	$ 8,765
Basic earnings per share from continuing operations	$ 0.36
Diluted earnings per share from continuing operations	$ 0.34

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

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

On June 27, 2002, the Company acquired all of the outstanding common stock of UPSI, a provider of uninterruptible power supply systems for the DoD, intelligence agencies and commercial customers. The purchase price was approximately $5.5 million plus certain contingent cash consideration based upon UPSI's net revenue levels through two measurement dates, December 31, 2002 and October 31, 2003. Based upon UPSI's net revenue through the December 31, 2002 measurement date, $5.0 million of cash consideration was added to purchase price and paid during the year ended October 31, 2003. Based upon UPSI's net revenue through the October 31, 2003 measurement date, $2.0 million of cash consideration was added to purchase price and paid in December 2003. The fair value of the assets acquired, including goodwill of $12.5 million, was $13.6 million and liabilities assumed totaled $1.1 million. The purchase price was financed with short-term borrowings under the Company's revolving credit facility.

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

NOTE E - OTHER COMPREHENSIVE INCOME (LOSS)

The Company's other comprehensive income (loss) for the three months ended April 30, 2004 and 2003 was $(159) and $0, respectively. The Company's other comprehensive income (loss) for the six months ended April 30, 2004 and 2003 was $(222) and $177, respectively. The components of other comprehensive income (loss) include a minimum pension liability adjustment, a currency translation adjustment and an adjustment to the fair value of derivatives.

NOTE F - INTANGIBLE ASSETS

The following disclosure presents certain information on the Company's acquired intangible assets as of April 30, 2004 and October 31, 2003. All acquired intangible assets are being amortized over their estimated useful lives with no estimated residual values.

	Weighted Average Amortization Period	Gross Amount	Accumulated Amortization
Customer-related intangibles:			
April 30, 2004	12.1 years	$45,159	$7,831
October 31, 2003	5.4 years	15,300	4,251

The amortization expense related to acquired intangible assets was $2,870 for the three months ended April 30, 2004 and $3,580 for the six months ended April 30, 2004. Amortization expense related to acquired intangible assets totaled $710 for the three months ended April 30, 2003 and $1,420 for the six months ended April 30, 2003. Related estimated amortization expense is $5,982 for the year ending October 31, 2004, $4,821 for the years ending October 31, 2005 and 2006, $4,453 for the year ending October 31, 2007 and approximately $1,800 for the years ending October 31, 2008 through October 31, 2018.

NOTE G - OPERATIONAL RESTRUCTURING

During the quarter ended April 30, 2003, the Company announced a restructuring plan under which the electronics assembly work performed at the Company's Sanford, Florida facility of its SEI subsidiary would be relocated to alternate SEI facilities. Statement of Financial Accounting Standards No. 146 (SFAS 146), "Accounting for Costs Associated with Exit or Disposal Activities", applies to all disposal activities initiated after December 31, 2002 and prospectively nullifies EITF 94-3. SFAS 146 requires that a liability for employee termination costs associated with an exit or disposal activity be recognized when the liability is incurred. (EITF 94-3 had previously required that a liability for such costs be recognized at the date of the Company's commitment to an exit or disposal plan). The Company recorded expense related to this plan of $2.1 million during the year ended October 31, 2003, consisting of $1.2 million for severance and related benefits and $0.9 million for non-cash costs. The Company anticipates that it will record no additional restructuring expense related to this plan for periods ending after April 30, 2004. The plan involved the termination of 106 employees, all of which were terminated as of April 30, 2004.

During the six months ended April 30, 2004, the Company recorded the following costs in connection with this restructuring plan.

	Accrued at October 31 2003	Expensed	Utilized
Severance and related benefits	$983	$66	$995

NOTE H - DISCONTINUED OPERATIONS

During the second quarter of 2002, the Company formally adopted a plan to dispose of Engineered Specialty Plastics, Inc. (ESP), a wholly-owned subsidiary representing the entirety of the Plastic Products business segment. The Company completed the sale of ESP in the quarter ended April 30, 2003 to a private equity group. Consideration received by the Company included $4.1 million of cash, a $3.3 million two-year note from the buyers secured by the real property of ESP, and contingent consideration based upon ESP's future revenues, net of a $0.8 million working capital adjustment paid by the Company. In conjunction with the intended disposition of ESP, the Company had previously recorded an estimated loss on disposal of discontinued operations of $4.2 million during the year ended October 31, 2002 to reduce the carrying value of ESP's net assets to their estimated fair value less estimated selling costs. The completion of the sale resulted in an additional $0.2 million loss on disposal during the year ended October 31, 2003. The Company has reported the results of operations of ESP as discontinued operations for the three and six month periods ended April 30, 2003 in the Condensed Consolidated Statements of Income.

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

	Three Months Ended April 30, 2003	Six Apr
Net revenues	$4,010	
Income (loss) on discontinued operations,		

net of income tax	$ 157

NOTE I - NOTES PAYABLE

Effective April 23, 2003, the Company retired all borrowings under its existing credit facility and entered into a new bank agreement which provided a $125 million unsecured, revolving credit facility. Borrowings under the new agreement, which expires April 23, 2007, are subject to interest, at the Company's option, at either the Eurodollar rate plus an applicable margin or at the prime rate plus an applicable margin. The margin applicable to the Eurodollar rate varies from 0.875% to 1.625% and the margin applicable to the prime rate varies from 0.0% to 0.25% depending upon the Company's ratio of total indebtedness to earnings before interest, taxes, depreciation and amortization (leverage ratio). As of April 30, 2004, the Company had borrowings of $56.0 million against the new revolving credit facility.

NOTE J - CONTRACTS IN PROCESS AND INVENTORIES

Contracts in process and inventories of certain of the Company's operating subsidiaries (SEI, Engineered Air, Keco, Fermont, Radian, TAMSCO and Pivotal Power) represent accumulated contract costs, estimated earnings thereon based upon the percentage of completion method and contract inventories reduced by the contract value of delivered items. Inventories of Marlo Coil, UPSI and EEI are valued at the lower of cost or market using the first-in, first-out method. Contracts in process and inventories are comprised of the following:

	April 30, 2004	October 31, 2003
Raw materials	$ 2,407	$ 2,669
Work-in-process	3,999	2,332
Finished goods	497	185
Inventories substantially applicable to government contracts in process, less progress payments of $72,779 and $55,010	58,944	45,773
	$65,847	$50,959

NOTE K - SEGMENT INFORMATION

The Company operates in two business segments: Support Systems and Support Services. The Support Systems segment designs, engineers and manufactures integrated military electronics and other military support equipment primarily for the DoD, as well as related heat transfer and air handling equipment for domestic commercial and industrial users, and material handling equipment primarily for the U.S. Postal Service. Segment products include environmental control systems, load management and transport systems, power generation, distribution and conditioning systems, airborne radar systems, reconnaissance, surveillance and target acquisition systems, chemical and biological protection systems, petroleum and water distribution systems and other

multipurpose military support equipment. The Support Services group provides engineering services, logistics and training services, advanced technology services, asset protection systems and services, telecommunication systems integration and information technology services primarily for the DoD. The Support Services segment also provides certain power generation and distribution equipment to the DoD.

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

Total assets at April 30, 2004, by segment were $289,988 for Support Systems and $194,534 for Support Services. Goodwill by segment as of April 30, 2004 totaled $104,374 for Support Systems and $67,826 for Support Services.

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

	Three Months Ended April 30		Six
	2004	2003	2004
Net Revenues:			
Support Systems	$130,034	$101,050	$241,82
Support Services	86,515	24,758	175,65
Intersegment Revenues	(6,413)	(751)	(12,21
Total	$210,136	$125,057	$405,26
Operating Income from Continuing Operations:			
Support Systems	$ 28,340	$ 11,163	$ 47,32
Support Services	1,657	2,960	8,92
	29,997	14,123	56,24
Interest expense, net	(203)	(223)	(84

Gain (loss) on sale of assets	(1)		(
Income from continuing operations before income taxes	$ 29,793	$ 13,900	$ 55,39

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NOTE L - SHAREHOLDERS' EQUITY

The following summary presents a reconciliation of total shareholders' equity from October 31, 2003 to April 30, 2004:

Balance at October 31, 2003	$197,167
Comprehensive income:	
Net income	34,066
Currency translation adjustments	(222)
Total comprehensive income	33,844
Cash dividends	(453)
Exercise of stock options	37,826
Issuance of common stock	1,280
Issuance of treasury stock	1,938
Balance at April 30, 2004	$271,602

NOTE M - PENSION AND OTHER POSTRETIREMENT BENEFITS

The following tables detail the amount of net periodic benefit cost recognized related to the Company's pension and other postretirement benefits for the three and six month periods ended April 30, 2004 and 2003.

	Three Months Ended April 30			
	Pension Benefits		Other Postretirement Benefits	
	2004	2003	2004	2003
Service cost	$ 706	$ 546	$ 71	$ 59
Interest cost	1,743	1,255	169	155
Expected return on plan assets	(1,823)	(1,257)		
Amortization of prior service cost	148	92		
Actuarial loss (gain)	641	268	110	74
Other		7		
	$ 1,415	$ 911	$350	$288

	Six Months Ended April 30			
	Pension Benefits		Other Postretirement Benef	
	2004	2003	2004	200
Service cost	$ 1,412	$ 1,089	$142	$11
Interest cost	3,486	2,509	337	30
Expected return on plan assets	(3,646)	(2,515)		
Amortization of prior service cost	297	176		
Actuarial loss (gain)	1,282	536	221	14
Other		14		
	$ 2,831	$ 1,809	$700	$57

As of April 30, 2004, $3,850 of contributions have been made to pension and other postretirement benefit plans. The Company anticipates contributing an additional $4,179 to fund the pension and other postretirement benefit plans in 2004 for a total of $8,029.

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

CRITICAL ACCOUNTING POLICIES

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

The following analysis should be read in this context.

RESULTS OF OPERATIONS

Consolidated net revenues from continuing operations increased $85.1 million, or 68.0%, to $210.1 million in the second quarter of 2004 compared to $125.0 million in the second quarter of 2003. The increase was primarily due to the inclusion of the results of the Company's most recent acquisitions combined with solid organic revenue growth. Technical and Management Services Corporation (TAMSCO), Engineered Environments, Inc. (EEI) and Pivotal Power Inc. (Pivotal Power), each acquired within the past twelve months, generated net revenues (prior to the exclusion of intersegment revenues) of $59.3 million, $2.7 million and $2.0 million, respectively, during the second quarter of 2004. All other operating subsidiaries contributed a combined 16.9% increase in net revenues during the quarter. Gross profit from continuing operations for the three months ended April 30, 2004 increased $23.6 million, or 79.3%, to $53.4 million (25.4% of consolidated net revenues) from $29.8 million (23.8% of consolidated net revenues) in the comparable 2003 period. Contributions from the above recent acquisitions totaling $7.2 million, coupled with higher revenues and overall improved gross margins at existing business units, primarily within the Support Systems segment, drove the increase in gross profit. Selling, general and administrative expense from continuing operations increased $8.9 million, or 61.7%, in the second quarter of 2004 to $23.4 million (11.1% of consolidated net revenues) from $14.5 million (11.6% of consolidated net revenues) in the second quarter of 2003. Selling, general and administrative expense for TAMSCO, EEI and Pivotal Power accounted for $7.4 million of the $8.9 million increase. During the second quarter of 2003, the Company recorded a restructuring expense of $1.2 million related to its plan to relocate electronics assembly work performed at the Company's Sanford, Florida facility of its Systems & Electronics Inc. (SEI) subsidiary to alternate SEI facilities. As a result of the above, operating income from continuing operations increased $15.9 million, or 112.4%, in the quarter ended April 30, 2004 to $30.0 million from $14.1 million in the second quarter of 2003.

Consolidated net revenues from continuing operations increased $158.5 million, or 64.3%, to $405.3 million in the six months ended April 30, 2004 compared to $246.7 million in the first half of 2003. This increase was primarily due to the inclusion of the results of the Company's most recent acquisitions combined with solid organic revenue growth. TAMSCO, EEI and Pivotal Power generated net revenues (prior to the exclusion of intersegment revenues) of $114.6 million, $7.1 million and $3.1 million, respectively, during the six months ended April 30, 2004. All other operating subsidiaries contributed a combined 13.7% increase in net revenues during the first half of 2004. Gross profit from continuing operations for the six months ended April 30, 2004 increased $42.8 million, or 75.1%, to $99.7 million (24.6% of consolidated net revenues) from $56.9 million (23.1% of consolidated net revenues) in the comparable 2004 period.

Again, contributions from the acquisitions of TAMSCO, EEI and Pivotal Power totaling $15.9 million, along with higher revenues and overall improved gross margins at existing business units, primarily within the Support Systems segment, drove the increase in gross profit. Selling, general and administrative expense from continuing operations increased $16.0 million, or 58.5%, in the six months ended April 30, 2004 to $43.4 million (10.7% of consolidated net revenues) from $27.4 million (11.1% of consolidated net revenues) in the first half of 2003. Selling, general and administrative expense for TAMSCO, EEI and Pivotal Power accounted for $11.8 million of the $16.0 million increase. During the second quarter of 2003, the Company recorded a restructuring expense of $1.2 million related to its plan to relocate electronics assembly work performed at the Company's Sanford, Florida facility of its Systems & Electronics Inc. (SEI) subsidiary to alternate SEI facilities. As a result of the above, operating income from continuing operations increased $27.9 million, or 98.3%, in the six months ended April 30, 2004 to $55.4 million from $28.3 million in the first half of 2003.

SUPPORT SYSTEMS. Net revenues in the second quarter of 2004 for the

Support Systems segment totaled $130.0 million compared to $101.0 million (prior to the elimination of intersegment revenues in each period) for the same period in the prior year, a 28.7% increase. The improved results reflect the inclusion of a combined $4.7 million in net revenues from EEI and Pivotal Power during the second quarter and overall higher revenues at existing business units. Net organic revenue growth for the Support Systems segment during the second quarter totaled $25.3 million, an increase of 25.0%. The programs with the largest revenue gains during the quarter include $7.0 million from the Field Deployable Environmental Control Unit (FDECU), which is deployed extensively in worldwide U.S. military operations, and $18.2 million from the Manportable Surveillance and Target Acquisition Radar (MSTAR), which is serving a wide range of defense applications including base perimeter security. Comparatively lower revenue levels on the Tunner 60K Aircraft Cargo Loader/Transporter of $9.5 million partially offset these increases for the period. Gross profit for the segment increased by $18.1 million, or 76.4%, in the three months ended April 30, 2004 to $41.8 million (32.1% of segment revenues) from $23.7 million (23.4% of segment revenues) primarily on the strength of significant revenue increases. Quarterly operating income for the segment climbed to $28.3 million (21.8% of segment revenues) compared to $11.2 million (11.0% of segment revenues) last year. Incremental gross profit contributions, cost savings realized under the Company's facility rationalization initiatives and the absorption of corporate overhead costs by the Support Services business segment led to the improved results for the Support Systems segment.

Net revenues in the six months ended April 30, 2004 for the Support Systems segment totaled $241.8 million compared to $197.8 million (prior to the elimination of intersegment revenues in each period) for the first six months of 2003. The improved results reflect the inclusion of a combined $10.2 million in net revenues from EEI and Pivotal Power during the six months ended April 30, 2004 and overall higher revenues at existing business units. Net organic revenue growth for the Support Systems segment during the first half of 2004 totaled $33.8 million, an increase of 17.1%. Again, significant revenue gains from the FDECU ($14.9 million) and MSTAR ($30.8 million) programs were prime contributors to this increase. Gross profit for the segment increased by $28.1, or 61.4%, in the six months ended April 30, 2004 to $73.9 million (30.5% of segment revenues) compared to $45.8 million (23.2% of segment revenues) last year primarily on the strength of significant revenue increases. Quarterly operating

income for the segment increased to $47.3 million (19.6% of segment revenues) compared to $23.3 million (11.8% of segment revenues) in the prior year. Again, incremental gross profit contributions, cost savings realized under the Company's facility rationalization initiatives and the absorption of corporate overhead costs by the Support Services business segment led to the improved results for the Support Systems segment.

SUPPORT SERVICES. Net revenues of the Support Services segment increased to $86.5 million, an increase of $61.8 million, or 249.4%, compared to $24.8 million (prior to the elimination of intersegment revenues in each period) for the second quarter of 2003, principally due the inclusion of results from TAMSCO ($59.3 million in revenues). TAMSCO's revenues were above previous forecasts by the Company primarily due to additional activity under the eight-year, $2.9 billion ceiling Rapid Response (R2) contract. Net organic revenue growth for the Support Services segment grew 10.1% during the second quarter. This growth was generated in spite of comparatively lower revenues from the Company's Deployable Power Generation and Distribution System (DPGDS) related to the timing of order receipt and delivery requirements. DPGDS revenues are anticipated to be significantly higher in the second half of 2004. Gross profit for the segment increased by $5.5 million, or 90.2%, in the three months ended April 30, 2004 to $11.6 million (13.5% of segment revenues) from $6.1 million (24.7% of segment revenues). Task orders awarded under the R2 contract for goods and services typically carry a lower fee, or mark-up, than those projects that contain a high level of labor content. The initial purchase price allocation for TAMSCO was based on preliminary information, which was subject to adjustment upon obtaining complete valuation information. During the second quarter of 2004, the Company obtained the final valuation report from an independent third party valuation firm of the assets acquired and adjustments assumed. As a result, the Company reclassified $29.9 million from goodwill, as recorded in the preliminary allocation, to acquired customer-related intangibles and recorded a $2.2 million non-cash charge in the quarter ended April 30, 2004 to reflect amortization expense from acquisition date. Segment operating income for the first quarter of 2004 totaled $1.7 million (1.9% of segment revenues) compared to $3.0 million (12.0% of segment revenues) in the same period last year.

Net revenues for the Support Services segment increased to $175.7 million, an increase of $125.4 million, or 249.6%, compared to $50.3 million (prior to the elimination of intersegment revenues in each period) for the first half of 2003, principally due to the inclusion of results from TAMSCO ($114.6 million in revenues). TAMSCO's revenues for the six months ended April 30, 2004 were above Company forecasts primarily due to additional activity under the R2 contract. Net organic revenue growth for the Support Services segment grew 21.5% during the first six months of 2004, primarily as a result of Radian's security and asset protection service offerings and a significant increase in ESSIbuy revenues. Gross profit for the segment increased by $14.7 million, or 132.3%, in the six months ended April 30, 2004 to $25.8 million (14.7% of segment revenues) from $11.1 million (22.1% of segment revenues) in the prior year. Task orders awarded under the R2 contract typically carry a lower fee, or mark-up, than those projects that contain a high level of labor content.

Segment operating income for the first six months of 2004 totaled $8.9 million (5.1% of segment revenues) compared to $5.1 million (10.2% of segment revenues) in the same period last year.

Net interest expense was approximately the same in both the second quarter of 2004 and of 2003, and increased by $0.2 million to $0.8 million in the six months ended April 30, 2004, reflecting comparable average borrowing levels during these periods as significant operating cash flows offset the financing requirements of acquisition activities. The effective income tax rate was 38.5% for the three and six month periods ended April 30, 2004 and was 39.0% for the three and six month periods ended April 30, 2003. As a result of the foregoing, net income from continuing operations increased 116.1% to $18.3 million (8.7% of consolidated net revenues) in the quarter ended April 30, 2004 as compared to $8.5 million (6.8% of consolidated net revenues) in the second quarter of 2003. For the six months ended April 30, 2004, net income from continuing operations increased 101.3% to $34.1 million (8.4% of consolidated net revenues) from $16.9 million (6.9% of consolidated net revenues) for the first half of 2003.

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

Based on second quarter results, existing backlog and anticipated orders, the Company anticipates that 2004 revenues will approximate $840 million, and that earnings per share will approximate between $2.65 and $2.70.

RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In December 2003, the FASB issued a revision to Interpretation 46 (FIN 46R) to clarify some of the provisions of FASB Interpretation No. 46, "Consolidation of Variable

Interest Entities," and to exempt certain entities from its requirements. The adoption of FIN 46R will not have a material impact on the Company's financial statements as it does not maintain any of the interests governed by this pronouncement.

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

LIQUIDITY AND CAPITAL RESOURCES

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

Effective April 23, 2003, the Company retired all borrowings under its existing credit facility and entered into a new bank agreement which provided a $125 million unsecured, revolving credit facility. Borrowings under the new agreement, which expires April 23, 2007, are subject to interest, at the Company's option, at either the Eurodollar rate plus an applicable margin or at the prime rate plus an applicable margin. The margin applicable to the Eurodollar rate varies from 0.875% to 1.625% and the margin applicable to the prime rate varies from 0.0% to 0.25% depending upon the Company's ratio of total indebtedness to earnings before interest, taxes, depreciation and amortization (leverage ratio). As of April 30, 2004, the Company had borrowings of $56.0 million against the revolving credit facility and a cash balance of $21.7 million.

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

At April 30, 2004, the Company's working capital and ratio of current assets to current liabilities were $33.1 million and 1.19 to 1 as compared with $(30.1) million and 0.84 to 1 at October 31, 2003. The Company generated cash from continuing operations of $20.7 million in the six months ended April 30, 2004 as compared to generating $48.3 million of cash flow from continuing operations in the first six months of 2003. This decrease in operating cash flows was a result of a significant growth in accounts receivable and contract inventories relating to the Company's increasing revenue base

and to the contractual requirements of certain programs. Investment in property, plant and equipment totaled $4.1 million and $5.3 million for the first six months of 2004 and 2003, respectively. The Company anticipates that capital expenditures in 2004 should not exceed $10.0 million. Management believes that cash flow generated from operations, together with the available line of credit, will provide the necessary resources to meet the needs of the Company in the foreseeable future.

There have been no material changes in the total contractual and contingent obligations included in the Company's annual report to shareholders for the year ended October 31, 2003.

BUSINESS AND MARKET CONSIDERATIONS

Approximately 97% of consolidated net revenues from continuing operations for the six months ended April 30, 2004 were directly or indirectly derived from defense orders by the U.S. government and its agencies. As of April 30, 2004, the Company's funded backlog of orders totaled $695.1 million, with related customer options of an additional $775.3 million. These amounts compare to funded backlog of $533.4 million and related customer options of an additional $922.7 million as of October 31, 2003.

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

FORWARD-LOOKING STATEMENTS

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

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

exposure to interest rate fluctuations has had, or will have, a significant impact on the Company's operations.

ITEM 4. CONTROLS AND PROCEDURES.

As of April 30, 2004, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon the evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

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

PART II
OTHER INFORMATION

Items 1-5 Not applicable.

Item 6 Exhibits and Reports on Form 8-K.

(a) Exhibits

11. Statement Re: Computation of Earnings Per Share

31.1 Certification of Chief Executive Officer

31.2 Certification of Chief Financial Officer

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

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

(b) During the quarter ended April 30, 2004, the Company filed the following reports on Form 8-K:

(1) Form 8-K dated March 1, 2004 regarding release of the Company's financial results for the three months ended January 31, 2004

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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.

ENGINEERED SUPPORT SYSTEMS, INC.

Date: June 14, 2004

By: /s/ Gerald E. Daniels

Gerald E. Daniels
Vice Chairman and
Chief Executive Officer

Date: June 14, 2004

By: /s/ Gary C. Gerhardt

Gary C. Gerhardt
Vice Chairman and Chief
Financial Officer

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