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ESPEY MFG & ELECTRONICS CORP
Form 10-Q
November 12, 2004

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2004

Commission File Number I-4383

ESPEY MFG. & ELECTRONICS CORP.

(Exact name of registrant as specified in charter)

NEW YORK

14-1387171

(State of Incorporation)

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

233 Ballston Avenue, Saratoga Springs, New York

12866

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code

518-584-4100

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class | Outstanding at November 12, 2004 |
|-----------------------------------|----------------------------------|
| ----- | ----- |
| Common stock, \$.33-1/3 par value | 1,011,404 shares |

ESPEY MFG. & ELECTRONICS CORP.
Quarterly Report on Form 10-Q
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PART I: Financial Information

ESPEY MFG. & ELECTRONICS CORP.

Balance Sheets (Unaudited)

September 30, 2004 and June 30, 2004

A S S E T S

| | 2004 September 30, | 2004 June 30, |
|--|-----------------------|------------------|
| | ----- | ----- |
| ASSETS: | | |
| Cash and cash equivalents | \$11,873,233 | \$12,310,972 |
| Short term investments | 1,440,000 | 1,056,000 |
| Trade accounts receivable, net | 2,869,707 | 2,140,397 |
| Other receivables | 7,199 | 1,809 |
| Inventories: | | |
| Raw materials and supplies | 1,546,909 | 1,543,930 |
| Work-in-process | 3,932,555 | 3,390,133 |
| Costs relating to contracts in process, net of advance payments of \$556,150 at September 30, 2004 and \$905,646 at June 30, 2004 | 4,272,160 | 5,151,234 |
| | ----- | ----- |
| Total inventories | 9,751,624 | 10,085,297 |

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| | | |
|---|--------------|--------------|
| | ----- | ----- |
| Deferred income taxes | 76,876 | 76,876 |
| Prepaid expenses and other current assets | 271,812 | 359,393 |
| | ----- | ----- |
| Total current assets | 26,290,451 | 26,030,744 |
| | ----- | ----- |
| Property, plant and equipment, net | 3,086,555 | 3,100,516 |
| | ----- | ----- |
| Total assets | \$29,377,006 | \$29,131,260 |
| | ===== | ===== |

See accompanying notes to the financial statements.

(Continued)

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ESPEY MFG. & ELECTRONICS CORP.

Balance Sheets (Unaudited), Continued

September 30, 2004 and June 30, 2004

LIABILITIES AND STOCKHOLDERS' EQUITY

| | 2004 September 30, | 2004 June 30, |
|--|-----------------------|------------------|
| | ----- | ----- |
| LIABILITIES AND STOCKHOLDERS' EQUITY: | | |
| Accounts payable | \$ 746,732 | \$ 250,675 |
| Accrued expenses: | | |
| Salaries, wages and commissions | 61,652 | 44,519 |
| Employees' insurance costs | 8,791 | 7,487 |
| Vacation | 386,997 | 451,516 |
| Other | 54,311 | 50,370 |
| Payroll and other taxes withheld and accrued | 34,529 | 26,000 |
| Income taxes payable | 84,802 | 134,471 |
| | ----- | ----- |
| Total current liabilities | 1,377,814 | 965,038 |
| | ----- | ----- |
| Deferred income taxes | 335,047 | 324,316 |
| | ----- | ----- |
| Total liabilities | 1,712,861 | 1,289,354 |
| | ----- | ----- |
| Common stock, par value .33-1/3 per share | | |
| Authorized 10,000,000 shares; issued 1,514,937 | | |
| shares on September 30, 2004 and June 30, 2004 | | |
| Outstanding 1,010,804 and 1,014,618 on September | | |
| 30, 2004 and June 30, 2004, respectively | 504,979 | 504,979 |

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| | | |
|---|--------------|--------------|
| Capital in excess of par value | 10,410,675 | 10,411,915 |
| Retained earnings | 24,820,884 | 24,911,920 |
| | 35,736,538 | 35,828,814 |
| Less: Common stock subscribed | -- | -- |
| Cost of 504,133 and 500,319 shares on September 30, 2004 and June 30, 2004 respectively of common stock in treasury | (8,072,393) | (7,986,908) |
| Total stockholders' equity | 27,664,145 | 27,841,906 |
| Total liabilities and stockholders' equity | \$29,377,006 | \$29,131,260 |

See accompanying notes to the financial statements.

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ESPEY MFG. & ELECTRONICS CORP.

Statements of Income (Unaudited)

Three Months Ended September 30, 2004 and 2003

| | Three Months | |
|---|--------------|--------------|
| | 2004 | 2003 |
| Net sales | \$ 4,730,327 | \$ 5,095,317 |
| Cost of sales | 4,081,185 | 4,195,145 |
| Gross profit | 649,142 | 900,172 |
| Selling, general and administrative expenses | 600,679 | 549,803 |
| Operating income | 48,463 | 350,369 |
| Other income (expense) | | |
| Interest and dividend income | 34,870 | 23,365 |
| Other | 3,217 | 1,240 |
| | 38,087 | 24,605 |
| Income before income taxes | 86,550 | 374,974 |
| Provision for income taxes | 25,965 | 94,009 |
| Net income | \$ 60,585 | \$ 280,965 |

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Net income per share:

| | | |
|--|-----------|-----------|
| Basic and diluted | | |
| Net income per share | \$.06 | \$.28 |
| | ----- | ----- |
| Weighted average number of shares outstanding: | | |
| Basic | 1,013,160 | 1,016,105 |
| Diluted | 1,020,880 | 1,018,805 |
| | ===== | ===== |

See accompanying notes to the financial statements.

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ESPEY MFG. & ELECTRONICS CORP.
 Statements of Cash Flows (Unaudited)
 Three Months Ended September 30, 2004 and 2003

| | September 30, 2004 | 2003 |
|---|-----------------------|------------|
| | ----- | ----- |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 60,585 | \$ 280,965 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation | 127,722 | 122,901 |
| Deferred income tax | 10,731 | 33,200 |
| Changes in assets and liabilities: | | |
| Increase in receivables | (734,700) | (371,645) |
| Decrease in inventories | 333,673 | 631,807 |
| Decrease in prepaid expenses and other current assets | 87,581 | 27,974 |
| Increase (Decrease) in accounts payable | 496,057 | (7,273) |
| Increase in accrued salaries, wages and commissions | 17,133 | 7,060 |
| Increase in accrued employee insurance costs | 1,304 | 424 |
| Increase (Decrease) in other accrued expenses | 3,941 | (25,290) |
| Decrease in vacation accrual | (64,519) | (65,450) |
| Increase in payroll & other taxes withheld and accrued | 8,529 | 5,413 |
| Decrease in income taxes payable | (49,669) | (151,908) |
| Increase in ESOP payable | -- | 134,413 |
| | ----- | ----- |
| Net cash provided by operating activities | 298,368 | 622,591 |
| | ----- | ----- |
| Cash Flows From Investing Activities: | | |
| Additions to property, plant & equipment | (113,761) | (66,140) |
| Purchase of short term investments | (384,000) | -- |
| | ----- | ----- |
| Net cash used by investing activities | (497,761) | (66,140) |

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| | | |
|--|------------|------------|
| Cash Flows From Financing Activities: | ----- | ----- |
| Dividends on common stock | (151,621) | (632,946) |
| Purchase of treasury stock | (90,315) | (170,093) |
| Proceeds from exercise of stock options | 3,590 | 36,565 |
| | ----- | ----- |
| Net cash used in financing activities | (238,346) | (766,474) |
| | ----- | ----- |
| Decrease in cash and cash equivalents | (437,739) | (210,023) |
| Cash and cash equivalents, beginning of period | 12,310,972 | 10,996,483 |
| | ----- | ----- |
| Cash and cash equivalents, end of period | 11,873,233 | 10,786,460 |
| | ===== | ===== |
| Income Taxes Paid | \$ 64,903 | \$ 216,501 |
| | ===== | ===== |

See accompanying notes to the financial statements.

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ESPEY MFG. & ELECTRONICS CORP.

Notes to Financial Statements (Unaudited)

 Note 1. Basis of Presentation

In the opinion of management the accompanying unaudited financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary for a fair presentation for results for such periods. The results for any interim period are not necessarily indicative of the results to be expected for the full fiscal year. Certain information and footnote disclosures normally included in financial statements prepared in accordance with United States generally accepted accounting principles have been condensed or omitted. These financial statements should be read in conjunction with the Company's most recent audited financial statements included in its 2004 Form 10-K.

Note 2. Net income per Share

Basic net income per share excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted net income 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 or resulted in the issuance of common stock that then shared in the income of the Company.

Note 3. Employee Stock Ownership Plan

In fiscal 1989 the Company established an Employee Stock Ownership Plan (ESOP) for eligible non-union employees. The ESOP used the proceeds of a loan from the Company to purchase 316,224 shares of the Company's common stock for approximately \$8.4 million and the Company contributed approximately \$400,000 to the ESOP, which was used by the ESOP to purchase an additional 15,000 shares of the Company's common stock. Effective June 30, 2004, the ESOP loan was paid in full and all shares in the ESOP are allocated to participant's accounts. As of September 30, 2004, there were 236,735 shares allocated to participants.

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Note 4. Stock Based Compensation

The Company has elected to account for its stock-based compensation plans under the intrinsic value-based method of accounting as permitted by SFAS No. 123 and as prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations including FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation - An Interpretation of APB No. 25," in accounting for its fixed stock option plans. Under this method, compensation expense would be recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price.

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS no. 123 to stock-based employee compensation.

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| | Three Months Ended September 30 | |
|--|------------------------------------|------------|
| | 2004 | 2003 |
| Net income as reported | \$ 60,585 | \$ 280,965 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (8,377) | (9,227) |
| Pro forma net income | \$ 52,208 | \$ 271,738 |
| Net income per share: | | |
| Basic-as reported | \$.06 | \$.28 |
| Basic-pro forma | \$.05 | \$.27 |
| Diluted-as reported | \$.06 | \$.28 |
| Diluted-pro forma | \$.05 | \$.27 |

Note 5. Commitments and Contingencies

The Company has entered into standby letters of credit agreements with financial institutions primarily relating to the guarantee of future performance on certain contracts. Contingent liabilities on outstanding standby letters of credit agreements aggregated approximately \$190,000 at September 30, 2004. The Company does not expect to fund any of the amounts under the standby letters of credit.

The Company also has an operating lease commitment for a copier machine for \$500 per month which expires on June 1, 2008.

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

Overview

Espey Mfg. & Electronics Corp. (the "Company") located in Saratoga Springs, New York, is engaged principally in the development, design, production and sale of specialized electronic power supplies, a wide variety of transformers and other types of iron-core components, and electronic system components. In some cases, the Company manufactures such products in accordance with pre-developed mechanical and electrical requirements ("build to print"). In other cases, the Company is responsible for both the overall design and manufacture of the product. The Company does not generally manufacture standardized components. The products manufactured by the Company find application principally in (i) shipboard and land based radar, (ii) locomotives, (iii) aircraft, (iv) short and medium range communication systems, (v) navigation systems, and (vi) land based military vehicles.

Business is solicited from large industrial manufacturers and defense companies, the government of the United States and foreign governments and major foreign electronic equipment companies. In certain countries, the Company has external sales representatives to help solicit and coordinate foreign contracts. The Company is also on the eligible list of contractors of the United States Department of Defense and generally is automatically solicited by such agencies for procurement needs falling within the major classes of products produced by the Company. In addition, the Company directly solicits bids from the United States Department of Defense for prime contracts.

There is competition in all classes of products manufactured by the Company from divisions of the largest electronic companies, as well as from many small companies. The Company's sales do not represent a significant share of the industry's market for any class of its products. The principal methods of competition for electronic products of both a military and industrial nature include, among other factors, price, product performance, the experience of the particular company and history of its dealings in such products. The Company, as well as other companies engaged in supplying equipment for military use, is subject to various risks, including, without limitation, dependence on United States and foreign government appropriations and program allocations, the competition for available military business, and government termination of orders for convenience.

Business Outlook

Management of the Company is optimistic about the future of the Company. In the first quarter of fiscal 2005, the Company received approximately \$4.8 million in new orders. These orders include both follow-on production quantities for mature products, and engineering development orders which will enable the Company to utilize its engineering expertise in developing new customer specific products. These products, once developed, will be produced in the Company's manufacturing facility and are expected to provide large production order quantities over several years. These orders are in line with the Company's strategy of getting involved in long-term high quantity military programs.

Management expects to receive several more orders in fiscal 2005. These orders will increase the Company's backlog which is approximately \$15.5 million at November 10, 2004. Many potential orders are currently being discussed and negotiated with our customers. In addition to the backlog, the Company currently has outstanding quotations representing in excess of \$38 million in the aggregate for both repeat and new programs. Based on management's communications

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with customers, the Company expects to receive substantial orders for spare parts on the various types of transmitters already in service, a number of contracts for the further development and manufacture of power supplies and transformers, as well as, additional contracts for pre-engineered hardware. We expect these contracts to substantially increase sales in years beyond 2005. The outstanding quotations encompass various new and previously manufactured power supplies, transformers, and subassemblies. However, there can be no assurance that the Company will acquire any or all of the anticipated orders described above, many of which are subject to allocations of the United States defense spending and factors affecting the defense industry and military procurement generally.

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Management, along with the Board of Directors, continues to evaluate the need and use of the Company's working capital. Expectations are that the working capital will be required to fund the expected increase in orders over the next several quarters, dividend payments, and general operations of the business. Also, the Mergers and Acquisitions committee of the Board continues to evaluate potential strategic alternatives.

As stated in the Company's 10-K filed for the year ended June 30, 2004, the Company anticipates a decrease in sales for fiscal 2005. During fiscal 2004, while net sales increased, new orders received by the Company did not keep pace with backlog relieved. Thus, while the sales backlog of approximately \$15.4 million at June 30, 2004 gave the Company a solid base of future sales, the Company continues to anticipate a reduction of sales during fiscal 2005.

Critical Accounting Policies and Estimates

We believe our most critical accounting policies include revenue recognition and cost estimation.

Revenue recognition and cost estimation

A significant portion of our business is comprised of development and production contracts. Generally, revenues on long-term fixed-price contracts are recorded on a percentage of completion basis using units of delivery as the measurement basis for progress toward completion.

Percentage of completion accounting requires judgment relative to expected sales, estimating costs and making assumptions related to technical issues and delivery schedule. Contract costs include material, subcontract costs, labor and an allocation of overhead costs. The estimation of cost at completion of a contract is subject to numerous variables involving contract costs and estimates as to the length of time to complete the contract. Given the significance of the estimation processes and judgments described above, it is possible that materially different amounts of contract costs could be recorded if different assumptions were used, based on changes in circumstances, in the estimation of cost at completion. When a change in expected sales value or estimated cost is determined, changes are reflected in current period earnings.

Results of Operations

The Company's operating cycle is long-term and includes various types of products and varying delivery schedules. Accordingly, results of a particular period or period-to-period comparison of recorded revenues and income may not be indicative of future operating results. The following comparative analysis should be viewed in this context.

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Net sales for the three months ended September 30, 2004 were \$4,730,327 as compared to \$5,095,317 for the same period in 2003. The \$364,990 or 7.2% decrease in sales for the three month period ended September 30, 2004 is mainly due to a decrease in shipments of radar transmitter components.

The primary factor in determining gross profit and net income is product mix. In any given accounting period, the mix of product shipments between higher margin mature programs and less mature programs has a significant impact on gross profit and net income. For the three months ended September 30, 2004, gross profit and net income were lower, as shipments were made on less mature programs with lower gross margins, as compared to the three month period ended September 30, 2003. In addition, the Company continued to invest in engineering contracts that resulted in charges to cost of sales for loss contracts in the current accounting period. These contracts are expected to improve the operating results of the Company when the engineering phase of these contracts are completed and follow-on production orders are received. Also, as discussed above, the overall decrease in net sales contributed to the decline in gross profit and net income. Management continues to evaluate the Company's workforce to ensure that production and overall execution of the backlog orders and additional anticipated orders are successfully performed. Employment at September 30, 2004 was 178 people compared to 193 people at September 30, 2003.

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The backlog at September 30, 2004 was approximately \$15.6 million compared to approximately \$20.9 million at September 30, 2003. Management continues to market the engineering capabilities and products of the Company. Currently, approximately \$38 million in quotations are outstanding to various customers of the Company. New orders for the quarter totaled approximately \$4.8 million.

Selling, general and administrative expenses were \$600,679 for the three months ended September 30, 2004, an increase of \$50,876 compared to the three months ended September 30, 2003. The increase is primarily due to an increase in professional fees and general selling salaries.

Other income for the three months ended September 30, 2004 increased to \$38,087 as compared to \$24,605 for the three months ended September 30, 2003. This increase is due to the higher return on short-term investments. The Company does not believe there is significant risk associated with its investment policy, since at September 30, 2004 all of the investments are primarily represented by short-term liquid investments including certificates of deposit and money market accounts.

The Company estimates its income taxes using an estimated effective tax rate for the annual period. The effective income tax rate at September 30, 2004 and 2003 was 30.0% and 25.1%, respectively. The effective tax rate fluctuates between periods and is less than the statutory tax rate mainly due to the foreign exportation benefit the Company receives on its foreign sales.

Liquidity and Capital Resources

As of September 30, 2004, the Company had working capital of \$24.9 million compared to \$25.1 million at June 30, 2004. The Company meets its short-term financing needs through cash flow from operations and when necessary, from its existing cash and cash equivalents.

The table below presents the summary of cash flow for the periods indicated:

Three Months Ended September 30,

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| | 2004 ----- | 2003 ----- |
|--|---------------|---------------|
| Net cash provided by operating activities | \$ 298,368 | \$ 622,591 |
| Net cash used provided by investing activities | (497,761) | (66,140) |
| Net cash used in financing activities | (238,346) | (766,474) |

Net cash provided by operating activities fluctuates between periods primarily as a result of differences in net income, the timing of the collection of accounts receivable, purchase of inventory, level of sales and payment of accounts payable. The change in net cash used by investing activities is due to the purchase of short-term certificates of deposit. The decrease in net cash used in financing activities is due mainly to decreased dividends. The first quarter of fiscal year ended June 30, 2004 included the payment of a special dividend in the amount of \$506,357 or \$.50 per share.

The Company currently believes that the cash flow generated from operations and when necessary, from cash and cash equivalents, will be sufficient to meet its long-term funding requirements. Management, if necessary, has at its disposal a \$3,000,000 line of credit to help fund further growth. For the first three months of fiscal 2004 capital expenditures were \$113,761.

During the three months ended September 30, 2004, the Company repurchased 4,014 shares of its common stock for a total of \$90,315. The Company repurchased 9,529 shares of its common stock for a total of \$170,093 during the three months ended September 30, 2003. As of September 30, 2004, under existing Board authorization, \$452,251 could be utilized to repurchase shares of company stock. For the three month period ended September 30, 2004, 200 stock options were exercised under the Company's existing stock option plan.

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CAUTIONARY STATEMENT FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This report contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. The terms "believe," "anticipate," "intend," "goal," "expect," and similar expressions may identify forward-looking statements. These forward-looking statements represent the Company's current expectations or beliefs concerning future events. The matters covered by these statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those set forth in the forward-looking statements, including the Company's dependence on timely development, introduction and customer acceptance of new products, the impact of competition and price erosion, supply and manufacturing constraints, potential new orders from customers and other risks and uncertainties. The foregoing list should not be construed as exhaustive, and the Company disclaims any obligation subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made.

Item 4. Controls and Procedures

(a) The Company's management, with the participation of the Company's chief executive officer and chief financial officer, carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such

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evaluation, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

(b) There have been no changes in our internal controls over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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PART II: Other Information and Signatures

Item 1. Legal Proceedings

None

Item 2. Unregistered Sales of Equity Securities and Securities Repurchased

(a) Securities Sold - For the three month period ended September 30, 2004, 200 stock options were exercised under the Company's existing stock option plan. The securities were sold for cash and were made without registration under the Securities Act in reliance upon the exemption from registration afforded under Section 4(2) of the Securities Act of 1933. Proceeds were used for general working capital purposes.

(c) Securities Repurchased

Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan or Program | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plan or Program (1) |
|--------------------------------|---|---------------------------------------|---|---|
| August 1 to August 31, 2004 | 4,014 | \$22.50 | 4,014 | \$452,251 |
| Total | 4,014 | | 4,014 | |

(1) The Board of Directors has authorized the Company to repurchase up to \$452,251 of its common stock pursuant to an ongoing plan.

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

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Item 6. Exhibits

- 31.1 Certification of the Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of the Principal Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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S I G N A T U R E S

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.

ESPEY MFG. & ELECTRONICS CORP.

/s/ Howard Pinsley

Howard Pinsley, President and
Chief Executive Officer

/s/ David O'Neil

David O'Neil, Treasurer and
Principal Financial Officer

November 12, 2004

Date

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