ARMOR HOLDINGS INC
Form 10-Q
August 04, 2006
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006, or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THETRANSITION PERIOD FROM TO .

Commission File Number 0-18863

ARMOR HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

| Delaware | 59-3392443 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |
| 13386 International Parkway Jacksonville, Florida | 32218 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (904) 741-5400

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. See definition of ‘‘accelerated filer and large accelerated filer’’ in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of shares outstanding of the registrant's Common Stock as of July 27, 2006 is 35,504,392.

Armor Holdings, Inc.

Form 10-Q

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

The accompanying unaudited condensed consolidated financial statements of Armor Holdings, Inc. and its wholly-owned subsidiaries include all adjustments that management considers necessary for a fair presentation of

operating results and financial position as of June 30, 2006, and for the three- and six-month periods ended June 30, 2006, and June 30, 2005.

These unaudited condensed consolidated financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-K, as amended, for the fiscal year ended December 31, 2005.

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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

| | June 30, 2006 (unaudited) | December 31, 2005* |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 35,791 | $ 471,841 |
| Accounts receivable (net of allowance for doubtful accounts of $6,677 and $6,763) | 266,101 | 212,124 |
| Inventories | 309,767 | 210,517 |
| Prepaid expenses and other current assets | 87,731 | 38,087 |
| Total current assets | 699,390 | 932,569 |
| PROPERTY AND EQUIPMENT (net of accumulated depreciation of $43,831 and $37,041) | 154,247 | 79,929 |
| GOODWILL (net of accumulated amortization of $4,024 and $4,024) | 942,181 | 273,696 |
| PATENTS, LICENSES AND TRADEMARKS (net of accumulated amortization of $22,320 and $15,256) | 431,104 | 130,620 |
| OTHER ASSETS | 23,335 | 46,048 |
| TOTAL ASSETS | $ 2,250,257 | $ 1,462,862 |

*Condensed from audited financial statements.
See notes to condensed consolidated financial statements.

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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS — CONTINUED

(IN THOUSANDS, EXCEPT FOR SHARE DATA)

| | June 30, 2006 (unaudited) | December 31, 2005* |
|---|---|---|
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Current portion of long-term debt | $ 1,873 | $ 430 |
| Short-term debt | 343,901 | 344,274 |
| Accounts payable | 141,214 | 90,963 |
| Accrued expenses and other current liabilities | 256,360 | 100,924 |
| Income taxes payable | 8,739 | 8,767 |
| Total current liabilities | 752,087 | 545,358 |
| LONG-TERM LIABILITIES: | | |
| Long-term debt, less current portion | 499,117 | 151,910 |
| Other long-term liabilities | 47,090 | 10,475 |
| Deferred income taxes | 156,995 | 44,537 |
| Total liabilities | 1,455,289 | 752,280 |
| COMMITMENTS AND CONTINGENCIES (NOTE 14) | | |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock, $.01 par value, 5,000,000 shares authorized; no shares issued and outstanding | — | — |
| Common stock, $.01 par value; 75,000,000 shares authorized; 41,553,795 and 41,347,628 issued and 35,493,573 and 35,287,406 outstanding at June 30, 2006, and December 31, 2005, respectively | 416 | 415 |
| Additional paid-in capital | 529,938 | 525,890 |
| Retained earnings | 333,460 | 257,991 |
| Accumulated other comprehensive income (loss) | 3,471 | (1,397) |
| Treasury stock | (72,317) | (72,317) |
| Total stockholders' equity | 794,968 | 710,582 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 2,250,257 | $ 1,462,862 |

*Condensed from audited financial statements.

See notes to condensed consolidated financial statements.



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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| REVENUES: | | | | |
| Aerospace & Defense | $446,820 | $262,770 | $791,923 | $528,465 |
| Products | 78,914 | 70,723 | 155,750 | 134,056 |
| Mobile Security | 26,192 | 38,149 | 49,693 | 74,086 |
| Total revenues | 551,926 | 371,642 | 997,366 | 736,607 |
| COSTS AND EXPENSES: | | | | |
| Cost of revenues | 439,295 | 275,840 | 780,105 | 549,495 |
| Selling, general and administrative expenses | 45,399 | 35,534 | 81,541 | 69,350 |
| Amortization | 4,808 | 2,038 | 7,067 | 4,076 |
| Integration | 407 | 834 | 877 | 1,634 |
| Other charges | (1,530) | — | (1,530) | — |
| OPERATING INCOME | 63,547 | 57,396 | 129,306 | 112,052 |
| Interest expense, net | 9,459 | 1,514 | 9,718 | 3,759 |
| Other income, net | (129) | (3,093) | (936) | (1,970) |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 54,217 | 58,975 | 120,524 | 110,263 |
| PROVISION FOR INCOME TAXES | 20,157 | 21,560 | 45,055 | 41,819 |
| NET INCOME | $ 34,060 | $ 37,415 | $ 75,469 | $ 68,444 |
| BASIC EARNINGS PER SHARE | $ 0.96 | $ 1.09 | $ 2.13 | $ 1.99 |
| DILUTED EARNINGS PER SHARE | $ 0.92 | $ 1.05 | $ 2.05 | $ 1.93 |
| WEIGHTED AVERAGE SHARES – BASIC | 35,425 | 34,480 | 35,384 | 34,321 |
| WEIGHTED AVERAGE SHARES – DILUTED | 36,954 | 35,562 | 36,835 | 35,536 |

See notes to condensed consolidated financial statements.



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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW (UNAUDITED)
(IN THOUSANDS)

| | Six Months Ended | |
|---|---|---|
| | June 30, 2006 | June 30, 2005 |
| CASH FLOW FROM OPERATING ACTIVITIES: | | |
| Net income | $ 75,469 | $ 68,444 |
| Adjustments to net income to cash provided by operating activities: | | |
| Depreciation and amortization | 19,812 | 10,588 |
| Loss on disposal of fixed assets | 347 | 503 |
| Deferred income taxes | 3,420 | 3,640 |
| Fair value adjustment for put options | (710) | (3,793) |

| | | |
|---|---|---|
| SERP expense | 1,450 | — |
| Changes in operating assets and liabilities, net of acquisitions: | | |
| Decrease (increase) in accounts receivable | 13,050 | (2,648) |
| Decrease (increase) in inventories | 2,848 | (32,538) |
| Increase in prepaid expenses and other assets | (4,804) | (1,255) |
| (Decrease) increase in accounts payable, accrued expenses and other current liabilities | (91,924) | 14,592 |
| (Decrease) increase in income taxes payable | (5,041) | 498 |
| Net cash provided by operating activities | 13,917 | 58,031 |
| CASH FLOW FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (16,346) | (8,146) |
| Purchase of patents and trademarks | (115) | (100) |
| Purchases of short-term investment securities | (538,310) | (562,750) |
| Proceeds from sales of short-term investment securities | 538,310 | 186,225 |
| Sale of put options | — | 4,790 |
| Collection of note receivable | 428 | — |
| Purchase of equity investment | (57) | — |
| Additional cash received from sale of business | — | 300 |
| Additional consideration for purchased businesses | (150) | (4,604) |
| Purchase of businesses, net of cash acquired | (758,511) | (1,362) |
| Net cash used in investing activities | (774,751) | (385,647) |
| CASH FLOW FROM FINANCING ACTIVITIES: | | |
| Proceeds from the exercise of stock options | 1,166 | 4,304 |
| Taxes paid for withheld shares on restricted stock issuances | (430) | (5,794) |
| Windfall tax benefit of stock options | 2,444 | — |
| Cash paid for debt issue costs | (5,329) | — |
| Borrowings of long-term debt | 100,000 | — |
| Repayments of long-term debt | (25,289) | (314) |
| Borrowings under lines of credit | 578,937 | 9,634 |
| Repayments under lines of credit | (329,086) | (6,985) |
| Net cash provided by financing activities | 322,413 | 845 |
| Effect of exchange rate changes on cash and cash equivalents | 2,371 | (2,121) |
| Net decrease in cash and cash equivalents | (436,050) | (328,892) |
| Cash and cash equivalents, beginning of period | 471,841 | 421,209 |
| Cash and cash equivalents, end of period | $ 35,791 | $ 92,317 |

See notes to condensed consolidated financial statements.

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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (UNAUDITED)

NOTE 1 — BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Armor Holdings, Inc. and its wholly-owned subsidiaries (‘‘Armor’’, the ‘‘Company’’, ‘‘we’’, ‘‘our’’, ‘‘us’’) have been prepared in accordance with account principles generally accepted in the United States of America (‘‘U.S. GAAP’’) for interim information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, and do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary to present a fair presentation have been included. The results of operations for the three and six month periods are not necessarily indicative of the results to be expected for the full year and should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005, as amended. The amounts disclosed in the footnotes are related to continuing operations unless otherwise indicated. Certain prior year amounts have been reclassified to conform to the current year presentation.

NOTE 2 — ACQUISITIONS

On April 6, 2006, we acquired 100% of the stock of Swiss-Photonics AG. Swiss-Photonics, through its trade name, Projectina, which manufactures, markets and distributes highly specialized document examination equipment used in verifying document authenticity and detecting counterfeit currency and crime lab microscopes used to evaluate ballistics and bullet casings. Projectina also develops optical subsystems for leading electronic original equipment manufacturers. Based in Heerbrugg, Switzerland, Projectina serves the forensics, homeland security and crime scene markets, predominantly in Europe and Asia. Projectina generated revenue of approximately $9.2 million in 2005. As a result of the Projectina acquisition, we expect to (1) enter the document examination equipment business; (2) achieve cross-selling opportunities by leveraging our global sales force and relationships; (3) leverage the multi-lingual skills of Projectina's European based customer service team, and (4) offer opportunities for cost reduction through integration and rationalization of operations.

On May 25, 2006, we completed the acquisition of Stewart & Stevenson for approximately $792.0 million in cash, excluding transaction costs and after deducting Stewart & Stevenson's net cash balance. Stewart & Stevenson designs and manufactures tactical wheeled vehicles (‘‘TWV’’) used by the U.S. and international militaries, and is one of the three major original equipment manufacturers (‘‘OEM’’) of TWV sold to the U.S. military. Stewart & Stevenson is the sole manufacturer of the U.S. Army's Family of Medium Tactical Vehicles (‘‘FMTV’’), has delivered over 30,000 of these vehicles since 1991, and is currently under contract to produce the FMTV through September 2008. The U.S. Army's stated acquisition objective for the FMTV program is approximately 83,000 vehicles. In addition, Stewart & Stevenson has been selected as the only manufacturer for the U.S. Army's next generation technology demonstrator vehicle, referred to as the Maneuver Sustainment Variant, which is part of the Future Tactical Truck System. Stewart & Stevenson derived approximately 75% of its revenues of $726.4 million for the fiscal year ended January 31, 2006, from the production of FMTV and vehicle cabs.

A primary strategic benefit of our acquisition of Stewart & Stevenson is our new position as an OEM of the TWV fleet. As the U.S. Army transitions its long-term armoring strategy, TWV OEMs are expected to gain contracting authority for all ballistic and blast protection armoring systems, giving us the ability to better position our armoring technology and survivability systems on the FMTV. We believe that the combination of our core competency in vehicle armoring and Stewart & Stevenson's leading design and fabrication operations will allow us to capitalize on the U.S. military's evolving needs for its TWV fleet.

On June 30, 2006, we acquired 100% of the stock of Integrated Textile Systems, Inc. (‘‘ITS’’), a Monroe, North Carolina-based manufacturer of the high-strength material, Tensylon(TM).

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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (UNAUDITED) CONTINUED

Tensylon(TM), derived from an ultra-high molecular weight polyethylene polymer, has a wide variety of applications, including advanced fiber composites for use in ballistic products. The Tensylon high performance fiber or tape can be processed into any number of specialty tailored composites, depending on the unique application. This acquisition is expected to allow us to develop complete solutions for emerging blast and ballistic threats by starting with the base material.

We expect to make capital investments of $12 to $15 million over the next two years to significantly increase Tensylon(TM) capacity, which we expect to utilize largely in force protection products and systems. Our application development phases are largely complete and we plan to qualify Tensylon(TM) into a variety of our programs including, among others, vehicle armoring applications which are currently underway. ITS will give us core technology for our markets, and allow us to gain control over a versatile, low-cost, high-performance ballistic material. We expect to utilize this material as a complementary solution with other ballistic materials we currently procure though key suppliers.

These three acquisitions were accounted for as purchase business combinations, and accordingly, the results of operations were included in our financial statements from the acquisition date. The costs to acquire all of the stock of Stewart & Stevenson, Projectina and ITS, which were acquired during the three months ended June 30, 2006, have been allocated to the assets acquired and liabilities assumed according to their estimated fair values at the time of the acquisition as follows:

| | Stewart & Stevenson | Projectina | ITS | Total |
|---|---|---|---|---|
| | | (In thousands) | | |
| Working capital, net of cash | $ (87,447) | $ 1,590 | $ (76) | $ (85,933) |
| Property and equipment | 60,690 | 2,023 | 1,408 | 64,121 |
| Other long-term assets | 5,295 | — | — | 5,295 |
| Long-term debt | (25,227) | — | — | (25,227) |
| Other long-term liabilities | (33,172) | (466) | — | (33,638) |
| Deferred tax liability | (111,088) | — | — | (111,088) |
| Customer-related intangibles | 275,964 | 1,398 | — | 277,362 |
| Technology-related intangibles | 8,519 | 522 | 1,921 | 10,962 |
| Marketing-related intangibles | 18,998 | 468 | — | 19,466 |
| Goodwill | 664,189 | 2,059 | 1,921 | 668,169 |
| | $ 776,721 | $ 7,594 | $ 5,174 | $ 789,489 |

The customer-related intangible assets relate to acquired customer relationships and are being amortized over an eleven year weighted-average useful life on a straight-line basis. The technology-related intangible asset relates to certain acquired patents and is being amortized over a sixteen year weighted-average useful life on a straight-line basis. The marketing-related intangible assets relates to acquired trade names and trademarks, which have an indefinite useful life. The allocations of the purchase prices to the assets acquired and liabilities assumed are preliminary and subject to change because, among other things, with the assistance of an independent valuation firm, we are finalizing amounts assigned to tangible and intangible assets acquired in the transactions and the transactions occurred late in the second quarter. The goodwill acquired in the acquisitions of Stewart & Stevenson and Projectina

is not deductible for tax purposes, while the goodwill acquired in the acquisition of ITS is deductible for tax purposes.

Unaudited pro forma results. Businesses acquired are included in consolidated results from the date of acquisition. Pro forma results of the 2006 acquisitions of Projectina and ITS, and the 2005 acquisitions of Optemize and Second Chance are not presented, as they would not differ by a material amount from actual results. The following unaudited pro forma consolidated results are presented to



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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (UNAUDITED) CONTINUED

show the results on a pro forma basis as if the 2006 acquisition of Stewart & Stevenson had been made as of January 1, 2005:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| | (In thousands) | | | |
| Revenues | $ 664,543 | $ 552,842 | $ 1,297,122 | $ 1,072,513 |
| Net income | $ 24,417 | $ 38,031 | $ 49,309 | $ 68,750 |
| Basic earnings per share | $ 0.69 | $ 1.11 | $ 1.39 | $ 2.00 |
| Diluted earnings per share | $ 0.66 | $ 1.07 | $ 1.34 | $ 1.93 |

NOTE 3 — COMPREHENSIVE INCOME

The components of comprehensive income, net of income tax provision of $269,000 and income tax benefit of $298,000 for the three months ended June 30, 2006 and 2005, respectively, and net of tax provision of $506,000 and income tax benefit of $412,000 for the six months ended June 30, 2006 and 2005, respectively, are listed below:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| | (in thousands) | | (in thousands) | |
| Net income | $ 34,060 | $ 37,415 | $ 75,469 | $ 68,444 |
| Other comprehensive income: | | | | |
| Unrealized (loss) gain on equity securities | (10) | — | (10) | — |
| Elimination of unrealized gain on equity securities upon consolidation | (18,261) | — | 2,484 | — |
| Foreign currency translation, net of tax | 1,326 | (2,021) | 2,395 | (4,064) |
| Comprehensive income | $ 17,115 | $ 35,394 | $ 80,338 | $ 64,380 |

NOTE 4 — INVENTORIES

The components of inventory as of June 30, 2006, and December 31, 2005, are summarized as follows:

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| | (In thousands) | |
| Raw material | $ 197,345 | $ 127,465 |
| Work-in-process | 78,905 | 48,900 |
| Finished goods | 33,517 | 34,152 |
| Total inventories | $ 309,767 | $ 210,517 |



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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (UNAUDITED) CONTINUED

NOTE 5 — ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accrued expenses and other current liabilities as of June 30, 2006, and December 31, 2005, are summarized as follows:

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| | (In thousands) | |
| Accrued expenses and other current liabilities | $ 126,735 | $ 76,576 |
| Vest exchange program / warranty revision accrual (See Note 16) | 9,968 | 18,511 |
| Customer deposits | 119,657 | 5,837 |
| Total accrued expenses and other current liabilities | $ 256,360 | $ 100,924 |

NOTE 6 — SHORT- AND LONG-TERM DEBT

Short-Term Debt

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| | (In thousands) | |
| 2% Convertible Notes, due November 1, 2024[a] | $ 341,838 | $ 341,751 |
| Credit facility – Colombia[b] | 2,063 | 1,565 |
| Credit facility – Brazil[c] | — | 958 |

| | $ 343,901 | $ 344,274 |
|---|---|---|

(a) On October 29, 2004, we completed the placement of $300 million aggregate principal amount of 2.00% Senior Subordinated Convertible Notes due November 1, 2024 (‘‘2% Convertible Notes’’). On November 5, 2004, Goldman, Sachs & Co. exercised its option to purchase an additional $45 million principal amount of the 2% Convertible Notes. The 2% Convertible Notes are guaranteed by most of our domestic subsidiaries on a senior subordinated basis (see Note 15). The 2% Convertible Notes provide for interest at a rate of 2.00% per year, payable on November 1 and May 1 of each year beginning on May 1, 2005 and ending on November 1, 2011. The 2% Convertible Notes provide for accretion of the principal amount beginning on November 1, 2011, at a rate that provides holders with an aggregate annual yield to maturity of 2.00%, as defined in the agreement. The 2% Convertible Notes provide for contingent interest during any six-month period beginning November 1, 2011, of 15 basis points paid in cash if the average trading price of the notes is above certain levels. The 2% Convertible Notes are convertible, at the bond holder’s option, at any time prior to maturity, initially at a conversion rate of 18.5151 shares of our common stock per $1,000 principal amount of notes, which is the equivalent conversion price of approximately $54.01 per share, subject to adjustment. Upon conversion, we are obligated to satisfy our conversion obligation with respect to the accreted principal amount of the notes to be converted in cash, with any remaining amount to be satisfied in shares of our common stock. The conversion rate is subject to adjustment, without duplication, upon the occurrence of any of the following events: (1) stock dividends in common stock, (2) issuance of rights and warrants, (3) stock splits and combinations, (4) distribution of indebtedness, securities or assets, (5) cash distributions, (6) tender or exchange offers, and (7) repurchases of common stock. In accordance with U.S. GAAP, the 2% Convertible Notes are classified as short term debt as they can be converted at any time prior to maturity.

(b) On March 12, 2003, we entered into a collateralized revolving credit facility with Corporaciòn Financiera to provide for working capital needs for our Colombia facility. In 2004, we expanded



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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (UNAUDITED) CONTINUED

the collateralized revolving credit facility with four additional Colombian banks. The Colombian credit facility is a one-year revolving credit facility and, among other things, provides for total maximum borrowings of 6.5 billion Colombian Pesos (U.S. $2.6 million based on the exchange rate as of June 30, 2006). All borrowings under the credit facility bear interest at a rate equal to the Colombian Central Bank rate based on averages of 30 day loans, plus an applicable margin ranging from 3.5% to 4.0%. The Colombian credit facility is guaranteed by a U.S. $100,000 standby letter of credit and bank signature notes.

(c) In February 2005, we entered into a collateralized revolving credit facility with Itaú S.A. to provide working capital funds for our Brazilian facility. The Brazilian credit facility ran through March 2006 and was not renewed.

Long-Term Debt

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| | (In thousands) | |
| Revolving facility[a] | $ 250,000 | $ — |
| Term loan[a] | 100,000 | — |
| 8.25% Senior Subordinated Notes due 2013[b] | 144,086 | 148,099 |
| 7.38% Senior Notes due May 2006 [c] | — | — |
| Other long term debt | 2,766 | 2,814 |
| Plus fair value of interest rate swaps[d] | 4,138 | 1,427 |
| | 500,990 | 152,340 |
| Less current portion | (1,873) | (430) |
| | $ 499,117 | $ 151,910 |

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(a)On May 25, 2006, we terminated our prior senior secured credit facility and entered into a new senior secured credit facility (the ''Credit Facility'') with Wachovia Bank, National Association, as administrative agent, Bank of America, N.A., and Suntrust Bank, as co-syndication agents, Key Bank National Association and JPMorgan Chase Bank, as co-documentation agents, and the other lenders party thereto. The Credit Facility establishes a commitment to the Company to provide up to $825,000,000 in the aggregate of loans and other financial accommodations consisting of (i) a five year senior secured revolving credit facility in an aggregate principal amount of up to $425,000,000 (''the Revolving Facility''), (ii) a five year senior secured term loan in an aggregate principal amount of $100,000,000 (the ''Term Loan''), and (iii) a thirty day senior secured interim term loan in aggregate principal amount of $300,000,000 (the ''Interim Term Loan''). The Revolving Facility, Term Loan and Interim Term Loan make up the ''Senior Secured Facilities''. The Revolving Facility includes a sublimit of up to an aggregate amount of $75,000,000 in letters of credit and a sublimit of up to an aggregate of $20,000,000 in swing line loans. At June 30, 2006, we had $156 million in availability under our credit facility excluding $19 million in outstanding letters of credit.

All borrowings under the Credit Facility will bear interest at either (i) a rate equal to LIBOR, plus an applicable margin ranging from 0.875% to 1.5%, depending on certain conditions, or (ii) an alternate base rate which will be the higher of (a) the Federal Funds rate plus 0.50% or (b) the Wachovia prime rate, plus an additional margin ranging from 0.0% to 0.25% depending on certain conditions.



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ARMOR HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (UNAUDITED) CONTINUED

The Credit Facility is guaranteed by certain of our direct and indirect domestic subsidiaries and is secured by, among other things, (a) a pledge of (i) all of the issued and outstanding shares of stock or other equity interests of certain of our direct and indirect domestic subsidiaries, (ii) 65% of the issued and outstanding shares of voting stock or other voting equity interests of certain of our direct and indirect foreign subsidiaries, and (iii) 100% of the issued and outstanding shares of nonvoting stock or other nonvoting equity interests of certain of our direct and indirect foreign subsidiaries pursuant to a pledge agreement delivered in connection with the Credit Facility (the ''Pledge Agreement'') and (b) a first priority perfected security interest on certain of our domestic assets and certain domestic assets of certain of our direct and indirect domestic subsidiaries pursuant to a

security agreement delivered in connection with the Credit Facility (the ‘‘Security Agreement’’).

We have made customary representations, warranties and covenants in the Credit Agreement, Pledge Agreement and Security Agreement. The Credit Facility is subject to customary rights of the lenders and the administrative agent upon the occurrence and during the continuance of an Event of Default, including, under certain circumstances, the right to accelerate payment of the loans made under the Credit Facility and the right to charge a default rate of interest on amounts outstanding under the Credit Facility.

The Interim Term Loan was paid in full in the quarter ended June 30, 2006.

(b)On August 12, 2003, we completed a private placement of $150 million aggregate principal amount of 8.25% Senior Subordinated Notes due 2013 (the ‘‘8.25% Notes’’). The 8.25% Notes are guaranteed by most of our domestic subsidiaries on a senior subordinated basis (see Note 15). The 8.25% Notes were sold to qualified institutional buyers in reliance on Rule 144A of the Securities Act of 1933, as amended, and to non-U.S. persons in reliance on Regulation S under the Securities Act of 1933, as amended. In 2004, after the completion of the private placement of the 8.25% Notes, we conducted an exchange offer pursuant to which holders of the privately placed 8.25% Notes exchanged such notes for 8.25% Notes registered under the Securities Act of 1933, as amended. During 2003, we used a portion of the funds to fund acquisitions, including Simula and Hatch, repay a portion of our outstanding debt and for general corporate and working capital purposes, including the funding of capital expenditures. Interest on the 8.25% Notes is payable semiannually on the fifteenth of February and August of each year. The 8.25% Notes were issued at a discount of approximately $2.5 million to investors. The 8.25% Notes may be redeemed at our option in whole or in part on a pro-rata basis, on and after August 15, 2008, at certain specified redemption prices plus accrued interest payable to the redemption date.

(c)In connection with our May 25, 2006, acquisition of Stewart & Stevenson, we assumed $25 million of 7.38% Senior Notes due May 31, 2006. We paid these notes in full on May 31, 2006.

(d)On September 2, 2003, we entered into interest rate swap agreements, designated as fair value hedges as defined under SFAS 133 with an aggregate notional amount totaling $150 million. The agreements were entered to exchange the fixed interest rate on the 8.25% Notes for a variable interest rate equal to six-month LIBOR, set in arrears, plus a spread ranging from 2.735% to 2.75% fixed semi-annually on the fifteenth day of February and August. At June 30, 2006, the six-month LIBOR was 5.6%. The agreements are subject to other terms and conditions common to transactions of this type. In accordance with SFAS 133, changes in the fair value of the interest rate swap agreements offset changes in the fair value of the fixed rate debt due to changes in the market interest rate. The fair value of the interest rate swap agreements was approximately $4.1 million at June 30, 2006. The agreements are deemed to be perfectly effective fair value



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hedges and therefore qualify for the short-cut method of accounting under SFAS 133. As a result, no ineffectiveness is expected to be recognized in earnings associated with the interest rate swap agreements on the 8.25% Notes.

Maturities of long-term debt are as follows:

| Twelve Month Periods | (In thousands) |
|---|---|
| July 1, 2006 – June 30, 2007 | $ 1,873 |
| July 1, 2007 – June 30, 2008 | 6,772 |
| July 1, 2008 – June 30, 2009 | 10,376 |
| July 1, 2009 – June 30, 2010 | 26,567 |
| July 1, 2010 – June 30, 2011 | 306,544 |
| Thereafter | 148,858 |
| | $ 500,990 |

NOTE 7 — DERIVATIVE FINANCIAL INSTRUMENTS

We account for derivative instruments in accordance with Statement of Financial Accounting Standards No. 133, ‘‘Accounting for Derivative Instruments and Hedging Activities,’’ as amended by Statement of Financial Accounting Standards No. 138, ‘‘Accounting for Certain Derivative Instruments and Certain Hedging Activities — an Amendment of SFAS 133’’, and Statement of Financial Accounting Standards No. 149 ‘‘Amendment of SFAS 133 on Derivative Instruments and Hedging Activities’’ (collectively ‘‘SFAS 133’’). SFAS 133 requires all freestanding and embedded derivative instruments to be measured at fair value and recognized on the condensed consolidated balance sheet as either assets or liabilities. In addition, all derivative instruments used in hedging relationships must be designated, reassessed and accounted for as either fair value hedges or cash flow hedges pursuant to the provisions of SFAS 133.

As defined in SFAS 133, ‘‘Accounting for Derivative Instruments and Hedge Activities’’ the contingent interest feature of the 2% Convertible Notes is an embedded derivative that is not considered clearly and closely related to the host contract. The fair value of this bifurcated derivative at June 30, 2006, and December 31, 2005, is immaterial to our financial position.

At December 31, 2005, there was a $1.4 million asset included in other assets, which, as a result of the change in fair value, is a $4.1 million hedge liability at June 30, 2006. The fair values of our interest rate swap agreements are obtained from our counter-parties and represent the estimated amount we would receive or pay to terminate the agreement, taking into consideration the difference between the contract rate of interest and rates currently quoted for agreements of similar terms and maturities.

NOTE 8 — GOODWILL AND IDENTIFIED INTANGIBLE ASSETS

Under Statement of Financial Accounting Standards No. 142, ‘‘Goodwill and Other Intangible Assets’’ (‘‘SFAS 142’’), goodwill and intangible assets with indefinite lives are no longer amortized, but are tested for impairment at least annually or more often if indicators of impairment arise. The changes in the carrying amount of goodwill for the six months ended June 30, 2006, are as follows:



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| | Aerospace & Defense | Products | Mobile Security (In thousands) | Corporate | Total |
|---|---|---|---|---|---|
| Balance at December 31, 2005 | $ 155,772 | $ 109,791 | $ 6,490 | $ 1,643 | $ 273,696 |
| Goodwill acquired during fiscal 2006 | 664,189 | 3,980 | — | — | 668,169 |
| Finalization of purchase price | — | 134 | — | — | 134 |
| Foreign currency translation and other adjustments | — | 155 | 27 | — | 182 |
| Balance at June 30, 2006 | $ 819,961 | $ 114,060 | $ 6,517 | $ 1,643 | $ 942,181 |

Included in patents, licenses and trademarks in the accompanying condensed consolidated balance sheets are the following intangible assets as of June 30, 2006:

| | Customer Relationships | Technology (In thousands) | Marketing | Total |
|---|---|---|---|---|
| Gross amount | $ 337,760 | $ 31,018 | $ 84,646 | $ 453,424 |
| Accumulated amortization | (14,277) | (5,068) | (2,975) | (22,320) |
| Net amount | $ 323,483 | $ 25,950 | $ 81,671 | $ 431,104 |

Included in Marketing are approximately $80.6 million of marketing-related intangible assets, which have indefinite lives.

NOTE 9 — INFORMATION CONCERNING BUSINESS SEGMENTS AND GEOGRAPHICAL REVENUES

Revenues, operating income and total assets, net for each of our segments are as follows (net of intercompany eliminations):

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| | (In thousands) | | (In thousands) | |
| Revenues: | | | | |
| Aerospace & Defense | $ 446,820 | $ 262,770 | $ 791,923 | $ 528,465 |
| Products | 78,914 | 70,723 | 155,750 | 134,056 |
| Mobile Security | 26,192 | 38,149 | 49,693 | 74,086 |
| Total revenues | $ 551,926 | $ 371,642 | $ 997,366 | $ 736,607 |
| Operating income (loss): | | | | |
| Aerospace & Defense | $ 55,998 | $ 49,224 | $ 114,586 | $ 97,292 |
| Products | 13,271 | 12,501 | 25,423 | 20,972 |
| Mobile Security | 1,981 | 5,312 | 2,870 | 10,918 |
| Corporate | (7,703) | (9,641) | (13,573) | (17,130) |
| Total operating income | $ 63,547 | $ 57,396 | $ 129,306 | $ 112,052 |

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| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| | (In thousands) | |
| Total assets: | | |
| Aerospace & Defense | $ 1,763,550 | $ 546,141 |
| Products | 355,094 | 347,932 |
| Mobile Security | 92,557 | 87,866 |
| Corporate | 39,056 | 480,923 |
| Total assets | $ 2,250,257 | $ 1,462,862 |

Beginning in 2006, responsibility for Cyconics International Training Systems, Inc., a subsidiary providing certain training services, was transferred from the Products segment to the Aerospace & Defense segment. Accordingly, business segment information presented for the three and six months ended June 30, 2005, has been reclassified to conform with the current period's presentation.

Financial information of our continuing operations with respect to revenues based on the geographic location of the customer, and property and equipment, net, to principal geographic areas, based on the actual location of the principal facility, is as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| | (In thousands) | | (In thousands) | |
| Revenues: | | | | |
| United States of America | $ 511,240 | $ 324,465 | $ 927,215 | $ 643,725 |
| North America (excluding the United States of America) | 2,581 | 2,344 | 4,251 | 4,533 |
| South America | 5,393 | 5,934 | 10,362 | 10,327 |
| Africa | 3,336 | 5,256 | 5,697 | 10,000 |
| Europe/Asia | 29,376 | 33,643 | 49,841 | 68,022 |
| Total revenues | $ 551,926 | $ 371,642 | $ 997,366 | $ 736,607 |

| | June 30, 2006 | December 31, 2005 |
|---|---|---|
| | (In thousands) | |
| Total property and equipment, net: | | |
| North America | $ 129,928 | $ 60,573 |
| South America | 1,212 | 1,419 |
| Europe/Asia | 23,107 | 17,937 |
| Total property and equipment, net | $ 154,247 | $ 79,929 |

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NOTE 10 — EARNINGS PER SHARE

The following details the basic and diluted earnings per share computations for income from continuing operations:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| | (In thousands, except per share data) | | | |
| Numerator for basic and diluted earnings per share: | | | | |
| Net income | $ 34,060 | $ 37,415 | $ 75,469 | $ 68,444 |
| Denominator for basic earnings per share – weighted average shares outstanding | 35,425 | 34,480 | 35,384 | 34,321 |
| Effect of shares issuable under stock option and stock grant plans, based on the treasury stock method | 1,529 | 1,082 | 1,451 | 1,215 |
| Denominator for diluted earnings per share – adjusted weighted average shares outstanding | 36,954 | 35,562 | 36,835 | 35,536 |
| Basic earnings per share | $ 0.96 | $ 1.09 | $ 2.13 | $ 1.99 |
| Diluted earnings per share | $ 0.92 | $ 1.05 | $ 2.05 | $ 1.93 |

Our 2% Convertible Notes include net share settlement of the conversion option and cash settlement of the par amount of $345 million. As a result, this requires us to use the treasury stock method to calculate the dilutive effect of our 2% Convertible Notes, which had no effect on our diluted share count during the three and six months ended June 30, 2006.

NOTE 11 — EMPLOYEE PENSION AND OTHER BENEFIT PLANS

On May 25, 2006, we acquired all of the outstanding stock of Stewart & Stevenson (See Note 2). Included in Stewart & Stevenson's liabilities that we acquired is $30.6 million related to the following: (1) a frozen noncontributory defined benefit pension plan covering substantially all of Stewart & Stevenson's full-time employees; (2) an unfunded defined benefit supplemental executive retirement plan covering certain highly compensated employees; and (3) an unfunded defined benefit postretirement medical benefit plan.

Effective July 1, 2003, Stewart & Stevenson froze the benefits earned under its defined benefit pension plans and its defined benefit postretirement medical plan, with the exception of a small transition group.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the ‘‘Act’’) was signed into law. The Act introduced a prescription drug benefit under Medicare (‘‘Medicare Part D’’) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. The defined benefit postretirement medical plan was amended by Stewart & Stevenson prior to our acquisition such that, effective January 1, 2006, prescription medication coverage was discontinued for all participants who are both eligible for prescription drug benefits under Medicare and for whom Medicare is the primary payor.



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The net periodic benefit cost (income) associated with our previously existing and recently acquired defined benefit pension plans and defined benefit postretirement medical plan consisted of the following components:

Pension Benefits

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| | (In thousands) | | (In thousands) | |
| Service cost | $ 354 | $ — | $ 690 | $ — |
| Interest cost | 968 | 119 | 1,237 | 237 |
| Expected return on assets | (840) | (135) | (984) | (269) |
| Prior service cost amortization | 245 | — | 489 | — |
| Net periodic benefit cost | $ 727 | $ (16) | $ 1,432 | $ (32) |

Other Postretirement Benefits

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| | (In thousands) | | (In thousands) | |
| Interest cost | $ 11 | $ — | $ 11 | $ — |
| Net periodic benefit cost | $ 11 | $ — | $ 11 | $ — |

We expect to contribute approximately $265,000 to our defined benefit plans in the year ended December 31, 2006.

NOTE 12 — STOCKHOLDERS' EQUITY

Preferred stock. On July 16, 1996, our stockholders authorized a series of preferred stock with such rights, privileges and preferences as the Board of Directors shall from time to time determine. We have not issued any of this preferred stock.

Common stock. On June 22, 2004, our stockholders approved an amendment to our Certificate of Incorporation, as amended, that increased the number of shares of our authorized capital stock to 80,000,000. Of this amount, 75,000,000 shares are common stock and 5,000,000 shares of which are preferred stock.

Treasury stock. We had 6,060,222 shares in treasury as of June 30, 2006, and December 31, 2005.

Stock options and grants. On June 22, 2005, we implemented the 2005 Stock Incentive Plan. The 2005 Stock Incentive Plan authorizes the issuance of up to 2,500,000 shares of our common stock. Any shares of our common stock granted as restricted stock, performance stock or other stock-based awards will be counted against the shares authorized as one and eight-tenths (1.8) shares for every one share issued in connection with such award. The 2005 Stock Incentive Plan authorizes the granting of stock options, restricted stock, performance awards and other stock-based awards to employees, officers, directors and consultants, independent contractors and advisors of the Company and its subsidiaries. Upon adoption of our 2005 Stock Incentive Plan, we agreed to not grant awards under any of our pre-existing stock incentive plans.

During 2002, we implemented two new stock option plans. The 2002 Stock Incentive Plan authorizes the issuance of up to 2,700,000 shares of our common stock upon the exercise of stock options or in connection with the issuance of restricted stock and stock bonuses. On June 22, 2004,



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our stockholders approved an amendment to increase, by 2,000,000 shares, the total number of shares of common stock that may be awarded under the 2002 Stock Incentive Plan. The 2002 Stock Incentive Plan authorizes the granting of stock options, restricted stock and stock bonuses to employees, officers, directors and consultants, independent contractors and advisors of the Company and its subsidiaries. The 2002 Executive Stock Plan provides for the grant of a total of 470,000 stock options and stock awards to our key employees. The terms and provisions of the 2002 Executive Stock Plan are substantially the same as the 2002 Stock Incentive Plan, except that we may only grant non-qualified stock options under the 2002 Executive Stock Plan. The 2002 Executive Stock Plan was adopted on March 13, 2002, and all shares available for grant under the 2002 Executive Stock Plan were granted to our executive officers on March 13, 2002.

In 1999, we implemented the 1999 Stock Incentive Plan. We reserved 2,000,000 shares of our common stock for the 1999 Stock Incentive Plan. The 1999 Stock Incentive Plan provides for the granting of options to employees, officers, directors, consultants, independent contractors and advisors of the Company. The option prices of stock which may be purchased under the 1999 Stock Incentive Plan are not less than the fair market value of common stock on the dates of the grants. During 1998, we implemented a new non-qualified stock option plan. Pursuant to the new plan, 725,000

shares of common stock were reserved and made available for distribution. On January 1, 1999, we distributed all 725,000 shares allocated under the plan.

In 1996, we implemented an incentive stock plan and an outside directors' stock plan. These plans collectively provide for the granting of options to certain key employees and directors. Pursuant to such plans, as amended, 2,200,000 shares of common stock were reserved and made available for distribution. The option prices of stock that may be purchased under the incentive stock plan are not less than the fair market value of common stock on the dates of the grants.

In 1994, we implemented an incentive stock plan and an outside directors' stock plan. These plans collectively provide for the granting of options to certain key employees as well as providing for the grant of common stock to outside directors and to all full time employees. Pursuant to such plans, 1,050,000 shares of common stock were reserved and made available for distribution. The option prices of stock that may be purchased under the incentive stock plan are not less than the fair market value of common stock on the dates of the grants. Effective January 19, 1996, all stock grants awarded under the 1994 incentive stock plan were accelerated and considered fully vested.

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), ‘‘Share-Based Payments’’ (‘‘FAS 123R’’), requiring us to recognize expense related to the fair value of our stock option awards. We recognize the cost of share-based awards on a straight-line basis over the vesting period of the award. Prior to January 1, 2006, we accounted for our stock option plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, ‘‘Accounting for Stock Issued to Employees’’ (‘‘APB 25’’) and related interpretations, as permitted by Statement of Financial Accountant Standard No. 123, ‘‘Accounting for Stock-Based Compensation’’ (‘‘SFAS 123’’). Excluding modification to stock option agreements, no stock option-based employee compensation cost was recognized in the income statement, as all stock options granted under those plans had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant.

Effective January 1, 2006, we adopted the fair value recognition provisions of FAS 123R, using the modified prospective transition method. Under this transition method, compensation cost recognized during the first six months of 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of FAS 123R. Results for prior periods have not been



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restated. As a result of adopting FAS 123R on January 1, 2006, our income before income taxes and net income for the three and six months ended June 30, 2006, was $273,000 and $164,000 lower and $476,000 and $296,000 lower, respectively, than if we had continued to account for share-based compensation under ABP 25.

Prior to the adoption of FAS 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the statement of cash flows. Beginning on January 1, 2006, we changed our cash flow presentation in accordance with FAS 123R, which requires the cash flows resulting from the tax benefits

resulting from tax deductions in excess of the compensation cost recognized for those options (windfall tax benefits) to be classified as financing cash flows.

We have estimated the fair value of our option awards granted after January 1, 2006, using a Black-Scholes option pricing model. The expected life of the options granted is management's estimate and represents the period of time that options granted are expected to be outstanding. We currently do not pay dividends. Volatility is based on the historical volatility of our stock price. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The fair value of each option grant during the three and six months ended June 30, 2006 and 2005, is estimated on the date of grant with the following weighted-average assumptions:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| Expected life of option | 4.8 yrs | 4.2 yrs | 4.8 yrs | 5.1 yrs |
| Dividend yield | 0% | 0% | 0% | 0% |
| Volatility | 44.2% | 48.7% | 44.7% | 48.6% |
| Risk free interest rate | 4.8% | 3.7% | 4.7% | 4.0% |

The weighted average fair value of options granted during the three and six months ended June 30, 2006 and 2005, are as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2006 | June 30, 2005 | June 30, 2006 | June 30, 2005 |
| | (In thousands, except per share data) | | (In thousands, except per share data) | |
| Fair value of each option granted | $ 25.16 | $ 16.58 | $ 24.13 | $ 19.13 |
| Total number of optio | | | | |