

SUNTRON CORP
Form 10-Q
August 14, 2002

Table of Contents

**SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 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, 2002**

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

Commission file number: **0-49651**

SUNTRON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

86-1038668
(IRS Employer Identification No.)

**2501 West Grandview Road
Phoenix, Arizona 85023**
(Address of principal executive offices)

(602) 789-6600
(Issuer's telephone number)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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

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

Common Stock, par value \$0.01
(Class of Common Stock) (Outstanding as of August 2, 2002)

27,409,388 shares

TABLE OF CONTENTS

UNAUDITED CONSOLIDATED BALANCE SHEETS

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Statement Regarding Forward-Looking Statements

Organization and Basis of Financial Presentation

Information About Our Business

Critical Accounting Policies and Estimates

Overview of Statement of Operations

Results of Operations

Liquidity and Capital Resources

Impact of Recently Issued Accounting Standards

Factors That May Affect Future Results

Item 3. Quantitative and Qualitative Disclosures about Market Risk

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Item 2. Changes in Securities and Use of Proceeds

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits and Reports on Form 8-K

EX-10.17

EX-10.18

EX-99.1

EX-99.2

Table of Contents

SUNTRON CORPORATION

FORM 10-Q

INDEX

**Page
Number(s)**

PART I. FINANCIAL INFORMATION

**Item 1. Unaudited
Financial Statements**

Consolidated Balance
Sheets- December 31,
2001 and June 30,
2002
3-4

Consolidated
Statements of
Operations- For the
Quarters and Six
Months Ended July 1,
2001 and June 30,
2002
5

Consolidated
Statements of Cash
Flows- Six Months
Ended July 1, 2001
and June 30, 2002
6-7

Notes to Consolidated
Financial Statements
8-14

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

Statement Regarding
Forward-Looking
Statements
15

Organization and
Basis of Financial
Presentation
15-16

Information About
Our Business
16-17

Critical Accounting
Policies and Estimates
17-19

Overview of
Statement of
Operations
19

Results of Operations	20-24
Liquidity and Capital Resources	24-26
Impact of Recently Issued Accounting Standards	27
Factors That May Affect Future Results	28-38
Item 3. Quantitative and Qualitative Disclosures about Market Risk	39
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	39
Item 2. Changes in Securities	39
Item 3. Defaults Upon Senior Securities	39
Item 4. Submission of Matters to a Vote of Security Holders	39
Item 5. Other Information	40
Item 6. Exhibits and Reports on Form 8-K	40
SIGNATURES	41

Table of Contents

SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands, Except Per Share Amounts)

	<u>December 31, 2001</u>	<u>June 30, 2002</u>
ASSETS		
Current Assets:		
Cash and equivalents		
\$14,172	\$115	
Trade receivables, net of allowance for doubtful accounts of \$5,636 and \$4,953, respectively		
31,029	38,406	
Inventories		
106,768	85,210	
Prepaid expenses and other		
2,037	3,002	
<hr/>		
<hr/>		
Total current assets		
154,006	126,733	
<hr/>		
<hr/>		
Property, Plant and Equipment:		
Land		
4,798	4,798	
Buildings and improvements		
27,094	27,281	
Manufacturing machinery and equipment		
54,163	54,170	
Furniture, computer equipment and software		
32,928	33,369	
<hr/>		
<hr/>		
Total		
118,983	119,618	

Less accumulated depreciation and
amortization
(37,559) (46,936)

Net property, plant and equipment
81,424 72,682

Intangible and Other Assets:

Goodwill
82,604 6,923
Identifiable intangible assets, net of
accumulated
amortization of \$3,329 and \$3,680,
respectively
2,383 2,032
Debt issuance costs, net
1,806 1,448
Deposits and other
416 370

Total intangible and other assets
87,209 10,773

\$322,639 \$210,188

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

Table of Contents

SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS, Continued
(Dollars in Thousands, Except Per Share Amounts)

	December 31, 2001	June 30, 2002
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable		
\$28,391	\$38,510	
Accrued compensation and benefits		
8,197	8,219	
Accrued interest expense		
1,721	113	
Payable to affiliates		
1,730	129	
Accrued exit costs related to facility closures		
1,900	1,445	
Accrued property taxes		
1,347	1,182	
Outstanding checks in excess of cash balances		
900	1,518	
Other accrued liabilities		
4,290	4,718	
<hr/>		
<hr/>		
Total current liabilities		
48,476	55,834	
Long-term Liabilities:		
Long-term debt, net of current maturities:		
Banks		
31,628	11,000	
Former parent of K*TEC		
12,202		
Other		
201	226	
<hr/>		
<hr/>		
Total liabilities		
92,507	67,060	

Stockholders Equity:

Preferred stock, \$.01 par value.
Authorized 10,000,000 shares;
none issued

Common stock, \$.01 par value.
Authorized 50,000,000 shares;

issued and outstanding
27,409,589 and 27,409,388
shares, respectively

274 274

Additional paid-in capital

380,000 379,998

Deferred stock compensation
cost

(205) (185)

Accumulated deficit

(149,937) (236,959)

Total stockholders equity

230,132 143,128

\$322,639 \$210,188

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

Table of Contents

SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars In Thousands, Except Per Share Amounts)

	For the Quarter Ended		For the Six Months Ended	
	July 1, 2001	June 30, 2002	July 1, 2001	June 30, 2002
Net Sales	\$ 156,676	\$ 100,387	\$ 354,591	\$ 192,995
Cost of Goods Sold				
155,585 99,177 345,262 193,185				
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Gross profit (loss)				
1,091 1,210 9,329 (190)				
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Operating Costs and Expenses:				
Selling, general and administrative expenses				
8,596 8,216 17,414 16,620				
Related party expenses:				
Acquisition and financing expenses				
1,750				
Management fees				
313 188 625 459				
Reorganization transaction costs				
1,038 32 1,088 297				
Goodwill amortization				
727 1,454				
<hr/>				
<hr/>				

Total operating costs and expenses
 10,674 8,436 22,331 17,376

Operating loss
 (9,583) (7,226) (13,002) (17,566)

Other Income (Expense):

Interest expense
 (3,245) (477) (6,579) (1,711)
 Reduction of interest expense due to settlement of dispute
 1,029
 Gain (loss) on sale of assets
 734 (8) 738 (157)
 Other, net
 5 124 67 162

Loss before income taxes and cumulative effect of

change in accounting
 (12,089) (7,587) (18,776) (18,243)

Income Tax Benefit (Expense)
 (305) (18) 236

Loss before cumulative effect of change in accounting
 (12,394) (7,587) (18,794) (18,007)

Cumulative Effect of Change in Accounting for Goodwill
 (69,015)

Net loss
\$(12,394) \$(7,587) \$(18,794) \$(87,022)

Basic and Diluted Net Loss Applicable to Common

Stockholders:

Loss before cumulative effect of change in accounting
\$(12,599) \$(7,587) \$(19,344) \$(18,007)
Cumulative effect of change in accounting for goodwill
(69,015)

Net loss applicable to common stockholders
\$(12,599) \$(7,587) \$(19,344) \$(87,022)

Basic and Diluted Net Loss Per Share Applicable

to Common Stockholders:

Edgar Filing: SUNTRON CORP - Form 10-Q

Loss before cumulative effect of change in accounting
\$(0.57) \$(0.28) \$(0.93) \$(0.66)
Cumulative effect of change in accounting for goodwill
(2.52)

Net loss per share applicable to common stockholders
\$(0.57) \$(0.28) \$(0.93) \$(3.18)

Number of Shares Used for Computation- Basic and Diluted
2,089,000 27,409,000 20,721,000 27,409,000

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

Table of Contents

SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)

For the Six Months Ended

July 1, 2001	June 30, 2002
-----------------	------------------

Cash Flows from Operating Activities:

Net loss	\$(18,794)	\$(87,022)
Adjustments to reconcile net loss to net		
cash provided by operating activities:		
Cumulative effect of change in accounting for goodwill	69,015	
Depreciation and amortization	12,276	11,029
Amortization of debt issuance costs	636	636
Impairment of property, plant and equipment	1,095	
Severance, retention, closure and relocation costs	(1,376)	(455)
Accrued interest on convertible notes	2,217	
Provision for doubtful accounts receivable	544	24
Loss (gain) on sale of assets	(738)	157
Reduction of interest expense due to settlement	(1,029)	
Stock-based compensation and services expense	37	20
Changes in operating assets and liabilities, net		
of effects of purchase of business:		
Decrease (increase) in:		
Trade receivables	51,580	(4,252)
Inventories		

30,718 25,113
Prepaid expenses and other
1,282 (681)
Increase (decrease) in:

Accounts payable
(57,509) 8,383
Accrued compensation and
benefits
(487) (780)
Other accrued liabilities
4,428 (1,897)

Net cash provided by operating
activities
25,909 18,261

**Cash Flows from Investing
Activities:**

Proceeds from sale of assets
1,163 105
Cash payments for acquisition of
business
(5,523)
Capital expenditures
(12,773) (1,268)

Net cash used by investing
activities
(11,610) (6,686)

**Cash Flows from Financing
Activities:**

Proceeds from long-term debt
402,704 132,972
Principal payments on long-term
debt
(435,439) (158,942)

Payments for debt issuance costs
(4,220) (280)
Increase in outstanding checks in
excess of cash balances
8,390 618
Distribution to former owner of
K*TEC
(20,000)
Proceeds from exercise of stock
options
186

Net cash used by financing
activities
(48,379) (25,632)

Net decrease in cash and
equivalents
(34,080) (14,057)

Cash and Equivalents:

Beginning of period
34,163 14,172

End of period
\$83 \$115

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

Table of Contents

**SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS, Continued
(Dollars in Thousands)**

	<u>For the Six Months Ended</u>	
	<u>July 1, 2001</u>	<u>June 30, 2002</u>
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest		
\$4,014	\$1,654	

**Supplemental Schedule of
Non-cash Investing and**

Financing Activities:

Reduction of note payable
to Former Parent due to
settlement of dispute
\$ 6,860

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

Table of Contents

**SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts)**

1. Basis of Presentation

Suntron Corporation (the Company or Suntron) is a Delaware Corporation that was formed on May 2, 2001. As discussed in Note 2, at December 31, 2001, Suntron was a wholly owned subsidiary of EFTC Corporation (EFTC). On February 28, 2002, the mergers described in Note 2 were completed whereby Suntron became the parent company of EFTC. EFTC subsequently was merged into a successor Delaware Corporation. The mergers described in Note 2 have been accounted for as a reorganization of entities under common control. Accordingly, the accompanying consolidated financial statements present the accounts of EFTC Corporation and its wholly owned subsidiaries since the date of formation or acquisition. The accounts of K*TEC Operating Company, L.L.C. (K*TEC) are presented from the date that common control of EFTC and K*TEC was established, which was on October 10, 2000. All share and per share information in these consolidated financial statements has been adjusted to give retroactive effect for the exchange ratio of one share of Suntron for four shares of EFTC, and to give retroactive effect for the issuance of 15,119,356 shares of Suntron common stock to the sole holder of membership interests of K*TEC, as if the merger with K*TEC occurred on October 10, 2000. All intercompany balances and transactions have been eliminated in the preparation of these consolidated financial statements.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and in conformity with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and the six months ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. The unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in Suntron's Annual Report on Form 10-K for the year ended December 31, 2001, as well as the consolidated financial statements and notes thereto of K*TEC that are included in a Current Report on Form 8-K/A filed on May 14, 2002.

2. Reorganization of Entities Under Common Control

On May 3, 2001, EFTC; K*TEC Electronics Holding Corporation, formerly known as K*TEC Electronics Corporation (KEHC); K*TEC Operating Company, L.L.C., formerly known as Thayer-Blum Funding II, L.L.C.; and Suntron, entered into an Amended and Restated Merger Agreement (the Merger Agreement), providing for, among other things, the merger of two wholly owned subsidiaries of Suntron with and into EFTC and K*TEC, respectively.

KEHC was a privately held electronic manufacturing services company based in Sugar Land, Texas. KEHC was 100% owned by K*TEC, an affiliate of Thayer-Blum Funding L.L.C. (TBF), EFTC's principal stockholder. On May 31, 2001, TBF owned approximately 77% of the outstanding common stock of EFTC. A special committee comprised of EFTC's independent directors negotiated the terms of the Merger Agreement on behalf of the minority stockholders of EFTC. On February 28, 2002, EFTC's stockholders voted in favor of the business combination and the transaction was completed on that date.

Table of Contents

SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts)

In connection with the signing of the Merger Agreement, EFTC entered into a stockholder agreement, as amended (the "Stockholder Agreement"), with TBF, K*TEC and Suntron that required TBF to convert Senior Subordinated Convertible Notes of EFTC, and Series B Preferred Stock of EFTC, into EFTC common stock on or before May 31, 2001. These conversions resulted in the issuance of an aggregate of 8,056,586 additional shares of Suntron common stock to TBF. Pursuant to the Stockholder Agreement, TBF agreed to vote all its shares of EFTC's common stock in favor of the business combination.

Under the terms of the Amended and Restated Merger Agreement, Suntron formed two new wholly owned subsidiaries, which merged with and into EFTC and K*TEC, respectively. EFTC subsequently was merged into a successor Delaware corporation. Accordingly, as a result of the business combination, EFTC's successor and K*TEC became wholly owned subsidiaries of Suntron. Suntron's common stock is traded on the Nasdaq National Market under the trading symbol "SUNN". Based upon the Amended and Restated Merger Agreement's exchange ratios, the owner of K*TEC received approximately 55% of Suntron's outstanding capital stock, while EFTC's former stockholders received approximately 45% of Suntron's outstanding capital stock. TBF and its affiliates currently own approximately 90% of the outstanding capital stock of Suntron.

The business combination of EFTC and K*TEC has been accounted for as a reorganization of entities under common control. Accordingly, the accompanying financial statements have been restated to give effect to the business combination as if it occurred on October 10, 2000, which is the date that common control was established. Under this accounting method all transaction costs were charged to operations in the period incurred.

3. Business Combinations

On October 10, 2000, K*TEC acquired all of the outstanding common stock of KEHC from Kent Electronics Corporation (the "Former Parent") in a business combination accounted for as a purchase. The effective date of the acquisition was October 7, 2000. No events occurred between October 7, 2000 and October 10, 2000 that materially affected KEHC's financial position or results of operations. The purchase price amounted to \$238,009, consisting of a cash payment to the seller of \$175,000, notes payable to the seller of \$62,202 and acquisition costs of \$807. The purchase price allocation was based on the estimated fair value of the assets acquired and liabilities assumed, as follows:

Trade receivables, net	\$66,922
Inventories	
102,457	
Prepaid expenses and other	
1,072	
Property, plant and equipment	
67,336	
Goodwill	
79,089	
Other intangible assets	
1,050	
Liabilities assumed and other	
(79,917)	
<hr/>	
	\$238,009
<hr/>	

In applying purchase accounting, the historical cost basis of property, plant and equipment was increased by \$1,980, and inventories were reduced by \$21,219 to arrive at the fair value amounts shown above. The Company accrued \$2,995 of remaining noncancelable lease costs

associated with facilities in Milpitas, California and Austin, Texas, as part of exit plans to relocate

Table of Contents

**SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts)**

those operations. Approximately \$615 of these lease costs were paid in 2000, \$1,268 was paid in 2001, and the remaining \$1,112 is expected to be paid in 2002.

A portion of the purchase price was subject to a dispute that was expected to be resolved through arbitration proceedings. On May 7, 2002, the parties agreed to settle the dispute whereby the \$12,202 principal balance of a note payable to the Former Parent was reduced by \$6,860, resulting in an adjusted principal balance of \$5,342. In accounting for this settlement, during the first quarter of 2002 the Company reduced the carrying amount of goodwill by \$6,860 and recognized a credit to operations of \$1,029 for accrued interest that was previously expensed and that is no longer payable due to the settlement.

On March 11, 2002, the Company purchased substantially all of the assets of Midwestern Electronics, Inc., a privately held Electronics Manufacturing Services (EMS) provider. Midwestern focuses on high mix manufacturing services and provides EMS services and products, including printed circuit board assembly, subassemblies, box build and aftermarket repair services. This acquisition was accounted for under the purchase method prescribed in Statement of Financial Accounting Standards No. 141. The purchase price was approximately \$5,500, and the purchase price allocation resulted in goodwill of \$194.

4. New Accounting Standards

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement No. 141, *Business Combinations* and Statement No. 142, *Goodwill and Other Intangible Assets*. Statement No. 141 requires that the purchase method of accounting be used for business combinations initiated after June 30, 2001, except for business combinations between entities under common control. The provisions of Statement 142 were required to be adopted by the Company beginning in the first quarter of 2002. Statement 142 addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. Statement 142 also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements.

During the first quarter of 2002, the Company adopted the provisions of Statement 142, which resulted in the elimination of the requirement under previous accounting rules to amortize goodwill. Instead of amortizing goodwill, Statement 142 requires a periodic impairment test, using a two-step process. The first step is to identify if potential impairment of goodwill exists. If impairment of goodwill is determined to exist, the second step of the goodwill impairment test measures the amount of the impairment loss, using a fair value-based approach.

In connection with the adoption of Statement 142, the Company engaged an independent firm specializing in valuation services to assist in the determination if impairment of goodwill should be recognized under Statement 142. The Company concluded that no impairment exists with respect to goodwill with a carrying value of \$6,729 on January 1, 2002 related to the Company's Northwest reporting unit (which arose in connection with the February 1997 acquisition of Current Electronics). However, goodwill related to the K*TEC reporting unit (which arose in connection with the October 2000 acquisition from Kent Electronics) was determined to be impaired for the entire carrying value which resulted in an impairment loss that was computed as follows:

Table of Contents

**SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts)**

Net carrying value of K*TEC goodwill, December 31, 2001	\$75,875
Less effect of settlement of dispute discussed in Note 3 (6,860)	
<hr style="border: 0.5px solid black;"/>	
Impairment loss	
\$69,015	
<hr style="border: 1px solid black;"/>	

This impairment loss was recorded as the cumulative effect of a change in accounting principle.

The following table presents reported net loss and loss per share exclusive of goodwill amortization expense for the quarter and six months ended July 1, 2001 and June 30, 2002:

	Quarter Ended:		Six Months Ended:	
	July 1, 2001	June 30, 2002	July 1, 2001	June 30, 2002
Reported net loss	\$(12,394)	\$(7,587)	\$(18,794)	\$(87,022)
Add back goodwill amortization				
727 1,454				
<hr style="border: 0.5px solid black;"/>				
<hr style="border: 0.5px solid black;"/>				
<hr style="border: 0.5px solid black;"/>				
<hr style="border: 0.5px solid black;"/>				
Adjusted net loss	\$(11,667)	\$(7,587)	\$(17,340)	\$(87,022)
<hr style="border: 1px solid black;"/>				
<hr style="border: 1px solid black;"/>				

Basic and Diluted Loss Per Share:

Reported net loss per common share
 \$(0.57) \$(0.28) \$(0.93) \$(3.18)
 Add back goodwill amortization
 0.03 0.07

Adjusted net loss
 \$(0.54) \$(0.28) \$(0.86) \$(3.18)

In August 2001, the FASB issued Statement No. 143, *Accounting for Asset Retirement Obligations*. This standard requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity capitalizes a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement. This standard is effective for fiscal years beginning after June 15, 2002, with earlier application encouraged. Management does not believe the initial application of Statement 143 will have a significant impact on the Company's consolidated financial statements.

In July 2002, the FASB issued Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. This standard requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. Previous accounting guidance was provided by EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. Statement 146 replaces Issue 94-3. Statement 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. Accordingly, the planned closure of the facilities discussed in Note 9 that were announced on August 8, 2002 will not be accounted for under Statement 146.

Table of Contents

SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts)

5. Inventories

Inventories at December 31, 2001 and June 30, 2002 are summarized as follows:

	<u>2001</u>	<u>2002</u>
Purchased parts and completed sub-assemblies	\$77,225	\$59,096
Work-in-process		
8,115 9,790		
Finished goods		
21,428 16,324		
<hr/>		
<hr/>		
\$106,768 \$85,210		
<hr/>		
<hr/>		

For the quarters ended July 1, 2001 and June 30, 2002, the Company recorded charges for excess and obsolete inventories of \$3,719 and \$828, respectively. For the six months ended July 1, 2001 and June 30, 2002, the Company recorded charges for excess and obsolete inventories of \$6,121 and \$1,791, respectively. The determination of write-downs related to excess and obsolete inventories requires management's estimates about the outcome of uncertainties, including customers' level of financial responsibility when an order is cancelled, the ability to liquidate inventories in volatile electronic component markets, and the timing and amount of future orders from the Company's customers.

6. Debt Financing

At December 31, 2001 and June 30, 2002, long-term debt consisted of the following:

	<u>2001</u>	<u>2002</u>
Note payable to Citibank, N.A. under revolving line of credit, interest at variable rates (weighted average rate of 5.9% at December 31, 2001 and 5.2% at June 30, 2002), collateralized by substantially all assets, due February 2005	\$31,556	\$11,000
Note payable to bank group under revolving line of credit, interest at the prime rate plus 0.5% (5.3% at December 31, 2001), repaid in March 2002		
72		

Edgar Filing: SUNTRON CORP - Form 10-Q

Note payable to Former
Parent, interest at variable
rate (14.0% at
December 31, 2001),
unsecured, repaid in May
2002
12,202

Total long-term debt
\$43,830 \$11,000

The credit facility with Citibank provides for a \$75,000 revolving line of credit. The interest rate is the prime rate plus 2.0% (6.8% at December 31, 2001 and June 30, 2002) for Base Rate borrowings and the LIBOR rate plus 3.3% (weighted average rate of 5.6% at December 31, 2001 and 5.2% at June 30, 2002) for LIBOR Rate borrowings. The Company can periodically elect to use either the base rate or LIBOR rate in connection with borrowings under the line of credit. Total borrowings are subject to limitation based on a percentage of eligible accounts receivable, inventories, real estate, and equipment. Substantially all of the Company's assets are pledged as collateral for outstanding borrowings. The credit agreement requires compliance with certain

Table of Contents

**SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts)**

financial and non-financial covenants, including quarterly requirements related to tangible net worth; earnings before interest, taxes, depreciation and amortization (EBITDA); and limitations on the amount of capital expenditures. The credit agreement also limits or prohibits the Company from paying dividends, incurring additional debt, selling significant assets, or merging with other entities without the consent of the lenders.

As of June 30, 2002, the borrowing base calculation permitted borrowings of approximately \$69,100 and the outstanding principal balance on that date was \$11,000, resulting in \$58,100 of availability.

Under the Company's credit agreement and banking arrangements, the Company is not required to fund amounts for outstanding checks until the day that the checks are presented to the Company's bank for payment. Accordingly, the Company is not required to maintain cash balances in anticipation of funding requirements for outstanding checks, which results in a current liability for outstanding checks in excess of cash balances. Changes in the amount of outstanding checks in excess of cash balances are reflected as a financing activity in the accompanying statements of cash flows.

7. *Loss Per Share*

Basic loss per share excludes dilution for potential common shares and is computed by dividing net income or loss by the weighted average number of common shares outstanding for the period. Diluted loss per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. Basic and diluted loss per share are the same for the six months and the quarters ended July 1, 2001 and June 30, 2002, as all potential common shares were antidilutive. As of June 30, 2002, common stock options and warrants that were excluded from the calculation of earnings per share amounted to an aggregate of 2,425,000 shares at exercise prices ranging from \$7.36 to \$64.00 per share.

For the quarter and six months ended July 1, 2001, accrued dividends of \$205 and \$550, respectively, related to EFTC's Series B Convertible Preferred Stock were deducted in the calculation of loss applicable to common stockholders. As discussed in Note 2, the outstanding shares of EFTC's Series B Preferred Stock were converted to common stock on May 31, 2001.

Table of Contents

**SUNTRON CORPORATION AND SUBSIDIARIES
UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts)**

8. Stockholders Equity

Presented below is a reconciliation of the Company's stockholders' equity as reported in its Annual Report on Form 10-K to the restated amounts included herein due to the accounting for the business combination with K*TEC as a reorganization of entities under common control:

	Common Stock		Additional Deferred			Total
	Shares	Amount	Paid-in Capital	Stock Compensation	Accumulated Deficit	
Balances, December 31, 2001	49,160,932	\$ 492	\$ 169,782	\$ (205)	\$ (80,588)	\$ 89,481

Give effect to exchange ratio of four shares of EFTC for one share of Suntron
(36,870,699) (369) 369

Sub-total
12,290,233 123 170,151 (205) (80,588) 89,481
Give retroactive effect to merger with K*TEC Operating Company, L.L.C.
15,119,356 151 209,849 (69,349) 140,651

Balances, December 31, 2001, as restated
27,409,589 274 380,000 (205) (149,937) 230,132
Amortization of deferred stock compensation cost

	20	20
Retirement of fractional shares	(201)	(2)
Net loss	(87,022)	(87,022)

Balances, June 30, 2002
 27,409,388 \$274 \$379,998 \$(185) \$(236,959) \$143,128

9. Subsequent Events

On August 8, 2002, the Company announced its plans to consolidate manufacturing capabilities by closing its facilities in Ottawa, Kansas and Fremont, California in order to eliminate both fixed and variable costs associated with excess capacity.

As a result of these planned actions, Suntron expects to record restructuring related charges between \$7 million and \$9 million, primarily in the third quarter of 2002. The Company expects that substantially all of these charges will be classified as a component of cost of goods sold in the period that these charges are recorded. The company expects the closure of both facilities will be completed by the end of 2002.

Table of Contents

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

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes, and the other financial information included in this report, as well as the information in our Annual Report on Form 10-K for the year ended December 31, 2001.

Statement Regarding Forward-Looking Statements

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

Organization and Basis of Financial Presentation

Suntron Corporation is a provider of vertically integrated electronics manufacturing solutions supplying high-mix services for the aerospace and defense, semiconductor capital equipment, industrial controls, instrumentation, medical, networking, and telecommunications industries. Our manufacturing services include printed circuit card assembly, cable and harness production, plastic injection molding, sheet metal, engineering services, and full systems integration, testing, and after-market repair and warranty services. High-mix manufacturing involves processing printed circuit board assemblies in small lots (generally less than 100 assemblies per production run) in a flexible manufacturing environment. Our success in the marketplace is a direct result of our ability to provide intelligent solutions tailored to match customer requirements, while meeting the highest quality standards in the industry.

Suntron was formed as a holding company for the purpose of effecting the business combination of EFTC Corporation and K*TEC Operating Company, L.L.C. (formerly known as Thayer-Blum Funding II, L.L.C.) and its wholly owned subsidiary, K*TEC Electronics Holding Corporation.

The combination of EFTC and K*TEC was completed on February 28, 2002 and, in connection with the combination, EFTC and K*TEC each became a wholly owned subsidiary of Suntron. As a result of the combination, the former holder of membership interests in K*TEC Operating Company, L.L.C. received 15,119,356 shares of Suntron common stock, and the former stockholders of EFTC received .25 shares of Suntron common stock for each share of

Table of Contents

EFTC common stock, resulting in the issuance of an additional 12,290,032 shares of Suntron common stock.

Beginning in the first quarter of 2002, the combination was accounted for as a reorganization of entities under common control. Accordingly, our consolidated financial statements included herein have been retroactively restated to include the combined results of EFTC since its inception and K*TEC Operating Company, L.L.C. since October 10, 2000 (the date that common control was established). However, because the combination was not completed until the first quarter of 2002, the retroactively combined annual financial statements for the years ended December 31, 2000 and 2001, have not been published yet. Additionally, the retroactively combined interim financial statements have not been published for the last two quarters of the fiscal year ended December 31, 2001. The separate consolidated financial statements of K*TEC for the period from September 14, 2000 (inception) through December 31, 2000 and for the fiscal year ended December 31, 2001, as well as pro forma combined consolidated financial information, are included in a current report on Form 8-K/A that was filed with the SEC on May 14, 2002.

Information About Our Business

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

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

The electronics manufacturing services industry is extremely dynamic and our customers make frequent changes to their orders. The magnitude and frequency of these changes make it difficult to predict revenues beyond the next quarter, and even relatively short-term forecasts may prove inaccurate depending on changes in economic, political, and military factors, as well as unexpected customer requests to delay shipments near the end of our fiscal quarters. These changes in customer orders also cause substantial difficulties in managing inventories, which often leads to excess inventories and the need to recognize losses on inventories. However, from time to time, we may also have difficulties obtaining certain electronic components that are in short supply, which can result in a decision to purchase some materials before formal notice of demand is received from our customer. In addition, our inventories consist of over 100,000 different parts and many of these parts have limited alternative uses or markets, beyond the products that we manufacture for our customers. When we liquidate excess materials through an inventory broker or auction, we often realize less than 25% of the original cost of the materials, and in some cases we determine that there is no market for the excess materials.

The most common reasons we incur losses related to inventories are if we purchase more materials than are necessary to meet a customer's requirements or if we fail to act promptly to

Table of Contents

minimize losses once the customer communicates a cancellation. Occasionally it is not clear what action caused an inventory loss and there is a shared responsibility whereby our customers agree to negotiate a settlement with us. Accordingly, on a quarterly basis management evaluates inventory on-hand, forecasted demand, contractual protections, and net realizable values in order to determine whether an adjustment to the carrying amount of inventory is necessary. When the relationship with a customer terminates, we tend to be more vulnerable to inventory losses because the customer may be reluctant to accept responsibility for the remaining inventory if a product is at the end of its life cycle. We can also incur inventory losses if a customer becomes insolvent and the materials do not have alternative uses or markets into which we can sell them.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires that we make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to bad debts, inventories, property, plant and equipment, intangible assets, income taxes, warranty obligations, restructuring, and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. We cannot assure you that actual results will not differ from those estimates. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

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

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

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required in future periods. Likewise, if we underestimate contractual recoveries from customers or future demand, hindsight may indicate that we over-reported our costs of goods sold in earlier periods, which results in the recognition

Table of Contents

of additional gross profit at the time the material is used in production and the related goods are sold. Therefore, although we make every effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand or the outcome of customer negotiations with respect to the enforcement of contractual provisions, could have a significant impact on the value of our inventory and our reported operating results.

Allowance for Doubtful Accounts Receivable. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments, as well as to provide for adjustments related to pricing and quantity differences. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances would be required.

Impairment of Long-Lived Assets. When we undergo changes in our business, including the closure or relocation of facilities, we often have equipment and other assets that are no longer needed in our business. When this occurs, we estimate how much we believe we are likely to receive upon disposal of the assets, and we record an impairment charge if this amount is less than the net carrying value. If actual market conditions for these assets are less favorable than those projected by management, additional impairment charges may be required.

Effective January 1, 2002, we were required to adopt a new accounting standard that changed the method for evaluating impairment of goodwill. In order to comply with this standard we engaged an independent business valuation firm to determine the fair value of each reporting unit that had goodwill associated with it. The valuation of reporting units is a highly subjective process that can be influenced by a wide range of factors including historical and forecasted results for the reporting unit, interest rates, and political, regulatory, and economic conditions. Because of the volatility of these factors, a significant reduction in the value of a reporting unit may occur in a relatively short period of time, which could result in a material charge for impairment. Effective January 1, 2002, we implemented this new accounting standard and were required to recognize an impairment charge of \$69.0 million related to the K*TEC reporting unit. We will be required to evaluate potential impairment of goodwill related to other reporting units at least annually and, depending on changes in the fair value of those reporting units at future testing dates, we may need to recognize additional impairment losses that could have a material adverse impact on our results of operations.

Income taxes. In 1998 through 2001, we recognized net losses in our financial statements of approximately \$150 million. These losses generated a sizeable federal tax net operating loss, or NOL, carryforward of approximately \$96.0 million as of December 31, 2001. Approximately \$52 million of this NOL carryforward is subject to limitation of use as a result of changes in ownership that occurred in 2000, whereby approximately \$3.6 million becomes available each year through 2015. The remaining \$44 million NOL can be utilized to offset future taxable income that may be generated in our continuing business activities. Additionally, even though the goodwill related to the K*TEC acquisition was written off as a cumulative effect adjustment in the first quarter of 2002, this amount will not be deductible for income tax purposes in 2002. The tax basis of goodwill will continue to be amortized over 15 years for income tax purposes, which will generate additional tax deductions through 2015.

Generally accepted accounting principles require that we record a valuation allowance against deferred tax assets if it is more likely than not that we will not be able to utilize it to offset future taxes. Due to our history of unprofitable operations, we have not recognized a benefit for any of this net deferred tax asset. We currently provide for income taxes only to the extent that we expect to pay cash taxes (primarily state taxes) for current income.

Table of Contents

It is possible, however, that we could be profitable in the future at levels that cause management to conclude that it is more likely than not that we will realize all or a portion of the NOL carryforward. Upon reaching such a conclusion, we would immediately record the estimated net realizable value of the deferred tax asset at that time and would begin providing for income taxes at a rate equal to our combined federal and state effective rates. Subsequent revisions to the estimated net realizable value of the deferred tax asset could cause our provision for income taxes to vary significantly from period to period, although our cash tax payments would remain unaffected until the benefit of the NOL is utilized in full.

For a detailed discussion on the application of these and other accounting policies, see Note 1 in our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2001.

Overview of Statement of Operations

We recognize revenue when title is transferred to our customers, which generally occurs upon shipment from our facilities. Our gross sales are reduced by an allowance for returns to arrive at the net sales reported in our financial statements. Currently, we do not have non-cancelable long-term contracts with our customers.

Cost of goods sold includes materials, labor, and overhead expenses incurred in the manufacture of our products. Cost of goods sold also includes charges for obsolete and slow moving inventories and charges for impairment of long-lived assets used in our manufacturing operations. Many factors affect our gross margin, including capacity utilization, product mix, and production volume. We generally do not have long-term contracts with our suppliers.

Selling, general, and administrative expenses primarily include the salaries for executive, finance, accounting, and human resources personnel; salaries and commissions paid to our internal sales force and marketing costs; insurance expenses; depreciation expense related to assets not used in manufacturing activities; and professional fees for auditing and legal assistance and general corporate expenses. Related party expenses include management fees and advisory fees paid to affiliates of our majority stockholder.

Reorganization transaction costs relate primarily to costs incurred in connection with the business combination between EFTC and K*TEC, which is described in Note 2 of our consolidated financial statements included in this report. The costs included fees primarily related to professional fees and printing costs for the combination and related Securities and Exchange Commission filings. The business combination is being accounted for as a reorganization of entities under common control, and, accordingly, these costs were charged to operations in the period when the costs were incurred.

Goodwill amortization expenses include the amortization of goodwill relating to the 1997 acquisition of Current Electronics, Inc. and the 2000 acquisition of K*TEC Electronics Holding Corporation. Effective January 1, 2002, goodwill was no longer permitted to be amortized when Statement of Financial Accounting Standards No. 142 became effective.

Interest expense relates to our senior credit facilities and other long-term debt obligations. Interest expense also includes the amortization of debt issuance costs.

Table of Contents

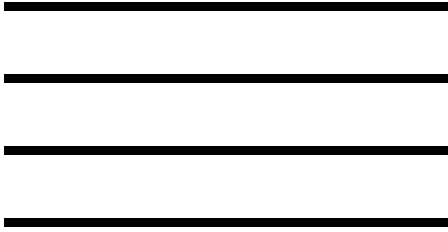
Results of Operations

Our results of operations are affected by several factors, primarily the level and timing of customer orders (especially orders from Honeywell, Applied Materials, and Emulex). The level and timing of orders placed by a customer vary due to the customer's attempts to balance its inventory, changes in the customer's manufacturing strategy, and variation in demand for its products due to, among other things, product life cycles, competitive conditions and general economic conditions. In the past, changes in orders from customers have had a significant effect on our quarterly results of operations. The following table sets forth certain operating data as a percentage of net sales for the quarters and the six months ended July 1, 2001 and June 30, 2002.

	<u>Quarter Ended:</u>		<u>Six Months Ended:</u>	
	<u>July 1, 2001</u>	<u>June 30, 2002</u>	<u>July 1, 2001</u>	<u>June 30, 2002</u>
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold				
99.3% 98.8% 97.4% 100.1%				

Gross profit (loss)				
0.7% 1.2% 2.6% (0.1)%				
Operating costs and expenses:				
Selling, general, and administrative				
5.5% 8.2% 4.9% 8.6%				
Related party management and advisory expenses				
0.2% 0.2% 0.7% 0.2%				
Reorganization transaction costs				
0.7% 0.3% 0.2%				
Goodwill amortization				
0.5% 0.4%				

Operating income (loss)				
(6.2)% (7.2)% (3.7)% (9.1)%				



Quarter Ended July 1, 2001 Compared to Quarter Ended June 30, 2002

Net Sales. Net sales decreased \$56.3 million, or 35.9%, from \$156.7 million for the second quarter of 2001 to \$100.4 million for the second quarter of 2002. This decrease in second quarter 2002 net sales was primarily attributable to significant decreases in net sales to Honeywell and Emulex of \$43.0 million and \$12.2 million, respectively. The decrease in net sales in 2002 was primarily attributable to significant downturns in the industries that our major customers are engaged in, including aerospace and defense, networking and telecommunications equipment. These decreases were partially offset by \$7.7 million of sales related to the March 2002 acquisition of the assets of Midwestern Electronics, Inc. For the third quarter of 2002, we expect our net sales will remain at approximately \$100 million as a result of the continuing soft demand in the end markets served by our customers.

For the second quarter of 2001, Honeywell, Applied Materials and Emulex accounted for 52.0%, 12.1% and 11.5%, respectively, of our net sales. For the second quarter of 2002, Honeywell, Applied Materials and Emulex accounted for 38.3%, 25.7% and 5.8%, respectively, of our net sales.

Gross Profit (Loss). Our gross profit increased \$0.1 million from \$1.1 million in the second quarter of 2001 to \$1.2 million in the second quarter of 2002. Similarly, gross profit as a percentage of net sales improved from 0.7% of net sales in the second quarter of 2001 to 1.2% of net sales in the second quarter of 2002. The improvement in gross profit in the second quarter of 2002 reflects the benefits of indirect cost reductions and manufacturing consolidations, partially

Table of Contents

offset by higher fixed costs associated with lower overall capacity utilization. As discussed under the caption *Capital Resources*, during the third quarter of 2002 we expect to incur substantial restructuring related charges that will be reported under cost of goods sold.

During the second quarter of 2001, we assessed certain long-lived assets for impairment, due to changes in our customers and product mix. We assessed the carrying value of intellectual property costs and manufacturing equipment related to those customers and determined that an impairment charge of \$0.4 million was required in the second quarter of 2001. Accordingly, this impairment charge is included in our cost of goods sold in 2001.

Inventory write-downs decreased \$2.9 million from \$3.7 million, or 2.4% of net sales, in the second quarter of 2001 to \$0.8 million, or 0.8% of net sales, in the second quarter of 2002. This reduction in inventory write-downs resulted primarily from our substantial efforts over the past year to improve our inventory management processes and to work more closely with our customers to minimize losses due to excess inventories.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses (SG & A) decreased \$0.4 million, or 4.5%, from \$8.6 million in the second quarter of 2001 to \$8.2 million in the second quarter of 2002. The decrease in SG & A during the second quarter of 2002 was primarily attributable to a reduction in selling related expenses, partially offset by an increase in professional fees.

Related Party Expenses. Related party expenses decreased \$0.1 million, or 39.9%, from \$0.3 million in the second quarter of 2001 to \$0.2 million in the second quarter of 2002. During the second quarter of 2001, affiliates of the majority stockholder charged management fees of \$0.3 million. Effective in the second quarter of 2002, management fees were revised to provide for a quarterly fee of \$0.2 million.

Reorganization Transaction Costs. In the second quarter of 2001, we incurred costs, primarily for a fairness opinion and professional fees, of \$1.0 million related to the combination with K*TEC that was completed on February 28, 2002. This business combination was accounted for as a reorganization of entities under common control, and, accordingly, these costs were charged to operations when the costs were incurred.

Goodwill amortization. During the second quarter of 2001, goodwill amortization includes \$0.1 million related to the 1997 acquisition of Current Electronics, Inc., and \$0.6 million related to the 2000 acquisition of K*TEC Electronics Holding Corporation. Effective January 1, 2002, goodwill was no longer permitted to be amortized when Statement of Financial Accounting Standards No. 142 became effective.

Interest Expense. Interest expense decreased \$2.7 million, or 85.3%, from \$3.2 million in the second quarter of 2001 to \$0.5 million in the second quarter of 2002, primarily due to a decrease in average outstanding borrowings. Our weighted average borrowings decreased from \$111.4 million during the second quarter of 2001 to \$15.1 million during the second quarter of 2002. Our weighted average interest rate also decreased from 10.4% in the second quarter of 2001 to 9.0% in the second quarter of 2002. The most significant event leading to lower borrowings and interest rates in the second quarter of 2002 was the May 2001 conversion to common stock of over \$59 million of Convertible Notes held by Thayer-Blum Funding. These

Table of Contents

notes accrued interest at 8.875% and were converted to 8,056,586 shares of Suntron common stock as a condition of the K*TEC merger agreement that was entered into in May 2001.

Lower interest rates on the Company's revolving credit facilities in 2002 also contributed to the reduction in interest expense. The prime rate decreased by approximately 2.5 percentage points for the second quarter of 2002 compared to the second quarter of 2001, and this also had a favorable impact because the interest rate on the revolving line of credit is a variable rate based on the prime and LIBOR rates. However, the positive impact of lower prime and LIBOR rates in 2002 was partially offset by an increase in the margin in excess of these rates due to the November 2001 amendment to our credit agreement with Citibank.

A portion of the purchase price for the October 2000 acquisition of K*TEC Electronics Holding Corporation was subject to a dispute that was expected to be resolved through arbitration proceedings. On May 7, 2002, the parties agreed to settle the dispute whereby the \$12.2 million principal balance of a note payable to the former owner was reduced by \$6.9 million, resulting in an adjusted principal balance of \$5.3 million. This note, which provided for interest at 14%, was repaid in May 2002.

Six Months Ended July 1, 2001 Compared to Six Months Ended June 30, 2002

Net Sales. Net sales decreased \$161.6 million, or 45.6%, from \$354.6 million for the first six months of 2001 to \$193.0 million for the first six months of 2002. This decrease in 2002 net sales was primarily attributable to significant decreases in net sales across our customer basis, including decreases with Honeywell, Emulex and Applied Materials of \$81.5 million, \$29.8 million and \$19.9 million, respectively. The decrease in net sales in 2002 was primarily attributable to significant downturns in the industries that our major customers are engaged in, including aerospace and defense, semiconductor capital equipment, and networking and telecommunications equipment. These decreases were partially offset by \$9.0 million of sales related to the March 2002 acquisition of the assets of Midwestern Electronics, Inc.

For the first half of 2001, Honeywell, Applied Materials and Emulex accounted for 46.8%, 16.6% and 12.5%, respectively, of our net sales. For the first half of 2002, Honeywell, Applied Materials and Emulex accounted for 43.7%, 20.2% and 7.5%, respectively, of our net sales.

Gross Profit (Loss). Our gross profit decreased \$9.5 million from \$9.3 million in the first six months of 2001 to a deficiency of \$0.2 million in the first six months of 2002. Similarly, gross profit as a percentage of net sales deteriorated from 2.6% of net sales in the first six months of 2001 to a loss of 0.1% of net sales in the first six months of 2002. The reduction in gross profit in the first six months of 2002 is primarily attributable to higher fixed costs associated with lower overall capacity utilization.

During the first six months of 2001, we assessed certain long-lived assets for impairment related to the planned move to a new facility in the Northeast, and the abandonment of manufacturing-related software that is no longer expected to be used. Due to changes in our customers and product mix, we also assessed the carrying value of intellectual property and manufacturing equipment related to those customers during the first six months of 2001. Accordingly, we recognized impairment expense of \$1.1 million that is included in our cost of goods sold in 2001.

Table of Contents

Inventory write-downs decreased \$4.3 million from \$6.1 million, or 1.7% of net sales, in the first six months of 2001 to \$1.8 million, or 0.9% of net sales, in the first six months of 2002. This reduction in inventory write-downs resulted primarily from our substantial efforts over the past year to improve our inventory management processes and to work more closely with our customers to minimize losses due to excess inventories.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses (SG & A) decreased \$0.8 million, or 4.6%, from \$17.4 million in the first six months of 2001 to \$16.6 million in the first six months of 2002. The decrease in SG & A during the first six months of 2002 was primarily attributable to a reduction in selling related expenses, partially offset by an increase in professional fees.

Related Party Expenses. Related party expenses decreased \$1.9 million, or 80.7%, from \$2.4 million in the first six months of 2001 to \$0.5 million in the first six months of 2002. During the first six months of 2001, affiliates of the Company's majority stockholder charged fees of \$1.8 million for investment advisory services related to the credit facility entered into in January 2001 with Citibank. During the first six months of 2001, affiliates of the majority stockholder charged management fees of \$0.6 million. Effective in the second quarter of 2002, management fees were revised to provide for a quarterly fee of \$0.2 million.

Reorganization Transaction Costs. In the first six months of 2001, we incurred costs, primarily for a fairness opinion and professional fees, of \$1.1 million related to the combination with K*TEC that was completed on February 28, 2002. This business combination was accounted for as a reorganization of entities under common control and, accordingly, these costs were charged to operations when the costs were incurred.

Goodwill amortization. During the first six months of 2001, goodwill amortization included \$0.2 million related to the 1997 acquisition of Current Electronics, Inc., and \$1.3 million related to the 2000 acquisition of K*TEC Electronics Holding Corporation. Effective January 1, 2002, goodwill was no longer permitted to be amortized when Statement of Financial Accounting Standards No. 142 became effective.

Interest Expense. Interest expense decreased \$4.9 million, or 74.0%, from \$6.6 million in the first six months of 2001 to \$1.7 million in the first six months of 2002, primarily due to a decrease in average outstanding borrowings. Our weighted average borrowings decreased from \$121.6 million during the first six months of 2001 to \$25.4 million during the first six months of 2002. Our weighted average interest rate also decreased from 9.8% in the first six months of 2001 to 8.5% in the first six months of 2002. The most significant event leading to lower borrowings and interest rates in the first six months of 2002 was the May 2001 conversion to common stock of over \$59 million of Convertible Notes held by Thayer-Blum Funding. These notes accrued interest at 8.875% and were converted to 8,056,586 shares of Suntron common stock as a condition of the K*TEC merger agreement that was entered into in May 2001.

Lower interest rates on the Company's revolving credit facilities in 2002 also contributed to the reduction in interest expense. The prime rate decreased by approximately 3.2 percentage points for the first six months of 2002 compared to the first six months of 2001, and this also had a favorable impact because the interest rate on the revolving line of credit is a variable rate based on the prime and LIBOR rates. However, the positive impact of lower prime and LIBOR rates in

Table of Contents

2002 was partially offset by an increase in the margin in excess of these rates due to the November 2001 amendment to our credit agreement with Citibank.

A portion of the purchase price for the October 2000 acquisition of K*TEC Electronics Holding Corporation was subject to a dispute that was expected to be resolved through arbitration proceedings. On May 7, 2002, the parties agreed to settle the dispute whereby the \$12.2 million principal balance of a note payable to the former owner was reduced by \$6.9 million, resulting in an adjusted principal balance of \$5.3 million. This note, which provided for interest at 14%, was repaid in May 2002.

Cumulative Effect of Change in Accounting for Goodwill. During the first quarter of 2002, the Company adopted the provisions of Statement of Financial Accounting Standards No. 142, which resulted in the requirement to perform a periodic impairment test, using a two-step process. The first step is to identify if potential impairment of goodwill exists. If impairment of goodwill is determined to exist, the second step of the goodwill impairment test measures the amount of the impairment loss, using a fair value-based approach.

The Company engaged an independent firm specializing in valuation services to assist in the determination if impairment of goodwill should be recognized under Statement 142. The Company concluded that goodwill related to the K*TEC reporting unit was determined to be impaired for the entire carrying value, which resulted in an impairment loss of \$69.0 million. This impairment loss was recorded as the cumulative effect of a change in accounting principle.

Liquidity and Capital Resources

Cash Flows from Operating Activities. Net cash provided by operating activities in the first six months of 2001 was \$25.9 million, compared with net cash provided by operating activities of \$18.3 million in the first six months of 2002. The difference between our net loss in the first six months of 2002 of \$87.0 million and \$18.3 million of operating cash flow was primarily attributable to the \$69.0 million cumulative effect adjustment related to the change in accounting for goodwill, a reduction in inventories of \$25.1 million, \$11.0 million of depreciation and amortization expense, and an increase in accounts payable of \$8.4 million, partially offset by an increase of \$4.3 million in trade receivables and a reduction of \$1.9 million in other accrued liabilities.

Days sales outstanding (based on annualized net sales for the quarter and net trade receivables outstanding at the end of the quarter) decreased to 35 days for the second quarter of 2002, compared to 36 days for the comparable period of 2001.

Inventories decreased 20.2% to \$85.2 million at June 30, 2002, compared to \$106.8 million at December 31, 2001. For the second quarter of 2002, inventory turns (i.e., annualized cost of goods sold divided by period end inventory) amounted to 4.7 times per year, compared to 3.6 times for the second quarter of 2001.

Cash Flows from Investing Activities. Net cash used by investing activities in the first half of 2001 was \$11.6 million compared with net cash used by investing activities of \$6.7 million in 2002. Investing cash flows in the first half of 2002 reflect the payment of approximately \$5.5 million in March 2002 for the acquisition the assets of Midwestern Electronics, Inc., and \$1.3 million for other capital expenditures.

Edgar Filing: SUNTRON CORP - Form 10-Q

At June 30, 2002, the borrowing base under our \$75.0 million revolving credit facility with Citibank would have supported borrowings up to \$69.1 million, and we had outstanding borrowings of approximately \$11.0 million under that credit facility. Accordingly, we had unused availability of \$58.1 million as of June 30, 2002. At June 30, 2002, we also had cash and equivalents of \$0.1 million and outstanding checks in excess of cash balances of \$1.5 million, resulting in aggregate capital resources of \$56.7 million.

On February 28, 2002, the combination of EFTC and K*TEC was completed, and EFTC and K*TEC became wholly owned subsidiaries of Suntron. The credit facility with Bank of America, N.A. was repaid in March 2002, and we are now a party to the credit facility with Citibank, N.A. that K*TEC entered into in January 2001. This amended credit facility provides for a revolving line of credit of up to \$75.0 million, maturing in February 2005. Borrowings under the amended credit facility currently bear interest at the prime rate plus 2.00% for Base Rate borrowings and the LIBOR rate plus 3.25% for LIBOR Rate borrowings. Total borrowings are subject to limitation based on a percentage of eligible accounts receivable,

Table of Contents

inventories, real estate, and equipment. The credit agreement requires compliance with certain financial and non-financial covenants. The credit agreement also limits or prohibits us from paying dividends, incurring additional debt, selling significant assets, or merging with other entities without the consent of the lenders. Substantially all of our assets are pledged as collateral for outstanding borrowings.

On August 8, 2002, we announced plans to consolidate manufacturing capabilities by closing our facilities in Ottawa, Kansas and Fremont, California by the end of 2002, in order to eliminate both fixed and variable costs associated with excess capacity. While we believe there will be substantial long-term benefits that we will begin to realize after these actions are completed, we also reported that we expect to record restructuring related charges between \$7 million and \$9 million, primarily in the third quarter of 2002. Although we have not finalized our assessment of the exact breakdown of the restructuring related charges, we believe the majority of the charges will be associated with a loss related to our plans to sublease the Fremont facility, and we also expect a substantial non-cash impairment charge related to the property and equipment at these locations. Accordingly, the cash impact in the second half of 2002 is expected to be less than 30% of the total restructuring related charges associated with these closures; the cash impact associated with the Fremont lease is expected to be paid out over the remaining term of the lease unless we are successful in negotiating a settlement agreement with the landlord.

We believe that adequate capital resources are in place to fund our working capital and other cash requirements for the next 12 months. However, depending on the amount of capital resources that are devoted to any future acquisitions of businesses, and increased working capital requirements if sales levels increase significantly, we may need to seek additional funds through public or private debt or equity offerings, bank borrowings, or leasing arrangements.

The continued availability of our credit facility with Citibank is a critical assumption underlying our belief that adequate capital resources are currently in place to fund our planned activities for the next 12 months. The borrowing base calculation under this credit facility is based on a percentage of eligible receivables and inventories, plus the appraised value of certain real estate and equipment. Accordingly, our borrowing availability decreases as our net receivables and inventories decline. However, the borrowing base generally increases as our receivables and inventories increase. If our sales begin to increase rapidly, this credit facility is critical to enable us to finance the increased working capital requirements associated with growth. We are also required to comply with certain financial and reporting covenants that must be adhered to in order to ensure the continuous availability of funding under this credit facility. If we are unable to comply with all of our covenants, the credit facility could be withdrawn and this would have a material adverse effect on the Company's liquidity, resulting in the need to seek other sources of financing. There is no assurance that we would be successful in securing additional financing, and even if we would be successful, the terms may be less favorable than we currently have with Citibank.

Table of Contents

Impact of Recently Issued Accounting Standards

In August 2001, the Financial Accounting Standards Board (FASB) issued Statement No. 143, *Accounting for Asset Retirement Obligations*. This standard requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity capitalizes a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement. This standard is effective for fiscal years beginning after June 15, 2002, with earlier application encouraged. Management does not believe the initial application of Statement 143 will have a significant impact on our consolidated financial statements.

In July 2002, the FASB issued Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. This standard requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Examples of costs covered by the standard include lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, plant closing, or other exit or disposal activity. Previous accounting guidance was provided by EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. Statement 146 replaces Issue 94-3. Statement 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. Accordingly, the closure of our plants in Ottawa, Kansas and Fremont, California that were announced on August 8, 2002 will not be accounted for under Statement 146.

Table of Contents

Factors That May Affect Future Results

An investment in our common stock involves a high degree of risk. You should carefully consider the factors described below, in addition to those discussed elsewhere in this report, in analyzing an investment in our common stock. If any of the events described below occurs, our business, financial condition, and results of operations would likely suffer, the trading price of our common stock could fall, and you could lose all or part of the money you paid for our common stock.

In addition, the following factors could cause our actual results to differ materially from those projected in our forward-looking statements, whether made in this 10-Q, our annual or quarterly reports to stockholders, future press releases, SEC filings or orally, whether in presentations, responses to questions, or otherwise. See Statement Regarding Forward-Looking Statements.

Our inability to successfully integrate our operations may adversely affect our ability to realize the anticipated benefits of the recent business combinations.

The success of recent business combination will depend on our ability to unite the business strategies, human resources and information technology systems of previously separate companies. The difficulties of combining operations include the necessity of coordinating geographically separated organizations and integrating personnel with diverse business backgrounds. Combining management resources will result in changes affecting all employees and operations. Differences in management approach and corporate culture may strain employee relations. The process of integrating operations could cause an interruption of, or loss of momentum in, the activities of the combined businesses and the loss of key personnel. We may encounter difficulties in the process of integrating the business operations, which could adversely affect our ability to realize the anticipated benefits of the combinations, including expected synergies from cost-cutting initiatives and cross-selling of products and services across customers and geographic regions. The diversion of management's attention and any delays or difficulties encountered in connection with the combination and the integration of operations could have an adverse effect on our business, financial condition, results of operations, or prospects.

The combination may result in a loss of customers and employees, which could harm our results of operations.

The combination could cause certain customers to either seek alternative sources of product supply or service, or delay or change orders for products due to uncertainty over the integration of the two companies or the strategic position of the combined company. As a result, we may experience some customer attrition. Any customer attrition could harm our results of operations. Difficulties in integrating the operations of EFTC, K*TEC and Midwestern, including the uncertainty related to organizational changes, could also negatively affect employee morale and result in the loss of key employees. We may not be able to retain key management, sales, marketing, and technical personnel. Any steps taken by us to address customer and employee attrition may not be effective, and this attrition could negatively affect our results of operations.

Table of Contents

We have experienced declining net sales.

Our net sales declined throughout 2001 from \$197.9 million in the first quarter of 2001 to \$156.7 million in the second quarter of 2001, \$133.8 million in the third quarter of 2001, and \$86.0 million in the fourth quarter of 2001. During 2002, our net sales have increased to \$92.6 million in the first quarter and \$100.4 million in the second quarter. However, much of these increases are attributable to the March 2002 acquisition of Midwestern Electronics and there can be no assurance that further increases will be realized during the remainder of 2002.

We are dependent on the aerospace industry, and recent terrorist attacks may negatively impact our results of operations.

Our principal customer is engaged in the aerospace market. See We are dependent upon a small number of customers for a large portion of our net sales, and a decline in sales to major customers would harm our results of operations. Consequently, a significant percentage of our net sales will be derived from the aerospace segment of the electronics industry, and a significant decline in the aerospace market could have a negative impact on our results of operations. The September 11, 2001 terrorist attacks on the World Trade Center in New York and the Pentagon in Washington, D.C. using hijacked commercial aircraft have been highly publicized. We believe that these events have had an adverse impact on our recent results of operations. See We have experienced declining net sales. The long-term impact is not known at this time, but may include reduced demand for products of our aerospace customers, which would have a negative impact on our results of operations.

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

Our business is heavily dependent on the electronics industry. A significant percentage of our net sales are generated from the aerospace and defense, semiconductor capital equipment, industrial controls and instrumentation, medical equipment, networking and telecommunications equipment segments of the electronics industry, which is characterized by intense competition, relatively short product life-cycles and significant fluctuations in product demand. Furthermore, these segments are subject to economic cycles and have experienced in the past, and are likely to experience in the future, recessionary periods. A recession or any other event leading to excess capacity or a downturn in these segments of the electronics industry could result in intensified price competition as well as a decrease in our gross margins and unit volume sales.

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

A small number of customers is responsible for a significant portion of our net sales. Sales to Honeywell, Applied Materials and Emulex represented approximately 43.7%, 20.2% and 7.5%, respectively, of our net sales for the first half of 2002. We expect a significant portion of our net sales will continue to be generated by a small number of customers.

Our customer concentration could increase or decrease depending on future customer requirements, which will depend in large part on market conditions in the electronics industry segments in which our customers participate. The loss of one or more major customers or a decline in sales to our major customers could significantly harm our business and results of operations and lead to declines in the price of our common stock.

Table of Contents

If we are not able to expand our customer base, we will continue to depend upon a small number of customers for a significant percentage of our net sales. Despite existing contractual arrangements, there can be no assurance that current customers, including Honeywell, Applied Materials, Emulex, or future customers will not terminate their manufacturing arrangements with us or significantly change, reduce, or delay the amount of manufacturing services ordered from us.

In addition, we generate significant accounts receivable in connection with providing services to our customers. If one or more of our significant customers were to become insolvent or were otherwise unable or unwilling to pay for our services, our results of operations would be harmed.

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

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

In addition, we make significant decisions, including determining the levels of business that we seek and accept, production schedules, component procurement commitments, personnel needs, and other resource requirements based on estimates of customer requirements. The short-term nature of our customers' commitments and the possibility that a rapid change in demand for their products reduces our ability to estimate accurately future customer requirements. In addition, because many of our costs and operating expenses are relatively fixed, a reduction in customer demand could harm our gross margins and operating income. Conversely, customers may on occasion require rapid increases in production, which can stress our resources and reduce margins, and we may not have sufficient capacity at any given time to meet our customers demands.

Our results of operations will be affected by a variety of factors, which could cause our results of operations to fail to meet expectations and our stock price to decline.

Our results of operations have varied, and our results of operations may continue to fluctuate significantly from period to period, including on a quarterly basis. Our results of operations will be affected by a number of factors, including:

- timing of orders from and shipments to major customers;
- mix of products ordered by major customers;
- volume of orders as related to our capacity at individual locations;
- pricing and other competitive pressures;
- component shortages, which could cause us to be unable to meet customer delivery schedules;
- our ability to minimize inventory obsolescence and bad debt expense risk;
- our ability to manage effectively inventory and fixed asset levels;

Table of Contents

our ability to time expenditures in anticipation of future sales; and

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

Our results of operations can also be significantly influenced by development and introduction of new products by our customers. From time to time, we may experience changes in the volume of sales to our principal customers, and results of operations may be affected on a period-to-period basis by these changes. See Our customers may cancel their orders, change production quantities, or delay production. Results of operations in any period should not be considered indicative of the results to be expected for any future period. In addition, fluctuations in results of operations may also result in fluctuations in the price of our common stock.

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

As of June 30, 2002, we had outstanding indebtedness of approximately \$11.0 million. In addition, subject to the restrictions under our debt agreements, we may incur significant additional indebtedness from time to time to finance acquisitions or capital expenditures or for other purposes.

Our level of debt could have negative consequences. For example, it could:

require us to dedicate a substantial portion of our cash flow from operations to repayment of debt, limiting the availability of cash for other purposes;

increase our vulnerability to adverse general economic conditions by making it more difficult to borrow additional funds to maintain our operations if we suffer revenue shortfalls;

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

hinder our flexibility in planning for, or reacting to, changes in our business and industry by preventing us from borrowing money to upgrade our equipment or facilities; and

limit or impair our ability to obtain additional financing in the future for working capital, capital expenditures, acquisitions, or general corporate purposes.

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

The market for our products and services is characterized by rapidly changing technology and continual implementation of new production processes. The future success of our business will depend in large part upon our ability to maintain and enhance our technological capabilities, to develop and market products that meet changing customer needs, and to successfully anticipate or respond to technological changes on a cost-effective and timely basis. We expect that the investment necessary to maintain our technological position will increase as customers make demands for products and services requiring more advanced technology on a quicker turnaround basis. We may not be able to borrow additional funds in order to respond to technological changes as quickly as our competitors.

In addition, the electronics manufacturing services industry could encounter competition from new or revised manufacturing and production technologies that render existing manufacturing and production technology less competitive or obsolete. We may not be able to

Table of Contents

respond effectively to the technological requirements of the changing market. If we need new technologies and equipment to remain competitive, the development, acquisition and implementation of those technologies and equipment may require us to make significant capital investments.

We are dependent on limited and sole source suppliers for electronic components and may experience component shortages, which would cause us to delay shipments to customers, resulting in potential declines in net sales and results of operations.

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

If we experience excess capacity due to variability in customer demand, our gross margins may fall.

We may schedule certain of our production facilities at less than full capacity to retain our ability to respond to additional quick turnaround orders. However, if these orders are not made, we may forego some production and could experience excess capacity. When we experience excess capacity, our sales revenue may be insufficient to fully cover our fixed overhead expenses and our gross margins will fall. Conversely, we may not be able to capture all potential revenue in a given period if our customers' demands for quick turnaround services exceed our capacity during that period.

We periodically address excess capacity issues through plant closures which may result in significant charges.

When our net sales decline significantly, it is difficult to operate our plants profitably since it is not possible to eliminate most of our fixed costs. If we determine that the decline in sales is unlikely to be followed by a rapid recovery, we may determine that there are significant benefits to reducing our cost structure by closing plants and transferring existing business to other plants that are also operating below optimal capacity levels. In order to realize the long-term benefits of these actions, we usually incur substantial charges for impairment of assets, termination of leases, and the payment of severance and retention benefits to affected employees. In addition to the up-front costs associated with these actions, the transition of inventory and manufacturing services to a different facility can result in quality and delivery issues that may have an adverse impact in retaining customers that are affected by the plant closure. Our results of operations could also be materially and adversely affected by our inability to timely sell or sublet closed facilities on expected terms or otherwise achieve the expected benefits of our restructuring activities.

Table of Contents

Our inability to expand our Web-based supply chain management system could negatively impact our future competitiveness.

Our future success depends in part on our ability to rapidly respond to changing customer needs by scaling operations to meet customers requirements, shift capacity in response to product demand fluctuations, procure materials at advantageous prices, manage inventory, and effectively distribute products to our customers. In order to continue to meet these customer requirements, we have developed a Web-based supply chain management system that enables us to collaborate with our customers on product content and to process engineering changes. We are currently implementing an enhanced version of our existing system, which will include real-time communications between our customers across all of our facilities. Our inability to expand this Web-based system or delays or defects in such expansion could negatively impact our ability to manage our supply chain in an efficient and timely manner to meet customer demands, which could adversely affect our competitive position and negatively affect our ability to be competitive in the electronics manufacturing services industry.

We may expand our business into new products and services and may not be able to compete effectively with other companies who have been in these businesses longer than we have.

In the future, we may broaden our service offerings by providing new products and services. If we do this, we will likely compete with companies that have substantially greater financial and manufacturing resources than we have and who have been providing these services longer than we have. We may not be able to compete successfully on this basis with more established competitors.

Our industry is extremely competitive.

The electronics manufacturing services industry is extremely competitive and includes hundreds of companies. The contract manufacturing services we provide are available from many independent sources, and we compete with numerous domestic and foreign electronic manufacturing services firms, including Solectron Corporation; SMTC Corporation; Benchmark Electronics, Inc.; Pemstar, Inc.; Plexus Corp.; Group Technologies Corporation; Sanmina Corporation; Flextronics International Ltd.; Manufacturers Services, Ltd.; Celestica Inc; Jabil Circuit, Inc.; and others. Many of such competitors are more established in the industry and have greater financial, manufacturing or marketing resources than us. We may be operating at a cost disadvantage as compared to our competitors that have greater direct buying power from component suppliers, distributors, and raw material suppliers and have lower cost structures. In addition, certain of our competitors have broader geographic presence, including manufacturing facilities in foreign countries. We believe that the principal competitive factors in our targeted market are quality, reliability, ability to meet delivery schedules, technological sophistication, geographic location, and price. We also face competition from our current and potential customers, who are continually evaluating the relative merits of internal manufacturing versus contract manufacturing for various products.

In recent years, many participants in our industry have substantially expanded their manufacturing capacity. If overall demand for electronics manufacturing services decreases, this increased capacity could result in substantial pricing pressures, which could seriously harm our operating results.

Table of Contents

We may be subject to risks associated with acquisitions, and these risks could harm our results of operations and cause our stock price to decline.

In 2002, we acquired substantially all of the assets of Midwestern Electronics, Inc., and we anticipate that we may seek to identify and acquire additional suitable businesses in the electronics manufacturing services industry. Acquisitions of companies and businesses and expansion of operations involve certain risks, including the following:

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

diversion of management's attention;

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

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

loss of key employees of acquired operations; and

the potential liabilities of the acquired businesses.

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

Products we manufacture may contain design or manufacturing defects, which could result in reduced demand for our services and increased liability claims.

We manufacture products to our customers' specifications, which are highly complex and may contain design or manufacturing errors or failures despite our quality control and quality assurance efforts. Defects in the products we manufacture, whether caused by a design, manufacturing or component failure or error, may result in delayed shipments, customer dissatisfaction, or a reduction or cancellation of purchase orders. If these defects occur either in large quantities or too frequently, our business reputation may be impaired. Because our products are used in products that are integral to our customers' businesses, errors, defects or other performance problems could result in financial or other damages to our customers, for which we may be legally required to compensate them. Product liability litigation against us, even if it were unsuccessful, would be time consuming and costly to defend.

Table of Contents

Our management team has not worked together as a combined unit, which may make it more difficult to conduct and grow our business.

Our management team has only been working together since July 2000 after the completion of the initial stage of EFTC's recapitalization by Thayer-Blum. If our management team cannot successfully work together, we may not be able to execute our business strategy or compete effectively. Any failure to manage the combined operations of EFTC, K*TEC and Midwestern could harm our business and limit our ability to realize the anticipated benefits of the combinations.

Our major stockholder controls us and could prevent a change of control or other business combination or could effect a short form merger without the approval of other stockholders.

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

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

Our inability to manage our growth successfully may divert our resources and harm our results of operations.

Our future results of operations will be affected by our ability to manage expected growth successfully. Our future results may also be impacted by our ability to execute future acquisitions and integrate the operations of acquired companies with our operations. Any further growth is likely to continue to place a significant strain on our managerial, operational, financial, and other resources. This growth will require us to implement additional management information systems, to further develop our operating, administrative, financial, and accounting systems and controls and to maintain close coordination among our accounting, finance, sales and marketing, and customer service and support departments. In addition, we may be required to retain additional personnel to adequately support our growth. If we cannot effectively manage our expanding operations, we may not be able to continue to grow, or we may grow at a slower pace. Any failure to successfully manage growth and to develop financial controls and accounting and operating systems or to add and retain personnel that adequately support growth could harm our business and financial results.

Table of Contents

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

While we believe our capital resources are currently adequate, we may need to raise additional funds for the following purposes:

- to fund our operations;
- to fund any growth we experience;
- to enhance or expand the range of services we offer;
- to increase our promotional and marketing activities; or
- to respond to competitive pressures or perceived opportunities, such as investment, acquisition, and international expansion activities.

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

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

We have no patent or trade secret protection for our manufacturing processes, but instead rely on the collective experience of our employees to ensure that we continuously evaluate and adopt new technologies in our industry. Although we are not dependent on any one employee or a small number of employees, if a significant number of employees involved in our manufacturing processes were to leave our employment and we are not able to replace these people with new employees with comparable experience, our manufacturing processes may suffer as we may be unable to keep up with innovations in the industry. As a result, we may not be able to continue to compete effectively.

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

Our future success will depend to a significant degree upon the continued contributions of our key management, marketing, technical, financial, accounting and operational personnel, including James K. Bass, our President and Chief Executive Officer. We do not have employment agreements with any of our key employees, except Mr. Bass and R. Michael Gibbons, one of our vice presidents. The loss of the services of one or more key employees could have a material adverse effect on our results of operations. We also believe that our future success will depend in large part upon our ability to attract and retain additional highly skilled management, technical, marketing, product development, operational personnel, and consultants. Competition for such personnel is intense. There can be no assurance that we will be successful in attracting and retaining such personnel. In addition, recent and potential future facility shutdowns and workforce reductions may have a negative impact on employee recruiting and retention.

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

Our operations are regulated under a number of federal, state, and foreign environmental and safety laws and regulations that govern, among other things, the discharge of hazardous materials into the air and water, as well as the handling, storage, and disposal of such materials.

Table of Contents

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

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

We may be exposed to intellectual property infringement claims by third parties that could be costly to defend, could divert management's attention and resources and, if successful, could result in liability.

We could be subject to legal proceedings and claims for alleged infringement of third party proprietary rights, such as patents, from time to time in the ordinary course of business. In certain cases, we may find it necessary or desirable to license or otherwise acquire rights to intellectual property held by others. For example, in February 2000, EFTC settled a dispute with the Lemelson Foundation by entering into a license agreement that required EFTC to make payments totaling approximately \$160,000 over 18 months. Other similar disputes could arise in the future. These disputes could be costly to defend and could also result in the diversion of management time and attention. In addition, adverse determinations in any proceedings could require us to pay monetary damages and could also result in loss of intellectual property rights. In the event we were able to settle disputes through licensing or similar arrangements, the costs of these licenses could be substantial. Accordingly, future disputes regarding intellectual property rights could harm our business, financial condition, and results of operations.

Table of Contents

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

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

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

- failure to meet the performance estimates of securities analysts;
- changes in financial estimates of our net sales and results of operations by securities analysts;
- the timing of announcements by us or our competitors of significant contracts or acquisitions; and
- general stock market conditions.

Recently, when the market price of a company's stock has been volatile, stockholders have often instituted securities class action litigation against that company. If a class action lawsuit is filed against us, we could incur substantial costs defending the lawsuit and management time and attention would be diverted. An adverse judgment could cause our financial condition or results of operations to suffer.

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

We currently have foreign operations in Mexico. We may in the future expand into other foreign countries. We have limited experience in managing geographically dispersed operations and in operating in foreign countries. Because of the scope of our international operations, we are subject to the following risks, which could adversely impact our results of operations:

- economic or political instability;
- transportation delays and interruptions;
- increased employee turnover and labor unrest;
- incompatibility of systems and equipment used in foreign operations;
- difficulties in staffing and managing foreign personnel and diverse cultures; and
- less developed infrastructures.

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

Table of Contents**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

On January 26, 2001, the Company entered into a revolving line of credit agreement with Citibank, N.A. The amended credit agreement provides for total borrowings up to \$75 million. The interest rate under this agreement is based either on the prime rate or LIBOR rate, plus applicable margins. Therefore, as interest rates fluctuate, the Company may experience changes in interest expense that will impact financial results. The Company has not entered into any interest rate swap agreements, or similar instruments, to protect against the risk of interest rate fluctuations. Assuming outstanding borrowings of \$75 million, if interest rates were to increase or decrease by 1%, the result would be an increase or decrease in annual interest expense of \$750,000. Accordingly, significant increases in interest rates could have a material adverse effect on the Company's future results of operations.

PART II. OTHER INFORMATION**Item 1. Legal Proceedings**

Not Applicable.

Item 2. Changes in Securities and Use of Proceeds

Not Applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

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

On June 28, 2002, the Company held its annual meeting of stockholders to vote on the election of three directors, each for a term of three years, and to approve the Amended and Restated 2002 Stock Option Plan. The results of the meeting are as follows:

Election of Directors:

<u>Name</u>	<u>For</u>	<u>Withhold</u>
James K. Bass	24,783,326	289,661
Allen S. Braswell, Jr.	24,784,589	288,398
Richard L. Monfort	24,784,489	288,498

Adoption of the Company's Amended and Restated 2002 Stock Option Plan:

<u>For</u>	<u>Against</u>	<u>Abstain</u>
24,731,683	339,880	1,424

Table of Contents

Item 5. Other Information

Not Applicable.

Item 6. Exhibits and Reports on Form 8-K

(a). Exhibits

The following exhibits are filed with this report:

Exhibit 10.17
Consulting
Services
Agreement dated
as of April 24,
2002 by and
between Suntron
Corporation and
Allen S. Braswell,
Jr. Exhibit 10.18
Management and
Consulting
Agreement by and
between Suntron
Corporation and
Thayer-Blum
Funding III,
L.L.C. Exhibit 99.1
Certificate of
Chief Executive
Officer Exhibit 99.2
Certificate of
Chief Financial
Officer

(b). Reports on Form 8-K

On March 15, 2002, the Company filed a Current Report on Form 8-K. The Company reported under Item 2 that effective February 28, 2002 the business combination with K*TEC Electronics Holding Corporation was consummated. The Company also reported that the financial statements and pro forma financial information required under Item 7 would be filed by amendment within 60 days. On May 14, 2002, the Company filed a Form 8-K/A to provide the required audited financial statements and pro forma financial information.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

SUNTRON CORPORATION

(Registrant)

Date: August 14, 2002 /s/ James K. Bass

James K. Bass
Chief Executive Officer Date: August 14, 2002 /s/ Peter W. Harper

Peter W. Harper
Chief Financial Officer Date: August 14, 2002 /s/ James A. Doran

James A. Doran
Chief Accounting Officer

Table of Contents

EXHIBIT INDEX

Exhibit 10.17	Consulting Services Agreement dated as of April 24, 2002 by and between Suntron Corporation and Allen S. Braswell, Jr.
Exhibit 10.18	
Management and Consulting Agreement by and between Suntron Corporation and Thayer-Blum Funding III, L.L.C.	Exhibit 99.1
Certificate of Chief Executive Officer	Exhibit 99.2
Certificate of Chief Financial Officer	