

SUNTRON CORP  
Form 10-Q  
November 05, 2003

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

**FORM 10-Q**

- Quarterly report pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the fiscal quarter ended **September 28, 2003**, or
- Transition report pursuant section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number **0-49651**

**SUNTRON CORPORATION**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

**86-1038668**

(State of Incorporation)

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

**2501 West Grandview Road, Phoenix, Arizona**

**85023**

(Address of Principal Executive Offices)

(Zip Code)

**(602) 789-6600**

(Registrant's telephone number, including area code)

**Not Applicable**

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

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

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

As of **October 31, 2003**, there were outstanding **27,409,338** shares of the registrant's Common Stock, \$0.01 par value.

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**December 31, 2002 and September 28, 2003**  
**(Dollars in Thousands, Except Per Share Amounts)**

|  | 2002       | 2003       |
|--|------------|------------|
| <b>ASSETS</b>  |            |            |
| <b>Current Assets:</b>   |            |            |
| Cash and equivalents   | \$ 1,621   | \$ 23      |
| Trade receivables, net of allowance for doubtful accounts of \$1,740 and \$1,630, respectively       | 29,161     | 40,440     |
| Inventories  | 67,381     | 57,709     |
| Prepaid expenses and other   | 1,860      | 1,407      |
|  |            |            |
| Total Current Assets   | 100,023    | 99,579     |
|  |            |            |
| <b>Property, Plant and Equipment, at cost:</b>   |            |            |
| Land   | 4,798      | 4,798      |
| Buildings and improvements   | 25,721     | 25,822     |
| Manufacturing machinery and equipment  | 53,699     | 53,760     |
| Furniture, computer equipment and software   | 32,056     | 33,477     |
|  |            |            |
| Total  | 116,274    | 117,857    |
| Less accumulated depreciation and amortization   | (54,368)   | (69,464)   |
|  |            |            |
| Net Property, Plant and Equipment  | 61,906     | 48,393     |
|  |            |            |
| <b>Intangible and Other Assets:</b>  |            |            |
| Goodwill   | 6,964      | 8,996      |
| Identifiable intangible assets, net of accumulated amortization of \$4,004 and \$4,421, respectively | 1,708      | 1,291      |
| Debt issuance costs, net   | 1,156      | 1,065      |
| Deposits and other   | 459        | 298        |
|  |            |            |
| Total Intangible and Other Assets  | 10,287     | 11,650     |
|  |            |            |
|  | \$ 172,216 | \$ 159,622 |

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

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS, Continued**  
**December 31, 2002 and September 28, 2003**  
**(Dollars in Thousands, Except Per Share Amounts)**

|   | 2002       | 2003       |
|---|------------|------------|
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |            |            |
| <b>Current Liabilities:</b>   |            |            |
| Accounts payable  | \$ 32,550  | \$ 29,860  |
| Outstanding checks in excess of cash balances   |            | 1,331      |
| Accrued compensation and benefits   | 7,268      | 4,737      |
| Current portion of accrued exit costs related to facility closures                                    | 3,341      | 2,779      |
| Accrued interest expense  | 87         | 209        |
| Payable to affiliates   | 295        | 220        |
| Accrued property taxes  | 1,626      | 1,178      |
| Accrued business acquisition cost   |            | 1,587      |
| Other accrued liabilities   | 4,484      | 3,471      |
|   | 49,651     | 45,372     |
| <b>Long-term Liabilities:</b>   |            |            |
| Revolving line of credit  | 10,856     | 31,629     |
| Accrued exit costs related to facility closures   | 6,980      | 5,848      |
| Other   | 718        | 772        |
|   | 68,205     | 83,621     |
| <b>Stockholders Equity:</b>   |            |            |
| Preferred stock, \$.01 par value. Authorized 10,000,000 shares, none issued                           |            |            |
| Common stock, \$.01 par value. Authorized 75,000,000 shares; issued and outstanding 27,409,338 shares | 274        | 274        |
| Additional paid-in capital  | 380,175    | 380,197    |
| Deferred stock compensation cost  | (351)      | (206)      |
| Accumulated deficit   | (276,087)  | (304,264)  |
|   | 104,011    | 76,001     |
|   | \$ 172,216 | \$ 159,622 |

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

|  | Quarter Ended         |                       | Nine Months Ended     |                       |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
|  | September 29,<br>2002 | September 28,<br>2003 | September 29,<br>2002 | September 28,<br>2003 |
| <b>Net Sales</b>   | \$ 99,535             | \$ 79,638             | \$ 292,530            | \$ 234,647            |
| <b>Cost of Goods Sold</b>  | 117,095               | 80,780                | 312,376               | 244,071               |
| Gross profit (loss)  | (17,560)              | (1,142)               | (19,846)              | (9,424)               |
| <b>Operating Costs and Expenses:</b>   |                       |                       |                       |                       |
| Selling, general and administrative expenses                                     | 6,864                 | 5,039                 | 21,388                | 16,381                |
| Related party expenses- management fees  | 188                   | 188                   | 647                   | 563                   |
| Merger transaction costs   | 15                    |                       | 312                   |                       |
| Total operating costs and expenses   | 7,067                 | 5,227                 | 22,347                | 16,944                |
| Operating loss   | (24,627)              | (6,369)               | (42,193)              | (26,368)              |
| <b>Other Income (Expense):</b>   |                       |                       |                       |                       |
| Interest expense   | (411)                 | (761)                 | (2,122)               | (1,941)               |
| Reduction in interest expense due to settlement of dispute                       |                       |                       | 1,029                 |                       |
| Gain (loss) on sale of assets  | (5)                   | 6                     | (162)                 | 42                    |
| Interest and other income  | 525                   | 4                     | 687                   | 90                    |
| Loss before income taxes and cumulative effect of change in accounting principle | (24,518)              | (7,120)               | (42,761)              | (28,177)              |
| <b>Income Tax Benefit (Expense)</b>  | 40                    |                       | 276                   |                       |
| Loss before cumulative effect of change in accounting principle                  | (24,478)              | (7,120)               | (42,485)              | (28,177)              |
| <b>Cumulative Effect of Change in Accounting Principle</b>                       |                       |                       | (69,015)              |                       |
| Net loss   | \$ (24,478)           | \$ (7,120)            | \$ (111,500)          | \$ (28,177)           |
| <b>Loss Per Share Applicable to Common Stockholders (Basic and Diluted):</b>     |                       |                       |                       |                       |
| Loss before cumulative effect of change in accounting principle                  | \$ (0.89)             | \$ (0.26)             | \$ (1.55)             | \$ (1.03)             |
| Cumulative effect of change in accounting principle                              |                       |                       | (2.52)                |                       |
| Net loss   | \$ (0.89)             | \$ (0.26)             | \$ (4.07)             | \$ (1.03)             |
| <b>Number of Shares Used for Computation:</b>                                    |                       |                       |                       |                       |
| Basic and diluted  | 27,409,000            | 27,409,000            | 27,409,000            | 27,409,000            |



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



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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Nine Months Ended September 29, 2002 And September 28, 2003**  
**(Dollars in Thousands)**

|  | <u>2002</u>     | <u>2003</u>     |
|--|-----------------|-----------------|
| <b>Cash Flows from Operating Activities:</b>   |                 |                 |
| Net loss   | \$(111,500)     | \$ (28,177)     |
| Adjustments to reconcile net loss to net cash provided (used) by operating activities: |                 |                 |
| Cumulative effect of change in accounting principle                                    | 69,015          |                 |
| Depreciation and amortization  | 16,558          | 16,843          |
| Amortization of debt issuance costs  | 793             | 719             |
| Impairment of property, plant and equipment  | 2,671           | 40              |
| Change in accrued severance, retention and lease exit costs                            | 8,757           | (2,212)         |
| Reduction of interest expense due to settlement  | (1,029)         |                 |
| Loss (gain) on sale of assets  | 162             | (42)            |
| Stock-based compensation and services expense  | 32              | 167             |
| Changes in operating assets and liabilities, net of effects of purchase of businesses: |                 |                 |
| Decrease (increase) in:  |                 |                 |
| Trade receivables, net   | (5,944)         | (9,667)         |
| Inventories  | 36,992          | 10,789          |
| Prepaid expenses and other   | (431)           | 614             |
| Increase (decrease) in:  |                 |                 |
| Accounts payable   | 12,809          | (3,754)         |
| Accrued compensation and benefits  | (3,143)         | (2,480)         |
| Other accrued liabilities  | (1,980)         | (1,770)         |
| Net cash provided (used) by operating activities                                       | <u>23,762</u>   | <u>(18,930)</u> |
| <b>Cash Flows from Investing Activities:</b>   |                 |                 |
| Proceeds from sale of assets   | 111             | 19              |
| Cash paid for acquisition of businesses  | (5,523)         | (205)           |
| Cash acquired in business acquisition  |                 | 301             |
| Capital expenditures   | (1,965)         | (2,672)         |
| Net cash used by investing activities  | <u>(7,377)</u>  | <u>(2,557)</u>  |
| <b>Cash Flows from Financing Activities:</b>   |                 |                 |
| Proceeds from long-term debt   | 227,148         | 246,016         |
| Principal payments on long-term debt   | (258,829)       | (226,830)       |
| Payments for debt issuance costs   | (311)           | (628)           |
| Increase in outstanding checks in excess of cash balances                              | 1,517           | 1,331           |
| Net cash provided (used) by financing activities                                       | <u>(30,475)</u> | <u>19,889</u>   |
| Net decrease in cash and equivalents   | (14,090)        | (1,598)         |
| <b>Cash and Equivalents:</b>   |                 |                 |
| Beginning of period  | <u>14,172</u>   | <u>1,621</u>    |
| End of period  | <u>\$ 82</u>    | <u>\$ 23</u>    |

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**SUNTRON CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS, Continued**  
**Nine Months Ended September 29, 2002 And September 28, 2003**  
**(Dollars in Thousands)**

|  | <u>2002</u>       | <u>2003</u>       |
|--|-------------------|-------------------|
| <b>Supplemental Disclosure of Cash Flow Information:</b>                             |                   |                   |
| Cash paid for interest   | \$ 1,900          | \$ 1,100          |
|  | <u>          </u> | <u>          </u> |
| Cash paid for income taxes   | \$ 20             | \$                |
|  | <u>          </u> | <u>          </u> |
| <b>Supplemental Schedule of Non-cash Investing and Financing Activities:</b>         |                   |                   |
| Reduction of goodwill and note payable to Former Parent due to settlement of dispute | \$ 6,860          | \$                |
|  | <u>          </u> | <u>          </u> |
| Assumption of bank debt for acquisition of business                                  | \$                | \$ 1,156          |
|  | <u>          </u> | <u>          </u> |
| Accrued business acquisition cost  | \$                | \$ 1,587          |
|  | <u>          </u> | <u>          </u> |
| Contract payable for purchase of software  | \$                | \$ 984            |
|  | <u>          </u> | <u>          </u> |

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

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

***1. Basis of Presentation***

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 nine months ended September 28, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. 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, 2002.

During the fourth quarter of 2002, the Company completed an accounting system conversion to integrate the accounts of K\*TEC into the system used by the Company. During this process, management reclassified certain 2002 amounts.

***2. New Accounting Standards***

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 this 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. The Company has applied Statement 146 in accounting for all exit or disposal activities initiated after December 31, 2002. During the third quarter of 2003, the Company recognized restructuring costs of approximately \$1,177, primarily due to consolidation of manufacturing operations in Phoenix. As discussed in Note 8, during the fourth quarter of 2003 the Company expects to recognize additional restructuring costs of \$500 related to the final phase of the consolidation of operations in Phoenix.

In November 2002, the EITF reached a consensus on Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 apply to revenue arrangements entered into fiscal periods beginning after June 15, 2003. The provisions of EITF Issue No. 00-21 did not have a material effect on our consolidated financial statements.

***3. 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 quarters and the nine months ended September 29, 2002 and September 28, 2003, as all potential common shares were antidilutive. As of September 28, 2003, common stock options and warrants that were excluded from the calculation of earnings per share amounted to an aggregate of 2,105,000 shares at exercise prices ranging from \$2.83 to \$57.24 per share.

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

**4. Stock-Based Compensation**

The Company accounts for stock-based compensation issued to employees using the intrinsic value method. Accordingly, compensation cost for stock options granted to employees is measured as the excess, if any, of the quoted market price of the Company's common stock at the measurement date (generally, the date of grant) over the amount an employee must pay to acquire the stock. For fixed awards of stock options with pro rata vesting, the Company utilizes the attribution method described in FASB Interpretation No. 28.

If compensation cost had been determined for all options granted to employees under the fair value method using an option pricing model, the Company's pro forma net loss and earnings (loss) per share (EPS) for the quarters and the nine months ended September 29, 2002 and September 28, 2003, would have been as follows:

|   | Quarter Ended:     |          |                    |          |
|---|--------------------|----------|--------------------|----------|
|   | September 29, 2002 |          | September 28, 2003 |          |
|   | Net Loss           | EPS      | Net Loss           | EPS      |
| Amounts reported  | \$(24,478)         | \$(0.89) | \$(7,120)          | \$(0.26) |
| Add stock-based employee compensation recorded under the intrinsic value method | 12                 |          | 56                 |          |
| Less stock-based employee compensation recorded under the fair value method     | (629)              |          | (714)              |          |
| Pro forma under fair value method   | \$(25,095)         | \$(0.92) | \$(7,778)          | \$(0.28) |

  

|   | Nine Months Ended: |          |                    |          |
|---|--------------------|----------|--------------------|----------|
|   | September 29, 2002 |          | September 28, 2003 |          |
|   | Net Loss           | EPS      | Net Loss           | EPS      |
| Amounts reported  | \$(111,500)        | \$(4.07) | \$(28,177)         | \$(1.03) |
| Add stock-based employee compensation recorded under the intrinsic value method | 32                 |          | 167                |          |
| Less stock-based employee compensation recorded under the fair value method     | (1,887)            |          | (2,381)            |          |
| Pro forma under fair value method   | \$(113,355)        | \$(4.14) | \$(30,391)         | \$(1.11) |

**5. Inventories**

Inventories at December 31, 2002 and September 28, 2003 are summarized as follows:

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|  | <u>2002</u>     | <u>2003</u>     |
|--|-----------------|-----------------|
| Purchased parts and completed sub-assemblies | \$47,686        | \$41,909        |
| Work-in-process                              | 6,967           | 7,634           |
| Finished goods                               | 12,728          | 8,166           |
|  | <u>        </u> | <u>        </u> |
|  | \$67,381        | \$57,709        |
|  | <u>        </u> | <u>        </u> |

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

For the quarters ended September 29, 2002 and September 28, 2003, the Company recognized write-downs of excess and obsolete inventories of \$1,838 and \$827, respectively. For the nine months ended September 29, 2002 and September 28, 2003, the Company recognized write-downs of excess and obsolete inventories of \$3,629 and \$2,897, respectively.

**6. Business Combination**

On May 30, 2003, the Company purchased substantially all of the assets and assumed certain liabilities of Trilogic Systems, LLC, a privately held manufacturer and service provider for original equipment manufacturers. Trilogic's services include design, new product introduction, manufacturing, and product life cycle management for customers in the aerospace and defense, medical and industrial markets. The initial purchase consideration was \$855, which consisted of the assumption and immediate repayment of \$1,156 of Trilogic's bank debt, offset by cash acquired of \$301. The net purchase consideration was funded through borrowings under the Company's revolving line of credit with Citibank. Trilogic's results of operations have been included in the consolidated financial statements since the date of acquisition. The purchase agreement provides for the payment of additional consideration up to approximately \$4,025 based on the achievement of certain sales targets during 2003 and 2004. During the third quarter of 2003, the initial sales targets were achieved. Accordingly, the Company recorded an accrual of \$1,587 that will be payable in the first quarter of 2004 along with additional amounts related to sales targets that are achieved in the fourth quarter of 2003.

The preliminary allocation of the acquisition cost resulted in goodwill of \$2,018. The allocation of the purchase price is based on preliminary data and could change when the final valuation of certain intangible assets is completed. The historical results of operations of Trilogic would not have had a material effect on the Company's consolidated results of operations, and therefore no unaudited pro forma results of operations are presented herein.

In July 2003, the Company purchased certain design and engineering assets from an entity affiliated with Trilogic. The purchase price was \$205, of which \$191 was allocated to software and equipment and \$14 was allocated to goodwill.

**7. Debt Financing**

At December 31, 2002 and September 28, 2003, long-term debt consisted of a credit facility with Citibank that provides for a \$75,000 revolving line of credit. As of December 31, 2002, the interest rate was the prime rate plus 2.00% (6.25% at December 31, 2002) for Base Rate borrowings and the LIBOR rate plus 3.25% (weighted average rate of 4.7% at December 31, 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 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.

On April 11, 2003, the Company and Citibank agreed to an amendment that resulted in an increase of 0.5% from the rates shown above for both Base Rate and LIBOR borrowings (the

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

effective rate as of September 28, 2003 was 6.50% for Base Rate borrowings and 4.89% for LIBOR Rate borrowings), the calculation of the borrowing base was revised, and the maturity date was extended until April 2005. In addition, the Company is obligated to pay a commitment fee of 0.5% per annum of the unused portion of the credit facility up to \$50,000, plus an unused commitment fee of 1.0% to the extent that the unused portion of the credit facility exceeds \$50,000. During the first quarter of 2003, the Company also completed updated inventory and equipment appraisals for purposes of determining the borrowing base. After giving effect to these changes, the borrowing base calculation permitted total borrowings of \$51,983 as of September 28, 2003. After deducting the outstanding principal balance and an outstanding letter of credit, the Company had borrowing availability of \$20,040 as of September 28, 2003 under the amended credit agreement.

The credit agreement requires compliance with certain 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. As of September 28, 2003, the Company is in compliance with the covenants under the credit facility with Citibank.

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.

***8. Restructuring Activities***

The Company periodically takes actions to increase capacity utilization through the closure of facilities and reductions in workforce with the objective of eliminating fixed and variable costs associated with excess capacity. In June 2003, the Company initiated actions to consolidate its Phoenix operations into a single facility with the objective of subleasing up to one-third of the existing leased space in Phoenix. In connection with the initial phase of the Phoenix consolidation, effective June 1, 2003, the estimated useful life of leasehold improvements with a carrying value of \$1,309 was shortened from approximately four years to periods ranging from two months to seven months to coincide with the expected period that the assets will continue to be used in the business. This change in estimate resulted in an increase in depreciation and amortization expense of \$590 (\$0.02 per share) and \$1,083 (\$0.04 per share) for the quarter and the nine months ended September 28, 2003, respectively.

During the third quarter of 2003, the Company recognized lease exit costs of approximately \$352, primarily due to the initial phase of the consolidation of manufacturing operations in Phoenix. Management expects that further lease exit charges related to the Phoenix consolidation of approximately \$500 will be incurred when the Company ceases use of additional leased space, which is expected to occur late in the fourth quarter of 2003.

During the third quarter of 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. Additionally,



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

during the first nine months of 2002 the Company terminated certain employees at other locations in response to reduced business levels.

As a result of the actions described above, the Company recorded restructuring related charges in the three and nine months ended September 29, 2002 and September 28, 2003, as follows:

|   | Quarter Ended:        |                       | Nine Months Ended :   |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September<br>29, 2002 | September<br>28, 2003 | September<br>29, 2002 | September<br>28, 2003 |
| <b>Cost of goods sold:</b>                                      |                       |                       |                       |                       |
| Lease exit costs  | \$ 9,280              | \$ 352                | \$ 9,400              | \$ 444                |
| Impairment of plant and manufacturing equipment                 | 2,434                 | 40                    | 2,434                 | 40                    |
| Accelerated depreciation due to shortened lives of improvements |                       | 590                   |                       | 1,083                 |
| Relocation, moving and other costs                              |                       |                       |                       | 96                    |
| Severance and retention costs                                   | 369                   | 195                   | 474                   | 722                   |
| <b>Total</b>  | <b>12,083</b>         | <b>1,177</b>          | <b>12,308</b>         | <b>2,385</b>          |
| <b>Selling, general and administrative expenses:</b>            |                       |                       |                       |                       |
| Lease exit costs  |                       |                       |                       | (20)                  |
| Impairment of administrative equipment                          | 237                   |                       | 237                   |                       |
| Severance and retention costs                                   | 72                    |                       | 72                    | 68                    |
| Relocation, moving and other costs                              | 17                    |                       | 17                    | 3                     |
| <b>Total</b>  | <b>326</b>            |                       | <b>326</b>            | <b>51</b>             |
| <b>Total restructuring related costs</b>                        | <b>\$ 12,409</b>      | <b>\$ 1,177</b>       | <b>\$ 12,634</b>      | <b>\$ 2,436</b>       |

The following summarizes changes in restructuring related liabilities for the quarter and the nine months ended September 28, 2003:

|  | Quarter                        |                                 | Nine Months                    |                                 |
|--|--------------------------------|---------------------------------|--------------------------------|---------------------------------|
|  | Accrued<br>Lease<br>Exit Costs | Accrued<br>Severance<br>& Other | Accrued<br>Lease<br>Exit Costs | Accrued<br>Severance<br>& Other |
| Balance, beginning of period             | \$ 8,978                       | \$ 40                           | \$ 10,321                      | \$ 61                           |
| Accrual for new activities               | 404                            | 232                             | 404                            | 831                             |
| Revisions of previous estimates          | (61)                           | (40)                            | (109)                          | (42)                            |
| Cash receipts under subleases            | 86                             |                                 | 309                            |                                 |
| Cash payments                            | (823)                          | (232)                           | (2,833)                        | (850)                           |
| Accretion of interest                    | 12                             |                                 | 12                             |                                 |
| Non-level rent expensed in prior periods | 33                             |                                 | 489                            |                                 |
| Other, net                               | (2)                            |                                 | 34                             |                                 |
| <b>Balance, September 28, 2003</b>       | <b>8,627</b>                   |                                 | <b>8,627</b>                   |                                 |
| Less current portion                     | (2,779)                        |                                 | (2,779)                        |                                 |

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|                   |          |    |          |    |
|-------------------|----------|----|----------|----|
| Long-term portion | \$ 5,848 | \$ | \$ 5,848 | \$ |
|-------------------|----------|----|----------|----|

The Company expects that accrued lease exits costs will be paid over the remaining lease terms (all of which expire by September 2007), net of existing and expected sublease rentals.

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

*The following discussion of our financial condition and results of operations should be read in conjunction with our 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, 2002.*

#### **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**

Suntron Corporation delivers complete manufacturing services and solutions to support the entire life cycle of complex products in the semiconductor capital equipment, aerospace and defense, medical and industrial markets. Our manufacturing services include printed circuit card assembly, cable and harness production, plastic injection molding, sheet metal, engineering services, quick-turn manufacturing services and full systems integration, testing, and after-market repair and warranty services. Our success in the marketplace is a direct result of our ability to provide unique solutions tailored to match each of our customer's specific requirements, while meeting the highest quality standards in the industry.

#### **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 raw material quotes from our suppliers and then estimating the amount of labor and overhead that will be required to make the products.

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

The 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 150,000 different parts and many of these parts have limited alternative uses or markets, beyond the products that we manufacture for our customers. When we liquidate excess materials through an inventory broker or auction, we often realize less than the original cost of the materials, and in some cases we determine that there is no market for the excess materials.

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

## **Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations is based upon our 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-related obligations, and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. We cannot assure you that actual results will not differ from those estimates. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

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***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 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 long-lived assets that are no longer needed in continuing operations. When this occurs, we are required to estimate future cash flows and if such cash flows are less than the carrying value of the assets (or asset group, as applicable), we recognize impairment charges to reduce the carrying value to estimated fair value. The determination of future cash flows and fair value tend to be highly subjective estimates. When assets are held for sale and the actual market conditions deteriorate, or are less favorable than those projected by management, additional impairment charges may be required in subsequent periods.

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 assist in determining the fair value of each reporting unit that had goodwill associated with it. The valuation of reporting units is a highly

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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 we recognized an impairment charge of \$69.0 million related to the K\*TEC reporting unit. We are 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.

**Accrual of Lease Exit Costs.** When we undertake restructuring activities and decide to close a plant that we occupy under a non-cancelable operating lease, we are required to estimate how long it will take to locate a new tenant to sublease the facility and to estimate the rate that we are likely to receive when a tenant is located. Accordingly, we will incur additional lease exit charges in future periods if our estimates of the rate or timing of sublease payments turns out to be less favorable than our current expectations. We also consider the estimated cost of building improvements, brokerage commissions, and any other costs we believe will be incurred in connection with the subleasing process. The precise outcome of most of these factors is difficult to predict. We review our estimates at least quarterly, including consultation with our commercial real estate advisors to assess changes in market conditions, feedback from parties that have expressed interest, and other information that we believe is relevant to most accurately reflect the expected outcome of obtaining a subtenant to lease the facility. Commercial real estate conditions are currently very poor in the areas in which we are attempting to sublease closed facilities, and we believe our estimates have appropriately considered these conditions. As discussed under *Impact of Recently Issued Accounting Standards* below, new accounting rules are effective for all restructuring activities after December 31, 2002.

**Revenue Recognition.** We generally recognize revenue from manufacturing services and product sales upon shipment of the manufactured product. Revenue from manufacturing services is generally recognized upon shipment and the transfer of title to the manufactured product whereby our customers assume the risks and rewards of ownership of the product. Generally, there are no formal customer acceptance requirements or further obligations related to manufacturing services; if such requirements or obligations exist, then revenue is recognized at the point when such requirements are completed and such obligations fulfilled. Revenue from design, engineering and other services is recognized as the services are performed.

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, 2002.

## **Overview of Statement of Operations**

We recognize revenue when title is transferred to our customers, which generally occurs upon shipment from our facilities. Our sales are recorded net of customer discounts taken or expected to be taken.

Cost of goods sold includes materials, labor, and overhead expenses incurred in the manufacture of our products. Cost of goods sold also includes charges for obsolete and slow moving inventories and charges for impairment of long-lived assets used in our manufacturing

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operations. Many factors affect our gross margin, including capacity utilization, product mix, and production volume.

Selling, general, and administrative expenses primarily include the salaries for executive, finance, accounting, and human resources personnel; salaries and commissions paid to our internal sales force and external sales representatives and marketing costs; insurance 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 fees include management fees and advisory fees paid to affiliates of our majority stockholder.

Merger transaction costs relate to costs incurred in connection with a business combination between EFTC Corporation and K\*TEC Operating Company, L.L.C., which was consummated on February 28, 2002. 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 was 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.

Interest expense relates to our senior credit facilities and other debt obligations. Interest expense also includes the amortization of debt issuance costs and unused commitment fees that are charged for the portion of our \$75 million credit facility that is not used from time to time.

**Results of Operations**

Our results of operations are affected by several factors, primarily the level and timing of customer orders (especially orders from our major customers). The level and timing of orders placed by a customer vary due to the customer's attempts to balance its inventory, changes in the customer's manufacturing strategy, and variation in demand for its products due to, among other things, product life cycles, competitive conditions, and general economic conditions. In the past, changes in orders from customers have had a significant effect on our quarterly results of operations. The following table sets forth certain operating data as a percentage of net sales for the quarters and the nine months ended September 29, 2002 and September 28, 2003:

|                                      | Quarter Ended            |                          | Nine Months Ended        |                          |
|--------------------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
|                                      | September<br>29,<br>2002 | September<br>28,<br>2003 | September<br>29,<br>2002 | September<br>28,<br>2003 |
| Net sales                            | 100.0%                   | 100.0%                   | 100.0%                   | 100.0%                   |
| Cost of goods sold                   | 117.6%                   | 101.4%                   | 106.8%                   | 104.0%                   |
| Gross profit (loss)                  | (17.6)%                  | (1.4)%                   | (6.8)%                   | (4.0)%                   |
| Operating costs and expenses:        |                          |                          |                          |                          |
| Selling, general, and administrative | 6.9%                     | 6.3%                     | 7.3%                     | 7.0%                     |
| Related party management fees        | 0.2%                     | 0.3%                     | 0.2%                     | 0.2%                     |
| Merger transaction costs             | %                        | %                        | 0.1%                     | %                        |
| Operating loss                       | (24.7)%                  | (8.0)%                   | (14.4)%                  | (11.2)%                  |

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**Quarter Ended September 29, 2002 Compared to Quarter Ended September 28, 2003**

**Net Sales.** Net sales decreased \$19.9 million, or 20.0%, from \$99.5 million for the third quarter of 2002 to \$79.6 million for the third quarter of 2003. During the third quarter of 2003, we continued to be impacted adversely by significant downturns in the industries that many of our customers are engaged in, especially aerospace and defense. The decrease in net sales in the third quarter of 2003 was attributable to a \$22.0 million reduction in our net sales to Honeywell and a \$15.5 million reduction in our net sales to Applied Materials. The reduction in net sales to Honeywell and Applied Materials in the third quarter of 2003 was partially offset by approximately \$14.1 million of sales to new customers and \$3.2 million of sales related to the May 30, 2003 acquisition of the assets of Trilogic.

Net sales for the third quarter of 2002 and 2003 include approximately \$6.7 million and \$0.9 million, respectively, of excess inventories that were sold back to customers pursuant to contractual provisions of our customer agreements. For the third quarter of 2003, net sales includes recovery of unauthorized customer discounts of approximately \$0.4 million.

For the third quarter of 2002, Honeywell and Applied Materials accounted for 42% and 27%, respectively, of our net sales. For the third quarter of 2003, Honeywell and Applied Materials accounted for 25% and 14%, respectively, of our net sales. In 2001, Emulex was also a major customer but our net sales to Emulex have been declining over the past two years and, by the end of the third quarter of 2003, Emulex had essentially disengaged as a customer. For the fourth quarter of 2003, we expect our net sales will be up to 5% lower than net sales for the third quarter of 2003. We are not able to provide guidance beyond the fourth quarter of 2003 due to uncertainty in the markets served by many of our customers.

**Gross Profit (Loss).** Our gross profit increased by \$16.5 million from a loss of \$17.6 million in the third quarter of 2002 to a loss of \$1.1 million in the third quarter of 2003. Similarly, gross profit as a percentage of net sales improved from a loss of 17.6% of net sales in the third quarter of 2002 to a loss of 1.4% of net sales in the third quarter of 2003.

For the third quarter of 2002, we incurred a gross profit deficiency of \$17.6 million, primarily due to \$12.1 million of restructuring charges (consisting of \$9.3 million for lease exit costs; \$2.4 million for impairment of a building and manufacturing equipment; and \$0.4 million for severance and retention costs related to our manufacturing workforce). For the third quarter of 2003, we incurred restructuring costs of \$1.2 million, consisting of \$0.6 million of accelerated depreciation due to shortened lives of leasehold improvements, \$0.4 million for lease exit costs associated with the consolidation of operations in Phoenix and \$0.2 million for severance costs related to terminated employees. The improvement in gross profit in the third quarter of 2003 is primarily attributable to the reduction in restructuring costs and improved capacity utilization. However, despite our extensive restructuring and cost cutting achievements over the past two years, we have not been able to increase net sales to a level that would result in profitable operations.

Inventory write-downs decreased \$1.0 million from \$1.8 million, or 1.8% of net sales, in the third quarter of 2002 to \$0.8 million, or 1.0% of net sales, in the third quarter of 2003. This reduction in inventory write-downs resulted primarily from our substantial efforts over the past two years to improve our inventory management processes and to work more closely with our customers to minimize losses due to excess inventories. Write-downs of excess inventories are



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related to a variety of customers for which we do not expect to realize the carrying value through production or other means of liquidation.

***Selling, General, and Administrative Expenses.*** Selling, general, and administrative expenses ( SG & A ) decreased \$1.9 million, or 26.6%, from \$6.9 million in the third quarter of 2002 to \$5.0 million in the third quarter of 2003. The decrease in SG & A during the third quarter of 2003 was primarily attributable to reductions in compensation and benefits of \$1.0 million, professional fees of \$0.4 million, and information technology and facilities costs of \$0.3 million.

***Interest Expense.*** Interest expense increased \$0.4 million, or 85.2%, from \$0.4 million in the third quarter of 2002 to \$0.8 million in the third quarter of 2003, primarily due to an increase in the weighted average outstanding borrowings in the third quarter of 2003. Our weighted average borrowings increased from \$9.6 million during the third quarter of 2002 to \$31.9 million during the third quarter of 2003.

**Nine Months Ended September 29, 2002 Compared to Nine Months Ended September 28, 2003**

***Net Sales.*** Net sales decreased \$57.9 million, or 19.8%, from \$292.5 million for the first nine months of 2002 to \$234.6 million for the first nine months of 2003. This decrease in 2003 net sales was attributable to significant decreases in net sales across our customer base, including decreases with Honeywell and Applied Materials of \$55.7 million and \$27.8 million, respectively. The reduction in net sales to Honeywell and Applied Materials was partially offset by approximately \$41.8 million of sales to new customers and \$4.3 million of sales related to the May 30, 2003 acquisition of the assets of Trilogic.

Net sales for the first nine months of 2002 and 2003 includes approximately \$15.8 million and \$6.7 million, respectively, of excess inventories that were sold back to customers pursuant to contractual provisions of our customer agreements. For the first nine months of 2003, net sales include the recovery of unauthorized customer discounts of approximately \$1.0 million.

For the first nine months of 2002, Honeywell and Applied Materials accounted for 43% and 23%, respectively, of our net sales. For the first nine months of 2003, Honeywell and Applied Materials accounted for 30% and 16%, respectively, of our net sales. In 2001, Emulex was also a major customer but our net sales to Emulex have been declining over the past two years and, by the end of the third quarter of 2003, Emulex had essentially disengaged as a customer.

***Gross Profit (Loss).*** Our gross profit increased by \$10.4 million from a loss of \$19.8 million for the first nine months of 2002 to a loss of \$9.4 million for the first nine months of 2003. Similarly, gross profit as a percentage of net sales improved from a loss of 6.8% of net sales for the first nine months of 2002 to a loss of 4.0% of net sales for the first nine months of 2003.

For the first nine months of 2002, we incurred a gross profit deficiency of \$19.8 million, primarily due to \$12.3 million of restructuring charges (consisting of \$9.4 million for lease exit costs; \$2.4 million for impairment of a building and manufacturing equipment; and \$0.5 million for severance and retention costs related to our manufacturing workforce). For the first nine months of 2003, we incurred restructuring costs of \$2.4 million, including \$1.1 million of

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accelerated depreciation due to shortened lives of leasehold improvements, \$0.4 million for lease exit costs associated with the consolidation of operations in Phoenix, and \$0.7 million for severance costs related to terminated employees. The increase in gross profit for the first nine months of 2003 is primarily attributable to the reduction in restructuring costs. However, despite our extensive restructuring and cost cutting achievements over the past two years, we have not been able to increase net sales to a level that would result in profitable operations.

Inventory write-downs decreased \$0.7 million from \$3.6 million, or 1.2% of net sales, for the first nine months of 2002 to \$2.9 million, or 1.2% of net sales, in the first nine months of 2003. This reduction in inventory write-downs resulted primarily from our substantial efforts over the past two years to improve our inventory management processes and to work more closely with our customers to minimize losses due to excess inventories. Write-downs of excess inventories are related to a variety of customers for which we do not expect to realize the carrying value through production or other means of liquidation.

***Selling, General, and Administrative Expenses.*** Selling, general, and administrative expenses ( SG & A ) decreased \$5.0 million, or 23.4%, from \$21.4 million in the first nine months of 2002 to \$16.4 million in the first nine months of 2003. The decrease in SG & A during the first nine months of 2003 was primarily attributable to reductions in compensation and benefits of \$2.4 million, professional fees of \$1.5 million, and information technology and facilities costs of \$0.9 million.

***Related Party Expenses.*** Related party expenses decreased \$0.1 million, or 13.0%, from \$0.7 million in the first nine months of 2002 to \$0.6 million in the first nine months of 2003. Effective in the second quarter of 2002, management fees were lowered to provide for a quarterly fee of approximately \$0.2 million.

***Merger Transaction Costs.*** In the first nine months of 2002, we incurred costs of \$0.3 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.

***Interest Expense.*** Interest expense decreased \$0.2 million, or 8.5%, from \$2.1 million in the first nine months of 2002 to \$1.9 million in the first nine months of 2003, primarily due to a decrease in interest rates. Our weighted average interest rate decreased from 8.8% in the first nine months of 2002 to 6.7% in the first nine months of 2003. The benefit of lower interest rates was partially offset by an increase in our weighted average borrowings from \$20.2 million in the first nine months of 2002 to \$23.5 million in the first nine months of 2003.

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. In accounting for this settlement, the Company reduced the carrying amount of goodwill by \$6.9 million and recognized a credit to operations of \$1.0 million for accrued interest that was previously expensed and that was no longer payable due to the settlement. This note, which provided for interest at 14%, was repaid in May 2002.

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***Cumulative Effect of Change in Accounting Principle.*** Effective January 1, 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 third 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 during the first quarter of 2002, we engaged an independent firm specializing in valuation services to assist us in determining whether impairment of goodwill should be recognized under this new standard. We concluded that no impairment exists with respect to goodwill with a carrying value of \$6,729 on January 1, 2002 related to our Northwest reporting unit (which arose in connection with the February 1997 acquisition of Current Electronics). However, we concluded that goodwill related to the K\*TEC reporting unit (which arose in connection with the October 2000 acquisition from Kent Electronics) was impaired for the entire carrying value of \$69.0 million. This impairment loss was reported as a cumulative effect of a change in accounting principle.

## **Liquidity and Capital Resources**

***Cash Flows from Operating Activities.*** Net cash used by operating activities in the first nine months of 2003 was \$18.9 million, compared with net cash provided by operating activities of \$23.8 million in the first nine months of 2002. The difference between our net loss of \$28.2 million in the first nine months of 2003 and \$18.9 million of negative operating cash flow was primarily attributable to \$16.8 million of depreciation and amortization expense, a reduction in inventories of \$10.8 million, and \$0.7 million of amortization of debt issuance costs, partially offset by an increase of \$9.7 million in trade receivables, a decrease in accounts payable and other accrued liabilities of \$8.0 million, and a reduction of \$2.2 million in accrued severance, retention and lease exit costs.

Days sales outstanding (based on annualized net sales for the quarter and net trade receivables outstanding at the end of the quarter) increased to 46 days for the third quarter of 2003, compared to 37 days for the comparable period of 2002. Days sales outstanding has been increasing over the past year as the mix of our net sales has shifted away from customers that took advantage of discounts in exchange for accelerated payment terms.

Inventories decreased 14.4% to \$57.7 million at September 28, 2003, compared to \$67.4 million at December 31, 2002. For the third quarter of 2003, inventory turns (i.e., annualized cost of goods sold divided by period end inventory) amounted to 5.6 times per year compared to 5.7 times per year for the comparable period in 2002.

***Cash Flows from Investing Activities.*** Net cash used by investing activities in the first nine months of 2003 was \$2.6 million compared with net cash used by investing activities of \$7.4 million in the first nine months of 2002. Investing cash flows in 2003 include capital expenditures of \$0.6 million for leasehold improvements at our Olathe, Kansas facility, \$1.5 million for new manufacturing equipment at several locations (including approximately \$0.9 million for testing equipment to meet new customer manufacturing requirements), and \$0.6 million for software and computer equipment. In July 2003, we also paid \$0.2 million for the purchase of certain design and engineering assets from an entity affiliated with Trilogic. Our cash outflows for investing activities were partially offset by \$0.3 million of cash acquired in the acquisition of Trilogic.

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Investing cash flows in the first nine months of 2002 include the payment of approximately \$5.5 million in March 2002 for the acquisition of the assets of Midwestern Electronics, Inc., and \$2.0 million for other capital expenditures.

**Cash Flows from Financing Activities.** Net cash provided by financing activities in the first nine months of 2003 was \$19.9 million, compared with net cash used by financing activities of \$30.5 million in the first nine months of 2002. Financing cash flows in the first nine months of 2003 reflect net borrowings under our revolving line of credit of \$19.2 million. During the first nine months of 2003, the Company also paid debt issuance costs of \$0.6 million related to our amended credit facility with Citibank. During the first nine months of 2003, an increase in outstanding checks in excess of cash balances of \$1.3 million contributed positively to cash flows from financing activities.

During the first nine months of 2002, financing cash flows reflect the net repayment of debt under revolving credit facilities of \$31.7 million. The Company utilized temporary cash investments of approximately \$14.0 million at the end of 2001 to repay outstanding debt during the first nine months of 2002. During the first nine months of 2002, an increase in outstanding checks in excess of cash balances of \$1.5 million contributed positively to cash flows from financing activities.

**Contractual Obligations.** The following table summarizes our contractual obligations as of September 30, 2003 (Dollars in Thousands):

|                           | <b>Long-term<br/>Debt<br/>(Citibank)</b> | <b>Non-cancelable<br/>Operating<br/>Leases</b> | <b>Total</b>                |
|---------------------------|--|--|-----------------------------|
|                           | <u>                    </u>              | <u>                    </u>                    | <u>                    </u> |
| Year ending September 30: |  |  |                             |
| 2004                      | \$                                       | \$ 8,194                                       | \$ 8,194                    |
| 2005                      | 31,629                                   | 6,820  | 38,449                      |
| 2006                      |  | 6,355  | 6,355                       |
| 2007                      |  | 5,688  | 5,688                       |
| 2008                      |  | 1,211  | 1,211                       |
| After 2008                |  | 1,897  | 1,897                       |
|                           | <u>                    </u>              | <u>                    </u>                    | <u>                    </u> |
|                           | \$31,629                                 | \$30,165                                       | \$61,794                    |
|                           | <u>                    </u>              | <u>                    </u>                    | <u>                    </u> |

The amounts shown above for non-cancelable operating leases include \$11.6 million, which has been included in the determination of our liability for lease exit costs which is recorded on our balance sheet at September 28, 2003. Accounting principles generally accepted in the United States require that we record a liability for future lease payments, net of estimated sublease rentals, for facilities that we have closed.

In August 2003, we renewed an operating lease for our Newberg, Oregon facility. The landlord is an entity that is affiliated with a director of the Company. The renewal terms provided for a reduction in our monthly rent from approximately \$58,000 to \$47,000 and the lease term was extended for five years through December 2008.

The table shown above does not include contingent consideration related to the purchase of Trilogic on May 30, 2003. Pursuant to the purchase agreement, we may be required to pay up

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to approximately \$4.0 million if certain sales targets are achieved through 2004. As of September 28, 2003, the minimum sales target was achieved and we accrued a payable of \$1.6 million. The agreement also requires that we estimate the annual amount of qualified 2003 sales based on actual sales for the first half of 2003 and calculate the estimated amount of consideration that would be payable for the annual 2003 sales target. Accordingly, we will be required to issue a letter of credit in the fourth quarter of 2003 for the estimated amount of the contingent consideration payable related to the 2003 annual sales target. We expect that the letter of credit will be issued in an amount up to approximately \$2.0 million. Upon payment of the contingent consideration in the first quarter of 2004, the letter of credit will be canceled. The agreement provides for a similar process related to the contingent consideration applicable to sales targets for 2004.

We believe we will be able to fund our contractual lease obligations from operating cash flows during the periods that payments are required. We intend to enter into negotiations with Citibank for a new credit agreement that provides for an extension of the maturity date. However, there can be no assurance that we will be successful in this regard.

**Capital Resources.** Our working capital at September 28, 2003 totaled \$54.2 million compared to \$50.4 million at December 31, 2002.

On April 11, 2003, Citibank agreed to amend the credit facility to provide less stringent covenants for EBITDA and tangible net worth. The amended facility continues to provide a revolving line of credit up to \$75.0 million, and the maturity date was extended until April 2005. Borrowings under the amended credit facility bear interest at the prime rate plus 2.50% for Base Rate borrowings and the LIBOR rate plus 3.75% for LIBOR Rate borrowings. In addition, the Company is obligated to pay a commitment fee of 0.5% per annum of the unused portion of the credit facility up to \$50.0 million, plus an unused commitment fee of 1.0% to the extent that the unused portion of the credit facility exceeds \$50.0 million. 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. As of September 28, 2003, the Company is in compliance with the covenants under the amended credit facility with Citibank.

Total borrowings are subject to limitation based on a percentage of eligible accounts receivable, inventories, real estate, and equipment. During the first quarter of 2003, updated inventory and equipment appraisals related to the borrowing base determinations were completed. After giving effect to the revised appraisals and other changes resulting from the April 2003 amendment, the borrowing base calculation permitted borrowings up to \$52.0 million as of September 28, 2003. After deducting the outstanding principal balance and an outstanding letter of credit, we had borrowing availability of approximately \$20.0 million as of September 28, 2003 under the amended credit agreement.

We believe that adequate capital resources are in place to fund our working capital and other cash requirements, including up to \$4.0 million of contingent consideration related to the Trilogic acquisition, 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.

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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 generally decreases as our net receivables and inventories decline. However, the borrowing base generally increases as our net 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.

In order to ensure the continuing availability of funding under our credit facility, we are required to comply with certain financial and reporting covenants, including the EBITDA covenant discussed in the following paragraph. While the EBITDA financial covenant included in the April 2003 amended credit agreement is less stringent than the previous agreement, we are generally required to demonstrate sequential quarterly improvements in our financial performance beginning in the third quarter of 2003. If we violate the financial covenants in the future, there can be no assurance that Citibank would waive our noncompliance. In these circumstances, Citibank could elect to withdraw the credit facility, which would have a material adverse effect on our liquidity and financial condition, resulting in the need to seek other sources of financing. There can be 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.

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

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|  | Quarter Ended         |                       | Nine Months Ended     |                       |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
|  | September 29,<br>2002 | September 28,<br>2003 | September 29,<br>2002 | September 28,<br>2003 |
|  | (In Thousands)        |                       | (In Thousands)        |                       |
| Net loss   | \$(24,478)            | \$(7,120)             | \$(111,500)           | \$(28,177)            |
| Cumulative effect of change in accounting for goodwill |                       |                       | 69,015                |                       |
| Income tax expense (benefit)                           | (40)                  |                       | (276)                 |                       |
| Interest expense                                       | 411                   | 761                   | 2,122                 | 1,941                 |
| Interest reversed in settlement                        |                       |                       | (1,029)               |                       |
| Depreciation and amortization                          | 5,529                 | 5,873                 | 16,558                | 16,843                |
| EBITDA per press releases                              | (18,578)              | (486)                 | (25,110)              | (9,393)               |
| Restructuring costs (A)                                | 12,409                | 587                   | 12,634                | 1,353                 |
| Reorganization transaction costs                       | 15                    |                       | 312                   |                       |
| Other charges (B)                                      | 225                   | 113                   | 792                   | 186                   |
| EBITDA per credit agreement                            | \$ (5,929)            | \$ 214                | \$ (11,372)           | \$ (7,854)            |

(A) Restructuring costs include lease exit costs, impairment of long-lived assets, and severance, retention, and moving costs related to facility closures and other reductions in workforce. Restructuring costs exclude accelerated depreciation due to shortened lives of leasehold improvements since these amounts are included in depreciation and amortization expense.

(B) Primarily consists of certain professional fees, stock-based compensation expense, and cash costs related to restructuring activities. In order to remain in compliance with the EBITDA covenant under the amended credit agreement, the Company's EBITDA (as defined in the credit agreement) for the fourth quarter of 2003 must be more favorable than negative \$5.6 million.

**Impact of Recently Issued Accounting Standards**

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 this 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. The Company has applied Statement 146 in accounting for all exit or disposal activities initiated after December 31, 2002. During the third quarter of 2003, the Company recognized restructuring costs of approximately \$0.6 million, primarily due to consolidation of manufacturing operations in Phoenix. During the fourth quarter of 2003 the Company expects to recognize additional restructuring costs of approximately \$0.5 million related to the final phase of the consolidation of operations in Phoenix.

In November 2002, the EITF reached a consensus on Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 apply to revenue arrangements entered into fiscal periods beginning after June 15, 2003. The provisions of EITF Issue No. 00-21 did not have a material effect on our consolidated financial statements.

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**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 Form 10-Q, our annual or quarterly reports to stockholders, future press releases, other SEC filings, or orally, whether in presentations, responses to questions, or otherwise. See Statement Regarding Forward-Looking Statements.*

**We have experienced declining net sales.**

As a result of the continuing soft demand in the end markets served by our customers, specifically aerospace and semiconductor capital equipment, our net sales have generally declined from \$197.9 million in the first quarter of 2001 to \$79.6 million in the third quarter of 2003.

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

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

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

A significant percentage of our net sales are generated from the aerospace and defense, semiconductor capital equipment, industrial, networking and telecommunications, and medical segments of the electronics industry, which is characterized by intense competition and



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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 economic cycles. A recession or any other event leading to excess capacity or a downturn in these segments of the electronics industry results in intensified price competition as well as a decrease in our unit volume sales and our gross margins.

**We are dependent on the aerospace industry.**

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 have been derived from the aerospace segment of the electronics industry. The September 11, 2001 terrorist attacks using hijacked commercial aircraft and the ensuing war on terrorism have resulted in a reduction in demand for our services, which has had an adverse impact on our results of operations. See We have experienced declining net sales. In addition, continuing tensions in the Middle East, have resulted in higher oil prices, which could result in further reductions in demand for products of our aerospace customers, which would have a continuing negative impact on our results of operations.

**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 are responsible for a significant portion of our net sales. Sales to Honeywell and Applied Materials represented approximately 42% and 22%, respectively, of our net sales for the year ended December 31, 2002. For the first nine months of 2003, Honeywell and Applied Materials accounted for 30% and 16%, respectively, of our net sales. In 2001, Emulex was also a major customer but our net sales to Emulex have been declining over the past two years and, by the end of the third quarter of 2003, Emulex had disengaged as a customer. 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 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.

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. There can be no assurance that current customers, including Honeywell and Applied Materials, 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 deteriorate substantially.

**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

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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. When customer orders are changed or cancelled, we may be forced to hold excess inventories and incur carrying costs as a result of delays, cancellations, or reductions in orders or poor forecasting by our key customers.

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

Conversely, customers may on occasion require rapid increases in production. These situations often result in inefficiencies related to hiring and training workers, as well as incremental costs incurred to expedite the purchase and delivery of raw materials. Periods of rapid growth tend to stress our resources and we may not have sufficient capacity to meet our customers' delivery requirements.

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

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 received, we could experience losses due to excess capacity. Whenever we experience excess capacity, our sales revenue may be insufficient to fully cover our fixed overhead expenses and our gross margins will decline. 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.

**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.

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

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**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, lease exit costs, and the payment of severance and retention benefits to affected employees. In addition to the up-front costs associated with these actions, the transition of inventory and manufacturing services to a different facility can result in 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.

**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;

foreign currency exposure;

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

less developed infrastructures.

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

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

Our future results of operations will be affected by our ability to successfully manage future opportunities for growth. Rapid growth is likely to place a significant strain on our managerial, operational, financial, and other resources. If this growth materializes, it may require us to implement additional management information systems, to further develop our operating, administrative, financial, and accounting systems and controls and to maintain close coordination among our accounting, finance, sales and marketing, and customer service and support departments. In addition, we may be required to retain additional personnel to adequately support our growth. If we cannot effectively manage periods of rapid growth in our operations, we may

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not be able to continue to grow, or we may grow at a slower pace. Any failure to successfully manage growth and to develop financial controls and accounting and operating systems or to add and retain personnel that adequately support growth could harm our business and financial results.

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

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 are 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; and

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

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

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

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

Our future success will depend to a significant degree upon the continued contributions of our key management, marketing, technical, financial, accounting and operational personnel, including James K. Bass, our President and Chief Executive Officer. 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

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additional highly skilled managerial and technical resources. Competition for such personnel is intense. There can be no assurance that we will be successful in attracting and retaining such personnel. In addition, recent and potential future facility shutdowns and workforce reductions may have a negative impact on employee recruiting and retention.

**Our manufacturing processes depend on the collective 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.

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

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

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level of unplanned capital investment or relocation. It is possible that environmental compliance costs and penalties from new or existing regulations may harm our business, financial condition, and results of operations.

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

We completed two business combinations in 2002 and one in 2003, and we anticipate that we will seek to identify and acquire additional suitable businesses in the electronics manufacturing services industry. The long-term success of recent business combinations 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.

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

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

the business fails to achieve anticipated revenue and profit expectations;

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

diversion of management's attention;

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

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

loss of key employees of acquired operations; and

the potential liabilities of the acquired businesses.

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

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**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 September 28, 2003, we had outstanding bank debt of approximately \$31.6 million. In addition, subject to the restrictions under our debt agreements, we may incur significant additional indebtedness from time to time to finance business acquisitions, capital expenditures, or for other purposes.

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

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

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

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

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

**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 working capital requirements for future growth that we may 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 stock price may be volatile, and our stock is thinly traded, which could cause investors to lose all or part of their investments in our common stock.**

The stock market 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.

During 2002 and 2003, the average number of shares of our common stock that traded on the NASDAQ exchange amounted to approximately 7,000 shares per day compared to

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27,409,000 issued and outstanding shares. When trading volumes are this low, a relatively small buy or sell order can result in a large percentage change in the trading price of our common stock, which may be unrelated to changes in our stock price that are associated with our operating performance.

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

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

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

Thayer-Blum owns approximately 90% of our common stock, and 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.



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

We have a revolving line of credit with Citibank, N.A. and the amended credit agreement provides for total borrowings up to \$75 million. The interest rate under this agreement is based on the prime rate and LIBOR rates, 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 one percentage point, 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.

**Item 4. Controls and Procedures**

As required by Rule 13a-15 under the Exchange Act, within the 90 days prior to the filing date of this report, the Company carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures. This evaluation was carried out under the supervision and with the participation of the Company's management, including our Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date the Company carried out its evaluation.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed in Company reports filed under the Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

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**

Not Applicable.

**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 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

**(b). Reports on Form 8-K**

Not Applicable.

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**SIGNATURES**

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

**SUNTRON CORPORATION**  
(Registrant)

Date: November 3, 2003

/s/ James K. Bass

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James K. Bass  
*Chief Executive Officer*

Date: November 3, 2003

/s/ Peter W. Harper

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Peter W. Harper  
*Chief Financial Officer*

Date: November 3, 2003

/s/ James A. Doran

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James A. Doran  
*Chief Accounting Officer*

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