AERO SYSTEMS ENGINEERING INC
Form 10-Q
November 14, 2001

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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

For the quarterly period ended September 30, 2001

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from to

Commission file number 0-7390

Aero Systems Engineering, Inc.
(Exact name of registrant as specified in its charter)

Minnesota	41-0913117
(State or other jurisdiction of incorporation or organization)	(I.R.S Employer Identification No.)
358 East Fillmore Avenue, St. Paul, Minnesota	55107
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code 651-227-7515

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

As of September 30, 2001, 4,401,625 shares of common stock, par value $.20 per share, were outstanding.

AERO SYSTEMS ENGINEERING, INC.

Form 10-Q

Quarter Ended September 30, 2001

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

AERO SYSTEMS ENGINEERING, INC.
CONDENSED BALANCE SHEETS

ASSETS	September 30, 2001	De
	(Unaudited)	
	(000's omitted, except share	
CURRENT ASSETS		
Cash and Cash Equivalents	$ 37	$
Accounts Receivable, net	7,484	
Costs and Estimated Earnings in Excess of Billings on Uncompleted Contracts	4,068	
Inventories:		
Materials and Supplies	964	

Projects in Process	598
Prepaid Expenses	117
Deferred Financing Costs	84
Income Tax Receivable	0
Total Current Assets	13,352
PROPERTY, PLANT AND EQUIPMENT	
Land	486
Buildings	3,025
Furniture, Fixtures, & Equipment	8,639
Wind Tunnels & Instrumentation	3,100
Building Improvements	1,489
	16,739
Less Accumulated Depreciation	11,985
Property, Plant, and Equipment, net	4,754
Total Assets	$ 18,106

AERO SYSTEMS ENGINEERING, INC.
CONDENSED BALANCE SHEETS
(continued)

LIABILITIES	September 30, 2001 (Unaudited)	Dec
	(000's omitted, except share	
CURRENT LIABILITIES		
Current Maturities of Capital Lease Obligations	$ 65	$
Notes Payable:		
Bank	3,000	
Affiliated Companies	2,600	
Accounts Payable:		
Trade	1,403	
Affiliated Companies	15	
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	2,333	
Accrued Warranty and Losses	460	
Accrued Salaries and Wages	975	
Other Accrued Liabilities	1,316	

Total Current Liabilities	12,167
OTHER LIABILITIES	
Capital Lease Obligations, Less Current Maturities	211
Long Term Note Payable - Affiliate	1,500
STOCKHOLDERS' EQUITY	
Common Stock - Authorized 10,000,000 Shares of $.20 Par Value; Issued 4,401,625 on September 30, 2001 and December 31, 2000.	880
Additional Paid-in Capital	900
Retained Earnings	2,448
Total Stockholders' Equity	4,228
Total Liabilities and Stockholders' Equity	$ 18,106

Note: The balance sheet at December 31, 2000 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

AERO SYSTEMS ENGINEERING, INC.

CONDENSED STATEMENTS OF EARNINGS
(Unaudited, 000's omitted)

	Three Months Ended September 30 2001	2000
Earned Revenue	$ 5,709	$ 8,751
Cost of Earned Revenue	4,025	7,017
Gross Profit	1,684	1,734
Operating Expenses	1,372	1,228
Operating Profit	312	506

Other Income (Expense)		
Interest Expense	(180)	(153)
Other	(25)	(13)
	(205)	(166)
Income (Loss) Before Income Taxes	107	340
Income Tax Expense	100	0
Net Income (Loss)	$ 7	$ 340
NET INCOME (LOSS) PER SHARE	$ 0.00	$ 0.08
Dividends per Share	None	None

AERO SYSTEMS ENGINEERING, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited, 000's omitted)

	Nine Mo Septe
	2001
CASH FLOW FROM OPERATING ACTIVITIES:	
Net Income (Loss)	$ (372)
Adjustment to reconcile net income (loss) to net cash provided (used) by operating activities:	
Depreciation and Amortization	866
Other Non-Cash Charges	100
(Increase) Decrease in Assets:	
Accounts Receivable	(1,123)
Cost and Estimated Earnings in Excess of Billings on Uncompleted Contracts	929
Inventories	(79)
Prepaid Expenses	(147)
Increase (Decrease) in Liabilities:	
Accounts Payable and Accrued Expenses	(250)
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	272
Net Cash Provided by	

Operating Activities	196
CASH FLOW FROM INVESTING ACTIVITIES:	
Capital Expenditures	(290)
Net Cash Used in Investing Activities	(290)
CASH FLOW FROM FINANCING ACTIVITIES:	
Net Borrowings under Line of Credit Agreement	(1,376)
Principal Payments under Capital Lease Obligations	(41)
Borrowings From Affiliates	1,500
Net Cash Provided (Used) by Financing Activities	83
NET CHANGE IN CASH	(11)
CASH AT BEGINNING OF YEAR	48
CASH AT END OF QUARTER	$ 37
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:	
Non-Cash Investing and Financing Activities	
Purchase of Equipment under Capital Leases	146

AERO SYSTEMS ENGINEERING , INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited, 000's omitted)

September 30, 2001

NOTE A - BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and 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 solely of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ending September 30, 2001 are not necessarily indicative of the results that may be expected for the year ended December 31, 2001. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2000.

NOTE B - SIGNIFICANT EVENTS

On September 25, 2001, Minnesota ASE, LLC acquired 2,245,000 shares of common stock of Aero Systems Engineering, Inc. ("Aero Systems") from Celsius Inc., a subsidiary of Saab AB, representing 51% of the outstanding shares. Celsius Inc. retained a 29% stock interest in Aero Systems. In accordance with the terms of the transaction, Aero Systems borrowed $1,500,000 from Celsius Inc. in order to provide working capital to Aero Systems. This loan was collateralized by a third party pledge by Minnesota ASE, LLC of the shares of Aero Systems purchased by Minnesota ASE, LLC from Celsius Inc. and has a term of three years at an annual percentage rate of 8%. In connection with the acquisition of Aero Systems' stock by Minnesota ASE, LLC, Aero Systems entered into a secured credit agreement with a bank which provides for up to $6 million in loans and $3 million in letters of credit. The operating loans up to $6 million are secured by the Company's receivables, inventories, and machinery and equipment. The letter of credit borrowing base of up to $3 million is secured by the Company's mortgaged property. The term of the credit agreement is two years, and the loans under it bear interest at a variable interest rate equal to the bank's base rate plus a margin of up to one-half of one percent. The bank's base rate as of September 30, 2001 was 6.0%. On September 25, 2001, Minnesota ASE, LLC also loaned Aero Systems $2,600,000 in order to supplement bank financing. The maturity date of this note is January 11, 2002, and the interest rate is variable at the bank's base rate plus .25%.

Through September 25, 2001, Aero Systems was included in the consolidated federal income tax return of Celsius Inc. The Company's income tax provision was calculated and presented on a separate return basis. Upon the closing of the acquisition of 51% of Aero Systems' stock by Minnesota ASE, LLC, Celsius Inc. will own less than 80% of Aero Systems and, accordingly, will no longer include Aero Systems in its consolidated federal income tax return. In the third quarter, in conjunction with that transaction, the Company recorded income tax expense of $99,686 to reduce its income tax receivable from Celsius Inc. as a result of the termination of the tax sharing agreement.

AERO SYSTEMS ENGINEERING , INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(Unaudited, 000's omitted)

NOTE C - DERIVATIVES AND HEDGING

The Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments and Hedging Activities, during the first quarter of 2001. In doing so, the Company did not incur any material transition adjustments. All derivatives are recognized on the balance sheet at their fair value. On the date a derivative contract is entered into, the derivative is designated as a fair value or cash flow hedge.

The Company formally documents all relationships between hedging instruments and the hedged items, as well as its risk-management objectives and strategy for undertaking various hedge transactions. The Company formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of the hedged items.

The Company uses foreign currency forward exchange contracts to hedge against the effect of exchange rate fluctuations on certain foreign currency denominated contracts.

NOTE D - RECLASSIFICATION

Certain prior period amounts have been reclassified to conform to current period presentation.

NOTE E - CONTRACTS IN PROCESS

Information with respect to contracts in process follows:

	September 30, 2001
Costs Incurred on Uncompleted Contracts	$ 52,616
Estimated Earnings Thereon	15,997
Total Earned Revenue on Uncompleted Contracts	68,613
Less Billings Applicable Thereto	66,878
	$ 1,735
Included in Accompanying Balance Sheet Under Following Captions:	
Costs and Estimated Earnings in Excess of Billings on Uncompleted Contracts	$ 4,068
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	2,333
	$ 1,735

NOTE F - CONTINGENCIES AND COMMITMENT

Guarantees of approximately $5,661,600 were outstanding on September 30, 2001 to various customers as bid bonds or in exchange for down payments or warranty performance bonds.

AERO SYSTEMS ENGINEERING, INC.

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

Financial Condition

(All dollar amounts are in thousands.)

On September 25, 2001, Minnesota ASE, LLC acquired 2,245,000 shares of common stock of Aero Systems Engineering, Inc. ("Aero Systems") from Celsius Inc., a subsidiary of Saab AB, representing 51% of the outstanding shares. Celsius Inc. retained a 29% stock interest in Aero Systems. This transaction is further described in Footnote B to the Quarterly Financial Statements.

Worldwide revenue for the third quarter 2001 totaled $5,709, which was a 35% decrease from $8,751 in revenue for the third quarter of last year. Income before taxes for the third quarter was $107 as compared to third quarter income before taxes of $340 last year.

Backlog of orders as of September 30, 2001 was $29,722 as compared with $27,710 and $31,423 as of December 31, 2000 and September 30, 2000, respectively. The change from December 31, 2000 represents a 7% increase. The year to date orders through September are $19.6 million.

The revenue and earnings before taxes decrease were mostly attributable to the delay of U.S. government approval of the export license application for the wind tunnel project in Singapore. The export license was submitted for approval during the fourth quarter of 2000. Due to this delay, work on the project had been very limited, resulting in lower revenue and margin recognition. The export license was received in early September 2001, and the activity level has now increased on the project.

Through September 25, 2001, Aero Systems was included in the consolidated federal income tax return of Celsius Inc. The Company's income tax provision was calculated and presented on a separate return basis. Upon the closing of the acquisition of 51% of Aero Systems' stock by Minnesota ASE, LLC, Celsius Inc. will own less than 80% of Aero Systems and, accordingly, will no longer be able include Aero Systems in its consolidated federal income tax return. In the third quarter, in conjunction with that transaction, the Company recorded income tax expense of $100 to reduce its income tax receivable from Celsius Inc. as a result of the termination of the tax sharing agreement.

Cost as a percentage of earned revenue for the third quarter, which includes manufacturing and engineering costs, was 71% as compared to 80% during the same period of last year. This decrease is mostly the result of improved project margins on the wind tunnels and Aerotest Lab projects during the third quarter of 2001.

The Company recognizes revenue using the percentage of completion method for its long-term contracts. Estimates of revenues earned and expenses to be incurred to complete the contracts are made in conjunction with the preparation of the quarterly financial statements. However, final determination of the profitability of the contracts are subject to settlement of any final claims which may develop at the time the completed contract is accepted by the customer as well as risks inherent in estimates which are made during the course of the contract work.

Selling, general and administrative expenses of $1,302 were 23% of revenues during the third quarter of 2001 as compared to $1,066 and 12% during the same period of last year. This increase of $236 or 22% was primarily related to the additional marketing staff added at the end of 2000 and the increase in bid and proposal activities related to several new proposals.

Research and development expenses were $70 during the third quarter of 2001 as compared to $162 in the same period in 2000. This decrease of $92 or 57% is mostly related to the focus of certain resources in the third quarter 2001 on project and proposal work rather than on R&D activities. During 2001, additional research and development expenses will be incurred for continued enhancements to the ASE2000, aero-acoustic analysis and new product initiatives.

Interest expense of $180 was incurred during the third quarter of 2000 as compared to $153 for the same period in the prior year. The average rate of interest on short-term borrowings has had little change, while the average amount of borrowings outstanding has increased in the third quarter of 2001 as compared to the third quarter of last year.

Capital expenditures for the third quarter 2001 were $22 as compared to $358 for the same period of last year. It is expected that for the remainder of 2001, additional capital expenditures will be used to purchase additional equipment for R&D projects and the engineering departments.

Accounts receivable at the end of the third quarter 2001 were $7,484 as compared with the year-end 2000 balance of $6,361. This increase of $1,123 was due mainly to invoice timing on several large contracts.

Costs and estimated earnings in excess of billings on uncompleted contracts at the end of the third quarter decreased $929, or 19%, to $4,068 as compared with the year-end 2000 balance of $4,997. The Company recognizes profit on long-term projects on the percentage of completion basis, which permits earned revenue to be recognized prior to the time that progress payments are billed. When this occurs, amounts are added to this asset account for the recognition of earned revenue prior to the billing of progress payments. The decrease since year-end is due to the timing of billing milestones related to the contracts. Billings are a function of contract terms and do not necessarily relate to the percentage of completion of a project.

Current notes payable balance was $5,600 as compared to the year-end 2000 balance of $6,976, which is a decrease of $1,376 or 20%. This decrease is primarily the result of the receipt of $1,500 cash from Celsius Inc. for the three year note payable. As of October 31, 2001, current notes payable was $2,500. Long term notes payable balance was $1,500 at the end of the third quarter 2001 compared to the year-end 2000 balance of $0.

Accounts payable and accrued expenses at the end of the third quarter decreased $250 or 6% as compared to the year-end 2000 balance. This was primarily due to the delay of the Singapore wind tunnel project moving into the procurement phase as a result of the delay in receiving the export license.

Billings in excess of costs and estimated earnings on uncompleted contracts at the end of the third quarter increased $272 to $2,333 compared to the year-end 2000 balance of $2,061. The increase since year-end is due to the timing of billing milestones related to contracts. Billings are a function of contract terms and do not necessarily relate to the percentage of completion of a project.

The Company operates on a global basis, and during an average year, it generates approximately 50% of its revenues from international customers. This trend has continued for the last five years as foreign airlines and government agencies purchase products that ASE designs and produces. Most of the Company's contracts are denominated in U.S. dollars. However, a few of them are denominated in the customer's local currency. Therefore, the Company has entered into several foreign exchange forward contracts having maturities within the next eighteen months. The face amounts represent U.S. dollar equivalents of a non-U.S. dollar denominated forward contract. The amounts at risk are not material, and the Company has the financial ability to generate cash flows to offset the expected gain or losses when the contracts mature.

The Company has consistently relied upon bank credit lines during recent years as a source of its working capital resources and liquidity. During the third quarter 2001, Celsius Inc. sold 51% of the total outstanding shares of common stock of ASE to Minnesota ASE, LLC. Related to this transaction, the Company has secured new bank financing agreements for operating funds and future letter of credit needs. These new agreements are asset based collateral agreements, with the funds available under these agreements determined by the available securable assets at any point in time, up to a maximum of $6,000 of operating funds, and $3,000 of letter of credit funds. Also related to the transaction, Celsius Inc. has agreed to continue to hold certain existing bank guarantees until maturity that were previously provided to a few of the Company's customers, and Celsius Inc. has provided a three year $1,500 loan to the Company at 8% per year, which is subordinated debt under the new bank agreement. The Company has provided an indemnification agreement to Celsius Inc. to secure Celsius Inc.'s interest in the above items.

At the end of the third quarter, the Company had notes payable balances of $5,600 current and $1,500 long term. The current notes payable balance of $5,600 consisted of $3,000 of borrowings under the new bank agreement, and $2,600 of interim loans provided by Minnesota ASE, LLC for a period up to 120 days to bridge cash needs until significant customer invoice payments are received. At the time of this filing, $1,600 of the $2,600 interim loans have been repaid to Minnesota ASE, LLC. The Company believes that these bank lines of credit, along with cash flows from continuing operations, are adequate to support the Company's cash needs for the immediate future.

Highly competitive market conditions have continued to put pressure on the margins on new contracts. Productivity improvements and cost reduction programs are continually being initiated to increase margins. The Company received ISO9001 certification in 1997, an international quality systems standard. This is expected to continue to enhance the Company's marketing effort on an international basis.

Looking ahead throughout the remainder of 2001, the contracts awarded in the recent months of the year and the improved backlog should provide a solid base for the rest of 2001.

AERO SYSTEMS ENGINEERING, INC.

PART II - OTHER INFORMATION

Item 6: Exhibits and Reports on Form 8-K

(a) No exhibits are included in this filing.

(b) No Current Reports on Form 8-K were filed during the quarter ended September 30, 2001. On October 4, 2001, the registrant filed a Form 8-K report to declare a change in control of registrant, and to file the new bank documents as a result of the change in control.

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 thereto duly authorized.

Date: November 13, 2001

/s/ Charles Loux

Charles Loux, President and CEO

/s/ Steven R. Hedberg

Steven R. Hedberg, Chief Financial Officer