

GRIFFON CORP
Form 10-K
December 14, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended September 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File No. 1-06620

GRIFFON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)
100 Jericho Quadrangle, Jericho, New York
(Address of Principal Executive Offices)
Registrant's telephone number, including area code:

11-1893410
(I.R.S. Employer
Identification No.)
11753
(Zip Code)
(516) 938-5544

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|-------------------------------|---|
| Common Stock, \$.25 par value | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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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 disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked prices of common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. As of March 31, 2006 approximately \$713,000,000.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. As of December 8, 2006 29,824,789.

DOCUMENTS INCORPORATED BY REFERENCE:

Part III (Items 10, 11, 12, 13 and 14). Registrant's definitive proxy statement to be filed pursuant to Regulation 14A of the Securities Exchange Act of 1934.

PART I

Item 1. *Business*

The Company

Griffon Corporation (*Griffon* or the *Company*) is a diversified manufacturing company with operations in four business segments: Garage Doors; Installation Services; Specialty Plastic Films; and Electronic Information and Communication Systems. The company's Garage Doors segment designs, manufactures and sells garage doors for use in the residential housing and commercial building markets. The Installation Services segment sells, installs and services garage doors, garage door openers, manufactured fireplaces, floor coverings, cabinetry and a range of related building products primarily for the new residential housing market. The company's Specialty Plastic Films segment develops, produces and sells plastic films and film laminates for use in infant diapers, adult incontinence products, feminine hygiene products and disposable surgical and patient care products. The company's Electronic Information and Communication Systems segment designs, manufactures, sells and provides logistical support for communications, radar, information, command and control systems and large-scale integrated circuits for defense and commercial markets.

The company relies upon both internal growth and strategic investments to develop its business. Over the past five years, the company has invested significant amounts to support growth. Equipment and plant expenditures in fiscal 2006 aggregated \$42 million, approximately \$22 million of which were for expansion of the Garage Doors segment manufacturing capacity and \$11 million was for Specialty Plastic Films. Over the past several years, the company constructed a manufacturing facility near São Paulo, Brazil to expand its South American specialty plastic film operations. That facility began operations in 2006. The company has also made strategic investments in each of its business segments to enhance its market position and expand into new markets, including:

- In 2005, the Specialty Plastics Films segment acquired for \$82 million the minority interest in its largest European operation and increased its investment in its Brazilian operation.
- In 2005, the Electronic Information and Communication Systems segment acquired the Systems Engineering Group in Maryland to expand its capabilities for radar systems analysis, radar systems engineering and tactical missile defense studies and analysis. In addition, the segment also acquired its short range radio product line from SAAB.

The company was incorporated on May 18, 1959 under the laws of the State of New York. It was reincorporated in Delaware in 1970 and its name was changed to Griffon Corporation in 1995. The company makes available, free of charge through its website at www.griffoncorp.com, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) of the Securities Exchange Act of 1934 as soon as reasonably practicable after such material is filed with or furnished to the Securities and Exchange Commission. For information regarding revenue, profit and total assets of each segment see Note 7 of Notes to Consolidated Financial Statements.

Garage Doors

The company believes that its wholly-owned subsidiary, Clopay Corporation, is the largest manufacturer and marketer of residential garage doors and among the largest manufacturers of commercial sectional doors in the United States. The company's building products are sold under Clopay®, Ideal Door® and Holmes® brand names through an extensive distribution network throughout the United States. The company estimates that the majority of Garage Doors net sales are from sales of garage doors to the home remodeling segment of the residential housing market, with the balance from the new residential housing and commercial building markets. The segment employs approximately 1,700

employees. Sales into the home remodeling market are being driven by the continued aging of the housing stock and the trend of improving home appearance.

According to industry sources, the residential and commercial sectional garage door market for 2005 was estimated to be \$2.2 billion. Over the past decade there have been several key trends driving the garage door industry, including the shift from wood to steel doors and the growth of the home center channel of distribution. The company estimates that over 90% of the total garage door market today is steel doors. Superior strength, reduced weight and low maintenance have favored the steel door. Other product innovations during this period include insulated double-sided steel doors, new springing systems, sophisticated window options, and residential garage doors with improved safety features.

Products and Services

The company manufactures a broad line of residential sectional garage doors with a variety of options at varying prices. The company offers garage doors made primarily from several materials, including steel and wood. The company also sells related products such as garage door openers manufactured by third parties.

The company also markets commercial sectional doors. Commercial sectional doors are similar to residential garage doors, but are designed to meet more demanding performance specifications.

Sales by Garage Doors have provided approximately 32% of the company's consolidated revenue in 2006, 37% in 2005 and 33% in 2004.

Sales and Marketing

The company distributes its building products through a wide range of distribution channels including installing dealers, retailers and wholesalers. The company owns and operates a national network of 48 distribution centers. The company's building products are sold to approximately 2,000 independent professional installing dealers and to major home center retail chains, including The Home Depot, Inc., Menards, Inc. and Lowe's Companies, Inc. The company maintains strong relationships with its installing dealers and believes it is the largest supplier of residential garage doors to the retail and professional installing channels.

Over the past decade, an increasing number of garage doors have been sold through home center retail chains such as The Home Depot, Inc. The company estimates that approximately 35% of its garage doors are sold through the home center channel of distribution. These home centers sell garage doors to the do-it-yourself consumer, the small residential and commercial contractor, as well as installed residential doors and operators for the rapidly growing do-it-for-me consumer segment. Distribution through the retail channel requires different capabilities and skills than those traditionally utilized by garage door manufacturers. Factors such as immediately available inventory, national distribution, national installation services, point-of-sale merchandising and special packaging are all important to the retailer.

The company is the principal supplier of residential garage doors throughout the United States and Canada to The Home Depot, Inc., with Clopay® brand doors being sold exclusively to this customer in the retail channel of distribution. Sales of the Clopay® brand outside the retail channel of distribution are not restricted. The segment's largest customers are The Home Depot, Inc. and Menards, Inc. The loss of either of these customers would have a material adverse effect on the company's business. The company distributes its garage doors directly to customers from its manufacturing facilities and through its network of 48 company-owned distribution centers located throughout the United States and in Canada. These distribution centers allow the company to maintain an inventory of garage doors near installing dealers and provide quick-ship service to retail and professional dealer customers.

Manufacturing and Raw Materials

The company currently operates five garage door manufacturing facilities, having added an additional facility in Troy, Ohio in 2006. A key aspect of Garage Doors' research and development efforts has been the ability to continually improve and streamline its manufacturing processes. The company's engineering and technological expertise, combined with its capital investment in equipment, generally has enabled the company to efficiently manufacture products in large volume and meet changing customer needs. The company's facilities use proprietary manufacturing processes to produce the majority of its products. Certain of the company's equipment and machinery are internally modified to achieve its manufacturing objectives. These manufacturing facilities produce a broad line of high quality garage doors for distribution to professional installer, retail and wholesale channels.

The principal raw material used in the company's manufacturing operations is galvanized steel, the price of which increased significantly during 2005, was relatively stable during fiscal 2006 and began to trend upwards toward the end of 2006. The company also utilizes certain hardware components as well as wood and insulated foam. All of these raw materials are generally available from a number of sources.

Research and Development

The company operates a technical development center where its research engineers work to design, develop and implement new products and technologies and perform durability and performance testing of new and existing products, materials and finishes. Also at this facility, the company's process engineering team works to develop new manufacturing processes and production techniques aimed at improving manufacturing efficiencies.

Competition

The garage door industry is characterized by several large national manufacturers and many smaller regional and local manufacturers. The company competes on the basis of service, quality, price, brand awareness and product design.

The company's brand names are widely recognized in the building products industry. The company believes that it has earned a reputation among installing dealers, retailers and wholesalers for producing a broad range of high-quality doors. The company's market position and brand recognition are key marketing tools for expanding its customer base, leveraging its distribution network and increasing its market share.

Installation Services

The company has developed a substantial network of specialty building products installation and service operations. Its network of locations cover many of the key new single family home markets in the United States and offer a variety of building products and services to the residential construction and remodeling industries. The segment employs approximately 1,400 employees.

The company provides installed specialty building products primarily to residential builders. Builders are increasingly acting as developers and marketers, sub-contracting a substantial portion of the actual construction of a home. Traditionally, the market for installation services has been very fragmented, characterized by small operations offering a single type of building product in a single market. In what has historically been an undercapitalized, fragmented industry, the company has sufficient capital and the scale to attract professional management, achieve operating economies, and serve the needs of even the largest national builders.

Installation Services has targeted geographic markets that have a sizeable population or significant growth demographics. The markets served account for approximately 17% of all new residential housing

permits in the United States. Installation Services' multiple product offering is primarily targeted at new construction, wherein products are generally consumed at approximately the same time in the construction process. Products offered can be selected and upgraded by the end-customer in the company's design centers. The company believes that its multi-product offering provides strategic marketing advantages over traditional, single product competitors, and provides the company with operational efficiencies. The company seeks to increase the cross-selling of its multiple products to its existing customers. Additionally, the company plans further growth through the introduction of additional installed building products. The replacement and remodeling markets are additional markets for the company's products and professional installation services.

Products and Services

Installation Services sells and installs a variety of building products:

Garage Doors and Openers garage doors are distributed, professionally installed and serviced in the new construction and replacement markets. Installation Services sources most of its garage doors from the Garage Doors segment.

Fireplaces manufactured wood and gas fireplaces and related products such as stone or marble surrounds, wood mantels and gas logs are distributed, professionally installed and serviced, primarily to the new construction market.

Flooring flooring products distributed and installed to the new construction market include carpeting, tile and stone, wood and vinyl.

Appliances appliances distributed to the new construction market include refrigerators, stoves, cooktops, ovens and dishwashers.

Kitchen and Bath Cabinets cabinetry, with options in wood varieties and door styles, are offered for distribution and installation to the new construction market.

Other other products include closet systems, window coverings and bath enclosures. Tile and stone applications for shower and bath walls, counter tops and fireplace surrounds are also offered.

The company is able to leverage the offering of these products over a common customer base, providing efficiencies and convenience to the customer. The company operates well-appointed product design centers that facilitate selection of products by the consumer, enhancing customer service and providing an environment conducive to up-selling into higher margin products.

Sales by Installation Services have provided approximately 21% of the company's consolidated revenue in both 2006 and 2005 and 22% in 2004.

Competition

The installation services industry remains fragmented, consisting primarily of smaller, single-market companies which have limited financial resources. However, the company has recently observed the emergence of several multi-market competitors in various regions. The company competes on the basis of service, price and product line diversity.

Specialty Plastic Films

The company, through its wholly-owned subsidiary Clopay Plastics Products Company, develops and produces specialty plastic films and laminates for a variety of hygienic, health care and industrial uses in domestic and certain international markets. Specialty Plastic Films' products include thin gauge embossed and printed films, elastomeric films and laminates of film and non-woven fabrics. These products are used

primarily as moisture barriers in disposable infant diapers, adult incontinence products and feminine hygiene products, as protective barriers in single-use surgical and industrial gowns, drapes and equipment covers, and as packaging for hygienic products. Specialty Plastic Films products are sold through the company's direct sales force primarily to multinational consumer and medical products companies. The segment employs approximately 1,200 employees worldwide.

The segment's major customer is Procter & Gamble, with whom the company enjoys a long and growing relationship. Specialty Plastic Films supplies Procter & Gamble with a variety of products used primarily for its infant diapers, both domestically and internationally, and expects to continue to expand the relationship in the future.

The segment of the specialty plastic films industry in which Clopay participates has been affected by several key trends over the past five years. These trends include the increased use of disposable products in developing countries and favorable demographics, including increasing immigration, in the major global economies. Other trends representing significant opportunities for manufacturers include the continued demand for new advanced products such as cloth-like, breathable, laminated, and printed products and the need of major customers for global supply partners. Notwithstanding the positive trends affecting the industry, design changes by Procter & Gamble for its infant diaper products have resulted in a change in products produced by the company from laminates to narrower and thinner gauged printed film. As a result, the volume of film products sold by the segment for this customer has declined. The company believes that its business development activities targeting major multinational and regional producers of hygiene, healthcare and related products and its investments in its technology development capability and capacity increases will lead to additional sales of new and related products, minimizing the impact of this reduction.

Products

Specialty Plastic Films manufactures a wide variety of embossed and printed specialty films and laminates for the hygienic, healthcare and other markets. Specialty Plastic Films products are used as moisture barriers for disposable infant diapers, adult incontinence and feminine hygiene products and as protective barriers in surgical and industrial gowns and drapes, equipment covers, flexible packaging, house wrap and other products. A specialty plastic film is a thin-gauge film (typically 0.0005 to 0.003) that is manufactured from polymer resins and engineered to provide certain performance characteristics. A laminate is the combination of a plastic film and a non-woven fabric. These products are produced using both cast and blown extrusion and laminating processes. High speed, multi-color custom printing of films and customized embossing patterns further differentiate the products. The company's specialty plastic film products typically provide a unique combination of performance characteristics that meet specific, proprietary customer needs. Examples of such characteristics include strength, breathability, barrier properties, elastic properties, processibility and aesthetic appeal.

Sales by Specialty Plastic Films have provided approximately 23% of the company's consolidated revenue in 2006, 26% in 2005 and 30% in 2004.

Sales and Marketing

The segment sells its products primarily in the United States and Europe with sales also in Canada, Central and South America and Asia Pacific. The segment primarily utilizes an internal direct sales force, organized by customer accounts. Senior management actively participates by developing and maintaining close contacts with customers.

The segment's largest customer is Procter & Gamble, which has accounted for a substantial portion of Specialty Plastic Films sales over the last five years. The loss of this customer would have a material

adverse effect on the company's business. Specialty plastic films also are sold to a diverse group of other leading consumer, health care and industrial companies.

The company seeks to expand its market presence for Specialty Plastic Films by capitalizing on its technological and manufacturing expertise and on its relationships with major international consumer products companies. Specifically, the company believes that it can continue to increase its North American sales and expand internationally through ongoing product development and enhancement and by marketing its technologically advanced films and laminates and printed film for use in all of its markets. The company believes that its operations in Germany and Brazil provide a strong platform for additional sales growth in certain international markets.

Research and Development

The company believes it is an industry leader in the research, design and development of specialty plastic films and laminate products. The company operates a technical center where approximately 50 chemists, scientists and engineers work independently and in strategic partnerships with the company's customers to develop new technologies, products, processes and product applications. Currently, the company is engaged in several joint efforts with the research and development departments of its customers.

The company's research and development efforts have resulted in many inventions covering embossing patterns, improved processing methods, product formulations, product applications and other proprietary technology. Products developed by the company include microporous breathable films and cost-effective cloth-like films and laminates. Microporous breathability provides for moisture vapor transmission and airflow while maintaining barrier properties resulting in improved comfort and skin care. Cloth-like films and laminates provide consumers preferred aesthetics such as softness and visual appeal. The company recently began commercialization of patented elastic laminates for its baby diaper products. The company holds a number of patents for its current specialty film and laminate products and related manufacturing processes. The company believes its patents are a less significant factor in its success than its proprietary know-how and the knowledge, ability and experience of its employees.

International Operations

The segment has two operations in Germany from which it sells plastic films throughout Europe. One of its German operations, Finotech, was structured as a joint venture with Corovin GmbH, a manufacturer of non-woven fabrics headquartered in Germany that is a subsidiary of BBA Group PLC, a publicly owned diversified U.K. manufacturer. In July 2005, the company purchased the remaining 40% interest from BBA in a cash transaction.

In June 2002, the company acquired 60% ownership in Isofilme Ltda., a manufacturer of plastic hygienic and specialty films located in Sao Paulo, Brazil which operates under the name Clopay do Brasil. In October 2004, the company acquired an additional 30% of Isofilme. In October 2005, the company purchased the remaining 10% interest. In 2005 and 2006, the company constructed and relocated to a new facility near São Paulo. The installation of new manufacturing capacity and capabilities was completed in conjunction with the move. Clopay do Brasil provides a platform to broaden participation in South American markets and strengthen the company's position as a global supplier.

Manufacturing and Raw Materials

The company manufactures its specialty plastic film and laminate products on high-speed equipment designed to meet stringent tolerances. The manufacturing process consists of melting a mixture of polymer resins (primarily polyethylene) and additives, and forcing this mixture through a computer controlled die and rollers to produce embossed films. In addition, the lamination process involves extruding the melted

plastic films directly onto a non-woven fabric and bonding these materials to form a laminate. The company also manufactures multi-color printed films and laminates. Through statistical process control methods, company personnel monitor and control the entire production process.

This segment launched a significant capital expansion program in fiscal 2003 to support new opportunities with its major customers and to increase capacity throughout its operations. The product initiative involving the production of high-quality, multi-color printing of films and laminates for the baby diaper market in North America and Europe is complete. The segment's most advanced production line went onstream in 2005, and a new line in Brazil commenced production in 2006. In 2005 and 2006 the segment installed North American and European capacity for the production of the latest technology in elastomeric materials for its key customers. Capital spending for Specialty Plastic Films was approximately \$27 million in fiscal 2005 and \$11 million in fiscal 2006. It is anticipated that spending in fiscal 2007 will approach 2006 levels.

Plastic resins, such as polyethylene and polypropylene, and non-woven fabrics are the basic raw materials used in the manufacture of substantially all of Specialty Plastic Films' products, the price of which has increased dramatically since early 2002. The near-term outlook is for stabilization of resin prices. The company currently purchases its plastic resins in pellet form from several suppliers. The purchases are made under supply agreements that do not specify fixed pricing terms. The company's sources for raw materials are believed to be adequate for its current and anticipated needs.

Competition

The market for the company's specialty plastic film and laminate products is highly competitive. The company has a number of competitors in the specialty plastic films and laminates market, some of which are larger and have greater resources than the company. The company believes that its technical expertise and product development capabilities enhance its market position and customer relationships. The company competes primarily on the basis of technical expertise, quality, service and price.

The company has developed strong, long-term relationships with leading consumer and health care products companies. The company believes that these relationships, combined with its technological expertise, product development and production capabilities, including global operations, have positioned it to meet changing customer needs, which the company expects will drive growth. In addition, the company believes its strong, long-term relationships provide it with increasing opportunities to expand and enter new international markets.

Electronic Information and Communication Systems

The company, through its wholly-owned subsidiary, Telephonics Corporation, specializes in advanced electronic information and communication systems for defense, aerospace, civil, industrial, and commercial applications domestically and in certain international markets. The company designs, manufactures, sells, and provides logistical support for aircraft communication systems, radar, air traffic management, information and command and control systems, identification friend or foe (IFF) equipment, transportation communication systems and custom, mixed-signal, application specific integrated circuits. The company is a leading supplier of airborne maritime surveillance radar and aircraft intercommunication management systems, the segment's two largest product lines. In addition to its traditional defense products used predominantly by the United States Government, in recent years the company has adapted its core technologies to products used in international markets and has expanded its presence in both non-defense government and commercial markets. In fiscal 2006, approximately 73% of the segment's sales were to the United States defense industry, 24% to international customers and 3% to commercial customers. The segment employs approximately 1,200 employees.

The United States defense electronics procurement budget is expected to grow along with the overall defense budget. Growth in this budget area reflects the trend in recent years for the United States Department of Defense to opt for the installation of new electronic systems and equipment in existing aircraft rather than develop new weapons systems. Conflicts involving the country's military have also tended in recent years to require deployment and significant coordination between air, sea and ground forces, often in distant parts of the world, underscoring the evolution and growing importance of electronic systems that provide surveillance, tracking, communication and command and control. The company believes that Telephonics' advanced systems and sub-systems are well positioned to address the needs of an electronic battlefield with emphasis on the generation and dissemination of timely data for use by highly mobile ground, air and naval forces. The company anticipates that the need for such systems will also increase in connection with the increasingly active role that the military is playing in the war on terrorism, both at home and abroad.

Programs and Products

The table below lists some of the major programs the company currently participates in:

| Customer | Program | Product |
|-------------------------------|---|---|
| The Boeing Company | U.S. Air Force C-17A Cargo Transport U.S. Air Force C-130 Hercules Air Transport Airborne Warning and Control System (AWACS) U.S. Navy F/A-18/E/F Fighter/Attack Aircraft | Intercommunications Management Systems |
| General Dynamics, Canada | AWACS | Identification Friend or Foe System |
| BAE Systems | Maritime Helicopter Project | Maritime Surveillance Radar |
| | U.K. NIMROD Royal Maritime Patrol Aircraft | Intercommunications Systems Integration |
| Northrop Grumman | Joint-STARS Surveillance Aircraft | Intercommunications Management Systems |
| | U.S. Coast Guard HU-25 Aircraft | Maritime Surveillance Radar |
| Lockheed Martin Corporation | U.S. Navy MH-60S/MH-60R Helicopters U.S. Navy P-3 Aircraft | Intercommunications Management Systems |
| | U.S. Navy MH-60R Helicopter U.S. Coast Guard CN 235 Maritime Patrol Aircraft | Maritime Surveillance Radar and Identification Friend or Foe System |
| MacDonald Dettwiler | Canadian Forces CP-140 Aurora Aircraft Modernization Program | Maritime Surveillance Radar and Identification Friend or Foe System |
| Sikorsky Aircraft Company | S-70B Maritime Surveillance Helicopter | Maritime Surveillance Radar |
| | UH-60M Blackhawk Helicopter Upgrade Program | Management Systems |
| Syracuse Research Corporation | U.S. Army Warlock Duke | Counter IED Devices |

The company, under a contract with Syracuse Research Corporation manufactures counter IED devices to support the Warlock Duke program. The program entailed the achievement of high rate production, in an accelerated timetable, of equipment designed to defeat the roadside bomb threats that our armed forces face throughout the world.

The company specializes in communication systems and products and is a leading manufacturer of aircraft intercommunication systems with products in digital and analog communication management, digital audio distribution and control, and communication systems integration. Additionally, the company also manufactures a variety of wireless products for use in ground and airborne operations. The company's communication products are on platforms such as the U.S. Navy's MH-60R multi-mission and MH-60S utility helicopters, the United Kingdom's NIMROD surveillance aircraft, the U.S. Air Force C-17A cargo transport, the U.S. Air Force's Joint Surveillance and Target Acquisition Radar System (Joint-STARS) aircraft, and AWACS aircraft.

The company's command and control systems include airborne maritime surveillance radar, ground surveillance radar, weather and search radar systems, air traffic management systems and tactical instrument landing systems. The company provides expertise and equipment for detecting and tracking targets in a maritime environment and flight path management systems for air traffic control applications. Its maritime radar systems, which are used in more than 20 countries, are fitted aboard helicopters, fixed-wing aircraft, and aerostats for use at sea. The company's radar products will be utilized on the U.S. Coast Guard's helicopters, fixed wing aircraft and unmanned aerial vehicles for its Deepwater upgrade program. The company also increased its market penetration through an award to develop, manufacture and deliver radar with imaging in both maritime and overland environments for the Canadian Forces' CP-140 Aurora aircraft program. The company's electronic systems include IFF systems used by the U.S. Air Force and NATO on the AWACS aircraft and for the U.S. Navy's Multi-Mission Maritime Aircraft Contract.

Telephonics is generally a first tier supplier to prime contractors in the defense industry such as Boeing, Lockheed Martin, Northrop Grumman and Sikorsky Aircraft. With the significant contraction and consolidation that has occurred in the U.S. and international defense industry, major prime contractors worldwide are relying on smaller, key suppliers to provide advances in technology and greater efficiencies to reduce the cost of major systems and platforms. The company believes that this situation creates an opportunity for established, first tier suppliers to capitalize on existing relationships with major prime contractors and play a larger role in the foreseeable future.

The company also manufactures custom and standard, mixed-signal, application-specific large-scale integrated circuits for customers in the security, military telecommunications and multi-media industries.

Sales by Electronic Information and Communication Systems have provided approximately 24% of the company's consolidated revenue in 2006, 16% in 2005 and 16% in 2004.

Backlog

The funded backlog for Electronic Information and Communication Systems was approximately \$373 million at September 30, 2006, compared to \$217 million at September 30, 2005. The growth in backlog is attributable to the Syracuse Research Corporation contract and the MH-60R program. Approximately 76% of the current backlog is expected to be filled during fiscal 2007.

Sales and Marketing

Telephonics has approximately 25 technical business development personnel who act as the focal point for its marketing activities and approximately 40 sales representatives who introduce its products and systems to customers worldwide.

The company participates in a range of long-term defense and non-military government programs, both domestically and internationally. The company has developed a base of installed products in these programs that generate significant recurring revenue and retrofit, spare parts and customer support sales. Due to the inherent complexity of defense electronics, the company believes that its incumbent status on major platforms gives it a competitive advantage in the selection process for the upgrades and enhancements that have characterized defense electronics procurement in recent years. Furthermore, the company believes that with programs such as the U.S. Navy's MH-60R helicopter transitioning to full scale production concurrently with other radar and intercommunications systems production programs under way, the company will have a competitive price advantage on bids for new business.

In recent years, the segment has also significantly expanded its customer base in international markets. The company's international projects include a contract with BAE Systems as part of the United Kingdom's upgrade of the NIMROD surveillance aircraft and a number of contracts with the Civil Aviation Authority of China for air traffic management systems for Mainland China.

Research and Development

This segment regularly updates its core technologies through internally funded research and development. The selection of these R&D projects is based on available opportunities in the marketplace, as well as input from the company's customers. Recent internally funded research and development has resulted in the development of an airborne imaging maritime surveillance radar system with advanced technology and greater functionality, as well as an all-digital, totally secure intercommunications management system.

The company believes that it is a technological leader in its core markets and intends to pursue new growth opportunities by leveraging its systems design and engineering capabilities and incumbent position on key platforms. For example, during 2000 Telephonics was awarded a contract for the development of the next generation integrated radio management system for the U.S. Air Force's C-17A air transport. This program transitioned from development to production in fiscal 2003. Since 2003, the company has developed the next generation integrated radio management system for the C-17A Aircraft and will be retrofitting all of the previously installed systems going forward. The company also expects substantial sales growth as it transitions to the production phase for the US Navy's MH-60R helicopter program.

In addition to Telephonics' products for defense programs, the company has also applied its technology to produce products for commercial applications such as airborne weather and search radar air traffic control systems. The company believes that its reputation for innovative product design and engineering capabilities, especially in the areas of voice and data communications, radio frequency design, digital signal processing, networking systems, inverse synthetic aperture radar and analog, digital and mixed-signal integrated circuits, has enhanced its ability to secure, retain and expand its participation in defense programs and commercial undertakings. The company is capable of meeting a full range of customer requirements including system requirements definition, product design and development, manufacturing and test, integration and installation, and logistical support. As a result, the company has been successful in developing a number of relationships as an important strategic partner and first tier supplier to various prime contractors.

Telephonics' objective is to anticipate the needs of its core markets and to invest in research and development in an effort to provide solutions well in advance of its competitors. In an effort to ensure customer satisfaction and loyalty, Telephonics often designs its products to exceed customers' minimum specifications, providing its customers with greater performance and flexibility. The company believes that these practices engender increased coordination and communication with its customers at the earliest stages of new program development, thereby increasing the likelihood that Telephonics' products will be selected and integrated as part of a total system solution.

Competition

The Electronic Information and Communication Systems segment competes with major manufacturers of electronic information and communication systems that have greater financial resources than the company, and with several smaller manufacturers of similar products. The company competes on the basis of technology, design, quality, price and program performance.

Employees

On a consolidated basis, the company has approximately 5,700 employees located throughout the United States, in Europe and Brazil. Approximately 150 of its employees are covered by a collective bargaining agreement, primarily with an affiliate of the AFL-CIO. The company believes its relationships with its employees are satisfactory.

Regulation

The company's operations are subject to various environmental, health and employee safety laws. The company has spent money and management has spent time complying with environmental, health and worker safety laws which apply to its operations and facilities and the company expects to continue to do so. Compliance with environmental laws has not historically materially affected the company's capital expenditures, earnings or competitive position. The company does not expect compliance with environmental laws to have a material effect on the company in the future. The company believes that it generally complies with applicable environmental, health and worker safety laws and governmental regulations. Nevertheless, the company cannot guarantee that in the future it will not incur additional costs for compliance or that those costs will not be material.

Seasonality

Historically the company's revenues and earnings are lowest in its second fiscal quarter and highest in its fourth fiscal quarter.

Financial Information About Geographic Areas

Revenues, based on the customers' locations, and property, plant and equipment attributed to the United States and all other countries are as follows:

| | 2006 | 2005 | 2004 |
|---|------------------|------------------|------------------|
| Revenues by geographic area | | | |
| United States | \$ 1,286,470,000 | \$ 1,058,620,000 | \$ 1,045,943,000 |
| Germany | 74,886,000 | 66,853,000 | 73,341,000 |
| United Kingdom | 21,392,000 | 31,162,000 | 40,370,000 |
| Canada | 59,797,000 | 55,912,000 | 40,543,000 |
| Poland | 21,900,000 | 30,704,000 | 35,823,000 |
| All other countries | 172,135,000 | 158,742,000 | 157,789,000 |
| | \$ 1,636,580,000 | \$ 1,401,993,000 | \$ 1,393,809,000 |
| Property, plant and equipment by geographic area | | | |
| United States | \$ 133,005,000 | \$ 111,086,000 | \$ 113,631,000 |
| Germany | 79,493,000 | 88,102,000 | 86,815,000 |
| All other countries | 19,477,000 | 17,712,000 | 3,093,000 |
| | \$ 231,975,000 | \$ 216,900,000 | \$ 203,539,000 |

Research and Development

Research and development costs not recoverable under contractual arrangements are charged to expense as incurred. Research and development costs for all business segments were approximately \$15,300,000 in 2006, \$16,100,000 in 2005 and \$17,400,000 in 2004.

Executive Officers of the Registrant

Name