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Having Been Around for 80 Years, Espey Manufacturing & Electronics Corp., which has a Long History of Stable Profitability Providing Power Electronics to the Defense Industry is Now Focused on Growth



Technology
Diversified Electronics
(NYSE: "ESP")



Mark St. Pierre
President and CEO

Company Profile:

Espey Mfg. & Electronics Corp is a Power Electronics Design and Original Equipment Manufacturing (OEM) company with a long history of developing and delivering highly reliable products for use in military and severe environment applications. All design, manufacturing, and testing is performed in our 150,000+ square foot facility located at 233 Ballston Ave, Saratoga Springs, New York. Espey is a small business that is ISO 9001:2008 certified and publicly traded on NYSE Amex (ESP). Espey has been in business for 80 years and

continues to be successful through the design and manufacture of new and improved products by using cutting edge and emerging technologies.

Espey services include design and development to specification, build to print, design services, design studies, environmental testing services, metal fabrication, and painting services, and development of automatic testing equipment. Espey manufacturing is vertically integrated and will produce individual components (including inductors), populate printed circuit boards, fabricate metalwork, paint, wind magnetics, qualify, and fully test items in house; mechanically, electrically and environmentally.

Espey's primary products are power supplies, power converters, filters, power transformers, magnetic components, power distribution component, ups systems, antennas and high power radar systems. The applications of these products include AC and DC locomotives, shipboard power, shipboard radar, airborne power, ground-based radar, and ground mobile power.

Espey is on the eligible list of contractors on the United States Department of Defense and generally is automatically solicited by such agencies for procurement needs falling within the major classes of products produced by the company. Espey contracts with the Federal Government under cage code 20950 as Espey Mfg. & Electronics Corp. and cage code 98675 as Espey Mfg. & Electronics Corp., Saratoga Industries Division.

Interview conducted by:
Lynn Fosse, Senior Editor
CEOCFOinterviews.com

CEOCFO: Mr. St. Pierre, you have been with Espey Manufacturing and Electronics for almost two years; what attracted you to the company?

Mr. St. Pierre: What attracted me to Espey Manufacturing and Electronics was primarily, its longevity. Espey is a company that has not been on the industry's radar, yet it has been around for eighty years. I wondered how a company could survive and prosper that long and be so little known. Espey is largely unknown except by a handful of very loyal long-term defense contractors. Therefore, I was intrigued by an opportunity to take a company with that kind of history and grow it. It had been stable and steady, but had not grown over the years. For me it was an attractive opportunity to take this profitable steady business, make a growth engine out of it, get it on the map and get it recognized for what it is.

CEOCFO: As CEO for over a year, what have you done to change Espey, and what are you still working on in that area?

Mr. St. Pierre: There are many areas of focus for Espey, but the primary one is external. In other words, building a sales and marketing force is critical to getting the name out there and to bring new opportunities into the company, so we are hard at work on that. In fact, we just hired a Director of Sales and Marketing to lead that effort. He will in turn bolster the sales force nationally and even internationally where we have a couple of international reps or agents. That is prior-

ity one, but while that is going on and parallel to that, there are a bunch of internal initiatives like the lean initiative. For example, we are focused on making our factory efficient by removing non value-added activities throughout our operation. Thirdly, a strategic plan has been developed and that has for the first time in the company provided a comprehensible strategic vision that looks out five years and sees where opportunities are and where the company can focus on its core and leverage those for successful growth.

CEOCFO: Would you give us an example of what you design and create, and where Espey stands out?

Mr. St. Pierre: Espey is a niche designer and producer of electronics and power supplies for both military and commercial applications. That would include everything from missiles or weapons to communications and radar, and transportation systems. Anything that uses rugged environment, high reliability electronics generally surrounding the power question of how to get power to a specialized piece of device and how does it last in a tough environment-- that is where Espey shines. We are represented in a diverse set of applications like multi million dollar locomotives that carry freight all over the world, to fighter jet avionics to nuclear submarines. Anything that needs to be powered in a tough environment, convert one voltage to another, isolate a voltage from another so that it does not interfere with other electronics or just generally operate in a tough environment.

CEOCFO: Is it all custom or do you have an inventory of parts that you can put together for an application?

Mr. St. Pierre: It is effectively all custom designs for applications.

CEOCFO: When someone comes to you, do they know what they need and just ask Espey to put it together or are you guiding them?

Mr. St. Pierre: In our business what generally happens is a group of engineers have been hard at work at their specialty; for example. General Dynamics may be building the latest generation ship for the NAVY. On that

ship are a whole bunch of very fancy missile fire control and radars and all kinds of systems, with multimillions of dollars in sub-systems. That is their expertise as a prime contractor, but all those things then need to be powered. You do not just plug these things into the wall, as they take very specific voltages, usually many voltages. They have to be very carefully regulated so that they do not disrupt the equipment or conflict with other voltages and other frequencies in the ship or the system. Therefore, they come to us having designed this great radar, for example, but it needs 10,000 watts of power in these different voltages and configurations. It also needs to fit in a box that is usually very small in size for the power that it generates and it must survive everything from a missile strike or a mine explosion in the water to high temperatures such as in a fire. It has to be very survivable and very robust. They hand us what is called a Specification, which are a bunch of documents that define their power requirements, the operating environment as well as the envelope that it must fit in. They tell us, "You are the power supply or the magnetics experts, you make this work." It is a component of their larger system, but it is an absolutely essential one.

CEOCFO: Is international a growing area for Espey, and are their particular geographical areas that you are targeting?

Mr. St. Pierre: With the permission of the U.S. State Department, we sell to the Ministries of Defense of several foreign governments or corporations including Spain, Italy, Israel, U.K., as well as the NATO allies. It is 5% or 10% of our business. Is it growing? It is flat right now, but it goes up and down depending on the budgets and priorities of those foreign nations.

CEOCFO: Has the general economics hurt or is it not so important in the defense arena?

Mr. St. Pierre: Earlier, I mentioned that we are in a niche market. We have tried to create a strategy that immunizes ourselves from the typical cyclical defense spending cycle. The way we have done that is we have tried to target a combination of things

that include very old legacy programs that are very tried and true, that have "paid for themselves" from a development point of view. They deliver good value because they are already designed. The risk is taken out of them and they work very well, so soldiers and sailors like them. The military likes those programs because if they have performed well in service and they are a good platform, they can be upgraded at modest cost. Without redesigning and reinventing the wheel, they can be easily upgraded to fit a new mission as opposed to coming up with their entirely new and risky system. If you can piggy-back this old legacy system, upgrade it, modernize it, put new power into it, well that is exactly where we have been targeting. We are on a lot of old programs that have recent resets or recaps where they get refurbished and put out there in the field for another twenty or thirty years, but they need a brand new level of power and different kinds of power. That is a major portion of our business, in combination with some brand new programs that we think fit the strategic needs of the military strategy going forward. We read their strategy documents and when they say they need lighter mobile more agile forces, we target systems that look like they are going to survive the budget process to meet that mission that they declared they need. Therefore, it is kind of a combination of very old and very new targeted programs that we think combine to immunize ourselves against the typical upswings. For example, you could be just on a submarine or you are just targeting an expensive jet like the F-22 Raptor, which we do not do, but if you do that, those multibillion dollar programs tend to be the first ones cut in a budget crunch like we are in right now. So we don't target those. We might target the older systems on the F-16 that are being upgraded because those are relatively cheap compared to the new ones and the systems on them tend to be upgraded and we tend to get on those upgrades. That is what we like to do.

CEOCFO: Is that a new strategy for Espey?

Mr. St. Pierre: Yes, this is a new strategy to consciously target a combination of old and new programs and customers to achieve long-term growth.

CEOCFO: What areas has Espey been targeting outside of the military and how do you get inroads there?

Mr. St. Pierre: One major area for us, which has been one for some time now so it is not new to me, but we are expanding, is transportation. Locomotives and light rail have been sophisticated hybrid-electric vehicles now for many years, and their computing and electrical demand has grown dramatically, just as their environment is harsh--the two areas where Espey has particular core competency. They are full of electrical systems with big diesel engines running large generators and then they store battery power and release that battery power. They have very sophisticated computerized breaking, acceleration and energy consumption controls. It is a very rugged environment, because it is very hot in a locomotive with a lot of vibration, which tends to be similar to military applications. So we make a whole variety of power supplies, power management electronics for those applications for the major locomotive manufacturers around the world, of which there are three or four. In addition to that there are these huge mining trucks that are serving the growing energy needs of Asia. China in particular is basically consuming every bit of coal, oil, and natural resource they can get their hands on. That is all being carried by mining operations with these huge mining trucks that are also diesel/electric and need all kinds of electronic control, as well as that material being transported by rail. Therefore, we are very busy in that area with dozens of applications. That is keeping us busy on the non-military, and yet still very rugged applications.

CEOCFO: What is the competitive landscape for Espey?

Mr. St. Pierre: It is highly fragmented. Because we are a niche player I could name thirty or forty competitors, but we do not have anybody who competes with us in everything. We have a competitor on this application and a

competitor on that application, but seldom do we run into more than one or two at a time. There is no single competitor, because there are dozens of people who specialize in particular areas of energy management, power supplies and magnetic, but no one, in my opinion, who combines the experience and capability of Espey to solve difficult power solutions.

CEOCFO: Do all the people that should know about Espey, know you?

Mr. St. Pierre: Yes. When I said earlier that we are not well known, I should put a caveat on that. We sell to every one of the tier-one defense contractors, which means Boeing, General Dynamics, Northrop-Grumman, Raytheon and Lockheed Martin, etc. We sell to them all, but not to all their divisions. We will sell major application in one division of that company, but the divisions do not often talk to each other. They are completely different businesses, sometimes a result of an acquisition. Therefore, we need to leverage that, and after doing a great job for Raytheon division A, go into division B on the west coast or East coast and point that we are already a supplier to their corporation. That is why I say we need to get our name out there. We may be known for a very important application on a submarine that we did for General Dynamics, who knows us well, intimately in fact, but the other twelve divisions of General Dynamics making completely different products may not know us. That is where we are busy with that sales force extension and development.

CEOCFO: Are your customers buying decisions made based on price, expertise of the company or a little bit of both?

Mr. St. Pierre: Ultimately, price is always a factor. However, in our business it tends not to be the primary factor. The primary factor is almost always technical expertise followed by quality, which is now an automatic thing taken for granted that you will deliver perfect quality. In growing importance in tight budget times is performance to the contract delivery... on-time delivery. In our markets, in particular where it is specialized and rugged, our customers will tend to pay

a little more if they get very high quality, reliability and delivery. So I would say that it is not a price-driven business, but we must demonstrate a strong value proposition.

CEOCFO: Should some of these initiatives hit on all fronts at the same time, does Espey have the staff and capacity that would be required?

Mr. St. Pierre: We have a large plant of 150,000 square feet that is not fully at capacity, and we operate now on a single shift. In addition to having ample physical space in the plant, we also own outright 21 acres adjacent to the plant, which could be expanded upon or built upon. We can always expand our shift to two or even three shifts if need be.

CEOCFO: What is the financial picture like for Espey today?

Mr. St. Pierre: Probably the best story of all, as I mentioned previously that Espey is an 80-year old company with a very strong financial profile. It is a public company traded on the NYSE. Its fundamentals are secure, it owns its property, has no debt, and has cash or equivalents in the bank of approximately \$12 million. It has a strong cash flow, with strong backlog of about \$40 million on a company whose annual sales are about \$30 million. Therefore, its fundamentals are very strong and I give credit there to my predecessor and the current senior management team. They have done much to maintain the profitability of the company, which has paid high dividends, even through the worst of the recession.

CEOCFO: Has Espey done much investor outreach?

Mr. St. Pierre: Espey has been traditionally very thinly traded. I believe the float is in the order of 2.2 million shares or so out there. Three or four major institutional investors and three or four individual investors hold the major stakes. Then we have an employee stock ownership plan that probably owns in the area of 600,000 shares, so a pretty major portion of that 2.2 million is employee-owned. The float therefore is limited and the stock is thinly traded and that has not been a priority frankly. I am not saying it should not be, but it just has not

been a priority of the company. It has been profitable, the company is well-funded and capitalized, but it is certainly out there with shares for sale.

CEOCFO: In closing, why should investors, as well as government and military people, be interested in Espey?

Mr. St. Pierre: First, Espey is a "sleeper". For the limited audience that it has been serving for some time, it is a value play and "no-

brainer". It is a company with all its fundamentals performing well, has the same customer list for thirty years or so, forty years in some cases and tends to retain its customers. With that as a foundation, to me the prospects of the company going forward are very positive if the strategy plays out well and if we execute well. We must leverage our steady legacy into wider opportunities and more and more customers and more divisions of those customers, for Espey that is

a recipe for careful, gradual, but steady growth. That is what we are looking for. However, we are not going to do it overnight. We want to take our time and do it right and not upset the apple cart. We want to grow steadily, solidly, and keep it profitable while we grow into a market niche that we feel --despite the economic downturn-- is a very strong one.



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