SUNTRON CORP
Form 10-Q
November 09, 2004

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

þ Quarterly report pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934
For the fiscal quarter ended **September 26, 2004**, or

o 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.)
2401 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 þ No o

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

As of **October 18, 2004**, there were outstanding **27,415,221** shares of the registrant s Common Stock, $0.01 par value.

SUNTRON CORPORATION

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SUNTRON CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
December 31, 2003 and September 26, 2004
(In Thousands, Except Per Share Amounts)

	2003	2004
ASSETS		
Current Assets:		
Cash and equivalents	$ 26	$ 13
Trade receivables, net of allowance for doubtful accounts of $2,898 and $1,255, respectively	34,390	55,120
Inventories	61,391	85,160
Prepaid expenses and other	3,366	1,484
Total Current Assets	99,173	141,777
Property, Plant and Equipment, at cost:		
Land	4,798	4,798
Leasehold improvements	6,742	6,898
Buildings and improvements	19,120	19,092
Manufacturing machinery and equipment	53,852	54,901
Furniture, computer equipment and software	33,536	33,850
Total	118,048	119,539
Less accumulated depreciation and amortization	(74,554)	(83,015)
Net Property, Plant and Equipment	43,494	36,524
Intangible and Other Assets:		
Goodwill	9,627	10,390
Identifiable intangible assets, net of accumulated amortization of $4,560 and $4,787, respectively	1,152	925
Debt issuance costs, net	913	2,083
Deposits and other	287	199
Total Intangible and Other Assets	11,979	13,597
	$154,646	$191,898

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, 2003 and September 26, 2004
(In Thousands, Except Per Share Amounts)

	2003	2004
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 32,858	$ 41,879
Outstanding checks in excess of cash balances	41	6,758
Borrowings under revolving credit agreement		61,640
Accrued compensation and benefits	7,075	6,760
Payable for acquisition of business	2,197	839
Accrued property taxes	1,285	1,251
Current portion of accrued exit costs related to facility closures	900	570
Accrued interest expense	250	457
Payable to affiliates	207	218
Other accrued liabilities	4,982	4,015
Total Current Liabilities	49,795	124,387
Long-term Liabilities:		
Borrowings under revolving credit agreement	34,011	
Accrued exit costs related to facility closures	117	223
Other	774	220
Total Liabilities	84,697	124,830
Commitments and Contingencies (Notes 5 and 6)		
Stockholders Equity:		
Preferred stock, $.01 par value. Authorized 10,000 shares, none issued		
Common stock, $.01 par value. Authorized 75,000 shares; issued and outstanding 27,409 shares and 27,415 shares, respectively	274	274
Additional paid-in capital	380,804	380,749
Deferred stock compensation	(754)	(422)
Accumulated deficit	(310,375)	(313,533)
Total Stockholders Equity	69,949	67,068
	$ 154,646	$ 191,898

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

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SUNTRON CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
For The Quarters and the Nine months Ended September 28, 2003 And September 26, 2004
(In Thousands, Except Per Share Amounts)

	Quarter Ended		Nine months Ended	
	September 28, 2003	September 26, 2004	September 28, 2003	September 26, 2004
Net Sales	$79,638	$128,542	$234,647	$359,594
Cost of Goods Sold	80,780	120,913	244,071	340,246
Gross profit (loss)	(1,142)	7,629	(9,424)	19,348
Operating Costs and Expenses:				
Selling, general and administrative expenses	5,039	5,762	16,330	17,765
Severance, retention and lease exit costs		282	51	981
Related party expenses- management fees	188	188	563	563
Total operating costs and expenses	5,227	6,232	16,944	19,309
Operating income (loss)	(6,369)	1,397	(26,368)	39
Other Income (Expense):				
Interest expense	(761)	(991)	(1,941)	(2,937)
Unrealized loss on marketable securities		(428)		(428)
Gain (loss) on sale of assets	6	(1)	42	(35)
Interest and other income	4	133	90	203
Net income (loss)	$ (7,120)	$ 110	$ (28,177)	$ (3,158)
Earnings (Loss) Per Share:				
Basic	$ (0.26)	$ 0.0	$ (1.03)	$ (0.12)
Diluted	$ (0.26)	$ 0.0	$ (1.03)	$ (0.12)

Number of Shares Used for Computation:				
Basic	27,409	27,414	27,409	27,412
Diluted	27,409	27,536	27,409	27,412

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SUNTRON CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
For The Nine months Ended September 28, 2003 And September 26, 2004
(In Thousands)

	2003	2004
Cash Flows from Operating Activities:		
Net loss	$ (28,177)	$ (3,158)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	16,843	8,981
Amortization of debt issuance costs	719	739
Impairment of property, plant and equipment	40	
Change in accrued severance, retention and lease exit costs	(2,212)	(171)
Marketable securities received for recovery of bad debt		(777)
Unrealized loss on marketable securities		428
Loss (gain) on sale of assets	(42)	35
Stock-based compensation expense	167	255
Changes in operating assets and liabilities, net of effects of purchase of businesses:		
Decrease (increase) in:		
Trade receivables, net	(9,667)	(20,625)
Inventories	10,789	(23,520)
Prepaid expenses and other	614	2,319
Increase (decrease) in:		
Accounts payable	(3,754)	8,884
Accrued compensation and benefits	(2,480)	(368)
Other accrued liabilities	(1,770)	(863)
Net cash used by operating activities	(18,930)	(27,841)
Cash Flows from Investing Activities:		
Proceeds from sale of assets	19	24
Payments for acquisition of businesses	(205)	(2,466)
Cash acquired in business acquisition	301	
Capital expenditures	(2,672)	(2,223)
Net cash used by investing activities	(2,557)	(4,665)
Cash Flows from Financing Activities:		
Proceeds from borrowings under revolving credit agreement	246,016	387,202
Principal payments under revolving credit agreement	(226,830)	(359,587)
Payments for debt issuance costs	(628)	(1,839)

Increase in outstanding checks in excess of cash balances	1,331	6,717
Net cash provided by financing activities	19,889	32,493
Net decrease in cash and equivalents	(1,598)	(13)
Cash and Equivalents:		
Beginning of period	1,621	26
End of period	$ 23	$ 13

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, Continued
For The Nine months Ended September 28, 2003 And September 26, 2004
(In Thousands)

	2003	2004
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$1,100	$1,991
Cash paid for income taxes	$ —	$ —
Supplemental Schedule of Non-cash Investing and Financing Activities:		
Assumption of bank debt for acquisition of business	$1,156	$ —
Payable for acquisition of business	$1,587	$ 753
Contract payable for purchase of software	$ 984	$ —

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
(In Thousands, Except Per Share Amounts)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America 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 accounting principles generally accepted in the United States of America 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 fiscal quarter and the nine months ended September 26, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. 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, 2003.

2. Earnings (Loss) Per Share

Basic earnings (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 earnings (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 quarter and the nine months ended September 28, 2003 and for the nine months ended September 26, 2004, as all potential common shares were antidilutive. For the quarter and the nine months ended September 28, 2003, common stock options and warrants that were excluded from the calculation of diluted loss per share amounted to an aggregate of 2,105 shares at exercise prices ranging from $2.83 to $57.24 per share. For the nine month period ended September 26, 2004, common stock options that were excluded from the calculation of diluted loss per share amounted to an aggregate of 2,146 shares at exercise prices ranging from $0.01 to $57.24 per share. For the quarter ended September 26, 2004, common stock options that were excluded from the calculation of diluted earnings per share amounted to an aggregate of 1,520 shares at exercise prices ranging from $4.90 to $57.24 per share.

3. 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 income (loss) and earnings (loss) per share (EPS) for the quarters and the nine months ended September 28, 2003 and September 26, 2004, would have been as follows:

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

	Quarter Ended:			
	September 28, 2003		September 26, 2004	
	Net Loss	EPS	Net Income (Loss)	EPS
Amounts reported	$(7,120)	$(0.26)	$ 110	$ 0.00
Add stock-based employee compensation recorded under the intrinsic value method	56		85	
Less stock-based employee compensation recorded under the fair value method	(714)		(301)	
Pro forma under fair value method	$(7,778)	$(0.28)	$(106)	$(0.00)

	Nine months Ended:			
	September 28, 2003		September 26, 2004	
	Net Loss	EPS	Net Loss	EPS
Amounts reported	$(28,177)	$(1.03)	$(3,158)	$(0.12)
Add stock-based employee compensation recorded under the intrinsic value method	167		255	
Less stock-based employee compensation recorded under the fair value method	(2,381)		(904)	
Pro forma under fair value method	$(30,391)	$(1.11)	$(3,807)	$(0.14)

Basic and diluted historical and pro forma EPS are the same for all periods presented above.

4. Inventories

Inventories at December 31, 2003 and September 26, 2004 are summarized as follows:

	2003	2004
Purchased parts and completed sub-assemblies	$43,113	$59,499
Work-in-process	10,044	12,833
Finished goods	8,234	12,828
	$61,391	$85,160

For the quarters ended September 28, 2003 and September 26, 2004, the Company recognized write-downs of excess and obsolete inventories of $827 and $956, respectively. For the nine months ended September 28, 2003 and September 26, 2004, the Company recognized write-downs of excess and obsolete inventories of $2,897 and $2,017, respectively. In 2003 and 2004, write-downs of excess inventories are related to a variety of customers for which the Company does not expect to realize the carrying value through production or other means of liquidation.

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

5. Business Combination

Trilogic Acquisition. 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. Management believes Trilogic s comprehensive suite of design and integration capabilities, including hardware engineering, software integration, testing and product life cycle management services provide the Company with an opportunity to provide an expanded array of services to its customers, increase its customer base and expand market share in the Northeast.

The initial purchase consideration was $855, which 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. Based on the sales targets achieved in 2003, the Company recorded a payable of $2,197 and a corresponding increase to goodwill as of December 31, 2003, and $2,111 of this amount was paid in the first quarter of 2004. The 2004 sales target was achieved beginning in the second quarter of 2004, resulting in the accrual of a payable for $747 as of September 26, 2004. After recording the additional consideration related to the 2003 and 2004 sales targets, the allocation of the acquisition cost resulted in goodwill of $3,410. The historical results of operations for this acquisition 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.

Skyline Acquistion. In February 2004, the Company completed an acquisition for approximately $355. The purchase price was allocated to trade receivables for $105, inventories for $249, equipment for $3, goodwill for $10, and payables for $12. The agreement provides for the payment of additional consideration in the amount of 1% of net sales related to the customers of the acquired business during the one-year period following the acquisition. For the nine months ended September 26, 2004, the Company recorded additional goodwill of $6 related to the formula for additional consideration under the Skyline acquisition agreement. The historical results of operations for this acquisition 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.

6. Debt Financing

At December 31, 2003 and September 26, 2004, the Company had outstanding borrowings under a revolving credit facility under a $75,000 credit agreement with Citibank as the lead bank. The Company can periodically elect to use either the Base Rate or LIBOR Rate in connection with borrowings under the line of credit. Through July 6, 2004, the interest rate was the prime rate plus 2.50% for Base Rate borrowings and the LIBOR rate plus 3.75% for LIBOR Rate borrowings. The credit agreement limits or prohibits the Company from paying dividends, incurring additional debt, selling significant assets, acquiring other businesses, or merging with other entities without the consent of the lenders. The credit agreement requires compliance with certain financial and non-

SUNTRON CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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financial covenants, including quarterly requirements related to earnings before interest, taxes, depreciation and amortization (EBITDA).

On July 7, 2004, the credit agreement was amended whereby Congress Financial Corporation joined Citibank as parties to the amended credit agreement. The maturity date was extended until July 7, 2008 and the amendment includes less stringent covenants for EBITDA. The minimum tangible net worth and capital expenditures covenants were eliminated in the amended agreement. For the remainder of 2004, the interest rates were reduced from previous levels by 1.75% for Base Rate borrowings and 1.00% for LIBOR Rate borrowings. As of September 26, 2004, the interest rate for Base Rate borrowings was 5.5% and the effective rate for LIBOR Rate borrowings was 4.5%. Beginning in 2005, interest rates will be adjusted further depending on the amount of EBITDA for the preceding four fiscal quarters. In addition, the Company is obligated to pay a commitment fee of 0.5% per annum of the unused portion of the credit facility.

Under certain circumstances, the commitment under the amended credit agreement may be increased from $75,000 to $100,000. As of September 26, 2004, the borrowing base calculation permitted total borrowings of $75,000, and the Company was in compliance with all of the covenants under the amended credit agreement. After deducting the outstanding principal balance and an outstanding letter of credit for $270, the Company had borrowing availability of $13,090 as of September 26, 2004. 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. During the nine months ended September 26, 2004, the Company incurred debt issuance costs of $1,681 related to the amended credit agreement.

The amended credit agreement includes a lockbox arrangement that requires the Company to direct its customers to remit payments to restricted bank accounts, whereby all available funds are used to pay down the outstanding principal balance under the amended credit agreement. Accordingly, even though the maturity date of the amended credit agreement is in July 2008, the accounting rules require that the entire outstanding principal balance be classified as a current liability in the accompanying balance sheet as of September 26, 2004.

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

7. Restructuring Activities

During the past few years, the Company has taken action 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 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

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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 would 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 first quarter of 2004, the Company completed the move of its corporate headquarters and a charge of approximately $400 was recognized when the former headquarters building was no longer in use.

The Company incurred severance costs shown in the table below related to the termination of 77 and 15 employees during the third quarters of 2003 and 2004, respectively. For the first nine months of 2003 and 2004, the Company incurred severance costs shown in the table below related to the termination of 369 and 26 employees, respectively. 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. As a result of the actions described above, the Company recorded restructuring related charges for the quarters and the nine months ended September 28, 2003 and September 26, 2004, as follows:

	Quarter Ended		Nine months Ended	
	September 28, 2003	September 26, 2004	September 28, 2003	September 26, 2004
Cost of goods sold:				
Lease exit costs	$ 352	$ (40)	$ 444	$ 16
Accelerated depreciation due to shortened lives of improvements	590		1,083	
Relocation, moving and other costs			96	50
Impairment of manufacturing equipment	40		40	
Severance and retention costs	195	90	722	103
Total	1,177	50	2,385	169
Severance, retention and lease exit costs:				
Lease exit costs		252	(20)	634
Relocation, moving and other costs		15	3	28
Severance and retention costs		15	68	319
Total		282	51	981
Total restructuring related costs	$1,177	$ 332	$2,436	$ 1,150

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In Thousands, Except Per Share Amounts)

The following summarizes changes in restructuring related liabilities for the nine months ended September 26, 2004:

	Accrued Lease Exit Costs	Accrued Severance & Other (1)
Balance, December 31, 2003	$ 1,017	$ 55
Accrual for new activities	430	500
Revisions of previous estimates	184	
Cash receipts under subleases	359	
Cash payments	(1,271)	(448)
Non-level rent expensed in prior periods and other	74	
Balance, September 26, 2004	793	107
Less current portion	(570)	(107)
Long-term portion	$ 223	$

(1) Accrued severance costs are included in accrued compensation and benefits in the accompanying balance sheet as of September 26, 2004.

8. Bad Debt Recovery

During the third quarter of 2004, a former customer emerged from bankruptcy protection and the Company received marketable equity securities that are listed on NASDAQ in exchange for its fully-reserved receivable. The Company is accounting for this investment in accordance with Statement of Financial Accounting Standards No. 115. Management has classified the Company s investment as trading securities whereby changes in fair value are reported in operations.

The initial trading value of these securities indicated that the value of these securities was $777 and, accordingly, this amount was recorded as a bad debt recovery (shown as a reduction of selling, general and administrative expenses in the accompanying statements of operations) in the third quarter of 2004. By the end of the third quarter of 2004, the value of these securities had declined to $349 and the Company recorded an unrealized loss of $428 in the accompanying statements of operations for the quarter and the nine months ended September 26, 2004. Management intends to sell this investment (included in prepaid expenses and other in the accompanying balance sheet as of September 26, 2004) within the next year.

9. Income Taxes

The Company did not incur income tax expense for the third quarter of 2004 since a cumulative net loss was incurred for the first nine months of 2004. The Company has substantial net operating loss carryforwards that are expected to offset taxable income for the foreseeable future, which would result in the elimination of regular federal income taxes. However, the Company is also subject to the alternative minimum tax and state income taxes, which may result in future income tax charges.

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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 2003 Annual Report on Form 10-K.

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 and profitability; the ability to meet cost estimates and achieve the expected benefits associated with recent restructuring activities; trends affecting our growth; and the business and economic risks described herein under Factors That May Affect Future Results.

Executive Summary

During the third quarter of 2004, we achieved net income of $0.1 million compared to a net loss of $7.1 million in the third quarter of 2003. In 2001 through 2003, we experienced a severe contraction in our business where quarterly net sales declined from $197.9 million in the first quarter of 2001 to $78.6 million in the fourth quarter of 2003. We responded to the economic downturn by closing five of our manufacturing facilities, which resulted in significant restructuring charges. These plant closures combined with other restructuring and cost containment initiatives resulted in a much lower cost structure at the beginning of 2004.

For the first quarter of 2004, we experienced a 28% increase in our net sales compared to the fourth quarter of 2003, which was the first significant quarterly increase in the past three years. For the second and third quarters of 2004, our net sales increased by nearly 30% compared to the first quarter of 2004. The improvement in our net sales this year was primarily responsible for our ability to achieve operating income of $1.4 million in the third quarter of 2004. However, after seven consecutive quarters of improvement, our operating income declined in the third quarter of 2004 by $0.7 million compared to the second quarter of 2004.

Despite our improved earnings results in the first nine months of 2004, we used $27.8 million of operating cash flow, primarily to fund working capital requirements associated with the significantly higher sales volumes during this period. Our negative operating cash flows were funded by additional borrowings under our line of credit with Citibank, resulting in an increase in outstanding debt of $27.6 million during the first nine months of 2004. At the end of the third quarter of 2004, our borrowing availability was $13.1 million.

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On July 7, 2004, we entered into an amended credit agreement with Citibank and Congress Financial Corporation. The maximum borrowings permitted under the amended credit agreement remained unchanged at $75.0 million and the maturity date was extended until July 2008. However, due to the requirement to maintain a lockbox arrangement the entire principal balance is classified as a current liability. If the Company desires greater borrowing capacity, the amended credit agreement permits an increase up to $100.0 million if a third financial institution agrees to join the existing lenders. If the amended credit agreement is inadequate to fund our activities, we would consider the issuance of subordinated debt or equity instruments to enable us to meet our capital requirements.

We believe market conditions in the electronics industry peaked during the third quarter and we are currently taking steps to reduce costs in anticipation of sequentially lower net sales for the fourth quarter of 2004. Primarily due to a downturn in the semiconductor capital equipment sector and seasonal variations in other sectors that our customers are engaged in, we expect net sales will be between $102 million and $110 million for the fourth quarter of 2004. This is approximately 30% to 40% higher than the fourth quarter of 2003, but approximately 15% to 20% lower than the third quarter of 2004. While we have commenced efforts to reduce our cost structure in anticipation of lower net sales, our past experience indicates that it is extremely difficult to execute cost reduction actions without some deterioration in profitability. Additionally, it is not feasible to reduce fixed costs during temporary downturns, which results in lower margins due to less efficient capacity utilization.

In October 2004, Applied Materials informed us that there would be a significant reduction in orders starting in the first quarter of 2005, due to the transition of major programs to alternative contract manufacturers. For the third quarter of 2004, Applied Materials accounted for 25% of our net sales. We have had an ongoing dispute with Applied Materials with regard to non-payment related to Applied Materials contractual obligations for excess and obsolete materials. We expect that Applied Materials will satisfy its existing purchase order commitments, and that we will continue to satisfy our delivery obligations. We expect that this transition will not adversely impact our results of operations until the first quarter of 2005.

We are continuing to focus substantial efforts to improve operational performance and we believe these actions have the potential to partially mitigate the expected effects of lower net sales in the fourth quarter of 2004 and to improve profitability in 2005. Some of the tactical issues we are addressing include managing inventory purchases to improve our cash cycle time and to reduce incremental borrowings, monitoring production schedules to minimize overtime and materials expediting charges (except for those cases where our customers agree to reimburse us to support their orders placed inside standard lead-times), and the renegotiation of unfavorable arrangements with certain customers.

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Following is an overview of the information included under each section of Management s Discussion and Analysis of Financial Condition and Results of Operations:

Caption	Overview
Information About Our Business	Under this section we provide information to help understand our industry conditions and information unique to our business and customer relationships.
Critical Accounting Policies and Estimates	This section provides details about some of the critical estimates and accounting policies that must be applied in the preparation of our financial statements. It is important to understand the nature of key uncertainties and estimates that may not be apparent solely from reading our financial statements and the related footnotes.
Overview of Statement of Operations	This section includes a description of the types of transactions that are included in each significant category included in our statement of operations.
Results of Operations	This section includes a discussion and analysis of our operating results for the third quarter of 2003 compared to the third quarter of 2004. This section also contains a similar discussion and analysis of our operating results for the first nine months of 2003 compared to the first nine months of 2004.
Liquidity and Capital Resources	There are several sub-captions under this section, including a discussion of our cash flows for the first nine months of 2004 and other liquidity measures that we consider important to our business. Under the sub-caption for Contractual Obligations, we discuss on- and off-balance-sheet obligations and the expected impact on our liquidity. Under the sub-caption for Capital Resources, we have included a discussion of our amended credit facility with Citibank, including details about interest rates charged, calculation of the borrowing base and unused availability, compliance with the EBITDA covenant, and alternatives if current capital resources are inadequate.
Factors That May Affect Future Results	This section includes an in-depth discussion of many of the risks and uncertainties that affect our business and industry, as well as risks that should be considered before investing in our common stock. Our future financial results are dependent upon effectively managing and responding to these risks.

Information About Our Business

Suntron delivers complete manufacturing services and solutions to support the entire life cycle of complex products in the aerospace and defense, semiconductor capital equipment, industrial, and medical 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. We believe 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.

We are engaged in the electronic manufacturing services industry. Accordingly, our largest single expenditure is for the purchase of electronic components and our expertise in electronics manufacturing techniques is critical to our ability to provide competitive, quality services. However, in order to comprehend our business it is also important to understand that our customers are engaged in aerospace and defense, semiconductor capital equipment, medical products, and many other industries. While our ability to compete with other companies in the EMS industry is important to our long-term success, short-term fluctuations in the demand for our manufacturing services are primarily affected by the economic conditions in the industry sectors served by our customers. Since over 60% of our customers are concentrated in two industry sectors, the quarterly fluctuations in our net sales can be extremely volatile when these sectors are experiencing either rapid growth or contraction.

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.

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.

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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 of America. 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.

Revenue Recognition. We recognize revenue from manufacturing services and product sales upon shipment and transfer of title of 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; however, if such requirements or obligations exist, then revenue is recognized at the point when the requirements are completed and the obligations fulfilled. If uncertainties exist about whether the customer has assumed the risks and rewards of ownership or if continuing performance obligations exist, we expand our written communications with the customer to ensure that our understanding of the arrangement is consistent with that of the customer before revenue is recognized. In limited circumstances, the Company s customers agree to purchase products but they request that we store the physical product in our facilities. In these circumstances, revenue is only recognized when the terms of the arrangement comply with the guidance in SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*. Occasionally, we enter into arrangements where services are bundled and completed in multiple stages. In these cases, we follow the guidance in Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Revenue from design, engineering and other services is recognized as the services are performed.

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, (iv) a significant amount of the parts we purchase are unique to a particular customer s orders and there are limited alternative markets if that customer s order is canceled, and (v) 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

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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 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 an allowance 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. When our customers experience difficulty in paying us, we estimate how much of our receivable will not be collected. These judgments are often difficult because the customer may not divulge complete and accurate information. Even if we are fully aware of the customer s financial condition it can be difficult to estimate the expected recovery and there is often a wide range of outcomes. Over the past year, we have diversified our concentration of business with our major customers and have added smaller customers that generally have higher credit risk. Accordingly, we may experience higher bad debt losses in the future.

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.

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 weak in the areas in which we are attempting to sublease closed facilities, and we believe our estimates have appropriately considered these conditions.

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, 2003.

Overview of Statement of Operations

Net sales are recognized when title is transferred to our customers, which generally occurs upon shipment from our facilities. Net sales from design, engineering and other services are generally recognized as the services are performed. Our sales are recorded net of customer discounts and credits 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 and credits related to manufacturing operations for lease exit costs, severance and retention cost, impairment of long-lived assets, and obsolete and slow moving inventories. 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; bad debt charges and recoveries; professional fees for auditing and legal assistance; and general corporate expenses.

Severance, retention, and lease exit costs primarily relate to costs associated with the closure of administrative facilities and reductions in our administrative workforce. Severance, retention, and lease exit costs that relate to manufacturing activities are included in cost of goods sold.

Related party expenses- management fees consist of fees paid to affiliates of our majority stockholder.

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 28, 2003 and September 26, 2004:

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	Quarter Ended		Nine months Ended	
	September 28, 2003	September 26, 2004	September 28, 2003	September 26, 2004
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	101.4%	94.1%	104.0%	94.6%
Gross profit (loss)	(1.4)%	5.9%	(4.0)%	5.4%
Operating costs and expenses:				
Selling, general, and administrative	6.3%	4.5%	7.0%	4.9%
Severance, retention, and lease exit costs	0.3%	0.2%	0.2%	0.3%
Related party expense-management fees	%	0.1%	%	0.2%
Operating income (loss)	(8.0)%	1.1%	(11.2)%	%

Quarter Ended September 26, 2004 Compared to Quarter Ended September 28, 2003

Net Sales. Net sales increased $48.9 million, or 61.4%, from $79.6 million for the third quarter of 2003 to $128.5 million for the third quarter of 2004. The increase in 2004 net sales was primarily attributable to an increase of $34.1 million in our net sales to customers engaged in the semiconductor capital equipment sector, an increase of $6.8 million for customers in the industrial sector, and an increase of $4.5 million for customers in the aerospace and defense sector. For the third quarter of 2004, we recognized net sales to new customers of approximately $6.2 million. For the third quarter of 2003, net sales include recovery of unauthorized customer discounts of approximately $0.4 million.

For the third quarter of 2003, Honeywell and Applied Materials accounted for 25% and 14%, respectively, of our net sales. For the third quarter of 2004, Honeywell and Applied Materials accounted for 20% and 25%, respectively, of our net sales.

Gross Profit (Loss). Our gross profit improved by $8.8 million from a loss of $1.1 million in the third quarter of 2003 to a profit of $7.6 million in the third quarter of 2004. Similarly, gross profit as a percentage of net sales improved from a loss of 1.4% of net sales in the third quarter of 2003 to a profit of 5.9% of net sales in the third quarter of 2004. The improvement in gross profit in the third quarter of 2004 is primarily attributable to the significant increase in net sales while fixed manufacturing costs remained relatively unchanged.

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. For the third quarter of 2004, restructuring costs related to manufacturing activities were insignificant.

Through the third quarter of 2004 a substantial amount of equipment became fully depreciated, although many of these assets are still in service. Accordingly, depreciation expense for the third quarter of 2004 declined by approximately $3.4 million compared to the third

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quarter of 2003, and this reduction also contributed favorably to the improvement in our gross profit.

Inventory write-downs increased $0.2 million from $0.8 million, or 1.0% of net sales, in the third quarter of 2003 to $1.0 million, or 0.7% of net sales, in the third quarter of 2004. This reduction in inventory write-downs as a percentage of net sales resulted primarily from our substantial efforts to continue to improve our inventory management processes and to work more closely with our customers to minimize losses due to excess inventories. In 2003 and 2004, 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) increased by $0.8 million to $5.8 million in the third quarter of 2004 compared to $5.0 million in the third quarter of 2003. The increase in SG & A was primarily attributable to increases in salaries and benefits of $1.4 million, partially offset by net bad debt recoveries of $0.7 million.

Severance, Retention, and Lease Exit Costs. Severance, Retention, and Lease Exit Costs amounted to $0.3 million for the third quarter of 2004, primarily due to a lease exit charge related to a revision of estimates about the expected subleasing of a building in Phoenix that was previously used for administrative purposes. For the third quarter of 2003, no costs were incurred for severance, retention, and lease exit related to our administrative activities.

Interest Expense. Interest expense increased $0.2 million, or 30.2%, from $0.8 million in the third quarter of 2003 to $1.0 million in the third quarter of 2004, primarily due to an increase in average outstanding borrowings. Our weighted average borrowings increased from $31.9 million during the third quarter of 2003 to $64.5 million for the third quarter of 2004. The impact of higher borrowings was partially offset by a reduction in our weighted average interest rate from 6.5% in the third quarter of 2003 to 4.9% in the third quarter of 2004.

Unrealized Loss on Marketable Securities. During the third quarter of 2004, a former customer emerged from bankruptcy protection and we received marketable equity securities that are traded on NASDAQ in exchange for our fully-reserved receivable. The trading value of these securities declined from $0.8 million when the bankruptcy plan was confirmed to $0.4 million by the end of the third quarter of 2004, which resulted in an unrealized loss of $0.4 million. We are actively seeking a buyer of these securities and expect to complete a sale within the next year.

Nine Months Ended September 26, 2004 Compared to Nine Months Ended September 28, 2003

Net Sales. Net sales increased $124.9 million, or 53.2%, from $234.6 million for the first nine months of 2003 to $359.6 million for the first nine months of 2004. The increase in 2004 net sales was primarily attributable to an increase of $89.4 million in our net sales to customers engaged in the semiconductor capital equipment sector, an increase of $27.1 million for customers in the industrial sector, and an increase of $6.5 million for customers in the medical sector. For the first nine months of 2003 and 2004, we recognized net sales related to the May 2003 acquisition of Trilogic Systems $4.3 million and $12.4 million, respectively. For the first nine months of 2004, we recognized net sales to new customers of approximately $18.1 million.

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Net sales for the first nine months of 2003 and 2004 includes approximately $6.7 million and $5.2 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 also include the recovery of unauthorized customer discounts of approximately $1.0 million.

For the first nine months of 2003, Honeywell and Applied Materials accounted for 30% and 16%, respectively, of our net sales. For the first nine months of 2004, Honeywell and Applied Materials accounted for 21% and 26%, respectively, of our net sales.

Gross Profit (Loss). Our gross profit improved by $28.7 million from a loss of $9.4 million in the first nine months of 2003 to a profit of $19.3 million in the first nine months of 2004. Similarly, gross profit as a percentage of net sales improved from a loss of 4.0% in the first nine months of 2003 to a profit of 5.4% in the first nine months of 2004. The improvement in gross profit in the first nine months of 2004 is primarily attributable to the significant increase in net sales while fixed manufacturing costs remained relatively unchanged.

Through the first nine months of 2004 a significant amount of equipment became fully depreciated, although many of these assets are still in service. Accordingly, depreciation expense for the first nine months of 2004 declined by approximately $7.8 million compared to the first nine months of 2003, and this reduction also contributed favorably to the improvement in our gross profit. We expect depreciation expense will continue to decline by approximately $2.5 million for the year ending December 31, 2005 compared to the year ending December 31, 2004.

Inventory write-downs decreased $0.9 million from $2.9 million, or 1.2% of net sales, in the first nine months of 2003 to $2.0 million, or 0.6% of net sales, in the first nine months of 2004. This reduction in inventory write-downs resulted primarily from our substantial efforts to continue to improve our inventory management processes and to work more closely with our customers to minimize losses due to excess inventories. In 2003 and 2004, 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) increased $1.5 million, or 8.8%, from $16.3 million in the first nine months of 2003 to $17.8 million in the first nine months of 2004. The increase in SG & A during the first nine months of 2004 was primarily attributable to an increase in compensation and benefits of $2.2 million, an increase in professional fees of $0.2 million; offset by net bad debt recoveries of $0.4 million, and a decrease in facilities-related costs of $0.5 million.

Severance, Retention, and Lease Exit Costs. Severance, Retention, and Lease Exit Costs amounted to $1.0 million in the first nine months of 2004, primarily due to a lease exit charge of $0.6 million related to the consolidation of our Phoenix operations. We also incurred severance costs of approximately $0.3 million in the first nine months of 2004.

Interest Expense. Interest expense increased $1.0 million, or 51.3%, from $1.9 million in the first nine months of 2003 to $2.9 million in the first nine months of 2004, primarily due to an increase in average outstanding borrowings. Our weighted average borrowings increased from $23.5 million during the first nine months of 2003 to $53.5 million for the first nine months of 2004. The impact of higher borrowings was partially offset by a reduction in our weighted average interest rate from 6.7% in the first nine months of 2003 to 5.5% in the first nine months of 2004.

Unrealized Loss on Marketable Securities. During the third quarter of 2004, a former customer emerged from bankruptcy protection and we received marketable equity securities that are traded on NASDAQ in exchange for our fully-reserved receivable. The trading value of these securities declined from $0.8 million when the bankruptcy plan was confirmed to $0.4 million by the end of the third quarter of 2004, which resulted in an unrealized loss of $0.4 million. We are actively seeking a buyer of these securities and expect to complete a sale within the next year.

Liquidity and Capital Resources

Cash Flows from Operating Activities. Net cash used by operating activities in the first nine months of 2004 was $27.8 million, compared with net cash used by operating activities of $18.9 million in the first nine months of 2003. The difference between our net loss of $3.2 million in the first nine months of 2004 and $27.8 million of negative operating cash flow was primarily attributable to an increase in trade receivables of $20.6 million and an increase in inventories of $23.5 million, partially offset by an increase in accounts payable of $8.9 million, $9.7 million of depreciation and amortization expense, and a decrease in prepaid expenses and other of $2.3 million.

The large increases in trade receivables and inventories are directly related to a 53.2% increase in our net sales for the nine months ended September 26, 2004 compared to the nine months ended September 28, 2003. For the fourth quarter of 2004, we expect a decrease in our net sales between 15% and 20% compared to the third quarter of 2004. We expect this decrease in our net sales will result in lower receivables and inventories by the end of 2004, which will contribute to positive operating cash flow of approximately $10 million along with a corresponding reduction in outstanding debt for the fourth quarter of 2004.

Days sales outstanding (based on annualized net sales for the quarter and net trade receivables outstanding at the end of the quarter) decreased to 39 days for the third quarter of 2004, compared to 46 days for the comparable period of 2003.

Inventories increased 38.7% to $85.2 million at September 26, 2004, compared to $61.4 million at December 31, 2003. For the third quarter of 2004, inventory turns (annualized cost of goods sold excluding restructuring charges of $1.1 million for the third quarter of 2003 and $0.1 million for the third quarter of 2004, divided by quarter-end inventories) improved to 5.7 times per year compared to 5.5 times per year for the comparable period in 2003.

Cash Flows from Investing Activities. Net cash used by investing activities in the first nine months of 2004 was $4.7 million compared with net cash used by investing activities of $2.6 million in the first nine months of 2003. Investing cash flows for the first nine months of 2004 totaled $4.7 million of cash outflows, consisting of the payment of $2.1 million of contingent consideration related to the 2003 earn-out associated with the acquisition of Trilogic Systems, $0.4 million for the acquisition of a business, and $2.2 million for other capital expenditures.

Investing cash flows for the first nine months of 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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Cash Flows from Financing Activities. Net cash provided by financing activities in the first nine months of 2004 was $32.5 million, compared with net cash provided by financing activities of $19.9 million in the first nine months of 2003. Financing cash flows in the first nine months of 2004 reflect net borrowings under our revolving line of credit of $27.6 million. During the first nine months of 2004, an increase in outstanding checks in excess of cash balances of $6.7 million contributed positively to cash flows from financing activities. During the first nine months of 2004, the Company also paid debt issuance costs of $1.8 million, primarily related to the July 2004 amendment to our credit facility with Citibank.

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, 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 2003, the Company also paid debt issuance costs of $0.6 million related to our credit facility with Citibank.

Contractual Obligations. The following table summarizes our contractual obligations as of September 26, 2004:

	Revolving Credit(1)	Operating Leases (2)	Purchase Obligations (3)	Other	Total
	(Dollars in Table are in Millions)				
Year ending September 30:					
2005	$61.6	$ 3.9	$ 52.2	$ 1.3	$ 119.0
2006		3.4			3.4
2007		2.7	0.5		3.2
2008		1.2			1.2
2009		0.7			0.7
After 2009		0.9			0.9
	$61.6	$ 12.8	$ 52.7	$ 1.3	$ 128.4

(1) Revolving credit agreement expires in July 2008 but all borrowings are classified as current liabilities due to the banks requirement for a lockbox arrangement.

(2) Includes an aggregate of $1.9 million, which has been included in the determination of our liability for lease exit costs that is recorded on our balance sheet at September 26, 2004. Accounting principles generally accepted in the United States of America require that we record a liability for future lease payments, net of estimated sublease rentals, for facilities that we have closed.

(3) Consists of obligations under outstanding purchase orders. Approximately 86% of the deliveries under outstanding purchase orders are expected to be received in the fourth quarter of 2004. We often have the ability to cancel these obligations if we provide sufficient notice to our suppliers.

The table shown above does not include unearned contingent consideration payable in the first quarter of 2005 related to the purchase of Trilogic Systems. Pursuant to the purchase agreement, we may be required to pay up to approximately $1.9 million (of which approximately $0.8 million is included in the table above and has been accrued as a payable on our balance sheet at September 26, 2004) if certain sales targets are achieved for 2004. For the year ended December 31, 2003, the minimum sales target was achieved and we recorded a payable of approximately $2.1 million, which was paid in the first quarter of 2004. The purchase agreement also requires that we estimate the annual amount of qualified 2004 sales based on actual sales for the first nine months of 2004 and calculate the estimated amount of consideration that would be payable for the annual 2004 sales target. Accordingly, we may be required to issue a letter of credit up to $1.9 million in the fourth quarter of 2004 for the estimated amount of the contingent consideration payable related to the 2004 annual sales target. A letter of credit for the 2003 sales target was issued in the fourth quarter of 2003 for approximately $2.0 million and this letter of credit was canceled after we made the $2.1 million payment in the first quarter of 2004.

In October 2004, we entered into a new lease for a manufacturing facility in Tijuana, Mexico. This lease provides for annual rent payments of $0.4 million and expires in September 2009. These lease payments are excluded from the table shown above.

We believe we will be able to fund our contractual operating lease and purchase order obligations from operating cash flows during the periods that payments are required. We believe we will be able to fund the payments required under the Trilogic acquisition agreement through borrowings under our credit agreement with Citibank. As discussed below this credit agreement was amended in July 2004, resulting in a revised maturity date of July 2008.

Capital Resources. Our working capital at September 26, 2004 totaled $17.4 million compared to $49.4 million at December 31, 2003. This decrease in working capital is attributable to the reclassification to current liabilities of outstanding borrowings under our amended credit agreement due to the existence of the lockbox arrangement discussed below. At September 26, 2004, the borrowing base under our $75.0 million revolving credit facility with Citibank would have supported borrowings up to $75.0 million, and we had outstanding borrowings of approximately $61.6 million and an outstanding letter of credit for $0.3 million under this credit facility. Accordingly, as of September 26, 2004, we had unused availability of $13.1 million after deducting outstanding borrowings and the letter of credit.

On October 28, 2004, new banking regulations went into effect that will accelerate the time required for checks to clear, thereby reducing float time for our disbursements and receipts. At September 26, 2004, we had outstanding checks in excess of cash balances of $6.8 million. We estimate that if these new regulations had been in effect at the end of the third quarter, approximately $2.0 million of checks would have cleared and additional borrowings under our amended credit agreement would have been required to fund this amount.

Despite the improved operating results in the first nine months of 2004, we used $27.8 million of operating cash flow, primarily to fund working capital requirements associated with the significantly higher sales volumes during this period. Our negative operating cash flows were funded by additional borrowings under our line of credit with Citibank, resulting in an increase in outstanding bank debt of nearly $27.6 million during the first nine months of 2004. Based on our current estimates, we believe our borrowing availability of $13.1 million is adequate to fund our operations for at least the next twelve months.

On July 7, 2004, we entered into an amended credit agreement with Citibank and Congress Financial Corporation. The maximum borrowings permitted under the amended credit agreement remained unchanged at $75.0 million but the maturity date was extended until July 7, 2008. The amended credit agreement includes a lockbox arrangement that requires the Company to instruct our customers to remit payments to restricted cash accounts, whereby all available funds are immediately used to pay down the outstanding principal balance under the amended credit agreement. Accordingly, even though the maturity date of the amended credit agreement is in July

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2008, the accounting rules require that the entire outstanding principal balance be classified as a current liability in the accompanying balance sheet as of September 26, 2004.

The amended credit agreement includes less stringent covenants for EBITDA and covenants for minimum tangible net worth and capital expenditures were eliminated in the amended agreement. For the remainder of 2004, the interest rates were reduced from previous levels by 1.75% for Base Rate borrowings and 1.00% for LIBOR Rate borrowings. Beginning in 2005, interest rates will be adjusted further depending on the amount of EBITDA for the preceding four fiscal quarters. In addition, the Company is obligated to pay a commitment fee of 0.5% per annum of the unused portion of the credit facility.

If the Company desires greater borrowing capacity to make strategic business acquisitions or to accommodate growth beyond our current forecast, the amended credit agreement permits an increase up to $100.0 million if a third financial institution agrees to join the existing lenders. Furthermore, if the borrowing capacity under the amended credit agreement is not sufficient to fund our activities, we would consider the issuance of subordinated debt or equity instruments to enable us to meet our capital requirements. However, the issuance of subordinated debt instruments would require approval of the lenders under the amended credit agreement. The amended credit agreement also limits or prohibits us from paying dividends, selling significant assets, acquiring other businesses, 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 26, 2004, the Company is in compliance with the covenants under the amended credit agreement.

The continued availability of our credit facility is a critical assumption underlying our belief that adequate capital resources are currently in place to fund our operations for the next 12 months. The borrowing base calculation under the 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.

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 Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) covenant discussed below. If we violate the financial covenants in the future, there can be no assurance that the lenders would waive our noncompliance. In these circumstances, the lenders 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.

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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 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 below the details of the calculations for the quarter and the nine months ended September 26, 2004 using a traditional EBITDA definition, as well as the calculation of EBITDA as defined in our credit agreement. Our credit agreement provides for a modified definition of EBITDA that excludes 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 under a traditional definition differs significantly from the calculation of EBITDA under our credit agreement:

	Period Ended September 26, 2004:	
	Quarter	**Nine Months**
	(Dollars in Millions)	
Net income (loss)	$ 0.1	$ (3.2)
Income tax expense (benefit)		
Interest expense	1.0	3.0
Depreciation and amortization	2.5	9.0
EBITDA per traditional definition	3.6	8.8
Restructuring costs **(A)**	0.3	1.1
Other charges **(B)**	0.1	0.3
EBITDA per credit agreement definition	$ 4.0	$ 10.2

(A) Restructuring costs include lease exit costs, impairment of long-lived assets, severance, retention, and moving costs related to facility closures and other reductions in workforce.

(B) Primarily consists of stock-based compensation expense.

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) must be no less favorable than negative $2.5 million for the year ending December 31, 2004. Beginning in 2005, as of the end of each fiscal quarter, EBITDA must be no less favorable than break-even for the four preceding fiscal quarters. Management believes the Company will be able to comply with the EBITDA covenant over the entire term of the amended credit agreement.

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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 experience significant volatility in our net sales which leads to significant operating inefficiencies and the potential for significant charges.

As a result of the soft demand in the end markets served by our customers, our net sales declined from $197.9 million in the first quarter of 2001 to $78.6 million in the fourth quarter of 2003. As demand in these end markets increased, our net sales increased to $100.7 million in the first quarter of 2004 and $130.4 million in the second quarter of 2004. In the third quarter of 2004, our net sales were $128.5 million, and we expect that net sales will be in the range of $102 million to $110 million for the fourth quarter of 2004.

During periods of rapidly declining net sales, we generally take actions to eliminate variable and fixed costs, which often results in significant restructuring 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 believe 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.

During periods of rapidly increasing net sales, we often experience inefficiencies related to hiring and training workers, as well as incremental costs incurred to expedite the purchase and delivery of raw materials and overtime costs related to our workforce. Periods of rapid growth tend to stress our resources and we may not have sufficient capacity to meet our customers delivery requirements. Significant increases in net sales are typically accompanied by corresponding increases in inventories and receivables that must be financed with borrowings under our amended credit agreement.

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 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.

One of our principal customers 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 experience significant volatility in our net sales which leads to significant operating inefficiencies and the potential for significant charges. 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.

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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. For the year ended December 31, 2003, Honeywell and Applied Materials accounted for 29% and 18%, respectively, of our net sales. For the first nine months of 2004, Honeywell and Applied Materials accounted for 21% and 26%, respectively, of our net sales. 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. Applied Materials recently informed us that it has decided to transition substantially all of its business to alternative contract manufacturers. We expect that this transition will adversely impact our results of operations beginning in the first quarter of 2005.

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, 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 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.

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.

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, such as that experienced in the first nine months of 2004, is likely to place a significant strain on our managerial, operational, financial, and other resources. If this growth continues, 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 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 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 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 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 each in 2003 and 2004, 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

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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.

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 26, 2004, we had outstanding bank debt of approximately $61.6 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.

We may need to raise additional funds for the following purposes:

- 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.

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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 occur, 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.

Since March 2002 when Suntron shares began trading, the average number of shares of our common stock that traded on the NASDAQ exchange has been approximately 10,000 shares per day compared to 27,415,221 issued and outstanding shares as of September 26, 2004. 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 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 five of our eleven 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 that provides for total borrowings up to $75.0 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 $75.0 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 $0.75 million. 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

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we have evaluated the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Exchange Act Rule 13a-15 as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended September 26, 2004, that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Disclosure controls and procedures are designed to ensure that information required to be disclosed in our 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 our 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. Unregistered Sales of Equity Securities and Use of Proceeds

Not Applicable.

Item 3. Defaults Upon Senior Securities

Not Applicable.

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

On September 16, 2004, the Company held its annual meeting of stockholders to vote on the election of four directors, each for a term of three years. The shareholders voted in favor of election of four directors, with the following votes cast:

Name	For	Withhold
Jeffrey W. Goettman	25,026,496	131,955
John C. Walker	25,123,121	35,330
Thomas B. Sabol	25,028,274	130,177
Enrique Zambrano	25,121,556	36,895

Item 5. Other Information

Not Applicable.

Item 6. 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

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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 9, 2004	/s/ James K. Bass
	James K. Bass *Chief Executive Officer*
Date: November 9, 2004	/s/ Peter W. Harper
	Peter W. Harper *Chief Financial Officer*
Date: November 9, 2004	/s/ James A. Doran
	James A. Doran *Chief Accounting Officer*

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Exhibit Index

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