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STEWART & STEVENSON SERVICES INC
Form 10-Q
June 14, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MAY 4, 2002

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER 0-8493

STEWART & STEVENSON SERVICES, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

TEXAS
(State or other jurisdiction of
incorporation or organization)

74-1051605
(I.R.S. Employer
Identification No.)

2707 NORTH LOOP WEST, HOUSTON, TEXAS
(Address of principal executive offices)

77008
(Zip Code)

(713) 868-7700
(Registrant's telephone number, including area code)

not applicable
(Former name, former address and former fiscal year,
if changed since last report)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

COMMON STOCK, WITHOUT PAR VALUE
(Class)

28,447,196 SHARES
(Outstanding at May 31, 2002)

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

The following information required by Rule 10-01 of Regulation S-X is provided herein for Stewart & Stevenson Services, Inc. (the "Company"):

Consolidated Condensed Statements of Financial Position - May 4, 2002 and January 31, 2002.

Consolidated Condensed Statements of Earnings - Fiscal Quarters Ended May 4, 2002 and April 28, 2001.

Consolidated Condensed Statements of Cash Flows - Fiscal Quarters Ended May 4, 2002 and April 28, 2001.

Consolidated Condensed Statements of Comprehensive Income -Fiscal Quarters Ended May 4, 2002 and April 28, 2001.

Notes to Consolidated Condensed Financial Statements.

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STEWART & STEVENSON SERVICES, INC.
 CONSOLIDATED CONDENSED STATEMENTS OF FINANCIAL POSITION
 (IN THOUSANDS, EXCEPT SHARE DATA)

| | MAY 04, 2002 ----- (Unaudited) |
|--|--------------------------------------|
| ASSETS | |
| CURRENT ASSETS | |
| Cash and equivalents | \$ 67,318 |
| Accounts and notes receivable, net | 168,471 |
| Recoverable costs and accrued profits not yet billed | 981 |
| Inventories | 237,149 |
| Excess of current cost over LIFO values | (43,828) |
| Other current assets | 20,330 |
| Total assets of discontinued operations | 43,584 |
| TOTAL CURRENT ASSETS | 494,005 ----- |
| PROPERTY, PLANT AND EQUIPMENT, NET | 124,256 |
| DEFERRED INCOME TAX ASSET | 4,740 |
| INVESTMENTS AND OTHER ASSETS | 12,359 |
| TOTAL ASSETS | \$ 635,360 ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | |
| CURRENT LIABILITIES | |
| Notes payable | \$ 3,066 |

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| | |
|---|------------|
| Accounts payable | 45,645 |
| Accrued payrolls and incentives | 18,593 |
| Current portion of long-term debt | 250 |
| Billings in excess of incurred costs | 44,778 |
| Other current liabilities | 30,395 |
| Total liabilities of discontinued operations | 9,855 |
| | ----- |
| TOTAL CURRENT LIABILITIES | 152,582 |
| COMMITMENTS AND CONTINGENCIES | |
| LONG-TERM DEBT | 56,600 |
| ACCRUED POSTRETIREMENT BENEFITS AND PENSION | 33,185 |
| OTHER LONG-TERM LIABILITIES | 4,133 |
| | ----- |
| TOTAL LIABILITIES | 246,500 |
| | ----- |
| SHAREHOLDERS' EQUITY | |
| Common stock, without par value, 100,000,000 shares authorized; 28,471,281 and 28,444,281 shares issued and outstanding at May 4, 2002 and January 31, 2002, respectively | 54,500 |
| Accumulated other comprehensive loss | (9,090) |
| Retained earnings | 343,450 |
| | ----- |
| TOTAL SHAREHOLDERS' EQUITY | 388,860 |
| | ----- |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 635,360 |
| | ===== |

SEE ACCOMPANYING NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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STEWART & STEVENSON SERVICES, INC.
CONSOLIDATED CONDENSED STATEMENTS OF EARNINGS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

| | THREE MONTH |
|-------------------------------------|--------------|
| | MAY 04, 2002 |
| | ----- |
| | (Unaudi |
| Sales | \$ 299,670 |
| Cost of sales | 255,918 |
| | ----- |
| Gross profit | 43,752 |
| Recovery of costs incurred, net | -- |
| Selling and administrative expenses | 35,424 |
| Interest expense | 1,132 |
| Interest and investment income | (338) |
| Other income, net | (21) |
| | ----- |
| | 36,197 |

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| | |
|---|----------|
| Earnings from continuing operations before income taxes | 7,555 |
| Income tax expense | 2,659 |
| | ----- |
| Net earnings from continuing operations before cumulative effect of change in accounting | 4,896 |
| Loss from discontinued operations, net of taxes of \$(599) and \$(398) | (1,097) |
| Cumulative effect of change in accounting, net of taxes of \$(1,798) | (3,682) |
| | ----- |
| Net earnings | \$ 117 |
| | ===== |
| Weighted average shares outstanding: | |
| Basic | 28,454 |
| Diluted | 28,767 |
| Earnings per share: | |
| Basic | |
| Continuing operations before cumulative effect | \$ 0.17 |
| Loss from discontinued operations, net | (0.04) |
| Cumulative effect of change in accounting, net | (0.13) |
| | ----- |
| NET EARNINGS PER SHARE | \$ 0.00 |
| | ===== |
| Diluted | |
| Continuing operations before cumulative effect | 0.17 |
| Loss from discontinued operations, net | (0.04) |
| Cumulative effect of change in accounting, net | (0.13) |
| | ----- |
| NET EARNINGS PER SHARE | \$ 0.00 |
| | ===== |
| Cash dividends per share | \$ 0.085 |

SEE ACCOMPANYING NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

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STEWART & STEVENSON SERVICES, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

OPERATING ACTIVITIES

Net earnings from continuing operations

THR

MAY 04, 2

\$ 1,21

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| | |
|--|----------|
| Adjustments to reconcile net earnings from continuing operations to net cash provided by (used in) operating activities: | |
| Depreciation and amortization | 4,85 |
| Change in operating assets and liabilities net of the effect of discontinued operations: | |
| Accounts and notes receivable, net | (2,34) |
| Recoverable costs and accrued profits not yet billed | (98) |
| Inventories, net | (5,15) |
| Other current and noncurrent assets | 15,54 |
| Accounts payable | (25,62) |
| Accrued payrolls and incentives | (80) |
| Billings in excess of incurred costs | 4,90 |
| Other current liabilities | 7,42 |
| Accrued postretirement benefits & pension | 90 |
| Other long-term liabilities | (19) |
| NET CASH USED IN CONTINUING OPERATIONS | (26) |
| NET CASH PROVIDED BY (USED IN) DISCONTINUED OPERATIONS | (2,21) |
| NET CASH USED IN OPERATING ACTIVITIES | (2,47) |
| | |
| INVESTING ACTIVITIES | |
| Expenditures for property, plant and equipment | (9,99) |
| Proceeds from sale of business assets | - |
| Disposal of property, plant and equipment, net | 54 |
| NET CASH USED IN INVESTING ACTIVITIES | (9,45) |
| | |
| FINANCING ACTIVITIES | |
| Payments on long-term borrowings | - |
| Change in short-term notes payable | (4) |
| Dividends paid | (2,46) |
| Exercise of stock options | 32 |
| NET CASH USED IN FINANCING ACTIVITIES | (2,19) |
| | |
| Decrease in cash and equivalents | (14,12) |
| Cash and equivalents, beginning of period | 81,43 |
| Cash and equivalents, end of period | \$ 67,31 |
| | |
| Cash Paid For: | |
| Interest | \$ 35 |
| Taxes (excluding refunds) | 47 |

SEE ACCOMPANYING NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

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| | THREE MONTHS ENDED | |
|--|--------------------|----------------|
| | (Unaudited) | |
| | MAY 04, 2002 | APRIL 28, 2001 |
| | ----- | ----- |
| Net earnings | \$ 117 | \$ 20,333 |
| Unrealized loss on forward contracts, net of tax | (113) | -- |
| Currency translation loss | (233) | (64) |
| | ----- | ----- |
| Comprehensive income (loss) | \$ (229) | \$ 20,269 |
| | ===== | ===== |

SEE ACCOMPANYING NOTES TO THE CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

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STEWART & STEVENSON SERVICES, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

NOTE A - BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

The accompanying consolidated condensed financial statements have been prepared in accordance with Rule 10-01 of Regulation S-X for interim financial statements required to be filed with the Securities and Exchange Commission and do not include all information and footnotes required by generally accepted accounting principles for complete financial statements. However, the information furnished herein reflects all normal recurring adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim periods. The results of operations for the three months ended May 4, 2002 are not necessarily indicative of the results that will be realized for the fiscal year ending January 31, 2003.

The Company's fiscal year begins on February 1 of the year stated and ends on January 31 of the following year. For example, the Company's fiscal year 2002 (hereinafter referred to as "Fiscal 2002") commenced on February 1, 2002 and ends on January 31, 2003. In addition, other years are referred to in the same manner. The Company reports results on the fiscal quarter method with each quarter comprising approximately 13 weeks. The first quarter of Fiscal 2002 began on February 1, 2002 and ended on May 4, 2002.

The accounting policies followed by the Company in preparing interim consolidated financial statements are similar to those described in the "Notes to Consolidated Financial Statements" in the Company's January 31, 2002 Form 10-K. An actual valuation of inventory under the last-in-first-out ("LIFO") method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management's estimates of expected year-end inventory levels and costs. Interim results are subject to the final year-end LIFO inventory valuation.

The accompanying consolidated condensed financial statements for Fiscal 2001 and related notes contain certain reclassifications to conform with the presentation used in Fiscal 2002.

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NOTE B - SEGMENT INFORMATION

Financial information relating to industry segments with a reconciliation to earnings from continuing operations before income taxes is as follows (IN THOUSANDS EXCEPT PERCENTAGES):

STEWART & STEVENSON SERVICES, INC.
SEGMENT INFORMATION
(In thousands)

| | THREE MONTHS ENDED | |
|--|--------------------|----------------|
| | MAY 04, 2002 | APRIL 28, 2001 |
| | ----- | |
| | (Unaudited) | |
| | ----- | |
| SALES | | |
| Power Products | \$ 149,961 | \$ 136,623 |
| Distributed Energy Solutions | 11,783 | 31,049 |
| Tactical Vehicle Systems | 115,461 | 108,494 |
| Petroleum Equipment | 6,518 | 21,034 |
| Airline Products | 14,301 | 24,109 |
| Other Business Activities | 1,646 | 6,508 |
| | ----- | ----- |
| Total | \$ 299,670 | \$ 327,817 |
| | ===== | ===== |
| OPERATING PROFIT (LOSS) | | |
| Power Products | \$ 3,655 | \$ 1,632 |
| Distributed Energy Solutions | (2,201) | 52 |
| Tactical Vehicle Systems | 14,916 | 38,259 |
| Petroleum Equipment | (507) | 1,547 |
| Airline Products | (3,124) | (4,368) |
| Other Business Activities | (432) | 223 |
| | ----- | ----- |
| Total | 12,307 | 37,345 |
| | ----- | ----- |
| NON-OPERATING INCOME (EXPENSE) | | |
| Corporate expenses, net | (3,958) | (3,206) |
| Interest income | 338 | 1,214 |
| Interest expense | (1,132) | (1,860) |
| | ----- | ----- |
| Earnings from continuing operations before income taxes | \$ 7,555 | \$ 33,493 |
| | ===== | ===== |
| OPERATING PROFIT (LOSS) PERCENTAGE | | |
| Power Products | 2.4 % | 1.2 % |
| Distributed Energy Solutions | (18.7) | 0.2 |
| Tactical Vehicle Systems | 12.9 | 35.3 |
| Petroleum Equipment | (7.8) | 7.4 |
| Airline Products | (21.8) | (18.1) |
| Other Business Activities | (26.2) | 3.4 |
| | 4.1 | 11.4 |

NOTE C - ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations entered into after June 30, 2001 and SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. SFAS No. 142 requires that the balance sheet valuation of goodwill and other intangible assets be evaluated for impairment at least annually. Further, it requires that amortization of goodwill cease beginning with the Company's Fiscal 2002. Transition charges recognized upon implementation of SFAS No. 142 have been accounted for as a cumulative effect of a change in accounting principle. In the first quarter of Fiscal 2002, the company recognized a pre-tax impairment charge associated primarily with the Airline Products segment of \$5.5 million to goodwill (\$3.7 million after tax) and ceased amortization on the \$7.5 million of remaining unamortized goodwill. The Company's goodwill amortization for Fiscal 2001 was \$0.7 million.

The Company has adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets to Be Disposed Of," and the accounting and reporting provisions relating to the disposal of a segment of a business of Accounting Principles Board Opinion No. 30. The Company adopted SFAS No. 144 in the fourth quarter of Fiscal 2001 which resulted in the reclassification of certain operations as discontinued. Other than such reclassification, there was no material impact to the Company resulting from adoption.

NOTE D - COMMITMENTS AND CONTINGENCIES

As a custom packager of power systems, the Company issues bid and performance guarantees in the form of performance bonds or standby letters of credit. Performance type letters of credit totaled approximately \$3.2 million as of May 4, 2002.

The Company's government contract operations are subject to U.S. Government investigations of business practices and cost classifications from which legal or administrative proceedings can result. Based on government procurement regulations, under certain circumstances a contractor can be fined, as well as suspended or debarred from government contracting. In that event, the Company would also be unable to sell equipment or services to customers that depend on loans or financial commitments from the Export Import Bank, Overseas Private Investment Corporation, and similar government agencies during a suspension or debarment.

During Fiscal 1998, the U.S. Customs Service detained a medium tactical vehicle that was being shipped by the Company for display in a European trade show. The Company has been advised that the U.S. Customs Service and the Department of Justice are investigating potential violations by the Company of laws relating to the export of controlled military vehicles, weapons mounting systems, and firearms. Such investigation could result in the filing of criminal, civil, or administrative sanctions against the Company and/or individual employees and could result in a suspension or debarment of the Company from receiving new contracts or subcontracts with agencies of the U.S. Government or the benefit of federal assistance payments. It is presently impossible to determine the actual costs that may be incurred to resolve this matter or whether the resolution will

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have a material adverse effect on the Company's results of operations.

The Company is a defendant in a suit brought under the QUI TAM provision of the False Claims Act, United States of America, ex rel. Werner Stebner v. Stewart & Stevenson Services, Inc. and McLaughlin Body Co., Civil Action No. H-96-3363, in the United States District Court for the Southern District of Texas, Houston Division. The suit seeks penalties and damages in an unspecified amount. The suit alleges that the Company made false statements and certifications in connection with claims for payment for Family of Medium Tactical Vehicles delivered to the U.S. Army starting in 1995, and the suit alleges that the vehicles were substandard because of corrosion problems. The suit was filed under seal in 1996, and following an investigation by the Justice Department, the United States declined to intervene in the suit, which was unsealed on August 29, 2000. The case is set for trial December 1, 2003. The Company believes the claims in the suit are without merit and is vigorously defending the suit. It is presently impossible to determine the actual costs that may be incurred to resolve this matter or whether the resolution will have a material adverse effect on the Company's results of operations.

The Company is also a defendant in a number of lawsuits relating to contractual, product liability, personal injury, and warranty matters normally incident to the Company's business. No individual case, or group of cases presenting substantially similar issues of law or fact, are expected to have a material effect on the manner in which the Company conducts its business. Although the Company maintains certain insurance policies and has established reserves that it believes to be adequate in each case, an unforeseen outcome in such cases should not have a material adverse impact on the results of operations in the period it occurs.

The Company has provided certain guarantees in support of its customers' financing of purchases from the Company in the form of debt guarantees. The amount of such guarantees is approximately \$4.6 million as of May 4, 2002.

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The Company leases certain property and equipment under operating lease arrangements of varying terms whose annual rentals are less than 1% of consolidated sales.

NOTE E - GOVERNMENT CONTRACTING

The U.S. government is one of the Company's key customers. As such, decreased government spending or termination of significant government programs could adversely affect its business. The Company's Tactical Vehicle Systems segment depends largely on U.S. government expenditures. In recent years, government contracts in such segment have accounted for substantial percentages of its annual revenues and operating income. The Company is currently in production year four of its second multi-year contract with the U.S. Department of the Army ("U.S. Army") for production of the Family of Medium Tactical Vehicles ("FMTV"). The U.S. Army exercised an option to award a fifth program year to the current contract, which begins in October 2002 and is expected to be completed by September 2003. The U.S. Army holds an additional option to award a sixth program year that, if exercised by the U.S. Army, could extend production of the FMTV through September 2004. The funding of the FMTV contract is subject to the inherent uncertainties of Congressional appropriations. As is typical of multi-year defense contracts that may be canceled or adjusted by the government, the FMTV contract must be funded annually by the U.S. Department of the Army and may be terminated at any time for the convenience of the government. As of May

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4, 2002, funding in the amount of approximately \$1.5 billion for the new FMTV contract had been authorized and appropriated by the U.S. Congress, \$539 million of which is allocated to future production under the existing contract. If the FMTV contract is terminated, other than for the Company's default (in which event there could be serious adverse consequences and claims against the Company), it provides for termination charges that will reimburse the Company for certain allowable costs but not necessarily for all costs.

As the Company's current contract with the U.S. Army for production of the FMTV is nearing completion, it will be necessary for the Company to secure additional contracts to have continued success in this segment. The Company has been awarded a contract for the first phase of the competitive bid process for the next multi-year contract for production of the FMTV and is currently competing for the final award. The U.S. Army is scheduled to make its decision as to the final award of the next multiyear contract during the first quarter of Fiscal 2003. The U.S. Army will determine the award by a competitive bid process, and there can be no assurance that the Company will be successful in such regard or that its competitor will not be more successful than it will be in this or coming bids and awards for tactical vehicles. Even if the Company does receive the award, there can be no assurance that operating margins will be at the same level as the existing FMTV contract.

Major contracts for military systems are performed over extended periods of time and are subject to changes in scope of work and delivery schedules. Pricing negotiations on changes and settlement of claims often extend over prolonged periods of time. The Company's ultimate profitability on such contracts will depend on the eventual outcome of an equitable settlement of contractual issues with the U.S. Government. Due to uncertainties inherent in the estimation and claim negotiation process, no assurances can be given that management's estimates will be accurate, and variances between such estimates and actual results could be material. Continued success in this segment is dependent on securing additional contracts after completion of the current contract for production of the FMTV at acceptable operating margins.

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NOTE F - DISCONTINUED OPERATIONS

During the fourth quarter of Fiscal 2001, the company announced its intention to sell the Petroleum Equipment segment's blowout preventer and controls, valve, and drilling riser businesses. Results of operations have been restated herein to classify net earnings, assets, and liabilities of these businesses as discontinued operations. The net loss from discontinued operations for the first quarter of Fiscal 2002 was \$1.1 million. Included in the loss was a \$0.7 million net loss from the discontinued Petroleum Equipment segment and \$0.4 million net loss from a provision for a financial guarantee related to the discontinued gas turbine business. The \$0.7 million net loss from discontinued operations in the first quarter of Fiscal 2001 included a net loss of \$0.1 million from the discontinued Petroleum Equipment segment and a net loss of \$0.6 million for a reserve of certain taxes associated with previously disposed gas turbine operations. Discontinued Petroleum Equipment segment sales for the first quarter were \$9.2 million and \$13.7 million for Fiscal 2002 and 2001, respectively. The corporate allocations previously allocated to the discontinued Petroleum Equipment segment are now absorbed by the remaining continuing operations, resulting in restatement of operating profit by segment versus that which was originally reported in 2001.

The Company is currently unable to reliably predict the timing of any final sale of the discontinued operations formerly associated with its Petroleum Equipment

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segment.

Significant categories of assets and liabilities from discontinued operations are included in the table below:

| (IN THOUSANDS) | MAY 4, 2002 | JANUARY 31, 2002 |
|------------------------------------|-------------|------------------|
| | (Unaudited) | |
| Receivables, net | \$ 8,473 | \$ 11,123 |
| Inventory, net | 21,458 | 18,040 |
| Property, plant and equipment, net | 11,618 | 12,019 |
| Other assets | 2,035 | (489) |
| | ----- | ----- |
| Total assets | 43,584 | 40,693 |
| | ----- | ----- |
| Accounts payable | 7,571 | 5,097 |
| Other liabilities | 2,284 | 2,981 |
| | ----- | ----- |
| Total liabilities | 9,855 | 8,078 |
| | ----- | ----- |
| Net assets | \$ 33,729 | \$ 32,615 |
| | ===== | ===== |

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NOTE G - RECONCILIATION OF BASIC TO DILUTED SHARES OUTSTANDING

In accordance with SFAS No. 128, "Earnings Per Share," the following table is a reconciliation of the numerators and denominators used in the calculation of basic and diluted earnings per share as presented on the Consolidated Condensed Statements of Earnings.

| (IN THOUSANDS, EXCEPT FOR PER SHARE DATA) | THREE MONTHS E |
|---|----------------|
| | MAY 4, 2002 |
| | ----- |
| Numerator: | |
| Net earnings available to common shareholders | |
| From continuing operations before cumulative effect | \$ 4,896 |
| From discontinued operations | (1,097) |

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| | |
|--|---------|
| From cumulative effect of change in accounting | (3,682) |
| | ----- |
| Net earnings | \$ 117 |
| | ===== |
| Denominator: | |
| Denominator for basic earnings per share - Weighted-average shares outstanding | 28,454 |
| Effect of dilutive securities: | |
| Employee and director stock options | 313 |
| | ----- |
| Denominator for diluted earnings per share - Adjusted weighted-average shares outstanding | 28,767 |
| | ===== |
| Basic earnings (loss) per share | |
| From continuing operations before cumulative effect | \$ 0.17 |
| From discontinued operations | (0.04) |
| From cumulative effect of change in accounting | (0.13) |
| | ----- |
| Net earnings | \$ 0.00 |
| | ===== |
| Diluted earnings (loss) per share | |
| From continuing operations before cumulative effect | \$ 0.17 |
| From discontinued operations | (0.04) |
| From cumulative effect of change in accounting | (0.13) |
| | ----- |
| Net earnings | \$ 0.00 |
| | ===== |
| Number of anti-dilutive stock options outstanding | 1,375 |

NOTE H - RECOVERY OF COSTS INCURRED

In Fiscal 1998, the company filed a claim with the U.S. Government seeking recovery of costs incurred resulting from delays from the original production plan in the first multi-year FMTV contract. The U.S. Army and the Company participated in a voluntary dispute resolution process resulting in a \$22.0 million settlement. The settlement was netted against \$1.2 million in related expenses and is included in the Fiscal 2001 first quarter results. The net amount of \$20.8 million is presented on the Company's Consolidated Condensed Statements of Earnings in the caption entitled, "Recovery of costs incurred, net."

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion should be read in conjunction with the attached condensed consolidated financial statements and notes thereto, and with the Company's Form 10-K and notes thereto for the fiscal year ended January 31, 2002. The following discussion contains forward-looking statements, which are based on assumptions such as timing, volume, and pricing of customers' orders. In connection

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therewith, please see the cautionary statements contained therein and the heading labeled "Factors That May Affect Future Results" below, which identify important factors that could cause actual results to differ materially from those in the forward-looking statements.

The Company's fiscal year begins on February 1 of the year stated and ends on January 31 of the following year. For example, the Company's fiscal year 2002 (hereinafter referred to as "Fiscal 2002") commenced on February 1, 2002 and ends on January 31, 2003. In addition, other years are referred to in the same manner. The Company reports results on the fiscal quarter method with each quarter comprising approximately 13 weeks. The first quarter of Fiscal 2002 commenced on February 1, 2002 and ended on May 4, 2002.

RESULTS OF OPERATIONS

Sales for the first quarter of Fiscal 2002 were \$299.7 million compared to sales of \$327.8 million in the same period a year ago. This decrease was a result of lower volume in the Company's Distributed Energy Solutions, Airline Products, and Petroleum Equipment segments, further discussed below in "Segment Data." The Company's gross profit percentage improved slightly to 14.6% in the current quarter from 14.2% in the first quarter of Fiscal 2001, partially as a result of actions taken in the Airline Products segment during 2001 to reduce its cost structure.

Recovery of costs incurred, net represents a recovery pursuant to a certified claim with the U.S. Government for costs incurred by the Company resulting from production delays in the first multi-year Family of Medium Tactical Vehicles ("FMTV") contract in the Tactical Vehicle Systems segment. A settlement of \$22.0 million was reached during the first quarter of Fiscal 2001, which was reduced by \$1.2 million in related expenses for legal and professional services.

Selling and administrative expenses for the first quarter of Fiscal 2002 were \$35.4 million, or 11.8% of sales, versus \$33.4 million, or 10.2% of sales in the comparable quarter of Fiscal 2001. The increase of \$2.0 million was principally due to higher general office spending and higher costs associated with the Company's management information systems that have been implemented.

Interest expense is \$0.7 million lower in the first quarter of the current year versus the first quarter of the prior year, as \$20.0 million of long-term debt was paid off in the second quarter of Fiscal 2001. Interest income was also reduced by \$0.9 million as lower effective interest rates were earned on lower average cash balances.

Net earnings in the first quarter of Fiscal 2002 were \$0.1 million or \$0.00 per diluted share, compared to \$20.3 million, or \$0.71 per diluted share, in the prior year first quarter. This decrease in net income was principally a result of the settlement with the U. S. Government recognized in the prior year, as discussed above.

DISCONTINUED OPERATIONS

During the fourth quarter of Fiscal 2001, the Company announced its intention to sell the Petroleum Equipment segment's blowout preventer and controls, valve, and drilling riser business, and as a result, these activities were reclassified for reporting purposes for all periods shown as discontinued operations. Net losses from these activities for the first quarter of Fiscal 2002 and the first quarter of Fiscal 2001 were \$0.7 million and \$0.1 million, respectively. Also included in discontinued operations in the current quarter was a provision for a financial guarantee related to the discontinued gas turbine business. In addition, \$0.6 million of expense was included in discontinued operations in the first quarter of Fiscal 2001 related to a reserve for taxes associated with previously discontinued gas turbine operations.

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Discontinued Petroleum Equipment segment sales for the first quarter were \$9.2 million and \$13.7 million for Fiscal 2002 and 2001, respectively. The corporate allocations previously allocated to the discontinued Petroleum Equipment segment are now absorbed by the remaining continuing operations, resulting in a restatement of operating profit by segment versus that which was originally reported in 2001.

In total, discontinued operations accounted for a loss of \$1.1 million, or \$0.04 per diluted share, in the first quarter of Fiscal 2002 and

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\$0.7 million, or \$0.02 per diluted share, in the first quarter of Fiscal 2001.

The Company is currently unable to reliably predict the timing of any final sale of the discontinued operations formerly associated with its Petroleum Equipment segment. However, there is the potential for making a final decision on the sale of these businesses sometime during the second or early third quarter.

CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING

Effective February 1, 2002, the Company adopted two statements promulgated by the Financial Accounting Standards Board, Statement of Financial Accounting Standard ("SFAS") No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for business combinations and SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. SFAS No. 142 requires that the balance sheet valuation of goodwill and other intangible assets be evaluated for impairment at least annually. Further, it requires that amortization of goodwill cease. Any transition charges recognized upon implementation of SFAS No. 142 have been accounted for as a cumulative effect of a change in accounting principle and recorded net of tax. In the first quarter of Fiscal 2002, the company recognized a pre-tax impairment charge of \$5.5 million to goodwill primarily related to the Airline Products segment (\$3.7 million after tax) and ceased amortization on the \$7.5 million of remaining unamortized goodwill. The Company's goodwill amortization for Fiscal 2001 was \$0.9 million.

SEGMENT DATA

The Company's management analyzes financial results in six business segments based on distinct product and customer types: Power Products, Distributed Energy Solutions, Tactical Vehicle Systems, Petroleum Equipment, Airline Products, and Other Business Activities. Such segments are described below along with analyses of their respective results of operations.

The Power Products segment, which markets and services a wide range of industrial equipment, recorded sales in the first quarter of Fiscal 2002 of \$150.0 million, compared to \$136.6 million in the first quarter of Fiscal 2001. The increase in revenue resulted from a higher level of service and parts sales related to aftermarket activities. Within the service component of the business, there was an increased level of warranty work for the Company's supply partners which are typically at lower margin rates and a higher component of compensation expense, both of which put downward pressure on the service margins achieved for the quarter. Despite this, an improvement in the mix of other products sold led to an operating profit of \$3.7 million in the current quarter versus \$1.6 million in the prior year first quarter.

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While the Company continues its focus on cost and asset management in this segment and anticipates improved margin performance, it is not currently experiencing order patterns which indicate a near-term increase in sales volume.

The Distributed Energy Solutions segment was established in the fourth quarter of Fiscal 2001 and represents activities associated with the reciprocating power generation equipment business. Sales for this segment were \$11.8 million in the current year first quarter versus \$31.0 million in the same period of the prior year. The decrease of \$19.2 million is principally related to sales of large turnkey power generation contracts that were completed in Fiscal 2001 and not replaced in the first quarter of Fiscal 2002. This reduction in volume led to an operating loss in the current quarter of \$2.2 million compared to breakeven in the first quarter of Fiscal 2001. The orders filled by the Distributed Energy Solutions segment tend to be large in volume and sporadic as to timing, which causes large swings in the sales level for this segment. The order backlog for this segment has increased \$12.0 million during the quarter to \$52.3 million. The Company believes that the growth in backlog is an indicator that this segment will realize a higher level of sales in the second quarter of Fiscal 2002 than in the first quarter.

The Tactical Vehicle Systems segment, which manufactures tactical vehicles for the U.S. Army and others, recorded sales of \$115.5 million in the first quarter of Fiscal 2002 compared to \$108.5 million in the same period a year ago. Operating profit for the quarter totaled \$14.9 million, compared with \$17.5 million in the first quarter of Fiscal 2001, excluding the one-time benefit in Fiscal 2001 of a \$20.8 million claim settlement with the U. S. Government. After removing the impact of this prior-year item, operating margins for the current quarter were somewhat lower than the prior year due to lower equipment margins resulting from increased costs associated with the Company's efforts to win a third multi-year contract of the FMTV and other projects and a change in the mix of products sold. The Company expects the mix of products sold will remain relatively constant in the second quarter. During the second quarter of Fiscal 2002, the Company expects sales in this segment to be slightly lower while continued expenditures on activities associated with the effort to win a third multi-year contract of the FMTV and other contracts will exert downward pressure on margins.

The U.S. Army exercised an option to award a fifth program year to the current contract, which added \$374 million to the backlog for this segment in the fourth quarter of Fiscal 2001. Deliveries under this award should begin in October 2002 and are expected to be completed by September 2003.

As the current contract with the U.S. Army for production of the FMTV is nearing completion, the Company continues its preparation for the next multi-year contract award. The Company has been awarded a contract under the first phase of the competitive bid process and is currently competing for the final award. The Company cannot reliably predict when the U.S. Army will make its decision as to the final award for the new production contract or whether the Company will receive the award, but the decision is scheduled to be made during the Company's first quarter of Fiscal 2003 and the Company believes its proposal will be competitive. Even if the Company receives the award, there can be no assurance that operating margins will be at the same level as the existing FMTV contract. Continued success in this segment is dependent on securing additional contracts after completion of the current contract for production of the FMTV at acceptable operating margins.

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Production by the successful bidder for the new multi-year contract is anticipated to begin in October of FY2004. If this expectation proves to be correct and if the U.S. Army chooses not to incur a production break for the FMTV, there may be an opportunity for an additional one-year extension to the Company's current multi-year contract for the FMTV. This extension would provide for continued deliveries of the FMTV through September 2004.

The Petroleum Equipment segment manufactures equipment for the oil and gas exploration, production, and well stimulation industries. Sales in this segment were \$6.5 million for the first quarter of Fiscal 2002 versus the \$21.0 million reported for the same period last year. The decrease in sales for this segment was primarily attributable to the generally lower business levels in the oil and gas markets and the completion of several large equipment orders for well stimulation equipment in the prior year. This lower volume was the primary contributor to the operating loss for the first quarter of this year which was \$0.5 million compared to an operating profit of \$1.5 million in the same period of the prior year. During the quarter, the backlog for this segment increased to \$20.2 million versus \$17.8 million at the end of Fiscal 2001. Sales for the second quarter of Fiscal 2002 are expected to be somewhat higher than the first quarter, but still lower than the prior year.

The Airline Products segment, which manufactures airline ground support products, mobile railcar movers, and snow blowers, recorded sales of \$14.3 million in the first quarter of Fiscal 2002, compared with \$24.1 million in the same quarter last year. The airline industry has been adversely impacted by the events of September 11, and this segment is currently operating at below breakeven levels. Operating losses for the first quarter of Fiscal 2002 and Fiscal 2001 were \$3.1 million and \$4.4 million, respectively. Actions taken in prior quarters to reduce the breakeven level for this segment are being realized as costs were in line with expectations and the Company believes it is positioned to take advantage of any market recovery. The Company anticipates an improvement in the financial results of this segment during the remainder of Fiscal 2002. Sales for the second quarter of Fiscal 2002 are expected to be slightly higher than those recognized in the first quarter.

Other business activities not identified in a specific segment include predominantly the sales of gas compression equipment and wheelchair lifts. Sales in the first quarter of Fiscal 2002 were \$1.6 million, versus \$6.5 million for the comparable period last year. First quarter operating loss was \$0.4 million compared to a \$0.2 million operating profit in last year's first quarter.

UNFILLED ORDERS

The Company's unfilled orders consist of written purchase orders, letters of intent, and oral commitments. These unfilled orders are generally subject to cancellation or modification due to customer relationships or other conditions. Purchase options are not included in unfilled orders until exercised. Unfilled orders as of May 4, 2002 and January 31, 2002 were as follows:

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| | ----- May 4, 2002 | January 31, 2002 ----- |
|----------------|-------------------------|------------------------------|
| | (In millions) | |
| Power Products | \$ 49.1 | \$ 51.4 |

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| | | |
|------------------------------|----------|----------|
| Distributed Energy Solutions | 52.3 | 40.3 |
| Tactical Vehicle Systems | 582.7 | 686.0 |
| Petroleum Equipment | | |
| - Continuing | 20.2 | 17.8 |
| - Discontinued | 11.2 | 14.0 |
| Airline Products | 7.6 | 6.9 |
| All Other | 6.8 | 4.3 |
| | ----- | ----- |
| | \$ 729.9 | \$ 820.7 |
| | ===== | ===== |

Total unfilled orders decreased \$90.8 million during the quarter. The Tactical Vehicle Systems segment ("TVS") backlog includes the fifth option year exercised by the U.S. Government, but continued to decline as the Company completed work on the second multi-year contract for the FMTV. Backlog for the portion of the Company's business excluding TVS increased modestly by \$12.5 million, principally as a result of a \$12.0 million increase in the backlog in the Distributed Energy Solutions segment.

Over the coming months, the Company expects the backlog in its Tactical Vehicle Systems segment to continue to decrease as existing contractual orders are filled.

LIQUIDITY AND CAPITAL RESOURCES

The balance in cash and cash equivalents at the end of the quarter was \$67.3 million, \$14.1 million less than at the end of Fiscal 2001. During the first quarter of Fiscal 2002, cash of \$2.5 million was consumed by operations, \$2.2 million of which was used by discontinued operations. The use of cash resulted primarily from a lower balance of accounts payable as a result of the timing of payments to vendors at the end of Fiscal 2001 and the timing of purchases of certain inventory prior to the end of Fiscal 2001. Partially offsetting this impact was a receipt of a tax refund from the U. S. Government during the first quarter. Investing activities consumed \$9.5 million during the first quarter, principally for expenditures related to the continued construction on a fabrication facility at its Tactical Vehicle Systems segment and certain investments in long-term rental equipment. Financing activities used \$2.2 million, principally for the payment of dividends.

The Company's sources of cash liquidity include cash and equivalents, cash from operations, amounts available under credit facilities, and other external sources of funds. The Company believes that these sources are sufficient to fund the current requirements of working capital, capital expenditures, dividends, and other financial commitments. At May 4, 2002 the Company had no borrowings outstanding under an unsecured revolving debt facility that could provide up to approximately \$144 million, net of \$6 million outstanding under a \$25 million letter of credit sub facility. This revolving facility matures during Fiscal 2004. In addition, the Company has \$55 million in senior notes outstanding.

The Company's unsecured long-term notes, which include the revolving credit notes and senior notes, were issued pursuant to agreements containing covenants that restrict indebtedness, guarantees, rentals, and other items. Additional covenants in the revolving credit notes require the Company to maintain a minimum tangible net worth and interest coverage. The Company is not in violation of any such covenants. Since these requirements are calculated from earnings and cash flow, dividends could be restricted indirectly. Dividends at the current level are not restricted as of the date of this report.

The Company has additional banking relationships, which provide uncommitted borrowing arrangements. In the event that any acquisition of additional

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operations, growth in existing operations, settlements of lawsuits or disputes, changes in inventory levels, accounts receivable, tax payments, or other working capital items create a permanent need for working capital or capital expenditures in excess of the existing cash and equivalents and committed lines of credit, the Company may seek to borrow under other long-term financing instruments or seek additional equity capital.

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FACTORS THAT MAY AFFECT FUTURE RESULTS

FORWARD-LOOKING STATEMENTS

This filing contains forward-looking statements that are based on management's current expectations, estimates, and projections. These statements are not guarantees of future performance and involve a number of risks, uncertainties, and assumptions and are made pursuant to the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. Many factors, including those discussed more fully elsewhere in this release and in the Company's filings with the Securities and Exchange Commission, particularly its latest annual report on Form 10-K, as well as others, could cause results to differ materially from those stated. Specific important factors that could cause actual results, performance, or achievements to differ materially from such forward-looking statements include risk of competition, risks relating to technology, risks of general economic conditions, risks of oil and gas industry economic conditions, risks of airline industry economic conditions, risks as to terrorist attacks on the U.S. and their impact on the U.S. economy, risks relating to personnel, risks of dependence on government, inherent risks of government contracts, risks of claims and litigation, risks of product defects, risks as to foreign sales and global trade matters, risks as to cost controls, risks as to information technology, risks as to acquisitions, risks as to currency fluctuations, risks as to environmental and safety matters, risks as to distributorships, and credit risks, all as more specifically outlined in the Company's latest annual report on Form 10-K. In addition, such forward-looking statements could be affected by general industry and market conditions and growth rates, general domestic and international conditions including interest rates, inflation and currency exchange rates and other future factors. Actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

During 1998, the U.S. Customs Service detained a medium tactical vehicle that was being shipped by the Company for display in a European trade show. The Company has been advised that the U.S. Customs Service and the Department of Justice are investigating potential violations by the Company of laws relating to the export of controlled military vehicles, weapons mounting systems, and firearms. Such investigation could result in the filing of criminal, civil, or administrative sanctions against the Company and/or individual employees and could result in a suspension or debarment of the Company from receiving new contracts or subcontracts with agencies of the U.S. Government or the benefit of

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federal assistance payments.

The Company is a defendant in a suit brought under the QUI TAM provision of the False Claims Act, United States of America, ex rel. Werner Stebner v. Stewart & Stevenson Services, Inc. and McLaughlin Body Co., Civil Action No. H-96-3363, in the United States District Court for the Southern District of Texas, Houston Division. The suit seeks penalties and damages in an unspecified amount. The suit alleges that the Company made false statements and certifications in connection with claims for payment for Family of Medium Tactical Vehicles delivered to the U.S. Army starting in 1995, and the suit alleges that the vehicles were substandard because of corrosion problems. The suit was filed under seal in 1996, and following an investigation by the Justice Department, the United States declined to intervene in the suit, which was unsealed on August 29, 2000. The case is set for trial December 1, 2003. The Company believes the claims in the suit are without merit and is vigorously defending the suit.

The Company is also a defendant in a number of lawsuits relating to contractual, product liability, personal injury, and warranty matters normally incident to the Company's business. No individual case, or group of cases presenting substantially similar issues of law or fact, involve a claim for damages which are material to the Company's financial statements or are expected to have a material effect on the manner in which the Company conducts its business. Although management has established reserves that it believes to be adequate in each case, an unforeseen outcome in such cases could have a material adverse impact on the results of operations in the period it occurs.

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ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

Form 8-K Report Date - February 20, 2002 (Preliminary Fourth Quarter And Year End Results)
Items Reported - Item 5. Other Events
Item 7. Exhibits

Form 8-K Report Date - March 22, 2002 (Fiscal Fourth Quarter Earnings Release And Conference Call)
Items Reported - Item 5. Other Events
Item 7. Exhibits

Form 8-K Report Date - March 27, 2002 (Fiscal Year End And Fourth Quarter Results)
Items Reported - Item 5. Other Events
Item 7. Exhibits

Form 8-K Report Date - March 29, 2002 (Segment Information)
Items Reported - Item 5. Other Events
Item 7. Exhibits

Form 8-K Report Date - April 10, 2002 (Presentation To Investors)
Items Reported - Item 7. Exhibits
Item 9. Regulation FD Disclosure Form 8-K Report Date - April 10, 2002 (Present

Form 8-K Report Date - April 23, 2002 (Dividend Announcement)
Items Reported - Item 5. Other Events
Item 7. Exhibits

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Form 8-K Report Date - April 26, 2002 (Change In Registrant's Certifying Accountant)
Items Reported - Item 4. Change In Registrant's Certifying Accountant
Item 7. Exhibits

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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 on the 13th day of June 2002.

STEWART & STEVENSON SERVICES, INC.

By: /S/ MICHAEL L. GRIMES
Michael L. Grimes
President and Chief Executive Officer
(Principal Executive Officer)

By: /S/ JOHN B. SIMMONS
John B. Simmons
Vice President and Chief Financial Officer
(Principal Financial Officer and Chief
Accounting Officer)

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EXHIBIT INDEX

EXHIBIT NUMBER AND DESCRIPTION

None

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