STEWART & STEVENSON SERVICES INC
Form 10-K
April 13, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ý **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

for the fiscal year ended January 31, 2006 (Fiscal 2005) or

o **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	**77008**

(Address of principal executive offices)	(Zip Code)

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

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

Common Stock, without par value	**New York Stock Exchange**
(Title of class)	(Name of exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ý No o

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

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 ý No o

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

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

Large accelerated filer o Accelerated filer ý Non-accelerated filer o .

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

The aggregate market value of voting securities held by non-affiliates of the registrant as of July 30, 2005, the date of the registrant s most recently completed second fiscal quarter, was $639,225,087, based upon the closing price of the registrant s common stock on the New York Stock Exchange as of such date.

Number of shares outstanding of each of the registrant s classes of common stock, as of April 5, 2006:

Common Stock, Without Par Value: 29,495,398 Shares

PART I

FORWARD LOOKING STATEMENTS

Certain of the statements contained in this document, including those made under the captions Business, Legal Proceedings, and Management s Discussion and Analysis of Financial Condition and Results of Operations, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Other than statements of historical fact included herein, all statements herein, including in particular, but not limited to, statements regarding potential future products and markets, our future financial position or results of operations, business strategy, other plans and objectives for future operations, relating to trends, expressing our belief, referring to expectations, relating to future margins, referring to backlogs as to future product deliveries, relating to long-term contracts in progress or using the words should, could, may, and words of similar import and prospective focus, are forward-looking statements. We can give no assurance that any forward-looking statement of ours will prove to have been correct and such statements are not guarantees of future performance. They involve certain risks, uncertainties and assumptions that are difficult to predict, and actual outcomes and results may differ materially from what is expressed or forecasted or implied in such forward-looking statements. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Specific important factors that could cause actual results, performance, or achievements to differ materially from our forward-looking statements, and that otherwise may affect our operations, are identified below. All written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by such factors.

Item 1. Business.

Stewart & Stevenson Services, Inc. (together with its wholly-owned subsidiaries, the Company or Stewart & Stevenson) was founded in Houston, Texas in 1902 and was incorporated under the laws of the State of Texas in 1947. Since its beginning, the Company has been primarily engaged in the custom fabrication of engine-driven products. At the beginning of Fiscal 2004, the Company operated in five business segments: the Tactical Vehicle Systems segment, the Power Products segment, the Engineered Products segment, the Airline Products segment, and the Distributed Energy Solutions segment. The Company announced its plan to exit the Distributed Energy Solutions business in September 2003 and, after substantial progress in the wind-down activities, the Company reported this segment as a discontinued operation in the fourth quarter of Fiscal 2004. The Company sold the Airlines Products business in January 2005 for $56 million, after adjustment, plus the assumption of certain liabilities. In January 2006, the Company completed the sale of substantially all the operating assets and business of the Power Products segment and the Engineered Products segment for cash consideration of approximately $283 million, after adjustment, and the assumption of certain liabilities, leaving the Company with the Tactical Vehicle Systems business described below.

On February 27, 2006, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) with Armor Holdings, Inc. (Armor Holdings) and one of its wholly-owned subsidiaries, pursuant to which Armor Holdings agreed to acquire all of the outstanding common stock of the Company for $35.00 per share in a cash merger transaction. Upon completion of the merger, the Company will be a subsidiary of Armor Holdings and there will be no further market for the Company s common stock. The transaction is subject to Company shareholder approval, the expiration or termination of the Hart-Scott-Rodino waiting period and other customary conditions. Under specified circumstances, if the Merger Agreement is terminated, the Company would be required to pay Armor Holdings a termination fee. In addition, the Merger Agreement contains conditions to Armor Holdings obligations to consummate the merger, including the absence of a material adverse change (as defined in the Merger Agreement) since the date of the Merger Agreement. The Company has scheduled a special meeting of shareholders for May 9, 2006 to consider and vote upon the proposed merger. The Company anticipates that the transaction will close during the second quarter of Fiscal 2006. See Legal Proceedings.

The Company s Tactical Vehicle Systems business assembles the Family of Medium Tactical Vehicles (FMTV) under contracts with the U.S. Army, and provides sustaining design engineering, service and support. The initial FMTV contract was awarded in 1991 and called for the production of approximately 11,200 2-1/2-ton and 5-ton trucks in several configurations, including troop carriers, wreckers, cargo trucks, vans and dump trucks. Production pursuant to the initial FMTV contract was completed as of January 31, 1999.

During October 1998, the Company received a second multi-year contract from the U.S. Army that provided for continued production of the FMTV through December 2004, including exercised option years. Production under the second contract, including all option years, totaled approximately 11,491 trucks and 2,292 trailers, with a total contract value of $2.05 billion.

In April 2003, the Company received a third multi-year contract from the U.S. Army that provided for continued production of the FMTV through September 2008. Base production under the third contract includes 7,063 trucks and 3,826 trailers at an initial contract value of approximately $1.2 billion. The U.S. Army also has the option to order up to an additional 10,889 units over the term of the contract, which could extend production beyond September 2008 depending on options exercised. Base production under this contract has been funded by the U.S. government through September 2007, and as of March 31, 2006, the U.S. Army has exercised options for 3,382 trucks and 1,702 trailers under this contract.

During Fiscal 2004 and early Fiscal 2005, the Company received additional contract awards, which supplement the FMTV production under the U.S. Army contract. These awards included contracts for the production of 1,743 Low Signature Armored Cabs (LSAC) for use on the FMTV, which had a total contract value of approximately $153 million. Additionally, the Company received contract awards from the U.S. Army and Lear Siegler, Inc. to reset vehicles that have sustained damage in support of Operation Iraqi Freedom and Operation Enduring Freedom. Under these contracts, the Company has reset approximately 1,254 FMTVs which have been placed in service since 1992, along with 186 of the U.S. Army s Heavy Expanded Mobility Tactical Trucks (HEMTT) to their full operational standards. The total contract value under the reset contracts is approximately $76 million. The LSAC contracts and the reset contracts began in Fiscal 2004 and were substantially completed during Fiscal 2005.

The Company also received modifications to the FMTV contract from the U.S. Army in June 2005, valued at approximately $483 million. These modifications, which were funded by the 2005 U.S. Congress Supplemental Spending Bill, added 3,016 truck and trailer deliveries to the contract, including the exercise of options for 1,310 of the trucks and trailers described above. The Company is currently expanding the capacity of its Sealy, Texas production facility in order to meet these additional order deliveries, which are scheduled from June 2006 to September 2008. Total capital expenditures related to the expansion are expected to be approximately $25 million, approximately $13 million of which was incurred in Fiscal 2005. The expansion is expected to be completed by mid-2006.

In April 2005, the Company acquired all outstanding shares of Automotive Technik (Holdings) Limited (ATHL), the manufacturer of the Pinzgauer light tactical vehicle headquartered in the United Kingdom, for a total purchase price of approximately $48.2 million. The acquisition of ATHL broadens the Company s product offerings and provides additional marketing opportunities worldwide. ATHL currently has contracts to produce vehicles for the United Kingdom Ministry of Defence and the New Zealand Ministry of Defence, in addition to other programs worldwide.

The U.S. government is the Company s primary customer, accounting for over 85% of its sales from continuing operations. The FMTV contracts are subject to termination at the election of the customer and provide for termination charges that would reimburse the Company for allowable costs, but not necessarily all costs incurred. The loss of this customer would have a material adverse effect on the Company s future financial condition and results of operations.

The Company also sells the FMTV to other government contractors as a platform for installation of other equipment which is then resold to the U.S. Armed Forces. The Company also has sold vehicles to branches of the U.S. Armed Forces other than the U.S. Army, and believes there will be opportunities to sell additional vehicles to the U.S. Army, other branches of the U.S. Armed Forces and the armed forces of certain foreign countries.

The FMTV incorporates engines, transmissions, axles and a number of other components that are specified by the U.S. Army and are available only from the source or sources selected by the U.S. Army. In addition, the Company uses other suppliers for certain components of the FMTV, some of which are small businesses that are not well capitalized. Interruption in the supply of any of these components, for any reason, could have a material adverse effect on the results of operations of the Company. The Company believes that the U.S. Army would compensate the Company for any delays arising from the interruption in the supply of source-specified components under the FMTV contracts.

COMPETITION

The Company s primary competitor for U.S. sales is Oshkosh Truck Corporation. In addition to Oshkosh, the Company s primary competitors for international contracts for the sale of vehicles to foreign governments include DaimlerChrysler AG, Tatra, MAN and other companies that may have greater international recognition as vehicle manufacturers than the Company.

Competition involves pricing, delivery, quality, vehicle reliability and readiness, range of products and services, technology and other factors. Some of the Company s competitors have greater financial resources than the Company. The Company believes that its reputation for on-time delivery, quality engineering, vehicle reliability and readiness are important to the Company s market position.

INTERNATIONAL OPERATIONS

International operations are subject to risks caused by political and economic factors such as foreign governmental decrees, currency exchange rate volatility and inflation. The Company maintains operations in the United Kingdom, and historically had operations in other foreign jurisdictions, including Colombia, Venezuela and Argentina. The Company monitors the political and economic developments in those countries.

UNFILLED ORDERS

The Company s unfilled orders consist of written purchase orders and signed contracts. Historically, cancellations are rare; however, 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. Due to the inherent uncertainties of the Congressional appropriations process, the Company includes only the funded portions of awarded U.S. government contracts in unfilled orders. Unfilled orders relating to continuing operations increased to $957.8 million at January 31, 2006, from $456.6 million at January 31, 2005. Approximately $737 million of the unfilled orders at January 31, 2006 are expected to be recognized as sales in Fiscal 2006.

Unfilled orders at January 31, 2006 consisted primarily of vehicle production funded under the FMTV contract, production of Pinzgauer trucks in the U.K. operation and uncompleted reset contracts for vehicles ongoing in Sealy and Ft. Hood, Texas. During the first quarter of Fiscal 2005, the third program year of the FMTV contract was funded, extending production through September 2006 and increasing backlog by $316 million. During the second quarter of Fiscal 2005, we received contract modifications from the U.S. Army resulting from the 2005 U.S. Congress Supplemental Spending Bill, increasing backlog by $483 million. During the first quarter of Fiscal 2006, the fourth program year of the FMTV contract was funded, extending production through September 2007 and increasing backlog by approximately $344 million.

ENVIRONMENTAL MATTERS

The Company s operations are subject to numerous local, state and federal laws and regulations, including the regulations promulgated by the Occupational Safety and Health Administration, the U.S. Environmental Protection Agency and the U.S. Department of Transportation. The Company believes that it is in substantial compliance with these laws and regulations. In addition, the costs and expenditures related to compliance and remedial action under these laws and regulations were not material in Fiscal 2005, 2004 or 2003, and the Company currently expects that such costs and expenditures will not be material in Fiscal 2006.

Environmental laws, particularly those governing emissions standards, noise and disposal of hazardous wastes, have become more stringent in recent years. While the Company is not currently aware of any situation involving an environmental claim that would likely have a material adverse effect on its business, it is always possible that an environmental claim with respect to one or more of the Company s current or former product offerings or facilities could arise that could have a material adverse effect on the Company s financial condition, results of operations or cash flows.

EMPLOYEES

As of January 31, 2006, the Company employed approximately 1,245 full and part-time employees, none of which were represented by collective bargaining agreements. In the normal course of business, the Company utilizes the services of subcontractors. The Company believes that its employee relations are generally satisfactory.

AVAILABLE INFORMATION

The Company will make available its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, free of charge through our internet website at www.ssss.com as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (the Commission).

The information contained on the Company s website is not incorporated by reference into this Annual Report on Form 10-K and should not be considered to be a part of this Annual Report on Form 10-K.

Item 1A. Risk Factors.

Potential Sale of the Company: For additional information with respect to the potential merger with Armor Holdings, see the second paragraph of Item 1. Business.

Risks of Dependence on Government and Failure to Obtain New Government Contracts: Because the U.S. government is one of our key customers, decreased government spending or termination of significant government programs could adversely affect our business. U.S. government contracts account for a substantial portion of our annual revenues and operating income. In November 2004, we began full rate production under a third multi-year contract with the U.S. Army that provides for continued production of the FMTV through September 2008 at an initial contract value of $1.1 billion, excluding the exercise of any production options. Funding of the FMTV contract beyond September 2007 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. Army and may be terminated at any time for the convenience of the government. If the FMTV contract is terminated, other than for our default (in which event there could be serious adverse consequences and claims made against us), the contract includes a provision under which we will be reimbursed for certain allowable costs, but not necessarily for all costs incurred.

We have realized and expect to continue to realize lower margins under the third multi-year contract than under the FMTV contract completed in the fourth quarter of Fiscal 2004. There can be no assurance as to whether future governmental spending will adequately support our business in this area, and substantial decreases in government spending, the loss of the U.S. government as a customer or the cancellation of key significant government programs could materially and adversely affect our operations. Even if government spending in general continues at current levels, we are not assured that we can compete effectively as to the receipt of specific government orders and contract awards or as to the timing thereof. The U.S. Army is our primary customer, accounting for over 85% of our sales from continuing operations. The loss of this customer would have a material adverse effect on our consolidated financial condition and results of operations. In our forward-looking statements, we have assumed that we will continue to have satisfactory performance in our government contracting business.

Inherent Risks of Government Contracts: Government contracts present us with numerous special risks that are inherent in their nature and that could adversely affect our operations. Major contracts for military systems are often fixed-price contracts that 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. Our ultimate profitability on such contracts may depend on the eventual outcome of an equitable settlement of contractual issues with the U.S. government. Furthermore, there are significant risks in projecting actual costs on multi-year fixed-price government contracts because of unforeseen factors, including price and wage inflation and supply shortages. While we attempt to negotiate supply contracts with key suppliers that are synchronized with our long-term fixed-price obligations, we are not able to do that with a precision that eliminates risks that our actual costs of necessary items will not exceed the costs taken into account in the original contract pricing. Further, as to some suppliers and some items we do not have contracts that are synchronized at all with our long-term fixed-price obligations. As to such items, which include raw materials such as steel, as to which there have been recent substantial price increases, we are at continuous risk that we will have cost increases that were not taken into account in our contract pricing.

Our 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, we would also be prohibited from selling 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. In such events we might otherwise not be able to receive the benefits of federal assistance payments during a suspension or debarment. The U.S. Customs Service and the Department of Justice have conducted an investigation of potential violations by us of laws relating to the export of controlled military vehicles, weapons mounting systems and firearms. Such investigation could result in the filing of civil or administrative sanctions against us and/or individual employees, and could result in a suspension or debarment. In our forward-looking statements, we have assumed our reasonable management of risks inherent in our government contracting business, and that we will not experience a materially adverse outcome in any U.S. government investigations.

Risks of Supply Interruptions: The FMTV incorporates engines, transmissions, axles and a number of other components that are specified by the U.S. Army and are available only from the source or sources selected by the U.S. Army. Identifying additional or replacement suppliers approved by the U.S. Army for any of the numerous components used in the FMTV may not be accomplished quickly or on commercially reasonable terms, if at all. In addition to suppliers specified by the U.S. Army, we use other suppliers for certain components of the FMTV, some of which are small businesses that are not well capitalized. In the event we were unable to mitigate the impact or find an alternate supplier in a timely manner, significant interruption in the supply of any of these components, for any reason, including insolvency of a supplier, work stoppages at suppliers and transportation interruptions, could involve significant additional costs and result in delays in production and product deliveries and could have a material adverse effect on our results of operations. In our forward-looking statements, we have assumed that we will not experience significant supply interruptions.

Risks Associated with Distributed Energy Solutions Business: In the third quarter of Fiscal 2003, we announced our plans to exit the turnkey engineering, procurement, and construction, or EPC, activities of the Distributed Energy Solutions segment. Since that time, we have incurred significant losses in the process of exiting this business related to the completion of remaining construction projects, costs to satisfy customer warranty obligations, valuation adjustments related to the liquidation of inventory and costs associated with the settlement of customer disputes. During the fourth quarter of Fiscal 2004, we reached the point in this wind down effort in which we are substantially complete with our construction activities, and as a result, the identified assets, liabilities and results of operations for that segment have been reported as discontinued operations. We continue to have substantial risk with respect to the performance on such contracts, including warranty, product performance and other contractual obligations, as well as certain claims and litigation that have arisen against us with respect to contracts entered into in past years. While we have recognized all known estimated losses on these uncompleted contracts, warranty obligations and other customer disputes, continued uncertainty remains related to the execution of the remaining obligations. These uncertainties may result in additional unexpected losses until all contractual issues are resolved and remaining obligations are completed. Additionally, we expect to continue to recognize some general and administrative costs required to support the remaining warranty and contract performance aspects of this business. We are also obligated to execute under certain fixed-price operation and/or maintenance contracts related to previously completed EPC projects, which have terms potentially extending up to five years. We have assumed in our forward-looking statements that we will be able to manage this circumstance in an overall satisfactory manner, having already taken significant charges with respect to these matters in prior years.

Risks of Fixed-Price Contracts: Many of our equipment sales contracts are fixed-price contracts as to which the original price may be set at an early stage of the process. The terms of these contracts require us to guarantee the price of products and services we provide and to assume the risk that the costs to provide such products and services will be greater than anticipated. The profitability of these contracts is therefore dependent on the ability to reasonably predict the costs associated with performing the contracts. These costs may be affected by a variety of factors, some of which are beyond our control. For example, U.S. manufacturers and distributors of steel products, which are used in many of our products, have in recent years experienced difficulties with the pricing and availability of steel. The volatility of steel prices and increase in steel demand worldwide has had and is expected to continue to have a negative effect on our expected costs under certain of our fixed-price contracts in the near future. Our failure to accurately estimate the resources required for a project, or our failure to complete our contractual obligations in a manner consistent with the project plan upon which our fixed-price contract was based, could adversely affect our profitability and could have a material adverse effect on our business, financial condition and results of operations. In recent years, as a result of incurring greater costs than were taken into account in original contract pricing, we have incurred significant losses on certain EPC projects in our discontinued Distributed Energy Solutions business. In our forward-looking statements, we have assumed that fixed-price contracts will have no further material adverse impact on our business, financial condition or results of operations.

Risks as to Rising Steel Prices: While noted above generally in connection with other risk factors, we specifically note that since early 2004, manufacturers and distributors of steel, which is used in many of our products, have experienced sharply increased prices and limited availability of steel and component parts containing steel. These increased steel prices have had and are expected to continue to have a negative impact on our margins in the near future, particularly on fixed-price contracts and other contracts for which we are unable to pass such cost increases on to our customers. If these steel price conditions continue, and if we are unable to raise our prices to keep pace with the material cost increases, our operating margins and results of operations could be adversely impacted in future periods.

Risks as to Cost Controls: As a manufacturing and service company operating within tight margins, with substantial facilities and inventories, our operations have been, and can be, adversely affected by our inability to control costs and to accurately estimate and plan our costs. We continuously endeavor to implement cost identification, estimation and savings measures in our operations. Our forward-looking statements assume that we will be able to contain our costs and expense increases at reasonable levels consistent with expected revenues.

Risks of Dependence on Third Party for Support Services: In connection with the disposition of the Engineered Products and Power Products businesses, including a significant portion of our information technology assets and personnel, we entered into a transition services agreement with the buyer of those businesses pursuant to which the buyer is obligated to provide certain support services to us in the areas of information technology, telecommunications, accounting and payroll, record retention, tax compliance assistance and operational support for up to 18 months following the sale of those businesses, depending on the particular service. Because we no longer own the assets or employ the personnel necessary to perform those services, we are substantially dependent on the buyer to provide such support services. The buyer s failure to provide these services to us in a timely manner, or at all, could have material adverse effect on our business, operating results and financial condition.

Risk of a Decline in Defense Spending: Our government contracts are dependent upon the U.S. defense budget. Since the invasion of Iraq by the U.S. and other forces in March 2003, we have benefited from an upward trend in overall defense spending. Under the Bush Administration s fiscal 2007 budget, the defense budget is expected to continue to increase through fiscal year 2009. However, future defense spending could be negatively impacted by several factors, including, but not limited to, the U.S. government s budget deficits, a change in spending priorities and the costs of sustaining the U.S. military operations in Iraq and Afghanistan. A decrease in U.S. government defense spending or changes in spending allocation could result in a material decrease to our sales, earnings and cash flow.

Risks of General Economic Conditions: Our operations are to some extent dependent for success on the general economic well-being of the United States and certain international markets. A general economic downturn could adversely affect government military spending which could impact demand for our products and services. Although economic activity has improved in recent years, general economic conditions remain uncertain, particularly in light of the war in Iraq, other international tensions and related factors. If the U.S. or world economies decline or fail to further recover, the demand for our products and services could be adversely affected, thus adversely affecting our financial condition and results of operations. Further, other general market conditions such as increased inflation and higher interest rates could also adversely impact our results of operations. In our forward-looking statements, we have assumed that general market conditions will not worsen in Fiscal 2006 and that we are not entering a down-cycle in our markets or a period of significantly increasing inflation and interest rates.

Risk of Competition: Our international and domestic competitors may use their resources and product and service offerings to increase competition, both in terms of pricing and product and service offerings, thereby reducing our market shares and/or sales and profitability. Some of our existing and potential competitors have substantially greater marketing, financial and technical resources than we have, and these resources might be used in effective competition with us. We have assumed in our forward-looking statements that we will continue to be a reasonably effective competitor in our markets.

Risks Relating to Technology: Our business will suffer if we are unable to keep up with rapid technological change and product development. Our success will depend on our ability to anticipate changes in technology and industry requirements and to respond to technological developments on a timely basis, either internally or through strategic alliances. We will likely be constantly threatened by current competitors or new market entrants who may develop new technologies or products or establish new standards that could render our products less marketable or obsolete. Thus, we can offer no assurances that we will be successful in developing and marketing, on a timely and cost effective basis, products or product enhancements that respond to our competition, to technological developments, to changing industry standards and to marketplace acceptability. We have assumed in our forward-looking statements that we can reasonably keep pace with our competitors in technology changes and product development.

Risks Relating to Personnel: Labor shortages and our inability to recruit and retain key employees and workers could limit our operations and increase our labor costs and, in turn, adversely affect our results of operations. Our manufacturing operations are substantially dependent upon our ability to recruit and retain key managers and qualified machinists, welders, factory workers and other laborers. A strong labor market can adversely impact us by limiting our manufacturing capacity or resulting in significantly increased wages and other benefits to attract additional key employees and workers. We have assumed in our forward-looking statements that we will continue to be able to recruit and retain necessary personnel at overall costs that are comparable with our ability to produce revenues.

Risks of Claims and Litigation: Outcomes of pending litigation and governmental proceedings, as well as future unexpected litigation and legal disputes could have a material adverse impact on our operations. If we experience materially adverse outcomes or other unexpected results in our existing litigation and government proceedings, which in turn have a material adverse effect on our results of operations, the accuracy of our forward-looking statements would be affected. Similarly, if we experience in the future new, unexpected litigation or adverse results from new, unexpected litigation, there could also be a material adverse effect on our results, again affecting the accuracy of our forward-looking statements. Our forward-looking statements assume that there will be no materially adverse unexpected outcomes or results that we have not already adequately provided for.

Risks of Product Defects: Our customers often require demanding specifications for product performance and reliability. Because many of our products are complex and often use state-of-the-art components, processes, and techniques, undetected errors and design flaws may occur. Product defects result in higher product service, warranty and replacement costs and may cause damage to our customer relationships and industry reputation, all of which may negatively impact our results of operations. We have assumed in our forward-looking statements that we will not in the future incur material difficulties with respect to product defects and warranty claims.

Risks as to Foreign Sales and Global Trade Matters: Foreign sales are subject to special risks inherent in doing business outside of the United States, including the risk of war, terrorist activities, civil disturbances, embargoes, and government activities, all of which may disrupt markets. Foreign sales are also generally subject to the risk of compliance with additional laws, including tariff regulations and import and export restrictions. Sales in certain foreign countries require prior U.S. government approval in the form of an export license. We cannot assure you that we will not experience difficulties in connection with future foreign sales. Moreover, changes in global trade policies in our markets could impact our sales in these markets. We have assumed in our forward-looking statements that there will be no material changes in global trade policies, such as embargoes, new and large tariffs or other tax assessments and the like or other new and material restrictions on trade that apply in particular to our operations.

Risks as to Acquisitions and Restructuring Activities: Our success is dependent upon the integration of newly acquired businesses with our existing businesses. Our success is also dependent upon executing our restructuring plans in such a manner that we extricate value from facility closures and product offering and business exits, and that we structure continuing business activities in an efficient and tactical manner. This process involves some amount of realignment and reintegration of business processes. There can be no assurance as to the ultimate success of our integration and realignment efforts. Our forward-looking statements assume the successful integration of acquired businesses and realigned business activities and their future contribution to our operations.

Risks as to Currency Fluctuations: A material change in currency exchange rates in our markets could affect our future results as well as affect the carrying values of certain of our assets. World currencies have been subject to volatility in recent years. The U.S. dollar has continued to weaken somewhat against other key currencies (particularly the Euro and the British pound) in recent years. While a weakened U.S. dollar is not necessarily adverse to our business in general, it could be generally adverse for the U.S. economy in a number of ways, including putting upward pressure on interest rates. In addition, our U.K. manufacturing operation primarily conducts its business in British pounds sterling, but a portion of its costs are in Euros. Consequently, significant weakening of the U.K. pound in relation to the Euro would negatively impact the profitability of our U.K. operation. Significant weakening of the U.K. pound in relation to the U.S. dollar would reduce the carrying value of our U.K. assets, and would negatively impact the U.S. dollar-equivalent values of revenues and profits of our U.K. operation. Our forward-looking statements assume no material impact from future changes in currency exchange rates.

Risks as to Environmental and Safety Matters: Our operations and products, and the use thereof, are regulated under a number of federal, state, local and foreign environmental laws and regulations, which govern, among other things, the discharge of hazardous materials into the air and water as well as the handling, storage and disposal of hazardous materials. Compliance with these environmental laws is a major consideration in the manufacturing of our products and in their servicing and distribution, as we use and generate hazardous substances and wastes in our manufacturing operations and as we may be subject to material financial liability for any investigation and clean-up of such hazardous materials. In addition, many of our current and former properties are or have been used for industrial purposes. Accordingly, we also may be subject to financial liabilities relating to the investigation and remediation of hazardous materials resulting from the action of previous owners or operators of industrial facilities on those sites. Liability in many instances may be imposed on us regardless of the legality of the original actions relating to hazardous or toxic substances or whether or not we knew of, or were responsible for, the presence of those substances. We are also subject to various federal, state, local and foreign laws and regulations relating to safety and health conditions in our manufacturing facilities and with respect to our products and the use thereof. Those laws and regulations may also subject us to material financial penalties or liabilities for any noncompliance, as well as potential business disruption if any portion of any of our facilities is required to be temporarily closed as a result of any violation of those laws and regulations. Any financial liability or business disruption from environmental, health or safety issues could have a material adverse effect on our financial condition and results of operations. Our forward-looking statements assume no material adverse impact from environmental and safety issues.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

The Company maintains its corporate executive and administrative offices at 2707 North Loop West, Houston, Texas, which occupy approximately 18,300 square feet of leased space.

The Company s Tactical Vehicle Systems business is headquartered in a 822,000 square foot Company-owned facility in Sealy, Texas, which includes the 202,000 square foot expansion of the facility in Fiscal 2005. The business also leases approximately 31,500 square feet within 7 facilities located in Virginia, North Carolina, Georgia, Tennessee, and Michigan, and approximately 59,000 square feet within two facilities in the United Kingdom, which includes the production facility and administrative offices for the ATHL business acquired in April 2005.

The Company also owns a 255,000 square foot manufacturing facility in Houston, Texas, which is being leased to the buyer of the Company s Engineered Products business, which was sold in January 2006. The lease of the Engineered Products facility expires in July 2008, and has a purchase option that expires in July 2007. In addition, the Company owns an approximately 29,430 square foot facility which is currently being marketed for sale, and leases approximately 237,000 square feet within 12 locations in the former Engineered Products and Power Products businesses, all of which are currently sub-leased to third parties.

The Company considers all property owned or leased by it to be well maintained, adequately insured and suitable for its purposes.

Item 3. Legal Proceedings.

U.S. Government Contingencies: 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 U.S. Customs Service and the Department of Justice have conducted an investigation of 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 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. While they are possible, the Company does not believe that criminal sanctions will be sought. The Company believes that resolution of this matter will not have a material adverse effect on its consolidated results of operations, financial condition or liquidity and believes that the resolution of the matter that is possibly most adverse to the Company will involve the payment of a civil penalty that will not materially adversely affect the Company.

Klickitat Litigation: The Company and several of its subsidiaries in the Distributed Energy Solutions business are defendants in a suit filed by the Klickitat County Public Utility District No. 1 on December 11, 2003 arising out of claims relating to a landfill gas power generation facility in Roosevelt, Washington, Cause No. CY-03-3175-LRS; *Klickitat County Public Utility District No. 1 v. Stewart & Stevenson Services, Inc., Stewart & Stevenson Power, Inc., Sierra Detroit Diesel Allison, Inc., Pamco International, Inc. and Waukesha Engine Dresser, Inc.*; in the U.S. District Court for the Eastern District of Washington. The plaintiff has asserted claims with respect to equipment installed and used since 1999 for breach of contract; promissory estoppel; violations of the Washington Products Liability Act; breach of warranties; intentional or negligent misrepresentation; and violations of the Washington Consumer Protection Act and seeks recovery of damages in excess of $15 million. The Company is vigorously defending this suit. In an order filed April 7, 2006, the court granted partial summary judgment dismissing all but two of plaintiff s nine causes of action with prejudice. As to the remaining claims, it is not yet possible for the Company to determine the ultimate outcome of the suit or whether its resolution will, in the future, have a material adverse effect on the Company s consolidated results of operations, financial position or liquidity. The Company is presently unable to determine whether a material liability has been incurred in this matter or to reasonably estimate the amount of any loss that may result from this matter. Consequently, the Company has recorded no accrual for any losses related to the ultimate outcome of this litigation. The Company has, however, recorded accruals that it believes are adequate for estimated legal fees that it expects to incur associated with this matter.

Antitrust Litigation: The Company, which was a distributor of Detroit Diesel parts through its Power Products business, is a co-defendant with Detroit Diesel Corporation and other Detroit Diesel distributors in two putative class action suits filed on February 9, 2005, Civil Action No. 05-616; *Cumberland Truck Equipment Co. et al. v. Detroit Diesel Corp., et al.* (the Cumberland Litigation), and Civil Action No. 05-625; *Diamond International Trucks, Inc. et al. v. Detroit Diesel Corp., et al.* (the DIT Litigation). The suits were initially filed in the U.S. District Court for the Eastern District of Pennsylvania. On November 14, 2005, the cases were transferred to the Eastern District of Michigan. In the Cumberland Litigation, plaintiffs were dealers of Detroit Diesel parts whose agreements were terminated or not renewed on or after February 9, 2001. The plaintiffs are claiming antitrust violations arising out of the termination or non-renewal of their dealer agreements. In the DIT Litigation, plaintiffs are dealers of Detroit Diesel parts whose dealership classification was changed on or after February 9, 2001. The plaintiffs in the DIT Litigation are claiming antitrust violations arising out of changes to the classification of their dealerships. The plaintiffs in each suit have also alleged price fixing and group boycott in violation of Section 1 of the Sherman Act and have made claims for treble damages and injunctive and other relief. The Company is vigorously defending both suits. It is presently impossible for the Company to determine the ultimate outcome of either suit, but the Company currently believes that the resolution of these suits will not have a material adverse effect on the Company s consolidated results of operations, financial position or liquidity. The Company has recorded accruals that it currently believes are adequate for the estimated amount of costs and legal fees that it expects to incur associated with these matters.

Purported Class Action involving Merger: The Company and six of its directors are defendants in a purported class action lawsuit relating to the proposed merger transaction with Armor Holdings described above in Business . The lawsuit was filed on April 11, 2006, and alleges, among other things, that the defendants have breached their fiduciary duties to the shareholders of the Company by failing to maximize shareholder value when selling the Company, by favoring Armor Holdings in the proposed merger transaction and precluding superior offers for the Company and by failing to disclose material information or disclosing materially false information in its proxy materials relating to the shareholders meeting to be held on May 9, 2006. The lawsuit was filed in District Court in Harris County, Texas, by a purported shareholder of the Company on behalf of all other similarly situated shareholders. The lawsuit alleges that a class should be certified and the plaintiff named as representative of the purported class. No class has been certified at present and accordingly, we regard the action as a purported class action. Additional lawsuits could be filed in the future. The lawsuit seeks, among other things, a declaration that the merger agreement was entered into in breach of the fiduciary duties of the individual defendants and is therefore unlawful and unenforceable, an injunction against the Company proceeding with the transaction or consummating the transaction or any other business combination unless certain procedures are in place and damages, attorneys and experts fees, expenses and other relief. The Company believes that this lawsuit is wholly without merit and intends to vigorously defend it.

Environmental Contingencies: In 2001, the Company received from the U.S. Environmental Protection Agency (the EPA) a Request for Information under Section 104(e) of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, for information pertaining to the R&H Oil Company Site in San Antonio, Texas (the Site). Information provided to the Company by the EPA indicates that the Company may have sent waste oils to the Site for recycling in the late 1980s, and that such waste oils may potentially account for between one and two percent of the volume of total wastes received by the oil recycler at the Site. Since the Company expects to receive a claim for cleanup and other costs related to this site, it has established reserves which it believes to be adequate at this time. As additional facts are developed and definitive remediation plans and necessary regulatory approvals for implementation of remediation are established, changes in these and other factors may result in actual costs exceeding the amounts accrued. While uncertainties are inherent in the final outcome of these environmental matters, and it is presently impossible to determine the actual costs that ultimately may be incurred, management currently believes that the resolution of such uncertainties should not have a material adverse effect on the Company s consolidated results of operations, financial position or liquidity. The Company believes that the most likely outcome in this environmental matter is the expenditure of an immaterial amount of consideration as a contribution to the remediation effort.

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, is expected to have a material effect on the manner in which the Company conducts its business or on its consolidated results of operations, financial position or liquidity. The Company maintains certain insurance policies that provide coverage for product liability and personal injury cases. The

Company has established reserves that it believes to be adequate based on current evaluations and its experience in these types of claim situations. Nevertheless, an unexpected outcome or adverse development in any such case could have a material adverse impact on the Company s consolidated results of operations in the period it occurs.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

PART II

Item 5. Market Price of and Dividends on the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

The Company s common stock is traded on the New York Stock Exchange under the symbol SVC . There were 492 shareholders of record as of April 5, 2006. The following table sets forth the high and low sales prices relating to the Company s common stock and the dividends declared by the Company in each quarterly period within the last two fiscal years.

Fiscal Year 2004	**High**	**Low**	**Dividend**
First Quarter	$ 17.20	$ 12.46	$ 0.085
Second Quarter	18.25	14.02	0.085
Third Quarter	18.14	14.55	0.085
Fourth Quarter	20.63	16.57	0.085
Fiscal Year 2005	**High**	**Low**	**Dividend**
First Quarter	$ 25.00	$ 19.74	$ 0.085
Second Quarter	25.24	20.86	0.085
Third Quarter	26.00	21.08	0.085
Fourth Quarter	26.37	20.00	0.085
Fiscal Year 2006 (through April 12, 2006)	**High**	**Low**	**Dividend**
First Quarter			