

ULTRALIFE BATTERIES INC

Form 10-K

March 21, 2007

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K**

(Mark One)

**Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2006**

OR

**Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from**

**Commission file number 0-20852
ULTRALIFE BATTERIES, INC.
(Exact name of registrant as specified in its charter)**

Delaware

16-1387013

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

2000 Technology Parkway, Newark, New York

14513

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code:

(315) 332-7100

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

Title of each class
Common Stock, par value \$0.10 per share

Name of each exchange on which registered
The Nasdaq Stock Market, LLC

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

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

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

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer Accelerated filer Non-accelerated filer

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

On July 1, 2006, the aggregate market value of the Common Stock of Ultralife Batteries, Inc. held by non-affiliates of the Registrant was approximately \$149,000,000 based upon the closing price for such Common Stock as reported on the NASDAQ National Market System on June 30, 2006.

Edgar Filing: ULTRALIFE BATTERIES INC - Form 10-K

As of March 3, 2007, the Registrant had 15,149,204 shares of Common Stock outstanding, net of 727,250 treasury shares.

DOCUMENTS INCORPORATED BY REFERENCE

Part III Ultralife Batteries, Inc. Proxy Statement Certain portions of the Registrant's Definitive Proxy Statement relating to the June 6, 2007 Annual Meeting of Shareholders are specifically incorporated by reference in Part III, Items 10-14 herein, except for the equity plan information required by Item 12 as set forth therein.

Table of Contents**TABLE OF CONTENTS**

	PAGE
<u>PART I</u>	
ITEM	
<u>1 Business</u>	3
<u>1A Risk Factors</u>	16
<u>1B Unresolved Staff Comments</u>	23
<u>2 Properties</u>	23
<u>3 Legal Proceedings</u>	24
<u>4 Submission of Matters to a Vote of Security Holders</u>	24
<u>PART II</u>	
<u>5 Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities</u>	25
<u>6 Selected Financial Data</u>	26
<u>7 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	27
<u>7A Quantitative and Qualitative Disclosures About Market Risk</u>	43
<u>8 Financial Statements and Supplementary Data</u>	44
<u>9 Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	81
<u>9A Controls and Procedures</u>	81
<u>9B Other Information</u>	83
<u>PART III</u>	
<u>10 Directors, Executive Officers and Corporate Governance</u>	84
<u>11 Executive Compensation</u>	84
<u>12 Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters</u>	84
<u>13 Certain Relationships and Related Transactions, and Director Independence</u>	84
<u>14 Principal Accountant Fees and Services</u>	84
<u>PART IV</u>	
<u>15 Exhibits, Financial Statement Schedules</u>	85
<u>Signatures</u>	90
Exhibits	91
<u>EX-21</u>	
<u>EX-23.1</u>	
<u>EX-23.2</u>	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	

Table of Contents

PART I

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. This report contains certain forward-looking statements and information that are based on the beliefs of management as well as assumptions made by and information currently available to management. The statements contained in this report relating to matters that are not historical facts are forward-looking statements that involve risks and uncertainties, including, but not limited to, future demand for our products and services, addressing the process of U.S. military procurement, the successful commercialization of our products, general economic conditions, government and environmental regulation, finalization of non-bid government contracts, competition and customer strategies, technological innovations in the non-rechargeable and rechargeable battery industries, changes in our business strategy or development plans, capital deployment, business disruptions, including those caused by fires, raw materials supplies, environmental regulations, and other risks and uncertainties, certain of which are beyond our control. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may differ materially from those described herein as anticipated, believed, estimated or expected. See Risk Factors in Item 1A of this report.

As used in this report, unless otherwise indicated, the terms we, our and us refer to Ultralife Batteries, Inc. and include our wholly-owned subsidiaries, Ultralife Batteries (UK) Ltd., McDowell Research Co., Inc. and ABLE New Energy Co., Limited.

ITEM 1. BUSINESS

General

We are a global provider of high-energy power systems and communications accessories for diverse applications. We develop, manufacture and market a wide range of non-rechargeable and rechargeable batteries, charging systems and communications accessories for use in military, industrial and consumer portable electronic products. Through our portfolio of standard products and engineered solutions, we are at the forefront of providing the next generation of power systems and accessories. Our four operating units are Ultralife Batteries, Inc. in Newark, New York (Headquarters); Ultralife Batteries (UK) Ltd., in Abingdon, England; McDowell Research Co., Inc. in Waco, Texas; and ABLE New Energy Co., Ltd. in Shenzhen, China.

Our battery technologies allow us to offer batteries and power systems that are flexibly configured, lightweight and generally capable of achieving longer operating times than many competing batteries currently available, and that our communications accessories offer users a wide variety of integrated solutions that satisfy the most demanding applications.

We sell our products worldwide through a variety of trade channels, including original equipment manufacturers (OEMs), industrial and retail distributors, national retailers and directly to U.S. and international defense departments. We enjoy strong name recognition in our markets under the Ultralife®, ABLE™ and McDowell Research™ brands. Our manufacturing and product development facilities are located in the United States, England and China. We manufacture lithium-manganese dioxide, lithium-thionyl chloride, lithium ion and seawater-activated batteries, charging systems, power supplies, amplified speakers, equipment mounts and integrated communication systems in our company-operated manufacturing facilities.

We report our results in four operating segments: Non-Rechargeable Products, Rechargeable Products, Communications Accessories and Technology Contracts. The Non-Rechargeable Products segment includes: lithium 9-volt, cylindrical and various other non-rechargeable batteries, including seawater-activated batteries. The Rechargeable Products segment includes: lithium ion and lithium polymer rechargeable batteries and charging systems and accessories, such as cables. The Communications Accessories segment includes: power supplies, cable and connector assemblies, RF amplifiers, amplified speakers, equipment mounts, case equipment and integrated communication system kits. The Technology Contracts segment includes: revenues and related costs associated with various development contracts. We look at our segment performance at the gross margin level, and we do not allocate research and development or selling, general and administrative costs against the segments. All other items that do not specifically relate to these four segments and are not considered in the performance of the segments are considered to be Corporate charges. (See Note 11 in the Notes to Consolidated Financial Statements.)

We continually evaluate various ways to grow, including opportunities to expand through mergers and acquisitions. In May 2006, we acquired ABLE New Energy Co., Ltd., an established manufacturer of lithium batteries located in Shenzhen, China, with a combination of cash, common stock and stock warrants for a total value of

Table of Contents

approximately \$4.1 million. The acquisition broadened our product offering and provided additional exposure to new markets. In July 2006, we finalized the acquisition of substantially all the assets of McDowell Research, Ltd., a manufacturer of military communications accessories located in Waco, Texas, for approximately \$25 million consisting of \$5 million in cash and a \$20 million non-transferable convertible note held by the sellers. The purchase price is subject to a post-closing adjustment based on a final valuation of trade accounts receivable, inventory and trade accounts payable that were acquired or assumed on the date of the closing, using a base value of \$3 million. We estimate the net value of these assets to be approximately \$6 million, resulting in a revised purchase price of approximately \$28 million. The final purchase price is subject to the finalization of negotiations pertaining to the valuation of trade accounts receivable, inventory and trade accounts payable. Substantial negotiations involving this valuation remain ongoing. The acquisition enhanced our channels into the military communications area, strengthened our presence in global military markets and broadened our solutions offerings in the military and government sectors. (See Note 2 in the Notes to Consolidated Financial Statements.)

Our website address is www.ultralifebatteries.com. We make available free of charge via a hyperlink on our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission (SEC). We will provide copies of these reports upon written request to the attention of Peter F. Comerford, Secretary, Ultralife Batteries, Inc., 2000 Technology Parkway, Newark, New York, 14513. Our filings with the SEC are also available through the SEC website at www.sec.gov or at the SEC Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 or by calling 1-800-SEC-0330.

Non-Rechargeable Products

We manufacture and market a family of lithium-manganese dioxide (Li-MnO₂) non-rechargeable batteries including 9-volt, HiRate[®] cylindrical, and Thin Cell[®] form factors, in addition to magnesium silver-chloride seawater-activated batteries. We also manufacture and market a family of lithium-thionyl chloride (Li-SOCl₂) non-rechargeable batteries produced by our ABLE operating unit. Applications for our 9-volt batteries include: smoke alarms, wireless security systems and intensive care monitors, among many other devices. Our HiRate and Thin Cell lithium non-rechargeable batteries are sold primarily to the military and to OEMs in industrial markets for use in a variety of applications including radios, automotive telematics, emergency radio beacons, search and rescue transponders, pipeline inspection gauges, portable medical devices and other specialty instruments and applications. Military applications for our non-rechargeable HiRate and rechargeable lithium ion batteries include: man-pack and survival radios, night vision goggles, targeting devices, chemical agent monitors and thermal imaging equipment. Our lithium-thionyl chloride batteries, sold under our ABLE brand as well as various private label brands, can be used in a wide variety of applications including utility meters, security devices, electronic meters, automotive electronics and geothermal devices. We also manufacture seawater-activated batteries for specialty marine applications. We believe that the chemistry of lithium batteries provides significant advantages over other currently available non-rechargeable battery technologies. These advantages include: lighter weight, longer operating time, longer shelf life, and a wider operating temperature range. Our non-rechargeable batteries also have relatively flat voltage profiles, which provide stable power. Conventional non-rechargeable batteries, such as alkaline batteries, have sloping voltage profiles that result in decreasing power output during discharge. While the price for our lithium batteries is generally higher than alkaline batteries, the increased energy per unit of weight and volume of our lithium batteries allow longer operating times and less frequent battery replacements for our targeted applications.

According to a 2004 report, *World Primary Lithium Battery Markets*, by Frost & Sullivan, lithium non-rechargeable batteries generated revenues of approximately \$821 million in 2003 and are forecasted to reach over \$1.2 billion in 2009.

Revenues for this segment for the year ended December 31, 2006 were \$67.8 million and segment contribution was \$11.9 million.

Rechargeable Products

We believe that our range of lithium ion and lithium polymer rechargeable batteries offers substantial benefits, including the ability to design and produce lightweight batteries in a variety of custom sizes, shapes, and thickness. We market lithium ion and lithium polymer rechargeable batteries comprised of cells manufactured by qualified cell

manufacturers. Additionally, we are utilizing the rechargeable battery products and chargers we have developed for military applications to satisfy commercial customers seeking turnkey power solutions.

According to a 2006 report, *Worldwide Market Update on NiMH, Li Ion and Polymer Batteries for Portable Applications and HEVS*, by the Institute of Information Technology, Ltd., the global portable rechargeable batteries market was

Table of Contents

approximately \$6.1 billion in 2005 and is expected to reach approximately \$7.9 billion in 2009. The widespread use of a variety of portable consumer and commercial electronic products has increased demand. We believe our addressable market is approximately \$1 billion.

Revenues for this segment for the year ended December 31, 2006 were \$17.7 million and segment contribution was \$3.8 million.

Communications Accessories

In 2006, as a result of the acquisition of McDowell Research, we formed a new segment, Communications Accessories. We design and manufacture a line of power solutions and accessories to support military communications systems including: power supplies, power cables, connector assemblies, RF amplifiers, battery chargers, amplified speakers, equipment mounts, case equipment and integrated communication systems. Products include field deployable systems, which operate from wide-ranging AC and DC sources using a basic building block approach, allowing for a quick response to specialized applications. All systems are packaged to meet specific customer needs in rugged enclosures to allow their use in severe environments. We market these products to all branches of the U.S. military, approved foreign defense organizations, and U.S. and international prime defense contractors.

Revenues for this segment in the year ended December 31, 2006 were \$7.4 million and segment contribution was \$1.8 million.

Technology Contracts

On a continuing basis, we seek to fund part of our efforts to identify and develop new applications for our products and to advance our technologies through contracts with both government agencies and third parties. We have been successful in obtaining awards for such programs for both rechargeable and non-rechargeable battery technologies.

Revenues for this segment in the year ended December 31, 2006 were \$589,000 and segment contribution was a loss of \$8,000. We continue to obtain contracts that are in parallel with our efforts to ultimately commercialize products that we develop. Revenues in this segment may vary widely each year, depending upon the quantity and size of contracts obtained.

Corporate

We allocate revenues and cost of sales across the above business segments. The balance of income and expense, including but not limited to research and development expenses, selling, general and administrative expenses, and interest income and expense are reported as Corporate expenses.

There were no revenues for this category in the year ended December 31, 2006 and corporate contribution was a loss of \$20.4 million.

See Management's Discussion and Analysis of Financial Condition and Results of Operations and the 2006 Consolidated Financial Statements and Notes thereto for additional information.

History

We were formed as a Delaware corporation in December 1990. In March 1991, we acquired certain technology and assets from Eastman Kodak Company (Kodak) relating to its 9-volt lithium-manganese dioxide non-rechargeable battery. In December 1992, we completed our initial public offering and became listed on NASDAQ. In June 1994, we formed a subsidiary, Ultralife Batteries (UK) Ltd., which acquired certain assets of the Dowty Group PLC (Dowty) and provided us with a presence in Europe. In December 1998, we announced a venture named Ultralife Taiwan, Inc. (UTI) with PGT Energy Corporation (PGT), together with a group of investors, to produce lithium rechargeable batteries in Taiwan. At December 31, 2006, we continued to hold a 9.2% ownership interest in UTI. However, due to significant financial difficulties, UTI's manufacturing activity has ceased and UTI is no longer manufacturing product for us. In May 2006, we acquired ABLE New Energy Co., Ltd., an established manufacturer of lithium batteries located in Shenzhen, China, which broadened our product offering and provided additional exposure to new markets. In July 2006, we finalized the acquisition of substantially all the assets of McDowell Research, Ltd, a manufacturer of military communications accessories located in Waco, Texas, which enhanced our channels into the military communications area and strengthened our presence in global military markets.

Table of Contents**Products and Technology**

A battery is an electrochemical apparatus used to store and release energy in the form of electricity. The main components of a conventional battery are the anode, cathode, separator and an electrolyte, which can be either a liquid or a solid. The separator acts as an electrical insulator, preventing electrical contact between the anode and cathode inside the battery. During discharge of the battery, the anode supplies a flow of electrons, known as current, to a load or device outside of the battery. After powering the load, the electron flow reenters the battery at the cathode. As electrons flow from the anode to the device being powered by the battery, ions are released from the cathode, cross through the electrolyte and react at the anode.

Non-Rechargeable Products

A non-rechargeable battery is used until discharged and then discarded. The principal competing non-rechargeable battery technologies are carbon-zinc, alkaline and lithium. We manufacture a range of non-rechargeable battery products based on lithium-manganese dioxide, lithium-thionyl chloride and magnesium-silver chloride technologies.

Our non-rechargeable battery products are based predominantly on lithium-manganese dioxide and lithium-thionyl chloride technologies. Our only non-lithium-based non-rechargeable product is our magnesium-silver chloride battery, also known as a seawater-activated battery. We believe that the chemistry of lithium batteries provides significant advantages over currently available non-rechargeable battery technologies, which include: lighter weight, longer operating time, longer shelf life, and a wider operating temperature range. Our non-rechargeable batteries also have relatively flat voltage profiles, which provide stable power. Conventional non-rechargeable batteries, such as alkaline batteries, have sloping voltage profiles that result in decreasing power output during discharge. While the prices for our lithium batteries are generally higher than commercially available alkaline batteries produced by others, we believe that the increased energy per unit of weight and volume of our batteries will allow longer operating time and less frequent battery replacements for our targeted applications. As a result, we believe that our non-rechargeable batteries are price competitive with other battery technologies on a price per watt-hour basis.

Our non-rechargeable products include the following product configurations:

9-Volt Lithium Battery. Our 9-volt lithium battery delivers a unique combination of high energy and stable voltage, which results in a longer operating life for the battery and, accordingly, fewer battery replacements. While our 9-volt battery price is generally higher than conventional 9-volt carbon-zinc and alkaline batteries, we believe the enhanced operating performance and decreased costs associated with battery replacement make our 9-volt battery more cost effective than conventional batteries on a cost per watt-hour basis when used in a variety of applications.

We market our 9-volt lithium batteries to OEM, distributor and retail markets including industrial electronics, safety and security, medical and music/audio. Significant applications include: smoke alarms, wireless alarm systems, bone growth stimulators, telemetry devices, blood analyzers, ambulatory infusion pumps, parking meters, wireless audio devices and guitar pickups. A significant portion of the sales of our 9-volt battery is to major U.S. and international smoke alarm OEMs for use in their long-life smoke alarms. We also manufacture our 9-volt lithium battery under private label for a variety of U.S. and international companies. Additionally, we sell our 9-volt battery to the broader consumer market through national and regional retail chains and Internet retailers.

Our 9-volt lithium battery market has benefited as a result of a state law enacted in Oregon. The Oregon statute requires all battery-operated ionization-type smoke alarms sold in that state to include a 10-year battery. We believe that if similar legislation were to ultimately pass in any major state, and if other states were to follow suit, demand for our 9-volt batteries could increase significantly. We are also benefiting from local and national legislation passed in various U.S., European and Japanese locations, which require the installation of smoke alarms. The passage of this type of legislation in other countries could also increase the demand for our 9-volt batteries.

We believe that we manufacture the only standard size 9-volt battery warranted to last 10 years when used in ionization-type smoke alarms. Although designs exist using other battery configurations, such as three 2/3 A or 1/2 AA-type battery cells, we believe that our 9-volt solution is superior to these alternatives. Our current 9-volt battery manufacturing capacity is adequate to meet forecasted customer demand.

Table of Contents

Cylindrical Batteries. Featuring high energy, wide temperature range, long shelf life and operating life, our cylindrical cells and batteries, based on both lithium-manganese dioxide and lithium-thionyl chloride technologies, represent some of the most advanced lithium power sources currently available. We market a wide range of cylindrical non-rechargeable lithium cells and batteries in various sizes under both the HiRate and ABLE brands, which include: D, C, 5/4 C, 1/2 AA, 2/3 A and other sizes, which are sold individually as well as packaged into multi-cell battery packs, including our leading BA-5390 military battery, which is an alternative to the Li-SO₂ BA-5590 battery, which is the most widely used battery in the U.S. armed forces for portable applications and is manufactured and sold by our competitors. Our BA-5390 battery provides 50% to 100% more energy (mission time) than the BA-5590, and it is used in approximately 60 military applications.

We market our line of lithium cells and batteries to the OEM market for commercial, military, medical, automotive, tracking and search and rescue applications, among others. Significant commercial applications include pipeline inspection equipment, autoclosers and oceanographic devices. Tracking applications include RFID (Radio Frequency Identification) systems. Among the military uses are manpack radios, night vision goggles, chemical agent monitors, and thermal imaging equipment. Medical applications include: AED s (Automated External Defibrillators), infusion pumps and telemetry systems. Automotive applications include: telematics, tire-pressure monitoring and engine electronics systems. Search and rescue applications include: ELT s (Emergency Locator Transmitters) for aircraft and EPIRB s (Emergency Position Indicating Radio Beacons) for ships.

Thin Cell Batteries. We manufacture a range of thin lithium-manganese dioxide batteries under the Thin Cell brand. Thin Cell batteries are flat, lightweight batteries providing a unique combination of high energy, long shelf life, wide operating temperature range and light weight. With their thin prismatic form and a high ratio of active materials to packaging, Thin Cell batteries can efficiently fill most battery cavities. We are currently marketing these batteries to OEMs for applications such as wearable medical devices, theft detection systems, and RFID devices.

Seawater-Activated Batteries. We produce a variety of seawater-activated batteries based on magnesium-silver chloride technology. Seawater-activated batteries are custom designed and manufactured to end user specifications. The batteries, which can be stored almost indefinitely, are activated when placed in salt water, which acts as the electrolyte allowing current to flow. We market seawater-activated batteries to naval and specialty OEMs for applications including sonobuoys, underwater defense systems, air-sea rescue equipment, airborne surveillance drones and meteorological radiosondes.

Rechargeable Products

In contrast to non-rechargeable batteries, after a rechargeable battery is discharged, it can be recharged and reused many times. Generally, discharge and recharge cycles can be repeated hundreds of times in rechargeable batteries, but the achievable number of cycles (cycle life) varies among technologies and is an important competitive factor. All rechargeable batteries experience a small, but measurable, loss in energy with each cycle. The industry commonly reports cycle life in the number of cycles a battery can achieve until 80% of the battery s initial energy capacity remains. In the rechargeable battery market, the principal competing technologies are nickel-cadmium, nickel-metal hydride, lithium-ion and lithium-polymer-based batteries. Rechargeable batteries can be used in many applications, such as military radios, laptop computers, mobile telephones, portable medical devices, wearable devices and many other commercial, military and consumer products.

Three important parameters for describing the performance characteristics of a rechargeable battery suited for today s portable electronic devices are design flexibility, energy density and cycle life. Design flexibility refers to the ability of rechargeable batteries to be designed to fit a variety of shapes and sizes of battery compartments. Thin profile batteries with prismatic geometry provide the design flexibility to fit the battery compartments of today s electronic devices. Energy density refers to the total electrical energy per unit volume stored in a battery. High energy density batteries generally are longer lasting power sources providing longer operating time and necessitating fewer battery recharges. Lithium batteries, by the nature of their electrochemical properties, are capable of providing higher energy density than comparably sized batteries that utilize other chemistries and, therefore, tend to consume less volume and weight for a given energy content. Long cycle life is a preferred feature of a rechargeable battery because it allows the user to charge and recharge many times before noticing a difference in performance.

Energy density refers to the total amount of electrical energy stored in a battery divided by the battery's weight and volume as measured in watt-hours per kilogram and watt-hours per liter, respectively. High energy density and long achievable cycle life are important characteristics for comparing rechargeable battery technologies. Greater energy density will permit the use of batteries of a given weight or volume for a longer time period. Accordingly, greater energy density will enable the use of smaller and lighter batteries with energy comparable to those currently marketed. Long achievable

Table of Contents

cycle life, particularly in combination with high energy density, is suitable for applications requiring frequent battery recharges, such as cellular telephones and portable computers.

Lithium Ion and Lithium Polymer Cells and Batteries. We offer a variety of lithium ion and lithium polymer cells and batteries. Additionally, we offer battery packs made from single and multiple lithium ion and lithium polymer cells.

Battery Charging Systems and Accessories. To provide our customers with complete power system solutions, we offer a wide range of rugged military and commercial battery charging systems and accessories including smart chargers, multi-bay charging systems and a variety of cables.

Communications Accessories

Our McDowell Research unit designs and manufactures power solutions and accessories to support military communications systems including power supplies, RF amplifiers, battery chargers, amplified speakers, equipment mounts, case equipment and integrated communication systems. We specialize in field deployable power systems, which operate from wide-ranging AC and DC sources using a basic building block approach, allowing for a quick response to specialized applications. We package all systems to meet specific customer needs in rugged enclosures to allow their use in severe environments. Our strengths include deep ties to Special Operations, the Navy and U.S. Marines and the ability of our sales force and engineers to capitalize on opportunities to customize products, accessories and add enhancements to current products.

We offer a wide range of military communications accessories designed to enhance and extend the operation of communications equipment such as vehicle-mounted, manpack and handheld transceivers. Our communications accessories include the following product configurations:

Integrated Systems. Our integrated systems include: SATCOM on the Move (SOTM); ruggedized deployable case systems; multiband transceiver kits and HF transceiver kits; briefcase power systems; dual transceiver cases; enroute communications cases; four radio cases; and tactical repeater systems. These systems give communications operators everything that is needed to provide reliable links to support C4I (Command, Control, Communications, Computers and Information systems).

Power Systems. Our power systems include: universal AC/DC power supplies with battery backup for tactical manpack and handheld transceivers; Rover III power supplies; interoperable power adapters and chargers; portable power systems; tactical combat and AC to DC power supplies for encryption units, among many others. We can provide power supplies for virtually all tactical communications devices.

RF Amplifiers. Our RF amplifiers include: 20 and 100-watt multiband (30 – 512 MHz) and 50 watt VHF RF (30 – 90 MHz) amplifiers. These amplifiers are used to extend the range of manpack and handheld tactical transceivers and can be used on mobile or fixed site applications.

Sales and Marketing

We employ a staff of sales and marketing personnel in the U.S., England, Germany and China. We sell our current products directly to OEMs in the U.S. and abroad and have contractual arrangements with sales agents who market our products on a commission basis in particular areas. While OEM agreements and contracts contain volume-based pricing based on expected volumes, industry practices dictate that pricing is rarely adjusted retroactively when contract volumes are not achieved. Every effort is made to adjust future prices accordingly, but the ability to adjust prices is generally based on market conditions.

We also distribute our products through domestic and international distributors and retailers. Our sales are generated primarily from customer purchase orders. We have several long-term contracts with the U.S. government and companies within the automotive industry. These contracts do not commit the customers to specific purchase volumes, and they include fixed price agreements over various periods of time. We do not believe sales are seasonal, but it is possible we may experience seasonality in products sold to electronic markets.

In 2006, sales to U.S. and non-U.S. customers were \$57.3 million and \$36.2 million, respectively. (See Note 11 in the Notes to Consolidated Financial Statements.)

Table of Contents*Non-Rechargeable Products*

We have targeted sales of our non-rechargeable products to manufacturers of security and safety equipment, automotive telematics, medical devices, search and rescue equipment, specialty instruments, point of sale equipment and metering applications, as well as users of military equipment. Our strategy is to develop sales and marketing alliances with OEMs and governmental agencies that utilize our batteries in their products, commit to cooperative research and development or marketing programs, and recommend our products for design-in or replacement use in their products. We are addressing these markets through direct contact by our sales and technical personnel, use of sales agents and stocking distributors, manufacturing under private label and promotional activities.

We seek to capture a significant market share for our products within our targeted OEM markets, which we believe, if successful, will result in increased product awareness and sales at the end-user or consumer level. We are also selling our 9-volt battery to the consumer market through retail distribution. Most military procurements are done directly by the specific government organizations requiring products, based on a competitive bidding process. For those military procurements that are not bid, the procurements are typically subject to an audit of the product's underlying cost structure and associated profitability. Additionally, we are typically required to successfully meet contractual specifications and to pass various qualification testing for the products under contract by the military. An inability by us to pass these tests in a timely fashion could have a material adverse effect on our business, financial condition and results of operations. When a government contract is awarded, there is a government procedure that allows for unsuccessful companies to formally protest the award if they believe they were unjustly treated in the government's bid evaluation process. A prolonged delay in the resolution of a protest, or a reversal of an award resulting from such a protest could have a material adverse effect on our business, financial condition and results of operations.

During 2006, we had one major military-direct customer for our military products, the U.S. Defense Department. In October 2004, purchasing responsibility for battery procurement was transferred from the U.S. Department of the Army-Communications and Electronics Command (CECOM) to Defense Logistics Agency (DLA). Direct sales to the U.S. Defense Department comprised approximately 20% of our revenue in 2006, 25% in 2005, 56% in 2004, and 51% in 2003. We believe that the loss of this customer would have a material adverse effect on us. We believe that we have a good relationship with this customer. However, we also received 27% of our revenue in 2006 from a variety of other U.S. military customers, which reduced our dependence on direct U.S. military purchases.

We have been successfully marketing our products to military organizations in the U.S. and other countries. These efforts have resulted in us winning significant contracts. For example, in June 2002, we were awarded a five-year production contract by the U.S. Army/CECOM to provide three types of non-rechargeable lithium-manganese dioxide batteries to the U.S. Army. The contract provides for order releases over a five-year period. The originally awarded contract had a maximum potential value of up to \$32 million. In September 2005, we were awarded an increase, bringing the total contract value up to \$45 million. Combined, these batteries comprise what is called the Small Cell Lithium Manganese Dioxide Battery Group (Phase II) under CECOM's Next Gen II acquisition strategy. A major objective of this acquisition is to maintain a domestic production base of a sufficient capacity to timely meet peacetime demands and have the ability to surge quickly to meet deployment demands. In December 2004, we were awarded 100% of the Next Gen II Phase IV battery production contracts by the U.S. Defense Department to provide five types of non-rechargeable lithium-manganese dioxide batteries to the U.S. Army. Combined, these batteries comprise what is called the Rectangular Lithium Manganese Dioxide Battery Group. The government awarded 60 percent to our U.S. operation and 40 percent to our U.K. operation. The contract provides for order releases over a five-year period with a maximum potential value of up to \$286 million. In January 2005, a competitor of ours filed a protest with the U.S. government of our award of the Next Gen II Phase IV contract with the U.S. military, and in April 2005 the protest was denied by the government, allowing us to proceed with the qualification process for the batteries under this contract. In January 2006, our BA-5390A battery with State of Charge Indicator, one of the five battery types under this contract, passed the qualification process, allowing for future orders of this approved battery. Ultimate orders under this contract are dependent upon the demand for these batteries by end users and inventory stocking strategies, among other things. Through December 31, 2006, we have received orders for deliveries under this contract totaling \$6.5 million. In February 2005, we were awarded a five-year production contract by the U.S.

Defense Department, with a maximum total potential of \$15 million, to provide our BA-5347/U non-rechargeable lithium-manganese dioxide batteries to the U.S. military. The contract value represented 60 percent of a small business set-aside award. In March 2005, a competitor contested this award and in August 2005, the competitor's protest was denied. Production deliveries began in the first quarter of 2006.

At December 31, 2006, our backlog of non-rechargeable products was approximately \$15.7 million. The majority of this backlog was related to orders that are expected to ship throughout 2007.

Table of Contents

Rechargeable Products

We have targeted sales of our lithium ion and lithium polymer rechargeable batteries and charging systems through OEM customers, as well as distributors and resellers focused on our target markets. We are currently seeking a number of design wins with OEMs, and believe that our design capabilities, product characteristics and solution integration will drive OEMs to incorporate our batteries into their product offerings, resulting in revenue growth opportunities for us.

We continue to expand our marketing activities as part of our strategic plan to increase sales of our rechargeable batteries for military and communications applications, as well as hand-held devices, wearable devices and other electronic portable equipment. A key part of this expansion includes increasing our battery design and assembly capabilities as well as building our network of distributors and value added distributors throughout the world.

At December 31, 2006, our backlog related to rechargeable products was approximately \$5.9 million.

Communications Accessories

We have targeted sales of our communications accessories, which include power solutions and accessories to support military communications systems such as battery chargers, power supplies, power cables, connector assemblies, RF amplifiers, amplified speakers, equipment mounts, case equipment and integrated communication systems, to military OEMs and military organizations including the U.S. Department of Defense. We sell our products directly and through authorized distributors to OEMs and to military organizations in the U.S. and internationally.

We have been successfully marketing our products to military organizations and OEMs in the U.S. and internationally. These efforts have recently resulted in a number of significant contracts for us. For example, in October 2006, we were awarded a \$9 million contract from a major U.S. defense contractor for integration kits supporting military communications systems for installation on military vehicles. And in February 2007, we were awarded a \$1.4 million contract to supply our tactical repeater systems to an allied military organization.

At December 31, 2006, our backlog related to communications accessories orders was approximately \$12.8 million.

Technology Contracts

We have participated in various programs in which we performed contract research and development. These programs typically have incorporated a profit margin in their structure. Our strategy is to seek development projects that are in harmony with our process and product strategy. As an example, we were awarded a contract with General Dynamics in 2004 to develop portable non-rechargeable and rechargeable batteries and both vehicle and soldier chargers for the Land Warrior program. Although we report technology contracts as a separate business segment, we do not actively market this segment as a revenue source but rather accept technology contract business that supports and advances our overall battery business strategy.

Patents, Trade Secrets and Trademarks

We rely on licenses of technology as well as our patented and unpatented proprietary information, know-how and trade secrets to maintain and develop our commercial position. Although we seek to protect our proprietary information, there can be no assurance that others will not either develop the same or similar information independently or obtain access to our proprietary information, despite our efforts to protect such proprietary information. In addition, there can be no assurance that we would prevail if we asserted our intellectual property rights against third parties, or that third parties will not successfully assert infringement claims against us in the future. We believe, however, that our success is more dependent on the knowledge, ability, experience and technological expertise of our employees, as opposed to the legal protection that our patents and other proprietary rights may or will afford.

We hold 12 patents in the U.S. and foreign countries. Our patents protect technology that makes automated production more cost-effective and protect important competitive features of our products. However, we do not consider our business to be dependent on patent protection.

One of our past rechargeable battery technologies was based, in part, on non-exclusive technology transfer agreements. An initial payment of \$1.0 million was made in 1994 for such technology. While the technology transfer agreement requires royalty and other payments for products that incorporate the licensed technology of 8% of the fair market value of the royalty-bearing product, we no longer utilize this technology and have not paid any royalties since

2002.

10

Table of Contents

In 2003, we entered into an agreement with Saft Groupe S.A. to license certain tooling for certain BA-5390 battery cases. The licensing fee associated with this agreement is essentially one dollar per battery case. The total royalty expense reflected in 2006 was \$39,000. This agreement expires in the year 2017.

All of our employees in the U.S. and all our key employees involved with our technology in England and China are required to enter into agreements providing for confidentiality and the assignment of rights to inventions made by them while employed by us. These agreements also contain certain noncompetition and nonsolicitation provisions effective during the employment term and for varying periods thereafter depending on position and location. There can be no assurance that we will be able to enforce these agreements.

The following are registered trademarks or trademarks of ours: Ultralife[®], Ultralife Thin Cell[®], Ultralife HiRate[®], Ultralife Polymer[®], The New Power Generation[®], LithiumPower[®], SmartCircuit[®], PowerBug[®], We Are Power[®], ABLE[®], and McDowell Research[®].

Manufacturing and Raw Materials

We manufacture our products from raw materials and component parts that we purchase. We have ISO 9001:2000 certification for our manufacturing facilities in Newark, New York, Waco, Texas, Abingdon, England, and Shenzhen, China. In addition, our manufacturing facility in Shenzhen, China is ISO 14001 certified.

We expect that in the future, working capital requirements will fluctuate based on the timing of customer orders, the related need to build inventory in anticipation of orders and actual shipment dates.

Non-Rechargeable Products

Our Newark, New York facility has the capacity to produce in excess of nine million 9-volt batteries per year, approximately 14 million cylindrical cells per year and approximately 500,000 thin cells per year. Our manufacturing facility in Abingdon, England is capable of producing more than one million cylindrical cells per year. This facility also manufactures seawater-activated batteries and assembles customized multi-cell battery packs. Capacity, however, is also related to individual operations and product mix changes can produce bottlenecks in an individual operation, constraining overall capacity. Our ABLE operating unit in Shenzhen, China is capable of producing more than three million cylindrical cells per year. We have acquired new machinery and equipment in areas where production bottlenecks have resulted in the past and believe that we have sufficient capacity in these areas. We continually evaluate our requirements for additional capital equipment, and we believe that the planned increases in our current manufacturing capacity will be adequate to meet foreseeable customer demand. However, with unanticipated growth in demand for our products, demand could exceed capacity, which would require us to install additional capital equipment to meet these incremental needs, which in turn may require us to lease or contract additional space to accommodate needs.

We utilize lithium foil as well as other metals and chemicals to manufacture our batteries. Although we know of only three major suppliers that extrude lithium into foil and provide such foil in the form required by us, we do not anticipate any shortage of lithium foil or any difficulty in obtaining the quantities we require. Certain materials used in our products are available only from a single source or a limited number of sources. Additionally, we may elect to develop relationships with a single or limited number of sources for materials that are otherwise generally available. Although we believe that alternative sources are available to supply materials that could replace materials we use and that, if necessary, we would be able to redesign our products to make use of an alternative product, any interruption in our supply from any supplier that serves currently as our sole source could delay product shipments and adversely affect our financial performance and relationships with our customers. Although we have experienced interruptions of product deliveries by sole source suppliers, none of such interruptions has had a material adverse effect on us. All other raw materials utilized by us are readily available from many sources.

We use various utilities to provide heat, light and power to our facilities. As energy costs rise, we continue to seek ways to reduce these costs and will initiate energy-saving projects at times to assist in this effort. It is possible, however, that rising energy costs may have an adverse effect on our financial results.

The total carrying value of our non-rechargeable products inventory, including raw materials, work in process and finished goods, amounted to approximately \$17.3 million as of December 31, 2006.

Table of Contents

Rechargeable Products

We believe that the raw materials and components utilized for our rechargeable batteries are readily available from many sources. Although we believe that alternative sources are available to supply materials that could replace materials we use, any interruption in our supply from any supplier that serves currently as our sole source could delay product shipments and adversely affect our financial performance and relationships with our customers.

Our Newark, New York facility has the capacity to produce significant volumes of rechargeable batteries, as this segment generally assembles battery packs and chargers and is limited only by physical space and is not constrained by manufacturing equipment capacity. In addition, our facility in Waco, Texas has the capacity to produce significant volumes of chargers.

In December 2004, we recorded an impairment charge of \$1.8 million related to certain polymer rechargeable manufacturing assets based on our determination that these assets would no longer be utilized as a result of a strategic decision to no longer manufacture polymer rechargeable cells. Of the total impairment charge, \$0.7 million related to the net book value of our own assets and \$1.1 million related to the present value of remaining payments for leased assets.

The total carrying value of our rechargeable products inventory, including raw materials, work in process and finished goods, amounted to approximately \$4.3 million as of December 31, 2006.

Communications Accessories

We believe that the raw materials and components utilized by us for our communications accessories, including RF amplifiers, power supplies and integration kits are readily available from many sources. Although we believe that alternative sources are available to supply materials that could replace materials we use, any interruption in our supply from any supplier that serves currently as our sole source could delay product shipments and adversely affect our financial performance and relationships with our customers.

Our Waco, Texas facility has the capacity to produce significant volumes of communication accessories, as this segment generally assembles products and is limited only by physical space and is not constrained by manufacturing equipment capacity.

The total carrying value of our communications accessories inventory, including raw materials, work in process and finished goods, amounted to approximately \$5.8 million as of December 31, 2006.

Research and Development

We concentrate significant resources on research and development activities to improve upon our technological capabilities and to design new products for customers' applications. We conduct our research and development in Newark, New York, Shenzhen, China and Waco, Texas. During 2006, 2005 and 2004 we expended approximately \$5.1 million, \$3.8 million and \$2.6 million, respectively, on research and development. We expect that research and development expenditures in the future will be modestly higher than those in 2006, as new product development initiatives will drive our growth and the acquisition of McDowell has added more product development activity. As in the past, we will continue to make funding decisions for our research and development efforts based upon strategic demand for customer applications.

Non-Rechargeable Products

In 2001, we implemented a plan to develop new cells and batteries for various military applications, utilizing technology developed through work on cell development, funded by the U.S. government in early 2000. We have successfully grown revenues in this market since the product launch in late 2002, and continue to expand our military product portfolio. In 2004, after the successful launch of military batteries, we increased our development activities through the implementation of a Rapid Response Team, to enable us to quickly respond to customer development requests. This has led to a significant increase in the development of products used in commercial applications, which has led to additional revenues in 2005 and 2006.

Rechargeable Products

In 2003, we directed our research and development efforts toward design optimization and customization of rechargeable products to customer specification, including products with a broad range of potential applications. During the past few years, we realigned our development resources to more expeditiously respond to custom development requests

Table of Contents

for battery solutions. In 2006, the rechargeable product portfolio continued to grow as we determine the viability of commercializing certain rechargeable products.

Communications Accessories

In 2006, we acquired McDowell Research, which provides a variety of communications accessories to the military market. We conduct various design and product development operations to meet ever-changing customer demands.

Technology Contracts

The U.S. government sponsors research and development programs designed to improve the performance and safety of existing battery systems and to develop new battery systems. In 2003, we were awarded the initial phase of a government-sponsored contract for battery charging systems. We successfully completed the contract during 2003. In December 2003, we were awarded a Small Business Innovative Research (SBIR) contract for the development of a polymer battery. The development phase of this contract was completed in mid-2004.

In addition, we work to receive contracts with military contractors and commercial customers. For example, in February 2004, we announced that we received a development contract from General Dynamics valued at approximately \$2.7 million. The contract was for lithium non-rechargeable and lithium ion rechargeable batteries, as well as vehicle and soldier-based chargers for the Land Warrior-Stryker Interoperable (LW-SI) program. In 2005, we received an added scope award of this project, increasing the total project to approximately \$4.0 million. Additionally, purchase orders have been received for the products developed under this contract as the batteries have become commercialized. In 2005, we were awarded various development contracts, including the development of a rechargeable battery for a portable radio. In 2006, we completed the General Dynamics contract work and were awarded several small development contracts for rechargeable product development and new generation high-powered cells.

Safety; Regulatory Matters; Environmental Considerations

Certain of the materials utilized in our batteries may pose safety problems if improperly used. We have designed our batteries to minimize safety hazards both in manufacturing and use.

The transportation of non-rechargeable and rechargeable lithium batteries is regulated by the International Civil Aviation Organization (ICAO) and corresponding International Air Transport Association (IATA) Dangerous Goods Regulations and the International Maritime Dangerous Goods Code (IMDG), and in the U.S. by the Department of Transportation's Pipeline and Hazardous Materials Safety Administration (PHMSA). These regulations are based on the UN Recommendations on the Transport of Dangerous Goods Model Regulations and the UN Manual of Tests and Criteria. We currently ship our products pursuant to ICAO, IATA and PHMSA hazardous goods regulations. New regulations that pertain to all lithium battery manufacturers went into effect in 2003 and additional regulations will go into effect in 2009. The regulations require companies to meet certain testing, packaging, labeling and shipping specifications for safety reasons. We comply with all current U.S. and international regulations for the shipment of our products, and will comply with any new regulations that are imposed. We have established our own testing facilities to ensure that we comply with these regulations. If we were unable to comply with the new regulations, however, or if regulations are introduced that limit our ability to transport our products to customers in a cost-effective manner, this could have a material adverse effect on our business, financial condition and results of operations.

The European Union's RoHS (Restriction of Hazardous Substances) Directive places restrictions on the use of certain hazardous substances in electrical and electronic equipment. All applicable products sold in the EU market after July 1, 2006 must pass RoHS compliance. While this directive does not apply to batteries and does not currently affect our military products, should any changes occur in the directive that would affect our products, we will comply with any new regulations that are imposed. Our commercial chargers are in compliance with this directive. Additional EU Directives, entitled the Waste Electrical and Electronic Equipment (WEEE) Directive and the Directive on Batteries and Accumulators and Waste Batteries and Accumulators, impose regulations affecting our non-military products. These directives require that producers or importers of particular classes of electrical goods are financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. These directives assign levels of responsibility to companies doing business in EU markets based on their relative market share. These directives call on each EU member state to enact enabling legislation to implement the directive. As additional EU member states pass enabling legislation our compliance system should be sufficient to meet such

requirements. Our current estimated costs associated with our compliance with these directives based on our current market share are not significant. However, we

Table of Contents

continue to evaluate the impact of these directives as EU member states implement guidance, and actual costs could differ from our current estimates.

China's Management Methods for Controlling Pollution Caused by Electronic Information Products Regulation (China RoHS) provides a broad regulatory framework including similar hazardous substance restrictions as are imposed by the European RoHS Directive, and apply to methods for the control and reduction of pollution and other public hazards to the environment caused during the production, sale, and import of electronic information products in China affecting a broad range of electronic products and parts, with an effective implementation date of March 1, 2007. However, these methods do not apply to the production of products destined for export. Our compliance system should be sufficient to meet such requirements. Our current estimated costs associated with our compliance with this regulation based on our current market share are not significant. However, we continue to evaluate the impact of this regulation, and actual costs could differ from our current estimates.

National, state and local regulations impose various environmental controls on the storage, use and disposal of lithium batteries and of certain chemicals used in the manufacture of lithium batteries. Although we believe that our operations are in substantial compliance with current environmental regulations, there can be no assurance that changes in such laws and regulations will not impose costly compliance requirements on us or otherwise subject us to future liabilities. Moreover, state and local governments may enact additional restrictions relating to the disposal of lithium batteries used by our customers that could adversely affect the demand for our products. There can be no assurance that additional or modified regulations relating to the storage, use and disposal of chemicals used to manufacture batteries, or restricting disposal of batteries will not be imposed. In 2006, we spent approximately \$384,000 on environmental controls, including costs to properly dispose of potentially hazardous waste.

Since non-rechargeable and rechargeable lithium battery chemistries react adversely with water and water vapor, certain of our manufacturing processes must be performed in a controlled environment with low relative humidity. Our Newark, New York and UK facilities contain dry rooms as well as specialized air-drying equipment.

Non-Rechargeable Products

Our non-rechargeable battery products incorporate lithium metal, which reacts with water and may cause fires if not handled properly. In the past, we have experienced fires that have temporarily interrupted certain manufacturing operations. We believe that we have adequate fire insurance, including business interruption insurance, to protect against fire losses in our facilities.

Our 9-volt battery, among other sizes, is designed to conform to the dimensional and electrical standards of the American National Standards Institute, and the 9-volt battery and a range of 3-volt cells are recognized under the Underwriters Laboratories, Inc. Component Recognition Program.

Rechargeable Products

We are not currently aware of any regulatory requirements regarding the disposal of lithium polymer or lithium ion rechargeable cells and batteries.

Communications Accessories

We are not currently aware of any other regulatory requirements regarding the disposal of communications accessories.

Corporate

Please refer to the description of the environmental remediation for our Newark, New York facility set forth in Item 3, Legal Proceedings of this report.

Competition

Competition in the battery industry is, and is expected to remain, intense. The competition ranges from development stage companies to major domestic and international companies, many of which have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than ours. We compete against

Table of Contents

companies producing lithium batteries as well as other non-rechargeable and rechargeable battery technologies. We compete on the basis of design flexibility, performance and reliability. There can be no assurance that our technology and products will not be rendered obsolete by developments in competing technologies that are currently under development or that may be developed in the future or that our competitors will not market competing products that obtain market acceptance more rapidly than ours.

Historically, although other entities may attempt to take advantage of the growth of the lithium battery market, the lithium battery industry has certain technological and economic barriers to entry. The development of technology, equipment and manufacturing techniques and the operation of a facility for the automated production of lithium batteries require large capital expenditures, which may deter new entrants from commencing production. Through our experience in battery manufacturing, we have also developed expertise, which we believe would be difficult to reproduce without substantial time and expense in the non-rechargeable battery market.

Competition in the defense communications accessories market in which we participate is concentrated among a number of suppliers ranging from small distributors who purchase and resell products manufactured by others to major domestic and international defense contractors, which have financial, technical, marketing, sales, manufacturing, distribution and other resources significantly greater than those of ours. We compete on the basis of product design, functionality, flexibility, performance and reliability. There can be no assurance that our technology and products will not be rendered obsolete by developments in competing technologies that are currently under development or that may be developed in the future or that our competitors will not market competing products that obtain market acceptance more rapidly than ours.

Employees

As of February 3, 2007, we employed a total of 1,078 permanent and temporary employees: 48 in research and development, 927 in production and 103 in sales and administration. Of the total, 691 are employed in the U.S., 55 in Europe and 332 in China. None of our employees is represented by a labor union. We consider our employee relations to be satisfactory.

Table of Contents

ITEM 1A. RISK FACTORS

A decline in demand for products using our batteries could reduce demand for our batteries.

A substantial portion of our business depends on the continued demand for products using our batteries and communications accessories sold by original equipment manufacturers, OEMs. Our success depends significantly upon the success of those OEMs' products in the marketplace. We sell much of our products through OEM supply agreements and contracts. While OEM agreements and contracts contain volume-based pricing based on expected volumes, industry practices dictate that pricing is rarely adjusted retroactively when contract volumes are not achieved. Every effort is made to adjust future prices accordingly, but the ability to adjust prices is generally based on market conditions. We are subject to many risks beyond our control that influence the success or failure of a particular product manufactured by an OEM, including:

competition faced by the OEM in its particular industry,

market acceptance of the OEM's product,

the engineering, sales, marketing and management capabilities of the OEM,

technical challenges unrelated to our technology or products faced by the OEM in developing its products, and

the financial and other resources of the OEM.

For instance, in the year ended December 31, 2006, 27% of our revenues were comprised of sales of our 9-volt batteries, and of this, approximately 47% pertained to sales to smoke alarm OEMs. Similarly, in the year ended December 31, 2005, 32% of our revenues were comprised of sales of our 9-volt batteries, and of this, approximately 21% pertained to sales to smoke alarm OEMs. In 2004, 22% of our revenues were comprised of sales of our 9-volt batteries, and of this, approximately 19% pertained to smoke alarm OEMs. If the retail demand for long-life smoke alarms decreases significantly, this could have a material adverse effect on our business, financial condition and results of operations.

Our growth and expansion strategy could strain or overwhelm our resources.

Rapid growth of our business could significantly strain management, operations and technical resources. If we are successful in obtaining rapid market growth of our products, we will be required to deliver large volumes of quality products to customers on a timely basis at a reasonable cost to those customers. For example, the large contracts recently received from the U.S. military for our batteries using cylindrical cells could strain the current capacity capabilities of our U.K. facility and require additional equipment and time to build a sufficient support infrastructure at that location. This demand could also create working capital issues for us, as we may need increased liquidity to fund purchases of raw materials and supplies. We cannot assure, however, that business will grow rapidly or that our efforts to expand manufacturing and quality control activities will be successful or that we will be able to satisfy commercial scale production requirements on a timely and cost-effective basis.

In addition to organic growth, we have recently adopted a strategy to grow our business through the acquisition of complementary businesses. Our inability to acquire such businesses, or increased competition which could increase our acquisition costs, could impede our ability to close identified acquisitions, which could adversely affect our growth strategy and results of operations. In addition, our inability to improve the operating margins of businesses we acquire or operate such acquired businesses profitably or to effectively integrate the operations of those acquired businesses could also adversely affect our business and results of operations.

In 2006, we acquired the businesses of McDowell Research and ABLE New Energy Co., which added new facilities and operations to our overall business. We have faced some initial operational challenges at McDowell that are requiring a greater amount of management's time to resolve than we had expected. Our management team remains essentially the same, however, which places an increased burden and responsibility on a team which had little capacity to absorb such added responsibility. In addition, these acquisitions have strained our production capacity, which could have an adverse impact on our ability to meet customer demands for product delivery.

We will also be required to continue to improve our operations, management and financial systems and controls. The failure to manage growth and expansion effectively could have an adverse effect on our business, financial condition, results of operations, and liquidity.

Table of Contents

Our recent acquisitions may not result in the revenue growth that we expect. In addition, we may not be able to successfully integrate our recent acquisitions.

During the second quarter of 2006, we acquired ABLE New Energy Co., Ltd., a manufacturer of lithium batteries located in Shenzhen, China, and during the beginning of the third quarter of 2006, we acquired substantially all of the assets of McDowell Research, Ltd., a manufacturer of military communications accessories located in Waco, Texas. We have begun the process of integrating these acquisitions into our business and assimilating their operations, services, products and personnel with our management policies, procedures and strategies. We cannot be sure that we will achieve the benefits of revenue growth that we expect from these acquisitions or that we will not incur unforeseen additional costs or expenses in connection with these acquisitions. To effectively manage our expected future growth, we must continue to successfully manage our integration of these companies and continue to improve our operational systems, internal procedures, accounts receivable and management, financial and operational controls. If we fail in any of these areas, our business could be adversely affected.

The U.S. government can audit our contracts with the U.S. military and, under certain circumstances, can adjust the economic terms of those contracts.

A significant portion of our business comes from sales of product to the U.S. military through various government contracts. These contracts are subject to procurement laws and regulations that lay out uniform policies and procedures for acquiring goods and services by the U.S. government. The regulations also contain guidelines for managing contracts after they are awarded, including conditions under which contracts may be terminated, in whole or in part, at the government's convenience or for default. Failure to comply with the procurement laws or regulations can result in civil, criminal or administrative proceedings involving fines, penalties, suspension of payments, or suspension or disbarment from government contracting or subcontracting for a period of time.

We have had certain exigent, non-bid contracts with the U.S. government that have been subject to an audit and final price adjustment and have resulted in decreased margins compared with the original terms of the contracts. As of December 31, 2006, there were no outstanding exigent contracts with the government. As part of its due diligence, the U.S. government has conducted post-audits of the completed exigent contracts to ensure that information used in supporting the pricing of exigent contracts did not differ materially from actual results. In September 2005, the Defense Contracting Audit Agency, or DCAA, presented its findings related to the audits of three of the exigent contracts, suggesting a potential pricing adjustment of approximately \$1,400,000 related to reductions in the cost of materials that occurred prior to the final negotiation of these contracts. We have reviewed these audit reports, have submitted our response to these audits and believe, taken as a whole, the proposed audit adjustments can be offset with the consideration of other compensating cost increases that occurred prior to the final negotiation of the contracts. While we believe that potential exposure exists relating to any final negotiation of these proposed adjustments, we cannot reasonably estimate what, if any, adjustment may result when finalized. Such adjustments could reduce margins and have an adverse effect on our business, financial condition and results of operations.

We are subject to the contract rules and procedures of the U.S. government because we do business with the U.S. military. These rules and procedures create significant risks and uncertainties for us that are not usually present in contracts with private parties.

We will continue to develop both non-rechargeable and rechargeable battery products and related products to meet the needs of the U.S. military. We remain confident in our abilities to compete successfully in solicitations for awards of contracts for these products, as well as meeting delivery schedules for orders released under contract. The receipt of an award, however, does not usually result in the immediate release of an order. Any delay of solicitations or anticipated purchase orders by, or future failure of, the U.S. government to purchase products manufactured by us could have a material adverse effect on our business, financial condition and results of operations. Additionally, we are typically required to successfully meet contractual specifications and to pass various qualification-testing for the products under contract by the military. Our inability to pass these tests in a timely fashion could have a material adverse effect on our business, financial condition and results of operations. When a government contract is awarded, there is a government procedure that permits unsuccessful companies to formally protest such award if they believe they were unjustly treated in the evaluation process. As a result of these protests, the government is precluded from proceeding under these contracts until the protests are resolved. A prolonged delay in the resolution of a protest, or a

reversal of an award resulting from such a protest could have a material adverse effect on our business, financial condition and results of operations.

Many of our products are sold for ultimate use overseas in countries where the U.S. military is deployed. Government decisions regarding military deployment and budget allocations to fund overseas military operations have an impact on the demand for our products.

In the years ended December 31, 2006, 2005 and 2004, approximately 47%, 45%, and 65%, respectively, of our revenues were comprised of sales made directly or indirectly to the U.S. military. If the demand for products

Table of Contents

from the U.S. military were to decrease significantly, this could have a material adverse effect on our business, financial condition and results of operations.

A significant portion of our revenues is derived from contracts with the U.S. military or OEMs that supply the U.S. military.

We have one major customer, the U.S. Department of Defense, that comprised 20%, 25%, and 56% of our revenue in the years ended December 31, 2006, 2005, and 2004, respectively. There were no other customers that comprised greater than 10% of our total revenues in those years.

We have one customer that comprised 22% of our trade accounts receivable as of December 31, 2006. There were no other customers that comprised greater than 10% of our total trade accounts receivable as of December 31, 2006. In addition, there were no customers that comprised greater than 10% of our total trade accounts receivable as of December 31, 2005.

Currently, we do not experience significant seasonal trends in our product revenues. However, a downturn in the U.S. economy, which affects retail sales and which could result in fewer sales of smoke detectors to consumers, could potentially result in lower sales in our non-rechargeable battery market segment. The smoke detector OEM market segment comprised approximately 17% of total non-rechargeable revenues in 2006. Additionally, a lower demand from the U.S. and U.K. governments could result in lower sales to military and government users.

We generally do not distribute our products to a concentrated geographical area nor is there a significant concentration of credit risks arising from individuals or groups of customers engaged in similar activities, or who have similar economic characteristics. While sales to the U.S. military have been substantial during 2006, we do not consider this customer to be a significant credit risk. We do not normally obtain collateral on trade accounts receivable.

Our efforts to develop new commercial applications for our products could fail.

Although we are involved with developing certain products for new commercial applications, such as back-up batteries for the automotive telematics market, batteries for emergency locator transmitters and RF amplifiers for portable radio communications, we cannot assure that volume acceptance of our products will occur due to the highly competitive nature of the business. There are many new product and technology entrants into the marketplace, and we must continually reassess the market segments in which our products can be successful and seek to engage customers in these segments that will adopt our products for use in their products. In addition, these companies must be successful with their products in their markets for us to gain increased business. Increased competition, failure to gain customer acceptance of products, the introduction of disruptive technologies or failure of our customers in their markets could have a further adverse effect on our business.

We may incur significant costs because of the warranties we supply with our products.

With respect to our battery products, we typically offer warranties against any defects due to product malfunction or workmanship for a period up to one year from the date of purchase. With respect to our communications accessory products, we typically offer a four-year warranty. We also offer a 10-year warranty on our 9-volt batteries that are used in ionization-type smoke alarms. We provide for a reserve for these potential warranty expenses, which is based on an analysis of historical warranty issues. There is no assurance that future warranty claims will be consistent with past history, and in the event we experience a significant increase in warranty claims, there is no assurance that our reserves will be sufficient. This could have a material adverse effect on our business, financial condition and results of operations.

We may incur significant costs because of known and unknown environmental matters.

Due to the high energy density inherent in lithium batteries, our batteries can pose certain safety risks, including the risk of fire. Although we incorporate safety procedures in research, development, manufacturing processes and the transportation of batteries that are designed to minimize safety risks, we cannot assure that accidents will not occur. Although we currently carry insurance policies which cover loss of the plant and machinery, leasehold improvements, inventory and business interruption, any accident, whether at the manufacturing facilities or from the use of the products, may result in significant production delays or claims for damages resulting from injuries. Although we maintain what we believe to be sufficient casualty and liability insurance coverage to protect against such occurrences, these types of losses could have a material adverse effect on our business, financial condition and results of

operations.

National, state and local laws impose various environmental controls on the manufacture, storage, use and disposal of lithium batteries and/or of certain chemicals used in the manufacture of lithium batteries. Although we believe that our

Table of Contents

operations are in substantial compliance with current environmental regulations and that, except as noted below, there are no environmental conditions that will require material expenditures for clean-up at the present or former facilities or at facilities to which we have sent waste for disposal, there can be no assurance that changes in such laws and regulations will not impose costly compliance requirements on us or otherwise subject us to future liabilities.

Moreover, state and local governments may enact additional restrictions relating to the disposal of lithium batteries used by our customers that could have a material adverse effect on our business, financial condition and results of operations. In addition, the U.S. Department of Transportation, or DOT, and certain international regulatory agencies that consider lithium to be a hazardous material regulate the transportation of lithium-ion batteries and batteries that contain lithium metal. We currently ship lithium batteries in accordance with regulations established by the DOT and other international regulatory agencies. There can be no assurance that additional or modified regulations relating to the manufacture, transportation, storage, use and disposal of materials used to manufacture our batteries or restricting disposal of batteries will not be imposed or how these regulations will affect us or our customers.

In conjunction with our purchase/lease of our Newark, New York facility in 1998, we entered into a payment-in-lieu of tax agreement, which provides us with real estate tax concessions upon meeting certain conditions. In connection with this agreement, a consulting firm performed a Phase I and II Environmental Site Assessment, which revealed the existence of contaminated soil and ground water around one of the buildings. We have submitted various work plans to the New York State Department of Environmental Conservation, or NYSDEC, regarding further environmental testing and sampling in order to determine the scope of any additional remediation. We subsequently met with the NYSDEC in March 2006 to present the test results. In November 2006, the NYSDEC completed its review of the final investigation report and requested additional groundwater, soil and sediment sampling. A work plan to address the additional investigation is being developed. The ultimate resolution of this matter may result in us incurring additional costs.

The future regulatory direction of the RoHS and WEEE Directives, as they pertain to our products, is uncertain. Their potential impact to our business would become material if battery packs were to be included in new guidelines and we were unable to procure materials in a timely manner. Other associated risks under this scenario include excess or inventory risk due to a write off of non-compliant inventory. We continue to monitor the regulatory activity of the EU to ascertain such risks.

China's Management Methods for Controlling Pollution Caused by Electronic Information Products Regulation (China RoHS) provides a broad regulatory framework including similar hazardous substance restrictions as are imposed by the European RoHS Directive, and apply to methods for the control and reduction of pollution and other public hazards to the environment caused during the production, sale, and import of electronic information products in China affecting a broad range of electronic products and parts, with an effective implementation date of March 1, 2007. However, these methods do not apply to the production of products destined for export. Our compliance system should be sufficient to meet such requirements. Our current estimated costs associated with our compliance with this regulation based on our current market share are not significant. However, we continue to evaluate the impact of this regulation, and actual costs could differ from our current estimates.

Our inability to comply with changes to the regulations for the shipment of our products could limit our ability to transport our products to customers in a cost-effective manner

The transportation of non-rechargeable and rechargeable lithium batteries is regulated by the International Civil Aviation Organization (ICAO), and corresponding International Air Transport Association (IATA), Dangerous Goods Regulations and the International Maritime Dangerous Goods Code (IMDG), and in the U.S. by the Department of Transportation's Pipeline and Hazardous Materials Safety Administration (PHMSA). These regulations are based on the United Nations (UN) Recommendations on the Transport of Dangerous Goods Model Regulations and the UN Manual of Tests and Criteria. We currently ship our products pursuant to ICAO, IATA and PHMSA hazardous goods regulations. New regulations that pertain to all lithium battery manufacturers went into effect in 2003 and 2004, and additional regulations will go into effect in 2009. The regulations require companies to meet certain testing, packaging, labeling and shipping specifications for safety reasons. We comply with all current U.S. and international regulations for the shipment of our products, and will comply with any new regulations that are imposed. We have established our own testing facilities to ensure that we comply with these regulations. If we were unable to comply

with the new regulations, however, or if regulations are introduced that limit our ability to transport our products to customers in a cost-effective manner, this could have a material adverse effect on our business, financial condition and results of operations.

Our supply of raw materials could be disrupted.

Certain materials used in our products are available only from a single or a limited number of suppliers. As such, some materials could become in short supply resulting in limited availability and/or increased costs. Additionally, we may

Table of Contents

elect to develop relationships with a single or limited number of suppliers for materials that are otherwise generally available. Due to our involvement with supplying military batteries to the government, we could receive a government preference to continue to obtain critical supplies to meet military production needs. However, if the government did not provide us with a government preference in such circumstances, the difficulty in obtaining supplies could have a material adverse effect on our financial results. Although we believe that alternative suppliers are available to supply materials that could replace materials currently used and that, if necessary, we would be able to redesign our products to make use of such alternatives, any interruption in the supply from any supplier that serves as a sole source could delay product shipments and have a material adverse effect on our business, financial condition and results of operations. Although we have experienced interruptions of product deliveries by sole source suppliers, these interruptions have not typically had a material adverse effect on our business, financial condition and results of operations. However, as we increased production at our Waco, Texas facility in the fourth quarter of 2006, our operations were hindered by certain suppliers' inability to provide timely deliveries of materials. We cannot guarantee that we will not experience a material interruption of product deliveries from sole source suppliers. Additionally, we could face increasing pricing pressure from our suppliers dependent upon volume, due to rising costs by these suppliers that could be passed on to us in higher prices for our raw materials, which could have a material effect on our business, financial condition and results of operations.

Our inability to protect our proprietary and intellectual property could allow our competitors and others to produce competing products based on our proprietary and intellectual property rights.

Our success depends more on the knowledge, ability, experience and technological expertise of our employees than on the legal protection of patents and other proprietary rights. We claim proprietary rights in various unpatented technologies, know-how, trade secrets and trademarks relating to products and manufacturing processes. We cannot guarantee the degree of protection these various claims may or will afford, or that competitors will not independently develop or patent technologies that are substantially equivalent or superior to our technology. We protect our proprietary rights in our products and operations through contractual obligations, including nondisclosure agreements with certain employees, customers, consultants and strategic partners. There can be no assurance as to the degree of protection these contractual measures may or will afford. We have had patents issued and have patent applications pending in the U.S. and elsewhere. We cannot assure (1) that patents will be issued from any pending applications, or that the claims allowed under any patents will be sufficiently broad to protect our technology, (2) that any patents issued to us will not be challenged, invalidated or circumvented, or (3) as to the degree or adequacy of protection any patents or patent applications may or will afford. If we are found to be infringing third party patents, there can be no assurance that we will be able to obtain licenses with respect to such patents on acceptable terms, if at all. The failure to obtain necessary licenses could delay product shipment or the introduction of new products, and cost