

AIR INDUSTRIES GROUP
Form 10-K/A
April 08, 2019

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

Annual Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended: December 31, 2018

Transition Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File No. 001-35927

AIR INDUSTRIES GROUP

(Name of small business issuer in its charter)

Nevada 80-0948413
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

1460 Fifth Avenue, Bay Shore, New York 11706

(Address of Principal Executive Offices)

(631) 968-5000

(Registrant's Telephone Number, Including Area Code)

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

Name of Exchange on which Registered

NYSE AMERICAN

Title of Each Class

Common Stock, par value \$0.001

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 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 past 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 whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated

Edgar Filing: AIR INDUSTRIES GROUP - Form 10-K/A

filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer Non-Accelerated Filer Accelerated Filer Smaller Reporting Company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act.

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

As of June 30, 2018, the aggregate market value of our common stock held by non-affiliates was \$30,045,613, based on 16,692,007 shares of outstanding common stock held by non-affiliates, and a price of \$1.80 per share, which was the last reported sale price of our common stock on the NYSE American on that date.

There were a total of 28,655,572 shares of the registrant’s common stock outstanding as of March 27, 2019.

DOCUMENTS INCORPORATED BY REFERENCE: None

Explanatory Note

This amendment is being filed to include the information required by Part III of Form 10-K previously omitted pursuant to General Instruction G(3) to Form 10-K and to correct typographical errors in the original filing of this Form 10-K filed on April 1, 2019.

AIR INDUSTRIES GROUP

FORM 10-K/A

For the Fiscal Year Ended December 31, 2018

	Page No.
<u>PART I</u>	
Item 1. <u>Business</u>	1
Item 1A. <u>Risk Factors</u>	5
Item 2. <u>Properties</u>	13
Item 3. <u>Legal Proceedings</u>	13
Item 4. <u>Mine Safety Disclosures</u>	13
<u>PART II</u>	
Item 5. <u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	14
Item 6. <u>Selected Financial Data</u>	14
Item 7. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operation</u>	14
Item 8. <u>Financial Statements and Supplementary Data</u>	29
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	29
Item 9A. <u>Controls and Procedures</u>	29
Item 9B. <u>Other Information</u>	30
<u>PART III</u>	
Item 10. <u>Directors, Executive Officers, and Corporate Governance</u>	31
Item 11. <u>Executive Compensation</u>	36
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	38
Item 13. <u>Certain Relationships and Related Transactions and Director Independence</u>	39
Item 14. <u>Principal Accountant Fees and Services</u>	41
<u>PART IV</u>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	42
<u>Consolidated Financial Statements</u>	F-1

Cautionary Note Regarding Forward-Looking Statements

This report contains forward-looking statements. Certain of the matters discussed herein concerning, among other items, our operations, cash flows, financial position and economic performance including, in particular, future sales, product demand, competition and the effect of economic conditions, include forward-looking statements.

Forward-looking statements are predictive in nature and can be identified by the fact that they do not relate strictly to historical or current facts and generally include words such as “expects,” “anticipates,” “intends,” “plans,” “believes,” “estimates” and similar expressions. Although we believe that these statements are based upon reasonable assumptions, including projections of orders, sales, operating margins, earnings, cash flow, research and development costs, working capital, capital expenditures, distribution channels, profitability, new products, adequacy of funds from operations, and general economic conditions, these statements and other projections contained herein expressing opinions about future outcomes and non-historical information, are subject to uncertainties and, therefore, there is no assurance that the outcomes expressed in these statements will be achieved.

Investors are cautioned that forward-looking statements are not guarantees of future performance and actual results or developments may differ materially from the expectations expressed in forward-looking statements contained herein. Given these uncertainties, you should not place any reliance on these forward-looking statements which speak only as of the date hereof. See “Risk factors” for a discussion of factors that could cause our actual results to differ from those expressed or implied by forward-looking statements.

We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events or otherwise, except as may be required under applicable securities laws. You are advised, however, to consult any additional disclosures we make in our reports filed with the Securities and Exchange Commission (“SEC”).

PART I

ITEM 1. BUSINESS

Introduction

As used in this report, unless otherwise stated or the context requires otherwise, the “Company” and terms such as “we,” “us” “our,” and “AIRI” refer to Air Industries Group, a Nevada corporation, and its directly and indirectly wholly-owned subsidiaries.

We are an aerospace and defense company. We manufacture and design structural parts and assemblies that focus on flight safety, including landing gear, arresting gear, engine mounts, flight controls, throttle quadrants, components for jet engines and other components. Our products are currently deployed on a wide range of high profile military and commercial aircraft including Sikorsky’s UH-60 Black Hawk, Lockheed Martin’s F-35 Joint Strike Fighter, Northrop Grumman’s E2 Hawkeye, Boeing’s 777, Airbus’ 380 commercial airliners, the US Navy F-18 and USAF F-16 fighter aircraft. Our Turbine Engine sector makes components for jet engines that are used on the USAF F-15, the Airbus A-330 and A-380, and the Boeing 777, in addition to a number of ground turbine applications.

We became a public company in 2005 when our net sales were approximately \$30 million. Air Industries Machining, Corp. (“AIM”), our principal subsidiary, has manufactured components and subassemblies for the defense and commercial aerospace industry for over 50 years and has established long-term relationships with leading defense and aerospace manufacturers

In response to recent operating losses and their impact on our working capital, we have repositioned our business through the sale and liquidation of certain businesses we acquired since becoming a public company. We also consolidated our headquarters and the operations of our subsidiaries, Air Industries Machining and Nassau Tool Works, at our corporate campus in Bay Shore, New York, allowing us to re-focus our operations on our core competencies.

On December 20, 2018, we completed the sale of all of the outstanding shares of our subsidiary, Welding Metallurgy, Inc., which included our subsidiaries Miller Stuart, Woodbine, Decimal and Compac Development Corp. (collectively, the “WMI Group”), to CPI Aerostructures, Inc. (“CPI”) for a purchase price of \$9,000,000, net of a working capital adjustment of \$(1,093,000), pursuant to a Stock Purchase Agreement dated as of March 21, 2018. On March

19, 2019, we received a notice from CPI claiming that the working capital deficit used to compute the purchase price was understated which we intend to contest.

On November 8, 2018 EPC received formal notice from the Department of the Navy that EPC was barred from future government contracts until October 29, 2020. Management chose to implement its plan to complete existing contracts that had already been awarded and closed EPC by March 31, 2019.

We now conduct our operations through the following wholly-owned subsidiaries: Air Industries Machining (“AIM”); Nassau Tool Works (“NTW”); and The Sterling Engineering Corporation (“Sterling”). AIM and NTW comprise our Complex Machining segment and Sterling represents our Turbine Engine Components segment.

In addition to repositioning our business to obtain profitability and positive cash flow, we remain resolute on meeting customers’ needs and have and continue to align production schedules to meet the needs of customers. We believe that an unyielding focus on our customers will allow us to execute on our existing backlog in a timely fashion and take on additional commitments. We are pleased with our progress and the positive responses received from our customers.

Our Market

We operate primarily in the military and, to a lesser degree, commercial aviation industries. Defense revenues represent a preponderance of our sales. Our principal customers include Sikorsky Aircraft, Goodrich Landing Gear Systems, Northrop Grumman, the United States Department of Defense, GKN Aerospace, Lockheed, Boeing, Raytheon, Piper Aircraft, M7 Aerospace, Vought Aerospace, Ametek/Hughes-Treitler and Airbus.

Our products are incorporated into many aircraft platforms, the majority of which remain in production, and of which there are a substantial number of operating aircraft in fleets maintained by the military and commercial airlines. We believe that we are the largest supplier of flight critical parts to Sikorsky's Black Hawk helicopter. We have made, or currently make, or have been awarded, products for Lockheed Martin's F-35 Joint Strike Fighter, Northrop Grumman's E2 Hawkeye, Boeing's 777, Airbus' 380 commercial airliners, and the US Navy F-18 and USAF F-16 fighter aircraft. Our Turbine Engine Components segment makes components for jet engines that are used on the USAF F-15, the Airbus A-330 and A-380, and the Boeing 777, in addition to a number of non-military ground turbine applications.

Many of our products are "flight critical," essential to aircraft performance and safety on takeoff, during flight and when landing. These products require advanced certifications as a condition to being a supplier. For many of our products we are the sole or one of a limited number of sources of supply. Many of the parts we supply are subject to wear and tear or fatigue and are routinely replaced on aircraft on a time in service or flight cycle basis. Replacement demand for these products will continue, albeit at perhaps a lower rate, so long as an aircraft remains in service, which is usually many years after production has stopped.

Sales and Marketing

Our approach to sales and marketing can be best understood through the concept of customer alignment. The aerospace industry is dominated by a small number of large prime contractors and equipment manufacturers. These customers rely heavily upon subcontractors to supply quality parts meeting specifications on a timely and cost effective basis. These customers and other customers we supply routinely rate their suppliers based on a variety of performance factors. One of our principal goals is to be highly rated and thus relied upon by all of our customers.

The large prime contractors are increasingly seeking subcontractors who can supply and are qualified to integrate the fabrication of larger, more complex and more complete subassemblies. We seek to position ourselves within the supply chain of these contractors and manufacturers to be selected for subcontracted projects. Successful positioning requires that we qualify to be a preferred supplier by achieving and maintaining independent third-party quality approval certifications, specific customer quality system approvals and top supplier ratings through strong

performance on existing contracts.

During our sales and marketing efforts we let customers know that we have employees with the talent and experience to manage the manufacture of sections of aircraft structures to be delivered to the final assembly phase of the aircraft manufacturing cycle, and customers have now engaged us for these services.

Initial contracts are usually obtained through competitive bidding against other qualified subcontractors, while follow-on contracts are usually retained by successfully performing initial contracts. Our long-term business generally benefits from barriers to entry resulting from investments, certifications, familiarization with the needs and systems of customers, and manufacturing techniques developed during the initial manufacturing phase. We endeavor to develop each of our relationships to one of a “partnership” where we participate in the resolution of pre-production design and build issues, and initial contracts are obtained as single source awards and follow-on pricing is determined through negotiations.

Our Backlog

The production cycle of products we manufacture can extend from several months to a year or longer. This gives rise to significant backlogs as customers must order product with sufficient lead time to ensure timely delivery.

We have a number of long-term multi-year General Purchase Agreements or GPA's with several of our customers. These agreements specify part numbers, specifications and prices of the covered products for an agreed upon period, but do not authorize immediate production and shipment. Shipments are authorized periodically by the customer to fit its production schedule. In late 2017, we received a renewal of our multi-year contract with Sikorsky, MY9, for the years 2018 to 2023. This contract is for \$47 million worth of product during this period. This is the third multi-year contract award we have received from Sikorsky.

Our "firm backlog" includes only fully authorized orders received for products to be delivered within the forward 18-month period. As of February 28, 2019, our 18-month "firm funded backlog" was approximately \$92.4 million.

Competition

Winning a new contract is highly competitive. We manufacture to customer design specifications, and we compete against companies that have similar manufacturing capabilities in a global marketplace. Consequently, the ability to obtain contracts requires providing quality products at competitive prices. To accomplish this requires that we strive for continuous improvement in our capabilities to assure our competitiveness and provide value to our customers. Our marketing strategy involves developing long-term ongoing working relationships with customers. These relationships enable us to develop entry barriers to would-be competitors by establishing and maintaining advanced quality approvals, certifications and tooling investments that are difficult and expensive to duplicate. Many of our competitors are well-established subcontractors engaged in the supply of aircraft parts and components to prime military contractors and commercial aviation manufacturers. Among our competitors are: Monitor Aerospace, a division of Stellex Aerospace; Hydromil, a division of Triumph Aerospace Group; Heroux Aerospace and Ellanef Manufacturing, a division of Magellan Corporation.

Many of our competitors are larger enterprises or divisions of significantly larger companies having greater financial, physical and technical resources, and the capabilities to timelier respond under much larger contracts.

Raw Materials and Replacement Parts

The manufacturing process for certain products, particularly those for which we serve as product integrator, requires significant purchases of raw materials, hardware and subcontracted details. As a result, much of our success in profitably meeting customer demand for these products requires efficient and effective subcontract management. Price and availability of many raw materials utilized in the aerospace industry are subject to volatile global markets and political conditions. Most suppliers of raw materials are unwilling to commit to long-term contracts at fixed prices. This is a substantial risk as our strategy often involves long term fixed price commitments to our customers. Recently, we have had difficulties in securing timely shipments of raw materials and components from certain vendors due to our liquidity problems.

Employees

As of March 22, 2019, we employed approximately 209 people. Of these, approximately 32 were in administration, 3 were in sales and procurement, and 174 were in manufacturing.

Air Industries Machining is a party to a collective bargaining agreement (the “Agreement”) with the United Service Workers, IUJAT, Local 355 (the “Union”) with which we believe we maintain good relations. The Agreement was renewed as of December 31, 2018 and expires on December 31, 2021 and covers all of AIM’s production personnel, of which there are approximately 107 people. In light of the continuing consolidation and integration of NTW business with AIM, we intend to add more employees to the Union during 2019. AIM is required to make a monthly contribution to each of the Union’s United Welfare Fund and the United Services Worker’s Security Fund. This is the only pension benefit required by the Agreement and the Company is not obligated for any future defined benefit to retirees. The Agreement contains a “no-strike” clause, whereby, during the term of the Agreement, the Union will not strike and AIM will not lockout its employees.

All of our employees are covered under a co-employment agreement with Extensis, Inc., a professional employer organization that provides out-sourced human resource services.

Regulations

Environmental Regulation; Employee Safety

We are subject to regulations administered by the United States Environmental Protection Agency, the Occupational Safety and Health Administration, various state agencies and county and local authorities acting in cooperation with federal and state authorities. Among other things, these regulatory bodies impose restrictions that require us to control air, soil and water pollution, to protect against occupational exposure to chemicals, including health and safety risks, and to require notification or reporting of the storage, use and release of certain hazardous chemicals and substances. The extensive regulatory framework imposes compliance burdens and financial and operating risks on us. Governmental authorities have the power to enforce compliance with these regulations and to obtain injunctions or impose civil and criminal fines in the case of violations.

The Comprehensive Environmental Response, Compensation and Liability Act of 1980 (“CERCLA”) imposes strict, joint and several liability on the present and former owners and operators of facilities that release hazardous substances into the environment. The Resource Conservation and Recovery Act of 1976 (“RCRA”) regulates the generation, transportation, treatment, storage and disposal of hazardous waste. New York and Connecticut, the states where our production facilities are located, also have stringent laws and regulations governing the handling, storage and disposal of hazardous substances, counterparts of CERCLA and RCRA. In addition, the Occupational Safety and Health Act, which requires employers to provide a place of employment that is free from recognized and preventable hazards that are likely to cause serious physical harm to employees, obligates employers to provide notice to employees regarding the presence of hazardous chemicals and to train employees in the use of such substances.

Federal Aviation Administration

We are subject to regulation by the Federal Aviation Administration (“FAA”) under the provisions of the Federal Aviation Act of 1958, as amended. The FAA prescribes standards and licensing requirements for aircraft and aircraft components. We are subject to inspections by the FAA and may be subjected to fines and other penalties (including orders to cease production) for noncompliance with FAA regulations. Our failure to comply with applicable regulations could result in the termination of or our disqualification from some of our contracts, which could have a material adverse effect on our operations. We have never been subject to such fines or disqualifications.

Government Contract Compliance

Our government contracts and those of many of our customers are subject to the procurement rules and regulations of the United States government, including the Federal Acquisition Regulations. Many of the contract terms are dictated by these rules and regulations. During and after the fulfillment of a government contract, we may be audited in respect of the direct and allocated indirect costs attributed to the project. These audits may result in adjustments to our contract costs. Additionally, we may be subject to U.S. government inquiries and investigations because of our participation in government procurement. Any inquiry or investigation can result in fines or limitations on our ability to continue to bid for government contracts and fulfill existing contracts.

We believe that we are in compliance with all federal, state and local laws and regulations governing our operations and have obtained all material licenses and permits required for the operation of our business.

ITEM 1A. RISK FACTORS

The purchase of our common stock involves a very high degree of risk.

In evaluating our common stock and our business, you should carefully consider the risks and uncertainties described below and the other information and our consolidated financial statements and related notes included herein. If any of the events described in the risks below actually occurs, our financial condition or operating results may be materially and adversely affected, the price of our common stock may decline, perhaps significantly, and you could lose all or a part of your investment.

The risks below can be characterized into three groups:

- 1) Risks related to our business, including risks specific to the defense and aerospace industry:
- 2) Risks arising from our indebtedness; and
- 3) Risks related to our common stock.

Risks Related to Our Business

We incurred substantial net losses in 2018 and 2017 and may not be able to continue to operate as a going concern.

We suffered net losses from operations of \$5,963,000 and \$12,758,000 and net losses of \$10,992,000 and \$22,551,000 for the years ended December 31, 2018 and 2017, respectively. We also had negative cash flows from operations for the year ended December 31, 2017. In 2018 we sold our subsidiary WMI for \$9,000,000, net of a working capital adjustment of \$(1,093,000). Of the net purchase price for WMI, \$2,000,000 is held in escrow to secure any obligation we may have under the Purchase Agreement as a result of the working capital adjustment and as a result of our breach of the representations and warranties we made in the Purchase Agreement. During the years ended December 31, 2017 and 2018, and subsequent thereto, we sold in excess of \$29,000,000 in debt and equity securities to fund our business. The report of our independent registered public accountants on our financial statements for the year ended December 31, 2018 states that these factors raise uncertainty about our ability to continue as a going concern.

Unless we are able to generate positive cash flows from operations, we will continue to depend upon further issuances of debt, equity or other financings to fund ongoing operations. We may continue to incur additional operating losses and we cannot assure you that we will continue as a going concern.

We may need additional financing.

In the past, we have funded a portion of our operating losses through borrowings from two of our principal stockholders who are also directors. As of December 31, 2018, related party notes payable to Michael and Robert Taglich (and their affiliated entities), totaled \$4,835,000. Additional funding may not be available to us on reasonable terms, if at all, from third parties or our two principal stockholders. If we are unable to fund such losses from third parties or our principal stockholders, we may become insolvent.

The Seventeenth Amendment to our Amended and Restated Loan Agreement (the “Loan Facility”) with PNC Bank, our principal lender, increased the interest rate we pay for amounts borrowed thereunder to an Alternative Base Rate plus 4% per annum. The Seventeenth Amendment extended the Termination Date of the Loan Facility to December 31, 2019, provided that we pay an extension fee of (i) \$250,000 on the earlier of (a) the date that all obligations under the loan agreement (“Obligations”) are indefeasibly paid in full or (b) June 30, 2019, (ii) \$125,000 on the earlier of (a) the date that the Obligations are indefeasibly paid in full or (b) December 31, 2019, which amount is deemed earned in full if the Obligations have not been satisfied as of July 1, 2019, (iii) \$125,000 on the earlier of (a) the date that the Obligations are indefeasibly paid in full or (b) December 31, 2019, which amounts is deemed earned in full if the Obligations have not been satisfied as of October 1, 2019, and (iv) \$500,000 on December 31, 2019, which amounts is deemed earned in full if the Obligations have not been satisfied as of December 31, 2019.

There can be no assurance that PNC will renew the Loan Facility on December 31, 2019, or that the terms of any renewal will be acceptable to us.

We may need to raise additional capital in the future. Future financings may involve the issuance of debt, equity and/or securities convertible into or exercisable or exchangeable for our equity securities. These financings may not be available to us on reasonable terms or at all when and as we require funding. If we are able to consummate such financings, the trading price of our common stock could be adversely affected and/or the terms of such financings may adversely affect the interests of our existing stockholders. Any failure to obtain additional working capital when required would have a material adverse effect on our business and financial condition and may result in a decline in our stock price. Any issuances of our common stock, preferred stock, or securities such as warrants or notes that are convertible into, exercisable or exchangeable for, our capital stock, would have a dilutive effect on the voting and economic interest of our existing stockholders.

Sales and liquidations of our subsidiaries completed during 2017 and 2018 likely will lead to reduced revenues.

During 2017 and 2018 we sold or otherwise liquidated certain of our subsidiaries to enable us to focus on our capabilities in our Complex Machining (AIM and NTW), and Turbine Engine Components (Sterling) segments. The absence of the subsidiaries we sold or liquidated may reduce the range of services we can provide to our customers and likely will lead to a reduction in our revenues for the immediate future.

We have identified deficiencies and material weaknesses in our internal controls and we may not be successful in remediating these deficiencies and weakness in the near future.

In connection with our review of our disclosure controls and internal controls over financial reporting for the fiscal year ended December 31, 2018, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and internal controls over financial reporting were not effective as of such dates. In particular, certain portions of our inventory control system and the enterprise reporting system used to track employee hours have not been integrated into the system used by the balance of our company which could result in a failure to properly account for the costs associated with work in process, slow moving inventory and the value of inventory on hand. Accordingly, costs to be included in work in process, may not be sufficiently automated to ensure compliance at all times. In addition, our Chief Executive Officer and Chief Financial Officer concluded that our quarterly closing process was deficient at our subsidiaries and that our consolidating process and period end reporting and disclosure procedures were materially weak. They also concluded that our system for administering and disclosing stock compensation was deficient and that we lacked the accounting personnel necessary to account for complex accounting matters and unusual and nonstandard transactions. We intend to remediate these conditions. In the event we do not remediate these deficiencies and material weaknesses in our internal controls, our operations may be adversely affected and the market price of our common stock could decline. In addition, if we are unable to meet the requirements of Section 404 of the Sarbanes-Oxley Act, we may not be able to maintain our listing on the NYSE American.

A reduction in government spending on defense could materially adversely impact our revenues, results of operations and financial condition.

A large percentage of our revenue is derived from products for US military aviation. There are risks associated with programs that are subject to appropriation by Congress, which could be potential targets for reductions in funding. Reductions in United States Government spending on defense or future changes in the mix of defense products required by United States Government agencies could limit demand for our products, and may have a materially adverse effect on our operating results and financial condition. For the past several years, our operations have been impacted by volatility in government procurement cycles and spending patterns. There can be no assurance that our financial condition and results of operations will not be materially adversely impacted by future volatility in defense

spending or a change in the mix of products purchased by defense departments in the United States or other countries, or the perception on the part of our customers that such changes are about to occur.

We depend on revenues from a few significant relationships. Any loss, cancellation, reduction, or interruption in these relationships could harm our business.

We derive most of our revenues from a small number of customers. Three customers represented approximately 70% and 62% of total sales for the years ended December 31, 2018 and 2017, respectively. The markets in which we sell our products are dominated by a relatively small number of customers which have contracts with United States governmental agencies, thereby limiting the number of potential customers. Our success depends on our ability to develop and manage relationships with significant customers. We cannot be sure that we will be able to retain our largest customers or that we will be able to attract additional customers, or that our customers will continue to buy our products in the same amounts as in prior years. The loss of one or more of our largest customers, any reduction or interruption in sales to these customers, our inability to successfully develop relationships with additional customers or future price concessions that we may have to make, could significantly harm our business.

We depend on revenues from components for a few aircraft platforms and the cancellation or reduction of either production or use of these aircraft platforms could harm our business.

We derive a significant portion of our revenues from components for a few aircraft platforms, specifically the Sikorsky BlackHawk helicopter, the Northrop Grumman E-2 Hawkeye naval aircraft, the McDonnell Douglas (Boeing) C-17 Globemaster, the F-16 Falcon and the F-18 Hornet. Boeing closed its C-17 production line in 2015. A reduction in demand for our products as a result of either a reduction in the production of new aircraft or a reduction in the use of existing aircraft in the fleet (reducing after-market demand) would have a material adverse effect on our operating results and financial condition.

Intense competition in our markets may lead to a reduction in our revenues and market share.

The defense and aerospace component manufacturing market is highly competitive and we expect that competition will increase and perhaps intensify. Many competitors have significantly greater technical, manufacturing, financial and marketing resources than we do. We may not be able to compete successfully against either current or future competitors. Increased competition could result in reduced revenue, lower margins or loss of market share, any of which could significantly harm our business, our operating results and financial condition.

We may lose sales if our suppliers fail to meet our needs or shipments of raw materials are not timely made.

Although we procure most of our parts and components from multiple sources or believe that these components are readily available from numerous sources, certain components are available only from a sole or limited number of sources. While we believe that substitute components or assemblies could be obtained, use of substitutes would require development of new suppliers or would require us to re-engineer our products, or both, which could delay shipment of our products and could have a materially adverse effect on our operating results and financial condition. Recently, due to our liquidity problems, we have had difficulties in securing timely shipments of raw materials from certain vendors which has negatively impacted our results of operations. Any delays in the shipment of raw materials could significantly harm our business, our operating results and our financial condition.

There are risks associated with the bidding processes in which we compete.

We obtain many contracts through a competitive bidding process. We must devote substantial time and resources to prepare bids and proposals and may not have contracts awarded to us. Even if we win contracts, there can be no assurance that the prices that we have bid will be sufficient to allow us to generate a profit from any particular contract. There are significant costs involved with producing a small number of initial units of any new product and it may not be possible to recoup such costs on later production runs.

Due to fixed contract pricing, increasing contract costs expose us to reduced profitability and the potential loss of future business.

The cost estimation process requires significant judgment and expertise. Reasons for cost growth may include unavailability and productivity of labor, the nature and complexity of the work to be performed, the effect of change orders, the availability of materials, the effect of any delays in performance, availability and timing of funding from the customer, natural disasters, and the inability to recover any claims included in the estimates to complete. A significant change in cost estimates on one or more programs could have a material effect on our consolidated financial position or results of operations.

The prices of raw materials we use are volatile.

The prices of raw materials used in our manufacturing processes are volatile. If the prices of raw materials rise we may not be able to pass along such increases to our customers and this could have an adverse impact on our consolidated financial position and results of operations. It is possible that some of the raw materials we use might become subject to new or increased tariffs. Significant increases in the prices of raw materials could adversely impact our customers' demand for certain products which could lead to a reduction in our revenues and have a material adverse impact on our revenues and on our consolidated financial position and results of operations.

Some of the products we produce have long lead times.

Some of the products we produce require months to produce and we sometimes produce products in excess of the number ordered intending to sell the excess as spares when orders arise. As a result, our inventory turns slowly and ties up our working capital. Our inventory represented approximately 61% of our assets as of December 31, 2018. Any requirement to write down the value of our inventory due to obsolescence or a drop in the price of materials could have a material adverse effect on our consolidated financial position, results of operations and could result in a breach of the financial covenants in our Loan Facility.

We do not own the intellectual property rights to products we produce.

Nearly all the parts and subassemblies we produce are built to customer specifications and the customer owns the intellectual property, if any, related to the product. Consequently, if a customer desires to use another manufacturer to fabricate its part or subassembly, it would be free to do so, which could have a material adverse effect on our business,

our operating results and financial condition.

There are risks associated with new programs.

New programs typically carry risks associated with design changes, acquisition of new production tools, funding commitments, imprecise or changing specifications, timing delays and the accuracy of cost estimates associated with such programs. In addition, any new program may experience delays for a variety of reasons after significant expenditures are made. If we were unable to perform under new programs to the customers' satisfaction or if a new program in which we had made a significant investment was terminated or experienced weak demand, delays or other problems, then our business, financial condition and results of operations could be materially adversely affected. This could result in low margin or forward loss contracts, and the risk of having to write-off costs and estimated earnings in excess of billings on uncompleted contracts if it were deemed to be unrecoverable over the life of the program.

To perform on new programs we may be required to incur material up-front costs which may not have been separately negotiated and may not be recoverable. Such charges and the loss of up-front costs could have a material impact on our liquidity.

The need to control our expenses will place a significant strain on our management and operational resources. If we are unable to control our expenses effectively, our business, results of operations and financial condition may be adversely affected.

Attracting and retaining executive talent and other key personnel is an essential element of our future success.

Our future success depends to a significant extent upon our ability to attract executive talent, as well as the continued service of our existing executive officers and other key management and technical personnel. Experienced management and technical, marketing and support personnel in the defense and aerospace industries are in demand and competition for their talents is intense. Our failure to attract executive talent, or retain our existing executive officers and key personnel, could have a material adverse effect on our business, financial condition and results of operations.

We are subject to strict governmental regulations relating to the environment, which could result in fines and remediation expense in the event of non-compliance.

We are required to comply with extensive and frequently changing environmental regulations at the federal, state and local levels. Among other things, these regulatory bodies impose restrictions to control air, soil and water pollution, to protect against occupational exposure to chemicals, including health and safety risks, and to require notification or reporting of the storage, use and release of certain hazardous substances into the environment. This extensive regulatory framework imposes significant compliance burdens and risks on us. In addition, these regulations may impose liability for the cost of removal or remediation of certain hazardous substances released on or in our facilities without regard to whether we knew of, or caused, the release of such substances. Furthermore, we are required to provide a place of employment that is free from recognized and preventable hazards that are likely to cause serious physical harm to employees, provide notice to employees regarding the presence of hazardous chemicals and to train employees in the use of such substances. Our operations require the use of chemicals and other materials for painting and cleaning that are classified under applicable laws as hazardous chemicals and substances. If we are found to be in violation of any of these rules, regulations or permits, we may be subject to fines, remediation expenses and the obligation to change our business practice, any of which could result in substantial costs that would adversely impact our business operations and financial condition.

We may be subject to fines and disqualification for non-compliance with Federal Aviation Administration regulations.

We are subject to regulation by the FAA under the provisions of the Federal Aviation Act of 1958, as amended. The FAA prescribes standards and licensing requirements for aircraft and aircraft components. We are subject to inspections by the FAA and may be subjected to fines and other penalties (including orders to cease production) for noncompliance with FAA regulations. Our failure to comply with applicable regulations could result in the termination of or our disqualification from some of our contracts, which could have a material adverse effect on our operations. We have never been subject to such fines or disqualification.

Cyber security attacks, internal system or service failures may adversely impact our business and operations.

Any system or service disruptions, including those caused by projects to improve our information technology systems, if not anticipated and appropriately mitigated, could disrupt our business and impair our ability to effectively provide products and related services to our customers and could have a material adverse effect on our business. We could also be subject to systems failures, including network, software or hardware failures, whether caused by us, third-party service providers, intruders or hackers, computer viruses, natural disasters, power shortages or terrorist attacks. Cyber security threats are evolving and include, but are not limited to, malicious software, unauthorized attempts to gain access to sensitive, confidential or otherwise protected information related to us or our products, customers or suppliers, or other acts that could lead to disruptions in our business. Any such failures could cause loss of data and interruptions or delays in our business, cause us to incur remediation costs or require us to pay to ransom to a hacker which takes over our systems, or subject us to claims and damage our reputation. In addition, the failure or disruption of our communications or utilities could cause us to interrupt or suspend our operations or otherwise adversely affect our business. Although we utilize various procedures and controls to monitor and mitigate the risk of these threats, there can be no assurance that these procedures and controls will be sufficient. Our property and business interruption insurance may be inadequate to compensate us for all losses that may occur as a result of any system or operational failure or disruption which would adversely affect our business, results of operations and financial condition. Moreover, expenditures incurred in implementing cyber security and other procedures and controls could adversely affect our results of operations and financial condition.

Terrorist acts and acts of war may seriously harm our business, results of operations and financial condition.

United States and global responses to actual or potential military conflicts, terrorism, perceived nuclear, biological and chemical threats and other global political crises increase uncertainties with respect to U.S. and other business and financial markets. Several factors associated, directly or indirectly, with actual or potential military conflicts, terrorism, perceived nuclear, biological and chemical threats, and other global political crises and responses thereto, may adversely affect the mix of products purchased by defense departments in the United States or other countries to platforms not serviced by us. A shift in defense budgets to product lines we do not produce could have a material adverse effect on our business, financial condition and results of operations.

Risks Related to Our Indebtedness

Our indebtedness may have a material adverse effect on our operations.

We have substantial indebtedness under our Loan Facility. As of December 31, 2018, we had approximately \$15,615,000 of indebtedness outstanding under the Loan Facility. All of our indebtedness under the Loan Facility is secured by substantially all of our assets.

We also have outstanding a significant amount of indebtedness in the form of subordinated convertible notes which are payable on December 31, 2020. If we are unable to pay the outstanding principal and accrued interest on these notes when due, our operations may be materially and adversely affected.

Our leverage may adversely affect our ability to finance future operations and capital needs, may limit our ability to pursue business opportunities and may make our results of operations more susceptible to adverse economic conditions.