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CALIFORNIA MICROWAVE, INC. ANNUAL REPORT 1994

MOVING
INFORMATION
BY
WIRELESS
TECHNOLOGY



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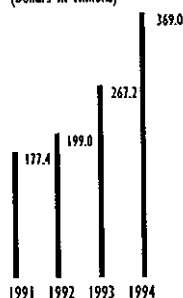
Financial Highlights

Fiscal year ended June 30

	1994	1993	% Change
Sales	\$369.0	\$267.2	+38
Net Earnings	15.1	10.0	+50
Earnings per Share	1.20	.98	+22
Orders Booked	400.4	293.1	+37
Year-end Backlog	220.4	156.2	+41

Dollars in Millions except per share amounts

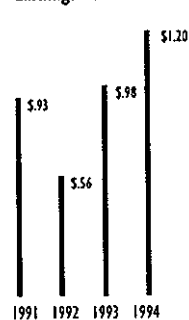
Sales
(Dollars in Millions)



Operating Income
(Dollars in Millions)



Earnings Per Share



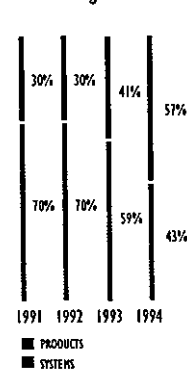
Orders Booked
(Dollars in Millions)



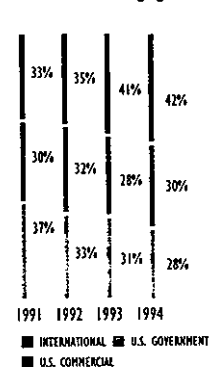
Backlog
(Dollars in Millions)



Sales Shifting to Products



Customer Mix Changing



Wireless Sales Growing



To Our Fellow Shareholders:

We are pleased to report that California Microwave posted record sales and earnings for its 1994 fiscal year. For the year ended June 30, we reported record net income of \$15.1 million, or \$1.20 per share, on a 38% increase over last year's sales to a record \$369 million. New orders booked during the year were a record-setting \$400 million, a 37% increase over last year. Year-end backlog reached \$220 million, a 41% increase over 1993. Last year's net income was \$10 million, or \$0.98 per share, on sales of \$267 million. New orders for that year totaled \$293 million and year-end backlog stood at \$156 million. Our 1994 results include eight months of results from our October 1993 acquisition of TeleCom Transmission Systems (TTS), formerly TeleSciences Transmission Systems, Inc.

For the fourth quarter, we reported net income of \$4.3 million, or \$0.35 per share, on sales of \$119 million. In comparison, our fourth quarter results last year showed net income of \$3.1 million, or \$0.26 per share, on sales of \$72 million.

MOVING INFORMATION BY RADIO: The business of California Microwave is to design, manufacture and market sophisticated radio-based systems and products used in satellite and wireless communications all over the world for the transmission of voice, data, facsimile and video. In other words, we supply a cost-effective means to move information between locations on the ground or by satellite across multiple locations within a broad communications network.

We believe we are now the largest manufacturer of both microwave radios and satellite telecommunications earth station systems and products in the United States. At the same time, we believe we are now one of the top two suppliers of this type of satellite equipment in the world, as well as one of the world's top three microwave radio producers.

MEETING GROWTH GOALS: In last year's Letter to Shareholders, we identified wireless communications as our focus for rapid expansion because of its expected accelerating growth rate over the rest of the decade. We also defined specific goals and methods for managing our growth process over the long term. I am pleased with our progress since then, and would like to comment briefly on our performance in each area:

WIRELESS EXPANSION: Bookings and sales growth were excellent in the wireless area — although we also achieved substantial growth in our other product areas. Nonetheless, as we intended, wireless products in 1994 represented California Microwave's fastest growing area. Orders for wireless products were up 55%. Wireless sales increased by 129% and amounted to 38% of total sales for the year, up from 23% in 1993.

PRODUCT MIX FOR IMPROVED GROSS MARGINS: Improved gross margins are essential for increased profitability, and we are focused on shifting our mix of business to attain higher gross margins. To achieve this, we intend to emphasize sales of our higher-margin product businesses relative to lower-margin system businesses, so that the former represents 60% of sales. In fiscal 1994, product sales increased by approximately 90% over the previous year and represented 57% of total 1994 sales compared to 41% of 1993 sales.

INTERNATIONAL EXPANSION: Our business outlook is especially positive in international markets, where the need for wireless infrastructure continues to expand. Because of our strong sales growth in Asia, Europe and Latin America, international revenue grew 40% to \$154.1 million or 42% of total sales — with our eventual goal to make it 60% of sales.

GOVERNMENT SALES SHIFT: As previously announced, our goal is to reduce the percentage of U.S. government sales while sustaining profitable growth in absolute dollars. In 1994, this business decreased as a percentage of total sales to 28% from last year's 31%. Nonetheless, sales in this sector actually grew by 25%. Therefore, our government business remains a strong contributor without detracting from our emphasis on higher growth-oriented wireless and satellite businesses.

RESEARCH & DEVELOPMENT: The Company continued to expand R&D investment, increasing this amount as a percent of sales. As a result, we succeeded in our goal of increasing the development and introduction of higher-margin satellite and wireless products.

ACQUISITIONS: Consistent with our commitment to grow in the wireless area, last October we acquired California Microwave TeleCom Transmission Systems, Inc. (TTS), a wireless communications equipment manufacturer. The acquisition was a vital addition to California Microwave's wireless group and key to attaining the critical mass necessary for continued market penetration in the wireless and international arenas. The acquisition also gained Motorola, Inc., which is a significant customer of TTS, as an investor in California Microwave. We intend to continue evaluating acquisitions of product-oriented businesses that fit into our existing structure and allow us to provide even broader wireless and satellite telecommunications solutions.

TOTAL NETWORK SOLUTIONS: In addition to the previously defined goals, we have identified an additional important strategic objective, which is to provide customers with total communications network solutions. The main focus of this strategy is to design, install and help maintain turnkey solutions that meet domestic and international network requirements.

Studies point to the growth of such communications network needs in Asia, Africa and Latin America over the next decade, projecting that tens of billions of dollars will be spent. With our complete portfolio of businesses involved in both satellite earth stations, and short- and long-haul digital radios, we believe we have the critical mass necessary to participate in this multi-billion-dollar opportunity and become a billion-dollar company ourselves.

STRENGTHENING MANAGEMENT: Throughout California Microwave, we continue to broaden and strengthen our management staff in support of our long-term goals. Since the acquisition of TTS, for instance, a new management team of experienced wireless industry professionals has been initiating programs to improve profits, increase our new-order rate, and improve product quality. Recently, we made similar changes in our satellite communications group. In April, we were also pleased to appoint Garrett E. Pierce as Executive Vice President and Chief Financial Officer. Along with his other duties, Pierce will help expand our financial management in the international arena. In addition, to further support growth of our business, we have strengthened the application of modern management techniques throughout the Company. Incentive programs are tied to improvements in our financial performance, including sustaining minimum revenue growth of 15% per year, with comparable or better profit growth.

LOOKING FORWARD: We are very proud of our 1994 fiscal year. We are on target with our strategy, and as we go forward, we pledge that our operating plans, strategies and management techniques will continue to be focused on achievement of sustainable, long-term growth. We will do this by continuing to make strategic acquisitions, broaden our leadership, improve our internal processes, and make changes in our operations when and where they are necessary to achieve our long-term goals. We will aggressively pursue international business, possibly in conjunction with appropriate partners. We at California Microwave intend to be a major player in each of our selected markets and take advantage of the explosive opportunities that are destined for this "wireless decade." We thank our customers, our employees and our shareholders for their enthusiastic support, and we look forward to reporting our progress next year.



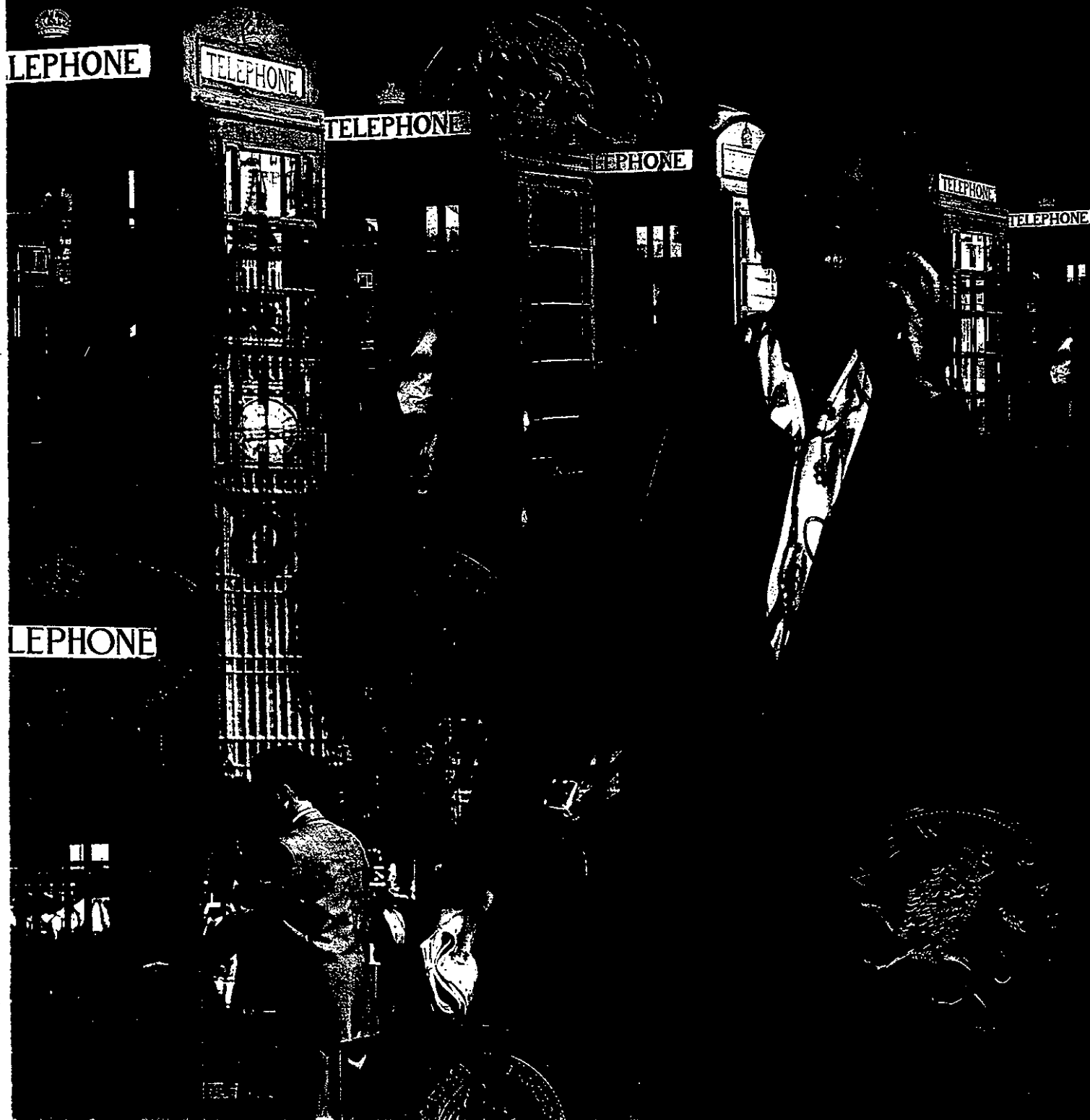
Philip F. Otto
Chairman and Chief Executive Officer

September 6, 1994

PERSONAL COMMUNICATION NETWORK

the City of London and substantial areas throughout England's South, East, and Midlands, plus the U.S. West. These are the first commercial mobile telephone services in the world. They are the first to be based on a mobile radio system that is not a landline extension. They are the first to be based on a mobile radio system that is not a landline extension. They are the first to be based on a mobile radio system that is not a landline extension.

These services are being provided by the British Telecom (BT) mobile telephone network, which is the first of its kind in the world. The network is based on a mobile radio system that is not a landline extension. It is the first to be based on a mobile radio system that is not a landline extension. It is the first to be based on a mobile radio system that is not a landline extension.



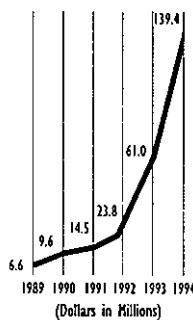
Current Commercial Applications: California Microwave has made itself a leading player in delivering information by wireless technology. The Company supplies the behind-the-scenes wireless products and systems that wireless providers need to offer their commercial services. Our products and systems are already well established in several emerging wireless applications.

Cellular: One of the most recognizable applications is cellular telephone, where users communicate via their mobile units to cellular base stations. Our products are often used to interconnect these base stations to the public telephone network. Cellular is already a well-established service in many nations, and is evolving to its next generation of services, as described below.

Personal Communication Services (PCS): Also referred to as Personal Communication Networks (PCN) in Europe, PCS networks require more base stations — and more microwave radio relay links — than cellular. PCS systems, like their cellular cousins, will enable mobile subscribers to be connected directly

to other mobile users, or through the switched public network to any other telephone in the world. Major European operators already employ our digital microwave radios to interconnect new PCN base stations under construction, and it is expected that the U.S. will soon see PCS growth after the federal government completes plans to make new segments of the radio spectrum available to service providers.

Wireless Sales



Wireless sales have grown at a compounded annual growth rate of 84% since 1989, now 38% of sales

CONNECTING WIRELESS DOTS

One of the high-frequency digital radios that provide point-to-point connections for PCNs in Europe, Microwave Radio Corporation's 40DR, will be the same radio



available to transmit PCS services in the U.S. when they begin operation.

This installed base of 40DRs has achieved proven field reliability that is projected to average over 17 years between equipment failures.

California Microwave And The Wireless Opportunity:

Wireless is a shorthand way of describing a variety of methods for moving information, which all rely on microwave radio-based analog and digital technologies. The information can be anything from a telephone conversation to a business fax, a video news broadcast, or even computer data. The need to move information is growing at a terrific rate for a number of reasons. For one thing, information is valuable — both as a resource and as a product. Technology also gives us more ways to send or sell information, such as via cellular phones, TVs, or portable computers. And people and companies that value information are willing to pay for better ways to move it in greater volumes.

Wireless is such an attractive alternative to traditional methods of moving information — telephone wires and cables — that industry analysts predict its use will expand dramatically all over the world. Because our terrestrial and satellite products and systems are essential to making wireless work, we have targeted wireless as a key growth arena.

In developed countries, the wireless opportunity is strong because the cost for wireless communications like cellular phone service continues to drop while demand is growing. Governments are also making it easier for wireless providers to use new radio frequencies, which creates new markets and attracts still more wireless customers.

Countries without a nationwide system of telephone wires already in place welcome wireless in large part because they need to quickly modernize to help their economies. Here, wireless telephony in many applications is more attractive than installing phone lines because it is more economical, faster to install, easier to maintain across remote terrain, and provides more flexible telecommunications solutions for both government and industry.

Instant Telephony: In remote rural areas without traditional service, or in developing countries that need to upgrade and modernize their communications, California Microwave's satellite telephony equipment provides instant infrastructure for reliable telephone, television and data service.

Networks: Our network business will be a key competitive differentiator, combining our strengths in terrestrial and satellite wireless technology with our systems management expertise. By exploiting our broad experience in network design and implementation, we will provide modern and efficient systems to network large amounts of information and data in a cost-effective manner.

Building Internal Infrastructure: California Microwave is one of the largest microwave companies in the world. The recent addition to our wireless group of

TeleCom Transmission Systems (TTS) gives us a full spectrum of microwave radio products. In addition, TTS brings us a valuable network management system for efficient monitoring and control of the hundreds or even thousands of microwave links that

networks sometimes comprise. By combining these capabilities with our established satellite business's strengths, we have the critical mass necessary to exploit the worldwide wireless opportunity and achieve significant growth. As we pursue this business, we are employing several strategies to realize this opportunity.

Emphasis on Higher Margins: We are investing in higher-margin product businesses, while working to improve returns from our systems businesses. With the acquisition of TTS, our sales mix

Privatization

Australia	South Korea
Argentina	Malaysia
Belgium	Mexico
Brazil	Netherlands
Czech Republic	New Zealand
Denmark	Pakistan
Germany	Portugal
Hong Kong	Singapore
Hungary	Spain
Indonesia	Sweden
Ireland	Thailand
Israel	Turkey
Italy	United Kingdom
Japan	Venezuela
Republic of Korea	

Countries
Proposing or
Implementing
Deregulation or
Privatization of
Telecommunications

DISHING OUT DATA

By the end of 1994,

Satellite Transmission

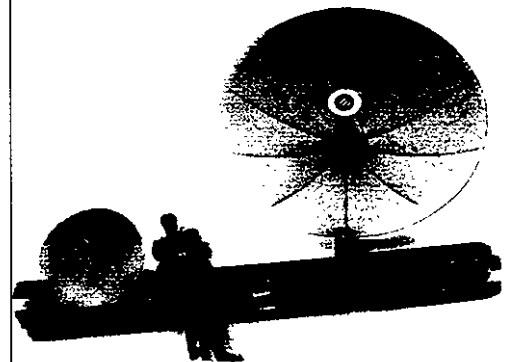
Systems, Inc. (STS) will

have installed approximately

50 remote earth stations,

each with a 3.7-meter dish

antenna, converters,



modems and a monitoring

and control system that

reports to a master station

in Shanghai. Installation

of earth stations continues at

a rate of about one per week,

and it is expected that all

currently planned stations will

be completed by mid-1996.

VOICE/DATA SATELLITE NETWORKS

In late 1990, the People's Republic of China revived the Shanghai Stock Exchange (SSE) to trade securities. As the SSE sought to open its lively computerized trading to brokerages throughout the country, an outdated telecommunications system made it impossible to quote prices and complete trades in a timely manner. California Microwave's Satellite Transmission Systems subsidiary is building

a satellite communications network which will eventually connect Shanghai's 2,000 traders electronically through several hundred remote satellite earth stations across the nation. All stations are monitored by a network hub station located at the SSE. Each station provides voice and data communications directly to the floor of the stock exchange while continuously updating securities prices.

**Data
Communication**

上海證券

上海證券交易所

is approaching our long-term goal of 60% products and 40% systems. Some key product samples are:

- LYNXX™, the world's first INMARSAT-B type-approved mobile digital satellite earth station, resulted from an effort between two of our subsidiaries, ViaSat Technology and EF Data. About the size of an overnight bag, it offers a portable telephone, fax and high-speed data gateway terminal to networks from anywhere on earth. It is the first product to address the new, reduced cost service on the digital INMARSAT-B worldwide satellite network, and it is generating substantial international sales.

- A full line of high-speed satellite modems for connecting satellite systems to telephone networks. EF Data has significant market share in this category the world over.

- The CGS-100, a PC-size device developed by the Government Electronics Division as a communications gateway system that

translates message protocols and formats for transmission across dissimilar networks.

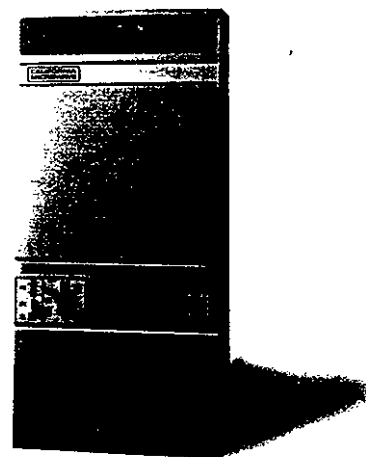
- PROGENY™, our recent entry into the digital satellite news gathering arena. Under a joint development project between Satellite Transmission Systems (STS) and EF Data, PROGENY offers lower costs and higher picture quality for TV networks when distributing program feeds to studios and transmitter sites.

International Expansion: Capital spending for telecommunications infrastructure outside the U.S. is projected to significantly eclipse domestic growth. With over a decade of international experience, we plan to increase international sales penetration —



THE NETWORKHORSES

To ensure that municipal-owned emergency service networks operate reliably, California Microwave - TeleCom Transmission Systems supplies two key components to Motorola. The TELESTAR® digital



microwave family, which is private labeled by Motorola as their ULTRASTAR™ series, transmits signals among network towers at frequencies between 2 and 18 GHz. The Digital Simulcast Module, which is manufactured exclusively for Motorola, manages network signals so they are transmitted and received throughout the system simultaneously.

MOTOROLA PUBLIC SAFETY NETWORKS

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with a goal of making it 60% of total sales. Much of this will come from emerging nations, where our U.S. government business experience is directly applicable to the necessary program management skills — especially as they relate to dealing with the requirements of complex bureaucracies.

In preparation, we are continuing to strengthen our sales presence in Asia, Europe and Latin America. We have formed inter-divisional teams to better address international markets. This last year, STS and ViaSat built, delivered and installed INMARSAT Land Earth Stations in Holland, India, Portugal, the UAE and Thailand. We are installing a rural telephony satellite network in Ecuador, as well as a private data network for the Shanghai Stock Exchange. Europe continues to present an important opportunity to supply PCN-related equipment from both Microwave Radio Corporation and TTS. We also foresee good potential in the international financial marketplace for a new radio product from Microwave Data Systems. Finally, through TTS we maintain a strong relationship with Motorola, supplying critical subsystems as part of their global microwave communication needs.

Growth Through Acquisitions: We have demonstrated our abilities to evaluate and acquire companies that are complementary to and consistent with our goals and objectives. While our current portfolio of businesses gives us strong capabilities in our core technology area, we're also in a position to pursue related businesses that broaden our product and networking strengths. These future acquisitions will be a key factor in our growth strategy, will enhance our ability to further exploit our existing areas of managerial, technological and worldwide market expertise, and will range between large acquisitions and entrepreneurial start-ups.

NETWORK NERVE CENTER

Keeping track of 44
remote stations across
Ecuador from the Quito
master station calls on
the expertise of Satellite
Transmission Systems'



(STS) network management
system. STS' graphical
monitor and control system
(GMACS) provides tech-
nicians at-a-glance
surveillance of the
operations and connectivity
of every remote earth
station from the satellite
network control center.

RURAL TELEPHONY

As the rural population grows, the need for telephone service becomes more acute. In many areas, the only way to get news or to make a long-distance call is to travel to a distant town. This is a costly and time-consuming process. The solution is to bring the telephone to the people. This is the goal of the Rural Electrification Administration (REA). The REA has been successful in bringing telephone service to many rural areas. In some cases, the REA has built new telephone lines. In other cases, it has helped to build existing lines. The REA has also helped to build new telephone exchanges. This has made it possible for many rural areas to have their own telephone service. The REA has also helped to build new telephone booths. This has made it possible for many rural areas to have a place to make a long-distance call. The REA has also helped to build new telephone exchanges. This has made it possible for many rural areas to have their own telephone service.



Consolidated Statements of Income

CALIFORNIA MICROWAVE, INC.

Three Years Ended June 30, 1994

	1994
Sales	\$ 369,017
Cost of products sold	273,415
Gross margin	95,602
Expenses:	
Research and development	13,203
Marketing and administration	54,142
Amortization of intangible assets	2,068
Total expenses	69,413
Operating income	26,189
Interest expense	(2,809)
Interest income	520
Income before income taxes	23,900
Provision for income taxes	8,844
Net income	\$ 15,056
Average shares and equivalents	12,572
Net income per share	\$ 1.20

(In thousands, except per share amounts)

	1993	1992
Sales	\$267,181	\$199,003
Cost of products sold	198,368	153,246
Gross margin	68,813	45,757
Expenses:		
Research and development	8,242	5,021
Marketing and administration	41,024	31,320
Amortization of intangible assets	1,554	797
Total expenses	50,820	37,138
Operating income	17,993	8,619
Interest expense	(2,327)	(908)
Interest income	213	269
Income before income taxes	15,879	7,980
Provision for income taxes	5,875	2,892
Net income	\$ 10,004	\$ 5,088
Average shares and equivalents	10,168	9,111
Net income per share	\$.98	\$.56

See Notes to Consolidated Financial Statements

Consolidated Balance Sheets

CALIFORNIA MICROWAVE, INC.

*June 30, 1994 and 1993**(Dollars in thousands)*

	1994	1993
Assets		
Current assets:		
Cash and cash equivalents	\$ 13,268	\$ 5,251
Short-term investments	434	162
Accounts receivable, less \$820 allowance for doubtful accounts (\$551 in 1993)	107,925	57,938
Inventories	69,700	44,055
Prepaid expenses	1,927	931
Total current assets	193,254	108,337
Property, plant and equipment, at cost	66,712	51,798
Less accumulated depreciation and amortization	33,557	27,016
Net property, plant and equipment	33,155	24,782
Intangible assets of businesses acquired, less accumulated amortization of \$6,896 (\$4,828 in 1993)	64,511	34,709
Other assets	3,063	1,797
	\$293,983	\$169,625
Liabilities and stockholders' equity		
Current liabilities:		
Current portion of long-term debt	\$ 389	\$ 289
Accounts payable	36,273	21,687
Accrued income taxes	2,108	892
Other accrued liabilities	42,510	22,279
Total current liabilities	81,280	45,147
Long-term liabilities:		
Loans and bonds payable	4,901	5,290
Other long-term liabilities	1,857	
Convertible subordinated notes	65,200	
Total long-term liabilities	71,958	5,290
Stockholders' equity:		
Common stock, \$.10 par value, 29,200,000 shares authorized:		
12,030,294 shares issued and outstanding (11,643,765 in 1993)	1,203	1,164
Capital in excess of par value	66,187	60,189
Retained earnings	74,130	59,074
Unamortized restricted stock plan expense	(775)	(1,239)
Total stockholders' equity	140,745	119,188
	\$293,983	\$169,625

See Notes to Consolidated Financial Statements

Consolidated Statements of Stockholders' Equity

CALIFORNIA MICROWAVE, INC.

Three years ended June 30, 1994

(In thousands, except for shares)

	Common Shares	Stock Amount	Capital in excess of par value	Retained earnings	Unamortized restricted stock plan expense	Total stockholders' equity
Balance, June 30, 1991	8,575,315	\$ 858	\$23,336	\$43,982	\$ (680)	\$ 67,496
Common stock issued under:						
Stock option and purchase plans	215,511	21	2,301			2,322
Restricted stock plan	64,400	6	1,052		(679)	379
Net income				5,088		5,088
Balance, June 30, 1992	8,855,226	885	26,689	49,070	(1,359)	75,285
Proceeds from public offering of common stock	2,530,000	253	30,934			31,187
Common stock issued under:						
Stock option and purchase plans	230,039	23	2,235			2,258
Restricted stock plan	28,500	3	331		120	454
Net income				10,004		10,004
Balance, June 30, 1993	11,643,765	1,164	60,189	59,074	(1,239)	119,188
Common stock issued under:						
Stock option and purchase plans	386,202	39	5,948			5,987
Restricted stock plan	(5,700)	(1)	(59)		464	404
Other	6,027	1	109			110
Net income				15,056		15,056
Balance, June 30, 1994	12,030,294	\$1,203	\$66,187	\$74,130	\$ (775)	\$140,745

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

CALIFORNIA MICROWAVE, INC.

Three years ended June 30, 1994

(In thousands)

	1994	1993	1992
Operating activities:			
Net income	\$15,056	\$10,004	\$ 5,088
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	9,629	7,769	5,133
Loss on equipment retired	349	131	126
Write-down of investments	100	50	100
Net effect of changes in:			
Accounts receivable	(33,056)	(12,543)	(9,751)
Inventories	(9,196)	(7,149)	6,066
Prepaid expenses	559	(283)	(119)
Accounts payable	1,208	6,489	74
Accrued income taxes	2,664	849	(577)
Other accrued liabilities	(7,974)	5,034	2,905
Net cash provided by (used in) operating activities	(20,661)	10,351	9,045
Investing activities:			
Capital expenditures	(11,248)	(10,780)	(8,024)
Acquisition of MRC	(1,550)		(33,490)
Acquisition of TTS	(24,196)		
Proceeds from sale of assets	142	98	5
Unexpended plant and equipment funds	341	2,981	(3,322)
Other	(257)	173	(679)
Net cash provided by (used in) investing activities	(36,768)	(7,528)	(45,510)
Financing activities:			
Net proceeds from issuance of convertible subordinated notes	61,103		
Payments on long-term obligations	(289)	(35,100)	(3,000)
Proceeds from issuance of long-term debt		246	38,203
Proceeds from issuance of common stock	4,632	32,959	1,683
Net cash provided by (used in) financing activities	65,446	(1,895)	36,886
Net increase in cash and cash equivalents	8,017	928	421
Cash and cash equivalents at beginning of year	5,251	4,323	3,902
Cash and cash equivalents at end of year	\$13,268	\$ 5,251	\$ 4,323
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	\$ 2,535	\$ 2,693	\$ 576
Income taxes	6,180	5,462	4,581
Supplemental disclosure of non-cash investing and financing activity:			
Additional purchase price for MRC's stock	9,600	1,400	
Tax benefit of options exercised	1,448	437	639
Notes used to purchase TTS' assets	2,000		

See Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies
Principles of Consolidation

The accompanying consolidated financial statements include the accounts of California Microwave, Inc. and all subsidiaries (the Company). All significant intercompany balances and transactions have been eliminated.

Fiscal Year

The Company's fiscal year ends on the Saturday closest to June 30 and includes 53 weeks in fiscal 1993 and 52 weeks in fiscal 1994 and 1992. For clarity of presentation, all fiscal periods are reported as ending on a calendar month-end.

Revenue Recognition

Generally, sales are recorded at the time individual items are shipped. Sales on certain long-term, small quantity, high unit-value contracts are recognized at the completion of significant project milestones which generally are contract line items. Scheduled billings and retainages under certain contracts (principally export contracts) have deferred billing provisions resulting in unbilled accounts receivable at June 30, 1994 and June 30, 1993 of \$21,359,000 and \$1,889,000, respectively. The unbilled receivable at June 30, 1994 is expected to be collected within one year.

Inventories and Cost of Products Sold

Inventories are recorded at the lower of cost or market. Project inventories are transferred to cost of products sold at the time revenue is recognized based on the estimated total manufacturing costs and total contract prices under each contract. Losses on contracts are recognized in full when the losses become determinable. The cost of other inventories is generally based on standard costs which approximate actual costs as determined by the first-in, first-out method.

Cash Equivalents and Short-Term Investments

Cash equivalents consist of highly liquid investments with maturities of three months or less. The Company's short-term investments are carried at cost which approximates market. The Company invests its excess cash principally in commercial paper of highly rated large industrial companies and in bankers' acceptances and certificates of deposits of large banks. Generally, these investments mature within 90 days. The Company has not experienced losses related to these investments. In May 1993, the Financial Accounting Standards Board issued Statement of Accounting Standards No. 115 - Accounting for Investments in Debt and Equity Securities, which is effective for fiscal years beginning after December 15, 1993. The adoption of this standard is not expected to have a material impact on the Company's financial position or results of operations.

Credit Risk

The Company manufactures and sells communications products and systems to large commercial customers, principally domestic and foreign telephone companies and major common carriers and to the U.S. government. The Company generally requires no collateral, but generally requires letters of credit, denominated in U.S. dollars, from its foreign customers. In 1994, 1993 and 1992, the Company expensed \$324,000, \$188,000 and \$694,000, respectively, for its provision for doubtful accounts.

Foreign Exchange Contracts

The Company enters into forward currency exchange contracts to hedge its foreign currency exposures. The gains or losses on these contracts are included in income when the underlying accounts receivable are paid. Contracts to sell 7.7 million United Kingdom pounds and 25.4 million German marks (total U.S. dollar equivalent of approximately \$28 million) were outstanding at June 30, 1994 and mature from July 1994 through March 1995. The net gains and losses resulting from these and other foreign currency transactions have not been material.

Property, Plant and Equipment

Property, plant and equipment is carried at cost, less accumulated depreciation and amortization. Depreciation and amortization charges are computed under the straight-line method based on the estimated useful lives of the related assets.

Net Income Per Share

Net income per share is based on the weighted average number of shares outstanding including the effect of the assumed exercise of stock options which are dilutive common stock equivalents. Fully diluted net income per share assuming conversion of the convertible subordinated notes and the related reduction of interest expense is not presented as such computation does not result in material dilution.

2. Sales

The Company operates in one industry - the manufacture of electronics equipment for communications, including telephone, data, control, detection, ranging and surveillance. A breakdown of sales, by product class and by market sector for the last three years, is shown below.

(In thousands)

	1994	1993	1992
Satellite communications	\$178,119 48%	\$157,282 59%	\$130,582 66%
Wireless	139,424 38%	61,005 23%	23,812 12%
Intelligence	49,796 14%	45,511 17%	38,714 19%
Other	1,678	3,383 1%	5,895 3%
Total	<u>\$369,017</u>	<u>\$267,181</u>	<u>\$199,003</u>
Export sales	\$154,086 42%	\$109,835 41%	\$ 69,700 35%
U.S. commercial sales	113,061 30%	75,887 28%	62,620 32%
U.S. government sales	101,870 28%	81,459 31%	66,683 33%
Total	<u>\$369,017</u>	<u>\$267,181</u>	<u>\$199,003</u>

Export sales by geographic area were as follows:

(In thousands)

	1994	1993	1992
Asia	\$ 56,881	\$ 25,744	\$21,943
Europe	45,894	36,784	27,882
Latin America	22,601	12,425	9,381
Africa and Middle East	17,735	28,212	9,024
Other - principally Canada	10,975	6,670	1,470
	<u>\$154,086</u>	<u>\$109,835</u>	<u>\$69,700</u>

3. Acquisitions

TeleCom Transmission Systems, Inc. (formerly TeleSciences Transmission Systems, Inc.) The Company acquired substantially all of the assets and certain of the liabilities of TeleSciences Transmission Systems, Inc. (TTS), a wholly owned subsidiary of TeleSciences, Inc., on October 26, 1993. TTS' product line consists of digital and analog microwave radios for the cellular, personal communications network and private network markets. The Company paid \$28.7 million for those net assets at the closing, consisting of \$23.7 million in cash and a \$5 million, five-year 5% convertible subordinated note, convertible (after the resolution of certain acquisition-related matters) at the option of the holder into common stock of the Company at a conversion price of \$28.50 per share. Of the \$5 million note, \$3 million has been offset against advances from TTS to its parent during the period prior to the closing of the acquisition and is no longer payable. Concurrent with the closing of this transaction, the Company issued for cash to Motorola, Inc., an investor in TeleSciences, Inc., a \$5.7 million, five-year 5% convertible subordinated note, convertible at Motorola's option into the Company's common stock at a price of \$28.50 per share. The acquisition was accounted for as a purchase transaction and accordingly, the acquired assets and liabilities were recorded at their estimated fair value at the date of acquisition. The net assets at acquisition were adjusted from preliminary estimates as information regarding asset and liability valuations and customer commitments was obtained and finalized. The excess of the purchase price over the valuation of the net assets acquired (\$22,103,000) is being amortized on a straight line basis over thirty years. The operating results of TTS have been included in the Consolidated Statements of Income from the acquisition date.

A contingent payment, payable in cash or common stock of the Company, at the Company's option, may be payable based on TTS' sales for the 18-month period commencing July 1, 1993. The amount of the contingent payment is based on the extent to which specified TTS-related sales exceed \$117 million during that period, but in no event will the contingent payment exceed \$29.9 million. For the year ended June 30, 1994, TTS' sales were \$72.6 million. The amount of contingent payment, if any, will be accounted for as additional purchase price and will be amortized over the remaining life of the purchased intangibles related to the TTS acquisition.

The effects of the acquisition of TTS on the Consolidated Statements of Cash Flows were as follows:

(In thousands)

	1994
Working capital acquired (excluding cash)	\$ 97
Property, plant and equipment	5,188
Other assets	497
Other long-term obligations	(1,689)
Excess of purchase price over valuation of net assets acquired	\$22,103
Less: note used in acquisition of TTS	2,000
	<u>20,103</u>
Total cash price, net of cash received	<u>\$24,196</u>

The following pro forma combined results for 1994 and 1993 are as if the above acquisition of TTS had been consummated on July 1, 1992.

(Unaudited)

(In thousands, except per share amounts)

	1994	1993
Sales	\$389,882	\$331,795
Income before income taxes	19,755	13,843
Net income	12,445	8,721
Net income per share	\$.99	\$.86
Average shares outstanding	12,572	10,168

The pro forma results, which are based upon certain assumptions and estimates which the Company believes are reasonable, do not purport to be indicative of results that actually would have occurred had the acquisition closed on July 1, 1992, and are not intended to be a projection of future results.

Microwave Radio Corporation In April 1992, the Company acquired all the shares of Microwave Radio Corporation (MRC), a manufacturer of digital and analog fixed-link and portable microwave radios. The Company paid \$33 million in cash at the time of the acquisition and \$11 million in cash in additional payments based upon MRC's income for the 27-month period ended June 30, 1994. The acquisition was accounted for as a purchase transaction and accordingly, the acquired assets and liabilities were recorded at their estimated fair value at the date of acquisition. The operating results of MRC have been included in the Consolidated Statements of Income from the acquisition date. The excess of the purchase price over the valuation of the net assets acquired (\$37,519,000) is being amortized on a straight line basis over thirty years.

The additional payments of \$11 million have been accounted for as additional purchase price and are being amortized over the remaining life of the purchased intangibles related to the MRC acquisition. For the periods ended June 30, 1994 and June 30, 1993, the Company recorded \$9.6 million and \$1.4 million, respectively, as additional purchase price under this agreement.

Notes to Consolidated Financial Statements

CALIFORNIA MICROWAVE, INC.

The effects of the acquisition of MRC on the 1992 Consolidated Statements of Cash Flows were as follows:

	(In thousands)
	1992
Working capital acquired (excluding cash)	\$ 4,164
Property, plant and equipment	1,806
Advances to MRC	1,151
Excess of purchase price over value of net assets acquired	26,369
Total cash price, net of cash received	<u>\$33,490</u>

Intangible assets resulting from acquisitions made prior to 1992 are being amortized over periods ranging from five to thirty years.

4. Inventories

The components of inventories were as follows:

	(In thousands)	
	1994	1993
Projects in process	\$20,963	\$17,423
Less progress billings	4,702	1,623
	<u>16,261</u>	<u>15,800</u>
Work-in-process and finished goods	28,208	16,276
Raw materials and parts	25,231	11,979
	<u>\$69,700</u>	<u>\$44,055</u>

5. Property, Plant & Equipment

Property, plant and equipment consisted of the following:

(In thousands)			
	Life (In years)	1994	1993
Land		\$ 2,514	\$ 1,693
Buildings	30-40	9,838	9,539
Test equipment and machinery	3-10	35,524	27,472
Office equipment	5-10	14,266	9,040
Vehicles	3-5	1,441	1,570
Leasehold improvements	Term of lease	3,129	2,484
		<u>\$66,712</u>	<u>\$51,798</u>

Depreciation and amortization expense was \$7,572,000 for the year ended June 30, 1994 (\$5,180,000 and \$3,784,000 in 1993 and 1992, respectively).

6. Accrued Liabilities

Other accrued liabilities consisted of the following:

	(In thousands)	
	1994	1993
Salaries, bonuses and commissions	\$ 9,942	\$ 6,288
Vacations	4,450	3,135
Other payroll related	4,112	1,456
Product warranties	4,849	1,082
Advance payments	2,605	4,494
Due to former MRC shareholders	9,600	1,400
Other	6,952	4,424
	<u>\$42,510</u>	<u>\$22,279</u>

7. Debt

Debt at June 30, 1994 and 1993 consisted of the following:

	(In thousands)	
	1994	1993
Industrial development bonds:		
Suffolk County, NY	\$ 2,130	\$2,230
Monroe County, NY	2,550	2,720
City of Rochester, NY loans	610	629
	<u>\$ 5,290</u>	<u>\$5,579</u>
Current portion of above	\$ 389	\$ 289
Long-term portion of above	<u>\$ 4,901</u>	<u>\$5,290</u>
Convertible subordinated notes:		
5 1/4 % Notes due 2003	\$57,500	
5% Notes due 1998	7,700	
	<u>\$65,200</u>	

Debt maturing in each of the next five years and thereafter is as follows: 1995 - \$389,000; 1996 - \$302,000; 1997 - \$413,000; 1998 - \$314,000; 1999 - \$8,126,000; 2000 and thereafter - \$60,946,000.

The industrial development bonds listed in the above table bear interest at a floating rate, based upon prevailing market conditions, which is redetermined every seven days. The weighted average interest rate in effect on both bonds as of June 30, 1994, was 2.64%. The Suffolk County bonds are scheduled for repayment in 15 annual installments beginning November 1993, while the Monroe County bonds are scheduled for repayment in 20 annual installments beginning June 1993. Both bonds may be prepaid at any time, without penalty, and are backed by letters of credit. The City of Rochester loans bear an interest rate of 5.9% and require monthly repayments. Both the bonds and the city loans are secured by mortgages on the properties involved.

On December 15, 1993, the Company issued \$57,500,000 of 5 1/4% convertible subordinated notes, due December 15, 2003. These notes are convertible, at the option of the holder, at a price of \$28.4375 per share at any time prior to maturity. These notes are redeemable at any time on or after January 1, 1997, at the option of the Company. Interest is payable semi-annually commencing June 15, 1994. The notes are subordinated to all existing and future senior indebtedness of the Company. These notes are traded in the Nasdaq Stock Market. At June 30, 1994, the fair value of the outstanding bonds was \$55.5 million, based on quoted market prices (which reflect the market value of the underlying securities into which they are convertible, as well as current interest rates), compared to the carrying amount of \$57.5 million.

Concurrent with the closing of the acquisition of TTS in October 1993, the Company issued \$7,700,000 of five-year 5% convertible subordinated notes to TeleSciences, Inc. and Motorola, Inc. convertible at each holder's option into the Company's common stock at a price of \$28.50 per share. At its option, the Company may redeem these notes without penalty, at any time after December 31, 1994. The notes are subordinated to all existing and future senior indebtedness of the Company.

In May and June 1993, the Company obtained two unsecured committed credit facilities totaling \$33.5 million. In October 1993, the Company amended one of these agreements to increase its credit facilities to a total of \$48.5 million. In February 1994, the unsecured committed credit facilities were reduced to \$33.5 million, of which \$25 million expires in October 1995, and \$8.5 million expires in April 1995. As of June 30, 1994, there were no borrowings and \$10.8 million of standby letters of credit outstanding under these credit lines. The standby letters of credit support certain export contracts. The facilities require 1/4% annual commitment fees and interest rates for borrowings will not exceed the banks' reference rates.

All of the above credit agreements contain similar covenants requiring the Company to maintain certain financial ratios.

The maximum amount of interest-bearing debt during 1994 was \$70,670,000 and the average amount borrowed was \$45,827,000 at an average interest rate of 4.9%. Comparable figures for 1993 and 1992 were \$42,443,000 and \$41,230,000 maximum borrowings, \$29,321,000 and \$11,014,000 average borrowings, and 5.3% and 6.3% average rates, respectively.

8. Common Stock

Stockholder Rights In October 1989, the stockholders approved a rights agreement under which there was distributed to the Company's stockholders the right to buy, for \$35, one share of common stock for each share of common stock held by such stockholders. The rights will only become exercisable if a person or group acquires 20% or more of the Company's common stock or announces an offer to acquire 30% or more of the Company's common stock. In the event the Company is acquired, or upon the occurrence of certain other events, each right may under certain circumstances entitle the holder to purchase, for \$35, \$70

worth of common stock. Until such events occur, the rights are redeemable at any time by the Company for \$.01 per right.

Public Offering In March 1993, the Company sold in a public offering 2,530,000 shares of its common stock at \$13.25 per share. The net proceeds of \$31.2 million were used in retiring the bridge loan incurred in the acquisition of MRC.

Options and Other Stock Plans Stock options have been granted to officers, directors and key employees under the Company's stock option plans at fair market value on the date of grant. Most options currently outstanding become exercisable in annual installments of 25%, beginning one year after date of grant. Options granted under the 1986 and 1992 Stock Option Plans expire after ten years.

On October 21, 1993, the Company's stockholders approved an increase of 500,000 in the number of shares available for grant under its 1992 Stock Option Plan. A summary of activity for fiscal 1994 under the 1986 and 1992 Stock Option Plans is presented below:

	Shares Available For Grant	Options Outstanding	Option Price Per Share
Beginning of year	445,064	1,280,667	\$.49 - \$21.00
Additional authorized	500,000		
Granted	(502,400)	502,400	18.38 - 27.25
Exercised		(300,354)	.56 - 21.00
Canceled	76,512	(76,512)	7.25 - 24.25
End of year	519,176	1,406,201	\$.49 - \$27.25
Exercisable		368,363	\$.49 - \$21.00

Stock grants have been made to officers and other key employees under the 1988 restricted stock plan at no charge to the employees. These grants generally vest 20% per year, beginning one year after the date of issue. The fair market value of the shares, at grant date, is charged to compensation expense over the five-year period. Compensation expense relating to this plan for the past three years was: 1994 - \$404,000; 1993 - \$454,000; 1992 - \$379,000. On October 21, 1993, the Company's 1992 Restricted Stock Plan covering 250,000 shares was terminated.

A summary of activity in the restricted stock plans is as follows:

	Shares Available For Grant	Non-vested Shares
Beginning of year	269,200	129,200
1992 Plan terminated	(250,000)	
Granted	(600)	600
Canceled	6,300	(6,300)
Vested	-	(40,200)
End of year	24,900	83,300

The Company has an employee stock purchase plan under which employees may purchase shares, subject to certain limitations, at no less than 85% of the lower of the fair market value of the shares at the beginning or end of a six-month purchase period. During the year, 87,480 shares were issued for \$1,271,000, leaving 82,923 shares reserved for future issuances.

Subsequent to June 30, 1994, the Company's board of directors approved, subject to stockholders' approval, an increase of 500,000 and 300,000 shares, respectively, in the number of shares covered by the stock option and employee stock purchase plans.

9. Retirement Plans

The Company has a defined contribution retirement plan covering substantially all employees. One part of the plan is a 401(k) savings plan which allows employees to contribute pre-tax compensation up to the lesser of 20% of total annual compensation or the statutory limit (currently \$9,240). The Company matches 50% of the first \$1,200 of each employee's contributions per year. In fiscal 1994, the Company converted its previous cash profit sharing plan to a defined contribution plan. In fiscal 1994, the Company contributed approximately 5% of pre-tax income to this plan, and the contributions were allocated based on the employee's salary and length of California Microwave employment. All of the above employer contributions are determined by and subject to the approval of the Company's board of directors.

Contributions to these plans are summarized below. Included in these amounts are amounts expensed under California Microwave's previous cash profit sharing plan and MRC's separate 401(k) plan. MRC's employees participated in the MRC 401(k) through June 30, 1994. They began participation in the Company's retirement plans on July 1, 1994.

Fiscal year	(In thousands)
1994	\$2,114
1993	1,229
1992	769

10. Income Taxes

Effective July 1, 1992, the Company changed its method of accounting for income taxes to the liability method required by Statement of Financial Accounting Standards (SFAS) Number 109, "Accounting for Income Taxes." The current and cumulative effects of adopting SFAS 109 were not material. As permitted under the new standard, prior years' financial statements have not been restated.

The provision (credit) for income taxes consisted of the following:

	(In thousands)		
	1994	1993	1992
Current:			
Federal	\$ 9,178	\$5,150	\$3,519
State	2,282	1,143	730
	11,460	6,293	4,249
Deferred:			
Federal	(2,192)	(3)	(1,357)
State	(424)	(415)	-
	\$ 8,844	\$5,875	\$2,892

Deferred income taxes reflect the net tax effects of temporary differences in reporting revenue and expense for financial statement and income tax purposes. At the end of fiscal 1994 and 1993, gross deferred tax assets were \$5.8 million and \$3.7 million, respectively, and deferred liabilities were \$1.2 million and \$1.7 million, respectively, and there was no valuation allowance for deferred tax assets. Deferred tax assets relate primarily to accruals and reserves not currently deductible for tax purposes. Deferred tax liabilities are mainly due to the acceleration of tax depreciation over book depreciation.

The difference between the U.S. federal statutory income tax rate and the Company's effective rate were as follows:

	1994	1993	1992
U.S. federal statutory income tax rate	35%	34%	34%
State income taxes, net of federal benefit	5	5	6
FSC tax benefit	(4)	(3)	(4)
Others, including amortization of goodwill	1	1	-
	37%	37%	36%

11. Commitments

All of the buildings occupied by the Company, except for the Company-owned Hauppauge and Rochester, New York, and Melbourne, Florida facilities, are under operating leases which expire in one to ten years. Certain of these leases contain escalation clauses. Total lease expense for the past three years was: 1994 - \$3,753,000; 1993 - \$2,599,000; 1992 - \$2,320,000. Lease commitments, exclusive of property taxes, which are payable by the Company, will be due as follows: 1995 - \$3,860,000; 1996 - \$3,555,000; 1997 - \$3,412,000; 1998 - \$1,738,000; 1999 - \$1,210,000; 2000 through 2004 - \$5,580,000.

The Board of Directors and Stockholders

California Microwave, Inc.

We have audited the accompanying consolidated balance sheets of California Microwave, Inc. at June 30, 1994 and 1993, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended June 30, 1994. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of California Microwave, Inc. at June 30, 1994 and 1993, and the consolidated results of its operations and its cash flows for each of the three years in the period ended June 30, 1994, in conformity with generally accepted accounting principles.

Ernst & Young LLP

Palo Alto, California
August 5, 1994

Overview

During the 1980s, the Company's sales were principally in the turnkey satellite earth station and intelligence systems areas. Systems include a relatively high percentage of large subcontracted items manufactured by others. Two key elements of the Company's strategy are to increase product sales as a proportion of total sales, where it believes the potential for growth in revenue and profits is greater, and to increase the proprietary product content of its systems sales. Consistent with this strategy, the Company has targeted the wireless product area and in April 1992 acquired Microwave Radio Corp. (MRC), a manufacturer of digital and analog fixed-link and portable microwave radios, and in October 1993 acquired substantially all of the assets and certain of the liabilities of TeleSciences Transmission Systems, Inc. (TTS), a manufacturer of digital and analog microwave radios for the cellular, personal communications network and private network markets. Wireless sales have grown from 8% of total sales in fiscal 1991 to 38% of total sales in fiscal 1994, and the Company expects wireless sales to continue to grow as a percentage of total sales.

The Company's international sales have expanded significantly, from 33% of total sales in 1991 to 42% of total sales in 1994. This growth has been in both satellite communications and wireless, as investment in telecommunications infrastructure in foreign countries has accelerated. The Company expects international sales to continue to grow as a percentage of total sales.

The Company's overall gross margin reflects a blend of higher gross margin product sales combined with lower gross margin systems sales. Gross margins as a percentage of sales increased from 23% to 26% over the three fiscal years ended June 30, 1994. This increase is due principally to a higher proportion of product sales.

Results of Operations

The following table sets forth, for the periods indicated, certain income and expense items expressed as a percentage of the Company's total sales:

	<i>Fiscal Year Ended June 30</i>		
	1994	1993	1992
Sales	100.0%	100.0%	100.0%
Gross margin	25.9	25.8	23.0
Research and development expenses	3.6	3.1	2.5
Marketing and administration expenses	14.7	15.4	15.8
Amortization of intangible assets	0.6	0.6	0.4
Operating income	7.1	6.7	4.3
Interest income (expense), net	(0.6)	(0.8)	(0.3)
Income before income taxes	6.5	5.9	4.0
Net income	4.1	3.7	2.6

Comparison of Fiscal Years 1994, 1993 and 1992

Bookings and Backlog. Bookings were \$400.4 million, \$293.1 million and \$202.5 million in fiscal 1994, 1993 and 1992, respectively, representing year-to-year increases of 37% in 1994 and 45% in 1993.

Bookings increased during the three-year period in each of the Company's principal product areas and market sectors. The most significant increase was in the wireless product area which includes the bookings of MRC and TTS after their acquisitions in April 1992 and October 1993, respectively. Wireless bookings accounted for 54% of the increase in bookings from 1992 to 1994. Wireless bookings were 12% of total bookings in 1992 and increased to 33% in 1994.

Backlog was \$220.4 million, \$156.2 million and \$130.2 million at the end of 1994, 1993 and 1992, respectively, representing year-to-year increases of 41% in 1994 and 20% in 1993. The proportion of such backlog that was expected to be delivered within 12 months was 80%, 85% and 95% as of the end of 1994, 1993 and 1992, respectively. The percentage decrease in 1993 and 1994 was due to two major multi-year U.S. government contract awards in the intelligence area.

Sales. Sales were \$369.0 million, \$267.2 million and \$199.0 million in 1994, 1993 and 1992, respectively, representing year-to-year increases of 38% in 1994 and 34% in 1993. Sales increased in each of the Company's three primary product areas. Approximately 68% of the increase over these two years was in wireless, which includes the sales of MRC and TTS from the dates of acquisition in fiscal 1992 and fiscal 1994. Significant sales increases (28% of the increase over two years) occurred in the satellite communication product area due to investments in telecommunications infrastructure by foreign countries. Seven percent of the increase over these two years was in intelligence systems.

Sales also increased significantly in each major market sector. International sales continued to lead the Company's growth, rising by 40% in 1994 and by 58% in 1993. About half of the overall sales increase over these two years was in the international sector. This increase was due to the growing demand for wireless and satellite networking products in expanding the worldwide telecommunications infrastructure, both within and between countries. This growth was broad-based, but strongest in Asia. International sales represented 42%, 41% and 35% of total sales for 1994, 1993 and 1992, respectively.

Another trend was the continuing increase in wireless and satellite product sales relative to lower margin intelligence and satellite system sales. Product sales were up approximately 90% in 1994 while systems sales were essentially unchanged. Thus, products represented 57% of total 1994 sales compared to 41% of 1993 sales.

No single customer accounted for more than 10% of sales in 1994, 1993 or 1992. However, the Company's total sales to all departments and agencies of the U.S. Government represented

28%, 31% and 33% of total sales in 1994, 1993 and 1992, respectively. Because the Company is concentrating its investments in commercial areas, this downward trend is expected to continue.

Gross Margin. Gross margin was \$95.6 million, \$68.8 million and \$45.8 million in 1994, 1993 and 1992, respectively, representing year-to-year increases of 39% in 1994 and 50% in 1993.

Gross margins as a percentage of sales for products are generally in the 35% to 45% range, while turnkey satellite earth station and intelligence systems typically yield gross margins in the 10% to 20% range. System sales include a relatively high percentage of large subcontracted items to which the Company adds less value and upon which customers allow minimal markup. In addition, engineering costs in turnkey satellite earth stations and intelligence systems are customer funded and are included in costs of products sold. The Company's strategy includes increasing the proportion of product sales.

Gross margins as a percentage of sales increased to 25.9% in 1994 from 25.8% in 1993 and 23.0% in 1992. These increases were principally due to the increasing proportion of wireless and satellite networking product sales relative to system integration sales. The impact of this favorable trend was offset in 1994 by sales of low margin backlog acquired in the purchase of TTS.

Research and Development. Research and development expenses were \$13.2 million, \$8.2 million and \$5.0 million in 1994, 1993 and 1992, respectively, representing year-to-year increases of 60% in 1994 and 64% in 1993. Research and development expenses as a percentage of total sales were 3.6%, 3.1% and 2.5% in 1994, 1993 and 1992, respectively. The Company anticipates that research and development expenses will continue to increase at a faster rate than sales as wireless and satellite networking product sales represent an increasingly higher percentage of total sales. In general, engineering expenditures in turnkey satellite earth stations and intelligence systems are customer funded and are included in cost of products sold.

Marketing and Administration. Marketing and administration expenses were \$54.1 million, \$41.0 million and \$31.3 million in 1994, 1993 and 1992, respectively, representing year-to-year increases of 32% in 1994 and 31% in 1993. Marketing and administration expenses as a percentage of total sales were 14.7%, 15.4% and 15.8% in 1994, 1993 and 1992, respectively. In general, the 1994 and 1993 increases relate to increased expenses associated with the Company's strategy of expanding its wireless operations, as well as increased expenses in satellite communications, where the Company continues to develop new international and domestic markets. In addition, the 1994 increase includes eight months of expenses at TTS. The 1992 expense included \$1.9 million of non-recurring charges (1.0% of sales). The Company anticipates that marketing and administration expense, as a percent of sales, will remain in the 14 to 15% range, excluding the impact of any future acquisitions.

Amortization of Intangible Assets. Amortization expenses associated with intangible assets were \$2.1 million, \$1.6 million and \$0.8 million in 1994, 1993 and 1992, respectively, representing increases of 33% in 1994 and 95% in 1993. The increases in 1994 and 1993 were due to the amortization of purchased intangible assets recorded in the acquisitions of TTS and MRC. Amortization will increase in 1995 as a result of the additional \$9.6 million paid to the former shareholders of MRC in August 1994 and to the fact that 1995 will include a full year's amortization of the purchased intangible assets related to the TTS acquisition.

Operating Income. Operating income was \$26.2 million, \$18.0 million and \$8.6 million in 1994, 1993 and 1992, respectively, representing increases of 46% in 1994 and 109% in 1993. Operating income as a percentage of total sales was 7.1%, 6.7% and 4.3% in 1994, 1993 and 1992, respectively. The increases in operating income as a percentage of sales in 1994 and 1993 were due principally to the increase in gross margins in 1993 and, in both years, the reduction, relative to sales, in marketing and administration expense. These improvements more than offset the increase in research and development expense as a percentage of sales.

Interest Expense (Net). Net interest expense was \$2.3 million, \$2.1 million and \$0.6 million in 1994, 1993 and 1992, respectively. Interest expense increased in 1993 and 1994 in order to finance the TTS and MRC acquisitions, and is expected to increase further in 1995 due to the full year's interest on the convertible subordinated notes issued in fiscal 1994.

Provisions for Income Taxes. The Financial Accounting Standards Board has issued Statement No. 109, "Accounting for Income Taxes" (SFAS 109), which establishes a new method of accounting for income taxes. The Company has adopted this method effective July 1, 1992. This method supersedes the previous accounting standard for income taxes, SFAS 96, which the Company had adopted in fiscal 1988. The cumulative effect of this change is immaterial and prior years have not been restated. Provision for income taxes was \$8.8 million, \$5.9 million and \$2.9 million in 1994, 1993 and 1992, respectively. This represents an effective tax rate of 37%, 37%, and 36% in 1994, 1993 and 1992, respectively.

Liquidity and Capital Resources

At June 30, 1994, the Company had working capital of \$112.0 million, including \$13.3 million of cash and cash equivalents, compared with working capital of \$63.2 million, including \$5.3 million of cash and cash equivalents, at June 30, 1993. Net cash used in operating activities was \$20.7 million in 1994 compared to cash provided by operations of \$10.4 million in 1993 and \$9.0 million in 1992. Two principal factors accounted for the decline in performance in 1994. First, TTS, at acquisition, required an infusion of cash of approximately \$25 million. Second, in order to penetrate certain key international markets, the Company provided extended payment terms covering a high percentage of its

1994 second-half international systems sales. Correspondingly, unbilled receivables increased from \$1.9 million at June 30, 1993 to \$21.4 million at June 30, 1994. The Company expects to collect these receivables in fiscal 1995. Due to these factors, inventory and accounts receivable turnover decreased in 1994. Due to TTS, inventory turnover declined to 4.8 turns in 1994 from 4.9 in 1993. Due to the extended payment terms on certain international projects, average receivables increased to 82 days of sales in 1994 from 71 days in 1993.

Capital expenditures were \$11.2 million in 1994 compared to \$10.8 million in 1993 and \$8.0 million in 1992. Capital expenditures in 1995 are expected to be at approximately the same level as in 1993-94.

During fiscal 1994, cash was generated from the sale of \$57.5 million of ten-year 5-1/4% convertible subordinated notes due 2003 and \$5,700,000 of five-year 5% convertible subordinated notes due 1998. The ten-year notes are convertible at the option of the holder into common stock of the Company at a conversion price of \$28.4375 per share and the five-year notes are convertible at \$28.50 per share. The net proceeds of approximately \$61.1 million were used to retire the bank loan incurred to fund the acquisition and working capital needs of TTS. The Company paid \$28.7 million for the net assets of TTS, consisting of \$23.7 million in cash and a \$5 million, five-year 5% convertible subordinated note, convertible at the option of the holder into common stock of the Company at a conversion price of \$28.50 per share. Of the \$5 million note, \$3 million was offset against advances from TTS to its parent prior to the closing of the acquisition and is no longer payable.

In fiscal 1993, the Company sold 2,530,000 shares of its common stock at \$13.25 per share. The net proceeds of approximately

\$31.2 million along with current cash balances were used to retire the \$35 million bridge loan incurred in connection with the 1992 acquisition of MRC.

In May and June 1993, the Company obtained two unsecured committed credit facilities totaling \$33.5 million. In October 1993, the Company amended one of these agreements to increase its credit facilities to a total of \$48.5 million. In February 1994, the unsecured committed credit facilities were reduced to \$33.5 million, of which \$25 million expires in October 1995 and \$8.5 million expires in April 1995. As of June 30, 1994, there were no borrowings and \$10.8 million of standby letters of credit outstanding under these credit lines, leaving \$22.7 million of available credit lines.

In August 1994, the Company made a cash payment of \$9.6 million to the former shareholders of MRC. This represents the final earn-out payment under the April 1992 MRC acquisition agreement.

A contingent payment will be payable if TTS' sales for the 18-month period commencing July 1, 1993, exceed \$117 million. The amount of the contingent payment, payable in cash or common stock at the Company's option, is based on the extent to which specified TTS-related sales exceed \$117 million during that period, but in no event will the contingent payment exceed \$29.9 million.

The Company believes that its current cash position, funds generated from operations and funds available from its current credit agreements, will be adequate to meet the Company's requirements for working capital, capital expenditures, debt service and external investments for the foreseeable future.

Selected Financial Data (Unaudited)

CALIFORNIA MICROWAVE, INC.

Five years ended June 30, 1994

(Dollars in thousands, except per share amounts)

	1994(A)	1993	1992(B)	1991	1990
Operations					
Sales	\$369,017	\$267,181	\$199,003	\$177,364	\$145,851
Operating income	26,189	17,993	8,619	13,677	12,105
Income before income taxes	23,900	15,879	7,980	12,700	10,532
Net income	15,056	10,004	5,088	8,001	6,642
Net income per share	\$ 1.20	\$.98	\$.56	\$.93	\$.80
Average shares and equivalents (in thousands)	12,572	10,168	9,111	8,636	8,416
Gross margin (percent of sales)	25.9%	25.8%	23.0%	23.1%	23.5%
Operating income (percent of sales)	7.1%	6.7%	4.3%	7.7%	8.3%
Income before income taxes (percent of sales)	6.5%	5.9%	4.0%	7.2%	7.2%
Net income (percent of sales)	4.1%	3.7%	2.6%	4.5%	4.6%
Return on average assets	6.5%	6.3%	4.1%	8.5%	7.6%
Return on average stockholders' equity	11.6%	10.3%	7.1%	13.0%	12.8%
Financial Position					
Total assets	\$293,983	\$169,625	\$147,240	\$ 98,481	\$ 89,987
Long-term debt (excluding current portion)	70,101	5,290	40,306	2,230	5,230
Current ratio	2.4:1	2.4:1	2.8:1	2.6:1	2.3:1
Debt to capitalization (C)	.33	.05	.35	.07	.20
Stockholders' equity per share	\$ 11.70	\$ 10.24	\$ 8.50	\$ 7.87	\$ 6.80
Ratio of earnings to fixed charges (D)	6.9	6.0	5.8	8.2	5.3
Other Selected Data					
Year-end backlog	\$220,388	\$156,174	\$130,232	\$118,381	\$111,504
Year-end employment	1,887	1,353	1,313	1,050	1,029
Year-end facilities (thousands of square feet)	735	556	505	404	372

(A) In October, 1993, the Company acquired substantially all the assets and certain of the liabilities of TeleSciences Transmission Systems, Inc. (TTS) for \$28.7 million in cash and notes. The acquisition was accounted for as a purchase transaction. The operating results of TTS have been included in operations from the acquisition date.

(B) In April 1992, the Company acquired all the shares of Microwave Radio Corporation (MRC) for \$33 million in cash. An additional \$11 million in contingent payments based on the income of MRC have been paid or accrued in fiscal 1993 and 1994. The acquisition was accounted for as a purchase transaction. The operating results of MRC have been included in operations from the acquisition date.

(C) Debt to capitalization is debt divided by debt plus stockholders' equity.

(D) The ratio of earnings to fixed charges has been computed by dividing income before income taxes plus fixed charges by fixed charges.

Stock and Quarterly Data (Unaudited)

California Microwave, Inc. has one series of common stock, \$.10 par value common stock. Holders of common stock have full voting rights and have the right to cumulate votes for the election of directors. California Microwave follows the policy of reinvesting all earnings to finance expansion of its business and has paid no cash dividends. No change in this policy is contemplated in the foreseeable future. At June 30, 1994, the number of California Microwave shareholders totaled approximately 11,000, of which 1,567 were holders of record. California Microwave stock is traded in the Nasdaq Stock Market, is quoted on the National Association of Securities Dealers, Inc. Automated Quotation System (Nasdaq National Market) under the trading symbol CMIC, and is listed in the *Wall Street Journal* and in other newspapers. The following table sets forth for the fiscal periods indicated the high and low stock prices.

Stock Prices by Quarter Fiscal years 1993 and 1994

	1993				1994			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
High	14 1/4	17 3/4	18 1/8	20 3/4	29	31 1/4	27 1/2	24
Low	9	10 1/4	12 3/4	13 1/4	17 1/4	21	19 1/4	16 1/2

Financial Results by Fiscal Quarter (Unaudited)

Fiscal Quarter	(In thousands, except per share amounts)			
	Sales	Gross Margin	Net Income	Net Income Per Share
1993				
1	\$60,114	\$15,579	\$ 2,096	\$.23
2	62,742	15,965	2,244	.24
3	72,052	18,091	2,560	.25
4	72,273	19,178	3,104	.26
	\$267,181	\$68,813	\$10,004	\$.98
1994				
1	\$62,516	\$18,307	\$ 3,316	\$.27
2	82,596	23,111	3,529	.28
3	104,702	26,562	3,865	.30
4	119,203	27,622	4,346	.35*
	\$369,017	\$95,602	\$15,056	\$1.20

*Net income per share assuming full dilution for the fourth quarter of fiscal 1994 was \$.33. For all other periods, net income per share assuming full dilution is not presented as such computation does not result in material dilution.

Board of Directors

Dr. Edward E. David, Jr.⁽¹⁾⁽³⁾
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Retired Commandant of the U.S. Marine
Corps and consultant to industry and
government

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Ampex Corporation, a video systems
manufacturer, business consultant and
private investor

Dr. Robert A. Helliwell⁽¹⁾⁽²⁾
Professor, Electrical Engineering
Stanford University

Gilbert F. Johnson
President-Government Group
California Microwave, Inc.

Dr. David B. Leeson⁽¹⁾⁽³⁾
Chairman of the Board Emeritus and Founder,
California Microwave, Inc.
and consultant

Philip F. Otto
Chairman of the Board
President and Chief Executive Officer
California Microwave, Inc.

⁽¹⁾ Member of Nominating Committee
⁽²⁾ Member of Compensation Committee
⁽³⁾ Member of Audit Committee

Corporate Headquarters

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Philip F. Otto, Chairman of the Board
President and Chief Executive Officer

Garrett E. Pierce, Executive Vice President and
Chief Financial Officer

Michael L. Foster, Vice President-Financial
Planning and Treasurer

Lanny B. Myers, Vice President-Controller

George L. Spillane, Vice President and
Secretary

Stephanie M. Day, Vice President-Corporate
Communications

Gordon H. Ferrie, Vice President-International
Finance

Operations

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Satellite Transmission Systems, Inc.
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ViaSat Technology Corporation
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Gerald A. Gutman, Chief Executive Officer

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Rochester, New York
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Belcamp and Baltimore, Maryland
William G. Shaver, President

Sunnyvale Products Division
Sunnyvale, California
E. Russell Hardy, President

California Microwave Navigation Systems, Inc.
Washington, D.C.
Harry F. Eustace, President

Government Communications Systems
Division
Annapolis Junction, Maryland
Nelson L. Ward, General Manager

*Also an officer of California Microwave, Inc.

Independent Auditors

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Palo Alto, California

Transfer Agent and Registrar

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Investor Relations
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(617) 575-3400

Corporate Counsel

Howard, Rice, Nemerovski, Canady,
Robertson, Falk & Rabkin
San Francisco, California

FORM 10-K Annual Report

The California Microwave, Inc. annual report
on Form 10-K to the Securities and Exchange
Commission will be mailed to stockholders,
without charge, upon written request to:

Stephanie M. Day
Vice President-Corporate Communications
California Microwave, Inc.
985 Almanor Avenue
Sunnyvale, California 94086

Street Name Stockholders: If you desire to
receive financial information directly from the
Company, please advise the Corporate
Communications office.

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