

SPACEHAB INC \WA\  
Form 10-Q  
November 13, 2006

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-27206

## SPACEHAB, Incorporated

(Exact name of registrant as specified in this charter)

**Washington**

(State or other jurisdiction  
of incorporation or organization)

**12130 Highway 3, Building 1  
Webster, Texas 77598-1504**

(Address of principal executive offices and zip code)

**(713) 558-5000**

(Registrant's telephone number, including area code)

**91-1273737**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.)

Yes  No

As of November 8, 2006 there were 12,919,582 shares of the registrant's common stock outstanding.

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**SPACEHAB, INCORPORATED AND SUBSIDIARIES**  
**SEPTEMBER 30, 2006 QUARTERLY REPORT ON FORM 10-Q**

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## DEFINITIONS

As used in this Form 10-Q, the abbreviations and acronyms contained herein have the meanings set forth below. Additionally, the terms SPACEHAB, the Company, we, us and our refer to SPACEHAB, Incorporated and its subsidiaries, unless the context clearly indicates otherwise.

1994 Plan	1994 Stock Incentive Plan
Astrium	Astrium GmbH
Astrotech	Astrotech Space Operations
Boeing	The Boeing Company
CE&R	Concept Exploration and Refinement
CMC	Cargo Mission Contract
Common stock	SPACEHAB common stock
EPS	Earnings Per Share
ESP2	External Stowage Platform 2
ICC	Integrated Cargo Carrier
IDIQ	Indefinite-Delivery, Indefinite-Quantity
ISS	International Space Station
Lloyd's	Lloyd's of London
Lockheed Martin	Lockheed Martin Corporation
NASA	National Aeronautics and Space Administration
PI&C	Program Integration and Control
RDM	Research Double Module
RSC Energia	Rocket Space Corporation-Energia
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SFS	SPACEHAB Flight Services
SGS	SPACEHAB Government Services
SMI	Space Media, Inc.
SMI Plan	Space Media, Inc. Stock Option Plan
SPF	Spacecraft Processing Facility

**PART I: FINANCIAL INFORMATION****ITEM 1. Unaudited Condensed Consolidated Financial Statements****SPACEHAB, INCORPORATED AND SUBSIDIARIES****Unaudited Condensed Consolidated Balance Sheets****(In thousands, except share data)**

	September 30, 2006 (unaudited)	June 30, 2006
<b>ASSETS</b>		
Cash and cash equivalents	\$ 9,793	\$ 6,317
Accounts receivable, net	12,913	11,379
Inventory	2,369	2,369
Prepaid expenses and other current assets	803	610
Total current assets	25,878	20,675
Property and equipment, net of accumulated depreciation and amortization of \$52,082 and \$50,620, respectively	60,246	61,637
Deferred financing costs, net	1,995	2,124
Other assets, net	1,040	1,014
Total assets	\$ 89,159	\$ 85,450
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Mortgage loan payable	\$ 1,103	\$ 1,636
Accounts payable	1,329	1,598
Accounts payable-Astrium	1,957	3,386
Accrued interest	1,733	804
Accrued expenses	2,170	2,394
Accrued subcontracting services	8,155	6,562
Deferred gains on sale of buildings	221	221
Customer deposits	3,093	
Deferred revenue	1,779	1,321
Total current liabilities	21,540	17,922
Accrued contract cost and other	159	96
Deferred gains on sale of buildings	1,318	1,373
Convertible 8% subordinated notes payable	10,306	10,306
Senior convertible 5.5% notes payable	52,944	52,944
Total liabilities	86,267	82,641
Commitments and contingencies		
Stockholders' equity		
Preferred Stock, no par value, convertible, authorized 2,500,000 shares, issued and 1,333,334 shares, (liquidation preference of \$12,000)	11,892	11,892
Common stock, no par value, 70,000,000 shares authorized, 13,035,682 and 12,976,264 shares issued, respectively	84,067	84,030
Treasury stock, 116,100 shares, at cost	(117)	(117)
Additional paid-in capital	362	284
Accumulated deficit	(93,312)	(93,280)
Total stockholders' equity	2,892	2,809
Total liabilities and stockholders' equity	\$ 89,159	\$ 85,450

See accompanying notes to unaudited condensed consolidated financial statements.

**SPACEHAB, INCORPORATED AND SUBSIDIARIES**

## Unaudited Condensed Consolidated Statements of Operations

(In thousands, except share data)

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Revenue	\$ 14,898	\$ 11,985
Costs of revenue	11,133	10,212
Gross profit	3,765	1,773
Operating expenses:		
Selling, general and administrative	2,687	2,280
Research and development	192	78
Total operating expenses	2,879	2,358
Income (loss) from operations	886	(585 )
Interest expense	(1,080 )	(1,408 )
Interest and other income, net	162	109
Loss before income taxes	(32 )	(1,884 )
Income tax expense		(32 )
Net loss	\$ (32 )	\$ (1,916 )
Loss per share:		
Net loss per share basic	\$ 0.00	\$ (0.15 )
Shares used in computing net loss per share basic	12,860,810	12,671,576
Net loss per share diluted	\$ 0.00	\$ (0.15 )
Shares used in computing net loss per share diluted	12,860,810	12,671,576

See accompanying notes to unaudited condensed consolidated financial statements.

**SPACEHAB, INCORPORATED AND SUBSIDIARIES**Unaudited Condensed Consolidated Statements of Cash Flows  
(In thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities</b>		
Net loss	\$ (32 )	\$ (1,916 )
Adjustments to reconcile net loss to net cash provided by operating activities:		
Stock-based compensation	78	86
Depreciation and amortization, including debt issuance cost of \$0.1 million and \$0.1 million	1,591	1,345
Recognition of deferred gain	(55 )	(50 )
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	(1,534 )	1,008
Increase in prepaid expenses and other current assets	(193 )	(8 )
Increase in other assets	(27 )	(131 )
Increase in deferred revenue	458	205
Decrease in accounts payable, accounts payable-Astrium, accrued interest, and accrued expenses	(993 )	(69 )
Increase in customer deposits	3,093	
Increase (decrease) in accrued subcontracting services and other	1,593	(217 )
Increase (decrease) in long-term accrued contract costs and other liabilities	63	(42 )
Net cash provided by operating activities	4,042	211
<b>Cash flows from investing activities</b>		
Purchases of property, equipment and leasehold improvements, net of reimbursements	(70 )	(642 )
Increase in restricted cash		(1,572 )
Net cash used in investing activities	(70 )	(2,214 )
<b>Cash flows from financing activities</b>		
Payment of mortgage loan	(533 )	(504 )
Increase in deferred financing costs		(514 )
Proceeds from issuance of common stock, net of expenses	37	49
Net cash used in financing activities	(496 )	(969 )
Net change in cash and cash equivalents	3,476	(2,972 )
Cash and cash equivalents at beginning of period	6,317	7,327
Cash and cash equivalents at end of period	\$ 9,793	\$ 4,355

See accompanying notes to unaudited condensed consolidated financial statements.

**SPACEHAB, INCORPORATED AND SUBSIDIARIES**  
**Notes to Unaudited Condensed Consolidated Financial Statements**

**1. The Company**

SPACEHAB is a developer and operator of space flight hardware assets, a provider of manned and unmanned payload processing services, and an entrepreneurial force in space commerce applications.

A substantial portion of our revenue has been generated under contracts with the National Aeronautics and Space Administration ( NASA ) and our contracts are subject to periodic funding allocations by the agency. NASA 's funding is dependent on receiving annual appropriations from the U.S. Government. During the years ended June 30, 2006, 2005, and 2004 approximately 80%, 81%, and 54% of our revenues were generated under U.S. Government contracts, respectively.

The SPACEHAB Flight Services ( SFS ) business unit is continuing operations for the U.S. space shuttle program, supporting two of the next three planned space shuttle missions through the use of our pressurized laboratory and logistics supply modules and cargo carriers, which significantly enhance the capabilities of the space shuttle fleet.

Our Astrotech Space Operations ( Astrotech ) subsidiary provides commercial spacecraft launch processing services and payload processing facilities in the U.S. These services are offered at the Astrotech facilities in Titusville, Florida and VAFB in California, and are provided on a fixed-price basis. Additionally, Astrotech supplies payload processing and facilities maintenance support services to Sea Launch Company, LLC for its Sea Launch program at the Home Port facilities in Long Beach, California.

Our SPACEHAB Government Services ( SGS ) subsidiary manages projects in need of comprehensive engineering solutions, and provides unique capabilities such as specialty engineering, hardware design and development, and configuration and data management. SGS also designs and fabricates space flight hardware. We continuously review and seek new business opportunities with NASA, either through current contract expansion or teaming with other aerospace companies on new contract bid initiatives.

A majority-owned subsidiary of SPACEHAB, Space Media, Inc. ( SMI ) operates a retail and internet store offering space-related merchandise to the space enthusiast.

We believe that NASA, as well as future space shuttle and International Space Station programs will continue to be funded and supported by the U.S. Government. While delays have occurred, we believe that it is highly unlikely that any decision to discontinue these programs would be made during the next twelve months. However, the Company is subject to risks and uncertainties. We continue to focus efforts on improving the overall liquidity of the Company through identifying new business opportunities within the areas of our core competencies, reducing operating expenses, and limiting cash commitments for future capital investments and new asset development.

As of September 30, 2006 our cash and cash equivalents was approximately \$9.8 million and working capital was approximately \$4.3 million. For the three months ended September 30, 2006 we generated \$4.0 million of cash from operating activities. Management believes that we have sufficient liquidity, including cash and cash equivalents and cash anticipated to be generated from operations, to fund ongoing operations for the next twelve months. In October 2007, \$10.3 million of the Company 's long-term debt will mature. Management expects that cash on hand and cash expected to be generated from operations will be available to redeem this debt on maturity. Management also expects to have unencumbered working capital and assets available that could provide additional liquidity. If the Company is not successful in achieving its business development objectives and is unable to execute its mitigation plans if anticipated business and contracts are not obtained, it may not have adequate resources to support strategies for new business initiatives and redeem maturing long-term debt.

**2. Basis of Presentation**

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting of only normal recurring accruals necessary for a fair presentation of the consolidated financial position of SPACEHAB, Incorporated and its subsidiaries as of September 30, 2006, and the results of its operations and cash flows for the periods ended September 30, 2006 and 2005. However, the unaudited condensed consolidated financial statements do not include all related footnote disclosures.





The consolidated results of operations for the three month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the full year. Our results of operations typically fluctuate significantly from quarter to quarter. The interim unaudited condensed consolidated financial statements should be read in conjunction with our audited consolidated financial statements appearing in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

### 3. Earnings per Share

The following is a reconciliation of the numerator and denominator of the basic and diluted earnings per share ( EPS ) computations for the three month period ended September 30, 2006 and September 30, 2005 (in thousands, except share and per share data):

	Three months ended September 30, 2006			Three months ended September 30, 2005		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>Basic EPS:</b>						
Income (loss) available to common stockholders	\$ (32 )	12,860,810	\$ 0.00	\$ (1,916 )	12,671,576	\$ (0.15 )
<b>Diluted EPS:</b>						
Income (loss) available to common stockholders	\$ (32 )	12,860,810	\$ 0.00	\$ (1,916 )	12,671,576	\$ (0.15 )

Convertible subordinated notes payable outstanding as of September 30, 2006, convertible into 756,404 shares of common stock at \$13.625 per share and due October 2007, were not included in the computation of diluted EPS for the three months ended September 30, 2006 and 2005 as the conversion price of the convertible notes payable per share was greater than the average market price of the common shares during the periods.

Senior convertible notes payable outstanding as of September 30, 2006 due 2010 convertible into 35,296,000 shares of common stock at \$1.50 per share, which include a mandatory conversion feature once the Company's stock price reaches \$1.95 per share, have not been included in the computation of diluted EPS for the three months ended September 30, 2006 and 2005 as the conversion price(s) of the convertible notes payable per share were greater than the average market price of the shares during the period.

Options to purchase 1,824,329 shares of common stock outstanding at September 30, 2006 were not included in diluted EPS for the three months ended September 30, 2006 as they were anti-dilutive to our net loss. The options expire between October 21, 2006 and August 9, 2016.

Options to purchase 1,672,059 shares of common stock outstanding at September 30, 2005 were not included in diluted EPS for the three months ended September 30, 2005 as they were anti-dilutive to the Company's net loss. The options expire between November 20, 2005 and August 3, 2015.

### 4. Revenue Recognition

Our business units' revenue is derived primarily from long-term contracts with the U.S. Government, U.S. Government contractors, and commercial customers. Revenue under these contracts is recognized using the methods described below. Estimating future costs and, therefore, revenues and profits is a process requiring management judgment. Management bases its estimate on historical experience and on various assumptions that are believed to be reasonable under the circumstances including the negotiation(s) of equitable adjustment(s) on the Cargo Mission Contract ( CMC ) that are added to the contract as pricing amendment(s) due to delay(s) in the space shuttle launch schedule. Costs to complete include, when appropriate, material, labor, subcontracting costs, lease costs, commissions, insurance, and depreciation. Our business segment personnel perform periodic contract status and performance reviews. In the event of a change in total estimated contract cost or profit, the cumulative effect of such change is recorded in the period that the change in estimate occurs.

We, from time to time, make expenditures for specific enhancements and/or additions to our facilities as required by certain contracts where the customer agrees to reimburse us for all or substantially all of such expenditures. We



account for such reimbursements as a reduction in the cost of such investments and recognize any excess of such reimbursements over the required investment as revenue.

**A Summary of Revenue Recognition Methods Follows:**

Business Segment	Services/Products Provided	Contract Type	Method of Revenue Recognition
SPACEHAB Flight Services	Commercial Space Habitat Modules, Integration & Operations Support Services	Firm Fixed Price	Percentage-of-completion based on costs incurred
Astrotech Space Operations	Payload Processing Facilities	Firm Fixed Price - Mission Specific	Ratably, over the occupancy period of a satellite within the facility from arrival through launch
		Firm Fixed Price - Guaranteed Number of Missions	For multi-year contract payments recognized ratably over the contract period
SPACEHAB Government Services	Configuration Management, Engineering Services	Cost Plus Award/Fixed Fee	Earned as reimbursable costs incurred plus award/fee
Space Media, Inc.	Space-Themed Commercial Products/Activities	Retail	Internet and retail sales recognized when goods are shipped

Revenues for the Lockheed Martin Corporation ( Lockheed Martin ) subcontract are being accounted for under the percentage-of-completion method based on costs incurred over the period of the agreement.

**5. Statements of Cash Flows - Supplemental Information**

- (a) Cash paid for interest costs was \$15,000 and \$51,000 for the three months ended September 30, 2006 and 2005, respectively. We did not capitalize any interest costs during the three months ended September 30, 2006 or 2005.
- (b) We paid no income taxes for the three months ended September 30, 2006 and paid an insignificant amount of income taxes for the period ended September 30, 2005.

**6. Credit Facilities**

We have entered into a revolving credit facility with a bank providing for loans up to \$5.0 million secured by our accounts receivable. Funds available under the revolving credit facility are limited to 80% of eligible accounts receivable and we are subject to various financial and other covenants including a minimum tangible net worth covenant, a cash flow coverage covenant, and a secured debt coverage covenant. The facility provides that we must secure advances with cash balances if the required tangible net worth or cash flow ratio is not met. As of September 30, 2006 there have been no borrowings under this revolving credit facility. As of September 30, 2006 available borrowings on this credit facility was limited to us posting an equivalent amount of restricted cash. The revolving credit facility expires on February 11, 2007.

Our Astrotech subsidiary has a mortgage loan with a financial institution for our Spacecraft Processing Facility ( SPF ) expansion project in Titusville, Florida. The loan agreement matures in January 2007 and bears interest at 5.5%. For the three months ended September 30, 2006, approximately \$0.5 million was repaid and the outstanding balance was \$1.1 million.



## 7. Segment Information

Based on our organization, we operate in four business segments: SFS, Astrotech, SGS, and SMI. SFS was founded to commercially develop space habitat modules that operate in the cargo bay of the space shuttles. SFS provides access to the modules and integration and operations support services for both NASA and commercial customers. Astrotech provides payload processing facilities and services to serve the spacecraft manufacturing and launch services industry. SGS is primarily engaged in providing engineering services and products to the Government, including NASA.

Our chief operating decision maker utilizes both revenue and income (loss) before income taxes in assessing performance and making overall operating decisions and resource allocations.

### Three Months Ended September 30, 2006

(in thousands):	Revenue	Income (Loss) before income taxes	Net Fixed Assets	Depreciation And Amortization
SFS	\$ 10,070	\$ 2,278	\$ 15,959	\$ 925
Astrotech	3,173	515	43,675	504
SGS	1,460	191		
Corporate and Other	195	(3,016)	) 612	162
	\$ 14,898	\$ (32)	) \$ 60,246	\$ 1,591

### Three Months Ended September 30, 2005

(in thousands):	Revenue	Income (Loss) before income taxes	Net Fixed Assets	Depreciation And Amortization
SFS	\$ 8,497	\$ 1,340	\$ 26,871	\$ 760
Astrotech	1,978	(131)	) 45,490	532
SGS	1,286	70		
Corporate and Other	224	(3,163)	) 684	53
	\$ 11,985	\$ (1,884)	) \$ 73,045	\$ 1,345

## 8. Common Stock Options and Stock Purchase Plans

We grant options to employees and directors utilizing four shareholder-approved plans and issue Company stock under an Employee Stock Purchase Plan.

### Non-qualified Options

Non-qualified options are granted at the sole discretion of the Board of Directors. Prior to the adoption of the 1994 Stock Incentive Plan ( 1994 Plan ), stock options granted to certain officers and employees were part of their employment contract or offer. The number and price of the options granted were defined in the employment agreements and such options vest incrementally over a period of four years and generally expire within ten years of the date of grant.

### The 1994 Plan

Under the terms of the 1994 Plan, the number and price of the options granted to employees is determined by the Board of Directors and such options vest, in most cases, incrementally over a period of four years and expire no more than ten years after the date of grant.

### The Directors' Stock Option Plan

Each new non-employee director receives a one-time grant of an option to purchase 10,000 shares of common stock at an exercise price equal to the fair market value on the date of grant. In addition, effective as of the date of each annual meeting of our stockholders, each non-employee director who is elected or continues as a member of the Board of Directors of the Company shall be awarded an option to purchase 5,000 shares of common stock. Options under the Director's Plan vest after one year and expire seven years from the date of grant.



**1997 Employee Stock Purchase Plan**

We adopted an employee stock purchase plan that permits eligible employees to purchase shares of common stock of the Company at prices no less than 85% of the current market price. Eligible employees may elect to participate in the plan by authorizing payroll deductions from 1% to 10% of gross compensation for each payroll period. On the last day of each quarter, each participant's contribution account is used to purchase the maximum number of whole and fractional shares of common stock determined by dividing the contribution account's balance by the lesser of 85% of the price of a share of common stock on the first day of the quarter or the last day of a quarter. The number of shares of common stock that may be purchased under the plan is 1,500,000. Through September 30, 2006, employees have purchased 1,375,031 shares under this plan. Employees purchased an aggregate of 59,418 shares at an average price of \$0.63 during the three-month period ended September 30, 2006. The shares purchased under this plan are considered compensatory for accounting and reporting purposes.

**Space Media, Inc. Stock Option Plan**

During the year ended June 30, 2000, Space Media, Inc., a majority-owned subsidiary, adopted an option plan ( SMI Plan ) for employees, officers, directors and consultants of SMI. Under the terms of the SMI Plan, 1,500,000 shares have been reserved for future grants for which the number and price of the options granted is determined by the Board of Directors and such options vest, in most cases, incrementally over a period of four years and expire no more than ten years after the date of grant.

**Accounting for Stock Issued to Employees**

The fair value of each option award is estimated on the date of grant using the Black Scholes option pricing model, which determines inputs as shown in the following table. Because of differences in option terms and historical exercise patterns among the plans, we have segregated option awards into two homogenous groups for the purpose of determining fair values for its options. Valuation assumptions are determined separately for the two groups which represent, respectively, the 1994 Stock Incentive Plan and the Director's Stock Option Plan. The assumptions are as follows:

- We estimated volatility using our historical share price performance over the last ten years. Management considered the guidance in SFAS No. 123R and believes the historical estimated volatility is materially indicative of expectations about expected future volatility.
- We use the simplified method outlined in the Securities and Exchange Commission ( SEC ) Staff Accounting Bulletin No. 107 to estimate expected lives for options granted.
- The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant for the expected term of the option.
- The expected dividend yield is based on our current dividend yield and the best estimate of projected dividend yield for future periods within the expected life of the option.

	Quarter Ended September 30, 2006		Quarter Ended September 30, 2005	
Dividend yield	0.00	%	0.00	%
Volatility	1.10		1.70	
Risk-free interest rate	4.83	%	4.25	%
Expected life (in years)	6.25		6.25	



A summary of our stock option activity as of September 30, 2006 and changes during the first three months of fiscal year 2007 are presented in the following table:

	Shares Under Fixed Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at June 30, 2006	1,577,201	\$ 2.96	5.52	\$
Granted	310,000	\$ 1.15	10.00	\$
Exercised		\$		\$
Forfeited/Expired	(62,872)	\$ 6.30		\$
Outstanding at September 30, 2006	1,824,329	\$ 2.54	6.13	\$
Exercisable	1,182,329	\$ 3.17	6.13	\$

The weighted-average grant-date fair value of options granted during the first three months of fiscal year 2007 was \$0.98 per share. The intrinsic value for stock options is defined as the difference between the current market value and the grant price. The total intrinsic value of options exercised during the first three months of fiscal year 2007 was \$0.0. As of September 30, 2006 there was \$548,284 of unamortized expense related to our stock option plans.

During the first three months of fiscal year 2007, there were no options exercised.

## 9. Related Party Transactions

We engaged in certain transactions with directors, executive officers, shareholders, and certain former officers during the three months ended September 30, 2006. Following is a description of these transactions:

### Astrium GmbH

Dr. Graul, a member of SPACEHAB's Board of Directors, is the Executive Vice President for Astrium GmbH (Astrium). Astrium provides unpressurized payload and integration efforts to SPACEHAB on a fixed-price basis in addition to providing engineering services as required. For the three months ended September 30, 2006 and 2005, Astrium's payload and integration services included in cost of revenue were approximately \$3.9 million and \$2.7 million, respectively.

### Daniel A. Bland

On June 27, 2005 we entered into an agreement with Daniel A. Bland whereas Mr. Bland will provide consulting services to us. The initial term of the agreement began July 2, 2005 and ended July 1, 2006 with additional optional periods of six months each until terminated by either party by notifying the other party of such termination at least thirty days prior to the end of the initial term or any subsequent term. We paid Mr. Bland a retainer fee at the rate of \$6,000 per month. SPACEHAB removed the retainer clause prior to the exercise of the optional periods identified in the agreement. Mr. Bland shall be paid at a rate of \$125 per hour worked plus related travel expenses during the option period exercised. Mr. Bland retired as Senior Vice President of our SPACEHAB Flight Services business unit as of June 30, 2005. During the three months ended September 30, 2006 and 2005, we paid Mr. Bland \$27,114 and \$22,133 respectively.

## 10. Recent Accounting Pronouncement

In July 2006, the Financial Accounting Standards Board issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN No. 48). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. It prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. We will adopt provisions of this interpretation beginning with the Company's first-quarter of fiscal year 2008. We do not expect the application of the standard to have a material impact on our financial position or results of operations.

Staff Accounting Bulletin (SAB) 108, *Considering the Effects of Prior-Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*—The Securities and Exchange Commission released SAB 108 to provide interpretive guidance on how the effects of the carry over or reversal of prior year misstatements should



be considered in quantifying a current year misstatement. There have been two approaches commonly used to quantify such errors. Under one approach, the error is quantified as the amount by which the current year income statement is misstated. The other approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated. The SEC staff believes that companies should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. We do not expect the application of this interpretation to have a material impact on our financial position or results of operations.

In September 2006 the FASB issued FASB Statement No. 157, *Fair Value Measurements*. Statement No. 157 establishes a common definition for fair value to be applied to U.S. generally accepted accounting principles requiring use of fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements. Statement No. 157 is effective for fiscal years beginning after November 15, 2007. The adoption of this statement is not expected to have a material impact on the Company's consolidated financial position and results of operations.

## 11. Legal Proceedings

Contract Claim. In January 2004 we filed a formal proceeding with NASA seeking indemnification under our Research and Logistics Mission Support contract in the amount of \$87.7 million for the value of our research double module ( RDM ) and related equipment that was destroyed during the Space Shuttle *Columbia* tragedy. NASA responded to this contract claim on October 5, 2004. NASA's determination claims that its liability is limited to \$8.0 million. We received payment from NASA of \$8.2 million, which included \$0.2 million of interest, from NASA, in October 2004. In January 2005 we filed an appeal of NASA's decision to deny its claim for indemnification in excess of \$8.0 million with the Armed Services Board of Contract Appeals. On July 12, 2006 the court denied NASA's motion for summary judgment in the matter and directed the parties to proceed with discovery. NASA and the Company have proposed a discovery plan that would lead to a hearing by the court in July 2008.

Lloyd's Complaint. In January 2004 Lloyd's of London, our insurer for the RDM, filed a complaint in the United States District Court for the Western District of Washington seeking the return of the \$17.7 million Lloyd's had paid to us under the RDM insurance policy. On May 12, 2005 we and Lloyd's agreed to jointly pursue recovery against NASA, with us in full control of the appeals process. Lloyd's will participate in any recovery, both pursuant to our administrative claim and our tort claim against NASA, net of legal costs, in accordance with a pre-agreed schedule under which our liability to Lloyd's ranges from a minimum of \$0.5 million if we do not recover any additional amounts to approximately \$17.7 million if we recover over \$70.0 million from NASA. Also, in accordance with the agreement, Lloyd's dismissed its complaint against us with prejudice. We recorded a charge in our fourth quarter fiscal year 2005 financial statements of \$0.5 million pending a final resolution of our actions against NASA.

Tort Claim. On November 8, 2004 we filed a second claim with NASA seeking damages of \$79.7 million under the federal tort claims act for the loss of our RDM resulting from NASA's alleged negligence leading to the destruction of the space shuttle *Columbia* and the loss of our module. The claim represents our loss of \$87.7 million less the \$8.0 million recovered from NASA. NASA failed to respond to this claim. On February 3, 2006 we filed a complaint in the Federal District Court for the Southern District of Texas seeking damages of \$79.7 million under the federal tort claims act. On June 30, 2006 the court granted a motion by the Department of Justice to stay the case until resolution of the Company's appeal (the Contract Claim) before the Armed Services Board of Contract Appeals.

## 12. Subsequent Events

On October 13, 2006 the Company consummated a transaction in which Space Media, Inc., a majority-owned subsidiary of SPACEHAB, Inc., sold the assets of The Space Store LLC, consisting of inventory, furniture, fixtures, and other items. Due to the amount and impact this transaction will have on our financial statements, we decided not to show this discounted operation as a separate component in our consolidated statements of operations for the three months ended September 30, 2006.

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On October 3, 2006 the Company received a letter from The NASDAQ Stock Market notifying the Company of its failure to maintain compliance with the \$1.00 per share of common stock minimum closing bid price requirement over the preceding 30 consecutive trading days as required by Marketplace Rule 4310(c)(4). The letter stated that the Company has until April 2, 2007 to demonstrate compliance by maintaining a minimum closing bid price of \$1.00 per share of common stock for a minimum of 10 consecutive trading days or its common stock will be delisted from The NASDAQ Stock Market.

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**13. Customer Deposits**

During the quarter ended September 30, 2006 we billed and received from our customer payment of \$3.1 million for in-flight insurance on our pressurized module for use on STS-116. STS-116 is scheduled to launch mid-December 2006. This amount is included in cash and cash equivalents as of September 30, 2006. The insurance payment is due to the insurance carrier one month prior to the launch date.

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

You should read the following discussion and analysis together with our consolidated financial statements and notes thereto and the discussion Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 1A. Risk Factors included in our 2006 Annual Report Form 10-K. The following information contains forward-looking statements, which are subject to risks and uncertainties. Should one or more of these risks or uncertainties materialize, our actual results may differ from those expressed or implied by the forward-looking statements.

**OVERVIEW****Forward Looking Statements**

This document may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including (without limitation) statements under Management's Discussion and Analysis of Financial Condition and Results of Operations and Liquidity and Capital Resources. Such statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected in the statements. In addition to those risks and uncertainties discussed herein, such risks and uncertainties include, but are not limited to, whether we will fully realize the economic benefits under our NASA and other customer contracts, continued utilization by NASA and others of our habitat modules and related commercial space assets, completion of the International Space Station (ISS), continued availability and use of the U.S. space shuttle system, technological difficulties, product demand, and market acceptance risks, the effect of economic conditions, uncertainty in government funding, and the impact of competition, delays, and uncertainties in future space shuttle and ISS programs, uncertainties related to the Government's commitment to President Bush's Vision for Space Exploration, and resolution of our claims against NASA arising from the loss of our RDM on the *Columbia* orbiter during the STS-107 mission.

**Financial Summary**

SPACEHAB's first quarter operating results were below management's expectations, however, the Company's revenues significantly exceeded the first quarter of the prior fiscal year and the net loss of \$32,000 improved substantially from the loss of \$1.9 million in the first quarter of the prior fiscal year.

The following table illustrates financial highlights for the quarters ended September 30, 2006 and September 30, 2005:

	<b>2006</b>	<b>2005</b>	<b>Percent</b>		
	<b>(in millions except per share amounts)</b>			<b>Change</b>	
<b>For the Three Months Ended September 30:</b>					
Revenue	14.9	12.0	24	%	
Net Loss	0	(1.9 )			
Diluted EPS	0	(0.15 )			
<b>As of September 30:</b>					
Cash and Cash Equivalents	9.8	4.4	123	%	
Total Debt	64.4	66.4	(3	)%	
Stockholders Equity	2.9	13.0	(78	)%	

**Industry and Market Overview**

We are pleased that the White House is maintaining its vision for U.S. space leadership. We view the President's commitment to space exploration, the human spaceflight program, and the plan for missions to the Moon, Mars, and beyond as positive indicators that will reinvigorate the space program, likely yielding benefits to the aerospace and space commerce industries. We believe that this vision provides NASA with a clear focus, will stabilize the NASA program, and will increase funding for new pursuits.

We believe the impacts of this vision are materializing over time, and we will continue to align our business direction to remain a constructive force in the human spaceflight program. In the long term, we believe that our core competencies offer opportunities to continue to provide services as well as to design, build, and operate assets that



could support initiatives beyond low earth orbit. We plan to pursue these new opportunities. In the near term, our primary objective is to continue providing services to NASA and the space community in support of the space shuttle and the International Space Station programs. We expect that the space shuttle and International Space Station will remain an integral part of the human spaceflight program through 2010 and the International Space Station will continue to support human spaceflight beyond 2010.

We are engaged in defining commercial payload service solutions capable of meeting the International Space Station on-orbit re-supply and return requirements more efficiently than the space shuttle. These activities, some of which leverage our international strategic partnerships and intellectual property rights, include the potential development of an affordable cargo transportation system based on existing commercial launch vehicles and our modular payload integration architecture to transport pressurized and unpressurized cargo to and from space. We further believe that our experience and expertise in the conceptual design, development, ground processing, and on-orbit operations support of payload and crew accommodations position us well for a role in the development of commercial access to space as well as NASA's space exploration systems, the envisioned next phase in human exploration of space.

We operate in three main areas generally related to spaceflight activities within the aerospace industry: space assets and mission support services for manned and unmanned space exploration and research missions; commercial and exploratory satellite pre-launch services; and engineering services in support of government space operations. We also operate a retail space merchandise business and provide space-related educational services. Because of the diversity among the operations of our activities, we report the results of each business as a separate segment in our consolidated financial statements. Our consolidated financial results also reflect corporate-level expenses such as general and administrative, interest, and depreciation and amortization, but because of their nature, these items are not reported as a separate segment.

#### **Business Segments**

Follows is a brief discussion of each of our four business segments, including a list of key factors that have affected, and are expected to continue to affect, their respective earnings and cash flows. We also present a brief discussion of our corporate-level expenses along with a summary of our current liquidity position and items that could impact our liquidity position in fiscal year 2007 and beyond.

*SPACEHAB Flight Services.* This business unit generates revenue by providing space shuttle-based, turnkey services that include customer access to space via our pressurized modules and unpressurized integrated cargo carriers; integration and operations support to logistics suppliers transporting their cargo aboard our modules and integrated cargo carriers to and from the orbiting International Space Station; and/or integration and operations support to scientists and technologists responsible for experiments performed aboard module and integrated cargo carrier research platforms.

We also offer on a space-available basis for each mission, access to space onboard the space shuttle, Russian *Progress*, and European Space Agency automated transfer vehicle cargo vehicles under commercial contracts with non-NASA customers, including both government and private customers. Commercial contracts with non-NASA customers will continue to be established directly between us and our commercial customers.

Additionally, we provided cargo shipment coordination services to NASA for all U.S. cargo shipped to the International Space Station via the Russian *Progress* space vehicle. These services are provided under contract with Lockheed Martin, the prime Cargo Mission Contract contractor to NASA. We also provide research access to space and on the International Space Station to the Japanese Aerospace Exploration Agency through Rocket Space Corporation-Energia (RSC-Energia), a major Russian aerospace enterprise. We contracted through V.J.F. Russian Consulting with RSC-Energia for construction of certain space research equipment, access to Russian *Progress* launch vehicles, and research space aboard the International Space Station when the originally-scheduled services on the space shuttle were suspended due to the *Columbia* tragedy.

The primary factors impacting our SFS business unit earnings and cash flows are the number of space shuttle missions flown and the configuration of the cargo handling and research logistics required for each mission. Our revenues and earnings, if any, from each mission are dependent upon the space assets required in the cargo or research logistics configuration and the mission support services required to employ those assets. Other factors that have impacted, and are expected to continue to impact, earnings and cash flows for this business unit include:





- Congress funding for NASA and the allocation of that funding to International Space Station operations and space shuttle cargo missions
- The dependability of the U.S. space shuttle manifest
- The role of international space research projects flying on future space shuttle and Russian and European Space Agency missions
- The growth of space exploration programs within NASA and NASA's commitment to the President's Vision for Space Exploration regarding enhancement of the role of commercial enterprise in space exploration programs
- Our ability to control our capital expenditures, particularly those for spare or replacement parts for space assets

*Astrotech Space Operations.* Revenue is generated from various fixed-price contracts with launch service providers in both the commercial and government markets. The services and facilities we provide to our customers support the final assembly, checkout, and countdown functions associated with preparing a spacecraft for launch.

The earnings and cash flows generated from our Astrotech operations are related to the number of commercial spacecraft launches, which reflects the growth in the satellite-based communication industries, and the requirement to replace aging satellites. Other factors that have impacted, and are expected to continue to impact, earnings and cash flows for this business include:

- Our ability to control our capital expenditures, which primarily are limited to modifications to accommodate payload processing for new launch vehicles, maintenance and safety, environmental and reliability projects, and other costs, through disciplined management and safe, efficient operations
- The continuing limited availability of competing facilities at the major domestic launch sites that can offer compatible services, leading to an increase in government use of our services

*SPACEHAB Government Services.* Our SGS business unit generates revenue by providing support to the U.S. Government in the areas of large-scale configuration and data management programs such as the International Space Station; specialized hardware design, development, and fabrication; low- to high-fidelity mockup design and construction; and safety and quality support services. This business unit offers a wide array of products and services in these varied fields. Our SGS business unit currently provides configuration management services as a subcontractor of ARES Corporation under ARES Program Integration and Control (PI&C) contract with NASA.

Earnings from our SGS business unit operations are dependent on our ability to continue to win contracts with NASA or other government entities through the competitive bidding process and our performance under those contracts in achieving performance bonuses. Other factors that have impacted, and are expected to continue to impact, earnings and cash flows for this business include:

- Continuation through the government fiscal year 2008 of our PI&C contract with the International Space Station program and exercise of the contract options through the government fiscal year 2010
- Our ability to maintain small business qualification for our SGS business unit under NASA contracting rules
- Our ability to control costs within our budget commitments

*Space Media.* Our space media business unit operates a retail store and internet store offering space-themed products. Revenue and earnings in our retail operations are dependent upon general enthusiasm for the space exploration program, advertising and promotion, and competition.

*Corporate and Other.* Significant items impacting future earnings and cash flows include:

- Interest expense which has decreased due to the repayment of a substantial portion of our mortgage debt during fiscal year 2004 using proceeds from The Boeing Company's ( Boeing's ) early termination of their satellite preparation contract with our Astrotech business unit and the refinancing of our long-term debt during fiscal year 2006
- The ultimate settlement of our claim against NASA for indemnification of our losses on the Space Shuttle *Columbia* mission and/or our tort claim
- Income taxes, with respect to which we currently only pay alternative minimum tax and minimal state income taxes; income taxes will also be impacted by our ability to realize our significant deferred tax assets, including loss carry forwards