

SPACEHAB INC \WA\  
Form 10-Q  
November 14, 2005  
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**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, 2005

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 No. 0-27206

**SPACEHAB, Incorporated**

(Exact name of registrant as specified in this charter)

Washington  
(State or other jurisdiction)

91-1273737  
(I.R.S. Employer)

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of incorporation or organization)

Identification No.)

**12130 Highway 3, Building 1**

**Webster, Texas 77598-1504**

**(713) 558-5000**

(Address of principal executive offices, including zip code, and telephone number)

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 an accelerated filer (as defined in rule 12b-2 of the Exchange Act). Yes  No

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 7, 2005 there were 12,717,727 shares of the registrant's common stock outstanding.

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**SPACEHAB, INCORPORATED AND SUBSIDIARIES**  
**MARCH 31, 2005 QUARTERLY REPORT ON FORM 10-Q**

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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.

APB	Accounting Principles Board
ASO	Astrotech Space Operations
Astrotech	Astrotech Space Operations
ATV	Automated Transfer Vehicle
Boeing	The Boeing Company
CE&R	Concept Exploration and Refinement
CMC	Cargo Mission Contract
Common Stock	SPACEHAB common stock
EADS	EADS Space Transportation
EELV	Evolved Expendable Launch Vehicle
EPS	Earnings Per Share
ESP2	External Stowage Platform 2
ESP3	External Stowage Platform 3
FASB	Financial Accounting Standards Board
ICC	Integrated Cargo Carrier
IDIQ	Indefinite Delivery Indefinite Quantity
ISS	International Space Station
IVA Handrails	Intravehicular Activity Handrails
JAXA	Japan Aerospace Exploration Agency
JETIS	Japanese Experiment Thermal Incubator Service
Lloyd s	Lloyd s of London
Lockheed Martin	Lockheed Martin Corporation
NASA	National Aeronautics and Space Administration
ORU	Orbital Replacement Unit
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.
SPF	Spacecraft Processing Facility

**Table of Contents****PART 1: 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, 2005 (unaudited)	June 30, 2005
<b>ASSETS</b>		
Cash and cash equivalents	\$ 4,355	\$ 7,327
Restricted cash	2,542	970
Accounts receivable, net	15,898	16,906
Prepaid expenses and other current assets	701	693
	<u>23,496</u>	<u>25,896</u>
Total current assets	23,496	25,896
Property and equipment, net of accumulated depreciation and amortization of \$53,467 and \$52,224, respectively	73,045	73,647
Deferred financing costs, net	1,695	1,278
Other assets, net	1,254	1,130
	<u>99,490</u>	<u>101,951</u>
Total assets	\$ 99,490	\$ 101,951
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Mortgage loan payable, current portion	\$ 2,085	\$ 2,057
Accounts payable	1,575	2,219
Accounts payable-EADS	2,417	1,796
Accrued interest	2,349	1,088
Accrued expenses	2,410	3,717
Accrued subcontracting services	7,335	7,552
Deferred gains on sale of buildings	233	221
Deferred revenue	2,016	1,811
	<u>20,420</u>	<u>20,461</u>
Total current liabilities	20,420	20,461
Accrued contract cost and other	177	221
Deferred gains on sale of buildings	1,526	1,587
Mortgage loan payable, net of current portion	1,103	1,635
Convertible subordinated notes payable	63,250	63,250
	<u>86,476</u>	<u>87,154</u>
Total liabilities	86,476	87,154
Commitments and contingencies		
Stockholders' equity		
Preferred Stock, no par value, convertible, 2,500,000 shares authorized, 1,333,334 shares issued and outstanding, (liquidation preference of \$12,000)	11,892	11,892

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Common stock, no par value, 30,000,000 shares authorized, 12,833,827 and 12,781,279 shares issued, respectively	83,938	83,889
Additional paid-in capital	16	16
Deferred stock-based compensation	86	
Treasury stock, 116,100 shares, at cost	(117)	(117)
Accumulated deficit	(82,801)	(80,883)
	<u>          </u>	<u>          </u>
Total stockholders' equity	13,014	14,797
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$ 99,490	\$ 101,951
	<u>          </u>	<u>          </u>

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****SPACEHAB, INCORPORATED AND SUBSIDIARIES****Unaudited Condensed Consolidated Statements of Operations**

(In thousands, except share data)

	<b>Three Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
Revenue	\$ 11,985	\$ 13,033
Costs of revenue	10,212	10,786
<b>Gross profit</b>	<b>1,773</b>	<b>2,247</b>
Operating expenses		
Selling, general and administrative	2,280	1,966
Research and development	78	7
Recovery related to Research Double Module ( RDM )		(8,244)
<b>Total operating expenses</b>	<b>2,358</b>	<b>(6,271)</b>
Income (loss) from operations	(585)	8,518
Interest expense	(1,408)	(1,458)
Interest and other income, net	109	41
<b>Income (loss) before income taxes</b>	<b>(1,884)</b>	<b>7,101</b>
Income tax expense	(32)	(142)
<b>Net income (loss)</b>	<b>\$ (1,916)</b>	<b>\$ 6,959</b>
Income (loss) per share:		
Net income (loss) per share basic	\$ (0.15)	\$ 0.55
Shares used in computing net income (loss) per share basic	12,671,576	12,574,224
Net income (loss) per share diluted	\$ (0.15)	\$ 0.49
Shares used in computing net income (loss) per share diluted	12,671,576	14,247,860

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****SPACEHAB, INCORPORATED AND SUBSIDIARIES****Unaudited Condensed Consolidated Statements of Cash Flows**

(In thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>Cash flows from operating activities</b>		
Net income (loss)	\$ (1,916)	\$ 6,959
Adjustments to reconcile net income to net cash provided by operating activities:		
Stock-based compensation	86	
Depreciation and amortization	1,345	1,365
Loss on asset sales and write-offs		3
Recognition of deferred gain	(50)	
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	1,008	(6,798)
Increase in prepaid expenses and other current assets	(8)	(153)
(Increase) decrease in other assets	(131)	1,088
Decrease in accounts payable, accounts payable-EADS, accrued interest, and accrued expenses	(69)	(1,930)
(Decrease) increase in accrued subcontracting services	(217)	771
(Decrease) increase in deferred revenue	205	(3,013)
Decrease in long-term accrued contract costs and other liabilities	(44)	(154)
<b>Net cash provided by (used in) operating activities</b>	<b>211</b>	<b>(1,862)</b>
<b>Cash flows from investing activities</b>		
Purchases of property, equipment and leasehold improvements	(642)	(95)
Sale of short-term investments		964
Increase in restricted cash	(1,572)	(128)
<b>Net cash provided by (used in) investing activities</b>	<b>(2,214)</b>	<b>741</b>
<b>Cash flows from financing activities</b>		
Borrowings under revolving loan payable, net		1,047
Payment of mortgage loan	(504)	(476)
Increase in deferred financing	(514)	
Proceeds from issuance of common stock, net of expenses	49	44
<b>Net cash provided by (used in) financing activities</b>	<b>(969)</b>	<b>615</b>
<b>Net change in cash and cash equivalents</b>	<b>(2,970)</b>	<b>(506)</b>
Cash and cash equivalents at beginning of period	7,327	506
<b>Cash and cash equivalents at end of period</b>	<b>\$ 4,355</b>	<b>\$</b>



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See accompanying notes to unaudited condensed consolidated financial statements.

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### **SPACEHAB, INCORPORATED AND SUBSIDIARIES**

#### **Notes to Unaudited Condensed Consolidated Financial Statements**

##### **1. The Company**

Incorporated in 1984, SPACEHAB is the first company to commercially develop, own and operate pressurized space habitat modules which serve the international community in supporting both manned and unmanned missions to space. Today, SPACEHAB is the leading provider of access to space, supporting research and cargo needs of commercial and government users alike. SPACEHAB and its subsidiaries provide the following services:

- Access to space through the use of research and logistics modules and carriers
- Expertise on space architectures, habitability and occupational challenges of space
- Facility operations and pre-launch spacecraft processing services
- Engineering, analysis, and space payload transportation services
- Program integration and control
- Space equipment and product design and development
- Space media, education, and retail goods

Through our SPACEHAB Flight Services ( SFS ) business unit, we own pressurized space habitat modules which are carried in the cargo bay of the space shuttle to provide capacity and workspace for cargo and research payloads, and unpressurized cargo carriers which also are carried in the cargo bay of the space shuttle providing unpressurized capacity for cargo payloads such as International Space Station spare and component parts. The need for our modules and integrated cargo carriers ( ICCs ) depends on the specific requirements of each space shuttle mission. When our equipment is deployed on a space shuttle mission we provide the mission integration and operations support required to successfully configure, load, operate and ultimately unload our modules and/or ICCs. We also solicit research payloads worldwide for space shuttle missions when space is available on our modules beyond the National Aeronautics and Space Administration s ( NASA s ) requirements and have provided similar research payload marketing for the Russian *Progress* spacecraft and the European automated transfer vehicle ( ATV ). Through September 30, 2005, SPACEHAB modules and ICCs have flown on 19 missions on the space shuttle, including 13 logistics missions (six to the International Space Station ( ISS ) and seven to the Russian space station *Mir*).

SPACEHAB provides commercial spacecraft processing facilities and services through its wholly-owned subsidiary, Astrotech Space Operations, Inc. ( Astrotech or ASO ). Astrotech is a commercial provider of ground processing services in the United States, supplying the facilities and services used in the launch preparation of spacecraft. We serve payload customers launching on a wide range of expendable launch vehicles including Atlas, Delta, Pegasus, Sea Launch, and Taurus, as well as secondary payloads flown on the space shuttle. In fiscal year 2002, we completed construction of a state-of-the-art processing facility in Titusville, Florida to process larger five-meter class satellites and payload fairings for the Evolved Expendable Launch Vehicle ( EELV ) programs. With more than 230 spacecraft processed, ASO diversifies SPACEHAB s customer base and broadens our core competencies.

SPACEHAB Government Services ( SGS ) provides engineering support services for the U.S. Government and various commercial industries. As a NASA contractor for over 30 years, this unit offers a wide array of products and services in the engineering, program integration and control, and product development disciplines. Specifically, we manage projects in need of comprehensive engineering solutions and provide unique capabilities such as specialty engineering, hardware design and development, and configuration and data management.

Space Media, Inc. ( SMI ), a majority-owned subsidiary intended to create proprietary space-themed content for education and commerce, provides the space enthusiast with a variety of services. These services range from outfitting a comprehensive space exhibit to providing astronaut appearances and product endorsements and includes an online retailing outlet, TheSpaceStore.com. This website and retail store, adjacent to NASA s Johnson Space Center in Houston, offers nearly 1,200 products, including distinctive and personalized gifts, clothing, mission patches, and more.

**Table of Contents****SPACEHAB, INCORPORATED AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****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, except as discussed elsewhere within, necessary for a fair presentation of the consolidated financial position of SPACEHAB, Incorporated and its subsidiaries as of September 30, 2005, and the results of its operations and cash flows for the periods ended September 30, 2005 and 2004. However, the condensed consolidated financial statements are unaudited and do not include all related footnote disclosures.

The consolidated results of operations for the three month period ended September 30, 2005 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 the Company's audited consolidated financial statements appearing in our Annual Report on Form 10-K for the fiscal year ended June 30, 2005.

The Company's cash as of September 30, 2005 was approximately \$6.9 million, of which \$2.5 million is subject to certain restrictions. Management believes that we have sufficient liquidity, including cash, advances available under the Company's revolving credit facility, and cash anticipated or expected to be generated from operations to fund ongoing operations. We also expect to utilize existing cash and cash anticipated from future operations for research and development activities, and for new business initiatives.

**3. Earnings per Share**

The following are reconciliations of the numerators and denominators of the basic and diluted earnings per share (EPS) computations for the three month period ended September 30, 2005 and 2004 (in thousands, except share and per share data):

	Three months ended September 30, 2005			Three months ended September 30, 2004		
	Income (Numerator)	Shares (Denominator)	Per Share Amount	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS:						
Income (loss) available to common stockholders	\$ (1,916)	12,671,576	\$ (0.15)	\$ 6,959	12,574,224	\$ 0.55
Effect of dilutive securities:						
Options and warrants, using the treasury stock method					340,302	
Convertible preferred shares					1,333,334	

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Diluted EPS:

Income (loss) available to common stockholders	\$ (1,916)	12,671,576	\$ (0.15)	\$ 6,959	14,247,860	\$ 0.49
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Convertible notes payable outstanding as of September 30, 2005, convertible into 4,642,202 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, 2005 and 2004, 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.

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.

**Table of Contents****SPACEHAB, INCORPORATED AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Options to purchase 1,191,697 shares of common stock, at prices ranging from \$3.44 to \$11.75 per share, were outstanding at September 30, 2004 but were not included in diluted EPS for the three months ended September 30, 2004 as the option prices were greater than the average market price of the common shares during the period. The options expire between October 21, 2004 and February 12, 2011.

**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 of an equitable adjustment on the Cargo Mission Contract ( CMC ) contract which was added to the contract as a pricing amendment due to the delay in the return to flight of the space shuttle. 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.

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

<u>Business Segment</u>	<u>Services/Products Provided</u>	<u>Contract Type</u>	<u>Method of Revenue Recognition</u>
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	Reimbursable costs incurred plus award/fixed fee
Space Media, Inc.	Space-Themed Commercial Products/Activities	Retail	Internet and retail sales recognized when goods are shipped

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Support for STS-121, 116, and 118 continues under a subcontract with Lockheed Martin Corporation ( Lockheed Martin ), effective February 1, 2004. Revenues for the Lockheed Martin subcontract are being accounted for under the percentage-of-completion method based on costs incurred over the period of the agreement. In August 2005 NASA announced a target of May 2006 for the next space shuttle mission launch, STS-121. We expect the delay of this and other missions to have a marginal impact on our revenues and margins over the coming months as we continue the mission specific work and receive revenue for our asset maintenance fees.

### 5. Statements of Cash Flows Supplemental Information

- (a) Cash paid for interest costs was \$0.1 million and \$0.1 million for the three months ended September 30, 2005 and 2004, respectively. We did not capitalize any interest costs during the three months ended September 30, 2005 or 2004.

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**SPACEHAB, INCORPORATED AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

- (b) We paid an immaterial amount of income taxes for the three months ended September 30, 2005 and paid \$0.3 million for income taxes for the three months ended September 30, 2004.

**6. Credit Facilities**

On August 29, 2002 we entered into a \$5.0 million line of credit with a financial institution. The term of this credit facility was through August 28, 2005. Covenants included a liquidity ratio and a limited pledge of \$5.6 million of the Company's investment account. The restriction on the investment balance was equal to 111% of the borrowings on the line of credit. In June 2004 the credit agreement was amended again to remove the financial covenant on capital expenditures. This credit facility was replaced with a new revolving credit facility from another financial institution on February 11, 2005.

On February 11, 2005 we entered into a revolving credit facility with a bank providing for loans up to \$5.0 million secured by the Company's accounts receivable. Funds available under the revolving credit facility are limited to 80% of eligible accounts receivable and the Company is 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. As of September 30, 2005 we amended this credit facility to modify the cash flow covenant so that the Company may secure advances with cash balances if the required cash flow ratio is not met. As of September 30, 2005 there have been no borrowings under this revolving credit facility, and we posted a restricted cash balance of \$2.0 million in accordance with the financial covenants. As of September 30, 2005 there was \$5.0 million available under this credit facility.

On August 30, 2001 our Astrotech subsidiary completed a \$20.0 million financing of its Spacecraft Processing Facility ( SPF ) expansion project in Titusville, Florida (the term loan ) with a financial institution. The proceeds of this financing were used to complete the construction of the SPF and supporting infrastructure. The term loan was collateralized primarily by the multi-year payload processing contracts with The Boeing Company ( Boeing ) and Lockheed Martin and by the building. The net book value of the building as of September 30, 2005 was \$22.2 million. The term loan was scheduled to mature on January 15, 2011.

On October 1, 2003 Astrotech was notified by Boeing that it was exercising its termination rights with regards to its financial guarantees under the contract agreement with Astrotech for payload processing support services for the Delta launch vehicle program. Boeing indicated that the decision to terminate its guarantees for future Astrotech services was based on the downturn of the commercial expendable launch market rather than performance related considerations. We were in full compliance with the contract terms at the time of the termination. Under the contract provision related to termination of its financial guarantees, Boeing paid us \$17.5 million in December 2003 representing consideration of future contract payments previously used to collateralize the obligation. The term loan agreement was amended on January 29, 2004, whereby the maturity date was shortened to January 2007, the interest rate was fixed at 5.5% and the hedge requirement was eliminated. In the quarter ending September 30, 2005 we repaid \$0.5 million of principal on the term loan.

**7. Segment Information**



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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. SMI was established in April 2000 to develop space-themed commercial business activities.

The Company's chief operating decision maker utilizes both revenue and income (loss) before income taxes, in assessing performance and making overall operating decisions and resource allocations.

**Table of Contents****SPACEHAB, INCORPORATED AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Three Months Ended September 30, 2005 (in thousands):**

	<u>Revenue</u>	<u>Income (Loss) before income taxes</u>	<u>Net Fixed Assets</u>	<u>Depreciation And Amortization</u>
SPACEHAB Flight Services	\$ 8,497	\$ 1,340	\$ 26,871	\$ 760
Astrotech	1,978	(131)	45,490	532
SPACEHAB Government Services	1,286	70		
Space Media	224	2		
Corporate		(3,165)	684	53
	<u>\$ 11,985</u>	<u>\$ (1,884)</u>	<u>\$ 73,045</u>	<u>\$ 1,345</u>

**Three Months Ended September 30, 2004 (in thousands):**

	<u>Revenue</u>	<u>Income (Loss) before income taxes</u>	<u>Net Fixed Assets</u>	<u>Depreciation And Amortization</u>
SPACEHAB Flight Services	\$ 9,642	\$ 10,147	\$ 31,505	\$ 662
Astrotech	1,712	(231)	46,577	512
SPACEHAB Government Services	1,539	227	58	7
Space Media	140	(21)		
Corporate		(3,021)	280	91
	<u>\$ 13,033</u>	<u>\$ 7,101</u>	<u>\$ 78,420</u>	<u>\$ 1,272</u>

**8. Common Stock Options and Stock Purchase Plans**

The Company grants options to employees and directors utilizing three shareholder-approved plans.

**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 (the 1994 Plan ), stock options granted to the Company s 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 the Company s 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.

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**SPACEHAB, INCORPORATED AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**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. Employees purchased an aggregate of 35,548 shares at an average price of \$1.03 during the three-month period ended September 30, 2005. The options granted 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 of the Company, 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. The options vest equally over a four-year period and have a life of 10 years.

**Statement of Financial Accounting Standard No. 123R**

Effective July 1, 2005, the Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), Share-Based Payment, ( SFAS No. 123R ) which was issued by the Financial Accounting Standards Board ( FASB ) in December 2004. SFAS No. 123R revises SFAS No. 123, Accounting for Stock Based Compensation, and supersedes Accounting Principles Board Opinion ( APB ) No. 25, Accounting for Stock Issued to Employees, and its related interpretations. SFAS No. 123R requires recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services in exchange for the award (presumptively the vesting period). SFAS No. 123R also requires measurement of the cost of employee services received in exchange for an award based on the grant-date fair value of the award. SFAS No. 123R also amends SFAS No. 95, Statement of Cash Flows, to require that excess tax benefits be reported as financing cash inflows, rather than as a reduction of taxes paid, which is included within operating cash flows.

As a result of adopting SFAS No. 123R using the modified prospective method, the Company recognized compensation expense in the current period for incentive stock awards and expense related to our employee stock purchase plan of \$0.1 million.

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Prior to July 1, 2005, the Company applied the provisions of APB No. 25 and its related interpretations to account for stock options. Under APB No. 25 and its related interpretations, the Company did not recognize any associated compensation expense related to stock options. If compensation expense associated with these plans was determined in accordance with SFAS No. 123, the Company's net earnings and earnings per share for the three month period ended September 30, 2004 would have been as follows:

**Table of Contents****SPACEHAB, INCORPORATED AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>Three Months Ended September 30,</b>
	<b>2004</b>
<b>(Unaudited)</b>	
Net income, as reported	\$ 6,959
Deduct effect of stock option based employee compensation, net of tax effects:	
Employee Stock Purchase Plan	(23)
Incentive Stock Plan	(31)
<b>Pro forma net earnings</b>	<b>\$ 6,905</b>
<b>Earnings per share, as reported:</b>	
Diluted	\$ 0.49
Basic	\$ 0.55
<b>Pro forma earnings per share:</b>	
Diluted	\$ 0.49
Basic	\$ 0.55

The Black-Scholes option pricing model was used to calculate the estimated fair value of the options.

**9. Stock Repurchase**

On March 25, 2003 the Board of Directors authorized the Company to repurchase up to \$1.0 million of the Company's outstanding common stock at market prices. Any purchases under the Company's stock repurchase program may be made from time to time, in the open market, through block trades or otherwise in accordance with applicable regulations of the Securities and Exchange Commission ( SEC ). For the three months ended September 30, 2005, we did not repurchase any shares. As of September 30, 2005, we had repurchased 116,100 shares at a cost of \$117,320 under the program, which represents an average cost of \$1.01 per share.

**10. Related Party Transactions**

The Company engaged in certain transactions with directors, executive officers, shareholders, and certain former officers during the three months ended September 30, 2005. Following is a description of these transactions:

**EADS Space Transportation**

Dr. Graul, a member of SPACEHAB's Board of Directors, is the Executive Vice President for EADS Space Transportation. EADS 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, 2005 and 2004, EADS's payload and integration services included in cost of revenue were approximately \$2.7 million and \$3.4 million, respectively.

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**SPACEHAB, INCORPORATED AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**V.J.F. Russian Consulting**

On January 30, 2004 we entered into a subcontract agreement with V.J.F. Russian Consulting. The president of V.J.F. Russian Consulting, Vladimir Fishel, is a former Vice President of SPACEHAB who at the time of entering into a part-time employment agreement for other consulting activities was receiving severance payments from the Company on a part-time employment arrangement for other consulting activities. The services being provided under the subcontract agreement (valued at \$2.6 million) is in support of a contract that SPACEHAB has with the Mitsubishi Corporation in support of Japan Aerospace Exploration Agency ( JAXA ). During the three months ended September 30, 2005 and 2004, the amounts paid were \$0.1 million and \$0.3 million, respectively.

On June 1, 2004 the Company entered into a consulting agreement with V.J.F. Russian Consulting for:

- (1) Marketing and promotion of SPACEHAB capabilities and services to Rocket Space Corporation-Energia ( RSC-Energia ), the Russian Federation Space Agency, and other Russian entities involved in the exploration and development of space;
- (2) Supporting and assisting SPACEHAB in the negotiation of service contracts and agreements between Russian entities; and
- (3) Providing technical expertise and services in support of SPACEHAB activities, under contracts with Russian entities.

Total commitments under the consulting agreement are \$0.3 million, of which \$0.1 million was paid in the three months ended September 30, 2005 and for the three months ended September 30, 2004.

**Daniel A. Bland**

On June 27, 2005 we entered into an agreement with Daniel A. Bland, whereas Mr. Bland will provide consulting services to the Company. The initial term of the agreement began July 2, 2005 and ends 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. The Company shall pay Mr. Bland a retainer fee at the rate of \$6,000 per month. In addition, in any month that Mr. Bland works over fifty hours in a month, he shall be paid at a rate of \$125 per hour worked. Mr. Bland retired as Senior Vice President of our SPACEHAB Flight Services business unit as of June 30, 2005.

**John B. Satrom**

On August 11, 2005 we entered into an agreement with John B. Satrom pursuant to which Mr. Satrom will provide consulting services to the Company. The initial term of the agreement begins August 15, 2005 and ends December 31, 2005, 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. The Company shall pay Mr. Satrom a retainer fee at the rate of \$5,000 per month. For any additional time spent over forty hours in a month, Mr. Satrom will be paid \$125 per hour. Mr. Satrom resigned as Senior Vice President and General Manager of our Astrotech Space Operations business unit effective August 12, 2005.

#### **11. Recent Accounting Pronouncement**

In May 2005 the FASB issued SFAS No. 154 Accounting Changes and Error Corrections. SFAS No. 154 replaces APB Opinion No. 20 and SFAS No. 3. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will adopt this Statement beginning July 1, 2006. Currently the Company is not aware of any financial impact the adoption of this statement will have on our consolidated financial statements.

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**SPACEHAB, INCORPORATED AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**12. Subsequent Events**

On July 21, 2005 we filed Form S-4 Registration Statement with the SEC which outlined the terms of our offer to exchange our 8% convertible subordinated notes due in 2007, which became effective September 2, 2005. On October 20, 2005 we filed a post-effective amendment to the terms of the offer in which the terms were stated that we intended to exchange our 8% convertible subordinated notes due in 2007 for 5.5% senior convertible notes due in 2010 with a conversion price of \$1.50 per share. Unless extended or terminated earlier, the offer is to expire on November 16, 2005.

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

*The following discussion should be read together with the unaudited consolidated financial statements and the notes thereto included in this report.*

**OVERVIEW**

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 the Company will fully realize the economic benefits under its NASA and other customer contracts, continued utilization by NASA and others of our habitat modules and related commercial space assets, completion of the 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 the Company's claims against NASA arising from the loss of its RDM on the *Columbia* orbiter during the STS-107 mission.

In the midst of great change within the global space services industry, our priority is on sustaining our reputation for innovation and technical excellence, securing new business, forging strategic partnerships, and expanding our core capability. While we continue to place an emphasis on enjoying our work, an attribute that draws to SPACEHAB the most knowledgeable and capable employees in the industry, we continue to focus, with great intensity, on business fundamentals. These entail the things that we must do to maintain our reputation as an affordable, capable, and dependable supplier of commercial space services while generating profit and attaining the success we seek in a highly competitive industry.

To better serve the emerging needs of the space-faring community worldwide, SPACEHAB is augmenting its proven services with new capabilities. We are conducting a detailed market assessment of the commercial and government markets identifying specific customer space access requirements. We are preparing for major NASA solicitations in support of their commercial ISS resupply requirements and procurements associated with the vision for space exploration. We are also developing a family of rocket-launched spacecraft, known as Apex, to accommodate delivery and return of pressurized and unpressurized cargo to and from ISS, and provide space and spacecraft services for space-based research, technology development, and mission operations across the full spectrum of science, exploration, commercial, and defense applications. The Apex modular, multipurpose spacecraft system includes a variety of configurations, sized to perform a range of missions, from small payload services platforms and advanced technology demonstrator, to cargo transport to and from the ISS and other destinations throughout the solar system. The Apex spacecraft are designed for a recoverable reentry to allow the payload owner or operator to get back their costly flight hardware, cargo item, or experiment results.

SPACEHAB operates in three main areas generally related to space flight 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 operation 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.



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### **Business Segments**

Following 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 2006 and beyond. This Overview section is merely a summary and should be read together with the remainder of Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as the audited consolidated financial statements, including the notes thereto, and the other information included in the Company's Form 10-K/A for the fiscal year ended June 30, 2005.

*SPACEHAB Flight Services* generates revenue by providing space shuttle-based, turnkey services that include customer access to space via our family of pressurized modules and unpressurized pallet carriers; integration and operations support to logistics suppliers transporting their cargo aboard our carriers to and from the orbiting ISS; and/or integration and operations support to scientists and technologists responsible for experiments performed aboard module and pallet 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 ATV 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 SPACEHAB and its commercial customers.

During the space shuttle stand-down period, SFS is providing cargo shipment coordination services to NASA for all U.S. cargo shipped to the ISS via the Russian *Progress* space vehicle. These services are provided under contract to Lockheed Martin, the CMC contractor to NASA. We are also providing research access to space and on the ISS to JAXA through RSC-Energia, a major Russian aerospace enterprise. SPACEHAB contracted through V.J.F. Russian Consulting with RSC-Energia for construction of certain space research equipment, launch vehicle, and research space aboard the Russian *Progress* carrier when the originally-scheduled services on the space shuttle were suspended due to the *Columbia* tragedy.

The primary factors impacting our SFS 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 ISS operations and space shuttle cargo missions

- The flight schedule of the U.S. Space Shuttle

- The role of international space research projects flying on future space shuttle and on Russian and European Space Agency missions

- The growth of space exploration programs within NASA and NASA's commitment to the Nation's Vision on 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, Inc.* revenue is generated from various fixed-price contracts with launch service providers in both the commercial and government markets. The services and facilities Astrotech provides to its customers support the final assembly, checkout, and countdown functions associated with preparing a spacecraft for launch. This preparation may include: the final assembly and checkout of the spacecraft, check-out and installation of the solid rocket motors, loading of the liquid propellants, encapsulation of the satellite in the launch vehicle payload fairings, and command and control of the spacecraft during pre-launch countdown.

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:

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

*SPACEHAB Government Services, Inc.* revenue is generated by providing support to the Government in the areas of large-scale configuration and data management programs such as the ISS; 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. SGS is currently under contract to provide configuration management services within the Program Integration and Control ( PI&C ) contract of which ARES Corporation is the prime contractor.

Our earnings in SGS 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 2008 of our PI&C contract with the ISS Program
- Our ability to maintain small business qualification under NASA contracting rules
- Our ability to control costs within our budget commitments

*Space Media, Incorporated* operates a retail store and internet store offering space-themed products and is engaged in space-related educational programs and other space-themed activities. 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:

- 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

*Liquidity.* As of September 30, 2005 we had cash on hand of \$6.9 million of which \$2.5 million is restricted. Our \$5.0 million revolving credit facility had no outstanding borrowings as of September 30, 2005. Our ability to maintain sufficient liquidity in the future will depend on a number of factors including our ability to acquire future business, control our costs and manage capital expenditures, the return to flight of the space shuttle, and the continued activity in the commercial and governmental satellite launch industry.

We expect that our operating cash flows through fiscal year 2006 will be sufficient to satisfy our capital expenditures, debt maturities, interest expenses, and operating commitments. In February 2005 we entered into a new \$5.0 million revolving credit facility, replacing our previous revolving credit facility. This new revolving credit facility is secured by our accounts receivable and is subject to various financial and other covenants, including a minimum tangible net worth covenant, a cash flow covenant, and a secured debt coverage covenant. The new revolving credit agreement provides access to previously restricted cash and short term investments and to advances secured by accounts receivable, enhancing the Company's liquidity.

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Over the longer term we believe that the space shuttle's return to flight and the President's vision for space exploration will lead to increased activity and related cash flows from operations for our SFS business segment. We expect additions to our contract with Lockheed Martin for ISS configuration hardware and contract additions in our satellite processing business, reflecting increased activity in the space exploration and commercial satellite industries. However, there can be no assurance that the space shuttle will return to flight in the near term or that we will be able to win future contracts with NASA, other national space agencies, or commercial space enterprises, or to successfully exploit other business opportunities. Failure to achieve such events would have a material adverse effect



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on our financial condition and results of operations and could adversely affect our ability to redeem our subordinated convertible notes when they mature in October 2007 which we are currently in the process of exchanging for New Notes that would extend maturity of this debt to October 2010.

## **Revenue**

The Company's revenue for the three months ended September 30, 2005 and 2004 was generated primarily from the Lockheed Martin Cargo Mission Contract, and contracts with related commercial customers in the SFS segment; the PI&C contract in the SGS segment; and our contract with Lockheed Martin in the Astrotech segment and other commercial satellite providers. Revenue for SMI was immaterial for the three months ended September 30, 2005 and 2004. During the period, there were shuttle and satellite launch delays that affected planned revenue that is expected to materialize in the upcoming months in our Astrotech and SFS business units.

Our SFS business segment is supporting NASA's return-to-flight activities and is continuing operations in preparation for shuttle missions including STS-121, 116, and 118 (in order of their anticipated flight sequence). SFS is preparing a cargo carrier for STS-118, the External Stowage Platform 3 (ESP3) that will be deployed and permanently mounted to the ISS. For STS-121, we are scheduled to provide our non-deployable unpressurized carrier to NASA under our CMC subcontract with Lockheed Martin for transport of several critical ISS Orbital Replacement Unit (ORU) spares. Additionally, commencing in April 2004, SFS stopped subcontracting its module mission integration, operations and sustaining engineering technical support to Boeing. Most module mission tasks previously performed by Boeing personnel are now being performed by SFS personnel, and selected NASA cargo integration tasks on SPACEHAB module missions are now being performed by Lockheed Martin as a part of their CMC with NASA. This decision enables SFS to continue to provide services to NASA and is consistent with the direction of the ISS Program Office.

In January 2004 the Company initiated activity under the Japanese Experiment Thermal Incubator Service (JETIS) contract with the Mitsubishi Corporation, representing JAXA that was entered into in 2000 and originally scheduled to fly aboard SPACEHAB's RDM. Subsequent to the suspension of the space shuttle flights and destruction of SPACEHAB's RDM, the Company contracted for construction of certain space research equipment and for research space aboard the ISS and up to three Russian *Progress* cargo missions with V.J.F. Russian Consulting, representing RSC-Energia, a major Russian aerospace manufacturer and mission operator. The first experiment was successfully launched on the Russian *Progress* spacecraft on August 11, 2004.

During the three months ended September 30, 2005, deferred revenue increased by \$0.2 million. This is as a result of us receiving cash or an increase in accounts receivable for contractual billings on contracts that we have not performed the work under as of the end of the current period. Management expects reductions in deferred revenue through the next twelve months which will result in revenue recognition on contracts for which the related cash was received in a prior period.

## **Costs of Revenue**

SPACEHAB has several types of costs of revenue in its business segments. Costs of revenue for SFS include integration and operations expenses associated with the performance of two types of efforts: (i) sustaining engineering in support of all missions under a contract and (ii) mission specific support. Costs associated with the performance of the contracts using the percentage-of-completion method of revenue recognition are expensed as incurred. Costs associated with the cost-plus award and fixed-fee contracts are expensed as incurred by SGS. Other costs of revenue include depreciation expense and costs associated with the Astrotech payload processing facilities. Flight related insurance covering transportation of the SPACEHAB modules from SPACEHAB's payload processing facility to the space shuttle, in-flight insurance, and

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third-party liability insurance are also included in costs of revenue and are recorded as incurred. Selling, general and administrative and interest and other expenses are recognized when incurred.

We have estimated the useful lives of our space flight assets, which is a component of property and equipment, through June 30, 2016, based on current available space-related programs and activities which management expects

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will extend through 2016. The shuttle retirement could occur at an earlier date, which would accelerate the depreciation recognized upon revision of the estimated useful life.

**Non Recurring Recovery, RDM**

On February 1, 2003 the RDM was lost in the STS-107 tragedy. The net book value of the RDM was \$67.9 million, which, net of insurance proceeds of \$17.7 million, was recognized as a loss in the third quarter of fiscal year 2004. The \$8.0 million plus interest of \$0.2 million paid by NASA as indemnification for our loss of the RDM is recognized as a recovery of previously recognized loss in the quarter ended September 30, 2004. At this time we do not plan to replace the RDM. SPACEHAB's SFS business segment has two additional modules and other flight assets available to support current NASA requirements. These modules and assets can also be used to support future NASA requirements. The shuttle is currently scheduled to return to flight no earlier than May 2006.

**Table of Contents****RESULTS OF OPERATIONS**

*For the three months ended September 30, 2005 as compared to the three months ended September 30, 2004.*

**Revenue.** Revenue decreased approximately 8% to \$12.0 million as compared to \$13.0 million for the three months ended September 30, 2005 and 2004, respectively (in millions).

	<b>Three Months Ended September 30,</b>		<b>Dollar Change</b>	<b>Percent Change</b>
	<b>2005</b>	<b>2004</b>		
SPACEHAB Flight Services	\$ 8.5	\$ 9.6	\$ (1.1)	(11%)
Astrotech Space Operations	2.0	1.7	0.3	18%
SPACEHAB Government Services	1.3	1.5	(0.2)	(13%)
Space Media	0.2	0.2	0.0	0%
	<b>\$ 12.0</b>	<b>\$ 13.0</b>	<b>\$ (1.0)</b>	<b>(8%)</b>

Revenue from the SFS business segment has been adversely affected by the temporary grounding of the shuttle fleet following technical concerns that resulted during the launch of the STS-114 mission in July 2005. This has caused planned fiscal year 2006 revenue to move out into fiscal year 2007 and beyond. Also, the JETIS program did not have any contract activities for the three months ended September 30, 2005, whereas, in the same period last year, the program had its first launch and subsequent on-orbit activities. The following summarizes the other significant items:

Decrease in revenue from External Stowage Platform 2 ( ESP2 ) of \$2.0 million due to the launch of STS-114 in July 2005

Decrease in revenue from the JETIS contract of \$1.5 million due to the timing of the mission operations

Increase in revenue from STS-118 under the CMC with Lockheed Martin of \$2.0 million that was initiated in the third quarter of fiscal year 2005

Increase in revenue from Concept Exploration and Refinement ( CE&R ) contract of \$0.2 million that was started in the first quarter of fiscal year 2005 and completed in the first quarter of fiscal year 2006

Other contract revenue increase of \$0.2 million

Revenue from our Astrotech business unit increased for the three months ended September 30, 2005 by \$0.3 million as compared to the same three month period last fiscal year. This increase is attributable to Astrotech processing two missions within the three month period this fiscal year. For the same period last fiscal year, Astrotech completed two missions that had minimal revenue remaining in the period.

The decrease in revenue at the SGS business segment is primarily due to the delivery of the Intravehicular Activity ( IVA ) Handrails in the third quarter of fiscal year 2005. The following summarizes the significant items:

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Revenue decrease of \$0.1 million due to the delivery of the IVA Handrails in the second quarter of fiscal year 2005

Revenue decrease of \$0.1 million for the PI&C contract due to less contract activity for the three months ended September 30, 2005 as compared to the same period in last fiscal year

Cost of Revenue. Cost of revenue for the three months ended September 30, 2005 decreased by 6% to approximately \$10.2 million, as compared to \$10.8 million for the prior year's quarter (in millions).

	<b>Three Months Ended September 30,</b>		<b>Dollar Change</b>	<b>Percent Change</b>
	<b>2005</b>	<b>2004</b>		
SPACEHAB Flight Services	\$ 7.0	\$ 7.6	\$ 0.6	8%
Astrotech Space Operations	2.0	1.9	(0.1)	(5%)
SPACEHAB Government Services	1.1	1.2	0.1	8%
Space Media	0.1	0.1		0%
	<b>\$ 10.2</b>	<b>\$ 10.8</b>	<b>\$ 0.6</b>	<b>6%</b>

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Cost of revenue from the SFS business segment has been affected by the temporary grounding of the shuttle fleet due to the foam problem that occurred during the launch of STS-114 in July 2005. This has caused project work to be delayed until later periods. Also, the JETIS program did not have any contract activities for the three months ended September 30, 2005, whereas, in the same period last year, the program had its first launch and subsequent on-orbit activities. The following summarizes the significant items:

Decrease in cost of revenue of \$1.5 million for ESP2 due to the launch of STS-114 in July 2005

Decrease in cost of revenue of \$0.7 million for JETIS due to the launch of the first launch and the subsequent on-orbit operations in the three month period ended September 30, 2004 and no contract activities in the three months period ended September 30, 2005

Increase in CE&R cost of revenue of \$0.2 million

Increase in STS-118 mission cost of revenue of \$0.9 million due to the project being initiated in the third quarter of fiscal year 2005

Increase in STS-121 and STS-116 cost of revenue of \$0.3 million due to the missions getting closer to their launch windows

Increased rent expense of \$0.1 million due to the sale and subsequent lease-back of the SPACEHAB Payload Processing Facility during the fourth quarter of fiscal year 2005

Cost of revenue from our Astrotech business unit increased for the three months ended September 30, 2005 by \$0.1 million as compared to the same three month period last fiscal year. This increase is attributable to Astrotech processing two missions for the current three month period which resulted in higher mission related costs of approximately \$0.1 million which resulted in an increase in mission specific expenses and higher fiscal costs. For the same period last fiscal year, Astrotech completed two missions that began in the previous three month period with minimal facility occupancy in the period.

The decrease in costs of revenue of \$0.1 million in the SGS business segment is primarily due to the delivery of the IVA Handrails in the third quarter of fiscal year 2005.

**Operating Expenses.** Operating expenses increased to \$2.3 million for the three months ended September 30, 2005 as compared to approximately \$2.0 million, excluding the recovery of \$8.2 million for the loss of the RDM, for the three months ended September 30, 2004. Operating expenses were higher in the quarter ended September 30, 2005 compared to last year's quarter due primarily to an increase in professional and consulting services and in research and development and related costs. Research and development expenses were higher for the three months ended September 30, 2005 as compared to the same quarter last fiscal year due to increased efforts on the Apex Project. In the three months ended September 30, 2005, the Company recognized legal expenses of \$0.1 million relating to its claims against NASA for loss of the RDM and response to Lloyd's of London (Lloyd's) complaint regarding its payment of insurance proceeds on the accident.

**Income Taxes.** Based on the Company's projected effective tax rate for fiscal year 2006 and 2005, we recorded minimal tax expense for the three months ended September 30, 2005 and for the three months ended September 30, 2004 respectively.

**Net Income (Loss).** Net loss for the three months ended September 30, 2005 was approximately \$1.9 million or \$0.15 per share basic and diluted on 12,671,576 shares as compared to net income of approximately \$7.0 million or \$0.55 per share basic and \$0.49 per share diluted on 12,574,224 and 14,247,860 shares, respectively, for the three months ended September 30, 2004.

**Liquidity and Capital Resources**

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Historically, the Company obtained operating and capital investment funds from the proceeds of its initial public offering of common stock and an offering of Series B Senior Convertible Preferred Stock. We also completed a private placement offering of convertible subordinated notes to support capital investments required for development and construction of space flight assets.

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Our primary source of liquidity is cash flow from operations. The principal uses of cash flow that affect our liquidity position include both operational expenditures and debt service payments. Management is focused on increasing cash flow and on managing cash effectively through limiting cash investments in long-term assets.

On February 11, 2005 we entered into a revolving credit facility with a new financial institution providing for loans up to \$5.0 million secured by the Company's accounts receivable. This new credit facility replaced the Company's previous \$5.0 million credit facility which terminated in January 2005. Funds available under the new 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 limitation of future secured debt relative to tangible net worth. As of September 30, 2005 we amended this credit facility to modify the cash flow covenant so that the Company may secure advances with cash balances if the required cash flow ratio is not met. As of September 30, 2005 there was \$5.0 million available under this credit facility and restricted cash of \$2.0 million.

*Cash Flows From Operating Activities.* Cash provided by (used in) operations for the three months ended September 30, 2005 and 2004 was \$0.2 million and \$(1.9 million), respectively. The significant items affecting the differences in cash flows from operating activities for the three months ended September 30, 2005 as compared to the three months ended September 30, 2004 are discussed below:

Net loss for the three months ended September 30, 2005 was \$1.9 million as compared to net income for the three months ended September 30, 2004 of \$7.0 million. Included in net income for the three months ended September 30, 2004 is \$8.2 million recognized as recovery of a previously reported loss on the RDM

For the three months ended September 30, 2005, changes in assets provided cash from operations of \$0.9 million primarily from a decrease in accounts receivable. For the three months ended September 30, 2004 change in assets consumed cash from operations of \$5.9 million. This change is due primarily to the recording of the NASA claim settlement of \$8.2 million, which was partially offset by the decrease in accounts receivable at Astrotech due to the anticipated downtime during the period and decrease in deferred mission costs due to the launch for the JETIS project

Changes in liabilities for the three months ended September 30, 2005 used cash from operations of \$0.1 million. This change is due primarily to the decreases in accounts payable and accrued expenses of \$0.3 million and the increase in deferred revenue of \$0.2 million. The increase in deferred revenue is primarily due to the signing of the NASA Indefinite Delivery Indefinite Quantity ( IDIQ ) contract at Astrotech for future satellite missions. For the three months ended September 30, 2004 changes in liabilities consumed cash from operations of \$4.3 million. This change in liabilities is primarily due to the decrease in accounts payable and accrued expenses of \$1.3 million and the decrease in deferred revenue of \$3.0 million. The decrease in deferred revenue is due to the first launch of the JETIS contract during the three months ended September 30, 2004

*Cash Flows From Investing Activities.* For the three months ended September 30, 2005 and 2004, cash flows provided by (used in) investing activities were \$(2.2 million) and \$0.7 million, respectively. The significant items affecting the differences in cash flows from investing activities for the three months ended September 30 2005 as compared to the three months ended September 30, 2004 are discussed below:

There were purchases of property and equipment of \$0.6 million for the three months ended September 30, 2005 as compared to \$0.1 million for the three months ended September 30, 2004

For the three months ended September 30, 2004, cash flows from investing activities were primarily generated from the sale of short-term investments of \$1.0 million as compared to no sales for the period ended September 30, 2005

This change in cash flows was offset by an increase in restricted cash of \$1.6 million as compared to an increase in restricted cash of \$0.1 million for the three months ended September 30, 2004

*Cash Flows From Financing Activities.* For the three months ended September 30, 2005 and 2004, cash flows provided by (used in) financing activities were \$(1.0 million) and \$0.6 million, respectively. The significant items affecting the differences in cash flows from financing activities for the three months ended September 30, 2005 as compared to the three months ended September 30, 2004 are discussed below:



For the three months ended September 30, 2004, we had net borrowings of \$1.4 million under the revolving credit facility as compared to no net borrowings for the three months ended September 30, 2005

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For the three months ended September 30, 2005 we incurred \$0.5 million of financing costs related to the offer to exchange our convertible subordinated notes

On March 25, 2003 the Board of Directors authorized the Company to repurchase up to \$1.0 million of the Company's outstanding common stock at market prices. Any purchases under our stock repurchase program may be made from time to time, in the open market, through block trades or otherwise in accordance with applicable regulations of the SEC. As of September 30, 2005, we had repurchased 116,100 shares at a cost of \$117,320 under the program. We will continue to evaluate the stock repurchase program and the funds authorized for the program, which represents an average cost of \$1.01 per share. This stock repurchase program remains available for purchases of the Company's stock.

The Company had capital expenditures during the period relating primarily to facility modifications and enhancements. Additionally, we had capital expenditures for replacement components for our modules. These expenditures are not expected to continue or be significant going forward. The Company expects to have additional capital expenditures relating to modifications for our Astrotech facilities which are specific requirements of our NASA IDIQ contract and compensated by NASA through the contract.

Management continues to focus its 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. Additionally, management continues to evaluate operating expenses in an effort to reduce or eliminate costs not required to effectively operate the Company.

The Company's cash was approximately \$6.9 million as of September 30, 2005 including restricted cash of \$2.5 million. Management believes that we have sufficient liquidity, including cash and short-term investments, advances available under our revolving credit facility, and cash anticipated or expected to be generated from operations to fund ongoing operations beyond the remainder of this fiscal year. We also expect to utilize existing cash, cash anticipated from future operations to support strategies for new business initiatives and reduce long-term debt.

The Company's contractual obligations as of September 30, 2005 are as follows (in thousands):

<u>Contractual Obligations</u>	<u>At September 30, 2005</u>	<u>Remaining in Fiscal Year 2006</u>	<u>Fiscal Year 2007</u>	<u>Fiscal Year 2008</u>	<u>Fiscal Year 2009</u>	<u>Fiscal Year 2010</u>	<u>Thereafter</u>
Long-term Debt	\$ 63,250	\$	\$	\$ 63,250	\$	\$	\$
Mortgage Loan Payable	3,188	1,553	1,635				
V.J.F. Russian Consultant Agreement	120	120					
V.J.F. Russian Subcontract	370	370					
Operating leases <sup>1</sup>	26,472	5,118	5,258	5,158	5,046	928	4,964
<b>Total Contractual Cash Obligations<sup>2</sup> (excluding interest payments)</b>	<b>\$ 93,400</b>	<b>\$ 7,161</b>	<b>\$ 6,893</b>	<b>\$ 68,408</b>	<b>\$ 5,046</b>	<b>\$ 928</b>	<b>\$ 4,964</b>

1 For the remainder of fiscal year 2006, the Company expects to receive net payments of \$0.6 million for subleases. For fiscal years 2007, 2008, and 2009, the Company expects to receive net payments of approximately \$0.6 million, \$0.4 million, and \$0.1 million, respectively, for subleases.

2 Does not include commitment to Dayna Justiz for compensation that can be earned as a result of the agreement dated June 19, 2000. The agreement states that Dayna Justiz can earn up to \$375,000 as additional compensation if she meets certain financial goals in the management of The Space Store. The yearly amount is equal to five percent of The Space Store's net after-tax operating income during each fiscal year until such time an aggregate amount of \$375,000 has been earned. At this time, we have not recorded a liability for this obligation due to the uncertainty of the obligation being met.



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### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company has no material changes to the disclosure made on this matter in our Annual Report on Form 10-K for the year ended June 30, 2005.

### **ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this quarterly report, and, based on our evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective. There have been no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Disclosure controls and procedures are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

## **PART II OTHER INFORMATION**

### **ITEM 1. 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 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 states 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 May 5, 2005 NASA filed its answer to our complaint with the Armed Services Board of Contract Appeals. We are now proceeding with discovery.

Lloyd's Complaint. In January 2004 Lloyd's of London, our insurer for the research double module, 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. Since NASA did not respond for six months from the date we made the claim, NASA is deemed to have denied the claim. As a result of the administrative claim being deemed denied due to NASA's failure to respond, we have a right to and we intend to pursue the claim in federal district court.

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**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

During the three months ended September 30, 2005 we did not issue any unregistered securities.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

During the three months ended September 30, 2005 we did not have any defaults upon senior securities.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of stockholders during the first quarter of the fiscal year 2006.

**Table of Contents****ITEM 6. EXHIBITS**

The following exhibits are filed herewith:

<b>Exhibit No.</b>	<b>Description</b>
<b>3</b>	<b>Articles of Incorporation and Bylaws</b>
3.1	Amended and Restated Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-3 (File No. 333-43221) filed with the Securities and Exchange Commission on December 24, 1997)
3.2	Designation of Rights, Terms and Preferences of Series A Junior Preferred Stock of the Registrant (incorporated by reference to Exhibit 2 of the Registrant's Report on Form 8-K filed with the Securities and Exchange Commission on April 1, 1999)
3.3	Designation of Rights, Terms and Preferences of Series B Senior Convertible Preferred Stock of the Registrant (incorporated by reference to Exhibit 4.1 of the Registrant's Report on Form 8-K filed with the Securities and Exchange Commission on August 19, 1999)
3.4	Amended and Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3.2 of the Registrant's Registration Statement on Form S-3 (File No. 333-43221) filed with the Securities and Exchange Commission on December 24, 1997)
<b>4</b>	<b>Instruments Defining the Rights of Security Holders, including Indentures</b>
4.1	Designation of Rights, Terms and Preferences of Series B Senior Convertible Preferred Stock of the Registrant (incorporated by reference to Exhibit 4.1 of the Registrant's Report on Form 8-K filed with the Securities and Exchange Commission on August 19, 1999)
4.2	Preferred Stock Purchase Agreement between the Registrant and DaimlerChrysler Aerospace AG dated as of August 2, 1999 (incorporated by reference to Exhibit 4.2 of the Registrant's Report on Form 8-K filed with the Securities and Exchange Commission on August 19, 1999)
4.3	Registration Rights Agreement between the Registrant and DaimlerChrysler Aerospace AG dated as of August 5, 1999 (incorporated by reference to Exhibit 4.3 of the Registrant's Report on Form 8-K filed with the Securities and Exchange Commission on August 19, 1999)
4.4	Rights Agreement, dated as of March 26, 1999, between the Registrant and American Stock Transfer & Trust Company, including the Designation of Rights, Terms and Preferences of Series A Junior Preferred Stock attached thereto as Exhibit A, the form of Rights Certificate attached thereto as Exhibit B and the Summary of Rights attached thereto as Exhibit C (incorporated by reference to Exhibit 2 of the Registrant's Report on Form 8-K filed with the Securities and Exchange Commission on April 1, 1999)
4.5	Indenture dated as of October 15, 1997 between the Registrant and First Union National Bank, as Trustee, relating to the Registrant's 8% Convertible Subordinated Notes due 2007 (incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form S-3 (File No. 333-43221) filed with the Securities and Exchange Commission on December 24, 1997)
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
32	Certification pursuant to Rule 13a-14(b) of the Securities and Exchange Act of 1934.

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 10, 2005

SPACEHAB, INCORPORATED

/s/ Michael E. Kearney  
Michael E. Kearney

President and Chief Executive Officer

/s/ Brian K. Harrington  
Brian K. Harrington

Senior Vice President and

Chief Financial Officer