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ENOVA SYSTEMS INC
Form 10-Q
November 14, 2003

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 ,2003

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. 0-25184

ENOVA SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

CALIFORNIA

95-3056150

(State or other jurisdiction of
incorporation or organization)

(IRS employer identification number)

19850 South Magellan Drive Torrance, CA 90502

(Address of Principal Executive Offices and Zip Code)
Registrant's telephone number, including area code (310) 527-2800

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 periods 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 Act). Yes [] No [X]

As of November 13, 2003, there were 364,085,000 shares of Common Stock, no par value, 2,820,000 shares of Series A Preferred Stock, no par value, and 1,217,000 shares of Series B Preferred Stock, no par value, outstanding.

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PART 1. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

ENOVA SYSTEMS, INC.
BALANCE SHEETS
(In thousands, except for share and per share data)

ASSETS

CURRENT ASSETS:

- Cash
- Accounts receivable, net of allowance of \$597,000 and \$0 respectively
- Inventory
- Stockholder receivable
- Prepays and other current assets

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Total Current Assets

PROPERTY, PLANT AND EQUIPMENT - NET
INVESTMENTS in JOINT VENTURE
OTHER ASSETS

TOTAL ASSETS

LIABILITIES AND SHAREHOLDERS' (DEFICIT)

CURRENT LIABILITES:

Accounts payable
Line of credit
Accrued payroll and related expense
Other accrued expenses
Bonds and notes payable

Total Current Liabilities

ACCRUED INTEREST PAYABLE
CAPITAL LEASE OBLIGATIONS
LONG TERM DEBT

TOTAL LIABILITIES

SHAREHOLDERS' (DEFICIT):

Series A convertible preferred stock - No par value; 30,000,000 shares authorized; 2,820,000 and 2,824,000 shares issued and outstanding at 9/30/03 and 12/31/02 liquidating preference at \$0.60 per share aggregating \$1,692,000 and \$1,695,000
Series B convertible preferred stock - No par value; 5,000,000 shares authorized; 1,217,000 shares issued and outstanding at 9/30/03 and 12/31/02 liquidating preference at \$2.00 per share aggregating \$2,434,000
Common Stock - No par value; 500,000,000 shares authorized; 373,837,000 and 345,194,000 shares issued and outstanding at 9/30/03 and 12/31/02
Common stock subscribed
Stock notes receivable
Additional paid-in capital
Accumulated deficit

Total Shareholders' equity (deficit)

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)

Note: The balance sheet at December 31, 2002 has been derived from the audited financial statements. See notes to financial statements.

ENOVA SYSTEMS, INC.
INCOME and EXPENSE STATEMENTS
(Unaudited)
(In thousands, except for share and per share data)

Three Months Ended
September 30

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| | 2003 | 2002 |
|--|-------------|-------------|
| | ----- | ----- |
| NET REVENUES | | |
| Research and development contracts | \$ 626 | \$ 219 |
| Production | \$ 149 | \$ 1,101 |
| | ----- | ----- |
| | \$ 775 | \$ 1,320 |
| | ----- | ----- |
| COST OF REVENUES | | |
| Research and development contracts | 563 | 175 |
| Production | 100 | 972 |
| | ----- | ----- |
| | 663 | 1,147 |
| | ----- | ----- |
| GROSS MARGIN | 112 | 173 |
| | ----- | ----- |
| OTHER COSTS AND EXPENSES: | | |
| Research & development | 57 | 165 |
| Engineering | 101 | 0 |
| Selling, general & administrative | 548 | 561 |
| Interest and financing fees | 55 | 55 |
| Other (income)/expense | 3 | 37 |
| Interest income | (1) | (10) |
| | ----- | ----- |
| Total other costs and expenses | 763 | 808 |
| | ----- | ----- |
| NET LOSS | \$ (651) | \$ (635) |
| | ----- | ----- |
| NET LOSS PER COMMON SHARE: | \$ (0.01) | \$ (0.01) |
| | ===== | ===== |
| WEIGHTED AVERAGE SHARES OUTSTANDING | 364,085,000 | 345,627,095 |

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ENOVA SYSTEMS, INC.
STATEMENTS OF CASH FLOWS
(UNAUDITED)
(In thousands)

| | Nine Months Ended September 30, | |
|--|------------------------------------|------------|
| | 2003 | 2002 |
| | ----- | ----- |
| OPERATIONS | | |
| Net loss | \$ (2,597) | \$ (1,876) |
| Adjustments to reconcile net loss to net cash used by operating activities: | | |
| Change in Allowance of uncollectible receivable | 595 | 0 |
| Depreciation and Amortization | 254 | 186 |
| Stock and Stock Options issued for Services | 140 | (178) |
| Change in operating assets and liabilities: | | |
| Accounts receivable | (389) | (176) |

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| | | |
|--|---------|----------|
| Inventory | 337 | (566) |
| Stockholder receivable | 24 | (8) |
| Prepays and other assets | (64) | (59) |
| Accounts payable and accrued expenses | (85) | 587 |
| | ----- | ----- |
| Net cash used by operating activities | (1,785) | (2,090) |
| | ----- | ----- |
| INVESTING: | | |
| Purchases of property, plant and equipment, net of disposals | (78) | (612) |
| Investment in joint ventures | (1,000) | 0 |
| | ----- | ----- |
| Net cash used by investing activities | (1,078) | (612) |
| | ----- | ----- |
| FINANCING: | | |
| Borrowing (Repayments) on leases and notes payable | (28) | 33 |
| Borrowing on line of credit | 108 | 0 |
| Proceeds from issuance of common stock | 1,661 | 4,210 |
| | ----- | ----- |
| Net cash provided by financing activities | 1,741 | 4,243 |
| | ----- | ----- |
| NET INCREASE (DECREASE) IN CASH AND EQUIVALENTS | (1,122) | 1,541 |
| | | |
| CASH AND EQUIVALENTS: | | |
| Beginning of period | 1,868 | 1,179 |
| | ----- | ----- |
| End of period | \$ 746 | \$ 2,720 |
| | ===== | ===== |

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STATEMENTS OF CASH FLOWS (Continued)
 SUPPLEMENTAL CASH FLOW INFORMATION
 (UNAUDITED)
 (In thousands)

| | Nine Months Ended September 30 | |
|--|-----------------------------------|-------|
| | 2003 | 2002 |
| | ----- | ----- |
| NONCASH INVESTING AND FINANCING ACTIVITIES: | | |
| Issuance of common stock for services | \$ 44 | \$ 12 |
| Conversion of Series A preferred stock to common stock | \$ 5 | \$ -- |

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ENOVA SYSTEMS, INC.

NOTES TO FINANCIAL STATEMENTS
 (Unaudited)

For the Nine Months Ended September 30, 2003 and 2002

NOTE 1 - Basis of Presentation

The accompanying unaudited financial statements have been prepared from the records of our company without audit and have been prepared in accordance with

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accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not contain all the information and notes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position at September 30, 2003 and the interim results of operations and cash flows for the three and nine months ended September 30, 2003 have been included. The balance sheet at December 31, 2002, presented herein, has been prepared from the audited financial statements of our company for the year then ended.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions affecting the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. The September 30, 2003 and December 31, 2002 inventories are reported at market value. Inventories have been valued on the basis that they would be used, converted and sold in the normal course of business. Certain reclassifications have been made to the prior periods financials statements to conform with the current periods presentation. The amounts estimated for the above, in addition to other estimates not specifically addressed, could differ from actual results; and the difference could have a significant impact on the financial statements.

Accounting policies followed by us are described in Note 1 to the audited financial statements for the fiscal year ended December 31, 2002. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted for purposes of the interim financial statements. The financial statements should be read in conjunction with the audited financial statements, including the notes thereto, for the year ended December 31, 2002, which are included in our Form 10-K Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 as filed with the Securities and Exchange Commission.

Loss per common share is computed using the weighted average number of common shares outstanding. Since a loss from operations exists, diluted earnings per share number is not presented because the inclusion of common stock equivalents, consisting of Series A and B preferred stock, unexercised stock options and warrants, would be anti-dilutive.

The results of operations for the three and nine months ended September 30, 2003 presented herein are not necessarily indicative of the results to be expected for the full year.

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NOTE 2 - Notes Payable, Long-Term Debt and Other Financing

Notes payable and long-term debt is comprised of the following (in thousands):

| September 30, 2003 | December 31, 2002 |
|-----------------------|----------------------|
|-----------------------|----------------------|

(unaudited)

Secured subordinated promissory note -
CMAC as exclusive agent for
Non-Qualified Creditors; interest at
3% through 2001, 6% in 2002 and 2003,
and then at prime plus 3% thereafter

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through the date of maturity; interest payments are made upon payment of principal, with principal and interest due no later than April 2016; with an interest in a sinking fund escrow with a zero balance as of December 31, 2002 and September 30, 2003. The sinking fund escrow requires the Company to fund the account with 10% of future equity financing, including convertible debt converted to equity, based upon approval of the new investors per the terms of the note. No additions were made to the sinking fund with respect to the equity investment from Hyundai Heavy Industries, Co. Ltd (refer to Note 6)

| | | |
|--------------------------|---------|---------|
| at the investor's option | 3,332 | 3,332 |
| Other | 120 | 120 |
| | ----- | ----- |
| Less current maturities | 3,452 | 3,452 |
| | | |
| Total | 120 | 120 |
| | ----- | ----- |
| | \$3,332 | \$3,332 |
| | ===== | ===== |

Note 3 - Stock-based compensation

On June 30, 2003, the Company issued 10,518,212 options from our Employee Stock Option Plan to purchase Enova Systems common stock at an exercise price of \$0.051 per share to a number of employees in lieu of cash compensation for a three month period. This plan was approved by the Board of Directors prior to implementation. Under the plan, these employees receive stock options, determined based on the discounted difference of the option exercise price of their monthly salary reduction, which will vest over the three-month period and be exercisable for a period of three years from the grant date. The exercise price represents a 15% discount to the market price of \$0.06 as of the date of the grant. As such, a charge against compensation expense totaling \$94,664 for the effects of this discount will be booked over the three months commencing June 30, 2003. During the quarter ended September 30, 2003, the remaining \$78,887 was charged to compensation expense.

Additionally, the Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) and complies with the disclosure provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS No. 123).

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Under APB No. 25, compensation expense is the excess, if any, of the fair value of the Company's stock at a measurement date over the amount that must be paid to acquire the stock.

As of January 1, 2003 the Company adopted the disclosure requirements of SFAS 148, Accounting for Stock Based Compensation, which amends accounting principals Board ("APB") No. 28 by adding to the list of disclosures to be made for interim periods.

SFAS No. 123 requires a fair value method to be used when determining

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compensation expense for stock options and similar equity instruments. SFAS No. 123 permits a company to continue to use APB No. 25 to account for stock-based compensation to employees, but pro forma disclosures of net income and earnings per share must be made as if SFAS No. 123 had been adopted in its entirety. For purposes of pro forma disclosures, the estimated fair value of the options is amortized over the options' vesting period. Stock options issued to non-employees are valued under the provisions of SFAS No. 123. Had compensation cost for the Company's options been determined based on the methodology prescribed under SFAS No. 123, the Company's net income and income per share would have been as follows:

| | Three Months Ended September 30, 2003 ----- | Three Months Ended September 30, 2002 ----- | Nine Months Ended September 30, 2003 ----- | N Month Septem 2003 ----- |
|---|---|---|--|---------------------------------------|
| Net loss for the quarter | \$ (414) | \$ (635) | \$ (2,360) | \$ (|
| Compensation expense, net of tax effect | \$ (229) | \$ (49) | \$ (308) | \$ |
| Proforma net loss | \$ (643) | \$ (684) | \$ (2,668) | \$ (|
| Proforma loss per common share | \$ (0.01) | \$ (0.01) | \$ (0.01) | \$ |

The fair value of each option is estimated on date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

| | Three Months Ended September 30, 2003 ---- | Three Months Ended September 30, 2002 ---- | Nine Months Ended September 30, 2003 ---- | S |
|-------------------------|--|--|---|---|
| Dividends | 0% | 0% | 0% | |
| Expected volatility | 88% | 83% | 88% | |
| Risk-free interest rate | 4.0% | 4.0% | 4.0% | |
| Expected life | 3 years | 5 years | 3 years | |

Note 4-Ballard Power Systems

Our development and production program with Ballard Power Systems for low voltage 30kW electric drive system components for use in Ford's Global Th!nk City was terminated by Ford and Th!nk Nordic in early 2003, as previously reported. Under the terms of the contract, Ballard is liable for all costs incurred by Enova which are normally associated with the production including inventory and other development or production costs. We invoiced Ballard for approximately \$952,000 for work-in-process inventory and other additional material, tooling and engineering costs for the initial production of the drive system component. Of this amount, Ballard remitted \$580,400 during the second quarter of 2003. In October 2003, Enova and Ballard reached a settlement on all remaining balances due wherein Enova will receive \$198,125 in cash and title to all inventory, raw materials, tooling and equipment in its

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possession that is associated with the program. The Company intends to sell such in the resale markets. The Company believes that the resale market value of the inventory and equipment will amount to at least the value of the remainder balance of the receivable of approximately \$173,000.

Note 5 - Advanced Vehicle Systems

In April 2003, one of our customers, Advanced Vehicle Systems, Inc., filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. At the time of filing, AVS had an outstanding account balance with Enova of approximately \$595,000, of which approximately \$564,000 is for components delivered during the first quarter of 2003. During the second quarter, Enova was informed by AVS that various vehicle manufacturing contracts which were anticipated to be completed were terminated by AVS customers and was therefore unable to collect on post-filing offset agreements. Enova's Audit Committee chairman has been appointed chairman of the creditor's committee formed by the Bankruptcy Court. Enova believes it will recover a portion of the funds now owed by AVS; however there are no assurances that we may recover any or all of these amounts owed. As of September 30, 2003, we have reserved an additional \$237,000 against these balances owed for a total of \$595,000 as an allowance for uncollectible receivables.

Note 6 - Hyundai-Enova Innovative Technology Center

In September 2003, Enova and Hyundai Heavy Industries, Co. Ltd. (HHI) funded the Hyundai-Enova Innovative Technology Center (HEITC) to be located at Enova's Torrance headquarters. In connection with the Joint Venture Agreement entered into between the two parties in March 2003, HHI purchased \$1,500,000 of common stock of Enova Systems, Inc. HHI purchased 23,076,923 shares representing a 6.2% ownership in Enova, Inc. Of this amount, Enova invested \$1,000,000 in the HEITC for a forty percent (40%) ownership interest. HHI invested an additional \$1,500,000 for a sixty percent (60%) ownership interest in the HEITC. Furthermore, in June of 2004, HHI will invest an additional \$3,000,000 in Enova and HEITC under the same terms as the initial investment, subject to stock price adjustments, in accordance with the Joint Venture Agreement. The joint venture company officially opened in November 2003 to pursue advanced research and development in hybrid automotive and stationary applications for fuel cell technologies.

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

OVERVIEW

The following information should be read in conjunction with the interim financial statements and the notes thereto in Part I, Item I of this Quarterly Report and with Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual report on Form 10-K for the year ended December 31, 2002. The matters addressed in this Management's Discussion and Analysis of Financial Condition and Results of Operations, with the exception of the historical information presented contains certain forward-looking statements involving risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including the risks discussed in this Item 2 and specifically discussed in this report under the heading "Certain Factors That May Affect Future Results" following this Management's Discussion and Analysis section, and elsewhere in this report.

In the ordinary course of business, the Company has made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of its financial statements in conformity with

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accounting principles generally accepted in the United States. Actual results could differ significantly from those estimates under different assumptions and

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conditions. The Company believes that the following discussion addresses the Company's most critical accounting policies, which are those that are most important to the portrayal of the Company's financial condition and results. The Company constantly re-evaluates these significant factors and makes adjustments where facts and circumstances dictate. Historically, actual results have not significantly deviated from those determined using the necessary estimates inherent in the preparation of financial statements. Estimates and assumptions include, but are not limited to, customer receivables, inventories, equity investments, fixed asset lives, contingencies and litigation. The Company has also chosen certain accounting policies when options were available, including:

- o The first-in, first-out (FIFO) method to value our inventories;
- o The intrinsic value method, or APB Opinion No. 25, to account for our stock options;
- o Review of customers' receivable to determine the need for an allowance for credit losses based on estimates of customers' ability to pay. If the financial condition of our customers were to deteriorate, additional allowances may be required.

These accounting policies were applied consistently for all periods presented. Our operating results would be affected if other alternatives were used. Information about the impact on our operating results is included in the footnotes to our consolidated financial statements.

GENERAL

Enova Systems, Inc., a California Corporation ("Enova" or the "Company"), was incorporated on July 30, 1976. The Company's fiscal year ends December 31. All year references refer to fiscal years.

Enova believes it is a leader in the development and production of commercial digital power management systems. Power management systems control and monitor electric power in an automotive or commercial application such as an automobile or a stand-alone power generator. Drive systems are comprised of an electric motor, an electronics control unit and a gear unit which power an electric vehicle. Hybrid systems, which are similar to pure electric drive systems, contain an internal combustion engine in addition to the electric motor, eliminating external recharging of the battery system. A fuel cell based system is similar to a hybrid system, except that instead of an internal combustion engine, a fuel cell is utilized as the power source. A fuel cell is a system which combines hydrogen and oxygen in a chemical process to produce electricity. Stationary power systems utilize similar components to those which are in a mobile drive system in addition to other elements. These stationary systems are effective as power-assist or back-up systems, alternative power, for residential, commercial and industrial applications.

Enova develops and produces advanced software, firmware and hardware for applications in these alternative power markets. Our focus is digital power conversion, power management, and system integration, for two broad market applications - vehicle power generation and stationary power generation.

Specifically, we develop; design and produce drive systems and related components for electric, hybrid-electric, fuel cell and microturbine-powered

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vehicles. We also develop, design and produce power management and power conversion components for stationary distributed power generation systems. These stationary applications can employ fuel cells, microturbines, or advanced batteries for power storage and generation. Additionally, we perform research and development to augment and support others' and our own related product development efforts.

Our product development strategy is to design and introduce to market successively advanced products, each based on our core technical competencies. In each of our product / market segments, we

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provide products and services to leverage our core competencies in digital power management, power conversion and system integration. We believe that the underlying technical requirements shared among the market segments will allow us to more quickly transition from one emerging market to the next, with the goal of capturing early market share.

The Company has been experiencing a gradual shift to more development work as demand for drive systems has tapered off in the second half of the year. Management believes that this trend will continue for the remainder of 2003; however, Enova's customer base has notified the Company of their intent to purchase additional drive systems in early 2004.

The Company has received much greater recognition from both governmental and private industry with regards to U.S. military applications of its hybrid drive systems and fuel cell power management technologies and believes that current negotiations with several parties will result in development contracts in the fourth quarter of 2003 and beyond; however at this time; there are no assurances that such additional contracts will be consummated.

During the quarter ended September 30, 2003, we continued to develop and produce electric and hybrid electric drive systems and components for Ford Motor Company (Ford), the City of Honolulu and several domestic and international vehicle and bus manufacturers in Italy, the United Kingdom and Japan. Our various electric and hybrid-electric drive systems, power management and power conversion systems are being used in applications including Class 8 trucks, monorail systems, transit buses and industrial vehicles. Enova has furthered its development and production of systems for both mobile and stationary fuel cell powered systems with major companies such as Ford, ChevronTexaco and UTC Fuel Cells, a division of United Technologies. We also are continuing on our current research and development programs with ChevronTexaco, the U.S. Air Force and the U.S. Department of Transportation (DOT) as well as developing new programs with Hyundai Motor Company (HMC), the U.S. government and other private sector companies for hybrid and fuel cell systems.

Heavy-Duty Drive Systems - Buses and Truck for Urban operators

Heavy-duty drive system sales continue to be a primary strategy of Enova. Our Panther(TM) 120kW and Panther(TM) 240kW drive systems are developed completely in-house and are in production and operating in global markets. Sales of our Panther(TM) 120kW drive systems continue to provide revenues for our company. Hyundai Heavy Industries has been selected as our outsource manufacturer for the Panther 120kW controller, as well as the manufacturer of the motor and controller for our Panther 240kW drive systems. This is a specific strategy of Enova's to minimize capital outlays and maximize efficiencies by utilizing proven manufacturing partners.

Eco Power Technology of Italy purchased components for our Panther 120kW hybrid electric drive systems in the third quarter of 2003 for service and maintenance

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of its fleet of 42 buses powered by Panther 120kW drive systems. Eco Power is one of the largest integrators of medium size transit buses for the European shuttle bus market, with key customers in five Italian cities including Turin, Genoa, Brescia, Ferrara and Vicenza. For the quarter ended September 30, 2003, we billed approximately \$75,000 for these systems.

Tomoe Electro-Mechanical Engineering and Manufacturing, Inc. of Japan continue to procure our 120kW and 90kW drive systems for integration into their industrial vehicle platforms. During the quarter, Enova successfully integrated its Panther 120kW system into a heavy-duty Isuzu dump truck. This is in addition to the three Tomoe passenger trams currently in service in Okinawa. We anticipate additional orders for these systems in 2003 and 2004. At this time; however, there are no assurances that such additional orders will be forthcoming.

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Wrights Environment, a division of Wrights Bus, one of the largest low-floor bus manufacturers in the United Kingdom, has integrated our hybrid electric Panther(TM) 120kW drive system into two of its buses with utilizing a 30kW Capstone microturbine as their power source. These buses have been in field service in several major cities throughout the United Kingdom and are performing to specifications. Wrights has indicated to Enova that they intend to purchase production drive systems in early 2004. At this time; however, there are no assurances that such additional orders will be forthcoming.

In the high performance heavy-duty drive system area, Enova's proprietary 240kW drive system has been successfully integrated into several heavy-duty applications including several 38 foot transit buses and a Class 8 urban delivery truck. This 240kW drive system is capable of providing 3,000 ft-lbs of torque at the drive shaft.

Additionally, Enova has modified the Panther 90kW to be used in an 180kW, dual wheel motor configuration, expanding its potential market penetration with bus and delivery vehicle manufacturers.

Additionally, we are in discussions with other bus manufacturers and industrial, commercial and military vehicle manufacturers regarding the purchase of our heavy-duty, high performance, 240kW drive systems in 2003. There are no assurances, however, that these discussions will result in any sales of the Panther 240kW or 120kW drive systems.

Light-Duty Drive Systems - Automobiles and Delivery vehicles

Our 90kW controller, motor and gear unit is utilized in light duty vehicles such as midsize automobiles and delivery vehicles. As part of our corporate strategy to outsource manufacturing, Enova selected Hyundai Heavy Industries to produce the Enova developed Panther 90kW drive system.

The City of Honolulu has contracted with Enova to upgrade several S-10 trucks in its electric vehicle fleet. During the third quarter, we completed the upgrade of 3 trucks to our Panther 90kW drive system. Two additional vehicles are currently being upgraded. In the quarter ended September 30, 2003, this program generated \$81,000 in revenues.

We continue to cross-sell our systems to new and current customers in the light and medium duty vehicle markets, both domestically and globally.

Ford Motor Company - Fuel Cell Technology

The High Voltage Energy Converter (HVEC) development program with Ford Motor

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Company for their fuel cell vehicle continues to advance on schedule. This converter is a key component in Ford's Focus Fuel Cell Vehicle. It converts high voltage power from the fuel cell into a lower voltage for use by the drive system and electronic accessories. Enova received a purchase order for 36 production system in the third quarter for delivery in the first quarter of 2004 valued at approximately \$410,000.

Research and Development Programs

We are aggressively pursuing several government and commercially sponsored development programs for both ground and marine heavy-duty drive system applications.

Our program with the U.S. Air Force and the State of Hawaii to integrate a Panther 120kW hybrid drive system into a second 30-foot bus for the Hickman Air Force base has been amended to develop this propulsion system as a fuel cell hybrid. The program is scheduled to be completed in the fourth quarter of 2003. For the quarter ended September 30, 2003, we billed approximately \$296,000 for this program.

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The all-electric Hyundai Santa Fe SUV demonstration project has been extended for another two years for three of the vehicles. Fast-charging capabilities and performance will be the primary focus of this continued evaluation.

Enova has commenced development for Hyundai Motor Company on fuel cell power management and conversion components for Hyundai's latest Santa Fe fuel cell vehicle. For the quarter ended September 30, 2003, Enova billed approximately \$37,000 for this program. Enova has entered into a development contract with Hyundai Motor Company for their next generation Santa Fe fuel cell vehicle. This program will continue through the second quarter of 2004 and is estimated to generate approximately \$400,000 in revenues for Enova.

Several other programs are in final negotiations or discussion in conjunction with the U.S. Navy, U.S. Air Force, and several other government agencies and private corporations. We anticipate commencing work on these contracts in the fourth quarter of 2003. There can be no assurances at this time, however, that such contracts will be realized.

We intend to establish new development programs with the Hawaii High Technology Development Corporation in mobile and marine applications as well as other state and federal government agencies as funding becomes available.

Stationary Power Applications

Enova continues to attract new partners and customers from both fuel cell manufacturers and petroleum companies. It is our belief that utilizing our power management systems for stationary applications for fuel cells will open new markets for our Company.

We are currently designing a process controller for ChevronTexaco Technology Ventures (CTTV) for their fuel reformer for a stationary fuel cell application. The first prototype of the controller board for this system performed above the customer's expectations. We are now completing the second phase of this program. For the three months ended September 30, 2003, Enova has billed ChevronTexaco \$223,000.

We believe the stationary power market will play a key role in our future. We continue to pursue alliances with leading manufacturers in this area. There are, however, no assurances that this market will develop as anticipated or that such

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alliances will occur.

LIQUIDITY AND CAPITAL RESOURCES

We have experienced cash flow shortages due to operating losses primarily attributable to research, development, marketing and other costs associated with our strategic plan as an international manufacturer and supplier of electric propulsion and power management systems and components. Cash flows from operations have not been sufficient to meet our obligations. Therefore, we have had to raise funds through several financing transactions. At least until we reach breakeven volume in sales and develop and/or acquire the capability to manufacture and sell our products profitably, we will need to continue to rely on cash from external financing sources. We anticipate that we may require additional outside financing within the next six months to meet research, development and general operations expenditures through 2004.

In the third quarter of 2003, management continued to re-assess current resource allocations and overhead costs. Due to the loss of the Advanced Vehicle Systems (AVS) programs - please refer to Part II, Item 1, Legal Proceedings - and an overall slowdown in heavy-duty drive system purchases, Enova's management analyzed current processes and budgets for potential targets for cost reduction. As a result of this analysis, management implemented several cost reduction programs including personnel reductions, work-week modifications and other cost reduction endeavors to achieve these

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goals. Personnel levels have been reduced to 30 employees from 45 at December 31, 2002. In early October 2003, management discontinued its modified compensation plan for full-time salaried employees [See Note 3]. These employees have had their prior pay levels re-instated. The company continues to realize a reduction in monthly cash outlays of approximately \$120,000 compared with the monthly average for the first six months without impact to our current operations.

During the nine months ended September 30, 2003, we spent \$1,122,000 in cash on operating activities to fund our net loss of \$2,597,000 resulting from factors explained in the following section of this discussion and analysis. Accounts receivable increased by \$389,000 from December 31, 2002 balances as the Company billed for development contracts and production sales and also awaited final settlement on the Ballard receivables. Inventory decreased by \$337,000 from December 31, 2002 to September 30, 2003 primarily due to charges against cost of sales for those inventories related to the terminated Ballard program which were billed to them and from other sales of production systems.

Current liabilities decreased by a net of \$92,000 from December 31, 2002 to September 30, 2003 due primarily to reductions of outstanding vendor payables primarily due Hyundai Heavy Industries in connection with additional power management and conversion component inventory and Hyundai Autonet for materials associated with the terminated Ballard/Ford Th!nk city program.

Capital lease obligations decreased by \$28,000 during the nine months ended September 30, 2003, from December 31, 2002, also due to scheduled payments of these liabilities.

Interest accruing on notes payable increased by \$159,000 for the nine months ended September 30, 2003 from December 31, 2002 per the terms of our notes payable. During the month of July 2003, interest accruing on the CMAC note of \$3.3M changed to a rate of prime plus 3% which will continue through the date of maturity of the note in 2016.

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The operations of the Company during the third quarter of fiscal 2003 were financed primarily by the funds received on engineering contracts and sales of drive system components as well as cash reserves provided by equity financings. It is management's intention to continue to support current operations through sales of products and engineering contracts, as well as to seek additional financing through private placements and other means to increase inventory reserves and to continue internal research and development.

The future unavailability or inadequacy of financing to meet future needs could force the Company to delay, modify, suspend or cease some or all aspects of its planned operations this year.

RESULTS OF OPERATIONS

Net revenues for the three months ending September 30, 2003 were \$775,000 as compared to \$1,320,000 for the corresponding period in 2002. Net production sales for the quarter ended September 30, 2003 decreased to \$149,000 from \$1,101,000 in the same period in 2002. The decrease in production revenues is as result of several major customers delaying orders to late 2003 or early 2004. The Company has been experiencing an increase in development contract activity which has offset this decline in production revenues. Research and development revenues nearly tripled to \$626,000 from the same period in 2002. Net research and development sales are a result of additional engineering services for the ChevronTexaco fuel reformer process controller and the HEVDP Hickam fuel cell bus program.

Cost of sales for the three months ended September 30, 2003 decreased to \$663,000 compared to cost of sales of \$1,147,000 for the same three-month period in 2002. The decrease in cost of sales is directly attributable to lower sales volumes for the quarter.

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Internal research, development and engineering expenses decreased in the three months ended September 30, 2003 to \$57,000 as compared with \$165,000 in the same period in 2002. Due to an increase in externally funded development programs and the decrease in the Company's workforce, Enova has allocated less of its own funds to new product development. Enova continues to allocate increased resources to the development of its diesel generation motor, upgraded proprietary control software, enhanced DC-DC converters and advanced digital inverters and other power management firmware. The Company is utilizing external funding, however, for a greater percentage of these development costs.

Selling, general and administrative expenses, net of additional reserves for uncollectible accounts receivable of \$237,000 [see Note 5] decreased \$250,000 to \$311,000 for the three months ended September 30, 2003 from the previous year's comparable period. The decrease is a direct result of management's cost reduction strategies which the Company is striving to maintain in order to reach breakeven in 2004, although management cannot assure that breakeven will be attained.

Interest and financing fees remained the consistent at approximately \$55,000 for the third quarter of 2003 and 2002.

We incurred a loss from continuing operations of \$651,000 in the third quarter of 2003 compared to a loss of \$635,000 in the third quarter of 2002. Without the additional allowance for uncollectible receivables of \$237,000, the net loss would be \$418,000 for the third quarter of 2003. As noted above, this decrease was primarily due to aggressive cost reduction strategies implemented by management and workforce restructurings. We will continue to review all costs and develop methods in our efforts to produce our systems more efficiently by

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utilizing contract manufacturers where applicable.

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CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS

This Form 10-Q contains forward-looking statements concerning our existing and future products, markets, expenses, revenues, liquidity, performance and cash needs as well as our plans and strategies. Forward-looking statements may be identified by the use of terminology such as "may," "anticipate," "estimate," "plans," "expects," "believes," "will," "potential" and by other comparable terminology or the negative of any of the foregoing. These forward-looking statements involve risks and uncertainties and are based on current management's expectations and we are not obligated to update this information. Many factors could cause actual results and events to differ significantly from the results anticipated by us and described in these forward looking statements including, but not limited to, the following risk factors.

Net Operating Losses. We experienced recurring losses from operations and had an accumulated deficit of \$96,488,000 at September 30, 2003. There is no assurance, however, that any net operating losses will be available to us in the future as an offset against future profits for income tax purposes.

Continued Losses. For the nine months ended September 30, 2003 and 2002, we had losses from continuing operations of \$2,597,000 and \$1,876,000 respectively on sales of \$3,469,000 and \$3,735,000, respectively.

Nature of Industry. The mobile and stationary power markets, including electric vehicle and hybrid electric vehicles, continue to be subject to rapid technological change. Most of the major domestic and foreign automobile manufacturers: (1) have already produced electric and hybrid vehicles, and/or (2) have developed improved electric storage, propulsion and control systems, and/or (3) are now entering or have entered into production, while continuing to improve technology or incorporate newer technology. Various companies are also developing improved electric storage, propulsion and control systems. In addition, the stationary power market is still in its infancy. A number of established energy companies are developing new technologies. Cost-effective methods to reduce price per kilowatt have yet to be established and the stationary power market is not yet viable.

Our current products are designed for use with, and are dependent upon, existing technology. As technologies change, and subject to our limited available resources, we plan to upgrade or adapt our products in order to continue to provide products with the latest technology. We cannot assure you, however, that we will be able to avoid technological obsolescence, that the market for our products will not ultimately be dominated by technologies other than ours, or that we will be able to adapt to changes in or create "leading-edge" technology. In addition, further proprietary technological development by others could prohibit us from using our own technology.

Changed Legislative Climate. Our industry is affected by political and legislative changes. In recent years there has been significant public pressure to enact legislation in the United States and abroad to reduce or eliminate automobile pollution. Although states such as California have enacted such legislation, we cannot assure you that there will not be further legislation enacted changing current requirements or that current legislation or state mandates will not be repealed or amended, or that a different form of zero emission or low emission vehicle will not be invented, developed and produced, and achieve greater market acceptance than electric or hybrid electric vehicles. Extensions, modifications or reductions of current federal and state legislation, mandates and potential tax incentives could also adversely affect

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our business prospects if implemented.

Because vehicles powered by internal combustion engines cause pollution, there has been significant public pressure in Europe and Asia, and enacted or pending legislation in the United States at the federal level and in certain states, to promote or mandate the use of vehicles with no tailpipe emissions ("zero emission vehicles") or reduced tailpipe emissions ("low emission vehicles"). Legislation requiring or promoting zero or low emission vehicles is necessary to create a significant market for

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electric vehicles. The California Air Resources Board (CARB) is continuing to modify its regulations regarding its mandatory limits for zero emission and low emission vehicles. Furthermore, several car manufacturers have challenged these mandates in court and have obtained injunctions to delay these mandates.

Our products are subject to federal, state, local and foreign laws and regulations, governing, among other things, emissions as well as laws relating to occupational health and safety. Regulatory agencies may impose special requirements for implementation and operation of our products or may significantly impact or even eliminate some of our target markets. We may incur material costs or liabilities in complying with government regulations. In addition, potentially significant expenditures could be required in order to comply with evolving environmental and health and safety laws, regulations and requirements that may be adopted or imposed in the future.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

None.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures.

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), an evaluation was carried out by the Company's President, Chief Executive Officer and acting Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-14(c) and 15d-14(c) under the Exchange Act) as of the end of the quarter ended September 30, 2003. Based upon that evaluation of these disclosure controls and procedures, the President, Chief Executive Officer and acting Chief Financial Officer concluded that the disclosure controls and procedures were effective as of the end of the quarter ended September 30, 2003 to ensure that material information relating to the Company was made known to him particularly during the period in which this quarterly report on Form 10-Q was being prepared.

Changes in internal controls over financial reporting.

There was not any change in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2003 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We may from time to time become a party to various legal proceedings arising in

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the ordinary course of business.

In April 2003, one of our customers, Advanced Vehicle Systems, Inc., filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. At the time of filing, AVS had an outstanding account balance with Enova of approximately \$595,000 of which approximately \$564,000 is for components delivered during the first quarter of 2003. During the second quarter, Enova was informed by AVS that various vehicle manufacturing contracts which were anticipated to be completed were terminated by AVS customers were terminated by AVS customers and was therefore unable to collect on post-filing offset agreements. Enova's Audit Committee chairman has been appointed chairman of the creditor's committee formed by the Bankruptcy Court. Enova believes it will recover a portion of the

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funds now owed by AVS; however there are no assurances that we may recover any or all of these amounts owed. As of September 30, 2003, we have reserved an additional \$237,000 against these balances owed for a total of \$595,000 as an allowance for uncollectible receivables.

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Item 2. Changes in Securities and Use of Proceeds

As discussed in Note 3 to the financial statements and in the Liquidity and Capital Resources section, we issued stock options under the 1996 Employee Stock Option Plan to several employees in connection with a workforce reorganization plan during the second quarter of 2003 which vested during the third quarter of 2003. Our board of directors adopted the 1996 Employee Stock Option Plan in October 1996 which was subsequently approved by our shareholders in May, 1997. The underlying shares for these options were registered via a Form S-8 on January 28, 2000 with the Securities and Exchange Commission. The proceeds from the exercise of these options will be used for general operations.

In September 2003, the Company issued 23,076,923 shares of common stock to Hyundai Heavy Industries Co., Ltd. in exchange for \$1,500,000 in cash. \$1,000,000 of the proceeds from this issuance were used to fund Enova's \$1,000,000 joint venture interest in the Hyundai-Enova Innovative Technology Center as previously noted, with the balance of the \$500,000 in proceeds to be used for general operations and working capital. The Company relied upon Regulation D, Rule 506 promulgated by the Securities and Exchange Commission as the exemption from registration for the issuance of these shares.

During the nine months ended September 30, 2003, the Company has issued or accrued common stock of Enova Systems to the non-executive board directors in accordance with the September 1999 Board of Directors compensation package for outside directors. For each meeting attended in person, each outside director is to receive \$1,000 in cash and \$2,000 of stock valued on the date of the meeting at the average of the closing ask and bid prices; for each telephonic Board meeting, each outside director is to receive \$250 in cash and \$250 of stock valued on the date of the meeting at the average of the closing ask and bid prices; for each meeting of a Board committee attended in person, the committee chairperson is to receive \$500 in cash and \$500 of stock valued on the date of the meeting at the average of the closing ask and bid prices. As of January 2002, this package was amended to include like compensation of \$500 in cash and \$500 in stock to all committee members in attendance at each committee meeting. During the nine months ended September 30, 2003, 555,556 shares of common stock were issued to the Board of Directors at prices ranging from \$0.07 to \$0.09 per share for full board meetings and committee meetings during that period. As of September 30, 2003, 2,639,918 shares had been issued under the above

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compensation plan for Directors.

Item 3. Defaults Upon Senior Securities:

None.

Item 4. Submission of Matters to a Vote of Securities Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K:

(a) Exhibits:

31.1* Certification of the Chief Executive Officer / Acting Chief Financial Officer, dated November 14, 2003 (This certification required as Exhibit 31 under

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Item 601(a) of Regulation S-K is filed as Exhibit 99.1 pursuant to SEC interim filing guidance.)

32.1* Written Statement of the Chief Executive Officer / Acting Chief Financial Officer, dated November 14, 2003 (This certification required as Exhibit 32 under Item 601(a) of Regulation S-K is furnished in accordance with Item 601(b) (32) (iii) of Regulation S-K as Exhibit 99.3 pursuant to SEC interim filing guidance.)

* - attached herewith

(b) Reports on Form 8-K

None

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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 14, 2003

ENOVA SYSTEMS, INC.
(Registrant)

/s/ Carl D. Perry

By: Carl D. Perry, President, Chief Executive Officer and Acting Chief Financial Officer

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