

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2002

or

[ ] Transition report pursuant to section 13 or 15(d) of the  
Securities Exchange Act of 1934 for the transition period from

\_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-20852

ULTRALIFE BATTERIES, INC.

(Exact name of registrant as specified in its charter)

Delaware

16-1387013

(State or other jurisdiction  
of incorporation or organization)

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

2000 Technology Parkway, Newark, New York 14513

(Address of principal executive offices)  
(Zip Code)

(315) 332-7100

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year,  
if changed since last report)

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 X No \_\_\_

Indicate the number of shares outstanding of each of the issuer's classes of  
common stock, as of the latest practicable date.

Common stock, \$.10 par value - 13,120,289 shares outstanding  
as of April 30, 2002.

ULTRALIFE BATTERIES, INC.  
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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

ULTRALIFE BATTERIES, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(Dollars in Thousands, Except Per Share Amounts)

ASSETS	March 31, 2002 ----	June 30, 2001 ----
	(unaudited)	
Current assets:		
Cash and cash equivalents	\$ 344	\$ 494
Available-for-sale securities	2	2,573
Restricted cash	201	540
Trade accounts receivable (less allowance for doubtful accounts of \$287 at March 31, 2002 and \$262 at June 30, 2001)	6,155	3,379
Inventories	4,687	5,289
Prepaid expenses and other current assets	726	1,648
	-----	-----
Total current assets	12,115	13,923
	-----	-----
Property, plant and equipment	30,613	32,997
Other assets:		
Investment in affiliates	--	--
Technology license agreements (net of accumulated amortization of \$1,243 at March 31, 2002 and \$1,168 at June 30, 2001)	208	283
	-----	-----
	208	283
	-----	-----
Total Assets	\$ 42,936	\$ 47,203
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	\$ 917	\$ 1,065
Accounts payable	3,445	3,755
Other current liabilities	1,950	2,282
	-----	-----
Total current liabilities	6,312	7,102
Long-term liabilities:		
Long-term debt and capital lease obligations	1,984	2,648
Shareholders' equity :		
Preferred stock, par value \$0.10 per share, authorized 1,000,000 shares; none outstanding	--	--
Common stock, par value \$0.10 per share, authorized 40,000,000 shares issued - 12,578,186 at March 31, 2002 and 11,488,186 at June 30, 2001)	1,258	1,149
Capital in excess of par value	105,621	99,389
Accumulated other comprehensive loss	(858)	(1,058)
Accumulated deficit	(71,078)	(61,724)
	-----	-----
	34,943	37,756
Less --Treasury stock, at cost -- 27,250 shares	303	303
	-----	-----
Total shareholders' equity	34,640	37,453
	-----	-----
Total Liabilities and Shareholders' Equity	\$ 42,936	\$ 47,203
	=====	=====

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

ULTRALIFE BATTERIES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(Dollars in Thousands, Except Per Share Amounts)  
(unaudited)

	Three Months Ended March 31, 2002 -----	March 31, 2001 -----	Nine Months Ended March 31, 2002 -----	March 31, 2001 -----
Revenues	\$ 8,862	\$ 5,817	\$ 23,937	\$ 17,958
Cost of products sold	7,940	6,548	23,675	20,840
	-----	-----	-----	-----
Gross margin	922	(731)	262	(2,882)
Operating expenses:				
Research and development	1,038	799	3,192	2,307
Selling, general, and administrative	1,981	1,979	6,194	5,835
	-----	-----	-----	-----
Total operating expenses	3,019	2,778	9,386	8,142
Operating loss	(2,097)	(3,509)	(9,124)	(11,024)
Other income (expense):				
Interest income	3	126	88	628
Interest expense	(101)	(134)	(276)	(387)
Equity loss in affiliate	--	(340)	--	(1,930)
Miscellaneous	(97)	(64)	(42)	(49)
	-----	-----	-----	-----
Loss before income taxes	(2,292)	(3,921)	(9,354)	(12,762)
	-----	-----	-----	-----
Income taxes	--	--	--	--
	-----	-----	-----	-----
Net loss	\$ (2,292)	\$ (3,921)	\$ (9,354)	\$(12,762)
	=====	=====	=====	=====
Net loss per share, basic and diluted	\$ (0.19)	\$ (0.35)	\$ (0.77)	\$ (1.15)
	=====	=====	=====	=====
Weighted average shares outstanding, basic and diluted	12,319	11,173	12,193	11,131
	=====	=====	=====	=====

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

ULTRALIFE BATTERIES, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Dollars in Thousands)  
(unaudited)

	Nine Months Ended March 31, 2002 ----	2001 ----
<b>OPERATING ACTIVITIES</b>		
Net loss	\$ (9,354)	\$(12,762)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	3,208	2,794
Equity loss in affiliate	--	1,930
Changes in operating assets and liabilities:		
Accounts receivable	(2,776)	1
Inventories	602	85
Prepaid expenses and other current assets	922	(503)
Accounts payable and other current liabilities	(642)	193
	-----	-----
Net cash used in operating activities	(8,040)	(8,262)
	-----	-----
<b>INVESTING ACTIVITIES</b>		
Purchase of property and equipment	(1,715)	(2,934)
Proceeds from sale leaseback	995	--
Purchase of securities	(8,424)	(24,671)
Sales of securities	11,334	19,652
Maturities of securities	--	12,695
	-----	-----
Net cash provided by investing activities	2,190	4,742
	-----	-----
<b>FINANCING ACTIVITIES</b>		
Proceeds from issuance of common stock	6,341	606
Principal payments on long-term debt and capital lease obligations	(812)	(836)
	-----	-----
Net cash provided by (used in) financing activities	5,529	(230)
	-----	-----
Effect of exchange rate changes on cash	171	(129)
	-----	-----
Decrease in cash and cash equivalents	(150)	(3,879)
Cash and cash equivalents at beginning of period	494	5,712
	-----	-----
Cash and cash equivalents at end of period	\$ 344	\$ 1,833
	=====	=====
<b>SUPPLEMENTAL CASH FLOW INFORMATION</b>		
Unrealized gain on securities	\$ --	\$ 1
	=====	=====
Interest paid	\$ 185	\$ 357
	=====	=====

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

ULTRALIFE BATTERIES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Dollar Amounts in Thousands - Except Share and Per Share Amounts)

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals and adjustments) considered necessary for a fair presentation of the condensed consolidated financial statements have been included. Results for interim periods should not be considered indicative of results to be expected for a full year. Reference should be made to the consolidated financial statements contained in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2001.

2. NET LOSS PER SHARE

Net loss per share is calculated by dividing net loss by the weighted average number of common shares outstanding during the period. Common stock options and warrants have not been included as their inclusion would be antidilutive. As a result, basic earnings per share is the same as diluted earnings per share.

3. COMPREHENSIVE INCOME (LOSS)

The components of the Company's total comprehensive loss were:

	(unaudited)			
	Three months ended		Nine months ended	
	March 31, 2002	March 31, 2001	March 31, 2002	March 31, 2001
	-----	-----	-----	-----
Net loss	\$ (2,292)	\$ (3,921)	\$ (9,354)	\$(12,762)
Unrealized (loss) gain on securities	--	--	--	1
Foreign currency translation adjustments	(22)	(271)	200	(447)
	-----	-----	-----	-----
Total comprehensive loss	\$ (2,314)	\$ (4,192)	\$ (9,154)	\$(13,208)
	=====	=====	=====	=====

4. INVENTORIES

Inventories are stated at the lower of cost or market with cost determined under the first-in, first-out (FIFO) method. The composition of inventories was:

	(unaudited)	
	March 31, 2002	June 30, 2001
	-----	-----
Raw materials	\$2,652	\$2,595
Work in process	1,610	1,233
Finished goods	771	1,872
	-----	-----
Less: Reserve for obsolescence	5,033	5,700
	346	411
	-----	-----
	\$4,687	\$5,289
	=====	=====

5. PROPERTY, PLANT AND EQUIPMENT

Major classes of property, plant and equipment consisted of the following:

	(unaudited) March 31, 2002	June 30, 2001
Land	\$ 123	\$ 123
Buildings and Leasehold Improvements	1,608	1,608
Machinery and Equipment	38,287	37,891
Furniture and Fixtures	308	291
Computer Hardware and Software	1,390	1,375
Construction in Progress	3,305	2,984
	-----	-----
	45,021	44,272
Less: Accumulated Depreciation	14,408	11,275
	-----	-----
	\$30,613	\$32,997
	=====	=====

6. COMMITMENTS AND CONTINGENCIES

As of March 31, 2002, the Company had \$201 in restricted cash with a certain lending institution primarily for letters of credit supporting leases for a building and some computer equipment. The funds that had previously been restricted by the Company's primary lending institution at December 31, 2001 were no longer restricted at March 31, 2002 because the amount of eligible assets applicable to the borrowing base exceeded borrowings against the revolver loan.

The Company is subject to legal proceedings and claims that arise in the normal course of business. The Company believes that the final disposition of such matters will not have a material adverse effect on the financial position or results of operations of the Company.

In August 1998, the Company, its Directors, and certain underwriters were named as defendants in a complaint filed in the United States District Court for the District of New Jersey by certain shareholders, purportedly on behalf of a class of shareholders, alleging that the defendants, during the period April 30, 1998 through June 12, 1998, violated various provisions of the federal securities laws in connection with an offering of 2,500,000 shares of the Company's Common Stock. The complaint alleged that the Company's offering documents were materially incomplete, and as a result misleading, and that the purported class members purchased the Company's Common Stock at artificially inflated prices and were damaged thereby. Upon a motion made on behalf of the Company, the Court dismissed the shareholder action, without prejudice, allowing the complaint to be refiled. The shareholder action was subsequently refiled, asserting substantially the same claims as in the prior pleading. The Company again moved to dismiss the complaint. By Opinion and Order dated September 28, 2000, the Court dismissed the action, this time with prejudice, thereby barring plaintiffs from any further amendments to their complaint and directing that the case be closed. Plaintiffs filed a Notice of Appeal to the Third Circuit Court of Appeals and the parties submitted their briefs. Subsequently, the parties notified the Court of Appeals that they had reached an agreement in principle to resolve the outstanding appeal and settle the case upon terms and conditions which require submission to the District Court for approval. Upon application of the parties and in order to facilitate the parties' pursuit of settlement, the Court of Appeals issued an Order dated May 18, 2001 adjourning oral argument on the appeal and remanding the case to the District Court for further proceedings in connection with the proposed settlement.

Subsequent to the parties entering into the settlement agreement, the Company's insurance carrier commenced liquidation proceedings. The insurance carrier informed the Company that in light of the liquidation proceedings, it would no longer fund the settlement. In addition, the value of the insurance

policy is in serious doubt. In April 2002, the Company and the insurance carrier for the underwriters offered to proceed with the settlement. Plaintiff's counsel has accepted the terms of the proposed settlement and the matter must now be approved by the Court and by the shareholders comprising the class. Based on the terms of the proposed settlement, the Company has established reserves against a significant portion of its share of the settlement costs and associated expenses.

In the event settlement is not reached, the Company will continue to defend the case vigorously. The amount of alleged damages, if any, cannot be quantified, nor can the outcome of this litigation be predicted. Accordingly, management cannot determine whether the ultimate resolution of this litigation could have a material adverse effect on the Company's financial position and results of operations.

In conjunction with the Company's purchase/lease of its Newark, New York facility in 1998, the Company entered into a payment-in-lieu of tax agreement which provides the Company with real estate tax concessions upon meeting certain conditions. In connection with this agreement, the Company received an environmental assessment, which revealed contaminated soil. The assessment indicated potential actions that the Company may be required to undertake upon notification by the environmental authorities. The assessment also proposed that a second assessment be completed and provided an estimate of total potential costs to remediate the soil of \$230. However, there can be no assurance that this will be the maximum cost. The Company entered into an agreement whereby a third party has agreed to reimburse the Company for fifty percent of the costs associated with this matter. Test sampling occurred in the fourth quarter of fiscal 2001 and the engineering report was submitted to the New York State Department of Environmental Conservation (NYSDEC) for review. NYSDEC reviewed the report and in January 2002 recommended additional testing. The Company responded by submitting a proposed work plan to NYSDEC, which was approved by NYSDEC in April 2002. The Company is now soliciting proposals from engineering firms to complete remedial work contained in the work plan, and it is unknown at this time whether the final cost to remediate will be in the range of the original estimate, given the passage of time. The ultimate resolution of this matter may have a significant adverse impact on the results of operations in the period in which it is resolved.

7. BUSINESS SEGMENT INFORMATION (unaudited)

The Company reports its results in four operating segments: Primary Batteries, Rechargeable Batteries, Technology Contracts and Corporate. The Primary Batteries segment includes 9-volt batteries, cylindrical batteries and various specialty batteries. The Rechargeable Batteries segment consists of the Company's rechargeable batteries. The Technology Contracts segment includes revenues and related costs associated with various government and military development contracts. The Corporate segment consists of all other items that do not specifically relate to the three other segments and are not considered in the performance of the other segments.

Three Months Ended March 31, 2002

	Primary Batteries	Rechargeable Batteries	Technology Contracts	Corporate	Total
	-----	-----	-----	-----	-----
Revenues	\$ 8,741	\$ 86	\$ 35	\$ --	\$ 8,862
Segment contribution	954	(1,072)	2	(1,981)	(2,097)
Interest, net				(98)	(98)
Equity loss in affiliate				--	--
Miscellaneous expense				(97)	(97)
Income taxes				--	--
Net loss					----- \$(2,292)
Total assets	\$20,976	\$19,031	\$309	\$ 2,620	\$42,936



Three Months Ended March 31, 2001

-----

	Primary Batteries	Rechargeable Batteries	Technology Contracts	Corporate	Total
	-----	-----	-----	-----	-----
Revenues	\$ 5,401	\$ 78	\$338	\$ --	\$ 5,817
Segment contribution	272	(1,835)	33	(1,979)	(3,509)
Interest income, net				(8)	(8)
Equity loss in affiliate				(340)	(340)
Miscellaneous				(64)	(64)
Income taxes				--	--
Net loss					----- \$(3,921)
Total assets	\$18,120	\$21,674	\$301	\$ 11,120	\$51,215

Nine Months Ended March 31, 2002

-----

	Primary Batteries	Rechargeable Batteries	Technology Contracts	Corporate	Total
	-----	-----	-----	-----	-----
Revenues	\$23,035	\$ 374	\$528	\$ --	\$23,937
Segment contribution	2,393	(5,376)	53	(6,194)	(9,124)
Interest, net				(188)	(188)
Equity loss in affiliate				--	--
Miscellaneous				(42)	(42)
Income taxes				--	--
Net loss					----- \$(9,354)
Total assets	\$20,976	\$19,031	\$309	\$ 2,620	\$42,936

Nine Months Ended March 31, 2001

-----

	Primary Batteries	Rechargeable Batteries	Technology Contracts	Corporate	Total
	-----	-----	-----	-----	-----
Revenues	\$16,310	\$ 242	\$1,406	\$ --	\$ 17,958
Segment contribution	72	(5,384)	123	(5,835)	(11,024)
Interest income				241	241
Equity loss in affiliate				(1,930)	(1,930)
Miscellaneous				(49)	(49)
Income taxes				--	--
Net loss					----- \$(12,762)
Total assets	\$18,120	\$21,674	\$ 301	\$11,120	\$ 51,215

8. OTHER MATTERS

On July 20, 2001, the Company completed a \$6,800 private placement of 1,090,000 shares of its common stock at \$6.25 per share. In conjunction with the offering, warrants to acquire up to 109,000 shares of common stock were granted. The exercise price of the warrants is \$6.25 per share and the warrants have a five-year term.

In October 2001, the Company was informed by its primary lending institution that its borrowing availability under its \$20,000 credit facility had been effectively reduced to zero as a result of a recent appraisal of its fixed assets. In February 2002, the Company and its primary lending institution amended the credit facility. The amended facility was reduced to \$15,000 mainly due to the reduction in the valuation of fixed assets that limited the borrowing capacity under the term loan component, as well as to minimize the cost of unused line fees. The term loan component was revised to an initial

\$2,733 based on the valuation of the Company's fixed assets (of which \$2,681 was outstanding on the term loan at March 31, 2002). The revolving credit facility component comprises the remainder of the total potential borrowing capacity. Certain definitions were revised which increased the Company's available borrowing base. In addition, the minimum net worth covenant was reduced to \$33,500. While these changes to the credit facility improve the Company's overall financial flexibility, the Company's future liquidity depends on the Company's ability to successfully generate positive cash flow from operations and achieve adequate operational savings. The Company is also exploring opportunities for new or additional equity or debt financing. (See Note 10 for additional information.) Notwithstanding the foregoing, there can be no assurance that the Company will have sufficient cash flows to meet its working capital and capital expenditure requirements.

In October and November 2001, the Company realigned its resources to address the changing market conditions and to better meet customer demand in areas of the business that are growing. The realignment did not significantly change any of the Company's existing operations nor were any product lines discontinued. A majority of employees affected by this realignment were re-deployed from the Rechargeable segment and support functions into open direct labor positions in the Primary segment, due to the significantly growing demand for primary batteries from the military. Less than 7% of the Company's total employees were terminated. The realignment did not result in any significant severance costs. The Company expects to realize cost savings from the measures being taken of approximately \$1,500 per quarter. These quarterly savings are comprised of approximately \$1,100 of reduced labor costs, approximately \$200 of reduced material usage, and approximately \$200 of lower administrative expenses. The Company realized the full value of the realignment in the third fiscal quarter.

Also in February 2002, in its ongoing effort to improve liquidity to bring costs more in line, the Company took further actions to reduce costs. The cost reductions included employee terminations and salary reductions, discontinuance of certain employee benefits and other cost saving initiatives in general and administrative areas. Approximately 15% of the Company's total employees were terminated during this time. As part of these actions, the Company temporarily suspended the Company's match on the 401k plan. The Company anticipates approximately \$800 in reduced expenses per quarter because of this action. Approximately two-thirds of the savings will reduce cost of products sold and one-third will reduce general and administrative costs. The Company realized approximately half of the savings in the third fiscal quarter and will realize the remaining cost savings in the fourth fiscal quarter. Severance costs associated with this action were incurred in the third fiscal quarter and were not material. The actions taken in February and the prior actions taken by the Company as outlined above will aggregate to an anticipated cost savings of approximately \$2,300 per quarter.

The Company has maintained a lease line of credit with a third party leasing agency. Under this arrangement, the Company has various options to acquire manufacturing equipment, including sales / leaseback transactions and operating leases. In October 2001, the Company expanded its leasing arrangement with a third party leasing agency. The revision increased the amount of the lease line from \$2,000 to \$4,000. The increase in the line is being used to fund capital expansion plans for manufacturing equipment that will allow increased capacity within the Company's Primary business unit. In conjunction with this lease, the Company has a letter of credit of \$3,800 outstanding. At March 31, 2002, approximately \$250 remained outstanding under the lease line of credit. Once the lease line has been fully utilized, which is expected to be by June 2002, the Company's quarterly lease payment will approximate \$226.

In November 2001, the Company received approval for two grants from New York State and a federally sponsored small cities program in the aggregate amount of \$1,050. The grants will assist in funding current capital expansion plans that the Company expects will lead to job creation. In most cases, the Company will be reimbursed for approved capital as it incurs the cost; in other cases, the

Company will be reimbursed after the full completion of the particular project. At March 31, 2002, in connection with these grants, approximately \$57 had been submitted for reimbursement and is awaiting final review and approval. Funding under these grants is subject to the Company's ability to go forward with these projects. Additionally, the Company is obligated under the terms of the grants to achieve a certain level of new jobs over the next five years. If the Company does not meet its employment quota, it may adversely affect reimbursement requests or the Company could be required to pay back a portion of the amount of the grant, depending on the lapsed time.

#### 9. NEW ACCOUNTING PRONOUNCEMENT

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144 ("SFAS No. 144"), "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144 supersedes Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," for the disposal of a segment of a business (as previously defined in that Opinion). The Company is required to adopt SFAS No. 144 for fiscal years beginning after July 1, 2002. The Company is currently assessing the financial impact of SFAS No. 144 on its financial statements.

#### 10. SUBSEQUENT EVENT

On April 23, 2002, the Company closed on a \$3,000 private placement consisting of common equity and a \$600 convertible note. Initially, 801,333 shares were issued. The note, which was issued to one of the Company's directors, will convert automatically into an additional 200,000 shares if the Company's shareholders vote to approve the conversion of the note into common shares at the Company's Annual Meeting in December 2002. If shareholder approval is not obtained, the Company is obligated to repay the note on December 31, 2002, with accrued interest at 10% per year. All shares will be issued at \$3.00 per share.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (in whole dollars)

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. This report contains certain forward-looking statements and information that are based on the beliefs of management as well as assumptions made by and information currently available to management. The statements contained in this report relating to matters that are not historical facts are forward-looking statements that involve risks and uncertainties, including, but not limited to, future demand for the Company's products and services, the successful commercialization of the Company's advanced rechargeable batteries, general economic conditions, world events, government and environmental regulation, competition and customer strategies, technological innovations in the primary and rechargeable battery industries, changes in the Company's business strategy or development plans, capital deployment, business disruptions, including those caused by fire, raw materials supplies, environmental regulations, and other risks and uncertainties, certain of which are beyond the Company's control. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may differ materially from those described herein as anticipated, believed, estimated or expected.

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the accompanying consolidated financial statements and notes thereto contained herein and the Company's consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K as of and for the year ended June 30, 2001.

#### General

Ultralife Batteries, Inc. develops, manufactures and markets a wide range of customized and standard lithium primary, lithium-ion and polymer rechargeable batteries for use in a wide array of applications. The Company believes that its proprietary technologies allow the Company to offer batteries that are ultra-thin, lightweight and generally achieve longer operating time than many competing batteries currently available. The Company manufactures a family of lithium/manganese dioxide primary (non-rechargeable) batteries for military, industrial and consumer applications which it believes is one of the most comprehensive lines of primary batteries commercially available. In addition, the Company manufactures and markets lithium polymer and lithium-ion rechargeable batteries for use in portable electronic applications.

The Company has incurred net operating losses primarily as a result of funding research and development activities and, to a lesser extent, manufacturing and general and administrative costs. To date, the Company has devoted a substantial portion of its resources to the research and development of its products and technology, particularly its proprietary polymer rechargeable technology. The Company's results of operations may vary significantly from quarter to quarter depending upon the number of orders received and the pace of the Company's research and development activities. Currently, the Company does not experience significant seasonal trends in primary battery revenues and does not have enough sales history on the rechargeable batteries to determine if there is seasonality.

The Company reports its results in four operating segments: Primary Batteries, Rechargeable Batteries, Technology Contracts and Corporate. The Primary Batteries segment includes 9-volt batteries, cylindrical batteries and various specialty batteries. The Rechargeable Batteries segment consists of the Company's rechargeable batteries. The Technology Contracts segment includes revenues and related costs associated with various government and military development contracts. The Corporate segment consists of all other items that do not specifically relate to the three other segments and are not considered in the performance of the other segments.

## Results of Operations

### Three months ended March 31, 2002 and 2001

Consolidated revenues were \$8,862,000 for the three month period ended March 31, 2002, an all-time quarterly record. This sales amount reflected an increase of \$3,045,000, or 52%, from \$5,817,000 in the same quarter in fiscal 2001. Primary battery sales increased \$3,340,000, or 62%, from \$5,401,000 last year to \$8,741,000 this year. Growth was seen in substantially all of Primary battery products, including strong demand for 9-volt batteries, and continuing growth of cylindrical battery products, including the BA-5368 and BA-5372 batteries, as well as new products, such as pouch cells and D-cells. These increases were offset in part by a decline in Technology Contract revenues. As expected, Technology Contract revenues declined \$303,000, from \$338,000 to \$35,000 due to the scheduled reduction of certain non-renewable government contracts.

Cost of products sold amounted to \$7,940,000 for the three-month period ended March 31, 2002, an increase of \$1,392,000, or 21% over the same three month period a year ago. The gross margin on consolidated revenues for the quarter was a positive 10%, compared to a loss of 13% in the prior year. The gross margin for this fiscal year's third quarter represented the first positive margin in nine quarters, resulting from the manufacturing improvements made by the Company. Primary gross margins increased \$1,051,000 over the prior year from a 7% gross margin in fiscal 2001 to a 16% gross margin in fiscal 2002. This improvement in margins is primarily the result of increased sales and improvements in manufacturing efficiencies, resulting from the implementation of lean manufacturing practices. Cost of products sold in the Rechargeable segment decreased \$625,000 over last year mainly due to cost savings initiatives that were enacted during the past six months. The Rechargeable gross margin improved from a loss of \$1,154,000 last year to a loss of \$521,000 this year. While the Company has taken significant steps to narrow its focus for polymer production in the Rechargeable area, the Company has enhanced its capability to source rechargeable sales opportunities with product it can purchase from other manufacturers, namely the Company's venture in Taiwan, Ultralife Taiwan, Inc., as well as others. The Company continues to believe that there are significant opportunities for growth in the Rechargeable area.

Operating and other expenses were \$3,019,000 for the three months ended March 31, 2002 compared to \$2,778,000 in the prior year, an increase of \$241,000, or 9%. The increase is mainly due to higher research and development costs that resulted from the development of new Primary battery products.

Interest income decreased \$123,000, or 98%, from \$126,000 in the third quarter of fiscal 2001 to \$3,000 in the third quarter of fiscal 2002. The reduction in interest income is principally the result of lower average cash balances and lower interest rates. Interest expense declined \$33,000 due to lower average balances outstanding on the credit facility and lower borrowing rates. Equity loss in affiliate was \$340,000 for its equity interests in Ultralife Taiwan, Inc. (UTI) for the quarter ended March 31, 2001. No losses have been recorded in fiscal 2002 as the investment on the balance sheet has been written down to zero under the equity method of accounting. Miscellaneous income (expense) relates primarily to foreign currency transaction gains and losses for the period reported.

Net losses were \$2,292,000, or \$0.19 per share, for the third quarter of fiscal 2002 compared to \$3,921,000, or \$0.35 per share, for the same quarter last year primarily as a result of the reasons described above.

### Nine months ended March 31, 2002 and 2001

Consolidated revenues reached a new nine-month record of \$23,937,000 for the first three quarters of fiscal 2002, an increase of \$5,979,000, or 33%, over the comparable period in fiscal 2001. Primary battery sales increased \$6,725,000, or 41%, from \$16,310,000 last year to \$23,035,000 this year. In fiscal 2001, the Company began production and shipments of the BA-5368 battery used by the military in

survival radios for pilots, and this new small cylindrical battery resulted in approximately \$3,300,000 in incremental sales in the first nine months of fiscal 2002. Sales of 9-volt and BA-5372 batteries also rose. Shipments of HiRate and assembled batteries continued the strong growth trend in the UK as a result of an increase in demand from the UK military. Partially offsetting these increases was a decline in Technology Contract revenues. As expected, Technology Contract revenues declined \$878,000, from \$1,406,000 to \$528,000 due to the scheduled reduction of certain non-renewable government contracts.

Cost of products sold amounted to \$23,675,000 for the nine-month period ended March 31, 2002, an increase of \$2,835,000, or 14% over the same nine month period a year ago. The gross margin on total revenues for the nine-month period of fiscal 2002 was a positive 1%, compared to a loss of 16% in the prior year. The improvement in gross margins was affected mainly by two factors. First, Primary gross margins increased \$2,952,000 over the prior year from a 2% gross margin in fiscal 2001 to a 15% gross margin in fiscal 2002. This improvement in margins is principally the result of increased sales and enhancements in the manufacturing process due to the implementation of lean manufacturing practices, which in some instances have resulted in reductions in the workforce. To date, lean manufacturing practices in the Primary battery segment have resulted in quicker manufacturing throughput times, greater operating efficiencies and a reduction of inventory. Second, Rechargeable gross margins improved \$262,000 over the prior year due largely to cost savings actions taken over the last six months, involving a realignment of resources and a more narrowed focus in the Rechargeable business unit. In the second quarter of fiscal 2001, due to the heavy competition, the Company shifted its focus to design and manufacture lightweight custom sized batteries for OEMs rather than focus on the broad retail cell phone market. The manufacture of cell phone batteries was an important milestone for the Company as it demonstrated the Company's ability to mass produce polymer rechargeable batteries. While the Company continues to actively design and develop polymer rechargeable batteries, it has broadened its supply source to include other lithium rechargeable cells made by other battery manufacturers, including the Company's affiliate in Taiwan, Ultralife Taiwan, Inc. Additionally, in the second and third quarters of fiscal 2002, the Company reduced costs and reallocated resources to better align itself with the demand in the marketplace. The Company has experienced significant demand from the military for its primary battery products and as a result shifted significant resources to be able to produce levels necessary to meet the demand. This has resulted in lower costs charged to the Rechargeable business unit.

Operating and other expenses were \$9,386,000 for the nine months ended March 31, 2002, compared with \$8,142,000 in the prior year, an increase of \$1,244,000, or 15%. Of the Company's operating and other expenses, research and development expenses increased \$885,000, or 38%, to \$3,192,000 for the first three quarters of fiscal 2002. The increase in research and development expenses was due to increased development effort for samples and new product designs of polymer rechargeable batteries in fiscal 2002. In addition, R&D costs rose due to increases in Primary battery development activity for new military batteries as prototypes were built for qualification with the US Army. Selling, general and administrative costs increased \$359,000 or 6% over the prior year period. This increase was mainly due to higher selling and marketing expenses overseas as the Company enhanced its market coverage, as well as severance costs pertaining to an executive employment agreement incurred in conjunction with the Company's resource realignment that was enacted in the second fiscal quarter.

Interest income decreased \$540,000, or 86%, from \$628,000 in the first three quarters of fiscal 2001 to \$88,000 in the first three quarters of fiscal 2002. The reduction in interest income is principally the result of lower average cash balances and the lower interest rates. Interest expense declined \$111,000 due to lower average balances outstanding on the credit facility and lower borrowing rates. Equity loss in affiliate was \$1,930,000 for its equity interest in Ultralife Taiwan, Inc. (UTI) for the first three quarters of fiscal 2001. No losses have been recorded in fiscal 2002 as the investment on the balance sheet has been written down to zero under the equity method of accounting. Additionally, in August 2001, the Company's ownership interest in UTI was reduced to 33% as a result of additional capital raised by UTI for its ongoing expansion. Miscellaneous income (expense) relates primarily to foreign currency transaction gains and losses for the period reported.

Net losses were \$9,354,000, or \$0.77 per share, for the first nine months of fiscal 2002 compared to \$12,762,000, or \$1.15 per share, for the same quarter last year primarily as a result of the reasons described above.

#### Liquidity and Capital Resources

At March 31, 2002, cash and cash equivalents and available for sale securities totaled \$547,000. Of this amount, \$201,000 was restricted at March 31, 2002 to support certain outstanding letters of credit. The Company used \$8,040,000 of cash in operating activities during the first nine months of fiscal 2002. This use of cash related primarily to the net loss reported for the period and an increase in accounts receivable, offset in part by depreciation and decreases in other current assets. More specifically, receivables increased \$2,776,000 from June 30, 2001 to March 31, 2002. This increase resulted from a significant increase in revenues in the third quarter of fiscal 2002 as compared with the fourth quarter of fiscal 2001. The Company does not anticipate any significant recoverability issues with these outstanding receivables. The Company spent \$1,715,000 for capital expenditures for production equipment and facilities improvements during the first three quarters 2002. Of this amount \$995,000, was received as proceeds in sales-leaseback transactions and incorporated under the Company's \$4,000,000 lease line. As of April 30, 2002, the remaining \$250,000 available under the lease line of credit has been committed for the acquisition of certain equipment.

At March 31, 2002, the Company had long-term debt outstanding including capital lease obligations of \$1,984,000 primarily relating to the financing arrangement entered into by the Company at the end of fiscal 2000, described below.

In June 2000, the Company entered into a \$20,000,000 secured credit facility with a lending institution. The financing agreement consisted of an initial \$12,000,000 term loan component based on the valuation of the Company's fixed assets and a revolving credit facility component for an initial \$8,000,000, based on eligible net accounts receivable (as defined) and eligible net inventory (as defined). While the amount available under the term loan component amortizes over time, the amount of the revolving credit facility component increases by an equal and offsetting amount. Principal and interest are paid monthly on outstanding amounts borrowed. The loans bear interest at the prime rate or other LIBOR-based rate options at the discretion of the Company. The Company also pays a facility fee on the unused portion of the commitment. The loan is secured by substantially all of the Company's assets and the Company is precluded from paying dividends under the terms of the agreement.

In October 2001, the Company was informed by its primary lending institution that its borrowing availability under the \$20,000,000 credit facility had been effectively reduced to zero as the result of a recent appraisal of its fixed assets. The appraisal resulted in a significant decrease in the valuation of the Company's machinery and equipment which was based on an "orderly liquidation valuation" methodology used by the appraiser.

In February 2002, the Company and its primary lending institution amended the credit facility. The amended facility was reduced to \$15,000,000 based on a realistic assessment of the Company's potential borrowing capacity and to minimize the cost of unused line fees. The term loan component was revised to an initial \$2,733,333 based on the valuation of the Company's fixed assets (of which \$2,681,000 was outstanding on the term loan at March 31, 2002). The revolving credit facility component comprises the remainder of the total potential borrowing capacity. Certain definitions were revised which increased the Company's available borrowing base. In addition, the minimum net worth covenant was reduced to \$33,500,000. At March 31, 2002, the total amount available under the revolver component was approximately \$700,000, net of \$3,800,000 of outstanding letters of credit.

On July 20, 2001, the Company completed a \$6,800,000 private placement of 1,090,000 shares of its common stock at \$6.25 per share. In conjunction with the offering, warrants to acquire up to 100,000 shares of common stock were granted. The exercise price of the warrants is \$6.25 per share and the warrants have a five-year term.

The Company has maintained a lease line of credit with a third party leasing agency. Under this arrangement, the Company has various options to acquire manufacturing equipment, including sales / leaseback transactions and operating leases. In October 2001, the Company expanded its leasing arrangement with a third party leasing agency. The revision increased the amount of the lease line from \$2,000,000 to \$4,000,000. The increase in the line is being used to fund capital expansion plans for manufacturing equipment that will allow increased capacity within the Company's Primary business unit. In conjunction with this lease, the Company has a letter of credit of \$3,800,000 outstanding. At March 31, 2002, approximately \$250,000 remained outstanding under the lease line of credit. Once the lease line has been fully utilized, which is expected to be by June 2002, the Company's quarterly lease payment will approximate \$226,000.

On April 23, 2002, the Company closed on a \$3,000,000 private placement consisting of common equity and a \$600,000 convertible note. Initially, 801,333 shares were issued. The note, which was issued to one of the Company's directors, will convert automatically into an additional 200,000 shares if the Company's shareholders vote to approve the conversion of the note into common shares at the Company's Annual Meeting in December 2002. If shareholder approval is not obtained, the Company is obligated to repay the note on December 31, 2002, with accrued interest at 10% per year. All shares will be issued at \$3.00 per share.

The Company's capital resource commitments as of March 31, 2002 consisted principally of capital equipment commitments of approximately \$520,000.

The Company periodically reviews the carrying amount of its long-lived assets for impairment. In particular, the recent activity surrounding the Company's Rechargeable business unit has caused the Company to review the carrying value of the long-lived assets associated with this business. At this time, the Company believes that the future cash flows from this business will exceed the carrying value of the assets. Therefore, no impairment has been reflected. The Company will continue to closely monitor and reevaluate the realizability of these assets each quarter. In the event that the Company is required to record an impairment charge in the future, it could have a material adverse effect on the Company's financial position and results of operations.

As previously noted, the Company's primary lending institution had significantly reduced the total amount of the credit facility available. Although the Company significantly improved its present liquidity position with the private placement offering that raised \$3,000,000 in April 2002, the Company's future liquidity depends on the Company's ability to successfully generate positive cash flow from operations and achieve adequate operational savings. Notwithstanding the foregoing, there can be no assurance that the Company will have sufficient cash flows to meet its working capital and capital expenditure requirements. See additional comments on the Company's recent cost reduction actions in "Outlook".

#### Outlook

The Company expects revenues in its fourth quarter of fiscal 2002 to be relatively consistent with the results in the third quarter, i.e. in the range of approximately \$8,500,000 to \$9,000,000. At this time, 9-volt orders are continuing their strong trend. Sales of new military battery offerings are expected to increase substantially, such as the BA-5390 battery used as the main communications battery by military forces, providing for an improving mix of higher margin products. Offsetting these improvements, however, is a delay in certain military battery awards, which will have some impact on BA-5368 battery sales. The Company is projecting modest revenues for its Rechargeable business in the fourth fiscal



quarter, but it believes that there are still significant upside opportunities in this area. For the year, the Company expects to conclude its year ended June 30, 2002 with approximately a 35% growth in revenues over the prior fiscal year.

While the Company made very significant strides toward meeting its goal of operating cash breakeven in the March 2002 quarter, it fell short of its goal by approximately \$1,000,000. There were a few primary reasons for this shortfall. First, the cost savings actions taken during the March quarter did not provide a full quarter's worth of benefit. Second, the Company made a conscious decision to continue to invest in its Primary R&D efforts to develop new products that are key to its near-term growth prospects. And lastly, the Company continued to improve the balance in its production schedule to keep inventory levels as low as possible, reducing inventories during the quarter by approximately \$800,000 which resulted in lower absorption of overheads than expected.

The Company believes that ongoing quarterly revenues of approximately \$9,000,000 to \$9,500,000 will be the point where the Company reaches its key financial target of operating cash breakeven. Depending on the mix of products sold, and the sustaining benefits from the cost savings actions that were taken over the past two quarters, the Company believes that it may be able to reach this milestone in the June 2002 quarter.

In October and November 2001, and in February 2002, the Company took various cost savings actions and realigned its resources to address changing market conditions and to better meet customer demand in areas of the business that are growing. While the actions have significantly reduced the production workforce in the polymer Rechargeable business unit, no product lines have been discontinued. In fact, the Company has broadened its product offerings by increasing its sales focus and production capabilities to assemble rechargeable battery packs from the purchase of cells from other sources, including its affiliate, Ultralife Taiwan, Inc. The terms of the transactions with our affiliate are arms-length. In total, approximately 20% of the Company's total employees as of September 30, 2001 were terminated. The resource realignment did not result in significant severance costs. The Company expects to realize cost savings from the measures being taken of approximately \$2,300,000 per quarter. Approximately two-thirds of the savings will reduce cost of products sold and one-third will reduce operating expenses. These quarterly savings are comprised of approximately \$1,800,000 of reduced labor costs, approximately \$200,000 of reduced material usage, and approximately \$300,000 of lower administrative expenses. The Company anticipates the full amount of these actions to be realized in the June 2002 quarter.

### Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

The Company is exposed to various market risks in the normal course of business, primarily interest rate risk and changes in market value of its investments and believes its exposure to these risks is minimal. The Company's investments are made in accordance with the Company's investment policy and primarily consist of commercial paper and U.S. corporate bonds. The Company does not currently participate in the investment of derivative financial instruments.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

The Company is subject to legal proceedings and claims that arise in the normal course of business. The Company believes that the final disposition of such matters will not have a material adverse effect on the financial position or results of operations of the Company.

In August 1998, the Company, its Directors, and certain underwriters were named as defendants in a complaint filed in the United States District Court for the District of New Jersey by certain shareholders, purportedly on behalf of a class of shareholders, alleging that the defendants, during the period April 30, 1998 through June 12, 1998, violated various provisions of the federal securities laws in connection with an offering of 2,500,000 shares of the Company's Common Stock. The complaint alleged that the Company's offering documents were materially incomplete, and as a result misleading, and that the purported class members purchased the Company's Common Stock at artificially inflated prices and were damaged thereby. Upon a motion made on behalf of the Company, the Court dismissed the shareholder action, without prejudice, allowing the complaint to be refiled. The shareholder action was subsequently refiled, asserting substantially the same claims as in the prior pleading. The Company again moved to dismiss the complaint. By Opinion and Order dated September 28, 2000, the Court dismissed the action, this time with prejudice, thereby barring plaintiffs from any further amendments to their complaint and directing that the case be closed. Plaintiffs filed a Notice of Appeal to the Third Circuit Court of Appeals and the parties submitted their briefs. Subsequently, the parties notified the Court of Appeals that they had reached an agreement in principle to resolve the outstanding appeal and settle the case upon terms and conditions which require submission to the District Court for approval. Upon application of the parties and in order to facilitate the parties' pursuit of settlement, the Court of Appeals issued an Order dated May 18, 2001 adjourning oral argument on the appeal and remanding the case to the District Court for further proceedings in connection with the proposed settlement.

Subsequent to the parties entering into the settlement agreement, the Company's insurance carrier commenced liquidation proceedings. The insurance carrier informed the Company that in light of the liquidation proceedings, it would no longer fund the settlement. In addition, the value of the insurance policy is in serious doubt. In April 2002, the Company and the insurance carrier for the underwriters offered to proceed with the settlement. Plaintiff's counsel has accepted the terms of the proposed settlement and the matter must now be approved by the Court and by the shareholders comprising the class. Based on the terms of the proposed settlement, the Company has established reserves against a significant portion of its share of the settlement costs and associated expenses.

In the event settlement is not reached, the Company will continue to defend the case vigorously. The amount of alleged damages, if any, cannot be quantified, nor can the outcome of this litigation be predicted. Accordingly, management cannot determine whether the ultimate resolution of this litigation could have a material adverse effect on the Company's financial position and results of operations.

In conjunction with the Company's purchase/lease of its Newark, New York facility in 1998, the Company entered into a payment-in-lieu of tax agreement which provides the Company with real estate tax concessions upon meeting certain conditions. In connection with this agreement, the Company received an environmental assessment, which revealed contaminated soil. The assessment indicated potential actions that the Company may be required to undertake upon notification by the environmental authorities. The assessment also proposed that a second assessment be completed and provided an estimate of total potential costs to remediate the soil of \$230,000. However, there can be no assurance that this will be the maximum cost. The Company entered into an agreement whereby a third party has agreed to reimburse the Company for fifty percent of the costs associated with this matter. Test sampling occurred in the fourth quarter of fiscal 2001 and the engineering report was submitted to the New York State Department of Environmental Conservation (NYSDEC) for review. NYSDEC reviewed the report and in January 2002 recommended additional testing. The Company responded by submitting a proposed

work plan to NYSDEC, which was approved by NYSDEC in April 2002. The Company is now soliciting proposals from engineering firms to complete remedial work contained in the work plan, and it is unknown at this time whether the final cost to remediate will be in the range of the original estimate, given the passage of time. The ultimate resolution of this matter may have a significant adverse impact on the results of operations in the period in which it is resolved.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

4.1 Senior Convertible Subordinated Debenture Agreement

10.1 Fourth Amendment to Financing Agreements

(b) Reports on Form 8-K

On April 24, 2002, the Company filed a Form 8-K with the Securities and Exchange Commission indicating that on April 23, 2002, the Company closed on a \$3 million private placement consisting of common equity and a convertible note. Initially, approximately 800,000 shares were issued. Subject to shareholder approval, an additional 200,000 shares will be issued upon conversion of the note which matures on December 31, 2002. Shareholders will vote to approve the conversion of the note into common shares at the Company's Annual Meeting in December 2002. All shares will be issued at \$3.00 per share.

SIGNATURES

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.

ULTRALIFE BATTERIES, INC.

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(Registrant)

Date: May 14, 2002  
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By: /s/John D. Kavazanjian  
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John D. Kavazanjian  
President and Chief Executive  
Officer

Date: May 14, 2002  
-----

By: /s/Robert W. Fishback  
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Robert W. Fishback  
Vice President - Finance and Chief  
Financial Officer

This Debenture has not been registered under the Securities Act of 1933, as amended, and cannot be sold or transferred except in compliance with that Act.

SENIOR CONVERTIBLE SUBORDINATED DEBENTURE

\$600,000

April 23, 2002

FOR VALUE RECEIVED, the undersigned, Ultralife Batteries, Inc., a Delaware corporation ("Ultralife"), hereby promises to pay to Joseph C. Abeles ("Purchaser"), or order on December 31, 2002 (the "Maturity Date"), the principal sum of Six-Hundred-Thousand Dollars (\$600,000), and to pay simple interest thereon, computed on the basis of a 360-day year of 12 30-day months, from the date hereof at the rate of 10% per annum. Interest shall be calculated monthly and shall be accrued through the Maturity Date.

The principal hereof and interest hereon shall be payable at the office of the undersigned, in such coin or currency of the United States of America as at the time of payment shall be legal tender for the payment of public and private debts.

This Debenture is one of a duly authorized issue of debentures of Ultralife Batteries, Inc. designated as its Senior Convertible Subordinated Debentures due December 31, 2002 ("Debentures"), each such Debenture being subject to the same terms and conditions as contained herein.

W I T N E S S E T H :

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I. Recording and Transfer.

1.1 Ultralife will have the right at any time, or from time to time, subsequent to the date hereof, to issue a new Debenture or Debentures to the Purchaser or holder in printed form or in any other form in substitution for this Debenture, provided that such substitute Debenture or Debentures shall contain all the terms and conditions of this Debenture, and no other terms and conditions. In the event of such reissuance of Debentures, the Purchaser or holder will be obligated to return to Ultralife this Debenture, or any subsequently issued Debentures, in exchange therefor.

1.2 Ultralife will keep books at its principal office for the registration or transfer of the Debentures, or Ultralife may designate any bank or trust company or any registrar and transfer company as its Registrar and Transfer Agent for such purpose. The person in whose name a Debenture shall be registered on the books of Ultralife or its Transfer Agent shall be deemed and regarded as the absolute owner thereof for all purposes, notwithstanding any notice or knowledge to the contrary, and payment of the principal of, the interest on, or the premium, if any, on the Debentures shall be made, and the conversion thereof shall be effected, only by or upon the order of such registered owner. Any such payment or conversion shall be valid and

effectual to satisfy and discharge Ultralife of liability upon such Debenture to the extent of such sum or sums so paid or the Common Stock of Ultralife issued upon such conversion.

1.3 Subject to the provisions hereof, the Debenture shall be treated as negotiable, and the Purchaser may transfer or assign the Debenture, or any portion thereof, subject to all of the provisions and obligations contained herein. No transfer shall be valid unless made on the books of Ultralife or its Transfer Agent. Such transfers may be effected on the books of Ultralife or its Transfer Agent upon delivery of: (a) this Debenture, duly endorsed or accompanied by a written instrument of transfer, with the signature of endorsement guaranteed by a commercial bank or trust company; (b) a sum sufficient to reimburse Ultralife for any documentary stock transfer tax or other governmental charge imposed upon the transfer; and (c) a letter or other document from the transferee, in form and content satisfactory to Ultralife, stating that such transferee is acquiring the Debenture for his own account and without a view to, or in connection with, any distribution thereof in violation of the Securities Act of 1933, as amended (hereinafter referred to as the "Act"), or applicable state law. Upon receipt of such documents, Ultralife shall issue a new Debenture in the form of the original Debenture to the proper parties as instructed by the transferor.

1.4 Upon receipt of evidence satisfactory to Ultralife or its Transfer Agent of the loss, theft, destruction or mutilation of this Debenture, together with indemnification reasonably satisfactory to Ultralife and reimbursement for all expenses incident thereto, Ultralife or its Transfer Agent shall issue and deliver a new Debenture in lieu of any Debenture which may become lost, stolen, destroyed or mutilated.

II. Subordination.

The parties hereto agree that the payment of the principal of and the interest on the Debenture is expressly subordinated to the payment of all Senior Indebtedness, to the extent and subject to the conditions set forth in this Article II. As used herein, the term "Senior Indebtedness" shall mean the principal of, the interest on and the premium, if any, on all indebtedness of Ultralife for money borrowed by it from any financial institution including banks, savings institutions or insurance companies and all renewals, extensions and refundings of any such indebtedness, whether such indebtedness shall have been incurred prior to, on, or subsequent to the date hereof, unless by the

terms of the instrument creating or evidencing any such indebtedness it is provided that such indebtedness is not to be considered Senior Indebtedness for the purpose of the Debenture.

2.1 No interest or principal shall be paid on the Debenture without the consent of the holders of all outstanding Senior Indebtedness if, at the date fixed herein for such interest or principal payment, Ultralife shall be in default of payment of principal or interest upon such Senior Indebtedness. In the event any payment of interest or principal hereunder shall be prohibited pursuant to this Section 2. 1, such payment shall be deemed to be deferred until the cure of all defaults in payment of principal or interest upon the Senior Indebtedness, and the payments hereon so deferred shall immediately become due and payable, without any interest thereon, upon the cure of such defaults.

2.2 In the event of any dissolution, winding up, liquidation or reorganization of

Ultralife, whether in bankruptcy, insolvency or receivership proceedings, or upon an assignment for the benefit of creditors or in any other marshalling of the assets and liabilities of Ultralife, the holders of all Senior Indebtedness shall first be entitled to receive payment in full of such Senior Indebtedness before the holders of the Debentures shall be entitled to receive any payment upon the principal of, the interest on, or the premium, if any, on the indebtedness evidenced by the Debentures. Upon any such dissolution, winding up, liquidation or reorganization, any payment or distribution of assets of Ultralife of any kind or character, whether in cash, property or securities, to which the holders of the Debentures would be entitled, except for the provisions of this Article II, shall be made by the liquidating trustee or agent or such person making such payment or distribution, whether a trustee in bankruptcy, a receiver or liquidating trustee or otherwise, directly to the holders of the Senior Indebtedness or their representatives or to the trustee or trustees under any indenture or indentures under which any instruments evidencing any such Senior Indebtedness may have been issued, ratably according to the aggregate amounts remaining unpaid on account of the Senior Indebtedness held or represented by each, to the extent necessary to pay in full all such Senior Indebtedness remaining unpaid, after giving effect to all concurrent payment or distribution with respect to such Senior Indebtedness.

2.3 In the event that, notwithstanding the provisions of Section 2.2 of this Article II, upon any such dissolution, winding up, liquidation or reorganization, any payment or distribution of assets of Ultralife of any kind or character, whether in cash, property or securities, shall be received by the holders of the Debentures before all Senior Indebtedness is paid in full, such payment or distribution shall be paid over to the holders of such Senior Indebtedness or their representatives or to the trustee or trustees under any indenture or indentures referred to in said Section 2.2, ratably as aforesaid, for application to the payment of all Senior Indebtedness remaining unpaid until all such Senior Indebtedness shall have been paid in full, after giving effect to any concurrent payment or distribution with respect to such Senior Indebtedness.

2.4 Subject to the payment in full of all Senior Indebtedness, the holders of the Debentures, to the extent permitted by law, shall be subrogated to the rights of each holder of Senior Indebtedness (to the extent of the payments or distributions made to such holder pursuant to the provisions of Sections 2.2 and 2.3 of this Article II) to receive payments or distributions of assets of Ultralife applicable to the Senior Indebtedness until the principal of, the interest on, and the premium, if any, on this Debenture shall be paid in full, and each holder of Senior Indebtedness by accepting such payments or distributions shall be deemed to have agreed to said subrogation. No payments or distributions to the Senior Indebtedness pursuant to the provisions of Sections 2.2 and 2.3 shall, as between Ultralife, its creditors, other than the holders of the Senior Indebtedness, and the holders of the Debentures, be deemed to be a payment by Ultralife to or on account of the Debentures, the provisions of this Article II being, and being intended, solely for the purpose of defining the relative rights of the holders of the Debentures, on the one hand, and the holders of the Senior Indebtedness, on the other hand; and nothing contained in this Article II or elsewhere in this Debenture is intended to or shall impair, as between Ultralife, the holders of the Debentures and the other creditors of Ultralife, other than the holders of Senior Indebtedness, the obligation of Ultralife, which is unconditional and absolute, to pay to the holders of the Debentures as and when the same shall become due and payable in accordance with the terms herein, or to affect the relative rights of the holders of the Debentures and the other creditors of Ultralife, other than the holders of Senior Indebtedness, or to prevent the holders of the Debentures from exercising all of the remedies otherwise permitted by applicable law upon default as provided for herein, subject to the rights, if any, under this Article II of the

holders of the Senior Indebtedness in respect of any cash, property or securities of Ultralife received upon the exercise of any such remedy.

2.5 In the event that this Debenture shall be declared due and payable before the Maturity Date because of the occurrence of a default hereunder, Ultralife will give prompt notice in writing of such happening to the holders of the Senior Indebtedness, and any and all Senior Indebtedness shall forthwith become immediately due and payable upon demand by the respective holders thereof regardless of the expressed maturity dates thereof.

### III. Conversion.

The Purchaser agrees that at any time prior to the Maturity Date hereof, if Ultralife obtains the approval of the holders of a majority of the issued and outstanding shares of its \$.10 per value Common Stock ("Common Stock") of the conversion of this Debenture, the principal amount of the Debenture shall automatically and mandatorily convert into Common Stock. The conversion price shall be Three Dollars and no Cents (\$3.00) per share (hereinafter referred to as the "Conversion Price") subject to the following terms and conditions:

3.1 Interest shall cease to accrue on the principal amount of the Debenture converted pursuant to the provisions of this Article III, immediately upon, and as of, the conversion thereof, and any and all accrued interest shall be forfeited by the Purchaser. As promptly as shall be practicable after the surrender of the Debenture for conversion in whole or in part, Ultralife will issue and deliver to the Purchaser or holder, the number of whole shares of Common Stock into which the Debenture shall be so converted. Such conversion shall for all purposes be deemed to have been effected at the close of business on the day of obtaining stockholder approval of the conversion of this Debenture.

3.2 In connection with the conversion, if there is not an effective registration statement with respect to the shares of Common Stock issuable on conversion, Ultralife reserves the right to imprint restrictive legends on the certificates representing the shares of Common Stock into which the Debenture shall be converted and to place stop transfer orders against the same. Nothing contained herein shall be construed as requiring counsel for Ultralife to subsequently issue any opinion letter that registration is not required, and such counsel may refuse to issue such an opinion letter on any reasonable grounds or may require opinion letters from counsel for the proposed transferor, affidavits from the proposed transferor or transferee, letters from the Securities and Exchange Commission or any other documents which said counsel may deem to be necessary or desirable and proper as a condition precedent to issuing such an opinion letter.

3.3 In the event that at any time the Common Stock of Ultralife shall be exchanged for, or changed into, a different kind and/or a number of shares of stock of Ultralife or of another corporation by reason of a merger, consolidation, sale of assets, recapitalization, reclassification, stock dividend, stock split-up or combination of shares or otherwise, then, until any further adjustment is required, there shall be issuable upon the conversion of this Debenture, in lieu of each share of Common Stock of Ultralife or of any other stock theretofore issued pursuant to the provisions of this Article III, the kind and/or number of shares of stock for which each share of Common Stock of Ultralife or such other stock shall be so exchanged, or into which each share of Common Stock of Ultralife or such other stock shall be so changed and the Conversion Price



of Three Dollars and no cents (\$3.00) per share of Common Stock shall be automatically adjusted to a new Conversion Price as nearly equivalent as practicable to the adjustment in shares of stock, if by reason of such merger, consolidation, recapitalization, reclassification or otherwise the number of issued and outstanding shares of Common Stock of Ultralife shall have been exchanged for or changed into such new shares on other than a one-to-one basis. If such event requires an adjustment in the Conversion Price, Ultralife shall mail notice of the nature of such event and the new Conversion Price to the Purchaser at the Purchaser's registered address within ten (10) days after the occurrence of such event.

3.4 No adjustment in the Conversion Price shall be made for cash dividends on the shares of Common Stock of Ultralife or any other stock issued upon any conversion of the Debenture. No fractional shares or scrip representing fractional shares will be issued upon the conversion of the Debentures. In lieu of the issuance of any fractional share otherwise called for upon such conversion, Ultralife will pay to the Purchaser or holder an amount in cash equal to the value of such fractional share, based upon the Conversion Price.

3.5 Ultralife shall at all times, prior to the maturity date of the Debenture, reserve and keep available out of its authorized but unissued Common Stock, solely for the purposes of issuance upon conversion of Debentures as herein provided an appropriate number of shares of Common Stock as shall be issuable upon the conversion of the Debenture. Such shares of Common Stock when issued upon conversion shall be duly and validly issued and fully-paid and non-assessable; however, unless such shares have been registered under the Act, such shares of Common Stock will be restricted and subject to restrictions on resale.

#### IV. Representations and Warranties of Ultralife.

Ultralife represents and warrants to the Purchaser as follows:

4.1 Ultralife is duly incorporated, validly existing and in good standing under the laws of the State of Delaware, and Ultralife is qualified to transact business and is in good standing in all states in which it owns property, and has power and authority to own its property and to carry on its business as now being conducted.

4.2 All necessary action on the part of Ultralife relating to the authorization of the execution and delivery of this Debenture and the performance of its other obligations hereunder has been taken, and all of the same shall be valid and enforceable in accordance with their respective terms, except as may be limited by bankruptcy, insolvency or other laws of general application relating to or affecting the enforcement of creditors' rights. Such action will not violate any provision of law, or of Ultralife's Certificate of Incorporation or By-Laws, and will not violate or create a default under any agreement to which Ultralife is a party, or by which any of its properties is bound, or any order, writ, injunction or decree of any Court or governmental instrumentality, and will not result in the creation or imposition of any lien, charge or encumbrance upon any of the properties of Ultralife.

#### V. Default.

In the event that there shall be any Event of Default hereunder and such Event of Default shall remain uncorrected or unremedied for a period of more than thirty (30) days after Ultralife

shall have received notice of such Event of Default from the Purchaser or other holders of Debentures, then such portion of the Debenture with respect to which the Event of Default occurred may, at the option of the Purchaser or the holders thereof, become immediately due and payable without further notice by the Purchaser or holders thereof.

"Event of Default" as used in this Article V shall mean and refer to any of the following: (i) the failure of Ultralife to pay any installment of interest or principal on any of the Debentures when and as the same shall become due and payable, whether at maturity, by call for redemption, by declaration or otherwise; (ii) the failure of Ultralife to cure a default declared by the holder of Senior Indebtedness within the applicable period of time to cure such default; (iii) the failure of Ultralife to observe and perform all of the covenants and agreements on the part of Ultralife contained herein; (iv) failure of any representation or warranty made by Ultralife herein to be truthful, accurate or correct; (v) the adjudication of Ultralife as a bankrupt by a court of competent jurisdiction or the entry by a court of competent jurisdiction of an order approving a petition seeking reorganization of Ultralife under the federal bankruptcy laws or any other applicable law or statute of the United States of America or any state thereof or any other jurisdiction; (vi) the appointment by a court of competent jurisdiction of a trustee or receiver or receivers of Ultralife of all or any substantial part of its property upon the application of any creditor in any insolvency or bankruptcy proceeding or other creditor's suit, unless such appointment or decree or order shall be stayed upon appeal or otherwise; (vii) the filing by Ultralife of a petition in voluntary bankruptcy or the making by Ultralife of an assignment for the benefit of its creditors or the consenting by Ultralife to the appointment of a receiver or receivers of all or any substantial portion of the property of Ultralife; (viii) the filing by Ultralife of a petition or answer seeking reorganization under the federal bankruptcy laws or any other applicable law or statute of the United States of America or any state thereof or any jurisdiction, or the filing by Ultralife of a petition to take advantage of any debtor's act.

5.1 Upon the occurrence of an Event of a Default, each holder of any of the Debentures shall at all times have the right to institute any suit, action or proceeding, in equity or at law, for the enforcement of his rights as provided for herein, or in aid of the exercise of any right or power granted herein.

5.2 The Debentures shall be the obligation of Ultralife solely and there shall be no recourse had for the payment thereof or interest thereon against any stockholder, officer or director of Ultralife, either directly or through Ultralife, by reason of any matter prior to the delivery of the Debentures, or against any present or future officer or director of Ultralife, all such liability being expressly released by the Purchaser and by any subsequent holders hereof by the acceptance hereof and as part of the consideration for the issue hereof.

#### VI. Miscellaneous.

6.1 All notices and other communications required to be given hereunder shall be in writing, by certified mail, postage prepaid, return receipt requested, addressed to Ultralife at its principal office or to the holder of the Debenture at his registered address as reflected on the books and records of Ultralife or its Transfer Agent.

6.2 This Debenture represents the entire agreement between the parties hereto and may not be modified or rescinded except by mutual agreement of the parties hereto, except in accordance with the terms herein.

6.3 No waiver of any breach of this Debenture shall be deemed or construed as a waiver of any subsequent breach thereof.

6.4 This Debenture may not be assigned by the Purchaser except in accordance with the provisions hereof. This Debenture shall inure to the benefit of, and be binding upon, the successors and assigns of Ultralife.

6.5 The headings of the Articles of this Debenture are inserted for convenience only and do not constitute a part hereof.

6.6 Throughout this Debenture, the masculine gender shall be deemed to include the feminine and neuter, and the singular the plural, and vice versa.

IN WITNESS WHEREOF, Ultralife has executed this Debenture on April 23, 2002.

ULTRALIFE BATTERIES, INC.

By: /s/ John D. Kavazanjian  
-----  
John D. Kavazanjian, President

ATTEST:

/s/ Peter F. Comerford  
-----  
Peter F. Comerford, Secretary

As of February 19, 2002

Ultralife Batteries, Inc.  
2000 Technology Parkway  
Newark, NY 14513

Ultralife Batteries (UK) Ltd.  
18 Nuffield Way  
Abingdon, Oxfordshire, OX 14  
1TG England

Re: Fourth Amendment to Financing Agreements ("Amendment")  
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Gentlemen:

Reference is made to the Loan and Security Agreement dated June 15, 2000, as amended, between you and the undersigned (the "Loan Agreement"). All capitalized terms not otherwise defined herein shall have the meanings given such terms in the Loan Agreement.

Borrowers have requested that Lender agree to certain modifications to the Loan Agreement. Subject to the terms and conditions hereof, the Lender agrees with the Borrowers as follows:

(1) Section 1.15 is amended to delete the first sentence thereof and to replace it with the following:

"1.15 "Eligible Inventory" shall mean Inventory consisting of finished goods held for resale in the ordinary course of business of Parent, raw materials for such finished goods and Quasi-Finished Goods."

(2) Section 1.35 is deleted in its entirety and replaced with the following:

"1.35 "Maximum Credit" shall mean the amount of \$15,000,000.00"

(3) Section 1.41 is deleted in its entirety and replaced with the following:

"1.41 "Quasi-Finished Goods" shall mean sub-assembled 9 volt (excluding labeling, packaging, cans, etc.), and fully assembled 5372 and 5368 batteries that are undergoing only final cure and testing, that satisfy the criteria for Eligible Inventory (other than the requirement of being only finished goods or raw materials) and that are otherwise acceptable to Lender."

(4) Section 1.49 is deleted in its entirety and replaced with the following:

"1.49 Intentionally Omitted."

(5) Section 2.1(a)(ii) is deleted in its entirety and replaced with the following:

"2.1(a)(ii) the lesser of: (A) the sum of (1) seventy (70%) percent of the Value of Eligible Inventory consisting of finished goods, plus (2) the lesser of seventy (70%) of the Value of Eligible Inventory consisting of Quasi-Finished Goods or \$750,000, plus (3) thirty (30%) percent of the Value of Eligible Inventory consisting of raw materials or (B) \$6,000,000.00, less"

(6) Section 2.3 is deleted in its entirety and replaced with the following:

"2.3 Term Loans. On the date of the Fourth Amendment, a Term Loan in the principal amount of \$2,050,000.00 was outstanding to Parent and a Term Loan in the principal amount of \$683,333.27 was outstanding to Ultralife (UK). Each Term Loan is (a) evidenced by a Term Promissory Note in the original principal amount borrowed, (b) to be repaid, together with interest and other amounts, in accordance with this Agreement, the applicable Term Promissory Note and other Financing Agreements and (c) secured by all of the Collateral."

(7) Section 9.15 of the Loan Agreement is deleted and replaced with the following:

"9.15 Adjusted Net Worth. Borrowers shall, at all times, maintain an Adjusted Net Worth of not less than \$33,500,000.00." If the Borrower takes an asset impairment write-down prior to June 30, 2002, then the Adjusted Net Worth shall not be less than: (a) \$33,500,000.00 less (b) asset impairment write-down amount.

(8) Parent has advised Lender that it may sell its 33% equity interest in Ultralife Taiwan, Inc. ("UTI") and has requested that Lender specify the

Ultralife Batteries, Inc.  
Ultralife Batteries (UK) Ltd.  
As of February 19, 2001  
Page 2

conditions that Lender would place on its consent to such sale. Accordingly, Lender agrees that so long as no Event of Default or event or condition which with the passage of time or notice or both would constitute an Event of Default, has occurred and is continuing, Lender will consent to the sale by Borrower of its equity interest in UTI and release its security interest in such equity interest, subject to the receipt by Lender in immediately available funds of twenty (20%) percent of the total proceeds of such sale, which amount will be applied to establish an Availability Reserve equal to such amount.

(9) In addition to and without in any way limiting or substituting for the Collateral granted by Borrowers to Lender pursuant to the Financing Agreements and under the amendments thereto, as security for the payment and performance of all Obligations and any and all other obligations of every type of Borrowers to Lenders, each Borrower hereby grants to Lender a continuing security interest and lien upon all of its property and assets of every type whatsoever, now owned or hereafter acquired, wherever located, including without limitation all of the following categories of property and interests in property, as defined under the UCC presently in effect in the Commonwealth of Massachusetts or as hereafter amended: goods (including inventory, equipment and any accessions thereto), instruments (including promissory notes), documents, accounts (including health-care insurance receivables), chattel paper (whether tangible or electronic), deposit accounts, letters of credit (whether or not the letter of credit is evidenced by a writing), banker's acceptances and similar instruments and including all letter-of-credit rights, commercial tort claims, securities and all other investment property, general intangibles (including payment intangibles and software), supporting obligations and any and all products and proceeds of any of the foregoing (collectively, the "Collateral"). For all purposes under the Financing Agreements, each of the foregoing categories of property shall be deemed to be included in the Collateral and the definition of Collateral is hereby amended to include such categories. No Borrower shall change its state of incorporation without obtaining Lender's prior written consent, such consent to be in Lender's discretion. Borrowers promptly shall notify Lender in writing upon any Borrower acquiring any commercial tort claim(s). Each Borrower irrevocably and unconditionally authorizes Lender (or its agent) to file at any time and from time to time such financing statements with respect to the Collateral naming Lender or its designee as the secured party and Borrowers as debtor, and including any other information with respect to the Borrowers or otherwise required by part 5 of Article 9 of the UCC, together with amendments and continuations with respect thereto, which authorization shall apply to all financing statements naming Lender or its designee as secured party and Borrowers as debtor filed on, prior to or after the date hereof. In no event shall Borrowers file or permit or cause to be filed any correction statement, amendment, or termination statement with respect to any such financing statement. Borrowers shall take or cause to be taken all action required to cause the attachment, perfection and first priority of, and the ability of Lender to enforce the Lender's security interests and liens including, without limitation, obtaining control agreements with respect to deposit accounts, letter-of-credit rights, electronic, chattel paper, instruments and investment property.

(10) In connection with the execution and delivery of this Amendment, Borrowers shall pay to Lender a fee of \$15,000.00, which fee shall be fully earned and non-refundable on the date hereof.

(11) In connection with the execution and delivery of this Amendment, if requested by Lender, the Borrowers shall furnish to the Lender certified copies of all requisite corporate action and proceedings of the Borrowers in connection with this Amendment.

(12) Each Borrower confirms and agrees that (a) all representations and warranties contained in the Loan Agreement and in the other Financing Agreements are on the date hereof true and correct in all material respects (except for changes that have occurred as permitted by the covenants in Section 9 of the Loan Agreement), and (b) it is unconditionally liable for the punctual and full payment of all Obligations, including, without limitation, all charges, fees, expenses and costs (including attorneys' fees and expenses) under the Financing Agreements, and that Borrowers have no defenses, counterclaims or setoffs with respect to full, complete and timely payment of all Obligations.

(13) Borrowers hereby agree to pay to Lender all reasonable attorney's fees and costs which have been incurred or may in the future be incurred by Lender in connection with the negotiation and preparation of this Amendment and any other documents and agreements prepared in connection with this Amendment. The undersigned confirm that the Financing Agreements remain in full force and effect without amendment or modification of any kind, except for the amendments explicitly set forth herein. The undersigned further confirm that after giving effect to this Amendment, no Event of Default or events which with notice or the passage of time or both would constitute an Event of Default have occurred and are continuing. Except as explicitly provided herein, the execution and delivery of this Amendment by Lender shall not be construed as a waiver by Lender of any Event of Default under the Financing Agreements. This Amendment shall be deemed to be a Financing Agreement and, together with the other Financing Agreements, constitute the entire agreement between the parties with respect to the subject matter hereof and supersedes all prior dealings, correspondence, conversations or communications between the parties with respect to the subject matter hereof.

[Remainder of Page Left Intentionally Blank]

If you accept and agree to the foregoing please sign and return the enclosed copy of this letter. Thank you.

Very truly yours,

CONGRESS FINANCIAL CORPORATION  
(NEW ENGLAND)

By: /s/ Melissa A. Post

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Name: Melissa A. Post  
Title: Assistant Vice President

AGREED:

ULTRALIFE BATTERIES, INC.

By: /s/ Robert W. Fishback

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Name: Robert W. Fishback

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Title: VP - Finance & CFO  
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ULTRALIFE BATTERIES (UK) Ltd.

By: /s/ William A. Schmitz

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Name: William A. Schmitz

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Title: C.O.O.  
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