

PECO II INC
Form 10-Q
November 05, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended September 30, 2001

OR

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

Commission File Number 000-31283

PECO II, INC.

(Exact name of Registrant as specified in its charter)

OHIO
(State or other jurisdiction
of Incorporation or organization)

34-1605456
(I.R.S. Employer
Identification No.)

1376 STATE ROUTE 598, GALION, OHIO 44833

(Address of principal executive office)

(Zip Code)

Registrant's telephone number including area code: (419) 468-7600

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

YES NO

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

CLASS
Common Shares, without par value

OUTSTANDING AT OCTOBER 12, 2001
21,798,616

PECO II, INC.

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PECO II, INC.

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

| In thousands | September 30, 2001 | December 31, 2000 |
|---|-----------------------|----------------------|
| | (Unaudited) | |
| | ASSETS | |
| Current assets: | | |
| Cash and cash equivalents | \$ 46,063 | \$ 54,920 |
| Accounts receivable | 14,682 | 30,601 |
| Inventories: | | |
| Raw materials | 24,499 | 32,123 |
| Work in process | 1,390 | 465 |
| Finished goods | 4,905 | 694 |
| Total inventories | 30,794 | 33,282 |
| Prepaid expenses and other current assets | 1,433 | 1,194 |
| Prepaid and deferred income taxes | 5,912 | 2,805 |
| Total current assets | 98,884 | 122,802 |
| Property and equipment, net | 39,123 | 25,293 |
| Other assets | 18,794 | 6,051 |
| TOTAL ASSETS | \$ 156,801 | \$ 154,146 |

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LIABILITIES AND SHAREHOLDERS' EQUITY

| | | | |
|--|----|-------------------|-------------------|
| Current liabilities: | | | |
| Current portion of long-term debt and capital leases | \$ | 613 | \$ 434 |
| Accounts payable | | 4,903 | 12,725 |
| Accrued compensation expense | | 3,064 | 4,554 |
| Other accrued expenses | | 5,370 | 5,113 |
| Accrued income taxes | | 230 | 1,499 |
| | | <u> </u> | <u> </u> |
| Total current liabilities | | 14,180 | 24,325 |
| Long-term liabilities: | | | |
| Borrowings under lines of credit | | | 375 |
| Long-term debt and capital leases | | 10,519 | 4,566 |
| | | <u> </u> | <u> </u> |
| Total long-term liabilities | | 10,519 | 4,941 |
| Shareholders' equity: | | | |
| Common shares | | 2,816 | 2,655 |
| Additional paid-in capital | | 111,583 | 99,801 |
| Retained earnings | | 19,324 | 22,424 |
| Treasury shares, at cost | | (1,621) | |
| | | <u> </u> | <u> </u> |
| Total shareholders' equity | | 132,102 | 124,880 |
| | | <u> </u> | <u> </u> |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ | 156,801 | \$ 154,146 |
| | | <u> </u> | <u> </u> |

The accompanying notes are an integral part of these consolidated balance sheets.

PECO II, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

| In thousands, except per share data | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---------------------------------------|---|-------------------|--|-------------------|
| | 2001 | 2000 | 2001 | 2000 |
| Net sales | \$ 23,110 | \$ 40,065 | \$ 83,760 | \$ 114,300 |
| Cost of goods sold | 21,317 | 27,984 | 67,793 | 79,433 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Gross margin | 1,793 | 12,081 | 15,967 | 34,867 |
| Operating expenses: | | | | |
| Research, development and engineering | 3,217 | 2,339 | 8,389 | 7,312 |
| Selling, general and administrative | 4,921 | 4,334 | 13,875 | 12,997 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| | 8,138 | 6,673 | 22,264 | 20,309 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Income (loss) from operations | (6,345) | 5,408 | (6,297) | 14,558 |
| Interest income (expense) | 206 | 50 | 1,174 | (775) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Income (loss) before income taxes | (6,139) | 5,458 | (5,123) | 13,783 |
| Provision (benefit) for income taxes | (2,425) | 2,237 | (2,023) | 5,568 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net income (loss) | \$ (3,714) | \$ 3,221 | \$ (3,100) | \$ 8,215 |

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| | | | | |
|--|-----------|---------|-----------|---------|
| Basic earnings (loss) per share | \$ (0.17) | \$ 0.18 | \$ (0.14) | \$ 0.53 |
| Diluted earnings (loss) per share | \$ (0.17) | \$ 0.17 | \$ (0.14) | \$ 0.49 |
| Weighted average common shares-outstanding | | | | |
| Basic | 22,131 | 17,552 | 21,381 | 15,624 |
| Diluted | 22,131 | 18,618 | 21,381 | 16,763 |

The accompanying notes are an integral part of these consolidated statements.

PECO II, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| In thousands | For the Nine Months Ended | |
|--|---------------------------|----------|
| | September 30, 2001 | 2000 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income(loss) | \$ (3,100) | \$ 8,215 |
| Adjustments to reconcile net income to net cash (used for) provided by operating activities- | | |
| Depreciation and amortization | 2,672 | 1,382 |
| Loss (gain) on disposals of property and equipment | 18 | (12) |
| Deferred income taxes | (2,084) | (1,019) |
| Stock compensation expense | 662 | 3,730 |
| Working capital changes | | |
| Accounts receivable | 21,462 | (8,028) |
| Inventories | 2,732 | (11,256) |
| Prepaid expenses and other current assets | (85) | (670) |
| Accounts payable, other accrued expenses and accrued income taxes | (13,762) | 11,952 |
| Accrued compensation expense | (2,044) | (343) |
| Net cash provided by operating activities | 6,471 | 3,951 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures | (16,007) | (4,688) |
| Acquisition of businesses, net of cash acquired | (5,055) | |
| Proceeds from sale of property and equipment | 3 | 36 |
| Net cash used by investing activities | (21,059) | (4,652) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Restricted cash on industrial revenue bond | (5) | 161 |
| Repayments under lines of credit | (375) | (8,029) |
| Borrowings of long-term debt | 6,351 | |

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| | | |
|--|-----------|-----------|
| Repayment of long-term debt and capital leases | (368) | (9,804) |
| Public sale of common shares | | 78,576 |
| Purchase of treasury shares | (1,642) | |
| Proceeds from stock options and stock purchases | 1,770 | 2,573 |
| | 5,731 | 63,477 |
| Net cash provided by financing activities | 5,731 | 63,477 |
| Net (decrease) increase in cash | (8,857) | 62,776 |
| Cash and cash equivalents at beginning of period | 54,920 | 299 |
| | \$ 46,063 | \$ 63,075 |
| Cash and cash equivalents at end of period | \$ 46,063 | \$ 63,075 |
| Supplemental Disclosure of Cash Flow Information: | | |
| Income taxes paid | \$ 1,075 | \$ 6,320 |
| Interest paid | 241 | 1,106 |
| Supplemental Disclosure of Non Cash Investing and Financing Activities | | |
| Common shares issued in connection with acquisition | \$ 9,533 | |
| Capital lease obligation incurred for lease of new equipment | | 3 |

The accompanying notes are an integral part of these consolidated statements.

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The accompanying consolidated financial statements include the accounts of PECO II, Inc. (the "Company") and its wholly owned subsidiaries. In the opinion of management, the accompanying unaudited interim condensed consolidated financial statements reflect all adjustments, of a normal and recurring nature, necessary to present fairly the results for the interim periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. The December 31, 2000 balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States. It is suggested that these condensed statements be read in conjunction with the Company's most recent Annual Report on Form 10-K.

This Form 10-Q contains forward-looking statements, which involve risks and uncertainties. The Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause the Company's actual results or activities to differ materially from these forward-looking statements include but are not limited to the statements under "Forward Looking Statements" and other sections in the Company's Form 10-K filed with the Securities and Exchange Commission and press releases.

Results for the interim period are not necessarily indicative of the results that may be expected for the entire year.

2. Acquisitions

On June 6, 2001 the Company acquired all of the common stock of Thornton Communications Co., Inc. of Bristol, Tennessee, a telecommunications provider of contract and engineering, furnishing and installation services for approximately \$13 million, of which \$3.4 million was cash and the remaining consideration was 886,000 shares of the Company's common stock at \$10.76 per share. Acquired intangible assets of \$3.4 million are being amortized over the estimated useful lives. The investment in excess of the fair market of assets purchased of approximately \$9 million is being amortized over 15 years.

On August 7, 2001 the Company acquired the assets of JNB Communications Inc., a South Carolina-based provider of telecommunications installation services for \$1.8 million in cash. The investment in excess of the fair market value of assets purchased of approximately \$1.8 million is being amortized over 15 years.

3. Long Term Debt

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On August 8, 2001 the Company entered into adjustable rate demand, industrial development revenue bonds for \$6.5 million from the County of Arapahoe, Colorado. The \$2 million Series A Bonds mature in 2017 and bear interest at 2.6% at September 30, 2001. The \$4.5 million Series B Bonds, mature in 2021 and bear interest at 2.76% at September 30, 2001.

4. Treasury Shares

In September 2001 the Board of Directors authorized the repurchase of up to 1 million shares of PECO II's common shares in the open market or in private transactions. Repurchased shares are being used for the issuance of shares in connection with the employee stock option and stock purchase plans. To date we have purchased 408,000 shares at a cost of \$1.64 million.

PECO II, INC.

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

Results of Operations

Net sales declined to \$23.1 million and \$83.8 million, respectively, for the three and nine months ended September 30, 2001, a decrease of \$17.0 million, or 42%, and \$30.5 million, or 27%, respectively, compared to the corresponding prior year periods. This decrease was primarily due to decreased demand for power systems, power distribution equipment and systems integration, offset partially by increased demand for engineering and installation services. As of September 30, 2001, our sales backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, was \$17.6 million, a 27% decline from \$24.2 million at December 31, 2000.

Gross margins were \$1.8 million and \$16.0 million, respectively, for the quarter and nine months ended September 30, 2001, as compared to \$12.1 million and \$34.9 million, respectively, for the quarter and nine months ended September 30, 2000. Gross margin as a percentage of net sales declined to 7.8% and 19.1% respectively, for the three months and nine months ended September 30, 2001 compared to 30.2% and 30.5%, respectively, for the comparable prior year periods. The margin percentage was lower in 2001, due primarily to unabsorbed overhead costs attributable to lower volume and incremental costs related to the 144,000 square foot addition in Galion coming into production.

Research, development and engineering expense increased to \$3.2 million and \$8.4 million, respectively, for the quarter and nine months ended a September 30, 2001, from \$2.3 million and \$7.3 million, respectively, for the quarter and nine months ended September 30, 2000. The increase relates to the continued development of new products. As a percentage of net sales, research, development and engineering expense was 13.9% and 10.0%, respectively, for the three months and nine months ended September 30, 2001 compared to 5.8% and 6.4%, respectively, in the comparable prior year periods.

Selling, general and administrative expense was \$4.9 million and \$13.9 million, respectively, for the quarter and nine months ended September 30, 2001, from \$4.3 million and \$13.0 million, respectively, for the quarter and the nine months ended September 30, 2000. The increase resulted from an expansion of our international and field sales forces, the addition of administrative staff throughout 2000 and the first quarter of 2001 and amortization costs related to acquisitions. The increase was offset partially by higher stock compensation costs of \$0.4 million and \$0.6 million, respectively, in the quarter and first nine months of the prior year periods. As a percentage of net sales, selling, general and administrative expense was 21.3% and 16.6%, respectively, for the three and nine months ended in September 30, 2001 compared to 10.8% and 11.4%, respectively, in the comparable prior year periods.

Net interest income was \$0.2 million and \$1.2 million, respectively, in the three and nine months ended September 30, 2001 compared to net interest income (expense) of \$0.1 million and \$(0.8) million, respectively, in the comparable prior year periods. The increase in interest income in the current quarter and nine months ended in 2001 was due to investment income of our funds received from the August 2000 initial public offering and reduced levels of debt.

In the first nine months of 2001, our effective provision (benefit) income tax rate was (39.5%) compared to 40.4% in the comparable prior year period.

Liquidity and Capital Resources

Our primary liquidity needs are for working capital, capital expenditures and strategic acquisitions. In August 2000 we completed an initial public offering of 5.75 million common shares at \$15 per share, generating net proceeds of approximately \$78.3 million. A portion of these proceeds was used to repay bank indebtedness. At September 30, 2001 cash invested in marketable securities approximated \$42.7 million.

PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

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Working capital was \$84.7 million at September 30, 2001 compared to \$98.5 million at December 31, 2000. The current ratio was 7.0 to 1 at September 30, 2001 compared to 5.0 to 1 at December 31, 2000. Our investment in inventories and accounts receivables was \$45.4 million at September 30, 2001 and \$63.9 million at December 31, 2000. Our capital expenditures were \$16.0 million for the nine months ended September 30, 2001 principally related to the opening of a new regional operating center in Aurora, Colorado. We have reduced our budgeted capital expenditures in 2001 that was principally related to new and expanded regional operating centers, from \$25 million to \$19 million due to the lower business volume.

In June 2001 we acquired Thornton Communications Co., Inc., a telecommunications provider of contract and engineering, furnishing and installation services, for 886,000 common shares and \$3.4 million in cash, and in August 2001 we acquired the assets of JNB Communications Inc., a telecommunications service provider for \$1.8 million in cash.

Cash flows generated from operating activities for the first nine months of 2001 improved slightly to \$6.5 million in comparison with the prior year nine months ended, due primarily to lower levels of accounts receivable resulting from improved collections and a decline in sales volume from the fourth quarter of 2000, offset by lower operating margins, and a decrease in payables and accrued expenses due to the lower business level.

In August 2001 we entered into adjustable rate demand, industrial revenue bonds for \$6.5 million from the County of Arapahoe, Colorado. The \$2 million Series A Bonds bear interest at 2.6% at September 30, 2001. The \$4.5 million Series B Bonds bear interest at 2.78% at September 30, 2001.

As of September 30, 2001, there were no borrowings on our unsecured \$20 million loan agreement. At September 30, 2001, we complied with or obtained waivers for the covenants under the borrowing agreement.

In September 2001 the Board Of Directors authorized the repurchase of up to 1 million of our common shares in the open market or in private transactions. At September 30, 2001 we had purchased 408,000 shares at a cost of \$1.64 million.

We do not currently plan to pay dividends, but rather to retain earnings for use in the operation of our business and to fund future growth.

We will continue to spend amounts of capital on property and equipment related to the expansion of our corporate headquarters, regional operating centers, and equipment and research, development and engineering costs to support our growth. In addition we will expand cash funds to acquire selective strategic acquisitions to increase our product and service offerings.

We believe that cash and cash equivalents on hand, anticipated cash flow from operations and our credit facilities will be sufficient to fund our working capital and capital expenditure requirements for at least the next 24 months.

Recent Accounting Pronouncements

The Financial Accounting Standards Board recently issued Statement of Financial Accounting Standard No. 141 (SFAS 141), "Business Combinations" and SFAS 142, "Goodwill and Other Intangible Assets." The statements are effective for us on January 1, 2002. These statements will result in modifications relative to our accounting for goodwill and other intangible assets. Specifically, we will cease goodwill and certain intangible asset amortization beginning January 1, 2002. Additionally, intangible assets, including goodwill, will be subjected to new impairment testing criteria. Other than the cessation of

PECO II, Inc.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont.)

intangible asset amortization, we have not had ample time to evaluate the impact of adoption on the our financial statements. The current annual run rate of amortization expense approximates \$1.3 million.

ITEM 3. Qualitative and Quantitative Disclosure About Market Risk

We are exposed to the impact of interest rate changes. We have not entered into interest rate transactions for speculative purposes or otherwise. Our foreign currency exposures were immaterial as of September 30, 2001. Our primary interest rate risk exposure has resulted from floating rate debt related to our revolving loan facility. If interest rates were to increase 100 basis points (1%) from September 30, 2001 rates, and assuming no changes in long-term debt from the September 30, 2001 levels, the additional annual expense to us would be immaterial to our results of operations. We currently do not hedge our exposure to floating interest rate risk.

PART II. OTHER INFORMATION

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ITEM 2(c) Recent Sales of Unregistered Securities

During the third quarter of 2001, we sold unregistered securities in the amount, at the times and for the aggregate amount of consideration as listed below. The securities were sold to purchasers directly by us and the sales did not involve any underwriter.

From July 1, 2001 to September 30, 2001, certain of our employees and directors exercised options to purchase 71,200 common shares for an aggregate consideration of \$482,860. The options exercised were issued under compensatory benefit plans in a transaction exempt under Section 4(2) of the Securities Act of 1933 and Rule 701 under the Securities Act of 1933.

Of the 71,200 common shares issued to employees from July 1, 2001 to September 30, 2001 from the exercise of options, options to purchase 10,000 common shares were granted on July 8, 1996; options to purchase 8,250 common shares were granted on July 14, 1997; options to purchase 25,400 common shares were granted on July 13, 1998; options to purchase 3,250 common shares were granted on October 9, 1998; options to purchase 2,250 common shares were granted on June 1, 1999; options to purchase 700 common shares were granted on June 28, 1999; options to purchase 20,750 common shares were granted on July 22, 1999; and options to purchase 600 common shares were granted on September 13, 1999.

ITEM 2(d) Use of Proceeds

On August 17, 2000, the SEC declared effective a Registration Statement on Form S-1 (File No. 333-37566) filed by us in connection with an initial public offering of 5,000,000 of our common shares, without par value. From the date of receipt of the proceeds from the offering through September 30, 2001, of the \$78.3 million in net proceeds, \$14.4 million was used to repay bank indebtedness, \$5.2 million was used in connection with the acquisitions of Thornton Communications and JNB Communications, \$14.0 million was used for capital expenditures, excluding the purchase of the Denver regional operating center in February 2000 which is being financed through industrial development bonds, and the remainder for general working capital purposes. The remaining net proceeds have been invested in short-term, interest-bearing, investment grade securities or guaranteed obligations of the U.S. government.

PECO II, INC.

PART II. OTHER INFORMATION (Cont.)

ITEM 6(a) Exhibits

- 10.1.1 Loan Agreement, dated August 8, 2001, between PECO II, Inc. and County of Arapahoe, Colorado
- 10.1.2 Bond Purchase Agreement, dated August 8, 2001, County of Arapahoe
- 10.1.3 Trust Indenture August 8, 2001 between The Huntington National Bank and County of Arapahoe, Colorado
- 10.1.4 Reimbursement Agreement, dated August 8, 2001 between PECO II, Inc. and The Huntington National Bank

ITEM 6(b) Reports on Form 8-K

No current reports on Form 8-K were filed during the quarter ended September 30, 2001.

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.

PECO II, INC.

Date: November 2, 2001

By: /S/ JOHN C. MAAG
John C. Maag
Chief Financial Officer
And Authorized Officer