PINNACLE DATA SYSTEMS, INC. 2ND QUARTER RESULTS CONFERENCE CALL

Moderator: John Bair
July 28, 2011
10:00 am CT

Operator: Greetings and welcome to the Pinnacle Data Systems Second Quarter 2011 Earnings conference call. At this time all participants are in a listen-only mode.

A brief question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference please press Star Zero on your telephone keypad.

As a reminder this conference is being recorded. It is now my pleasure to introduce your host Mr. John Bair, President and CEO for Pinnacle Data Systems. Thank you sir. You may begin.

John Bair: Thanks (Dan). Good morning. This is John Bair, President and CEO of Pinnacle Data Systems. Thank you for joining our 2011 Second Quarter Investor conference call. Please turn to Slide 2.

With me on today's call are TJ Harper, our Chief Operating Officer and Nick Tomashot, our Chief Financial Officer.

We appreciate this opportunity to share our second quarter results with you. Following our remarks we will be pleased to respond to your questions.

Please turn to Slide 3. Before continuing I'd like to refer you to the Safe Harbor Statement which indicates that today's discussion may include forward-looking statements and cautions investors regarding the risks and uncertainties that could cause actual results to differ materially from historical or anticipated results.

Please turn to Slide 4. Looking at our progress through first half of 2011 our stated goal was profitable growth across all three target market segments of our business -- electronic repair services, integrated ODM computing solutions, and embedded computing products.

In electronic repair services we continue to deliver outstanding revenue growth with Q2 showing 49% growth compared to last year and setting a quarterly revenue record.

We have ramped up multiple programs in the first half of the year including equipment repair and support for a new global telecommunications OEM customer.

We have added significant new repair and test capabilities for the telecom industry in the core infrastructure transmission, microwave and access equipment areas while at the same time expanding the number of products that we service and support using existing capabilities.

There have also been positive developments in the integrated ODM computing solutions and embedded computing product target segments.

We are seeing a solid pipeline of defense and aerospace opportunities impacting the second half of 2011.

In addition, we just announced that we have entered into an OEM agreement with IBM that I will discuss later in the call.

Finally, we are managing and improving the business in other ways to better position ourselves to take advantage of growth opportunities and scale out the business.

We continue to generate profits while accumulating cash; finishing the quarter with $1.3 million in the bank and never using a line of credit during the quarter.

We are selectively making capital investments; investing nearly $40,000 in the first half of the year to add new state-of-the-art tools for growing our systems, PCB computer board design layout, as well as bringing in new test equipment to expand our capabilities and capacity in the repair service part of our business.

Nick will now briefly take you through the second quarter results. Nick?

Nick Tomashot: Thanks John. Please turn to Slide 5. PDSI’s second quarter results showed net income of just under $200,000, or 2 cents, per diluted share.

These results include an approximately $100,000 net tax expense associated with finalization of the amended Federal and state tax returns for prior years impacted by the research and development or R&D tax credit study that we began in late 2010.

The company still retains the previously recorded $0.8 million cumulative benefit for these credits, net of a reserve for uncertain tax positions.

Revenue for the quarter was $6.8 million, which is up $400,000 or 6% compared to the first quarter of 2011.

This is the third sequential quarter of total revenue growth. The highlight of the quarter though is service revenue which came in at $4.7 million -- a new quarterly record for the company -- up almost 50% compared to prior year and up 27% compared to Q1 2011.

Overall operating income is up 34% compared to Q1 2011 from $260,000 to $349,000. As John mentioned, we continue to generate cash with $1 million in operating cash flow for the quarter and a $0.4 million in EBITDA.

We finished the quarter with $1.3 million in cash, and didn't use the line during the quarter.

Please turn to Slide 6.

Looking at some key financial results in the quarter compared to Q2 2010; net income was down just over $100,000 with most of the difference attributable to the Q2 2011 tax expense item that I just discussed.

Product revenue is down $2.7 million, or 55%, compared to prior year primarily due to the extremely strong activity we had with a few defense, aerospace, and telecom accounts in the first half of 2010.

Service revenue was up $1.5 million or 49% compared to 2010 reflecting growth generated at new and existing customers over the course of the year.

Overall gross profit was about flat year on year at $2.2 million. And margin as a percentage of revenue improved overall by five percentage points to 33% due to our shift in mix towards service, and active management of our overhead costs.

Finally, compared to last year the line of credit was maintained at zero throughout the quarter, reduced from $0.2 million at the end of Q2 2010 and cash on hand increased from just over $100,000 to $1.3 million at the end of Q2 2011.

This concludes my remarks. And I'll turn the call over to TJ Harper.

TJ Harper: Thank you Nick. Please turn to Slide 7. As John mentioned at the beginning of the call we have made progress toward our goals in the first half of 2011 by generating growth and executing our strategy across the three market segments.

Our team's focus on execution in the service market have led us to a new quarterly revenue record.

We set the benchmark at just under $4 million during the third quarter of 2010, so our current results shatter this record coming in at nearly $4.7 million.

The growth was really broad-based coming on many fronts. First, we have added new customers. Second, we have added new programs and products from existing customers.

Third, we won new business from existing customers with products similar to what we are doing for other OEMs. And finally, we had strong international growth. You name it and the team delivered it.

What's exciting is during the first half of the year we added capability in telecom service by making smart investments to support new business that can be leveraged and scaled as we grow.

As a final note on the service segment we are underway with our new service center in Singapore. We have already secured business with two customers which is well above our initial expectations.

Moving to the integration embedded design segments, in the near term we see this business approaching the bottom as the impact from the ramp down of programs lost in 2009 has occurred to this point.

We are seeing a lot of pipeline activity that could impact the second half of 2011 from industries such as defense, industrial, telecom, and aerospace.

With these opportunities we are leveraging our product designs and development capability to meet the needs of these potential customers.

Finally, with the IBM OEM agreement we just announced we have achieved a key strategic milestone for our products business.

This agreement combined with existing partnerships and our continued pursuit of additional OEM and technology agreements will provide us access to customers, products, technology that we can use to target integration opportunities.

We will serve these opportunities as a value-added reseller or as an original equipment manufacturer.

These agreements also support our ability to win new business in embedded computing allowing us to leverage the research of these technology leaders and adding value with our development expertise when designing industry-specific applications.

We are very pleased with our year to date performance in the service market. And with our most recent announcement we are poised to continue the execution of our 2011 strategy in the product segment.

I will now turn the call back over to John.

John Bair: Thank you TJ. Please turn to Slide 8. Before I move on to concluding remarks I wanted to spend some time discussing the importance of this first IBM agreement.

On last quarter's call I mentioned this type of business and technology partnership has been key to PDSI's past product success.

This agreement substantially broadens the technology platforms we offer giving us access to IBM's technologies as we design and build innovative solutions for the markets that we've targeted with specialized requirements like telecom, medical, industrial, defense, and aerospace.

At the same time, and perhaps even more importantly, this opens up new routes to market for PDSI leveraging IBM's extensive business development resources.

The matching up of PDSI's engineering design capabilities with specialized needs that arise in IBM's global customer base has the potential to be a powerful combination. And we are already developing a pipeline of opportunities with potential impact in late 2011 and early 2012.

Please turn to Slide 9. Before I open things up for questions I wanted to again reiterate that our focus in 2011 is on profitable growth in all three target market segments of our business.

Our service business growth has been excellent and we feel we have achieved positive milestones for the integration embedded computing business that will have a positive impact in the second half of 2011 and beyond.

Finally underpinning this is our successful management of the overall business with consistent earnings, cash on hand and capacity to fund future sustainable growth.

I'll now open things up for questions. Operator please provide the instructions for questions and answers session that are shown on Slide 10.

Operator: Thank you. We will now be conducting a question and answer session. If you would like to ask a question please press Star 1 on your telephone keypad.

A confirmation tone will indicate that your line is in the question queue. You may press Star 2 if you like to remove your question from the queue.

For participants using speaker equipment it may be necessary to pick up your handset before pressing the Star keys. One moment while we poll for questions.

Our first question comes from John Nobile of Taglich Brothers. Caller please proceed with your question.

John Nobile: Hi. Good morning John, TJ and Nick. I just want to congratulate you guys. Obviously I was impressed with the service revenue growth sequentially on the - in the quarter by quarter basis. That was pretty impressive.

And I'll get into that a little later but my first question; obviously the market liked the news about your agreement with IBM.

I was hoping you could give us more details about this agreement? And more specifically could you quantify the potential this agreement could have on revenue say near term and long term?

John Bair: Okay. So I think we kind of touched on the significance of the agreement John. Where our past success on the product side of the business has really been working with these global technology leaders like IBM where they have customers that have needs in certain areas that maybe the volume commitments that are required do not meet their volume requirements -- meaning they may have a requirement to build a product that they have to deploy 1 million units to make economical sense of the development where our threshold for development and quantities are well below that. So there's a lot of scale there.

Can I quantify the size of it? I think you're just going to have to wait and see as the opportunities come along and that projects we're working on currently turn into programs.

John Nobile: Do you have any if I could say internal guesstimates as to what this potential may be? I'm not saying put out a huge number but some kind of a ballpark range that...

John Bair: Sure.

John Nobile: ...in the coming quarters you may see from IBM?

John Bair: Sure. So if you look at when we entered into this agreement obviously working the agreement we had to come to some kind of forecast of what we think we can achieve.

And revenues from opportunities based off of historical information, historical programs, programs rolling into the future we believe with this agreement which is measured on a year to year basis will generate and get us back to the levels we were in the past from a product and integration business.

John Nobile: Okay levels in the past, I mean obviously if I go back several years we're looking at levels of - if I remember, over $50 million, $60 million.

I mean do you feel that strong about this or I mean that would be pretty impressive from current levels right now?

John Bair: Working on different scale John.

John Nobile: Okay and in the last call you mentioned that declining telecommunication products would resurface in the coming quarters. Are we still on track for this? And when specifically can we expect to see this revenue?

TJ Harper: Well John this is TJ. Talking at it from the different market segments, from the service side we are ramping and we are continuing to win business on the telecom side.

With what John was talking about with some of our partnerships and some of the pipeline that we have right now, we are - we have opportunities in the telecom industry on the product side that are going through qualification and program realization.

So those programs could take anywhere from six to 12 months before we see volumes in earnest that would have impact to the financials.

John Nobile: Okay six to 12 months of qualification testing is required or...

TJ Harper: Yes so basically we go through a whole design gate process. So it'll go from conception to proving that concept to having first office applications to getting that approved and then moving to the volumes.

Those take time through the different organizations...

John Nobile: Okay.

TJ Harper: ...inside of the telecom industry to get those approvals. So it does take some time.

John Nobile: Okay I understand. But let's just take this timeframe of roughly six months to 12 months of qualification to future say telecom business. How far along are we in the qualification testing in this business?

It varies. But I would say that we’re in the initial to mid stages.

John Nobile: Okay initial to mid stages. I'm just trying to get like a monthly or quarterly basis for this like just to try to figure out when we could see some of this telecommunication business coming back that say wasn't in the current or the previous quarter.

TJ Harper: Well I would say it, when I say initial I'm saying in the early month stages of that six to 12 months.

John Bair: So John some of the customers have prototypes that are in the qualification phases currently. Some are in what do you - so trials?

TJ Harper: Yes.

John Bair: And others are in pre so...

John Nobile: Okay.

John Bair: ...we're in all stages of it.

TJ Harper: And it can move. I mean it - that six to 12 months is pretty dynamic based upon a whole lot of other variables that are in the architecture of what the telecom folks are trying to put in place. So it can move more rapid and it could obviously be delayed...

John Nobile: Right.

TJ Harper: ...as well.

John Nobile: No, I understand.

TJ Harper: So those are things that are out of our control.

John Nobile: Okay no I understand that. I'm just trying to get a feel for in this quarter, actually Q3 that we are currently in if we could expect to see some of that revenue starting to ramp up? I'm talking specifically about the telecommunication revenue?

Nick Tomashot: On the services side yes we'll see some ramp in the third quarter.

John Nobile: Okay on the -well on that - actually the services side has been pretty impressive. Actually in regard to that, the service revenue was up 39% in the first half.

How sustainable do you believe that that growth rate is going forward? I mean approximately 12% has been averaging say over the past decade or so.

John Bair: Yes.

John Nobile: So the first half has been extremely impressive. So I just want to get an idea is like is this something that we can see going forward that it's going to be sustainable or maybe we just had some very good quarters in the Q1 and Q2 and maybe it won't revert backwards to - not backwards but still positive growth but not at this rate?

John Bair: Yes, so to answer that John we're still planning - we still have a very small piece of the overall electronic services market.

I mean if you look at the numbers out there it's about $22 billion in size, right? And our close - one of our competitors has 7% of that which, you know, is pretty substantial.

We see a lot of competitors that are falling down. We see a lot of consolidation going on. We see a lot of customers that are now willing to look at other alternatives that's third-party as the contract manufacturers seem to leave them without a service operation moving forward. So we think that that growth rate’s going to continue for some time.

TJ Harper: And any other...

John Nobile: I mean that growth rate being close to 40%.

TJ Harper: It probably will not - it will not grow 40% quarter over quarter or half over half. I mean we will see sustained growth...

John Bair: Yes.

TJ Harper: ...but not to that level.

John Nobile: Okay but obviously may be more than if I went back like historically the 12% average rate say over the last decade, it looks like things might be improving obviously from that level. Could I safely say something like that?

TJ Harper: Yes I think - this is TJ. I think when John and I back in February of 2009 were really dedicated to the services business we laid out a pretty good strategy. And we’re seeing that strategy unfold and develop in front of us.

So starting from that early 2009 standpoint we believe we have a very strong business model in the service business and we'll continue to see...

Man: Yes.

TJ Harper: We'll continue to see growth.

John Nobile: Okay and I'll have to look back at how it really has since early 2009 just take that and not look at the longer term.

Just one final question, in the presentation one of the - on Page 4 it mentions a solid pipeline impacting the second half of 2011 led by defense and aerospace.

I was wondering if you can actually elaborate a little more on that and even quantify these prospects?

John Bair: Nick you want to try to?

Nick Tomashot: Yes what I would say is that we're seeing, you know, a lot of inbound interest and quoting activity and that we feel we have a solid pipeline impacting the second half. But I really don't want to quantify it exactly.

John Bair: John these are also mature programs.

John Nobile: Okay and let's just take say quoting activity if we could, let's say an amount or a number on that. How would you say that might compared to say a year ago as far as quoting activity in these particular markets?

John Bair: Up considerably.

TJ Harper: Yes.

John Nobile: Okay fair enough. All right well thank you very much.

John Bair: Thanks John.

TJ Harper: Thank you John.

Operator: Our next question comes from (Bill Sepio) of UBS. Caller please proceed with your question.

Bill Cseplo: Good morning gentlemen. You know, good quarter and certainly a nice announcement on this - the OEM with OEM contract with IBM.

Can you kind of put this in context John on the other OEM contracts that you have previously?

I think you've had arrangements with Advanced Micro Devices and Intel, and Hewlett-Packard.

So if you could kind of - is this on the theme? Is it a little stronger, a little weaker than those kind of previous arrangements?

John Bair: Okay (Bill).

Nick Tomashot: Yes sure. I would say it's different. The one’s you mentioned, the AMD, the Intel -- there's a number of other ones out there -- those were really technology licensing agreements.

We did get support from the field service organization as they came along but it's not as - they weren't as strong as what I believe the IBM agreement’s going to be.

But you could kind of relate it to the Sun Microsystems agreements that we had in the past.

At any one time we probably had a dozen agreements with those guys working with their field organizations. But they still did not work on the scale that IBM works on.

So there’s an I think a larger opportunity to work with the IBM folks. They have a very, very diverse product line across many, many industry segments of which we can add value in many areas.

Bill Cseplo: Very good, very good. Are you pursuing other OEM agreements at this point in time or have you spent the majority of your time and concentration just on this IBM contract?

Nick Tomashot: No were working on other OEM agreements.

Bill Cseplo: Good, good, good. Okay well very good. Congratulations and we'll be in touch.

John Bair: Thanks (Bill).

Nick Tomashot: Thanks.

Operator: Our next question comes from Glen Ruediger, a private investor. Caller please proceed with your question.

Glen Ruediger): Hi John. That's a very nice quarter and the numbers on service look very good. I guess...

John Bair: Thank you.

Glen Ruediger: ...my question is there must have been something that keyed the IBM OEM agreement going.

Is there an active project that really is going to be kicking this off that's already there? I mean usually there's some kind of a thing that in context starts the talks for an agreement like that because of the special need out there.

John Bair: Yes there’s actually a number of them that kind of started this whole discussion Glenn.

Glen Ruediger: Okay.

John Bair: Some of these I can't really talk about because they're under nondisclosure. But I can't tell you how we began the OEM discussions approximately was it a year ago?

TJ Harper: Yes.

John Bair: Something like that?

TJ Harper: Yes, very close.

John Bair: It’s that through industry relationships and customers that we’ve worked with in the past especially through the Oracle Sun Microsystems relationships as there's been kind of a shift in the marketplace from those guys away from the OEM type business there is a lot of OEM activity going on the IBM side.

And really what happened was the guys that used to work for let's say Sun Microsystems now seem to work for IBM, right?

Glen Ruediger: And they brought your name with them?

John Bair: And they brought our name with them.

Glen Ruediger: That's interesting.

John Bair: And they brought us as a technology partner and a good solution provider and somebody that has a can-do attitude who doesn't really look at opportunities as - you know, short term. We look at them as long term. And that's what they're looking for in the OEM space.

Glen Ruediger: Okay.

John Bair: So...

(Glen Rudinger): Great. That's kind of what I wanted to know. That makes a lot of sense so appreciate it. Keep the good work up guys.

John Bair: Thanks Glen.

TJ Harper: Thank you.

Operator: Our next question is from Tony Wells, another private investor. Caller please proceed with your question.

Tony Wells: Morning guys.

Man: Good morning Tony.

Man: Good morning Tony.

Tony Wells: Could you speak to the strategic advantage of moving from the Hong Kong location to Singapore?

TJ Harper: Sure.

John Bair: Go ahead TJ.

TJ Harper: So (Tony) this is TJ. We did some market analysis over there and what we were looking at is where we were located in Hong Kong is more of a gateway into mainland China, more of a financial district.

And where we needed to be for the services that we bring to the market we need to be more in Singapore which is considered more of a logistics hub to the Asia region.

So by putting ourselves there we're putting ourselves in a position where a lot of our existing customers and new customers now can look at us as a repair center.

And we have a lot of channels to different parts of Asia in which we can support their entire portfolio. So it's more of a strategic geographic location in the Asia area.

Tony Wells: Okay and you had mentioned previously on the call that you had picked up several new customers. Are we losing customers by moving that location? What's the net?

TJ Harper: The net is an add.

Tony Wells: Okay.

TJ Harper: And that is definitely an add. So I had consulted with a number of our customers as we were going through making this decision.

In fact they were very much a part of the decision making process kind of giving us coaching along the way.

So it is being seen by our existing customer base and by new customers that do business with them as a very positive move.

Tony Wells: Terrific. And last question in comparison do you believe the potential for the Singapore location to be similar, less or greater to the Netherlands service area?

TJ Harper: I see it as being very similar. What we're doing in Singapore has a lot of the same feeling from a business model that we developed in the Netherlands.

So it'll be very similar. I think just because of the sheer size of that geography we have probably a larger opportunity.

Tony Wells: Great thank you.

John Bair: Thanks Tony.

Operator: It appears there are no further questions at this time. I would now like to turn the conference back over to management for closing comments.

John Bair: Okay. I’d just like to thank everybody for joining us today. Thank you.

Operator: This concludes today's teleconference. You may disconnect your line.

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