

PINNACLE DATA SYSTEMS, INC.
(AMEX: PNS)

2003 Q2 Conference Call

July 23, 2003

The following discussion will contain forward-looking information within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those projected in the forward-looking information due to many factors. Information concerning factors that could cause actual results to differ materially from those in the forward-looking statements is contained in the Management's Discussion on page 5 of our annual report to shareholders.

John Bair: Good morning. This is John Bair, CEO and President of Pinnacle Data Systems, Inc.

Thank you for joining us this morning on our 2003 second quarter investor conference call.

With me on this morning's call is Mike Sayre, our Executive Vice President and CFO.

Mike, will you please read the safe harbor statement and introduce the format for our call?

Mike Sayre:

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We do not intend to disseminate any material non-public information during this call.

On June 29, we completed our second thirteen-week quarter of 2003 and we reported our results for the quarter in a press release this morning.

John will talk a little about the nature of our business and go over some of the highlights of the second quarter, followed by my review of the financial results. Then, John will wrap up with additional comments and we'll have a brief question and answer session.

John Bair:

Thanks Mike.

For those of you who may not be familiar with PDSi, I will briefly discuss what we do and our general business strategy.

PDSi provides technical services and solutions, encompassing the development and production of embedded (built-in) computer systems and components, as well as the testing and repair of computer systems, components and peripherals. We market exclusively to Original Equipment Manufacturers (OEMs) in, among others, the computer, computer peripheral, data storage, medical diagnostic, digital-imaging, process-control, and telecommunications equipment industries. We offer a full range of services to increase product speed to market, extend product life, and provide service and support to units in the field through comprehensive product lifecycle management programs encompassing depot repair, advanced exchange, contact center support and end-of-life control.

Our business is comprised of two business segments; services (like depot repair and advanced exchange logistics) and products (like controller boards for complex medical diagnostic equipment).

Our strategy is to maximize the growth of the services business, which provides a recurring revenue stream, is profitable, and can be fairly predictable, to leverage the resources shared or provided by the services business and strategically invest in the development and manufacture of new products for customer-specific and niche industry applications; and to take advantage of the counter-cyclical nature of those two business units to achieve financial stability and continue to generate significant growth opportunities on an on-going basis in whatever the prevailing business climate happens to be.

We just achieved our fourth consecutive profitable quarter and are on track to achieve a profitable 2003 year by continuing to pursue our business strategy. During this portion of today's call, I want to share some of our recent accomplishments and upcoming opportunities with you. But before I do so, I'd like to take a couple of minutes to discuss the boundaries our customers and our contracts put around how much detail we can give out about the work we do.

In almost all of our contracts, our customers very specifically restrict us from disclosing the subjects or terms of our agreements, or using their names in any kind of promotion for our company, without their prior consent. Because we generally serve as an out-sourced provider of components of much larger product or service offerings, it's our customers who have their name on the finished products and they understandably want to control any message that goes out about their company or their products. In addition, our work may be on new products not yet released to the market. Although we have and will continue to work within these boundaries, we want to provide the investment community with as much information as we can about the types and sizes of the companies we are working with and the products and services we are providing for them.

There are a number of new programs we are working on that we are very excited about. We've talked a lot about our expanded capabilities and our growing customer list over the last year or so and many of these new programs are from first-time customers. However, we've also been successful in bringing our new capabilities and our new customers together and creating additional business opportunities beyond our initial programs in those accounts.

On the service side, for example, we received an opportunity to do tape library repair after a very successful first program doing board repair for a new Fortune Global 500 customer. Tape library repair has expanded into tape library manufacturing and the combined business has been exceeding our expectations. In addition, our expanded capabilities with tape library electro-mechanical technologies have resulted in an extensive engineering project that started in the second quarter and could expand into additional tape library repair programs in the near future. We believe tape library repair to be a multi-customer opportunity for us.

Another recent engineering project for a Fortune Global 500 aerospace company has resulted in the award of a new service program to ruggedize a very complex and expensive printed circuit board assembly to protect it from moisture condensation caused by sudden and extreme changes in environment, like altitude. This assembly ultimately ends up in military aircraft. Production will start in the third quarter for this new customer.

On the product side, we've more than doubled the number of active customers over the past year. Some of the products we have developed for new customers are embedded in production publishing, mammography screening, semi-conductor process control, and internet digital imaging equipment. Although there are no volume guarantees on these new products, we believe these programs are just starting to kick off, in terms of revenue.

One of those programs is for a Fortune 500 manufacturer of semi-conductor products. The development of this process control unit for semi-conductor manufacturing leveraged our expertise in developing solutions for process control equipment and helped propel us further into the world of Intel. Sales of this unit have made it one of our largest programs so far this year.

Another example of the leveraging of new capabilities and new relationships is evident in the two programs we are now engaged in with a Fortune Global 500 publishing equipment manufacturer. The initial program to integrate our BlueSwitch technology into a very high-end publishing system resulted in another opportunity to integrate the Sun Solaris operating system onto an Intel platform for this same customer. The first program has been over a year in development and the second program has been in development less than six months. We expect orders for both of these multi-year programs to start in the second half of this year.

In addition, the ability to integrate Solaris on Intel platforms has led to additional product development opportunities for us in imaging, and has raised the interest level of potential customers with development opportunities in telecommunications. Why is Solaris on Intel such an attractive proposition? Sun is most competitive on a price-performance basis in high-end servers. On low-end servers, certain applications run faster on Intel, even though the pricing is comparable. However, Sun's Solaris operating system is very scalable in its ability to handle very large numbers of instructions very reliably on multiple hardware platforms, bridging the gap between low-end and high-end servers and translating into a longer useful life for expensive software applications developed on Solaris for growing businesses.

Moving forward, we believe our capabilities in multiple platforms like SPARC and Intel better position us as a true solutions provider.

In recognition of the distinct level of expertise we have developed on Intel's technologies and solutions, especially with Intel's Itanium 2 technology, we were recently awarded Intel Premium Provider status.

Itanium 2 is the next generation 64-bit Intel processor that was co-developed with HP for extensive use in its next generation high-end line of servers. We are cultivating a great relationship with Intel and are already receiving referrals from Intel that could turn into additional business for us.

Also, we recently announced an agreement with Agilent, another Fortune Global 500 company) to be the North American reseller of their remote diagnostics cards and chips. However, the word “reseller” is an oversimplification of the role we are playing with Agilent and its customers. Agilent’s remote diagnostics cards and chips give our customers the capability of networking with their own products in the field to perform testing, maintenance and customer support without having to actually send a field service technician to the customer’s site. That can be a huge competitive advantage for our customers. However, the Agilent cards and chips must be integrated into the customers products. Earlier this year, we sent our engineers to Germany to learn more about this exciting technology so we could fully support our customers’ efforts to design Agilent’s remote diagnostics products into their products. Our support will include product design, development, assembly, test and after the sale service. The program is starting this quarter with the transitioning of a number of the current Agilent North American accounts that will immediately provide revenue to PDSi. However, we cannot speculate on the current or future revenue this agreement will provide.

In summary, we believe our increased number of active products, as well as our expanded capabilities and relationships, have positioned us well for a recovery of capital spending and we will continue our quest for more of these products as we have over the past year.

In that effort, we are currently updating our marketing and sales plans and will be increasing spending in this area.

In addition to our plans for organic growth, we are evaluating affordable acquisitions in the service arena that are, or can be made, accretive in a short period of time; that bring large OEM customer relationships with potential additional business for the combined company (that neither company would get on their own at this point); and that bring resources, in terms of people, processes and systems, that increase the scalability of the combined businesses. Acquisitions would most likely be funded by the issuance of additional common or preferred stock.

Mike will now review the financial results of the quarter for our listeners.

Mike Sayre:

Thank you, John.

Total sales were \$5.8 million for the second quarter of 2003, up 30% from the same period last year on stronger performances from both the product and service segments.

Product sales were \$3.5 million for the second quarter, up 15% compared to \$3.0 million for the second quarter last year, while service sales were \$2.3 million for the second quarter, up 60% compared to \$1.4 million last year. Product sales for the quarter have increased with the start-up of new programs like the tape library units and the process control units John discussed. Service sales for the quarter are up primarily due to our increased efforts over the past year to grow the service segment of our business. In addition, non-recurring component sales associated with the termination of an HP workstation repair program and non-recurring engineering billing for new projects contributed significantly to the increase in total service sales. If the non-recurring sales were excluded, service sales increased approximately 34%.

The overall gross profit percentage of 28% for the second quarter was also an improvement over the second quarter of last year, when the gross profit margin percentage was only 25%. The increase was primarily driven by an increase in the gross profit margin on products to 24% in the second quarter of 2003 from 21% in the 2002 quarter, due mainly to a more favorable mix of products. The gross profit margin percentage on services stayed about the same, at 34%. However, the component sales in services, that I mentioned a moment ago, were sold at cost, which lowered the gross profit margin on services approximately 2-3 percentage points for the 2003 quarter.

Those gross profit improvements increased gross profit dollars to over \$1.6 million for the second quarter of 2003, a 43% increase over the \$1.1 million gross profit posted in the second quarter of 2002.

Sales, general and administrative expenses (including research and development) of about \$1.3 million increased 16% from the \$1.1 million level of the second quarter of 2002 on the 30% increase in sales, mostly due to incentives and commissions tied to sales growth and bottom line profitability. R&D expenses have shifted to SG&A expenses over the year as engineering resources are focused on new service program implementation and customer -specific development rather than on more speculative new product development.

The net financial result for the second quarter of 2003 was net income of \$179,000 and earnings per diluted share of over \$0.03 compared to a net loss of \$11,000 and a near-break-even earnings per share in the second quarter of 2002.

As noted in the release, the last four quarters' results combine for a trailing twelve months sales of \$17.7 million, net income of \$545,000, earnings per diluted share of almost \$0.10 and a return on net assets of about 15%. We are very pleased with these results, given the economic climate in which they were achieved, and believe we now have good base-line performance upon which to measure our growth.

At the end of the second quarter of 2003, our line of credit borrowings were under \$2.0 million, down \$137,000 from the end of 2002, and significantly decreased from the \$3.2 million outstanding on the line at the end of the second quarter of 2002. Availability on the line was slightly over \$2 million at the end of June 2003.

We are not currently, and do not expect at this time to be, constrained by our credit limits.

And now I'll turn it back over to John for some final thoughts.

John Bair:

Thanks Mike.

Although we are very pleased with the last four quarters results and our position for a recovery in the economy, we are still operating in an uncertain environment. In some sectors of our economy, it feels like the constraints have been loosened, but not lifted from capital spending. We are encouraged by the increased spending of the second quarter and our backlog going into the third quarter of 2003. However, long sales cycles continue for customized solutions, service competition is heating up amongst the remaining players in the business, and volume orders for new products and large service contracts remain slow in closing.

As we discussed in our call last quarter, the over-lapping of out-going and in-coming service programs in the second quarter had a positive effect on revenues and earnings. A decrease in service revenues is expected in the third quarter as a result of the lost business. However, we believe the strength of our new programs will offset the loss of that business and provide the basis for additional growth going into 2004.

We have just enough time for a few questions...

[Q&A SESSION]

John Bair:

We'd like to thank you for the time you took to be with us this morning and hope this call provided you with helpful insight into what we're doing at PDSi to increase the value of the company for our shareholders. We appreciate your support. This concludes the conference call. Thank you.