

PINNACLE DATA SYSTEMS, INC.
(AMEX: PNS)

2004 Q2 Results Conference Call

July 21, 2004

The following discussion will contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, but not limited to, statements regarding the correlation of the Company's earnings leverage and large increases in product sales, higher sales in the second half of 2004 as compared to the same period in 2003, earnings in the second half of 2004 and the Company's financial performance and growth in 2004 and 2005. The words "believe," "expect," "anticipate," "estimate," "project," and similar expressions identify forward-looking statements that speak only as of the date thereof. Investors are cautioned that such statements involve risks and uncertainties that could cause actual results to differ materially from historical or anticipated results due to many factors, which are 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 for our 2004 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: Good morning, everyone.

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

On June 26, we completed the second fiscal quarter of 2004 and we reported our results for the quarter in a news release this morning.

John will talk a little about the nature of our business and go over some of the highlights of the 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's mission is to be the premier provider of high-quality, out-sourced product development, manufacturing and after-the-sale support services to computer and computer peripheral original equipment manufacturers (OEMs), as well as those OEMs who incorporate computers into their products.

We generally market to OEMs in, among others, the aerospace, computer, computer peripheral, data storage, digital-imaging, medical diagnostic, process-control, and telecommunications equipment industries.

Our services help OEMs increase product speed to market, extend product life, and provide high-quality cost-effective service and support to units in the field through comprehensive product lifecycle management programs.

Our business can be broken down into two business segments: services (with high labor content, like engineering services, depot repair and advanced exchange logistics) and products (with higher material content that are generally designed, developed and/or manufactured in-house).

Our strategy is

1. to maximize the growth in services, which generally provide recurring revenue streams and can be fairly predictable and profitable,
2. to leverage resources from the services we provide and strategically invest in the development and manufacture of new products with high revenue and profit potential for customer-specific and niche industry applications, and
3. to take advantage of the counter-cyclical nature of the services and products we provide to maintain financial stability and continue to generate significant growth opportunities on an on-going basis in whatever the prevailing business climate happens to be. When capital spending declines in our markets, our customers buy less products and start looking for more ways to maintain or

even extend the life of what's already in the field. This can create additional opportunities for us in what may otherwise be considered a down economy.

[PAUSE]

Increases in our base business and shipments on the two largest orders in the company's history resulted in both record quarterly sales and earnings in the second quarter of 2004. In addition to our recent record performances, we are very pleased to report that the second quarter of 2004 is our eighth consecutive quarter (representing two full years) of profitable operations.

We've highlighted two record orders in our discussions and press releases of the last two quarters, and rightly so, because of the impact they've had on the results of the first half of 2004...but also because they were both generated by significant sales efforts over the past two years and will continue to generate follow-on business over the next couple of years, as will the new program wins and expanded partnerships of the second quarter of 2004. Our investments in sales and marketing are working and we intend to increase those investments.

Our large customers varied ordering patterns can significantly swing our results from quarter-to-quarter. And our increasing investment in sales and marketing is coming out of the bottom line. But, over time, our growth, driven by larger numbers of customers and programs (the result of our additional investment in sales and marketing), is intended to lessen the impact of that variability on our results and drop more to the bottom line. In the mean time, we are focused on executing our strategic plan and believe the best way to measure our performance is by comparing yearly results as opposed to quarterly results.

Some of the results of our sales and marketing, as well as the rest of our organization's efforts, are evident in the highlights published in our earnings release this morning. During the quarter:

- We began a significant hardware management program, including software installation, distribution and maintenance support services for a home-based

learning program. This is similar to our full-service offering for customer-specific products, only it is for off-the-shelf computer systems.

- We accomplished our first win through Sun Microsystems' Network Equipment Provider support program. This program was announced by Sun in March 2004 with PDSi being listed as one of the key partners in the program. We discussed it on our last call. In this initial program, we will be providing upgrade and life-cycle extension services to a Fortune Global 500 telecommunications equipment provider over the next three years. The name of the customer we are servicing with this program is omitted, as is most often the case in our releases, because the customer wishes to remain anonymous, and we are bound to respect those wishes.
- We also won a major repair program with a new high-profile customer in the high-performance computing, visualization and storage industry that is expected to start its transition and its initial three-year term in the third quarter. We hope to have a more formal announcement in the next couple of weeks, but this win really speaks to the level of our capabilities and expertise and is a very exciting program for the engineers and technicians in our company,
- We became an authorized Hewlett-Packard Business Development Partner, further expanding our strategic partner base and product offerings to our OEM customers. This is a reseller program, not unlike past programs we have participated in with Sun, that we hope will be a stepping stone toward further expansion of our business partnership with HP,
- We also became a member of the Intel® Communications Alliance (ICA) in the second quarter. The ICA is a community of embedded communications solution providers, offering its members benefits and resources that help them innovate, deliver their products faster and offer their customers a true advantage. We are seeing a trend towards communities of smaller, more nimble companies, pooling their unique products sets and expertise to

collaborate on the high-speed development of new products and systems. Intel is a leader in the effort to take advantage of this growing trend to sell more of its products. Last quarter, we announced a relationship with Solid Information Technologies that combines our collective strengths for similar purposes.

- And, last, but not least, a comprehensive audit resulted in PDSi being recommended for registration under the ISO 13485 standard for medical device manufacturers and confirmed compliant to 21CFR820, the FDA's quality system regulations for medical device manufacturers. These registration and compliance accomplishments further qualify the Company for opportunities in the Medical Equipment industry.

Mike will now review the financial results for the quarter and I'll come back to discuss what we are working on today and where we are headed, then we'll wrap up the discussion with some Q&A. Mike?

Mike Sayre: Thank you John.

Total sales of \$11.3 million in the second quarter of 2004 were up 95% from \$5.8 million in the same quarter of 2003.

Product sales of \$9.8 million in the second quarter improved 182% over the \$3.5 million in product sales in the second quarter of 2003. Much of the increase was driven by the two orders we've been talking about. However, we also saw significant sales growth for customer-specific products used in semiconductor test equipment and commercial imaging equipment, and for remote management diagnostic products.

Service sales for the second quarter totaled \$1.5 million, a decrease of 35% from the second quarter of 2003. In the first half of 2003, the overlapping of significant in-coming and out-going HP repair programs were producing record quarterly service sales. In addition, part of the HP UNIX Workstation Repair program revenue that was in service sales in the first half of 2003 was replaced with the tape library assembly and test program revenue that now shows up in product sales in 2004.

Gross profits were \$2.7 million for the second quarter of 2004, up 67% compared to \$1.6 million for the second quarter of 2003, driven by the increased product sales.

We've said in previous quarters that in order to increase sales, we would be taking on some higher volume, lower margin business, and we have, resulting in a 22% gross profit margin on product sales in the second quarter of 2004 compared to a 24% gross profit margin on product sales in the second quarter of 2003. However, it's not all lower margin and our product mix will continue to drive margin percentage changes from quarter to quarter.

Service gross profit margins increased to 37% in the second quarter of 2004 from 34% in the second quarter of 2003 when there were additional start-up and tear-down expenses for the in-coming and out-going HP repair programs.

The operating expenses line of our statement of operations is basically selling, general and administrative (SG&A) expenses. SG&A expenses increased to \$1.8 million for the second quarter of 2004 from \$1.3 million in the second quarter of 2003 due to increasing costs tied directly to our growth in revenues and profits and to investment required for our future growth. In the second quarter of 2004, total SG&A expenses were only 16% of sales compared to 22% in the second quarter of 2003.

Net income for the second quarter of 2004 was a quarterly record for the company at \$497,000 compared to \$179,000 for the second quarter of 2003. The prior quarterly earnings record was \$362,000 set just last quarter.

For the trailing twelve months, sales were over \$31 million, earnings were almost \$1.1 million dollars, or 18 cents per diluted share, and return on equity was approximately 26%.

The increased business has resulted in both increased receivables and inventory. On June 26, 2004, borrowing on the line of credit increased to \$2.9 million from \$2.5 million at December 31, 2003, and availability on the line was over \$3.9 million. We took out a 120-day note with KeyBank in May that has been applied against the line, effectively increasing the limit of the line from \$5 million to \$7 million until September 2004.

On the investor relations front, we are on track with our quarterly visits to potential investors in varying markets. Since our last call, we presented the Company at the American Electronics Association Micro Cap Conference on the west coast, where we were well-received for being among the smaller of the companies at the conference. One reason may be because we were also in the minority of companies that could talk about being profitable for any extended period of time. We are headed back to New York this quarter to update investors, as well as others in the financial community, who we've presented the company to over the past couple of years, as well as to talk to some potential new investors.

John?

John Bair: Thanks Mike.

The markets for our products and services are in the billions. For instance, Venture Development Corporation estimates the size of the embedded computer board market at about \$2.2 billion, with about 86% of those boards being purchased by the communication, industrial control, medical and military/aerospace industries. We currently have customers in each of those market segments and are focusing sales and marketing efforts on increasing our market share in them. Market researcher iSuppli predicts that the electronics manufacturing services market will post 10% annual growth over the next few years, growing to over \$162 billion by 2008.

Granted, our high-complexity/low-volume niche is somewhat smaller than \$162 billion, but that is a huge market! And many of the products in these markets also represent repair and logistics opportunities.

So there are ample opportunities in our markets for significant growth. We just need to have more access to our markets to get more of those opportunities.

Over the past two years, we have been executing our strategic plan to expand our base of technology partners, build our own sales force, and grow and diversify our customer base.

In that time, we've expanded our base of technology partners to include Agilent, AMD, Hewlett-Packard and Intel in addition to Sun. These partners provide us

- Their technologies, including critical design detail that we may use to design their technology into new products,
- Training and support for our engineers and technicians,
- Discounted access to their products,
- Qualified sales leads, and
- Their support during the sales process.

With our expanded partner base and our own sales force, we have proven that there is a demand for our services and products, and that we can successfully convert that demand into profitable revenue. Over the past two years, our sales

organization has leveraged our technology partners and existing customer base to build an exciting pipeline of opportunities, has increased both the number of new customers and new programs we service, and has led the way in setting both new sales and/or earnings records over the last three quarters.

At the same time, we know that with our current sales force size, we are not adequately taking advantage of opportunities in every segment and geography that we could to drive growth.

Our strategy for the next couple of years is to expand our sales force to cover markets that have a real demand for our services. In 2004, we will more than double our field sales force and add complementary internal positions to support them. In addition, we will increase spending on targeted marketing to step-up lead generation.

We will be carefully monitoring the results of our increased spending through our pipe-line and actual sales growth. However, our recent experience has shown that the increased spending may not show up in our results for at least six to twelve months after the expenditures are made.

That means these expenses will occur ahead of the revenue they generate and, therefore, will lower short-term earnings. We expect second-half 2004 sales to show an increase over second-half 2003 sales. We also expect earnings in the second half of 2004 to be in the range of the second half of 2003. However, earnings in the second half could actually be lower than last year with the added expenses.

We believe reinvesting these earnings in the Company's growth will help us achieve better long-term returns on your total investment than just paying out dividends and borrowing for growth. Most of the potential investors Mike and I have talked to over the last year or so have said they are not interested in investing in companies with long-term debt.

The rest of the organization is responding well to our growth,

- by quickly building expertise in new technologies,
- by passing the most rigorous of audits from both current and potential customers and from various certification organizations, which increase our credibility in the industries we serve, and
- by achieving 99 to 100% scorecards, as well as other prestigious recognition, from our Fortune Global 500 customer base.

In order to continue that level of performance, we evaluate our internal infrastructure and its scalability on a regular basis, and we are making changes and investments in infrastructure as we believe the timing is appropriate.

I remember telling our shareholders at our annual meeting in April 2002, when product sales were in the midst of a huge decline, that we were focusing on growth strategies...and I have to tell you that we are very pleased with our recent accomplishments in that direction and that we remain committed to growth. Our goals include setting many more records in the future...but it all starts with the investments we are making today.

Thank you for joining us this morning. We'll now take your questions.

[Q&A SESSION]

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.