

**PINNACLE DATA SYSTEMS, INC.**  
**(AMEX: PNS)**

**2004 Q3 Results Conference Call**

**October 20, 2004**

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

Thank you for joining us this morning for our third quarter 2004 investor conference call.

Participating with me on this morning's call are Chris Winslow, our President and COO, and 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.

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. 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 Company’s Form 10-KSB for the fiscal year ended December 31, 2003. The Company undertakes no obligations to publicly update or revise such statements.

We’ve made some changes to the format for today’s conference call compared to previous quarters. We welcome your comments following the call today as we seek to further enhance our investor communication and corporate message.

I’ll begin with a commentary on the financial results of the quarter. John will follow with remarks concerning our vision, objectives, and key elements of our strategies to achieve them. Then, Chris will discuss our targeted sales and operations initiatives and our progress to date. We’ll wrap up with a short question and answer period.

Mike Sayre: On September 25, we completed the third quarter of fiscal 2004 and we reported our results for the quarter in a news release this morning.

Before beginning my remarks concerning the results we released this morning, I want to very briefly review our financial performance over the past two years. I believe it provides an important perspective to this discussion.

We will be referencing some slides during our discussion today that may be found on our website at the following link:

<http://www.pinnacle.com/company/presentation/investor/Oct-Pre-2004.pdf>

Looking at presentation slides 1, 2 and 3, trailing four quarter sales, gross profit and net income, in 2002, we saw how a strong base of repair and logistics programs combined with relatively low product sales could generate enough gross profit to sustain a lean overhead structure and a modest level of spending on sales and marketing. This enabled us to report near breakeven results that year, even in a weak economy. At that time, we talked about the earnings leverage we expected to achieve as the economy recovered, capital spending resumed and our product sales began to rise. And, since that time, if you look at slide 4 of the presentation, we have benefited from improved operating leverage, reporting a number of quarterly sales and earnings records.

In previous quarters, we've also discussed how we were going to take on some higher volume, lower margin production work, like less complex board and system integration, that would also increase our operating leverage. We've been successful at winning some of that work. We currently have several large product programs in house, at various gross profit margin levels, that cycle between large and small order volume from quarter to quarter. So, depending on the sales mix during a particular quarter, we can experience quarters where sales and gross profit margins go in the same direction, or even in opposite directions. For example, in the third quarter we just completed, sales increased significantly over the third quarter of 2003, but gross profit remained relatively unchanged.

Total sales for the third quarter of 2004 were \$8.8 million, an increase of 69% over sales of \$5.2 million for the comparable period of 2003. Year-to-date sales through September 25, 2004, totaled \$27.1 million, an increase of 79% over \$15.1 million for the comparable period of 2003.

Product sales for the third quarter of 2004 comprised \$7.6 million of the quarter's total sales, an increase of 114% over product sales of \$3.5 million for the third quarter of 2003. This improvement was due to increases in commercial imaging, medical diagnostic, hardware management service and remote management diagnostic product sales. Gross profit on product sales for the third quarter of 2004 totaled \$1.2 million, up 18% compared with \$1.0 million for the same period of 2003. The gross profit margin on products declined to 15% in the third quarter of 2004 from 28% a year ago, as higher volume, lower margin products dominated product mix for the quarter.

On the services side, our normal third quarter seasonal decline in repair sales was larger than in the recent past. For the third quarter of 2004, service sales totaled \$1.2 million, a decline of 26% from service sales of approximately \$1.7 million for the third quarter in 2003. Gross profit on service sales for the 2004 quarter totaled \$365,000, compared to \$536,000 for the same period in 2003. The gross profit margin on service sales was 30% in the third quarter of 2004, compared to 32% in the comparable quarter of 2003, due to the lower volume.

Our gross profit totaled \$1.5 million for the third quarters of both 2004 and 2003 due to sales mix. Year-to-date gross profit was \$6.5 million, an increase of 48% from \$4.4 million in the comparable period in 2003.

Now turning to our operating expense, which primarily includes sales, marketing, R&D and administrative expenses. Previously, we said we planned to increase sales and marketing expenses to achieve future growth. For the third quarter of 2004, operating expenses totaled \$1.5 million versus \$1.3 million in the comparable quarter of 2003. This increase of a little over \$200,000 from a year ago is fairly representative of the increase in the sales and marketing spend rate

we planned. In the third quarter of 2004, operating expenses were 17% of sales compared to 25% in the third quarter of 2003. For the year-to-date period, operating expenses were \$4.9 million, a 35% increase over \$3.7 million for the comparable period of 2003, but only 18% of sales in 2004 compared to 24% of sales in 2003.

Income from operations, a key measure of our performance, declined to \$25,000 for the third quarter of 2004 from \$234,000 for the comparable period of last year. This was directly attributable to the planned increase in operating expenses.

Net income for the third quarter of 2004 was about breakeven, compared to net income of \$122,000, or \$0.02 per share, for the third quarter of 2003. Year-to-date net income was \$860,000, or \$0.14 per diluted share, an increase of 129% over net income of \$376,000, or \$0.07 per diluted share, for the comparable period of 2003.

Last quarter, we stated that earnings for the second half of 2004 could be lower than the second half of 2003 with the added operating expenses, and that is what we continue to expect. We believe we will post strong sales and be profitable in the fourth quarter, but we do not expect to make up the gross profit on the lost repair sales of the third quarter.

Over the trailing four quarters, we've achieved \$34.9 million in sales and \$8.2 million in gross profit; resulting in net income of about \$1.0 million, earnings per share of \$0.16 and a return on equity of about 22%.

Over the past quarter, we've received a number of questions about our rising receivables and inventory levels this year. Record quarterly sales have generally increased our inventory, and end-of-quarter shipments requested by our customers have inflated our quarter-end receivables numbers, even though overall collection time on receivables has remained fairly consistent. In the third quarter of 2004, inventory increased approximately \$1.5 million to support two new multi-year programs where the inventory risk is either covered by contract or purchase order.

We re-paid the \$2 million 120-day note we took out in May of 2004 to fund additional working capital needs in the first half.

You may have also noticed a little different approach in our earnings release format this quarter and we expect to make additional improvements in coming quarters. For instance, while we will still reference the year-over-year comparisons of quarterly numbers, we will be increasing the focus on year-to-date and trailing four quarters' performance, consistent with our strategic focus. Also, we will provide more summarized balance sheet and cash flow statements, as they will continue to be provided in the detail formats in our SEC filings. We will also limit our balance sheet discussion in future releases to those items that we believe are pertinent to the understanding of our financial position at the end of the quarter.

John?

John Bair: Thanks, Mike.

PDSi provides lifecycle service solutions to Original Equipment Manufacturers (OEMs) in the medical, telecommunications, aerospace, imaging and computer equipment industries, among others. We offer a full range of computer and computer-related product development and manufacturing services to increase product speed to market and engineered product life, and to 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.

We are a services company and, as such, our vision is to build a business that is market- and customer-focused, growing in long-term value for our stakeholders, with sustainable levels of performance over market cycles.

This is what we are working on everyday...it is what drives us and will help us realize our long-term business and financial goals.

To illustrate our business opportunity and focus, slide 5 shows three intersecting circles that represent the three service arenas we compete in today; engineering services, contract manufacturing and value-added reselling. These are all multi-billion dollar markets that represent significant long-term opportunity for us. Today, most of our business sits in the intersections of these three circles. Our capabilities in all three arenas enable us to establish and expand customer relationships with some of the world's largest companies, like Hewlett Packard, General Electric, Philips, Siemens, Alcatel, Nortel, British Aerospace and Xerox.

There are fundamental conflicts between the business model of computer system manufacturers like Sun Microsystems, Hewlett-Packard, IBM and Dell, and the business requirements of the OEMs of products with embedded computers:

1. Computer manufacturers are challenged to constantly improve their technologies every 12-18 months to stay competitive...OEMs invest so much time and money in the development and certification of their products that

they need product lifecycles extending over 5-10 years to recoup their investments, and

2. Computer manufacturers must minimize the costs of their products by driving volume to stay competitive...after the 12-18 month window of opportunity for the computer manufacturer's technology, OEM volume is generally not enough to sustain the production levels the computer manufacturers need to justify the use of their capacity.

The result is that OEMs need a service provider that can help them develop and support computers that meet the form, fit and function requirements of their products, can take advantage of the best technologies available at the time of product development and that can reproduce and/or maintain those technologies for at least a 5-10 year product life cycle.

That's been PDSi's traditional entry point into these larger organizations.

Our Fortune Global 500 customer base values our expertise, agility and ability to meet their demanding certification, regulatory, and business requirements. They all have additional needs for services we can perform that fall outside of the intersections of the three circles that I previously mentioned. We are starting to get some of that business, driven by both our customers and our partners. That's why we are spending to build our marketing and sales capabilities and develop more partnerships. Our company is market- and customer-focused.

As shareholders in this public company, we want to achieve a sustained return on our investment that can only come from the successful implementation of an aggressive growth strategy. We believe that we can increase both our value and our visibility in the financial markets in the next five years by showing continued yearly growth toward achieving \$100 million in annual sales over that time period. As our customer and partner relationships continue to develop over that time, we will be planning for additional growth beyond the \$100 million level. However, we recognize that we must stay focused.

By being a market- and customer-focused services organization, developing great people, building a scalable organization and value in our company, we believe we can make this a sustainable business for generations to come.

That is our vision. Our objectives and the key elements of our strategies for achieving them are focused on balancing growth with improved long-term profitability. We believe that the successful execution of our strategies will result in the achievement of our objectives, and will positively influence shareholder value.

To execute these strategies, we recognized that we needed a strong management organization.

To lead the development of that organization and keep it focused on our objectives, we appointed Chris Winslow as President and Chief Operating Officer of the Company this past quarter. In his career, Chris has helped lead two companies through similar successful growth transformations and has been key to our company's improvement and growth over the past three years. We are confident in his leadership abilities and also welcome Chris to our Board of Directors.

Chris?

Chris W.: Thanks John.

I am excited about my role in leading the Company's transformation.

To provide perspective to this discussion, let me start with what we call our engagement model on slide 6. The model shows how we turn capabilities and partnerships into engagements and ultimately multi-year supply programs. We illustrate the model by drawing it in a pyramid that is made up of four horizontal sections that are stacked up to form the pyramid. We view it this way because the nature of our business requires us to independently invest in a variety of areas to generate success in the marketplace. But, also, at the end of the day, they all build upon each other in our pursuit of business excellence.

The base of the pyramid, and of our business, is our set of core capabilities and capacities, including product design, engineering, procurement, manufacturing, logistics, repair and program management.

The next level of the pyramid is our network of technology partners. Among them are Sun Microsystems, Intel, AMD, Agilent and Hewlett Packard, as well as channel partners and solution providers.

The next level is the engagement level. This is the point of attack where we match our capabilities to the unique needs of our clients through a professional and sophisticated, discovery-focused sales model. We view the results of our sales effort as an engagement, as we have proven that we can develop our relationships into long marriages with our customers.

And the pinnacle of our pyramid and our success with a customer is a multi-year supply program that keeps them "married" to us over a much longer period of time.

Many of these programs lead us into areas of new technology or new service offerings that are additive to our core set of capabilities and capacities, so that the top of the model can actually feed the bottom of the model with the benefits of the

additional capabilities flowing back up through the pyramid and turning into new business with other customers as well.

So let's talk about our progress in the different layers of our engagement model, the pyramid.

In the area of capabilities and capacity, we are aggressively aligning our organization for the next phase of growth. This includes adding seasoned professionals to our leadership team, investing in technologies and systems, and refining our operating processes.

Our existing partnerships with Sun, HP, Intel, AMD and others continue to be strong, however we are actively working to expand this base by engaging with software companies that offer unique solutions to the markets we currently serve and by driving new relationships with channel organizations that offer additional opportunities to penetrate new markets.

PDSi's engagement model resembles those of other technology service companies such as EDS, Accenture, and IBM Global Services. We focus on delivering services to companies that lead their industries and therefore offer the greatest long-term opportunity. By amassing a broad base of capabilities, and by using a laser focus to deliver those as a solution to significant business problems, we become an indispensable partner in our customer's business. Over the past several years, we have built a sales and support team capable of executing this model and I'm pleased to say that during the third quarter, we closed a number of significant new accounts, including a telecommunications market leader, an innovator in the computer visualization market and the industry leader in medical devices, among others. These new accounts, coupled with the development of our sales model and the expansion opportunities within our existing base, provide the foundation for continuing our maturity as an organization and emerging market innovator.

Over the past two years, we have proven that we can generate sales growth rates in excess of 40% per year, and while the math starts to catch up with us, making

that level of growth even more challenging, we have demonstrated that we have a solid business model that is attractive to the best companies in a broad range of industries. We have proven that we can execute at this level, consistently, while investing in those areas necessary for future growth. To get to the next level, it is critical that we continue to focus on gaining scale and relevance by growing our customer base, expanding our capabilities, and growing our revenue in areas that offer future leverage.

John mentioned in his remarks concerning our strategy that we participate within the confluence of three industries. The total global marketplace for those industries exceeds \$200 billion per year. Based upon our knowledge of the business and the progress we have made in our ability to execute, we expect to grow PDSi to \$100 million in annual sales in the next 5 years. Mike mentioned operating profit leverage in his discussion of our financial results. We believe that there are tremendous opportunities to achieve substantial leverage in this business once critical mass is attained. We've proven that we can generate profits at certain thresholds. Our mission as a team now is to get the organization to a size and scale that allows us to create sustainable leverage and generate consistent profits without sacrificing opportunities for continued growth. We believe that level is much greater than where we are today and that we have the means, focus, and business model to get us there.

We know our objectives are aggressive; however, we look forward to the challenge.

John Bair: Thanks, Chris.

And thanks to our audience for joining us this morning. We will 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.