

PECO II INC
Form 10-Q
August 14, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2008

or

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

For the transition period from _____ to _____

Commission File Number 000-31283

PECO II, INC.

(Exact name of registrant as specified in its charter)

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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 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 12 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 by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). 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 | Outstanding at July 31, 2008 |
|----------------------------------|------------------------------|
| Common Shares, without par value | 2,765,253 |

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PECO II, INC.

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Table of Contents**PECO II, INC.****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****PECO II, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands, except for share data)

| | June 30, 2008 (unaudited) | December 31, 2007 |
|--|---------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 7,686 | \$ 7,935 |
| Accounts receivable, net of allowance of \$81 at June 30, 2008 and \$90 at December 31, 2007 | 3,902 | 3,685 |
| Note receivable | 250 | |
| Inventories, net of allowance of \$1,819 at June 30, 2008 and \$1,906 at December 31, 2007 | 10,588 | 11,433 |
| Cost and earnings in excess of billings on uncompleted contracts | 789 | 514 |
| Prepaid expenses and other current assets | 184 | 263 |
| Assets held for sale | 83 | 219 |
| Total current assets | 23,482 | 24,049 |
| Property and equipment, at cost: | | |
| Land and land improvements | 195 | 195 |
| Buildings and building improvements | 7,251 | 7,251 |
| Machinery and equipment | 2,916 | 2,869 |
| Furniture and fixtures | 5,513 | 5,527 |
| | 15,875 | 15,842 |
| Less-accumulated depreciation: | (11,573) | (11,360) |
| Property and equipment, net | 4,302 | 4,482 |
| Other assets: | | |
| Goodwill | 1,485 | 1,515 |
| Intangibles, net | 3,285 | 3,822 |
| Investment in joint venture | 2 | 2 |
| Total assets | \$ 32,556 | \$ 33,870 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 5,984 | \$ 4,485 |
| Billings in excess of cost and estimated earnings on uncompleted contracts | | 510 |
| Accrued compensation expense | 897 | 722 |
| Accrued income taxes | 23 | 81 |
| Other accrued expenses | 1,769 | 1,800 |

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| | | |
|---|-----------|-----------|
| Total current liabilities | 8,673 | 7,598 |
| Shareholders' equity: | | |
| Common stock, no par value: 150,000,000 shares authorized; 2,756,155 and 2,739,157 shares issued at June 30, 2008 and December 31, 2007, respectively | 3,496 | 3,475 |
| Warrants | 5,130 | 5,078 |
| Additional paid-in capital | 116,572 | 116,412 |
| Accumulated deficit | (101,315) | (98,693) |
| Total shareholders' equity | 23,883 | 26,272 |
| Total liabilities and shareholders' equity | \$ 32,556 | \$ 33,870 |

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

Table of Contents**PECO II, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(unaudited)

(In thousands, except for per share data)

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|--|-------------|--|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| Net sales: | | | | |
| Product | \$ 8,505 | \$ 7,256 | \$ 15,795 | \$ 13,151 |
| Services | 2,552 | 3,298 | 4,273 | 5,497 |
| | 11,057 | 10,554 | 20,068 | 18,648 |
| Cost of goods sold: | | | | |
| Product | 7,429 | 6,305 | 13,807 | 11,746 |
| Services | 2,087 | 2,490 | 3,517 | 4,269 |
| | 9,516 | 8,795 | 17,324 | 16,015 |
| Gross margin: | | | | |
| Product | 1,076 | 951 | 1,988 | 1,405 |
| Services | 465 | 808 | 756 | 1,228 |
| | 1,541 | 1,759 | 2,744 | 2,633 |
| Operating expenses: | | | | |
| Research, development and engineering | 678 | 495 | 1,310 | 1,335 |
| Selling, general and administrative | 2,136 | 2,091 | 4,152 | 4,597 |
| | 2,814 | 2,586 | 5,462 | 5,932 |
| Loss from operations | (1,273) | (827) | (2,718) | (3,299) |
| Interest income, net | 41 | 95 | 105 | 197 |
| Loss before income taxes | (1,232) | (732) | (2,613) | (3,102) |
| Income tax expense | (1) | (13) | (9) | (27) |
| Net loss | \$ (1,233) | \$ (745) | \$ (2,622) | \$ (3,129) |
| Net loss per common share: | | | | |
| Basic and diluted | \$ (0.45) | \$ (0.27) | \$ (0.95) | \$ (1.15) |
| Weighted average common shares outstanding: | | | | |
| Basic and diluted | 2,755 | 2,720 | 2,751 | 2,719 |

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

Table of Contents**PECO II, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)

(In thousands)

| | For the Six Months Ended June 30, | |
|--|--|-------------|
| | 2008 | 2007 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (2,622) | \$ (3,129) |
| Adjustments to reconcile net loss to net cash (used for) provided by operating activities: | | |
| Depreciation and amortization | 763 | 847 |
| Provision for bad debts | 5 | (20) |
| Provision for obsolete and excess inventories | 447 | 195 |
| Provision for product warranty | 602 | 357 |
| Gain on disposals of property and equipment | | (71) |
| Asset impairments | 66 | |
| Compensation expense from share-based payments | 180 | 221 |
| Working capital changes: | | |
| Accounts receivable | (222) | 1,606 |
| Inventories | 398 | 2,482 |
| Prepaid expenses and other current assets | (165) | (69) |
| Accounts payable other current liabilities | 466 | (1,660) |
| Net cash (used for) provided by operating activities | (82) | 759 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Capital expenditures | (46) | (8) |
| Issuance of note receivable | (250) | |
| Proceeds from sale of property and equipment | 121 | 497 |
| Net cash (used for) provided by investing activities | (175) | 489 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Transfer from restricted cash | | 3,500 |
| Net repayments under line of credit agreement | | (2,249) |
| Repayment of capital leases | | (50) |
| Proceeds from issuance of common shares ESPP | 8 | 16 |
| Net cash provided by financing activities | 8 | 1,217 |
| Net change in cash | (249) | 2,465 |
| Cash and cash equivalents at beginning of period | 7,935 | 5,259 |
| Cash and cash equivalents at end of period | \$ 7,686 | \$ 7,724 |
| Supplemental disclosure of cash flow information: | | |
| Income taxes paid | \$ 68 | \$ 60 |
| Interest paid | 5 | 15 |

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

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PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited, in thousands except for share and per share data)

1. Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of PECO II, Inc. (the Company) and its wholly and partially 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.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Estimates are used for, but not limited to, the accounting for doubtful accounts, inventory obsolescence, depreciation and amortization, sales returns, warranty costs, taxes and contingencies. Actual results could differ from those estimates.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The December 31, 2007 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.

2. Recent Adopted and Recently Issued Accounting Pronouncements

Effective January 1, 2008, the Company adopted Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 applies to most current accounting pronouncements that require or permit fair value measurements. SFAS 157 provides a framework for measuring fair value and requires expanded disclosures about fair value methods and inputs by establishing a hierarchy for ranking the quality and reliability of the information used by management to measure and report amounts at fair value.

The Company has only partially applied the provisions of SFAS 157 as management has elected the deferral provisions of FASB Staff Position (FSP) SFAS 157-2 as it applies to nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The major categories of assets and liabilities that are recognized or disclosed at fair value on a nonrecurring basis include certain amounts of property and equipment and goodwill reported at fair value as a result of impairment testing, and certain other assets, liabilities and equity instruments recognized as a result of prior business combinations.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 provides guidance on various methods used to measure fair value including market, income and cost approaches. These approaches require the Company to utilize certain assumptions that market participants would use in pricing assets and liabilities, including assumptions about risk. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company attempts to utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Based on the inputs used in the valuation techniques, SFAS 157 requires the Company to classify the inputs under a fair value hierarchy that ranks the inputs based on their quality and reliability. Financial instruments carried at fair value will be classified and disclosed in one of the following three categories:

Level 1 Quoted market prices in active markets for identical assets or liabilities.

Level 2 Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3 Unobservable inputs that are not corroborated by market data.

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

The estimated fair values of the Company's short-term financial instruments, including cash and cash equivalents, receivables and payables arising in the ordinary course of business, and current portions of debt, approximate their individual carrying amounts due to the relatively short period of time between their origination and expected realization. The Company does not have any other financial instruments measured at fair value on a recurring basis that require further disclosure.

The Company does not have any financial instruments that required a cumulative-effect adjustment to beginning accumulated deficit upon adoption. There was no material impact to the Company's consolidated financial position, results of operations, or cash flows as a result of the adoption of SFAS 157.

Effective January 1, 2008, the Company adopted FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits the Company to voluntarily choose, at specified election dates, to measure specified financial assets and liabilities and other items at fair value that are not currently required to be measured at fair value. Subsequent changes in fair value would then be required to be reported in earnings each reporting period. At the date of adoption, the Company did not elect the fair value option for eligible items that existed at January 1, 2008. Therefore, the adoption of SFAS 159 did not have any effect on the Company's consolidated financial position, results of operations, or cash flows. Any future effect will be dependent upon the nature and amount of eligible items that the Company elects to account for using the fair value option.

3. Segment Information

The following summarizes additional information regarding segments of the Company's operations:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|-----------------------------------|--|-------------|--|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| Net sales: | | | | |
| Product | \$ 8,505 | \$ 7,256 | \$ 15,795 | \$ 13,151 |
| Services | 2,552 | 3,298 | 4,273 | 5,497 |
| | \$ 11,057 | \$ 10,554 | \$ 20,068 | \$ 18,648 |
| | | | | |
| | | | | |
| | | | | |
| (Loss) income from operations: | | | | |
| Product | \$ (1,130) | \$ (885) | \$ (2,315) | \$ (2,995) |
| Services | (143) | 58 | (403) | (304) |
| Consolidated loss from operations | \$ (1,273) | \$ (827) | \$ (2,718) | \$ (3,299) |

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

4. Inventories

Inventory is stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost on the first-in, first-out basis, net of allowances for estimated obsolescence. Major classes of inventory at June 30, 2008 and December 31, 2007 are summarized below:

| | June 30, 2008 | December 31, 2007 |
|---|----------------------|--------------------------|
| Raw materials | \$ 10,142 | \$ 11,270 |
| Work-in-process | 763 | 522 |
| Finished goods | 1,502 | 1,547 |
| Gross inventory | 12,407 | 13,339 |
| Allowance for obsolete and excess inventory | (1,819) | (1,906) |
| Net inventory | \$ 10,588 | \$ 11,433 |

From time to time, the Company has increased risk for obsolete and excess inventory depending on various unforeseen future events and circumstances, primarily related to the mix of future business and customer requirements for new technologies that could have a material impact on the Company's estimated allowance for obsolete and excess inventory in the near term. If these unforeseen events and circumstances do occur in the near term, the resulting changes in the estimate could be material to the Company's consolidated financial position and results of operation.

5. Uncompleted Contracts

Costs and estimated earnings on uncompleted contracts consist of the following:

| | June 30, 2008 | December 31, 2007 |
|---|----------------------|--------------------------|
| Costs incurred on uncompleted contracts | \$ 1,982 | \$ 1,767 |
| Estimated earnings | 480 | 446 |
| | 2,462 | 2,213 |
| Less: Billings to date | 1,673 | 2,209 |
| | \$ 789 | \$ 4 |

Included in the accompanying balance sheet under the following captions:

| | June 30, 2008 | December 31, 2007 |
|---|----------------------|--------------------------|
| Costs and estimated earnings in excess of billings on uncompleted contracts | \$ 789 | \$ 514 |
| Billings in excess of costs and estimated earnings on uncompleted contracts | | (510) |
| | \$ 789 | \$ 4 |

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

6. Asset Impairment Charges and Assets Held for Sale

As disclosed in Note 6 of the Company's most recent Annual Report on Form 10-K, the Company had recognized certain impairment charges for equipment and inventory related to the Company's outsourcing of certain manufacturing operations. At December 31, 2007, the remaining carrying value of the asset group was \$219 and is classified as "Assets held for sale" in the accompanying balance sheet. During the current year, the Company has been able to sell portions of the equipment and inventory as the outsourcing efforts progress. At June 30, 2008, the remaining carrying value of the asset group is \$83. During the second quarter on 2008, the sale of a piece of equipment resulted in an additional impairment charge of \$15.

7. Goodwill and Other Intangibles

Goodwill is summarized as follows:

| | Services | Product | Total |
|---|----------|---------|----------|
| Balance, December 31, 2007 | \$ 1,515 | \$ | \$ 1,515 |
| Adjustment for additional shares issuable under warrant | | 51 | 51 |
| Impairment charges | | (51) | (51) |
| Other write-offs of certain liabilities assumed | (30) | | (30) |
| Balance, June 30, 2008 | \$ 1,485 | \$ | \$ 1,485 |

Intangible assets are summarized as follows and relate to the product segment only:

| | June 30, 2008 | December 31, 2007 |
|---|------------------|----------------------|
| <u>Intangible Assets with Determinable Lives</u> | | |
| Customer relationships | \$ 2,000 | \$ 2,000 |
| Supply agreement | 3,700 | 3,700 |
| Total gross intangible assets | 5,700 | 5,700 |
| Less: Accumulated amortization | 2,415 | 1,878 |
| Intangibles, net | \$ 3,285 | \$ 3,822 |

Amortization expense for the six months ending June 30, 2008 and 2007 was \$537 for both periods. Amortization is calculated using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of the customer relationship and supply agreement intangibles are 6 years and 5 years, respectively.

8. Warranty

The Company's warranty activity for the six months ended June 30, 2008 and six months ended June 30, 2007 are summarized below:

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| | 2008 | 2007 |
|--|----------|--------|
| Accrued warranty cost, beginning of period | \$ 908 | \$ 913 |
| Warranty provision | 602 | 357 |
| Warranty claims | (489) | (337) |
| Accrued warranty cost, end of period | \$ 1,021 | \$ 933 |

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

9. Contingencies

The Company is subject to certain legal proceedings and claims which arise in the ordinary course of its business. Although the outcomes of such matters cannot be predicted with certainty, the Company believes the final disposition of such matters will not have a material adverse effect on its financial position, results of operations or liquidity.

The Company has a \$49 contingency reserve for potential sales tax liability from a prior acquisition for potential service nexus in states in which the Company is not currently filing and other miscellaneous sales or use tax issues. The Company does not volunteer to pay more taxes than necessary but believes this is an appropriate approach to the risks associated with prior and current year taxes.

10. Loss Per Share

The number of shares outstanding for calculation of loss per share is as follows:

| (Shares in thousands) | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---|---|-------|---|-------|
| | 2008 | 2007 | 2008 | 2007 |
| Weighted-average shares outstanding - basic | 2,755 | 2,720 | 2,751 | 2,719 |
| Effect of potentially dilutive shares | | | | |
| Weighted average in outstanding shares - dilutive | 2,755 | 2,720 | 2,751 | 2,719 |

Due to the Company's net loss for the three and six months ended June 30, 2008 and 2007, no common equivalent shares were included in the calculation of diluted loss per share for either period because their effect would have been anti-dilutive.

11. Stock-Based Compensation

Total stock-based compensation expense by type of award is as follows:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|--|---|-------|---|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Stock options | \$ 53 | \$ 39 | \$ 54 | \$ 115 |
| Restricted stock awards | 64 | 59 | 125 | 98 |
| Employee stock purchase plan | 1 | 4 | 2 | 8 |
| Total stock-based compensation expense | 118 | 102 | 181 | 221 |
| Tax effect on stock-based compensation expense | | | | |
| Net effect on loss from operations | 118 | 102 | 181 | 221 |

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There was no recorded tax effect on the recognition of stock-based compensation expense due to the Company's significant operating loss carry-forward and valuation reserve. In addition, there was no effect on the presentation of the statement of cash flows as excess tax benefits from the exercise of stock options have not been recorded as the Company does not expect to be able to realize current period deductions of taxable income.

Table of Contents**PECO II, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)**

(unaudited, in thousands except for share and per share data)

Stock Options

The following table represents stock option activity for the six months ended June 30, 2008:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contract Life |
|----------------------------------|---------------------|---------------------------------------|---|
| Outstanding at December 31, 2007 | 204,707 | \$ 10.44 | |
| Granted | 71,000 | 7.68 | |
| Exercised | | | |
| Forfeited/ Cancelled | (62,080) | 8.52 | |
| Outstanding at June 30, 2008 | 213,627 | 10.08 | 2.83 years |
| Exercisable at June 30, 2008 | 113,927 | \$ 11.38 | 1.68 years |

At June 30, 2008 there was no aggregate intrinsic value of stock options outstanding and exercisable as the exercise prices of the options were all greater than that of the average market price at the end of the period.

Restricted Stock Awards

The following table represents restricted stock awards activity for the year-to-date period ended June 30, 2008:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|--------------------------------|---------------------|--|
| Nonvested at December 31, 2007 | 7,500 | \$ 7.90 |
| Awarded | 15,829 | 6.60 |
| Vested | (10,032) | 6.48 |
| Nonvested at June 30, 2008 | 13,297 | \$ 7.46 |

At June 30, 2008, there was \$21 of unrecognized compensation expense from non-vested restricted stock awards that is expected to be recognized during fiscal 2008.

12. Related Party Transactions

The Company engages in certain related party transactions with the Company's largest shareholder, Delta Products Corporation. Delta is a significant supplier to the Company. The Company's related party transactions with Delta, for the six months ended June 30, 2008 include \$77 in sales and \$3,544 in purchases (\$158 in sales and \$3,476 in purchases for the six months ended June 30, 2007). At June 30, 2008, the Company had balances of \$28 and \$1,656 included in accounts receivable and accounts payable, respectively.

13. Major Customers

Because of the Company's concentration of sales to the Regional Bell Operating Companies (RBOCs) and wireless service providers, a small number of customers typically represent substantial portions of total sales. For the first six months of 2008, sales to three companies comprised 61.1% of total sales. Sales to our top customer included \$7,247 in product and \$1,424 in services, our second highest customer included \$1,903 in product and \$14 in services, and our third highest customer included \$642 in product and \$1,040 in services.

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PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Cont.)

(unaudited, in thousands except for share and per share data)

For the first six months of 2007, sales to three companies comprised 65.6% of total sales. Sales to our top customer included \$5,218 in product and \$1,547 in services, our second highest customer included \$1,118 in product and \$2,045 in services, and our third highest customer included \$2,268 in product and \$17 in services.

14. Note Receivable

On April 28, 2008 the Company agreed to enter into a bridge loan with a strategic partner. The loan is expected to be converted into equity in the strategic partner in 2008. This loan is a non-interest bearing note in the amount of \$250 thousand.

15. Reverse Stock Split

A reverse stock split of the Company's common stock at a ratio of 1-for-10 shares occurred on May 7, 2008. The Company has retroactively restated all share related data in the financial statements including shares outstanding, shares issuable under warrants, shares under the Company's stock-based compensation plans and loss per share amounts to reflect the effect of the reverse stock split.

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

References to we, us, our, the Company, or PECO II refer to PECO II, Inc. unless the context indicates otherwise.

Overview

PECO II, Inc. was organized in 1988 for the purpose of acquiring the assets of ITT's communications power product business. Today, we provide solutions to our telecommunications customers through a variety of products and services in order to meet their cost, quality, productivity and capacity challenges. As part of this process, we design and manufacture communications specific power products. We also provide on-site E&I, systems integration, installation, maintenance, and monitor services to our customers. Our power systems provide a primary supply of power to support the infrastructure of communications service providers, including local exchange carriers, long distance carriers, wireless service providers, internet service providers and broadband access providers. Our power distribution equipment directs this power to specific customer communications equipment. Our systems integration business provides complete built-to-order communications systems assembled and installed pursuant to customer specifications and incorporating other manufacturers' products.

Market conditions remain uncertain and difficult. In the recent past, several of our customers have engaged in mergers, acquisitions and divestitures, such as SBC acquiring AT&T, AT&T acquiring Bell South and Cingular, Alltel acquiring Western Wireless, and Sprint acquiring NEXTEL. Also, both Sprint Nextel and Alltel spun off their local wireline businesses to focus on their core wireless businesses. Recently Verizon has announced its intention to purchase Alltel. Currently, major wireline companies are focusing their capital expenditure spending on FTTC (fiber to the curb) and FTTN (fiber to the node) for both broadband and video services distribution, while wireless companies are focusing their capital expenditure spending on migration of acquired systems to the standards of the acquiring carrier, integrating networks, improving area coverage, deploying 3G data services and have begun to announce plans to deploy WIMAX and LTE networks.

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PECO II, INC.

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

While the telecommunications market is extremely volatile, capital expenditure spending expanded by the mid single digits in 2007 and analysts have projected further growth in 2008 and 2009. We believe this growth forecast provides us with an opportunity to capitalize on our customers capital expenditure plans.

In 2008, we are targeting the capital expenditure growth in the wireless market. We have successfully ramped the midsized power products, which serve the wireless base station market, including both cabinet and hut applications. The midsized product platforms are standardized at 3 wireless operators.

The acquisition of Delta Products' U.S. and Canadian Telecom Power business in 2006 added more cell site power solutions to our portfolio. The HDS3000 product provides customers with either +24V or -48V operation using a horizontal distribution architecture. Customer preferences for distribution architecture vary by region, so the HDS3000 offers a true complement to the vertical style used by PECO II plants.

Our R&D investment extends beyond traditional cell site applications. In 2007, the Company modified its 827E inverter system to address a specific application at a major wireline carrier and 2008 year-to-date revenues for this product have increased 19.4%. In June, we introduced our new small power platform at the NXTcomm08 trade show in Las Vegas. The Quantum Power System positions us as a player in the shelf power market segment and the fast growing outside plant broadband market. According to industry analyst Skyline Marketing, the size of this power market segment in the United States is estimated to be \$269 million in 2008, reaching \$450 million by 2011.

The Quantum platform is a 48-volt DC power system that combines high-density rectifiers, distribution and control in a sleek, low-profile shelf for optimized value to telecom carriers deploying fiber-to-the-node and traditional wireline architectures. Designed for the harsh outside plant environment, the Quantum system's small footprint makes it ideal for cabinets where rack space is at a premium.

The Quantum Power System has several distinctive features that optimize the user experience. Our innovative QuickLoad feature enables the technician to rapidly configure the system. The system controller features a technician-friendly input control device and a display that can easily be read in difficult outdoor conditions. The rectifiers include our unique I-View faceplate indicators that report rectifier current and load-sharing status.

In addition to introducing the Quantum system, we also completed the design of a new cabinet for powering wireless base stations. The SC1172 battery cabinet occupies the same footprint as the previous vintage, but with nearly twice the battery capacity. The improved system density lowers operating expenses for the wireless carriers by reducing the requirements for site leases at cell towers.

With the introduction of our small power products, we have an exciting opportunity to grow our business in a space in which we have not competed in to date. By leveraging our industry leading responsiveness capability with this new technology platform provides our customers with another reason to rely on PECO II for its power requirements.

Our services group focused on hardening our solution portfolio to meet the power needs of our Tier I customer base. The revenue decline in 2008 was driven by reduced spending at two of our major customers.

Our services division continues to provide multi-vendor engineering and installation services for all major power product brands. This capability is both respected and valued in the marketplace. Our strong power E&I services reputation has provided many opportunities for introducing new power products as well as a real user feedback channel on deployed products. This feedback continues to aid us with designing and improving products to meet the industry evolving needs.

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PECO II, INC.

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

We announced to customers at the end of June, plans to increase prices on non-contract items to compensate for the significant rise in the cost of key commodities such as copper, aluminum and sheet metal. The increase went into effect on August 4, 2008. The impact on the financial performance of our Company is contingent on product mix and order volumes.

Looking forward, we will continue to focus our efforts on delivering the services solutions our customers have come to expect from working with PECO II. This dedication has enabled us to minimize customer turn-over. We will continue to expand our services footprint on those opportunities that make the best utilization of our current available resources, and/or those that position us for success as our industry matures to the next level.

Results of Operations

The second quarter financial performance reflects solid in-year revenue growth for both products and services. Revenues for the quarter were the highest quarterly revenues recorded since the fourth quarter of 2006. Our net sales increased to \$11.1 million and \$20.1 million for the three and six months ended June 30, 2008, respectively, an increase of \$0.5 million and \$1.4 million, or 4.8% and 7.6%, respectively, compared to the corresponding prior year periods.

Product net sales were \$8.5 million for the second quarter of 2008, an increase of \$1.2 million, or 17.2%, compared to the second quarter of 2007. Product net sales were \$15.8 million for the six months ending June 30, 2008, an increase of \$2.6 million, or 20.1%, compared to the corresponding period in 2007. Product market share gains were realized among both our large Tier I customers as well as our general markets customers and was driven by gains in the wireless cellsite power and the inverter product lines.

Services net sales were \$2.5 million for the second quarter of 2008, a decrease of \$0.7 million, or 22.6%, as compared to the second quarter of 2007. Services net sales were \$4.3 million for the six months ending June 30, 2008, a decrease of \$1.2 million, or 22.3%, compared to the corresponding period in 2007. The decrease in sales year to-date in the services segment was primarily from the revenue reduction in engineering and installation services provided for two key customers; however, during the second quarter one of the two customers began to spend at expected levels. In addition, we believe that our services net sales have been adversely impacted by customers that have been engaged in the consolidation occurring in the telecom industry. We do not believe that the reduction of services sales to our two key customers were market share losses.

As of June 30, 2008, our sales backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, was \$6.2 million, a \$0.2 million, or 2.6%, decrease from the comparable prior year period, but was a 37.3% increase of \$1.7 million from December 31, 2007 and a 30.2% increase of \$1.4 million from March 31, 2008. Product backlog of \$4.0 million was a \$0.1 million, or 3% increase from December 31, 2007 and was a \$0.3 million, or a 7.0% increase from March 31, 2008, while services backlog was \$2.2 million, a \$1.6 million, or 252%, increase from December 31, 2007 and was a \$1.2 million, or a 116.7% increase from March 31, 2008. Given the telecom seasonality, the second quarter is normally our highest quarter for sales orders in a given year. Second quarter 2008 bookings were 6.6% better than second quarter 2007.

Gross margin dollars were \$1.5 million and \$2.7 million, respectively, for the three and six months ended June 30, 2008, as compared to \$1.8 million and \$2.6 million, respectively, for the three and six months ended June 30, 2007. Gross margin as a percentage of net sales was 13.9% and 13.7% for the three and six months ended June 30, 2008, compared to 16.7% and 14.1%, respectively, for the comparable prior year periods. Second quarter gross margins were negatively impacted by the write-off of inventory totaling \$0.3 million and the slow ramp of the services business that continued into the second quarter. We are currently performing a detailed review of product life cycles and we anticipate that we will discontinue a number of older products in the second half of 2008. Depending on customer needs, this elimination of certain product lines could lead to an additional inventory write-off of materials that will no longer be of use. We will take these charges to operating earnings once determined.

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PECO II, INC.

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

For the quarter ended June 30, 2008, product gross margin was \$1.1 million, or 12.6% of net product sales, as compared to \$951 thousand, or 13.1% of net product sales for the corresponding period in 2007. The \$1.1 million of gross margin includes the inventory write-down of \$0.3 million noted above. We are targeting continued product gross margin improvements, excluding any inventory obsolescence charges in the second half of 2008, given the pricing actions we have taken and the rollout of our new small power product line.

The services gross margin was \$465 thousand for the second quarter of 2008, or 18.2% of net services sales, as compared to \$808 thousand, or 24.5% of net services sales for the second quarter of 2007, or a services gross margin decrease of 6.3%. The services gross margin deterioration was driven by lower than expected revenue performance in the quarter. The decrease in the services segment was primarily in engineering and installation services provided for two key customers. In both cases, we do not believe these were market share losses.

Second quarter 2008 operating expenses of \$2.8 million are \$0.1 million ahead of the first quarter of 2008 and are \$0.2 million ahead of the second quarter of 2007. On a year to-date basis operating expenses include \$557 thousand of costs related to the development and rollout of our new small power product platform. The Quantum product is in lab trials, currently undergoing customer evaluations. We expect that these products will begin to be sold in the market in the third quarter and start generating revenues by the fourth quarter of 2008. We also expect our engineering expenses to decline somewhat in the second half of the year as we roll out our small power to market. We anticipate that our selling expenses will increase in the second half of the year as we invest in our go to-market strategy for small power.

Research, development and engineering expense incurred was \$678 thousand and \$1.3 million respectively, for the three and six months ended June 30, 2008, up slightly from \$495 thousand and \$1.3 million, respectively for the three and six months ended June 30, 2007. As a percentage of net product sales, research, development and engineering expense was 8.0% for the quarter ended June 30, 2008, which was an increase of 1.2% from the second quarter of 2007. During the six months ending June 30, 2008, we have spent \$557 thousand in developing our new small power platforms which is currently being introduced to the market. Our new product introduction cycles include, at times, significant out-of-pocket costs to bring new products to the market and as such, research, development and engineering expenses will continue to move up and down, period to period, as we introduce new products. The vast majority of the out-of-pocket costs in support of small power will have been incurred by September 30, 2008.

Selling, general and administrative expense was \$2.1 million and \$4.2 million for the three and six months ended June 30, 2008, as compared to \$2.1 million and \$4.6 million, respectively, for the comparable prior year period. As a percentage of net sales, selling, general and administrative decreased to 19.3% for the quarter ended June 30, 2008 compared to 19.8% in the comparable prior year period. As a percentage of net sales, we expect selling general and administrative expenses to continue at the current rate in the near term as we ramp our revenues from our new power platforms.

The second quarter 2008 net loss of \$1.2 million was a reduction of approximately \$0.2 million from the first quarter of 2008, and was primarily attributed to the sequential revenue growth, offset by increased inventory obsolescence charges of \$0.3 million. The increased net loss, when compared to the second quarter of 2007, of \$0.5 million was driven primarily by reductions in services gross margins of \$0.3 million driven by the reduced business levels combined with the inventory obsolescence charge noted above.

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PECO II, INC.

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

Liquidity and Capital Resources

As of June 30, 2008, available cash and cash equivalents approximated \$7.7 million. We believe that cash and cash equivalents, anticipated cash flow from operations, and our credit facilities will be sufficient to fund our working capital and capital expenditure requirements for the next 12 months. Working capital at June 30, 2008 was \$14.8 million, which represented a working capital ratio of 2.7 to 1, compared to \$16.5 million at December 31, 2007, which represented a working capital ratio of 3.2 to 1. Capital expenditures for the six months ended June 30, 2008, totaled \$46 thousand. We continue our efforts to conserve cash.

Cash flows used for operating activities for the six months ended June 30, 2008, was \$82 thousand. This was primarily from the net loss, offset by reductions in working capital and other non-cash charges. There was \$175 thousand of cash used for investing activities which was primarily from the issuance of the note receivable, offset by the sale of equipment sold as a result of outsourcing. Cash provided by financing activities was \$8 thousand.

Cash flows provided by operating activities for the six months ended June 30, 2007, was \$759 thousand. This was primarily from reductions in accounts receivable and inventory, offset by a net loss and decreases in accounts payable. There was \$489 thousand of cash provided by investing activities which was primarily from the sale of equipment sold as a result of outsourcing. Cash provided by financing activities was \$1.2 million, which included the pay off of our credit line and the transfer of our restricted cash to cash available as National City has limited its requirements regarding restricted PECO II, Inc. cash to borrowed funds only. The credit line had a zero balance as of June 30, 2007, making \$3.5 million of cash available on the credit line.

Contractual Obligations

We have signed an agreement with National City Bank to provide all banking services and a \$3.5 million line of credit. As collateral for the line of credit, we established a \$3.5 million deposit account with the bank. As of June 30, 2008, the balance on the line of credit was \$0.

We do not currently plan to pay dividends.

Critical Accounting Policies and Estimates

In preparing the accompanying unaudited condensed consolidated financial statements and accounting for the underlying transactions and balances, we applied the accounting policies disclosed in the Notes to Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended December 31, 2007. For a detailed discussion of the critical accounting policies and estimates, see the Management Discussion and Analysis included in our Annual Report. There were no significant changes in these critical accounting policies and estimates in the second quarter of 2008, except for the recently adopted accounting pronouncements as discussed below.

Recently Adopted Accounting Pronouncements

Effective January 1, 2008, the Company adopted Financial Accounting Standards Board (FASB) Statement No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 applies to most current accounting pronouncements that require or permit fair value measurements. SFAS 157 provides a framework for measuring fair value and requires expanded disclosures about fair value methods and inputs by establishing a hierarchy for ranking the quality and reliability of the information used by management to measure and report amounts at fair value.

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PECO II, INC.

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

The Company has only partially applied the provisions of SFAS 157 as management has elected the deferral provisions of FASB Staff Position (FSP) SFAS 157-2 as it applies to nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The major categories of assets and liabilities that are recognized or disclosed at fair value on a nonrecurring basis include certain amounts of property and equipment and goodwill reported at fair value as a result of impairment testing, and certain other assets, liabilities and equity instruments recognized as a result of prior business combinations.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 provides guidance on various methods used to measure fair value including market, income and cost approaches. These approaches require the Company to utilize certain assumptions that market participants would use in pricing assets and liabilities, including assumptions about risk. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company attempts to utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Based on the inputs used in the valuation techniques, SFAS 157 requires the Company to classify the inputs under a fair value hierarchy that ranks the inputs based on their quality and reliability. Financial instruments carried at fair value will be classified and disclosed in one of the following three categories:

Level 1 Quoted market prices in active markets for identical assets or liabilities.

Level 2 Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3 Unobservable inputs that are not corroborated by market data.

The estimated fair values of the Company's short-term financial instruments, including cash and cash equivalents, receivables and payables arising in the ordinary course of business, and current portions of debt, approximate their individual carrying amounts due to the relatively short period of time between their origination and expected realization. The Company does not have any other financial instruments measured at fair value on a recurring basis that require further disclosure.

The Company does not have any financial instruments that required a cumulative-effect adjustment to beginning accumulated deficit upon adoption. There was no material impact to the Company's consolidated financial position, results of operations, or cash flows as a result of the adoption of SFAS 157.

Effective January 1, 2008, the Company adopted FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). SFAS 159 permits the Company to voluntarily choose, at specified election dates, to measure specified financial assets and liabilities and other items at fair value that are not currently required to be measured at fair value. Subsequent changes in fair value would then be required to be reported in earnings each reporting period. At the date of adoption, the Company did not elect the fair value option for eligible items that existed at January 1, 2008. Therefore, the adoption of SFAS 159 did not have any effect on the Company's consolidated financial position, results of operations, or cash flows. Any future effect will be dependent upon the nature and amount of eligible items that the Company elects to account for using the fair value option.

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PECO II, INC.

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

Forward-Looking Statements

Certain of the Company's statements in this Quarterly Report on Form 10-Q and the foregoing Management's Discussion and Analysis of Financial Condition and Results of Operation are not purely historical, and as such are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, but may not be limited to, all statements regarding the Company's and management's intent, beliefs, expectations, and plans, such as statements concerning the Company's future profitability, industry trends, operating results, and product development strategy. These forward-looking statements include numerous risks and uncertainties, including, without limitation: a general economic recession; a downturn in our principal customers' businesses; current and future mergers of key customers; the volatility in the communications industry; the demand for communications equipment generally and in particular for the products and services offered by the Company; the Company's ability to generate sales orders during fiscal 2008 and thereafter; the ability to develop and market new products and product enhancements; the potential environmental issues in regards to an aging manufacturing facility; the ability to attract and retain customers; competition and technological change; and successful implementation of the Company's business strategy. One or more of these factors have affected, and in the future could affect, the Company's business and financial results in future periods and could cause actual results to differ materially from plans and projections.

There can be no assurances that the forward-looking statements included herein will prove to be accurate, and issuance of such forward-looking statements should not be regarded as a representation of the Company, or any other person, that the objectives and plans of the Company will be achieved. In addition, this Quarterly Report on Form 10-Q contains time-sensitive information that reflects management's best analysis only as of the date of this report. PECO II does not undertake any obligation to publicly update or revise any forward-looking statements to reflect future events, information or circumstances that arise after the date of this release. Further information concerning issues that could materially affect financial performance related to forward-looking statements can be found in the Company's periodic filings with the Securities and Exchange Commission.

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

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK

Not applicable to smaller reporting companies.

ITEM 4T. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

As of June 30, 2008, the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer/Chief Financial Officer, of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934). Based upon such evaluation, our Chief Executive Officer/Chief Financial Officer concluded that such disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PECO II, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF

OPERATIONS (Cont.)

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

Item 1A. of Part I of our Annual Report on Form 10-K for the year ended December 31, 2007, includes a detailed discussion of our risk factors, as updated by Item 1A. of Part II of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2008. The information presented below updates the information provided in Item 1A. of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2008, and should be read in conjunction with the risk factors and information disclosed in our Annual Report on Form 10-K for the year ended December 31, 2007.

Although our common shares are currently in compliance with The NASDAQ Stock Market's continued listing standards, we cannot assure you that we will be able to maintain such compliance in the future.

From February 13, 2007, to May 22, 2008, we had not been in compliance with The NASDAQ Stock Market's Marketplace Rule 4310(c)(4), which requires the Company to maintain a \$1.00 per share minimum bid price. In an effort to regain compliance, our shareholders approved, and on May 7, 2008, we effectuated, a 1-for-10 reverse stock split. On May 22, 2008, we received a decision that NASDAQ would continue the listing of our common shares on The NASDAQ Stock Market. Although our common shares are currently in compliance with the NASDAQ Stock Market's continued listing standards, we cannot assure you that we will continue to meet all continued listing standards in the future.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

PECO II held its Annual Meeting of Shareholders on Tuesday, May 6, 2008. At this meeting, the shareholders approved the following management proposals:

Proposal 1: The election of three directors in Class II for three-year terms and until their successors are duly elected and qualified.

| | Number of Shares Voted | |
|-------------------|------------------------|-----------------------|
| | FOR | WITHHOLD AUTHORITY |
| Albert Chang | 19,619,890 | 1,889,709 |
| John G. Heindel | 19,539,004 | 1,970,595 |
| Thomas R. Thomsen | 16,909,506 | 4,600,093 |

Proposal 2: To approve a shareholder resolution to authorize the Board of Directors, in its sole and absolute discretion without further action of the shareholders, to amend the Company's Amended and Restated Articles of Incorporation to implement a reverse stock split of the Company's common shares, without par value, at a ratio of 1-for-10 at any time prior to December 31, 2008.

| Number of Shares Voted | | | |
|------------------------|---------|---------|------------|
| FOR | AGAINST | ABSTAIN | TOTAL |
| 20,105,949 | 886,796 | 516,852 | 21,509,597 |

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PECO II, INC.

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

ITEM 6. Exhibits

- 3.1 Amendment No. 1 to Amended and Restated Articles of Incorporation of the Company
- 31.1 Rule 13a-14(a) Certification of Chief Executive Officer and Chief Financial Officer
- 32.1 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer

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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.

Date: August 14, 2008

PECO II, Inc.

/s/ JOHN G. HEINDEL

John G. Heindel

Chairman, President, Chief Executive Officer,

Chief Financial Officer and Treasurer

(Principal Executive Officer and Principal Financial Officer)