PECO II INC
Form 10-Q
August 14, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: **June 30, 2009**

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)

Ohio	**34-1605456**

(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
1376 State Route 598, Galion, Ohio	**44833**
(Address of principal executive offices)	*(Zip Code)*

419-468-7600

(Registrant s telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required 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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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 ¨	Non-accelerated filer ¨	Smaller Reporting Company þ
Accelerated filer ¨	(Do not check if a 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 o No þ

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, 2009
Common Stock, without par value	2,850,860 shares

PECO II, INC.

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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, 2009 *(unaudited)*	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,010	$ 5,814
Accounts receivable, net	3,553	4,366
Inventories, net	8,412	8,533
Cost and earnings in excess of billings on uncompleted contracts	1,722	622
Prepaid expenses and other current assets	216	267
Assets held for sale	10	28
Restricted cash	923	834
Total current assets	19,846	20,464
Property and equipment, at cost:		
Land and land improvements	195	195
Buildings and building improvements	4,628	4,628
Machinery and equipment	2,978	2,895
Furniture and fixtures	5,521	5,518
	13,322	13,236
Less-accumulated depreciation:	(10,282)	(10,109)
Property and equipment, net	3,040	3,127
Other assets:		
Idle facility	800	800
Intangibles, net	2,212	2,748
Total assets	$ 25,898	$ 27,139
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Borrowings under line of credit	$ 923	$ 834

Bank overdrafts		994
Accounts payable	4,399	3,387
Billings in excess of cost and estimated earnings on uncompleted contracts	420	235
Accrued compensation expense	1,107	923
Accrued income taxes	43	56
Other accrued expenses	1,674	1,633
Total current liabilities	8,566	8,062
Shareholders equity:		
Common stock, no par value: 150,000,000 shares authorized; 2,850,861 and 2,816,527 shares issued at June 30, 2009 and December 31, 2008, respectively	3,616	3,573
Additional paid-in capital	121,970	121,901
Accumulated deficit	(108,254)	(106,397)
Total shareholders equity	17,332	19,077
Total liabilities and shareholders equity	$ 25,898	$ 27,139

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

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PECO II, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(In thousands, except for per share data)

	For the Three Months Ended June 30, 2009	For the Three Months Ended June 30, 2008	For the Six Months Ended June 30, 2009	For the Six Months Ended June 30, 2008
Net sales:				
Product	$ 6,434	$ 8,505	$ 11,855	$ 15,795
Services	3,493	2,552	5,555	4,273
	9,927	11,057	17,410	20,068
Cost of sales (exclusive of depreciation and amortization):				
Product	4,973	7,170	9,638	13,290
Services	2,568	2,084	4,343	3,510
	7,541	9,254	13,981	16,800
Gross margin	2,386	1,803	3,429	3,268
Operating expenses:				
Depreciation and amortization	370	381	741	762
Research, development and engineering	413	666	934	1,287
Selling, general and administrative	1,841	2,029	3,610	3,937
	2,624	3,076	5,285	5,986
Loss from operations	(238)	(1,273)	(1,856)	(2,718)
Interest income, net	8	41	17	105
Loss before income taxes	(230)	(1,232)	(1,839)	(2,613)
Income tax expense	(10)	(1)	(18)	(9)
Net loss	$ (240)	$ (1,233)	$ (1,857)	$ (2,622)
Net loss per common share:				
Basic and diluted	$ (0.08)	$ (0.45)	$ (0.65)	$ (0.95)
Weighted average common shares outstanding:				
Basic and diluted	2,841	2,755	2,837	2,751

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

PECO II, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(In thousands)

	For the Six Months Ended June 30 2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (1,857)	$ (2,622)
Adjustments to reconcile net loss to net cash provided by (used for) operating activities:		
Depreciation and amortization	741	763
Provision for bad debts	11	5
Provision for obsolete and excess inventories	178	447
Provision for product warranty	477	602
Gain on disposals of property and equipment	(1)	
Asset impairments		66
Compensation expense from share-based payments	111	180
Working capital changes:		
Accounts receivable	802	(222)
Inventories	(57)	398
Prepaid expenses and other current assets	(1,049)	(165)
Accounts payable other current liabilities	931	466
Net cash provided by (used for) operating activities	287	(82)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(119)	(46)
Issuance of note receivable		(250)
Proceeds from sale of property and equipment	21	121
Net cash used for investing activities	(98)	(175)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Transfer to restricted cash	(89)	
Net usage under line of credit agreement	89	
Net decrease in bank overdraft	(994)	
Proceeds from issuance of common shares ESPP	1	8

Net cash (used for) provided by financing activities.		(993)		8
Net change in cash		(804)		(249)
Cash and cash equivalents at beginning of period		5,814		7,935
Cash and cash equivalents at end of period	$	5,010	$	7,686
Supplemental disclosure of cash flow information:				
Income taxes paid	$	23	$	68
Interest paid		11		5

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

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, goodwill and other asset impairments, warranty costs, valuation allowance on tax assets, stock-based compensation, 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, 2008 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.

Reclassifications

In 2009, the Company s presentation of certain expenses within its consolidated statements of operations was changed. Depreciation and amortization expenses were previously recorded in the captions Cost of sales, Research, development and engineering and Selling, general and administrative. In the current year, depreciation and amortization expenses are now being presented separately under the caption Depreciation and amortization. The Company believes that this change in presentation provides a more meaningful measure of its cost of sales and other operating expenses. These reclassifications had no effect on reported consolidated loss from operations, net loss or per share amounts. Amounts presented for the prior periods have been reclassified to conform to the current presentation. The following table provides the amounts reclassified for the three and six months ended June 30, 2009 and June 30, 2008.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2009	2008	2009	2008
Amounts reclassified:				
Cost of sales	$ (254)	$ (262)	$ (508)	$ (524)

Research, development and engineering	(11)	(12)	(22)	(23)
Selling, general and administrative	(105)	(107)	(211)	(215)
Depreciation and amortization	370	381	741	762
Total costs and expenses	$	$	$	$

Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, receivables, payables and debt. Fair values of cash and cash equivalents, receivables and payables approximate carrying values due to their relatively short-term nature. The carrying amount of debt approximates fair value due to either the length of maturity or existence of interest rates that approximate prevailing market rates.

Subsequent Events

The Company has evaluated for disclosure all subsequent events occurring through August 14, 2009, the date the financial statements were issued and filed with the United States Securities and Exchange Commission.

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

2.

Recently Adopted and Issued Accounting Pronouncements

As permitted, management elected to defer adoption of Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, until 2009 for nonfinancial assets and liabilities measured at fair value on a nonrecurring basis. Accordingly, beginning January 1, 2009, management will apply the provisions of SFAS 157 to nonfinancial assets and liabilities as the nonrecurring fair value measurements are required. During 2009, there have been no fair value measurements on a nonrecurring basis of the Company s nonfinancial assets and liabilities that require further consideration or disclosure.

Effective January 1, 2009, we adopted SFAS 141(R), *Business Combinations*, and SFAS 160, *Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements*. These new standards significantly change the financial accounting and reporting of business combination transactions and noncontrolling (or minority) interests in consolidated financial statements. We have not entered into any business combination transactions during 2009; and therefore, the effect of implementing these standards will be dependent upon the nature and extent of future business combination transactions.

Effective January 1, 2009, we adopted the Financial Accounting Standards Board s Staff Position on EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1). Under the guidance of FSP EITF 03-6-1, unvested share-based awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are included in the computation of earnings per share pursuant to the two-class method described in SFAS 128, *Earnings per Share*. Before adoption, the Company already treated unvested share-based awards granted in share-based payment transactions as participating securities. As such, the adoption of FSP EITF 03-6-1 did not have any effect on the computation of earnings per share.

Effective for the quarterly period ended June 30, 2009, we adopted SFAS 165, *Subsequent Events*. The new standard provides guidance for the accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. It also requires us to disclose the date through which subsequent events were evaluated and whether that date represents the date the financial statements were issued or were available to be issued. The adoption of this standard did not have a material effect on our consolidated results of operations, financial position, or cash flows.

Effective for the quarterly period ended June 30, 2009, we adopted the FASB s Staff Position on FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. The FSP amends SFAS 107 and APB 28 to require disclosures about the fair value of financial instruments for interim reporting periods in addition to annual financial statements. The adoption of this standard does not have a material effect on our consolidated results of operations, financial position, or cash flows.

In June 2009, the FASB issued SFAS 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. The FASB Accounting Standards Codification (the Codification) will become the single source of authoritative U.S. generally accepted accounting principles (GAAP) to be applied by nongovernmental entities. The Codification does not change current U.S. GAAP, but is intended to simplify user access to all authoritative U.S. GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents will be superseded and all other accounting literature not included in the Codification is considered non-authoritative. The Codification will be effective for our quarterly reporting period ended September 30, 2009 and will not have a material effect on our consolidated results of operations, financial position, or cash flows.

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

3.

Segment Information

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

	For the Three Months Ended June 30, 2009	For the Three Months Ended June 30, 2008	For the Six Months Ended June 30, 2009	For the Six Months Ended June 30, 2008
Net sales:				
Product	$ 6,434	$ 8,505	$ 11,855	$ 15,795
Services	3,493	2,552	5,555	4,273
	$ 9,927	$ 11,057	$ 17,410	$ 20,068

	For the Three Months Ended June 30, 2009	For the Three Months Ended June 30, 2008	For the Six Months Ended June 30, 2009	For the Six Months Ended June 30, 2008
(Loss) income from operations:				
Product	$ (607)	$ (1,130)	$ (1,895)	$ (2,315)
Services	369	(143)	39	(403)
Consolidated loss from operations	$ (238)	$ (1,273)	$ (1,856)	$ (2,718)

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, 2009 and December 31, 2008 are summarized below:

	June 30, 2009	December 31, 2008
Raw materials	$ 9,602	$ 9,924
Work-in-process	337	303
Finished goods	1,343	1,106
Gross inventories	11,282	11,333
Allowance for obsolete and excess inventory	(2,870)	(2,800)
Inventories, net	$ 8,412	$ 8,533

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.

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

5.

Uncompleted Contracts

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

	June 30, 2009	December 31, 2008
Costs incurred on uncompleted contracts	$ 2,433	$ 2,500
Estimated earnings	510	500
	2,943	3,000
Less: Billings to date	1,641	2,613
	$ 1,302	$ 387

Included in the accompanying balance sheet under the following captions:

	June 30, 2009	December 31, 2008
Costs and estimated earnings in excess of billings on uncompleted contracts	$ 1,722	$ 622
Billings in excess of costs and estimated earnings on uncompleted contracts	(420)	(235)
	$ 1,302	$ 387

6.

Intangibles

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

	June 30,	December 31,
Intangible Assets with Determinable Lives	**2009**	**2008**

Customer relationships	$	2,000	$	2,000
Supply agreement		3,700		3,700
Total gross intangible assets		5,700	$	5,700
Less: Accumulated amortization		3,488		2,952
Intangibles, net	$	2,212	$	2,748

Amortization expense for the six months ending June 30, 2009 and 2008 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.

7.

Warranty

The Company s warranty activity for the six months ended June 30, 2009 and six months ended June 30, 2008 are summarized below:

		2009		2008
Accrued warranty cost, beginning of period	$	1,012	$	908
Warranty provision		477		602
Warranty claims		(337)		(489)
Accrued warranty cost, end of period	$	1,152	$	1,021

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

8.

Contingencies

The Company is periodically a party, both as plaintiff and defendant, to lawsuits and claims arising out of the normal course of business. If necessary, the Company records reserves for losses that are deemed to be probable and that are subject to reasonable estimates. As of June 30, 2009, management does not believe that there are any matters that may have a material adverse effect on the financial condition or results of operations of the Company.

9.

Loss Per Share

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2009	2008	2009	2008
	(Shares in thousands)			
Weighted-average shares outstanding - basic	2,841	2,755	2,837	2,751
Effect of potentially dilutive shares				
Weighted average in outstanding shares - dilutive	2,841	2,755	2,837	2,751

Due to the Company s net loss for the three and six months ended June 30, 2009 and 2008, 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.

10.

Stock-Based Compensation

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

	For the Three Months	For the Six Months

	Ended June 30,		Ended June 30,	
	2009	2008	2009	2008
Stock options	$ 14	$ 53	$ 22	$ 54
Restricted stock awards	46	64	88	125
Employee stock purchase plan		1	1	2
Total stock-based compensation expense	60	118	111	181
Tax effect on stock-based compensation expense				
Net effect on loss from operations	60	118	111	181

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.

Stock Options

The following table represents stock option activity for the six months ended June 30, 2009:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contract Life
Outstanding at December 31, 2008	192,402	$ 9.98	
Granted			
Exercised			
Forfeited/ Cancelled	(42,402)	9.64	
Outstanding at June 30, 2009	150,000	10.08	1.58 years
Exercisable at June 30, 2009	124,200	$ 10.57	1.18 years

PECO II, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

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

At June 30, 2009 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, 2009:

	Number of Shares		Weighted Average Grant Date Fair Value
Nonvested at December 31, 2008	45,000	$	3.92
Awarded	33,732		2.82
Vested	(1,583)		3.16
Nonvested at June 30, 2009	77,149	$	3.45

At June 30, 2009, there was $157 of unrecognized compensation expense from non-vested restricted stock awards that is expected to be recognized over a weighted-average remaining service period of 1.04 years.

11.

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, 2009 include $48 in sales and $4,291 in purchases ($77 in sales and $3,544 in purchases for the six months ended June 30, 2008). At June 30, 2009, the Company had balances of $5 and $823 included in accounts receivable and accounts payable, respectively.

12.

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 2009, sales to three companies comprised 73.8% of total sales. Sales to our top customer included $7,045 in product and $1,567 in services, our second highest customer included $622 in product and $2,691 in services, and our third highest customer included $464 in product and $454 in services.

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.

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 otherwis

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 service 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 completed its purchase of Alltel and Embarq has merged with Century Telecom. During the third quarter of 2009, AT&T is expected to acquire Centennial Wireless. 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, and deploying 3G data services and have begun to announce plans to deploy WIMAX and LTE networks.

While the telecommunications market is extremely volatile, capital expenditure spending expanded by the mid single digits in 2007 and 2008 and analysts have projected further growth in 2009. In the event that capital spending does not grow in 2009, we believe we are positioned to take market share based on our industry leading responsiveness capability.

In 2009, we believe the merger and acquisition activity noted above has resulted in a slowing of 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 2009 year-to-date revenues for this product have increased 40.1%. The QuantumÔ Power System, introduced to the market in 2008, 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.

PECO II, INC.

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

The Quantum Power System has several distinctive features that optimize the user experience. Our innovative QuickLoadÔ 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-ViewÔ 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 growth in 2009 was primarily driven by a major customer contract that was awarded to us in late 2008.

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.

Looking forward, we will continue to focus our efforts on delivering the service 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.

In the second quarter of 2009, we were awarded a nationwide maintenance contract for the DC power component of a Tier II Wireline service provider s network. Additionally, we had six new account wins, most of which are with our new small power platform. Further, we had wins at three existing accounts deploying new cabinet solutions.

Lastly, in July 2009, PECO II received USDA (United States Department of Agriculture) Rural Utilities Services (RUS) acceptance for certain models of our power products. The USDA, through the RUS process, provides programs to finance rural America s telecommunications infrastructure.

Results of Operations

Our second quarter 2009 financial performance reflects the impact of the slowing economy, offset by our improved operational performance. Our net sales decreased to $9.9 million and $17.4 million for the three and six months ended June 30, 2009, respectively, a decrease of $1.1 million and $2.7 million, or 10.2% and 13.2%, respectively, compared to the corresponding prior year periods.

Product net sales were $6.4 million for the second quarter of 2009, a decrease of $2.1 million, or 24.4%, compared to the second quarter of 2008. Product net sales were $11.9 million for the six months ending June 30, 2009, a decrease of $3.9 million, or 24.9%, compared to the corresponding period in 2008. We attributed this reduction in product revenues to the impact of both the slowing economy and merger and acquisition activity among our customers, which resulted in a slowdown in orders during 2009.

Services net sales were $3.5 million for the second quarter of 2009, an increase of $0.9 million, or 36.8%, compared to the second quarter of 2008. Services net sales were $5.5 million for the six months ending June 30, 2009, an increase of $1.3 million, or 30.0%, compared to the corresponding period in 2008. This growth was primarily attributed to a contract with a major service provider that was awarded to PECO II in the fourth quarter of 2008 for engineering and installation services.

PECO II, INC.

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

As of June 30, 2009, our sales backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, was $7.2 million, a $1.0 million, or 15.8%, increase from the comparable prior year period, a $4.7 million, or 183.0%, increase from December 31, 2008, and a $2.2 million, or 43.1% increase, from March 31, 2009. Product backlog of $3.4 million as of June 30, 2009 represented a 15.9% decline over the $4.0 million product backlog recorded as of June 30, 2008 and was a $0.4 million, or a 13.7% increase from March 31, 2009. The services backlog was $3.8 million as of June 30, 2009, which represented a 73.8% increase over the $2.2 million services backlog recorded as of June 30, 2008 and was a $1.8 million, or a 85.8% increase from March 31, 2009. Given the telecom seasonality, the second quarter is normally our highest quarter for sales orders in a given year. We expect that to be the case this year. Second quarter 2009 bookings were 3.2% less than second quarter 2008 due to decreases in the product segment. This growth in backlog was totally attributable to our services business segment.

Gross margin dollars were $2.4 million and $3.4 million, respectively, for the three and six months ended June 30, 2009, as compared to $1.8 million and $3.3 million, respectively, for the three and six months ended June 30, 2008. Gross margin as a percentage of net sales was 24.0% and 19.7% for the three and six months ended June 30, 2009, compared to 16.3% for both of the comparable prior year periods. This improvement was primarily driven by increased services margins of $0.5 million with growth in the engineering and installation business volume related to the contract award noted above.

For the quarter ended June 30, 2009, product gross margin was $1.5 million, or 22.7% of net product sales, as compared to $1.3 million, or 15.7% of net product sales for the corresponding period in 2008, notwithstanding the revenue decline of $2.1 million. The product margin improvement was primarily attributable to a number of price increases and product enhancements that have been implemented which have resulted in a reduction in product support costs and reduced obsolescence charges combined with a favorable sales volume mix.

The services gross margin was $925 thousand for the second quarter of 2009, or 26.5% of net services sales, as compared to $468 thousand, or 18.3% of net services sales for the second quarter of 2008, or a services gross margin increase of 8.2%. The services gross margin improvement was driven by the increased volume of engineering and installation business combined with the successful completion of a number of projects significantly ahead of budget. We do not expect to maintain the 26.5% gross margin level moving forward.

Second quarter 2009 operating expenses of $2.6 million remained flat when compared to the first quarter of 2009 and are $0.5 million less than of the second quarter of 2008. The reduced level of operating expenses versus 2008 was directly attributable to cost reduction actions implemented to address the current economic climate.

Research, development and engineering expense incurred was $413 thousand and $934 thousand respectively, for the three and six months ended June 30, 2009, down from $666 thousand and $1.3 million, respectively for the three and six months ended June 30, 2008. As a percentage of net product sales, research, development and engineering expense was 6.4% for the quarter ended June 30, 2009, which was a decrease of 1.4% from the second quarter of 2008. With the enhancements that have been implemented in our product portfolio over the past two years, current level of expenditures are believed to be adequate to fund the ongoing product development work that is required to respond to our customer requirements.

Selling, general and administrative expense was $1.8 million and $3.6 million for the three and six months ended June 30, 2009, as compared to $2.0 million and $3.9 million respectively, for the comparable prior year period. As a percentage of net sales, selling, general and administrative increased slightly to 18.5% for the quarter ended June 30, 2009, compared to 18.4% in the comparable prior year period. As a percentage of net sales, we expect selling general and administrative expenses to decline in the near term as we grow services business segment revenues.

PECO II, INC.

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

Net loss was $0.2 million and $1.9 million for the three and six months ended June 30, 2009, as compared to $1.2 million and $2.6 million, respectively, for the comparable prior year period. The $1.0 million reduction in net loss compared to the second quarter of 2008 was driven primarily by improved services gross margins of $0.5 million resulting from strong revenue growth, attributed to a significant service provider contract that was awarded to PECO II in the fourth quarter of 2008, combined with a $0.4 million reduction in operating expenses noted above.

Liquidity and Capital Resources

As of June 30, 2009, available cash and cash equivalents approximated $5.0 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, 2009 was $11.3 million, which represented a working capital ratio of 2.3 to 1, compared to $12.4 million at December 31, 2008, which represented a working capital ratio of 2.5 to 1. Capital expenditures for the six months ended June 30, 2009, totaled $119 thousand. We continue our efforts to conserve cash.

Cash flows provided by operating activities for the six months ended June 30, 2009, was $287 thousand. While this included a net loss, it was offset by non-cash charges and reductions in working capital. There was $98 thousand of cash used for investing activities which was primarily from capital expenditures offset by the sale of equipment sold as a result of outsourcing. Cash used for financing activities was $993 thousand from the net decrease in bank overdraft.

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 a note, offset by the sale of equipment sold as a result of outsourcing. Cash provided by financing activities was $8 thousand.

Contractual Obligations

We have 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, the Company maintains a deposit account with the bank. As of June 30, 2009, the balance on the line of credit was $0.9 million. As such, $0.9 million of the deposit account is reflected as restricted cash.

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, 2008. 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 2009, except for the recently adopted accounting pronouncements as discussed below.

Recently Adopted and Issued Accounting Pronouncements

As permitted, management elected to defer adoption of Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, until 2009 for nonfinancial assets and liabilities measured at fair value on a nonrecurring basis. Accordingly, beginning January 1, 2009, management will apply the provisions of SFAS 157 to nonfinancial assets and liabilities as the nonrecurring fair value measurements are required. During 2009, there have been no fair value measurements on a nonrecurring basis of the Company s nonfinancial assets and liabilities that require further consideration or disclosure.

PECO II, INC.

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

Effective January 1, 2009, we adopted SFAS 141(R), *Business Combinations*, and SFAS 160, *Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements*. These new standards significantly change the financial accounting and reporting of business combination transactions and noncontrolling (or minority) interests in consolidated financial statements. We have not entered into any business combination transactions during 2009; and therefore, the effect of implementing these standards will be dependent upon the nature and extent of future business combination transactions.

Effective January 1, 2009, we adopted the Financial Accounting Standards Board s Staff Position on EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1). Under the guidance of FSP EITF 03-6-1, unvested share-based awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are included in the computation of earnings per share pursuant to the two-class method described in SFAS 128, *Earnings per Share*. Before adoption, the Company already treated unvested share-based awards granted in share-based payment transactions as participating securities. As such, the adoption of FSP EITF 03-6-1 did not have any effect on the computation of earnings per share.

Effective for the quarterly period ended June 30, 2009, we adopted SFAS 165, *Subsequent Events*. The new standard provides guidance for the accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. It also requires us to disclose the date through which subsequent events were evaluated and whether that date represents the date the financial statements were issued or were available to be issued. The adoption of this standard did not have a material effect on our consolidated results of operations, financial position, or cash flows.

Effective for the quarterly period ended June 30, 2009, we adopted the FASB s Staff Position on FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*. The FSP amends SFAS 107 and APB 28 to require disclosures about the fair value of financial instruments for interim reporting periods in addition to annual financial statements. The adoption of this standard does not have a material effect on our consolidated results of operations, financial position, or cash flows.

In June 2009, the FASB issued SFAS 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. The FASB Accounting Standards Codification (the Codification) will become the single source of authoritative U.S. generally accepted accounting principles (GAAP) to be applied by nongovernmental entities. The Codification does not change current U.S. GAAP, but is intended to simplify user access to all authoritative U.S. GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents will be superseded and all other accounting literature not included in the Codification is considered non-authoritative. The Codification will be effective for our quarterly reporting period ended September 30, 2009 and will not have a material effect on our consolidated results of operations, financial position, or cash flows.

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 2009 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, 2009, 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.

PART II. OTHER INFORMATION

ITEM 4.

SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

PECO II held its Annual Meeting of Shareholders on Tuesday, May 19, 2009. At this meeting, the shareholders approved the following management proposals:

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

	Number of Shares Voted	
	FOR	WITHHOLD AUTHORITY
James L. Green	1,539,208	264,984
Richard W. Orchard	1,286,160	518,032
Matthew P. Smith	1,563,536	240,656

ITEM 6.

Exhibits

Exhibit Number	Description
10.1	Supply Agreement, dated May 18, 2009, between the Company and DEI* (Incorporated by reference to the appropriate exhibit to the Company s Current Report on Form 8-K, dated May 18, 2009 and filed on May 22, 2009)
10.2	Description of the Material Terms of PECO II, Inc. s Non-Equity Incentive Compensation Plan for Fiscal 2009 (Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K, dated May 18, 2009, and filed on May 22, 2009)
10.3	Release and Waiver Agreement, dated June 29, 2009, between PECO II, Inc. and Guy Kevin Borders (Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K, dated June 29, 2009, and filed on July 6, 2009)
10.4	Release and Waiver Agreement, dated July 6, 2009, between PECO II, Inc. and Jacquie L. Boyer (Incorporated by reference to the appropriate exhibit to the Company's Current Report on Form 8-K, dated June 30, 2009, and filed on July 7, 2009)

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

*

Portions of this Exhibit have been given confidential treatment by the Securities Exchange Commission.

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, 2009

PECO II, Inc.

By:	/s/ JOHN G. HEINDEL
	John G. Heindel
	Chairman, President, Chief Executive Officer,
	Chief Financial Officer and Treasurer
	(Principal Executive Officer and Principal
	Financial Officer)