WSI INDUSTRIES, INC.
Form 10-Q
January 12, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended November 28, 2004

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 0-619

WSI Industries, Inc.

(Exact name of registrant, as specified in its charter)

Minnesota	41-0691607
(State or other jurisdiction of incorporation of organization)	(I. R.S. Employer Identification No.)
Monticello, Minnesota	55362
(Address of principal executive offices)	(Zip Code)

(763) 295-9202

(Registrant's telephone number, including area code)

Osseo, Minnesota

(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 [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes [ ] No [X]

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

2,557,629 shares of common stock were outstanding as of December 31, 2004.

WSI INDUSTRIES, INC.

AND SUBSIDIARIES

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Part I. Financial Information

Item I. Financial Statements

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS	NOVEMBER 28, 2004 (Unaudited)
CURRENT ASSETS:	
Cash and cash equivalents	$ 631,681
Accounts receivable	1,527,587
Inventories	1,075,091
Prepaid and other current assets	73,243
Deferred tax assets	198,225
Total Current Assets	3,505,827
Property, Plant and Equipment - Net	3,697,774
Deferred tax assets	1,673,522
Intangible assets, net	2,397,657
	$ 11,274,780
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Trade accounts payable	$ 1,065,463
Accrued compensation and employee withholdings	285,577
Miscellaneous accrued expenses	82,809
Current portion of long-term debt	322,688
Total Current Liabilities	1,756,537
Long term debt, less current portion	2,519,920
STOCKHOLDERS' EQUITY:	
Common stock, par value $.10 a share; authorized 10,000,000 shares; issued and outstanding 2,557,629 shares	255,763
Capital in excess of par value	1,837,441
Retained earnings	4,905,119
Total Stockholders' Equity	6,998,323
	$ 11,274,780

See notes to condensed consolidated financial statements

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	13 we
	November 28 2004
Net sales	$ 3,874,04
Cost of products sold	3,301,11
Gross margin	572,92
Selling and administrative expense	494,36
Interest and other income	(1,46
Interest and other expense	40,00
Earnings from operations before income taxes	40,02
Income tax expense	14,40
Net earnings	$ 25,61
Basic earnings per share	$ .0
Diluted earnings per share	$ .0
Cash dividend per share	$ .037
Weighted average number of common shares	2,557,62
Weighted average number of common and dilutive potential common shares	2,618,60

See notes to condensed consolidated financial statements.

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WSI INDUSTRIES, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	13 weeks end	
	November 28, 2004	Nov
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net earnings	$ 25,615	$
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	159,544	
Amortization	1,653	
Deferred taxes	14,409	
Changes in assets and liabilities:		
Decrease in accounts receivable	229,695	
Increase in inventories	(151,868)	
Decrease in prepaid expenses	20,151	
Increase in accounts payable and accrued expenses	229,165	
Net cash provided by operations	528,364	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant and equipment	(18,407)	
Net cash used in investing activities	(18,407)	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments of long-term debt	(77,130)	
Dividends paid	(95,912)	
Net cash used in financing activities	(173,042)	
NET INCREASE IN CASH AND CASH EQUIVALENTS	336,915	
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	294,766	
CASH AND CASH EQUIVALENTS AT END OF REPORTING PERIOD	$ 631,681	$
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$ 40,232	$
Income taxes	$ -	$

See notes to condensed consolidated financial statements.

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS:

The condensed consolidated balance sheet as of November 28, 2004, the condensed consolidated statements of income for the thirteen weeks ended November 28, 2004 and November 30, 2003 and the condensed consolidated statements of cash flows for the thirteen weeks then ended, respectively, have been prepared by the Company without audit. In the opinion of management, all adjustments (which include normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows for all periods presented have been made.

The condensed consolidated balance sheet at August 29, 2004 is derived from the audited consolidated balance sheet as of that date. 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. Therefore, these condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2004 annual report to shareholders. The results of operations for interim periods are not necessarily indicative of the operating results for the full year.

2. DEBT AND LINE OF CREDIT:

The Company has renewed its revolving credit agreement in the maximum amount of $1 million with its bank. Interest on the renewed agreement is at the bank's prime rate. It contains restrictive provisions concerning yearly capital expenditures, maximum debt to net worth and minimum current ratios, as well a minimum debt service coverage ratio. The Company has not accessed the Revolver since the original inception of the agreement on December 2, 2002. The credit agreement is secured by all non-real property assets of the Company and expires December 31, 2005.

3. INVENTORIES

Inventories consist primarily of raw material, work-in-progress (WIP) and finished goods. The following table breaks out the values in each category net of the inventory valuation allowances of $422,684 and $409,249 at November 28, 2004 and August 29, 2004, respectively.

	November 28, 2004	August 29, 2004
Raw material	$ 312,812	$ 277,359
WIP	431,008	359,432
Finished goods	331,271	286,432
	$ 1,075,091	$ 923,223

4. GOODWILL AND INTANGIBLE ASSETS

Under SFAS No. 142, Goodwill and Other Intangible Assets, goodwill and intangible assets are deemed to have indefinite lives and are not amortized but are subjected to annual impairment tests in accordance with the statement. Other intangible assets will continue to be amortized over their useful lives.

The Company adopted the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of fiscal 2002. The Company performed its annual impairment test in the fourth quarter of fiscal 2004 and has determined no charge is warranted.

Goodwill and other intangible assets resulting from acquisitions of business and the formation of the Company consist of the following:

	November 28, 2004	August 29, 2004
Goodwill	$ 2,428,264	$ 2,428,264
Less accumulated amortization	308,595	308,595
	$ 2,119,669	$ 2,119,669
Other identifiable intangibles:		
Organization Costs	$ 285,000	$ 285,000
Less accumulated amortization	36,217	36,217
	$ 248,783	$ 248,783
Deferred financing	$ 33,063	$ 33,063
Less accumulated amortization	3,858	2,204
	$ 29,205	$ 30,859
	$ 2,397,657	$ 2,399,311

5. DEBT:

The Company purchased a new manufacturing facility and office located in Monticello, Minnesota on May 3, 2004. In order to facilitate the purchase, the Company entered into two mortgage agreements. The first mortgage was with its bank for $1,360,000 with a monthly payment of $8,307 based on a 25-year amortization schedule. Interest is at 5.37% with a provision to adjust the rate after 5 years to the monthly five-year Treasury yield plus 2.5%. The entire principal balance is due May 1, 2014.

The second mortgage is with the City of Monticello Economic Development Authority (MEDA) for $350,000 with a monthly payment of $1,483 based on a 25-year amortization schedule. Interest is at 2.0%. The entire balance is due after five years on May 1, 2009. The indebtedness to the bank is secured pursuant to a mortgage and security agreement and fixture financing statement and the debt to MEDA is secured by a mortgage.

4. EARNINGS PER SHARE:

The following table sets forth the computation of basic and diluted earnings per share:

	Thirteen weeks ended	
	November 28, 2004	November 30, 2003
Numerator for basic and diluted earnings per share:		
Net earnings	$ 25,615	$ 56,370
Denominator:		
Denominator for basic earnings per share - weighted average shares	2,557,629	2,551,129
Effect of dilutive securities:		
Employee and non-employee options	60,975	77,962
Dilutive common shares Denominator for diluted earnings per share	2,618,604	2,629,091
Basic earnings per share	$ .01	$ .02
Diluted earnings per share	$ .01	$ .02

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Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

and

RESULTS OF OPERATIONS

Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Condition and Results of Operations discuss our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities.

We believe that the estimates, assumptions and judgments involved in the accounting policies described below have the greatest potential impact on our financial statements, so we consider these to be our critical accounting policies. Because of the uncertainty inherent in these matters, actual results could differ from the estimates we used in applying the critical accounting policies. Within the context of these critical accounting policies, we are not currently aware of any reasonably likely event that would result in materially different amounts being reported.

Reclassification: Certain prior year items have been reclassified to conform to the current year presentation.

Allowance for Excess and Obsolete Inventory: Inventories, which are composed of raw materials, work in process and finished goods, are valued at the lower of cost or market. On a periodic basis, the Company analyzes the level of inventory on hand, its cost in relation to market value and estimated customer requirements to determine whether write-downs for excess or obsolete inventory are required. Actual customer requirements in any future periods are inherently uncertain and thus may differ from our estimates. If actual or expected requirements were significantly greater or lower than the established reserves, we would record a reduction or increase to the obsolescence allowance in the period in which we made such a determination.

Goodwill Impairment: The Company evaluates the valuation of its goodwill according to the provisions of SFAS 142 to determine if the current value of goodwill has been impaired. To do this the Company determines the discounted present value of anticipated cash flows based on anticipated results of operations for the coming years. If we have changes in events or circumstances, including reductions in anticipated cash flows generated by our operations, goodwill could become impaired which would result in a charge to earnings.

Deferred Taxes: The Company accounts for income taxes using the liability method. Deferred income taxes are provided for temporary difference between the financial reporting and tax bases of assets and liabilities. A valuation allowance would be set up should the realization of any deferred taxes become less likely than not to occur. The valuation allowance is analyzed periodically by the Company and may result in income tax expense different than statutory rates.

Revenue Recognition: Revenues from sales of product are recorded upon shipment when all of the following criteria of Staff Accounting Bulletin No. 101 have been met: persuasive evidence of an arrangement exists, delivery has occurred, the price to the customer is fixed or determinable and collectibility is reasonably

assured. Credit losses relating to customers have been minimal and within management's expectations. Based on management's evaluation of uncollected accounts receivable at the end of each year, bad debts are provided for on the allowance method. Accounts are considered delinquent if they are 120 days past due. The Company mitigates its credit risk by performing credit checks and actively pursuing past due accounts.

Results of Operations:

Net sales were $3,874,000 for the quarter ending November 28, 2004, an increase of 38% or $1,068,000 from the same period of the prior year. The increase was due primarily to higher sales in the Company's recreational vehicle market.

Gross margin remained steady at 15% for the quarter ending November 28, 2004 versus the prior year quarter. Gains from the increase in volume were offset by higher supplies and machine repair expense as well as inefficiencies derived from operating in two buildings. With the purchase of the Monticello, Minnesota facility described in Note 4, the Company has been operating out of the Monticello building as well as its Osseo, Minnesota facility. The Company anticipates that it will be fully relocated by the end of its second fiscal quarter in February 2005.

Selling and administrative expense of $572,000 for the quarter ending November 28, 2004 was $150,000 higher than in the prior year. Selling and administrative expense was negatively affected by $168,000 in costs associated with the relocation of operations to the new facility in Monticello, as well the costs associated with maintaining the Osseo building.

Interest expense in the first quarter of fiscal 2005 was $40,000, which was $24,000 higher than the first quarter of fiscal 2004 amount of $16,000. The increase is attributable to higher debt due to the mortgages on the Monticello building, as well as additional capitalized leases.

The Company recorded income tax expense at an effective tax rate of 36% for the quarters ended November 28, 2004 and November 30, 2003, respectively.

Liquidity and Capital Resources:

On November 28, 2004, working capital was $1,749,000 compared to $1,756,000 at August 29, 2004. The ratio of current assets to current liabilities at November 28, 2004 was 2.0 to 1.0 compared to 2.16 to 1.0 at August 29, 2004. The Company's cash balance increased $337,000 during the first quarter, primarily from collections of accounts receivable.

As discussed in the Notes to Condensed Consolidated Financial Statements, the Company renewed its $1,000,000 revolving credit facility with its bank subsequent to the end of the fiscal 2005 first quarter. Interest on the new agreement is at prime. No amounts have been borrowed since the closing of the original agreement in December 2002.

It is the Company's belief that its current cash balance, plus future internally generated funds and its line of credit, will be sufficient to enable the Company to meet its working capital requirements through the end of fiscal 2005.

Cautionary Statement:

Statements included in this Management's Discussion and Analysis of Financial Condition and Results of Operations, in future filings by the Company with the Securities and Exchange Commission, in the Company's press releases and in oral statements made with the approval of an authorized executive officer that are not historical or current facts are "forward-looking statements." These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made.

The following important factors, among others, in some cases have affected and in the future could affect the Company's actual results and could cause the Company's actual financial performance to differ materially from that expressed in any forward-looking statement: (i) the Company's ability to obtain additional manufacturing programs and retain current programs; (ii) the loss of significant business from any one of its current customers could have a material adverse effect on the Company; (iii) the Company was dependent upon one customer for 79% of its revenues in fiscal year 2004 and expects that a significant portion of its future revenue will be derived from this customer; (iv) a significant downturn in the industries in which the Company participates could have an adverse effect on the demand for Company services; (v) our sales are concentrated in a limited number of highly competitive industries, each with a limited number of customers; (vi) the prices of our products are subject to downward pressure from customers and market pressure from competitors; (vii) the Company's ability to curtail its costs and expenses for new manufacturing programs, commensurate with expected revenues; (viii) the Company's ability to comply with covenants of its credit facility; (ix) fluctuations in operating results due to, among other things, changes in customer demand for our product, in our manufacturing costs and efficiently of our operations; (x) a trend among our customers toward outsourcing manufacturing to foreign operations.

The foregoing list should not be construed as exhaustive and the Company disclaims any obligation subsequently to revise any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures.

The Company's Chief Executive Officer, Michael J. Pudil, and Chief Financial Officer, Paul D. Sheely, have evaluated the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon that review, they have concluded that these controls and procedures are effective in ensuring that material information related to the Company is made known to them by others within the Company.

(b) Changes in Internal Controls over Financial Reporting.

There have been no significant changes in internal control financial reporting that occurred during the fiscal period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION:

ITEM 6. EXHIBITS

A. The following exhibits are included herein:

Exhibit 10.1	Amendment and Modification of Revolving Line of Credit dated January 1, 2005 and Excel Bank.
Exhibit 31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14 and 15d-14
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14 and 15d-14
Exhibit 32	Certificate pursuant to 18 U.S.C. Section 1350.

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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.

WSI INDUSTRIES, INC.

Date: January 11, 2005 /s/ Michael J. Pudil

Michael J. Pudil, President & CEO

Date: January 11, 2005 /s/ Paul D. Sheely

Paul D. Sheely, Vice President, Finance & CFO

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