WSI INDUSTRIES, INC.
Form 10QSB
June 20, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549
FORM 10-QSB

(Mark One)

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

For the quarterly period ended May 25, 2008

OR

o **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 small business issuer, as specified in its charter)

Minnesota	41-0691607
(State or other jurisdiction of incorporation of organization)	(IRS Employer Identification No.)
213 Chelsea Road Monticello, Minnesota	55362
(Address of principal executive offices)	(Zip Code)

(763) 295-9202

(Issuer s telephone number, including area code)

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

Indicate by check whether the small business issuer (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 small business issuer 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 small business issuer is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

Indicate by check mark if the small business issuer is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No þ

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:

2,825,111 shares of common stock were outstanding as of June 18, 2008.

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
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Item I. Financial Statements

WSI INDUSTRIES, INC.
AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	May 25, 2008	August 26, 2007
Assets		
Current Assets:		
Cash and cash equivalents	$ 1,619,384	$ 1,626,801
Accounts receivable	3,418,622	3,054,050
Inventories	2,464,958	1,899,299
Prepaid and other current assets	289,495	154,793
Deferred tax assets	169,124	162,535
Total Current Assets	7,961,583	6,897,478
Property, Plant and Equipment Net	5,730,874	4,520,382
Deferred tax assets	677,751	954,162
Goodwill and other assets, net	2,374,514	2,379,473
	$ 16,744,722	$ 14,751,495
Liabilities and Stockholders Equity		
Current Liabilities:		
Trade accounts payable	$ 2,244,360	$ 2,200,544
Accrued compensation and employee withholdings	581,694	680,419
Other accrued expenses	41,861	125,038
Current portion of long-term debt	938,155	518,718
Total Current Liabilities	3,806,070	3,524,719
Long-term debt, less current portion	4,076,970	3,328,694
Stockholders Equity:		
Common stock, par value $.10 a share; authorized 10,000,000 shares; issued and outstanding 2,825,111 and 2,731,165 shares, respectively	282,511	273,117
Deferred compensation	(244,433)	(26,577)
Capital in excess of par value	2,519,250	2,214,922

Retained earnings	6,304,354	5,436,620
Total Stockholders Equity	8,861,682	7,898,082
	$ 16,744,722	$ 14,751,495

See notes to condensed consolidated financial statements

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

	13 weeks ended		39 weeks ended	
	May 25, 2008	May 27, 2007	May 25, 2008	May 27, 2007
Net sales	$ 6,702,648	$ 5,237,690	$ 19,098,840	$ 13,807,227
Cost of products sold	5,497,337	4,248,881	15,409,688	11,336,389
Gross margin	1,205,311	988,809	3,689,152	2,470,838
Selling and administrative expense	596,806	582,566	1,823,463	1,555,023
Interest and other income	(16,099)	(14,494)	(163,855)	(64,072)
Interest expense	75,123	51,493	219,384	139,777
Earnings from operations before income taxes	549,481	369,244	1,810,160	840,110
Income tax expense	192,018	140,313	633,256	319,242
Net earnings	$ 357,463	$ 228,931	$ 1,176,904	$ 520,868
Basic earnings per share	$ .13	$ .08	$ .43	$ .19
Diluted earnings per share	$ .13	$ .08	$ .42	$ .19
Cash dividend per share	$ .0375	$ .0375	$ .1125	$ .1125
Weighted average number of common shares outstanding, basic	2,763,895	2,706,792	2,740,577	2,691,385
Weighted average number of common shares outstanding, diluted	2,859,507	2,768,480	2,811,097	2,733,635

See notes to condensed consolidated financial statements.

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

	39 weeks ended	
	May 25, 2008	May 27, 2007
Cash Flows From Operating Activities:		
Net earnings	$ 1,176,904	$ 520,868
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	592,230	365,380
Amortization	4,959	4,959
Gain on disposal of equipment	(94,869)	(18,000)
Deferred taxes	616,635	307,180
Stock option compensation expense	121,224	48,192
Changes in assets and liabilities:		
Increase in accounts receivable	(364,572)	(571,356)
Increase in inventories	(565,659)	(224,665)
(Increase) decrease in prepaid expenses	(134,702)	17,554
Increase (decrease) in accounts payable and accrued expenses	(552,341)	285,699
Net cash provided by operations	799,809	735,811
Cash Flows From Investing Activities:		
Proceeds from sales of equipment	123,073	18,000
Purchase of property, plant and equipment	(171,106)	(143,340)
Net cash used in investing activities	(48,033)	(125,340)
Cash Flows From Financing Activities:		
Payments of long-term debt	(492,108)	(309,948)
Issuance of common stock	42,085	14,405
Dividends paid	(309,170)	(302,560)
Net cash used in financing activities	(759,193)	(598,103)
Net Increase (Decrease) In Cash And Cash Equivalents	(7,417)	12,368
Cash And Cash Equivalents At Beginning Of Year	1,626,801	1,282,717
Cash And Cash Equivalents At End Of Reporting Period	$ 1,619,384	$ 1,295,085

Supplemental cash flow information:

Cash paid during the period for:		
Interest	$ 219,659	$ 139,867
Income taxes	$ 10,530	$ 4,630
Payroll withholding taxes in cashless stock option exercise	$ 414,255	$ 78,634
Non-cash investing and financing activities:		
Acquisition of machinery through capital lease	$ 1,659,820	$ 753,309
Deferred tax benefit from exercise of stock options	$ 346,813	$

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 May 25, 2008, the condensed consolidated statements of operations for the thirteen and thirty-nine weeks ended May 25, 2008 and May 27, 2007 and the condensed consolidated statements of cash flows for the thirty-nine 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 26, 2007 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 generally accepted accounting principles 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 2007 annual report to shareholders. The results of operations for interim periods are not necessarily indicative of the operating results for the full year.

2. INVENTORIES

Inventories consist primarily of raw material, work-in-progress (WIP) and finished goods and are valued at the lower of cost or market value:

	May 25, 2008	August 26, 2007
Raw material	$ 949,469	$ 537,033
WIP	1,029,467	963,702
Finished goods	486,022	398,564
	$ 2,464,958	$ 1,899,299

The Company did not dispose of any significant obsolete inventory during the quarter ended May 25, 2008 and therefore there was no material effect on gross margin from any dispositions.

3. GOODWILL AND INTANGIBLE ASSETS:

Goodwill and other intangible assets consist of costs resulting from business acquisitions which total $2,368,452 (net of accumulated amortization of $344,812). The Company assesses the valuation or potential impairment of its goodwill by utilizing a present value technique to measure fair value by estimating future cash flows. The Company constructs a discounted cash flow analysis based on various sales and cost assumptions to estimate the fair value of the Company (which is the only reporting unit). The result of the analysis performed in the fiscal 2007 fourth quarter did not show an impairment of goodwill. The Company will analyze goodwill more frequently should changes in events or circumstances, including reductions in anticipated cash flows generated by our operations, occur.

The Company recorded $33,063 of deferred financing costs incurred in connection with mortgages entered into in order to purchase the Company s facility in Monticello, Minnesota. The costs are being amortized over five years on a straight-line basis with the Company incurring $1,653 of amortization expense for the quarters ended May 25, 2008 and May 27, 2007, respectively. Accumulated amortization on the deferred financing costs amounted to $27,001 and $20,388 at May 25, 2008 and August 26, 2007, respectively.

4. EARNINGS PER SHARE:

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

	Thirteen weeks ended		Thirty-nine weeks ended	
	May 25, 2008	May 27, 2007	May 25, 2008	May 27, 2007
Numerator for basic and diluted earnings per share:				
Net earnings	$ 357,463	$ 228,931	$ 1,176,904	$ 520,868
Denominator				
Denominator for basic earnings per share weighted average shares	2,763,895	2,706,792	2,740,577	2,691,385
Effect of dilutive securities:				
Employee and non-employee options	95,612	61,688	70,520	42,250
Dilutive common shares				
Denominator for diluted earnings per share	2,859,507	2,768,480	2,811,097	2,733,635
Basic earnings per share	$ .13	$ .08	$ .43	$ .19
Diluted earnings per share	$ .13	$ .08	$ .42	$ .19

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 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 base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the result of which forms the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Results may differ from these estimates due to actual outcomes being different from those on which we based our assumptions. The estimates and judgments utilized are reviewed by management on an ongoing basis and by the audit committee of our board of directors at the end of each quarter prior to the public release of our financial results.

The critical accounting policies and estimates followed in the preparation of the financial information contained in this Quarterly Report on Form 10-QSB are the same as those described in the Company s Annual Report on Form 10-KSB for the year ended August 26, 2007. Refer to the Annual Report on Form 10-KSB for detailed information on accounting policies.

Results of Operations:

Net sales were $6,703,000 for the quarter ending May 25, 2008 compared to $5,238,000 in the same period of the prior year, an increase of 28%. Year-to-date sales for the first three quarters of fiscal 2008 were $19,099,000 compared to $13,807,000 in the prior year, an increase of 38%. The Company s fiscal third quarter sales increased due to an increase in the Company s energy business and the Company s ATV business offset by decreases in sales to the Company s motorcycle market. The overall increase in 2008 year-to-date sales as compared to 2007 were due to factors similar to those of the fiscal 2008 third quarter.

Sales from the Company s recreational vehicle market amounted to $3,444,000 and $4,078,000 for the quarters ended May 25, 2008 and May 27, 2007, respectively. Year-to-date sales for the Company s recreational vehicle market were $10,703,000 and $10,948,000 for the three quarters ended May 25, 2008 and May 27, 2007, respectively. Sales for the quarter and year-to-date ended May 25, 2008 for the Company s ATV market continue to be strong and are up 55% year-to-date over the prior year. Sales to the Company s motorcycle market were lower due to both a previously announced volume reduction, but also due to a model year changeover occurring in the Company s fiscal third quarter which normally occurs primarily in the Company s fiscal fourth quarter.

Sales from the Company s energy business amounted to $2,471,000 and $6,131,000 for the quarter and year-to-date ended May 25, 2008, respectively. In the prior year, the Company had $410,000 and $434,000 in sales for the quarter and year-to-date ended May 27, 2007, with the increases in fiscal 2008 due to the ramping up of production and new programs. In March 2008, the Company announced that it had secured a new customer in the energy industry and it expects that it will recognize its initial sales to this customer in the Company s fiscal 2008 fourth quarter.

Sales from the Company s aerospace and defense markets amounted to $592,000 and $511,000 for the quarter ended May 25, 2008 and May 27, 2007, respectively. Year-to-date sales for the Company s aerospace and defense markets were $1,662,000 and $1,582,000 for the three quarters ended May 25, 2008 and May 27, 2007, respectively. The Company believes these increases are a result from increases in business with certain of its existing customers as well as new sales from recently secured customers in these markets.

Sales from the Company s biosciences market totaled $162,000 and $207,000 for the quarter ended May 25, 2008 and May 27, 2007, respectively. Year-to-date sales for the biosciences market were $455,000 and $797,000 for the three quarters ended May 25, 2008 and May 27, 2007, respectively. The decreases in sales are due to the Company scaling back its involvement in this market and concentrating on higher margin components.

Sales from the Company s other revenue markets are at or under 1% of total sales in the current year and are immaterial to the Company s revenues as a whole.

Gross margin decreased to 18.0% for the quarter ending May 25, 2008 versus 18.9% in the prior year quarter. The decrease was due primarily to a sales mix that included parts with higher material content and therefore generally lower gross margins. Year-to-date gross margins increased to 19.3% from 17.9% with the increase primarily related to higher sales volume.

Selling and administrative expense was $597,000 for the quarter ending May 25, 2008 versus $583,000 in the prior year quarter. Year-to-date selling and administrative expense of $1,823,000 was $268,000 higher than the comparable prior year period due to increases in compensation costs.

Interest expense in the third quarter of fiscal 2008 was $75,000 as compared to $51,000 in the prior year quarter. Year-to-date interest expense for fiscal 2008 was $219,000 versus $140,000 in the prior year. Interest expense is up due to new capitalized leases entered into during fiscal 2008.

The Company recorded income tax expense at an effective tax rate of 35% for the quarter and year-to-date periods ended May 25, 2008 and 38% for the quarter and year-to-date periods ended May 27, 2007.

Liquidity and Capital Resources

On May 25, 2008, working capital was $4,156,000 compared to $3,373,000 at August 26, 2007. The increase in working capital is attributable primarily to increases in the level of accounts receivable and inventories coming from an increased level of business. The ratio of current assets to current liabilities at May 25, 2008 was 2.09 to 1.0 compared to 1.96 to 1.0 at August 26, 2007.

The Company renewed its $1,000,000 revolving credit facility with its bank during the Company s second quarter of fiscal 2008. Interest on the new agreement is at the bank s prime rate. At May 25, 2008, the Company did not have a balance owing under this revolving line of credit agreement nor had it borrowed any funds during fiscal 2008.

The Company paid quarterly dividends of $.0375 per share of its common stock in each of the first three quarters of fiscal 2008 and 2007. The dividend payments for the first three quarters of fiscal 2008 and fiscal 2007 totaled $309,000 and $303,000, respectively.

It is the Company s belief that its internally generated funds, as well as its line of credit, will be sufficient to enable the Company to meet its working capital requirements during the next 12 months.

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 risks and uncertainties, as well as others not now anticipated, 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 Company s ability to timely and cost effectively ramp up new programs; (iii) the loss of significant business from any one of its current customers could have a material adverse effect on the Company; (iv) the Company was dependent upon one customer for 75% of its revenues in fiscal year 2007 and expects that a significant portion of its future revenue will be derived from this customer; (v) a significant downturn in the industries in which the Company participates could have an adverse effect on the demand for Company services; (vi) our sales are concentrated in a limited number of highly competitive industries, each with a limited number of customers; (vii) the prices of our products are subject to a downward pressure from customers and market pressure from competitors; (viii) the Company s ability to curtail its costs and expenses for new manufacturing programs, commensurate with expected revenues; (ix) the Company s ability to comply with covenants of its credit facility; (x) fluctuations in operating results due to, among other things, changes in customer demand for our product in our manufacturing costs and efficiencies of our operations; and (xi) 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 3. 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 this review, they have concluded that these controls and procedures are effective.

(b) Changes in Internal Controls over Financial Reporting.

There have been no 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 31.1 Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) of the Exchange Act.

Exhibit 31.2 Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) of the Exchange Act

Exhibit 32 Certification pursuant to 18 U.S.C. § 1350.

SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WSI INDUSTRIES, INC.

Date: June 18, 2008 /s/ Michael J. Pudil

Michael J. Pudil, President & CEO

Date: June 18, 2008 /s/ Paul D. Sheely

Paul D. Sheely, Vice President, Finance & CFO