WINLAND ELECTRONICS INC
Form 10KSB
March 28, 2007

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

FORM 10-KSB

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

For the Fiscal Year Ended December 31, 2006 Commission File No.: 1-15637

WINLAND ELECTRONICS, INC.
(Name of small business issuer in its charter)

Minnesota	41-0992135
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

1950 Excel Drive, Mankato, Minnesota 56001
(Address of principal executive offices)

(507) 625-7231
(Issuer's telephone number)

Securities registered pursuant to Section 12(b) of the Exchange Act:

Title of Each Class	Name of Exchange
Common Stock, $.01 par value	American Stock Exchange
Preferred Stock Purchase Rights	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Exchange Act: None

Check whether the Issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. o

Check whether the Issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the 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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form and no disclosure will be contained, to the best of Issuer's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. o

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

Issuer's revenues for fiscal year ended December 31, 2006: $37,945,004

The aggregate market value of the Common Stock held by non-affiliates as of March 16, 2007 was approximately $11,121,997 based on the closing sale price of the Issuer's Common Stock on such date.

There were 3,600,856 shares of Common Stock, $.01 par value, outstanding as of March 16, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Documents incorporated by reference pursuant to Rule 12b-23: Portions of the Company's Proxy Statement for its 2007 Annual Meeting are incorporated by reference into Part III.

Transitional Small Business Disclosure Format (check one) Yes o No þ

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PART I

ITEM 1. DESCRIPTION OF BUSINESS

GENERAL

Winland Electronics, Inc. (the "Company") was incorporated as a Minnesota corporation in October 1972. The Company designs and manufactures custom electronic controls and assemblies primarily for original equipment manufacturer ("OEM") customers, providing services from early concept studies through complete product realization. Revenues from OEM customers provided 91.3% of the Company's total revenue in 2006. The Company continues to maintain a presence in the security/industrial markets with the sales of its own line of proprietary environmental security products, which accounted for 8.7% of the Company's total revenue in 2006.

PRODUCTS

The Company designs, produces and distributes products in two product categories defined as "Electronic Manufacturing Services ("EMS") for OEM Customers" and "Proprietary Products and Services," primarily for the Security/Industrial markets.

Electronic Manufacturing Services for OEM Customers:

The Company designs and manufactures circuit board assemblies and higher level products that incorporate them for many OEM customers. The Company is positioned to offer complete solutions to OEM customer needs by providing value-added services that complement the Company's contract manufacturing capabilities. The services provided may include product concept studies, product design, printed circuit board design, design for manufacturing, higher level assembly and box build, and legacy support. These services differentiate the Company from the competition and increase customer satisfaction, confidence, and loyalty. The Company views EMS customers as strategic partners and works to provide these "partners" with high level customer care and technical services. Although the Company has purchase orders in place from many of its OEM customers that are scheduled to be fulfilled in 2007, these customers may terminate their relationship with the Company at any time, with certain cancellation provisions. Therefore, there is no assurance that the Company will continue to be engaged by any of these customers. Sales to OEM customers accounted for 91.3% and 89.9% of the Company's total net sales during 2006 and 2005, respectively.

Proprietary Products:

The Company's proprietary products include an established family of environmental security products that can monitor critical environments. The Company's security/industrial products include simple and sophisticated microprocessor and mechanically controlled sensors and alarms. These products monitor and detect critical environmental changes, such as changes in temperature or humidity, water leakage and power failures. The Company's "ALERT" series of products may be connected to many burglar or fire alarm panels to monitor and report unfavorable environmental conditions. Proprietary product sales accounted for 8.7% and 10.1% of the Company's total net sales for 2006 and 2005, respectively.

Marketing and Distribution:

The Company markets its design and manufacturing services to prospective OEM customers primarily through direct sales and marketing efforts along with a referral network to promote its services and uncover new opportunities. Management believes that a direct sales force augmented by a referral network strategy effectively provides Winland an opportunity to build market share in the EMS (Electronic Manufacturing Services) market. One of the Company's key marketing objectives is to form long-term business partnerships with OEM customers by working directly with the customer to develop a degree of technological interdependence between the Company and the customer. With this in mind, the Company has worked to identify new OEM customers that need a broad range of services in addition to their manufacturing needs. The Company plans to achieve continued growth in OEM sales by providing its customers added value with a customer intimate strategy that is centered in exceptional service, application specific technical expertise, and exceptional quality.

The Company markets its proprietary products through dealers and wholesalers, in-house direct marketing and sales efforts, instrumentation catalogs, and national and regional trade expositions. Currently, the Company sells its environmental security products through a distribution network of over 900 locations in the United States, Canada, Mexico, and Europe. The Company continues to explore opportunities with its proprietary product lines, to expand into additional markets, as well as design new products.

Source of Materials:

Raw material components and some subassemblies are purchased from outside vendors, qualified through a vendor qualification process and inspected in accordance with Company inspection policies before being incorporated into products. Certain purchased components and subassemblies are manufactured to design specifications furnished by the Company, while others are standard off-the-shelf items. The Company utilizes multiple sources for the off-the-shelf components, but generally maintains only one source for the items manufactured to design specifications. If the Company loses one or more of its major components suppliers, and needs to seek alternative suppliers, some delay and possible additional costs may be incurred while obtaining alternative sources.

In addition to manufacturing its own products, the Company has contracted with companies in the United States and foreign countries to provide both finished goods assemblies and component assemblies designed to the Company's specifications. Although alternative sources for such items may be found, if the Company were to lose one or more of these suppliers, some delay and additional costs may be incurred while obtaining alternative sources.

Patents, Trademarks and Licenses:

The Company holds federal trademark registrations for marks used in the Company's business as follows: WATERBUG, TEMP ALERT, ENVIRONMENTAL SECURITY and ENVIROALERT.

Seasonality and Working Capital:

Due to the diversity of the Company's customer mix, the Company's business and working capital needs are not seasonal. Changes in the types of products produced for significant OEM customers could materially affect the seasonality of the Company's business in future years.

Significant Customers:

The Company has worked to develop long-term relationships with its OEM customers that are mutually beneficial. Due to the nature of the Company's contract manufacturing relationships, there is a significant degree of dependence between these customers and the Company. Net sales to Select Comfort Corporation (Select) equaled $14.5 million, or 38.3% of total net sales in 2006 and $15.9 million, or 52.1% of total net sales in 2005. Select is a Minnesota based air-sleep system manufacturer in the bedding industry. Net sales to XATA Corporation (XATA) equaled $7.2 million, or 18.9% of total net sales in 2006 and $1.5 million, or 4.9% of total net sales in 2005. XATA is a Minnesota based onboard fleet management solutions provider for the trucking industry. No other customer equaled or exceeded 10% of net sales for 2006 or 2005.

In 2006, nearly 41.1% of all proprietary products sales were to one of the world's largest security products distributors.

Competition:

The Company's business includes the design and manufacturing of custom electronic controls and assemblies for OEM customers and the development and marketing of proprietary security/industrial products. The competition for the contract design and manufacturing services offered by the Company is very competitive, both domestically and internationally. To enhance its ability to compete effectively, the Company has continued to invest in the development of its work force and technically advanced design production and test equipment. The Company distinguishes itself from many competitors by offering full service solutions to its contract design and manufacture customers. Significant competitive factors in this market include development and design expertise, quality of manufacturing, price, capacity, and company reputation. The Company believes that it performs favorably with respect to these competitive factors in the markets it serves. The Company's foreign competitors are often more aggressive in pricing their services and many of the Company's competitors have greater capacity, and are better-known and better-financed than the Company.

Competition among the security/industrial products has increased the last several years as additional companies have introduced competing products. The Company believes, however, that its products offer desirable features at competitive prices. Significant competitive factors in the market for security/industrial products include product effectiveness and features, price, reliability and company reputation. The Company believes that it competes favorably with respect to product effectiveness, features, price and reliability. However, given the Company's size and relatively small presence in this market, many of the Company's competitors have an advantage by being larger, better-known and better-financed.

Research and Development:

Throughout 2006, the Company has worked to provide full-service solutions to its OEM customers by offering varied design technologies such as wireless communications and embedded software design for control systems. The Company's engineering department is staffed with experienced electrical and software engineers that provide a wide range of customer services, including: conceptual design; custom enclosures and 3D modeling; board level, subsystem, and high-level assembly; PCB layout; analog and digital design, embedded systems and software; sensors, power and motor controls, and low power radio frequency design. The Company believes that with its internal engineering department and approved outside engineering consultants it will be able to meet the current needs of its customer base. The Company spent $642,330 or 1.7% of net sales for research and development expenses for the year ended December 31, 2006, compared to $798,138 or 2.6% of net sales for 2005.

Effect on Environmental Regulations:

There are two European Union ("EU") directives which could affect our business and results. The Restriction of the use of Certain Hazardous Substances ("RoHS") became effective on July 1, 2006, and restricts within the EU the distribution of products containing certain substances, including lead, which is the most relevant restricted substance to the Company.

The second EU directive is the Waste Electrical and Electronic Equipment directive, effective in August 2005, under which a manufacturer or importer will be required, at its own cost, to take back and recycle all of the products it either manufactured in or imported into the EU.

Since both of these directives affect the worldwide electronics supply-chain, we have made collaborative efforts with our suppliers and customers to develop compliant processes and products. The continued cost of such efforts, the degree to which we will be expected to absorb such costs, the impact that the directive may have on product shipments and our liability for non-compliant product is not yet known, but could have a material effect on our operations and results.

Evaluations of controls required by Section 404 of the Sarbanes-Oxley Act:

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act and related regulations implemented by the SEC, are creating uncertainty for public companies, increasing legal and financial compliance costs and making some activities more time consuming. We will be evaluating our internal controls systems to allow management to report on, and our independent auditors to attest to, our internal controls. We will be performing the system and process evaluation and testing (and any necessary remediation) required to comply with the management certification and auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act. While we anticipate being able to fully implement the requirements relating to internal controls and all other aspects of Section 404 by our December 31, 2007 deadline, we cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, we may be subject to sanctions or investigation by regulatory authorities, including the SEC. This type of action could adversely affect our financial results or investors' confidence in our company and our ability to access capital markets and could cause our stock price to decline. In addition, the controls and procedures that we will implement may not comply with all of the relevant rules and regulations of the SEC. If we fail to develop and maintain effective controls and procedures, we may be unable to provide the required financial information in a timely and reliable manner. Further, if we acquire any company in the future, we may incur substantial additional costs to bring the acquired company's systems into compliance with Section 404.

Foreign Operations and Export Sales:

The Company derived less than 1% of its revenues from sales outside the United States for both 2006 and 2005.

Personnel:

At December 31, 2006, the Company had 143 employees (138 full-time and 5 part-time). During 2006 and 2005, the Company also used temporary labor services during peak production times. The Company is not subject to a collective bargaining agreement, and it considers its relations with its employees to be good.

ITEM 2. DESCRIPTION OF PROPERTY

The Company owns its office and manufacturing facility located in Mankato, Minnesota. The 58,000 square foot building consists of 15,500 square feet of office space, 32,500 square feet of manufacturing space and 10,000 square feet of warehouse space, all of which is used by the Company. Management believes the current facility adequately supports the Company’s present and near future operations. Management believes its property is adequately covered by insurance. The Company’s office and manufacturing facility is subject to mortgages with an aggregate debt of $826,394 as of December 31, 2006.

ITEM 3. LEGAL PROCEEDINGS

None.

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

None.

EXECUTIVE OFFICERS OF THE COMPANY

The name and ages of all of the Company's executive officers and the positions held by them are listed below.

Name	Age	Position
Lorin E. Krueger	51	President, Chief Executive Officer, Secretary and Director
Glenn A. Kermes	46	Chief Financial Officer
Terry E. Treanor	44	Vice President of Manufacturing
Dale A. Nordquist	52	Senior Vice President of Sales and Marketing
Gregory W. Burneske	45	Vice President of Engineering

Lorin E. Krueger has served as our Chief Executive Officer since June 2001 and as our President since January 1999. In addition, Mr. Krueger has served as Secretary since 1983. Mr. Krueger, who has been an employee of the Company since 1976, served in several other positions, including Chief Operating Officer from January 1999 until June 2001, Senior Vice President of Operations from March 1987 until January 1999, and Vice President from January 1977 to March 1987.

Glenn A. Kermes has served as our Chief Financial Officer since October 2006. From September 2004 to June 2006, Mr. Kermes served as Vice President and Chief Financial Officer of Ross Manufacturing, a manufacturer of frozen dessert equipment. From January 2004 to September 2004, Mr. Kermes served as North American Controller for the Kendro Division of SPX Corporation. Mr. Kermes served as Operations Controller for the Newell Rubbermaid Hand Tools Division from July 2002 to January 2004. Prior to that, he served in several other financial positions.

Terry E. Treanor has served as our Vice President of Manufacturing since June 1996. He joined the Company in 1994 serving in various capacities, including Quality Assurance Manager and Operations Manager. Mr. Treanor was employed by Onan Corp., a power generation company, from January 1985 until July 1994, serving most recently as Supplier Quality Engineer.

Dale A. Nordquist has served as our Senior Vice President of Sales and Marketing since December 2002. From October 2001 to December 2002, Mr. Nordquist was our Vice President of Sales - EMS Western Region. From May 1999 to October 2001, Mr. Nordquist served as Vice President of Sales and Marketing for Quickdraw Conveyor Systems, Inc., which filed for Chapter 7 bankruptcy in January 2001 and was acquired by MagStar Technologies, Inc. in February 2001. From 1981 to May 1999, Mr. Nordquist served as Vice President of Sales and Marketing for HEI, Inc., a Minnesota based designer and manufacturer of ultra-miniature electronic devices and high technology products incorporating these devices.

Gregory W. Burneske has served as our Vice President of Engineering since January 2006. In May 2004, Mr. Burneske joined Winland as our Director of Engineering Services. From 1989 to May 2004, Mr. Burneske was employed by Plexus Technology Group, Inc. in various positions, including design engineer, a project manager and as the manager of analog and RF systems development.

PART II

ITEM 5. MARKET FOR COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

The Company's Common Stock is listed on the American Stock Exchange ("AMEX") under the symbol WEX. The following table sets forth the high and the low bid quotations, as reported by AMEX.

Fiscal Year Ended December 31, 2006	Low	High
First Quarter	3.37	5.75
Second Quarter	2.95	7.19
Third Quarter	3.25	3.90
Fourth Quarter	3.02	4.19
Fiscal Year Ended December 31, 2005		
First Quarter	3.95	5.19
Second Quarter	3.11	5.09
Third Quarter	3.20	7.44
Fourth Quarter	3.15	5.43

On March 16, 2007, the fair market value of the Company's Common Stock was $3.33 based on the closing sale price quoted by AMEX on that date. As of December 31, 2006, the Company had approximately 397 shareholders of record.

The Company has never paid cash dividends on its Common Stock. The Board of Directors presently intends to retain earnings for use in the Company's business and does not anticipate paying cash dividends on Common Stock in the foreseeable future. Any future determinations as to the payment of dividends will depend on the financial condition of the Company, restrictive debt covenants and such other factors as are deemed relevant by the Board of Directors. There were no dividends paid on Common Stock during 2006.

ITEM 6: MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

RESULTS OF OPERATIONS - 2006 vs. 2005

Net Sales: The Company recorded net sales of $37,945,004 for the year ended December 31, 2006, an increase of $7,512,044 or 24.7% from $30,432,960 for 2005. Nine new OEM customers provided 19.5% of this increase along with increased net sales to several long term customers. The increase in net sales to OEM customers was offset, in part, by a 8.3% reduction in net sales to Select Comfort. The Company was successful in introducing 164 new or revised line items for new and existing customers. Sales of Winland's proprietary products, primarily the security/industrial sector increased 6.5% to $3,286,980 for 2006 compared to $3,086,555 for 2005. As a percentage of total sales, proprietary product sales were 8.7% and 10.1% for the twelve months ended December 31, 2006 and 2005, respectively.

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The Company's Original Equipment Manufacture (OEM) customers have given the Company purchase orders and forecasts having an aggregate value of $19.6 million to be completed during 2007. The Company expects to receive additional orders from current OEM customers for 2007 and future production. Although the Company has purchase orders in place from many of its OEM customers, which are scheduled to be fulfilled in 2007, these customers may terminate their relationship with the Company at any time, with certain cancellation provisions. Therefore, there is no assurance that the Company will continue to be engaged by any of these customers.

On March 20, 2006, the Company entered into a new agreement with Select Comfort, its largest customer, which replaced a prior agreement with Select Comfort that granted the Company exclusive rights within the U.S. to supply certain products to Select Comfort. Under the terms of the new agreement, the Company has revised the pricing of the products it manufactures for Select Comfort and the new pricing represents a lower overall margin contribution to the Company. Under the new agreement, the Company will be one of two suppliers of electronic assemblies to Select Comfort and expects to receive approximately 50 percent of Select Comfort's total electronics assembly demand. The new agreement calls for periodic performance reviews for quality, delivery and price.

The Company has continued to provide a full range of Electronic Manufacturing Services (EMS) to OEM customers, delivering product needs from early concept through product realization. The Company continues to explore additional geographic regions to market its OEM services, primarily through networking with referral sources in the Chicago and Minneapolis areas. The loss of any significant OEM customer would likely have an adverse effect on the Company's short-term, and potentially long-term, results.

Cost of Sales: Cost of sales was $31,439,758 or 82.9% of net sales for year ended December 31, 2006, compared to $23,134,362 or 76.0% of net sales for the same period in 2005. The Company includes material and supplies, direct labor and other manufacturing expenses in its computation of cost of sales. Other manufacturing expenses, some of which are included in overhead, include, but are not limited to, indirect manufacturing labor and related benefits and expenses, depreciation and maintenance of manufacturing equipment and software, freight expense, purchasing expenses, warehousing expenses, warranty expense, inventory scrap and write-offs, an allocation for facility and information technology usage and product liability insurance.

Costs that are capitalized in work in process and finished goods inventory include all of the above, except certain expenses such as warranty expense, inventory scrap and write-offs and certain freight costs.

Gross Profits: Gross profits can fluctuate from period to period due to a variety of factors, including, but not limited to, sales volume, product mix, and plant efficiency. Gross profit was $6,505,246 or 17.1% of net sales for the year ended December 31, 2006 compared to $7,298,598 or 24.0% of net sales for the same period in 2005. Gross profit dollars decreased 10.9% for 2006 compared to 2005. The decrease in gross profit as a percentage of sales is attributable to reduced margins on Select Comfort sales due to adjusted pricing with the new agreement, continued margin pressure from other customers on existing products and costs of introducing new or revised products to manufacturing. In addition, gross profits decreased due to increases in indirect personnel expenses of $388,752, research & development application of $333,423 for specific jobs, depreciation expenses of $199,685 and plant re-layout expenses of $121,120, offset, in part, by decreases in employee training of $31,811 and prototype supplies of $26,178.

Operating Expenses: Operating expenses were $4,758,916 or 12.5% of net sales for the year ended December 31, 2006 compared to $4,079,049 or 13.4% for the same period ended December 31, 2005. Operating expenses include: 1) general and administrative expenses such as administrative salaries and related benefits and expenses, professional and legal fees, investor relations expenses, board of directors fees, and directors and officers insurance and other general office supplies and expenses; 2) sales and marketing expenses including salaries and related benefits and expenses for direct outside salesmen, program management, customer service and the senior vice president of sales and marketing, sales commissions, trade show expenses, web site development and maintenance, promotional materials, advertising expense and an allocation for facility and information technology usage; and 3) research and development expense such as salaries and related benefits and expenses, labor and material associated with new product development, depreciation and maintenance of research and development equipment and software, warranty expense associated with engineering projects and an allocation of facility and information technology usage.

General and administrative expenses were $2,479,584 or 6.5% of net sales for the year ended December 31, 2006 compared to $1,901,478 or 6.2% of net sales for the same period in 2005. The increase in general and administrative expense for the year ended December 31, 2006 is attributed to increased professional fees of $270,574, personnel expenses of $152,539, board of directors expense of $68,495, telephone expense of $19,389 offset in part by declines in investor relations expense of $41,932 and a $22,192 reduction in bad debt write offs. Of the significant increase in professional fees, $89,099 relates to consulting services to aid developing and documenting the Company's internal control documentation for compliance with Sarbanes-Oxley Section 404. The Company spent $51,153 on its executive search for a CFO while $40,488 was spent for consultants who aided in developing strategic initiatives for the Company and $40,000 for merger and acquisition initiatives.

Sales and marketing expenses (including project management) were $1,637,002 or 4.3% of net sales for the year ended December 31, 2006 compared to $1,379,433 or 4.5% of net sales for the same period in 2005. The increase in sales and marketing expense for the year ended December 31, 2006 is attributed to increased personnel expenses of $198,750, promotional and trade show expenses of $44,839, travel expenses of $22,666, and professional search fees of $17,745 offset in part by declines in employee training of $10,903 and advertising expenses of $10,652.

Research and development expenses (including the development of new Company products as well as design services and support to the OEM customer base) were $642,330 or 1.7% of net sales for year ended December 31, 2006, compared to $798,138 or 2.6% of net sales for the same period in 2005. For the twelve months ended December 31, 2006, the Company's customers had increased research and development projects. Labor cost of $333,423 for these projects was transferred to Engineering Cost of Goods Sold and included in total Cost of Sales shown above. This transfer in COGS was offset in part by increased research and development expenses of $115,733, personnel expenses of $107,232 and professional search fees of $19,500.

Interest Expense: Interest expense was $187,570 or 0.5% of net sales and $124,485 or 0.4% of net sales for the year ended December 31, 2006 and 2005, respectively. During 2006, the Company paid down $586,852 of long-term debt, added new long term debt of $957,317 and had outstanding balances on its revolving credit agreement.

Net Income: The Company reported net income of $1,038,096 or $0.29 per basic share and $0.28 per diluted share for t