

PECO II INC
Form 10-K
March 31, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2009

Commission file number: 000-31283

**PECO
II,
INC.**
(Exact
name of
registrant
as
specified
in its
charter)

Ohio
(State or other jurisdiction of
incorporation or organization)

34-1605456
(I.R.S. Employer
Identification No.)

1376
State
Route
598,
Galion,
Ohio
44833
(Address
of
principal
executive
offices)
(Zip
Code)

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Registrant's telephone number, including area code: (419) 468-7600

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

Common Shares, without par value (Title of each class)	Nasdaq (Name of each exchange on which registered)
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Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 No

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 No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>

(Don't 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 No

The aggregate market value of the registrant's common shares, without par value, held by non-affiliates of the registrant was approximately \$5.3 million on June 30, 2009.

On March 16, 2010, the registrant had outstanding 2,859,466 of its common shares, without par value.

DOCUMENTS INCORPORATED BY REFERENCE

None

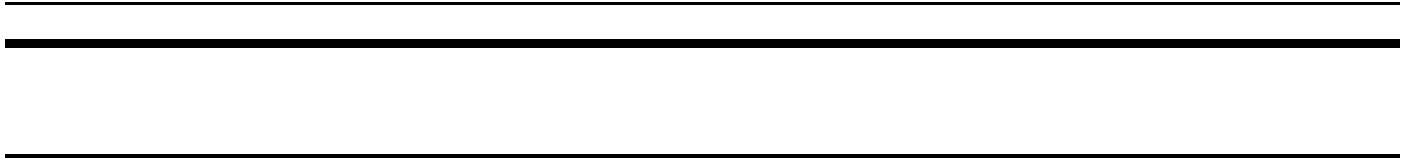


TABLE OF CONTENTS

		Page
PART I		
Item 1.	Business	1
Item 1A.	Risk Factors	7
Item 1B.	Unresolved Staff Comments	11
Item 2.	Properties	11
Item 3.	Legal Proceedings	12
Item 4.	(Removed and Reserved)	12
PART II		
Item 5.	Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	12
Item 6.	Selected Financial Data	13
Item 7.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	13
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	18
Item 8.	Financial Statements and Supplementary Data	18
Item 9.	Changes in and Disagreements With Accountants on Accounting and Financial Disclosures	36
Item 9A(T).	Controls and Procedures	36
Item 9B.	Other Information	37
PART III		
Item 10.	Directors, Executive Officers and Corporate Governance	37
Item 11.	Executive Compensation	39
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	44
Item 13.	Certain Relationships and Related Transactions, and Director Independence	48

Item 14.	Principal Accounting Fees and Services	49
PART IV		
Item 15.	Exhibits, Financial Statement Schedules	49
Signatures		50
Exhibit Index		E-1

PART I

ITEM 1—BUSINESS

All references to “we,” “us,” “our,” “PECO II,” or the “Company” in this Annual Report on Form 10-K mean PECO II, Inc.

PECO II, Inc. was incorporated in Ohio in 1988. Our headquarters is located at 1376 State Route 598 in Galion, Ohio 44833 and our telephone number is (419) 468-7600. Our corporate web site address is www.peco2.com.

In 1988, we acquired the assets of ITT’s communications power product business. In August 2000, we completed an initial public offering of 575,000 of our common shares resulting in net proceeds to us of \$78.3 million. We made two strategic acquisitions in 2001 to expand our engineering and installation, or E&I, services capabilities. In June 2001, we acquired Thornton Communications and in August 2001, we acquired JNB Communications. On March 28, 2006, the Company acquired the assets related to the Telecom Power Division of Delta Products Corporation, which consisted of certain wireline and wireless communications providers contracts and related inventory and assumed the liabilities associated therewith. In exchange, we issued 474,037 of our common shares without par value (the “Primary Shares”) and a warrant to purchase up to approximately 1.3 million of our common shares, or such other number of shares that, when aggregated with the Primary Shares, represented 45% of our issued and outstanding shares of common stock. The warrant expired unexercised in September 2008.

On February 18, 2010, we entered into an Agreement and Plan of Merger (merger agreement) with Lineage Power Holdings, Inc. (Lineage), a Gores Group company and a provider of intelligent power conversion solutions, and Lineage Power Ohio Merger Sub, Inc., a wholly-owned subsidiary of Lineage. Under the terms of the merger agreement, Lineage will acquire all of the outstanding shares of PECO II for \$5.86 per share in cash without interest and less any applicable tax withholding. The Board of Directors of both PECO II and Lineage have unanimously approved the proposed transaction. The completion of the merger and other transactions contemplated by the merger agreement is subject to a number of conditions, including adoption at the special meeting of PECO II shareholders of the merger agreement and the merger.

We offer solutions to our telecommunication customers’ cost, quality, productivity and capacity challenges by providing on-site E&I systems integration, installation, maintenance and monitoring services and by designing, assembling and marketing communications specific power products. The products we offer include power systems, power distribution equipment and systems integration products. 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. Our operations are organized within two segments: services and products. You can find more information regarding our two business segments in Note 2 to our consolidated financial statements located in Item 8 “Financial Statements and Supplementary Data” below.

Market Overview

We participate in the global telecommunication marketplace (wireline & wireless) with the majority of our current revenue being generated in North America. Our customers’ network power needs are influenced by numerous factors, including size of the organization, number and types of technology systems deployed in the network and geographic coverage. The North American market consists of multiple segments that include Regional Bell Operating Companies (RBOCs), Independent Telephone Companies (IOCs), Inter-exchange Carriers/Competitive Access Providers, Wireless, Cable TV, Private Network/Enterprise, and Government.

Wireline companies, including the RBOCs and IOCs, continue to upgrade their respective networks to meet the increasing demands of their local service area. These carriers have been increasingly offering broadband access and triple play services. Most are currently deploying a next generation high-speed architecture such as FTTN (fiber to the node) or FTTP (fiber to the premises) in order to compete against the cable companies and the hybrid service offerings from local wireless providers.

Inter-exchange Carriers/Competitive Access Providers are experiencing tremendous pressure to identify their fit within the global telecommunication network. The Inter-exchange Carrier provides a connection between two parties outside an immediate serving area. Competitive Access Providers came into play after the Telecom Act of 1996 enabled local service competition within a given wireline market. Over the years, many of the Competitive Access Providers and Inter-exchange Carriers have merged or formed partnerships to compete against the incumbent telephone company in a given area. Recent regulatory changes have increased the competitive pressure and have created significant infrastructure write-offs as well as mergers and acquisitions activity in these sectors.

Wireless providers continue to build and expand. As a result of mergers and acquisitions within the wireless segment, there are four large North American organizations competing for the largest growth sector among individual subscribers. Wireless providers will likely continue to invest in infrastructure to move closer to their subscriber base, fill coverage gaps, and add traffic capacity, as well as upgrade facilities to provide the latest subscriber services via high speed wireless technologies such as EVDO (Evolution Version Data Only), HSPA (High Speed Packet Access), and UMTS (Universal Mobile Telecommunications System). Several carriers announced plans to begin introducing 4G solutions in 2009. The two primary 4G solutions are LTE (Long Term Evolution) and WiMAX (Worldwide Interoperability for Microwave Access).

Cable TV companies have traditionally offered video services to their subscriber base. However, in the past several years they have expanded to offer high speed data access that competes with the incumbent telephone company's DSL service. New high-speed data/video infrastructure builds are underway to offer VOIP (Voice Over Internet Protocol), and wireless services and protect their market from the new video and data offerings currently planned by local incumbent telephone companies.

The Private Network/Enterprise market traditionally had been focused on providing in-building dial tone services to commercial organizations, but has now expanded offerings based on evolving IT technology and business requirements. Steady growth in the Enterprise market is anticipated to continue to occur over the next five years as new services such as in-building wireless, video conferencing, and web page commerce are introduced. A key enabler of these new services is improvements in the support infrastructure to maintain these services during critical power failures.

The Government market is undergoing continued changes, especially as a result of the terrorist attacks of 2001. Communication infrastructure redesign is currently underway on a federal, state, and local basis. The current Homeland Security communication infrastructure build is expected to continue for the next several years. As a result of the American Recovery and Reinvestment Act, additional spending is expected in both government and carrier networks.

There has been significant and material consolidation within the service provider market segment, which is predicted to continue into 2010. This consolidation has reduced the actual number of service provider customers while significantly increasing their purchase power. Four of our largest customers several years ago are now one customer. This provides both new opportunities and risks in budget distractions driven by focused synergy efforts to provide significant cost savings across the new organization.

Our Business Strategy

Our strategy is to capitalize on the growing need to afford service providers a reliable source of power to run their networks in order to serve their customers today. These needs are found in wireline and wireless networks both at the service provider and enterprise level today. We provide our customers with solutions and related services that power their voice, data, and broadband offerings. Our long term strategy is to:

§ profitably grow revenues by continuing to flawlessly serve our customers;

§ improve our ability to touch more customers through the Company's indirect sales channel capability;

§ continually improve the talent level of our employees through coaching, training, and adding experienced industry talent to upgrade our overall capability;

§

continue to organically expand our customer base while we evaluate selective acquisitions to augment our current capabilities;

§ leverage alliances to operationally improve our customer responsiveness and grow our product and solution capability, enabling us to expand on technical competencies while lowering our cost structure;

§ leverage power system services competency to grow a national service capability;

§ penetrate further into customer markets where we currently have a strong services embedded base;

§ evaluate key markets for expansion based on leveraging our DC power competency;

§ leverage industry partnerships to provide “green” solutions that meet our customer’s expectations;

§ further develop system integration and assembly capability to ensure we maintain the most responsive resource in the industry; and

§ refine our product development processes to focus on systems integration skills and practices that reduce design cycle times, positioning us to capture market share in the fast-paced telecommunications market.

Business Segments

Our operations are organized within two segments: products and services.

Products

We continued to transform our product offering in 2009. We filled a key product category gap by developing a new small power platform to address the growing market for broadband outside plant and network edge power solutions. The size of the small, or micro, power market in the U.S. is estimated to reach \$450 million by 2011, according to industry analyst Skyline Marketing. The inclusion of another platform to the Company’s small power portfolio will position the Company to participate in this high growth sector during 2010 and beyond.

Our small product platforms are the Quantum™ Power System and the MPS Micro Power System. The Quantum platform is a 48-volt DC power system that combines high-density rectifiers, distribution and control in a sleek, low-profile shelf. It is optimized for telecom carriers deploying FTTN 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. Both 23” and 19” Integrated Shelves were developed in 2008, along with a variety of distribution options. The Quantum system has achieved NEBS Level 3 Certification.

The MPS Micro Power System is a small power system designed for the network edge. Depending on configuration, the low profile system supplies anywhere from 18 Amps to 150 Amps of current at 48Vdc in a 1RU shelf by 19” wide shelf. The system contains up to three rectifiers, integrated distribution and a system controller. The controller provides standard DC power system management along with battery management, as well as an optional SNMP interface. Integrated distribution can include GMT fuses and a battery disconnect fuse, minimizing the size of the overall system and making it ideal for use in space-constrained remote cabinet applications. A primary application for the MPS is powering triple play solutions for multiple dwelling unit applications.

During the fourth quarter of 2009, we introduced our next generation mid-sized power plant products to the marketplace. These next generation 138 and 139 power plants utilize 1RU rectifiers and converters, incorporate a totally redesigned user interface, and implement reconfigured AC input and DC output interconnections. User friendliness, field serviceability, and cable management have all been significantly improved while preserving all tried and true customer practices. The 138 and 139 plants also support the growing number of “green” initiatives by incorporating high efficiency 1RU rectifiers and converters. Customer reaction has been very favorable. Several plants have already shipped to new customers and customers of existing mid-size power plants have expressed strong desire to move to the new power plants.

Our major product categories and building blocks are defined below:

Product Category	Purpose	Range of Products
Battery Plants	Convert and distribute power to run network equipment while storing energy in rechargeable batteries to be used in the event of an alternating current, or AC, input failure.	With capacities ranging from 3 to 10,000 Amperes, these systems are engineered for use in a wide number of applications, including central office, cellular, fiber optic, microwave, and broadband networks.
Rectifiers	Convert incoming AC power to DC power.	Our broad collection of rectifiers includes modules designed for larger applications as well as compact “hot swappable” modular switchmode rectifiers designed to be added or replaced without powering down the system.

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Power Distribution Equipment	Distribute and limit power from a centralized power plant to various loads or end uses.	We offer a wide range of products from large battery distribution fuse boards, which provide intermediate distribution in applications where large power feeds from a power plant need to be split into smaller distributions, to smaller distribution circuits cabled directly to the load.
Converter Plants	Convert one voltage of DC power to another voltage of DC power.	Various models are available utilizing modules that provide 24V-48V and 48V-24V conversions.
Inverter Plants	Convert voltage from DC to AC power suitable for end-use applications. Provides continuous AC power in the event of a utility interruption.	Numerous systems are available based on our 1.2 kW modular “hot swappable” and “redundant” modules.

Services

In 2009, we continued our efforts to address the needs of our Tier I customer base. We strengthened our Central Office/Mobile Switching Center reputation and skill set by expanding out to new customers and markets. We expanded our cell site service capabilities, resulting in the award of Power turn key cell site deployment services contracts from Tier I wireless carriers. Additionally, we were awarded a renewal and major expansion of an existing contract with a Tier I provider. We continue to emphasize skill set expansion to deepen our solution set within our embedded customer base, while assisting with the establishment of new services offerings that will enable us to expand beyond our current power centric wireline/wireless reputation. Our portfolio of services solutions include:

- Capital Deployment Engineering & Installation (E&I) Services

DC Power (PECO II or other OEM products)

§ Large and Small Power Plants

§ Battery Install/Testing/Removals

§ Converter and/or Inverter Plants

Transmission

- Project Management

Multi-site Network Build Plans

Multi-site Maintenance and Emergency Support Services

- After Market Services

Cell Site/Remote Terminal Services

Power, Grounding, Site Expansion Audits

Preventative Maintenance Programs

Central Office/Main Switching Office Services

Power & Grounding Audits

Preventative Maintenance Program

Depot & Field Repair Services of DC Power Equipment

Advance Exchange

Product Upgrade and Refurbishment

- Staffing Services within Wireline & Wireless Telecommunication Sector

Engineering Personnel

Installation Personnel

Technical & Field Personnel

We will strive to continue to develop and enhance these services to maintain our strong quality and professional services reputation within the telecommunication industry.

Marketing and Sales

In 2009, our focus was on growing the business; we increased business with existing customers, added channel partners to reach additional customers and looked to Original Equipment Manufacturer (OEM) partners in order to provide full turnkey solutions to the market place. Our sales force is located throughout the United States and calls directly on our National Carrier customers, as well as providing local sales support to our manufacture representatives and Value Added Resellers (VARs). Our go to market model includes a National Account focus driving new product introductions, product standardizations and approvals as well as positioning PECO II and developing relationships throughout the customer's corporate group that provide us visibility and opportunity to expand our relationships. Our regional sales efforts focus on growing business geographically and increasing our presence in those regions.

VARs and manufactures representatives are utilized as both a channel to Tier II and III customers, as well as to augment our overall account and market strategy. Distributors are utilized to support the local needs of our customer base as required. This channel supports local carriers and installation groups who have established purchasing practices with the local branch.

Marketing and Product Line Management are located at our headquarters in Ohio and are responsible for all pricing, promotion, and the coordination of all next generation product and services offerings. We identify product needs from the marketplace through feedback from our customers, our sales personnel, in house engineering staff, and services managers, as well as our strategic partners. We actively participate in industry trade shows as required to communicate to our target market.

Customers

We continue our long history of being a primary DC power solution supplier of product and services to the North American telecommunication marketplace. Our diverse portfolio of customer solutions and long standing reputation allow us to participate in capital deployment projects within all the North American telecommunication market segments such as RBOCs, Independent Telephone Operators, Inter-exchange Carriers, Competitive Access Providers, Original Equipment Manufacturers, Wireless, Cable TV, and Government.

In 2009, the wireless carriers provided us with 55% of our revenue. The major portion of this revenue came from manufactured products (power systems and outside plant cabinets), however, we continue to see an increasing demand and corollary growth with our services portfolio (engineering, installation, maintenance contracts, site audits, and training). We provide aforementioned services to companies such as: Sprint Nextel, Verizon Wireless and AT&T. Note that Alltel was acquired by Verizon Wireless and Centennial Wireless was acquired by AT&T in 2009.

The RBOCs made up 35% of our 2009 revenue. Major customers that we serve in this segment include: AT&T, Verizon and Qwest. This segment grew dramatically in 2009 as a result of the growth in our E&I services capability.

The remaining revenue comes from a large number of other customers that can be classified as Independent Telephone Companies, Competitive Access Providers, Inter-exchange Carriers, Government, Original Equipment Manufacturers, Cable TV, as well as international partners/service providers. This market made up 10% of our revenues in 2009. This segment included a healthy mix of services along with our traditional manufactured products. Some of the customers included in this segment of our customer base include: Level 3, Time Warner Telephone, Nokia and BT.

Backlog

As of December 31, 2009, the unshipped customer order backlog totaled \$2.9 million, compared to \$2.5 million as of December 31, 2008. We expect to ship the entire December 31, 2009 backlog in 2010.

Operations and Quality Control

The goal of our operations is to be recognized as a world class entity as measured by total customer satisfaction. We strive to achieve complete customer satisfaction by providing customers with zero defects in our installed equipment from product design to test and turn up, all at the best possible value. Our manufacturing operations are focused on factory flow, productivity improvement, cost reduction and evaluation of operations processes to ensure our long-term success. Our services capabilities are focused on zero defects and flawless on-time delivery of our services to meet the requirements of our customers. Likewise, through the development and deployment of quality process tools throughout PECO II, we aim to dramatically improve processes and associate involvement in our quest for excellence. By accomplishing the above, we aim to position PECO II to ensure customer satisfaction, which will enhance our ability to grow our business.

Our primary focus is to deliver our products on time and defect-free, using processes that are designed with employee involvement and focused manufacturing cell principles. Our facility in Galion, Ohio is TL9000 and ISO9001 certified

for quality assurance in design and manufacturing. TL9000 is a specific set of requirements for the telecommunications industry that is based on ISO9001 and developed by the Quest Forum. Our quality policy is a vital ingredient in the daily operations of all associates. Our quality values are based on trust, respect and teamwork. We are committed to continually improve and review our quality management system such that our services and products exceed our customers' needs and expectations every time. In conjunction with the TL9000 / ISO9001 standards, our cross-functional teams are focused to provide our customers with products that meet or exceed industry standards such as Underwriters Laboratories (UL), Canadian Safety Agency (CSA), European Conformity (EC), and the Network Equipment Building Standards (NEBS™).

We have valuable customer relationships, product knowledge, systems integration, and services expertise. We believe that people, both customers and employees, are the most important part of our business. Because we have personnel, as well as manufacturing facilities, in Galion, Ohio with a high level of industry knowledge, we are able to provide our customers with fast and flexible responses to their requirements for products, systems integration, and services.

Research, Development and Engineering

Our engineering efforts are focused on system design, integration and development. We utilize our knowledge of customer applications, safety and network compliance, and system level packaging to create products that meet both general and customer-specific needs. The focus on systems level design and integration allows us to design systems around different power conversion modules to meet specific customer needs. We actively participate in industry standards organizations, and design our products to meet those standards.

Patents and Trademarks

We use a combination of patents, trade secrets, trademarks, copyrights, and nondisclosure agreements to establish and protect our proprietary rights. We cannot assure that any new patents will be issued and that we will continue to develop proprietary products or technologies that are patentable. We also cannot assure that any issued patent will provide us with competitive advantages and will not be challenged by third parties. And finally, we cannot assure that the patents of others will not have a material adverse effect on our business and operating results.

Suppliers and Raw Materials

Our suppliers of metal parts, cable assemblies, electrical components, modules and other sub-assemblies, are vital to our success. We continue to build on our current relationships and to cultivate new suppliers to ensure that we achieve advantageous product costs and improved delivery times that will make us more cost competitive in the marketplace. Cost improvements are achieved through advanced planning with the key suppliers to ensure materials are purchased at optimum quantities and by improving the overall supply chain cycle time from raw materials to finished assemblies and/or sub-assemblies. This will provide opportunities to better respond to customer needs, to provide quality products, and meet the ever-increasing demands for short delivery intervals.

We rely on relationships with some of our competitors to access critical rectifier and converter technology for our power systems. Without access to this critical technology our ability to grow or maintain our current levels of revenue and earnings could be impaired.

Competition

Competition in the global marketplace is served by a number of local and global DC power organizations. These organizations can be broken down into full service providers, discount vendors, and new age vendors. Many of our competitors have more engineering, manufacturing, marketing, financial, and personnel resources than us. We will continue to see disruption in this market space as competitors face the increasing challenges of a shrinking customer base with significantly larger buying power. We believe we will be successful in competing with other similar suppliers based on our long-term customer relationships, our flexibility to scale and respond to customer and market changes, our delivery and services capabilities, our ability to contain costs, and our price, reliability, and quality of product and services.

There are three full service vendors in North America: we are one of the three and Emerson and Lineage are the other two. Telecom carriers who utilize these full service vendors are looking for organizations that have a complete product portfolio, installation and services capabilities, as well as efficient and competitive cost structures. The full service vendors maintain the majority of the market share of the traditional telephone carrier organizations such as the RBOCs, Inter-exchange Carriers, as well as the large incumbent telephone organizations. In addition to the traditional carriers, these full service organizations also dominate the large Tier I wireless providers. Recognition and acceptance as a full service DC power vendor generally requires a long history of top customer relationships, as well as a large embedded base.

In addition to the full service vendors, the North American marketplace is also made up of OEM DC power organizations as well as local and regional niche players. The OEM DC power organizations generally have strong relationships with the top radio manufacturers and integration organizations that allow them to participate in the wireless marketplace via indirect channels. These organizations generally compete on price alone or have a unique offering for a particular application.

Environmental Matters

We are subject to comprehensive and changing foreign, federal, state and local environmental requirements, including those governing discharges to the air and water, the handling and disposal of solid and hazardous wastes and the remediation of contamination associated with releases of hazardous substances. We believe we are in compliance with current environmental requirements. Nevertheless, we use hazardous substances in our operations and, as is the case with manufacturers in general, if releases of hazardous substances occur on or from our properties, we may be held liable and may be required to pay the cost of remedying the condition. The amount of any resulting liability could be material.

Employees

We presently have approximately 190 full-time employees. None of our employees are represented by a labor union. We have not experienced employment related work stoppages.

Additional Information

We make available on our website, www.peco2.com, links to our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and any amendments thereto, as well as proxy statements and other filing with the Securities and Exchange Commission. In addition, copies of our filings can be requested, free of charge, by writing to: Investor Relations, PECO II, Inc., 1376 State Route 598, Galion, Ohio 44833.

ITEM 1A—RISK FACTORS

Failure to consummate the announced merger with Lineage may adversely affect the market price of our common stock and our results of operations.

If the merger is not completed, the price of our common stock may decline to the extent that the current market price reflects a market assumption that the merger will be completed. In addition, in response to the announcement of the merger, our customers and strategic partners may delay or defer decisions which could have a material adverse effect on our business regardless of whether the merger is ultimately completed. Similarly, current and prospective employees of our company may experience uncertainty about their future roles with the combined company. These conditions may adversely affect employee morale and our ability to attract and retain key management, sales, marketing and technical personnel. In addition, focus on the merger and related matters have resulted in, and may continue to result in, the diversion of management's attention and resources. To the extent that there is uncertainty about the closing of the merger, or if the merger does not close, our business may be harmed if customers, strategic partners or others believe that they cannot effectively compete in the marketplace without the merger or if there is customer and employee uncertainty surrounding the future direction of the company on a stand-alone basis.

If the merger does not occur, we will not benefit from the expenses we have incurred in preparation for the merger.

If the merger is not consummated, we will have incurred substantial expenses for which no ultimate benefit will have been received by us. We currently expect to incur significant out-of-pocket expenses for services in connection with the merger, consisting of financial advisor, legal and accounting fees and financial printing and other related charges, many of which may be incurred even if the merger is not completed. Moreover, under specified circumstances, we may be required to pay a termination fee of \$1.1 million, depending upon the reason for termination, to Lineage in connection with a termination of the merger agreement.

Legal proceedings in connection with the merger could delay or prevent the completion of the merger.

A purported class action lawsuit has been filed by third parties challenging the proposed merger and seeking, among other things, to enjoin the consummation of the merger. One of the conditions to the closing of the merger is that no order shall have been issued by any court of competent jurisdiction preventing the consummation of the merger. If a plaintiff is successful in obtaining an injunction prohibiting consummation of the merger, then the injunction may delay the merger or prevent the merger from being completed.

The communications market fluctuates and is impacted by many factors, including decisions by service providers regarding capital expenditures and their timing of purchases as well as demand and spending for communications services by businesses and consumers.

After significant deterioration earlier this decade, the global communications market stabilized in 2004 and experienced modest growth through 2008, as reflected in increased capital expenditures by service providers and growing demand for telecommunications services. In 2009, the overall market was flat to down, primarily resulting from the ongoing industry level consolidation that continues amongst the service providers combined with the overall

economic conditions. Although we believe the overall market will continue to grow, the rate of growth could vary and is subject to substantial fluctuations, especially in times of overall economic uncertainty. Additionally, the specific market segments in which we participate may not experience the growth of other segments. If this were to continue to occur, or if there was a reduction in capital expenditures, our business, operating results, and financial condition may be adversely affected. If capital investment by service providers grows at a slower pace than we anticipate, our business, operating results and financial condition may be adversely affected. The level of demand by service providers can change quickly and can vary over short periods of time, including from month to month.

A small number of customers account for a high percentage of our net sales; there are only a small number of potential major customers in our primary market; and the loss of a key customer could have a negative impact on our operating results and cause our stock price to decline.

In any one quarter, it is typical for us to have two to three key customers that each account for over 10% of our revenues. In 2009, sales to our ten largest customers accounted for approximately 85.3% of net sales. We expect that we will continue to be dependent upon a limited number of customers for a significant portion of our revenues in future periods. In addition, almost all of our sales are made on the basis of purchase orders, and most of our customers are not obligated to purchase products or services from us. As a result of this customer concentration, our revenues and operating results may be materially adversely affected by the failure of anticipated orders to materialize or by deferrals or cancellations of orders. In addition, there can be no assurance that revenue from customers that accounted for significant sales in past periods, individually, or as a group, will continue, or if continued, will reach or exceed historical levels in any future period. Further, such customers are concentrated in the communications industry and our future success depends on the capital spending patterns and the continued demand of such customers for our products and services. Additionally, any merger or acquisitions among our customers could impact future orders from such customers.

If we are unable to meet our additional capital needs in the future, we may miss expansion opportunities or find ourselves unable to respond to actions by our competitors, which could impair our competitive position and hurt sales and earnings.

In the future, our competitive position could be impaired if we cannot raise capital when required and therefore we would not be able to take advantage of opportunities to expand our business either internally or through acquisitions. Our sales and earnings could suffer if we do not have the financial resources needed to respond to new product introductions or market price erosion. If additional funds are raised through the issuance of equity securities, the percentage ownership of our then-current shareholders may be reduced and such equity securities may have rights, preferences, or privileges senior to those of our common shareholders. In addition, there can be no assurance that additional financing will be available at favorable terms or will be available at all. If adequate funds are not available or not available on acceptable terms we may not be able to take advantage of unanticipated opportunities, develop new or enhanced services and related products, or otherwise respond to unanticipated competitive pressures. Our business, operating results, and financial condition could be materially adversely affected without additional capital.

We may fail to meet market expectations because of fluctuations in our quarterly operating results, which could cause our stock price to decline.

Our quarterly operating results have significantly varied in the past and will continue to do so in the future depending on factors such as the timing of significant orders and shipments; capital spending patterns of our customers; changes in the regulatory environment; changes in our pricing or the pricing of our competitors; increased competition; mergers and acquisitions among customers; personnel changes; demand for our products; the number, timing, and significance of new product and product enhancement announcements by us and our competitors; our ability to develop, introduce, and market new and enhanced versions of our products on a timely basis; and the mix of direct and indirect sales and general economic factors. A significant portion of our revenues have been, and will continue to be, derived from substantial orders placed by large organizations, such as the Tier I wireless providers, and the timing of such orders and their fulfillment has and will cause material fluctuations in our operating results, particularly on a quarterly basis. Due to the foregoing factors, quarterly sales and operating results have been and will continue to be difficult to forecast. Based upon all of the foregoing, we believe that quarterly sales and operating results are likely to vary significantly in the future and period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. Further, it is likely that in some future quarter, our sales or operating results will be below the expectations of public market analysts and investors. In such

event, the price of our common stock could be materially adversely affected.

If we engage in acquisitions, we may experience difficulty assimilating the operations or personnel of the acquired companies, which could threaten the benefits we seek to achieve through acquisitions and our future growth.

If we make additional strategic acquisitions, we could have difficulty assimilating or retaining the acquired companies' personnel or integrating their operations, equipment, or services into our organization. This could disrupt our ongoing business, distract our management and employees, and reduce or eliminate the financial or strategic benefits that we sought to achieve through the acquisition and threaten our future growth.

Equipment problems may seriously harm our credibility and have a significant impact on our revenues, earnings and growth prospects.

Communications service providers insist on high standards of quality and reliability from communications equipment suppliers. If we deliver defective equipment, if our equipment fails due to improper maintenance, or if our equipment is perceived to be defective, our reputation, credibility and equipment sales could suffer. Any of these consequences could have a serious effect on our sales, earnings and growth prospects.

We will not remain competitive if we cannot keep up with a rapidly changing market.

The market for the equipment and services we provide is characterized by rapid technological changes, evolving industry standards, changing customer needs and frequent new equipment and service introductions. Failure to keep up with these changes could impair our competitive position and hurt sales, earnings and our prospects for future growth. If we fail to adequately predict and respond to these market changes, our existing products or products in development could become obsolete in a relatively short time frame. Our future success in addressing the needs of our customers will depend, in part, on our ability to timely and cost-effectively:

§ respond to emerging industry standards and other technological changes;

§ develop our internal technical capabilities and expertise;

§ broaden our equipment and service offerings; and

§ adapt our products and services to new technologies as they emerge.

The need for our products to obtain certification and the high demand for lab time could reduce our revenue and earnings by impairing our ability to bring new products to markets.

Typically, our products must be compliant with and certified by certain certifying agencies and bodies, including the Underwriters Laboratories, Canadian Safety Agency, European Conformity and, more recently, the Network Equipment Building Standard. Certification typically requires a company to secure lab time to perform testing on the equipment to be certified. The time required to obtain approvals from certifying bodies may result in delays in new product introductions, which could delay or reduce anticipated revenue and earnings from those products.

We could lose revenue opportunities if we do not decrease the time it takes us to fill our customers' orders.

A customer's selection of power equipment is often based on which supplier can supply the requested equipment within a specified time period. Unless we increase our manufacturing capacity to meet the increasingly shortened delivery schedules of our customers, we may lose potential sales from existing or new customers.

The market for supplying equipment and services to communications service providers is highly competitive, and, if we cannot compete effectively, our ability to grow our business or even to maintain revenues and earnings at current levels, will be impaired.

Competition among companies that supply equipment and services to communications service providers is intense. A few of our competitors have significantly greater financial, technological, manufacturing, marketing and distribution resources than we do. There can be no assurance that our current or potential competitors will not develop products comparable or superior to those developed by us or adapt more quickly than us to new technologies, emerging industry trends or changing customer requirements. Increased competition may cause us to lose market share or

compel us to reduce prices to remain competitive, which could result in reduced gross margins. Additionally, we rely on relationships with some of our competitors to access critical rectifier and converter technology for our power systems. Without access to this critical technology, our ability to grow or to even maintain our current levels of revenues and earnings could be impaired.

A significant downturn in the general economy could adversely affect our revenue, gross margin, and earnings.

Our business could be unfavorably affected by changes in national or global economic conditions, including inflation, interest rates, availability of capital markets, consumer spending rates, and the effects of governmental plans to manage economic conditions. The demand for many of our products and services is strongly correlated with the general economic conditions and with the level of business activity of our customers. Economic weakness and constrained customer spending has resulted in the past, and may result in the future, in decreased revenue, gross margin, earnings, or growth rates. We also have experienced, and may experience in the future, gross margin declines reflecting the effects of increased pressure for price concessions as our customers attempt to lower their cost structures. In this environment, we may not be able to reduce our costs sufficiently to maintain our margins.

Our products are dependent in part upon our proprietary technology.

Our ability to compete is dependent in part upon our proprietary technology. We rely on a combination of patents, trade secrets, copyright and trademark laws, nondisclosure and other contractual agreements, and technical measures to protect our proprietary rights. Despite our efforts to protect these rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use the information that we regard as proprietary. There can be no assurance that the steps we take to protect our proprietary information will prevent misappropriation of such technology and such protections may not preclude competitors from developing products with functionality or features similar to our products. While we believe that our products and trademarks do not infringe upon the proprietary rights of third parties, there can be no assurance that we will not receive future communications from third parties asserting our products infringe, or may infringe, the proprietary rights of third parties. Any such claims could be time-consuming, result in costly litigation and diversion of technical and management personnel, cause product shipment delays, or require us to develop non-infringing technology or enter into royalty or licensing agreements. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all. In the event of a successful claim of product infringement against us, if we fail or are unable to develop non-infringing technology or license the infringed or similar technology, our business, operating results and financial condition could be materially adversely affected.

Failure to attract and retain qualified personnel may result in difficulties in managing our business effectively and meeting revenue growth objectives.

Our success in efforts to grow our business depends on the contributions and abilities of key personnel, executives, operating officers, and others. If we are unable to retain and motivate our existing employees and attract qualified personnel to fill key positions, we may not be able to manage our business effectively, including the development of both existing and new products and services. Success in meeting our revenue and margin objectives also depends in large part on our ability to attract, motivate, and retain highly qualified personnel in sales and information management positions. Competition for such personnel is intense and there can be no assurance that we will be successful in attracting, motivating, and retaining such personnel. Any inability to hire and retain salespeople or any other qualified personnel, or any loss of the services of key personnel, could harm our business.

There is a limited market for trading in our common shares and our stock price has been volatile.

Although we are listed on the Nasdaq Capital Market, there can be no assurance that an active or liquid trading market in our common shares will continue. The market price of our common shares is likely to be volatile and may be significantly affected by factors such as actual or anticipated fluctuations in our operating results; announcements of technological innovations, new products or new contracts by us or our competitors; developments with respect to copyrights or proprietary rights; general market conditions; and other factors.

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

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

Ownership of our common shares is concentrated among a few shareholders, who may be able to exert substantial influence over our Company.

Our present officers and directors own outright approximately 20.7% of our common shares as of March 12, 2010. In particular, Messrs. Matthew P. Smith and James L. Green, and their respective affiliates, own outright approximately 16.9% of our common shares as of March 12, 2010. In addition, Delta International Holding Ltd. owns outright 474,037 shares or approximately 16.6% of our common shares as of March 12, 2010. As a result, these shareholders have the potential to exercise significant influence over matters requiring shareholder approval, including the election of directors and approval of significant corporate transactions. Such ownership may have the effect of delaying or preventing a change in control of our Company.

We may be subject to certain environmental and other regulations.

Some of our operations use substances regulated under various federal, state, local and international environmental and pollution laws, including those relating to the storage, use, discharge, disposal and labeling of, and human exposure to, hazardous and toxic materials. Compliance with current or future environmental laws and regulations could restrict our ability to expand our facilities or require us to acquire additional expensive equipment, modify our manufacturing processes or incur other significant expenses. In addition, we could incur costs, fines and civil or criminal sanctions, third party property damage or personal injury claims or could be required to incur substantial investigation or remediation costs, if we were to violate or become liable under any environmental laws. Liability under environmental laws can be joint and several and without regard to comparative fault. There can be no assurance that violations of environmental laws or regulations have not occurred in the past and will not occur in the future as a result of our inability to obtain permits, human error, equipment failure or other causes, and any such violations could harm our business and financial condition.

There are inherent limitations in all control systems, and misstatements due to error or fraud may occur and not be detected.

While we continue to take action to ensure compliance with the disclosure controls and other requirements of the Sarbanes-Oxley Act of 2002 and the related Securities and Exchange Commission and Nasdaq rules, there are inherent limitations in our ability to control all circumstances. There is no guarantee that our internal controls and disclosure controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be evaluated in relation to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, in our company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may be inadequate because of changes in conditions or the degree of compliance with the policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

ITEM 1B—UNRESOLVED STAFF COMMENTS

None.

ITEM 2—PROPERTIES

The following table sets forth certain information about our principal facilities:

Location	Approximate Square Feet	Uses	Owned/Leased
Galion, Ohio (A)	285,375	Principal executive and corporate office, sales and services office, and manufacturing and assembly	Owned

Canton, Georgia	12,343	Engineering, installation services and sales office	Leased
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(A) Includes the Galion, Ohio corporate office shell, which is listed for sale, 42,000 square feet.

We have continued to narrow our excess capacity for our current operations and continue to attempt to sell or lease the Galion, Ohio, corporate office shell.

Our current capacity, with limited capital additions, is expected to be sufficient to meet production requirements for the near future. We believe our production facilities are suitable and can meet our future production needs.

ITEM 3—LEGAL PROCEEDINGS

We are party to legal proceedings and litigation arising in the ordinary course of business. Although the outcome of such items cannot be determined with certainty, management is of the opinion that the final outcome of these matters should not have a material effect on our results of operations or financial position.

The Company, each of the members of the Company's board of directors, Lineage Power Holdings, Inc. ("Lineage"), and Lineage Power Ohio Merger Sub, Inc. ("Merger Sub") were named defendants in a purported class action and shareholder derivative lawsuit filed in the Court of Common Pleas of Cuyahoga, County, Ohio, on or about March 5, 2010, and styled as follows: Harshad Sandesara v. PECO II, Inc., et al., Case No. CV 10 720332. Plaintiff is a shareholder of the Company and seeks both to enjoin the merger and damages. On March 15, 2010, plaintiff filed an amended complaint and a motion for expedited proceedings. Thereafter, on March 19, 2010, plaintiff filed a motion for preliminary injunction asking that the court block the merger. The lawsuit alleges, among other things, that the directors of the Company, aided and abetted by the Company and Lineage, breached their fiduciary duties in connection with the directors' recommendation that the shareholders adopt a proposed merger transaction between the Company and Merger Sub that would result in the Company being a wholly owned subsidiary of Lineage. On March 25, 2010, the defendants filed a motion to dismiss the amended complaint and a brief in opposition to the motion for expedited proceedings. On March 26, 2010, the Court denied plaintiff's motion to expedite discovery and ordered the Company to supplement its proxy statement filed March 18, 2010 with specific information concerning the background of the merger. At this stage, it is not possible to predict the outcome of this proceeding or its impact on the Company. The Company believes the allegations made in the amended complaint are without merit and intends to vigorously defend against the plaintiff's claims.

ITEM 4—(REMOVED AND RESERVED)

PART II

ITEM 5—MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common shares began trade on the Nasdaq Capital Market under the symbol "PIII." The following table sets forth the high and low sales prices (on a post-split basis) of our common shares on the Nasdaq Capital Market for the periods set forth below:

	High	Low
2009		
First Quarter	\$ 4.25	\$ 2.39
Second Quarter	\$ 4.75	\$ 2.40
Third Quarter	\$ 4.29	\$ 2.58
Fourth Quarter	\$ 5.20	\$ 2.89
2008		
First Quarter	\$ 7.60	\$ 5.50
Second Quarter	\$ 8.50	\$ 3.12
Third Quarter	\$ 4.85	\$ 3.28
Fourth Quarter	\$ 4.44	\$ 2.04

Holders

As of March 16, 2010, there were 496 holders of record of our common shares.

Dividends

We have not paid any dividends since our initial public offering in August 2000. We do not currently plan to pay dividends. Any future determination to pay dividends will be at the discretion of the board of directors and will depend upon our financial condition, operating results, capital requirements and other factors the board of directors deems relevant.

Performance Graph

Not required for smaller reporting companies.

Recent Sales of Unregistered Securities

During the fourth quarter of 2009, no unregistered securities were sold.

Purchases of Equity Securities by the Issuer and Affiliated Purchases

During the fourth quarter of 2009, no repurchases were made.

ITEM 6—SELECTED FINANCIAL DATA

Not required for smaller reporting companies.

ITEM 7—MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read this discussion together with the consolidated financial statements and other financial information elsewhere in this Form 10-K.

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 engineering and installation, systems integration, installation, maintenance, and monitor services to our customers. Our power systems provide a primary supply of power to support the infrastructure of communications service providers, including local exchange carriers, long distance carriers, wireless service providers, internet service providers and broadband access providers. Our power distribution equipment directs this power to specific customer communications equipment. Our systems integration business provides complete built-to-order communications systems assembled and installed pursuant to customer specifications and incorporating other manufacturers’ products.

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

While the telecommunications market is extremely volatile, estimated capital expenditure spending was flat to down in 2009 and analysts, given the economic uncertainty, are unsure regarding capital expenditure levels for 2010. The current economic environment is causing many companies to forecast flat to limited growth in spending in the near

future. Notwithstanding this possible ongoing slowdown, we believe that our capabilities, combined with our market position, will afford us the opportunity to take market share even in a slowing economy.

In 2009, we targeted the capital expenditures growth in the wireless market and services spending. We successfully maintained our market position with key customers notwithstanding a downturn in 2009 product revenues. We believe that the downturn in product revenues was primarily driven by reduced spending due to the industry consolidation that occurred in 2009.

Our R&D investment extended beyond traditional cell site applications. Our small product platforms are the Quantum™ Power System and the MPS Micro Power System. The Quantum platform is a 48-volt DC power system that combines high-density rectifiers, distribution and control in a sleek, low-profile shelf. It is optimized for telecom carriers deploying FTTN 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. Both 23" and 19" Integrated Shelves were developed in 2008, along with a variety of distribution options. The Quantum system has achieved NEBS Level 3 certification.

The MPS Micro Power System, is a small power system designed for the network edge. Depending on configuration, the low profile system supplies anywhere from 18 Amps to 150 Amps of current at 48Vdc in a 1RU shelf by 19" wide shelf. The system contains up to three rectifiers, integrated distribution and a system controller. The controller provides standard DC power system management along with battery management, as well as an optional SNMP interface. Integrated distribution can include GMT fuses and a battery disconnect fuse, minimizing the size of the overall system and making it ideal for use in space-constrained remote cabinet applications. A primary application for the MPS is powering triple play solutions for multiple dwelling unit applications. We began customer trials during the fourth quarter of 2008.

During the fourth quarter of 2009, we introduced our next generation mid-sized power plant products to the marketplace. These next generation 138 and 139 power plants utilize 1RU rectifiers and converters, incorporate a totally redesigned user interface, and implement reconfigured AC input and DC output interconnections. User friendliness, field serviceability, and cable management have all been significantly improved while preserving all tried and true customer practices. The 138 and 139 plants also support the growing number of "green" initiatives by incorporating high efficiency 1RU rectifiers and converters. Customer reaction has been very favorable. Several plants have already shipped to new customers and customers of existing mid-size power plants have expressed strong desire to move to the new power plants.

During the first quarter 2009, we achieved TL9000 recertification. The certification process included evaluation of our core business processes based on TL9000 Quality Management System Requirements Release 4.0, an upgrade over previous assessments. The TL9000 standard defines the telecommunications quality system requirements for the design development, production, delivery, installation and maintenance of products and services.

Our Services group focused on hardening our solution portfolio to meet the power needs of our Tier I customer base. The revenue decline in 2008 was driven by reduced spending at two of our major customers. During the fourth quarter of 2008, we were notified of a contract renewal with a major Tier I customer. This renewal included a major expansion of work to be performed by us. This contract award was the primary driver for our 2009 revenue growth.

Our Services division continues to provide multi-vendor E&I 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 turnover. 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.

Critical Accounting Policies and Estimates

In preparing our financial statements and accounting for the underlying transactions and balances, we applied the accounting policies disclosed in the Notes to the Consolidated Financial Statements. Preparation of our financial statements requires us to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Although we believe our estimates and assumptions are reasonable, they are based on information presently available and actual results may differ significantly from those estimates.

We consider the estimates discussed below as critical to an understanding of our financial statements because they place the most significant demands on management's judgment about the effect of matters that are inherently uncertain, and the impact of different estimates or assumptions is material to our financial condition or results of operations. Specific risks for these critical accounting estimates are described in the following paragraphs. The impact and any associated risks related to these estimates are discussed throughout this discussion and analysis where such estimates affect reported and expected financial results.

For a detailed discussion of the application of these and other accounting policies, see Note 1 to the Consolidated Financial Statements. Management has discussed the development and selection of the critical accounting policies and the related disclosure included herein with the Audit Committee of the Board of Directors.

Revenue Recognition

Product revenues are recognized when customer orders are completed and shipped, title passes to the customer and collection is reasonably assured. Product sales sometimes include multiple items including services such as installation. In such instances, product revenue is not recognized until installation is complete and the product is made available for customer use. Services revenues on E&I contracts and the costs for services performed are primarily recorded as the work progresses on a percentage of completion basis. Management believes that all relevant criteria and conditions are considered when recognizing sales.

Impairment of Long-Lived Assets

We assess the impairment of long-lived assets, which include intangible assets and plant and equipment, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important that could trigger an impairment review include, but are not limited to, the following:

- Sustained underperformance relative to expected historical or projected future operating results;
- Changes in the manner of use of the assets, their physical condition or the strategy for the Company's overall business;
 - Negative industry or economic trends;
 - Declines in stock price of an investment for a sustained period;
 - The Company's market capitalization relative to net book value;
- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit, or a long-lived asset will be sold or otherwise disposed of, significantly before the end of its previously estimated useful life;
 - A significant decrease in the market price of a long-lived asset;
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset, including an adverse action or assessment by a regulator;
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset;
- A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset;
 - Unanticipated competition; and
 - A loss of key personnel.

Inventory Valuation

Inventories are stated at the lower of cost or market with cost determined on a standard cost basis that approximates the first-in, first-out method. Inventory costs consist of purchased product, internal and external manufacturing costs, and freight. Management regularly reviews inventory for obsolescence or excessive quantities and records an allowance accordingly. Various factors are considered in making this determination, including recent usage history, forecasted usage and market conditions.

We continually review the inventory for obsolescence or excessive quantities and accrue accordingly. At a minimum, all part numbers are reviewed quarterly. We identify potential obsolete or excess inventory by identifying parts with no usage for a year and excess parts greater than the last twelve month usage or two times future six month requirements, whichever is greater. Management reviews the inventory identified as potentially obsolete or excess to determine the appropriate allowance.

Deferred Taxes

We record income taxes under the asset and liability method. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities, and any valuation allowance recorded against our deferred tax assets.

Our ability to realize deferred tax assets is primarily dependent on the future taxable income of the taxable entity to which the deferred tax asset relates. We evaluate all available evidence to determine whether it is more likely than not that some portion or the entire deferred income tax asset will not be realized.

Share-Based Compensation

Determining the appropriate fair value model and calculating the fair value of share-based payment awards require the input of subjective assumptions, including the expected life of the share-based payment awards and stock price volatility. The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be different in the future.

Under the fair value recognition provisions, we recognize stock-based compensation expense net of an estimated forfeiture rate and only recognize compensation expense for those shares expected to vest over the requisite service period of the award. If our actual forfeiture rate is materially different from our estimate, our stock-based compensation expense could be significantly different from what we have recorded in the current period.

Results of Operations

The following table shows, for the periods indicated, selected items and the percentage of net sales from our consolidated statement of operations.

	Year Ended December 31,					
	2009			2008		
Net sales:						
Product	\$24,105	57.0	%	\$31,554	75.6	%
Services	18,182	43.0	%	10,189	24.4	%
	42,287	100.0	%	41,743	100.0	%
Cost of sales (exclusive of depreciation and amortization):						
Product	18,854	44.6	%	25,549	61.2	%
Services	13,579	32.1	%	8,292	19.9	%
Obsolete inventory write-off	1,035	2.4	%	2,146	5.1	%
	33,468	79.1	%	35,987	86.2	%
Gross margin	8,819	20.9	%	5,756	13.8	%
Operating expenses:						
Depreciation and amortization	1,466	3.5	%	1,494	3.6	%
Research, development and engineering	1,873	4.4	%	2,306	5.5	%
Selling, general and administrative	7,179	17.0	%	8,083	19.3	%
Impairment of goodwill	—	—		1,503	3.6	%
Impairment of idle facility	—	—		200	0.5	%
	10,518	24.9	%	13,586	32.5	%
Loss from operations	(1,699)	(4.0	%)	(7,830)	(18.7	%)
Interest income, net	26	0.1	%	171	0.4	%
Loss before income taxes	(1,673)	(3.9	%)	(7,659)	(18.3	%)
Income tax expense	(14)	(0.1	%)	(45)	(0.1	%)
Net loss	\$(1,687)	(4.0	%)	\$(7,704)	(18.4	%)

Net Sales. Net sales increased \$0.5 million, or 1.3%, to \$42.3 million for the year ended December 31, 2009 from \$41.7 million for the year ended December 31, 2008. This increase was driven primarily by our services business. Services revenues grew by \$8.0 million in 2009. Our E&I capabilities were the major driver of this growth.

Net sales in our product segment decreased by \$7.5 million, with the result being \$24.1 million for the year ended December 31, 2009 as compared to \$31.6 million for the year ended December 31, 2008. We believe this reduction was primarily the result of the industry level consolidation that occurred in 2009 in North America. As of December 31, 2009, our product backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, had decreased to \$1.2 million from \$1.9 million at December 31, 2008.

Net sales in our services segment increased by \$8.0 million, resulting in \$18.2 million for year ended December 31, 2009 as compared with \$10.2 million for the year ended December 31, 2008. The increase in revenues was primarily driven by new services work with a major service provider for our E&I capabilities. As of December 31, 2009, our services backlog, which represents total dollar volume of firm sales orders not yet recognized as revenue, had increased to \$1.7 million from \$0.6 million at December 31, 2008.

Gross Margin. Gross margin dollars increased to \$8.8 million in 2009 as compared to \$5.8 million in 2008. Gross margin as a percentage of net sales increased to 20.9% in 2009 as compared to 13.8% in 2008. This increase included a charge of \$1.0 million for obsolete and slow-moving inventory as compared to a charge of \$2.1 million in 2008.

The product gross margin increased to \$4.2 million in 2009 as compared to \$3.9 million in 2008. Product gross margin, as a percentage of product sales, increased to 17.5% in 2009, compared to 12.2% in 2008. This increase was primarily driven by product price increases instituted in 2009 with a number of our major customers, combined with reduced obsolescence charges, when compared to 2008.

The services segment gross margin increased to \$4.6 million in 2009 as compared with the \$1.9 million in 2008. Services gross margin as a percentage of services sales was 25.3% in 2009 as compared to 18.6% in 2008. This increase reflected the impact of the services contract win noted above.

Research, Development and Engineering. Research, development and engineering expense decreased to \$1.9 million in 2009 from \$2.3 million in 2008, representing a decrease of \$0.4 million. The decrease was primarily driven by the completion of major small power work that was accomplished in 2008. As a percentage of net product sales, research, development and engineering expense increased to 7.8% in 2009 up from 7.3% in 2008.

Selling, General and Administrative. Selling, general and administrative expense decreased to \$7.2 million in 2009 from \$8.1 million in 2008, representing a decrease of \$0.9 million. As a percentage of net sales, selling, general and administrative expense decreased to 17.0% in 2009 from 19.3% in 2008. The decrease, as a percentage of revenues, reflected the productivity increases realized as we continued our focus on process improvements throughout the business.

Interest Income. Interest income, net, was \$26 thousand in 2009 compared to \$171 thousand in 2008. Of this amount, interest expense was \$18 thousand in 2009 compared to \$14 thousand in 2008, while interest income decreased to \$44 thousand in 2009 compared to \$185 thousand in 2008. The decrease in interest income, net, in the current year was due primarily to less income from investments from reduced interest-earning balances and reductions of effective interest rates.

Income Taxes. As a result of our significant continued operating losses in recent years, we have not been subject to significant income taxes and have a 100% valuation allowance for our net deferred tax assets. As such, our effective income tax rate was a negative 0.8% in 2009 compared to an effective rate of negative 0.6% in 2008.

Liquidity and Capital Resources

Our primary liquidity needs for the foreseeable future will be for working capital and operations. As of December 31, 2009, available cash and cash equivalents approximated \$7.4 million. Based on available funds and current plans, we believe that our available cash, borrowings and amounts generated from operations, will be sufficient to meet our cash requirements for the next 12 months. The assumptions underlying this belief include, among other things, that there will be no material adverse developments in the business or market in general. There can be no assurances however that those assumed events will occur. If management's plans are not achieved, there may be further negative effects on the results of operations and cash flows, which could have a material adverse effect on the Company.

Working capital was \$12.2 million at December 31, 2009, which represented a working capital ratio of 2.6 to 1, compared to \$12.4 million at December 31, 2008. Our investment in inventories and accounts receivables was \$11.3 million and \$12.9 million at December 31, 2009 and 2008, respectively. Our capital expenditures were \$0.2 million and \$0.07 million in 2009 and 2008, respectively. Our budgeted capital expenditures for 2010 are \$0.1 million as we remain focused on conserving cash. Accounts receivable days sales outstanding stood at 46 days at December 31, 2009, as compared to 46 days at December 31, 2008. At December 31, 2009, inventory days on hand, which represents gross inventory excluding impairments or reserves, was 152 days, as compared to 145 days on hand at December 31, 2008.

Cash flows provided by operating activities were \$2.7 million in 2009, compared to 2008 which had cash flows used for operating activities of \$3.0 million. This was primarily from a reduced net loss of \$6.0 million compared to 2008, decreases in inventory and other non-cash charges offset by increases in accounts receivable and other assets. There was \$671 thousand of cash provided by investing activities, which was primarily from reduction in restricted cash offset by capital expenditures. Cash used for financing activities was \$1.8 million, which was primarily the result of payoff of line of credit and bank overdraft.

We have an available line of credit agreement with National City Bank for borrowing up to \$3.5 million. The line of credit requires certain amounts be restricted in an identified collateral account based on the outstanding balance due. As of December 31, 2009, there is an outstanding balance of \$0 on the line of credit. As such, the portion of the deposit account collateralized is reflected as restricted cash in the accompanying balance sheet as of December 31, 2009.

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 at least the next 12 months. We do not currently plan to pay dividends.

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

We have operating leases covering certain office facilities and equipment that expire at various dates through 2014. Future minimum annual lease payments required during the years ending in 2010 through 2014 under non-cancelable operating leases having an original term of more than one year are \$324 thousand, \$191 thousand, \$92 thousand, \$93 thousand and \$47 thousand respectively.

Impact of New Accounting Standards

Recently adopted and recently issued accounting pronouncements and their effects on the Company’s consolidated financial statements are described in Note 1, “Summary of Significant Accounting Policies,” in Item 8.

Off-Balance Sheet Arrangements

We do not have any off balance sheet entities or arrangements. All of our subsidiaries are reflected in our financial statements. We do not have any interests in or relationships with any special-purpose entities that are not reflected in our financial statements.

ITEM 7A—QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not required for smaller reporting companies.

ITEM 8—FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

PECO II, INC.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
Report of Independent Registered Public Accounting Firm	19
Consolidated Balance Sheets as of December 31, 2009 and 2008	20
Consolidated Statements of Operations for the Years Ended December 31, 2009 and 2008	21
Consolidated Statements of Shareholders’ Equity for the Years Ended December 31, 2009 and 2008	22
Consolidated Statements of Cash Flows for the Years Ended December 31, 2009 and 2008	23
Notes to Consolidated Financial Statements	24

REPORT OF INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
PECO II, Inc.
Galion, Ohio

We have audited the accompanying consolidated balance sheets of PECO II, Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of operations, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of PECO II, Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ BATTELLE & BATTELLE LLP

Dayton, Ohio
March 31, 2010

PECO II, INC.

CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	December 31,	
	2009	2008
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 7,394	\$ 5,814
Accounts receivable, net	5,786	4,366
Inventories, net	5,470	8,533
Cost and earnings in excess of billings on uncompleted contracts	1,158	622
Prepaid expenses and other current assets	166	295
Restricted cash	-	834
Total current assets	19,974	20,464
Property and equipment, at cost:		
Land and land improvements	195	195
Buildings and building improvements	4,628	4,628
Machinery and equipment	3,031	2,895
Furniture and fixtures	5,538	5,518
	13,392	13,236
Less-accumulated depreciation	(10,471)	(10,109)
Property and equipment, net	2,921	3,127
Other assets:		
Idle facility	800	800
Intangibles, net	1,675	2,748
Total assets	\$ 25,370	\$ 27,139
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Borrowings under line of credit	\$ -	\$ 834
Bank overdrafts	-	994
Accounts payable	3,308	3,387
Billings in excess of cost and estimated earnings on uncompleted contracts	1,135	235
Accrued compensation expense	1,535	923
Accrued income taxes	36	56
Other accrued expenses	1,739	1,633
Total current liabilities	7,753	8,062
Shareholders' equity:		
Common stock, no par value: 150,000,000 shares authorized; 2,851,385 and 2,816,527 shares issued at December 31, 2009 and 2008, respectively	3,617	3,573
Additional paid-in capital	122,085	121,901
Accumulated deficit	(108,085)	(106,397)
Total shareholders' equity	17,617	19,077
Total liabilities and shareholders' equity	\$ 25,370	\$ 27,139

The accompanying notes are an integral part of these consolidated balance sheets.

PECO II, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Years Ended December	
	31,	
	2009	2008
Net sales:		
Product	\$ 24,105	\$ 31,554
Services	18,182	10,189
	42,287	41,743
Cost of sales (exclusive of depreciation and amortization):		
Product	18,854	25,549
Services		