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# STKR - Q2 2008 StockerYale Earnings Conference Call

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## CORPORATE PARTICIPANTS

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*Investor Relations Council - IR*

**Mark Blodgett**
*StockerYale, Inc - Chairman, CEO*

**Tim Losik**
*StockerYale, Inc. - COO, CFO*

## CONFERENCE CALL PARTICIPANTS

**Angus Burton**
*Marathon Capital - Analyst*

## PRESENTATION

**Operator**

Good afternoon, ladies and gentlemen. Thank you so much for standing by, and welcome to the StockerYale Second Quarter 2008 Earnings Conference Call. (OPERATOR INSTRUCTIONS) As a reminder, this conference is being recorded today on Thursday, the 24th of July, 2008. I will now turn the conference over to Mr. Sanjay Hurry, Investor Relations Council. Please go ahead.

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**Sanjay Hurry** - *Investor Relations Council - IR*

Thank you, Michael. Good afternoon, everyone, and thank you for joining us to discuss StockerYale's financial results for the second quarter ended June 30, 2008. With us today from management are Chairman and Chief Executive Officer Mark Blodgett and Chief Operating Officer and Chief Financial Officer Tim Losik. Management will provide a brief overview of the quarter and will then open the call up to your questions.

Comments made during today's call may contain forward-looking statements made within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements, other than statements of historical fact, including, without limitation, those with respect to StockerYale's goals, plans, and strategies, are forward-looking statements. Certain factors and uncertainties identified in today's accompanying press release could cause actual results to differ materially from those described in the forward-looking statements.

Forward-looking statements represent management's current expectations and are inherently uncertain. You should also refer to the discussion under "Factors Affecting Operating Results" in StockerYale's Annual Report on Form 10-KSB and the Company's quarterly reports on Form 10-QSB for additional matters to be considered in this regard. Thus, actual results may differ materially. StockerYale undertakes no duty to update any of the forward-looking statements discussed on today's call.

With that, I'd like to turn the call over to Mark. Mark?

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**Mark Blodgett** - *StockerYale, Inc - Chairman, CEO*

Thanks, Sanjay. Good afternoon, everyone, and thank you for joining us. I'm sure you've seen from our earnings press release we are pleased to report a record revenue quarter, with continued improvement in gross profit and EBITDA. In addition, during the quarter we began our tender offer for Virtek -- more on that in a moment.

Second quarter sales were strong and generated solid revenue growth. Revenues increased 23% year over year to a record $8.5 million, driven once again this quarter primarily by strength in our Montreal laser module business and growth in LED systems sales. All product lines demonstrated solid growth and in particular Photonic Products, which delivered better-than-anticipated sales and positive EBITDA.

With the exception of our fiber business, which is in the process of transitioning from an R&D-driven business to a production model, all three of our operations saw a meaningful increase in EBITDA profits during the second quarter.

Our performance this quarter was also highlighted by over-all operational improvement. We took steps several quarters ago to drive the business based on operational metrics, which are benefiting us today in the form of improving gross margins and higher average revenue per employee. In fact, average revenue per employee increased 33% year over year, from $129,000 to $171,000 during the same period. It is clear that with revenues up nicely this quarter, we are working smarter and running our factories more productively.

I'm particularly proud how our operations managers and sales teams have coalesced under Tim's leadership over the last two quarters. While much work remains on this front, I feel very confident we are on the right track and we will continue to make meaningful progress in the quarters ahead.

Gross profit increased almost 27% year over year to $2.9 million, and up 18% sequentially from $2.5 million, driven by increased capacity utilization, production improvement, strength in our LED systems business, and cost controls put in place over the last two quarters.

We continue to focus on a disciplined approach to expense control as an integral component to achieving more consistent financial performance. Excluding noncash and one-time charges during the second quarter, operating expenses were flat sequentially, even as revenues were up 23%.

Indicative of our tight cost controls, we closed our CNC machining operation at our high-end laser module business in Montreal. By outsourcing this requirement, we turned a fixed cost into a variable one and are already starting to realize cost savings from this in the third quarter as it ramps.

The end result was a smaller EBITDA loss of $284,000, as compared to losses of $402,000 for the second quarter of 2007 and $400,000 for the first quarter of 2008. EBITDA loss, excluding the one-time charges, was $106,000. Our EBITDA performance ex one-time charges, I believe, is a truer reflection of the progress we've made and shows further that senior management is executing well as a team and achieving operational efficiency improvements while also focusing on sales execution improvements.

Turning to the quarterly results for each of our three product lines, in brief, we're seeing growth across all three, supported by strong overseas sales. And we're experiencing meaningful progress on our medical strategy as we embed new laser, LED, and fiber-based products in a wide range of applications and customers.

Product sales mix for the second quarter was 72% lasers, 13% LED systems, 9% specialty fiber and optical components, and 6% other. This compares to 69% lasers, 14% LED, 12% specialty fiber, and 5% other in the year-ago quarter.

Laser and associated diode revenue grew 20% over the second quarter of 2007 and 8% sequentially. Growth was led by our Montreal laser business from biomedical and high-end automotive applications.

We're also benefiting from much better execution by our distributor in Germany, which is our largest market outside the US. They have recently -- by they, I mean the distributor -- have recently increased the size of their sales team marketing our laser products. And I suspect that we've also benefited from the weak dollar in Germany versus local competitors who price their product in euros.

As I mentioned earlier, our other laser business, Photonic Products, exceeded top-line and EBITDA expectations this quarter. We're very pleased with the continued progress there.

LED systems are doing extremely well as the increased sales and marketing expenses incurred a year ago have started to pay dividends. Demand is being driven by machine vision applications and, in particular, for solar cell and printed circuit board inspection.

Also, sales of LED systems for both a new medical application with a Fortune 100 company and an optical character recognition system for reading license plates contributed to revenue growth during the quarter.

Turning to specialty optical fiber, with the sale of one of our competitors to a large commercial laser company in the first quarter, we are now the last remaining independent US designer and manufacturer of fiber, which will provide significant strategic advantage as we continue to transition this business from what has been a long startup phase to a highly profitable production model. This business clearly has the highest potential operating leverage of any of our businesses and, under the leadership of our new general manager, I expect this business to grow rapidly as we move into 2009.

During the quarter, we were qualified for the use of our ytterbium double-clad fiber for use in the commercial fiber lasers of the world's largest optical communications equipment and testing solutions supplier.

Lastly, across all product lines, we continue to make meaningful progress with regards to our medical and biomedical instrumentation strategy as we continue to gain traction in such applications as flow cytometry, fiber laser delivery, lithotripsy, dental instrumentation, and dermatology. I'll come back to this in a moment to the exciting developments here.

Our activities have also extended to our M&A strategy. We commenced an all-cash tender offer for Virtek Vision International towards the end of the quarter for a total consideration of approximately CAD22 million. Virtek is an Ontario-based developer and manufacturer of industrial laser and optical solutions for the templating, inspection, marketing, and engraving markets.

We think it's a compelling combination from every perspective -- business strategy, operational, financial, and customer and investor for the following reasons. First, a combination would create a highly regarded laser and optics applications company that offers customers a broader product offering and takes advantage of numerous synergies.

Second, it would create an instant laser and optics industry leader with revenues approaching $100 million. In the optics industry today, there are only a handful of companies that exceed $100 million in revenues.

Third, we would have an expanded product offering and greater visibility with both customers as well as the investment community.

Fourth, we would realize improved financial operating leverage through the elimination of substantial combined public company and other duplicate costs. Canada is familiar territory for us by virtue of our established presence there, thereby lowering the risk of integration issues.

Two of the largest shareholders of Virtek are in agreement that this is a win-win situation and have committed to tendering their share to us. This process is ongoing and we will report updates to you via press releases as necessary.

With that, I'd like to turn the call over to Tim for his financial remarks. Tim?

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**Tim Losik** - *StockerYale, Inc. - COO, CFO*

Thank you, Mark. I'll provide a brief financial summary to follow here.

Net sales from continuing operations for the second quarter ended June 30, 2008, were a record $8.5 million, an increase of 23% compared to $7 million year over year and 6% sequentially. As Mark mentioned, the growth was driven by our laser and LED systems groups.

The geographic distribution of net sales was 46% in the US, 36% in Europe, 10% in Asia, and the remaining 8% in the rest of the world. This is fairly consistent with prior quarters' distribution of sales.

Bookings for the second quarter of 2008 reached $9 million, and backlog at the end of the quarter was $11.2 million.

Gross profit was $2.9 million for the second quarter of 2008, a 27% increase as compared to the $2.3 million in the second quarter of 2007, and up 18%, from $2.5 million, in the first quarter of 2008.

We saw margin improvement year over year, primarily in the illumination products segment. Second quarter 2008 gross margin was 34%, compared to 33% in the comparable year-ago quarter, and up substantially from 31% in the first quarter of 2008. The margin improvement is driven by the operating improvement initiatives underway in the Company, some of which were begun several quarters ago.

Second quarter gross profit was negatively impacted by about $150,000 due to the closure of the Company's Montreal machining department and the unfavorable impact of foreign currency exchange rates. Taking these factors into consideration, our gross margin would have been about 36%.

Operating expenses totaled $4.3 million for the second quarter of 2008, an increase of 20% over the $3.6 million in the second quarter of 2007, and an increase of 8% as compared to $4 million for the first quarter of 2008. The increase over 2007 was primarily due to noncash share-based compensation expense under FAS 123(R), foreign currency exchange rate changes, and one-time charges related to the proposed acquisition of Virtek Vision. Excluding these charges, operating expenses for the second quarter were flat sequentially, and indicative of the cost controls now in place.

Research and development expenses were flat, at about $800,000. Sales, marketing, and general and administrative expenses increased by 28%, or roughly $700,000, versus the year-ago period, primarily due to the non-cash share-based compensation expense, acquisition expenses, and investments in personnel costs.

The operating loss for the second quarter was $1.4 million, compared with operating losses of $1.3 million for the second quarter of 2007 and $1.5 million for the first quarter of 2008. Excluding one-time and foreign currency exchange rate charges, the operating loss for the quarter would be $1.1 million.

The EBITDA loss for the quarter was $284,000, compared to $402,000 for the second quarter of 2007, and $400,000 for the first quarter of 2008. The improvement over the prior year and sequential quarters is a reflection of the continuing steps to improve profitability. EBITDA, adjusted for one-time charges, would have been-- the loss would have been $106,000 for the quarter.

Following to the balance sheet, our net accounts receivable balance was $4.6 million as compared to $4.5 million March 31, 2008, and our day sales outstanding was 49 days compared to 52 days at the end of March. Inventory at quarter end was $4.4 million, compared to $4.1 million at March 31. Our days payable went from 64 days to 60 days at the end of the current quarter.

Finally, before turning the call over to Mark, I would like to update you on our NASDAQ listing status. As you are aware, we were informed on June 26 of this year that we remained out of compliance with the $1 minimum per share bid requirement for continued listing. We have appealed to the NASDAQ listing qualification panel and have an appearance scheduled for mid-August. At that time, we will present a plan to regain compliance with the minimum bid price requirement in order to maintain StockerYale's NASDAQ listing. It is our expectation that our appeal will be granted.

Pending the decision by the panel, the Company's common stock will remain listed under the ticker symbol STKR on the NASDAQ Capital Market. The NASDAQ will typically hold a hearing to consider an appeal approximately 45 days after the appeal is made, and it may take up to 30 days after the hearing to make a decision. We will update investors via press release once notified by the NASDAQ.

Now I'd like to turn the call back over to Mark for concluding remarks.

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**Mark Blodgett** - *StockerYale, Inc - Chairman, CEO*

Thank you, Tim. Our first half performance has set the table for a successful second half, defined by continued top-line growth and progress towards EBITDA profitability and beyond. I'd like to now spend a few minutes going through the catalysts we foresee in the coming periods.

Specific to lasers, Montreal has experienced growth in its defense business. An expected contract this quarter with one of the largest defense contractors is expected to begin to generate revenues in the third quarter and ramp up over the next two years. Further, this same customer was recently shipped our first thulium doped laser and we anticipate other contracts shortly.

Incidentally, you may recall that we acquired the thulium doped technology last fall, and the expected value -- or the value of what was already shipped, actually -- nearly equaled the purchase price of Spectrode.

Photonic Products is also seeing expanding opportunities in machine vision and medical applications. All in all, we expect our laser business to see a meaningful increase in revenue in the second half of this year and into 2009.

As I mentioned earlier, our LED systems business is experiencing substantial growth. I mentioned earlier that the sales and marketing investments made last year are bearing fruit. During the third quarter, we'll be moving this business to a new manufacturing facility that will double our production capacity, which will allow us to continue the aggressive growth of this business.

In terms of our medical strategy, on previous conference calls, I made mention of a large medical device client using our fibers for applications in urology. I can report that we have completed the R&D stage and are currently producing pre-production quantities for shipment this quarter. Next quarter, we expect to build the initial stocking order, with the expectation of moving into full-scale production early next year. Because this product represents a minimally invasive, disposable device, and our customer has the world's leading market share, it has taken longer to ramp this exciting new program than expected.

Beyond this, we're also seeing additional opportunities in flow cytometry, which represents our largest growth opportunity for our high-end laser and optics products, as well as in cell-sorting and microviral detection.

Our medical-biomedical strategy remains on track to generate approximately 20% of total revenue this year and increase as the medical fiber device opportunities referenced above ramp.

In conclusion, I hope you'll agree that we've engineered improvements across all of StockerYale, from sales and sales execution to operations and, ultimately, improved financial performance. More importantly, we've laid the foundation for a strong execution in the second half of 2008, moving into 2009.

This now concludes our prepared remarks and the operator certainly can open the call to questions. Thank you.

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## QUESTIONS AND ANSWERS

**Operator**

All right, thank you. (OPERATOR INSTRUCTIONS) I'm not registering any questions at this time. (OPERATOR INSTRUCTIONS) We do have a question, from the line of Angus Burton with Marathon Capital. Please go ahead.

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**Angus Burton** - *Marathon Capital - Analyst*

Hey, Mark and Tim. Great quarter, guys. Do you have any kind of a timeframe on how long you're willing to go back and forth with Virtek?

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**Mark Blodgett** - *StockerYale, Inc - Chairman, CEO*

A timeframe. I would say, Angus, that the answer is no, although I can say unequivocally our offer to buy the company expires next Friday at midnight. So my expectation is that this opportunity, whether we win or lose, will conclude relatively quickly compared to the amount of time that's already been invested.

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**Angus Burton** - *Marathon Capital - Analyst*

Okay. Another thing I was wondering -- it looks like you're starting to get some traction internationally. Is there any particular area or region that you guys are particularly excited about right now?

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**Mark Blodgett** - *StockerYale, Inc - Chairman, CEO*

Several regions. As I mentioned a little bit earlier, the German market is our second most important market for us. Our products very often get embedded in quality systems or capital equipment. As we all know, Germany is the biggest exporter in the world of this type of equipment. And we have two competitors in terms of our high-end laser modules in Germany; I know the companies well. Our product, pricing, our performance, frankly, is probably the highest in the world in terms of these types of laser modules.

And just from the very fact that the dollar has weakened against the euro over the last two years has really been very beneficial to us in terms of being more competitive in that marketplace.

The second thing I would mention is we continue to see an increase-- I think Tim mentioned that Asian revenues was approximately 10%. We see some very interesting opportunities in Asia. Mitsubishi is our partner in Japan. As many of you know, we'd gotten a distribution agreement with them some time ago. We supplied fiber for EDFAs or amplifiers for the cable TV market, but they're also working on our behalf to sell our fiber-based products in Japan in other areas.

We're also starting to sell more of our products through a distribution partner in China as well. So I see those two markets as very important markets for us.

Then lastly, the biomedical, or medical, market is giving us new impetus in the US market. So I see a high degree of possibility that next year we will see the US go back over 50% of total revenue, just on the basis of these medical and biomedical instrumentation initiatives that are currently underway, plus some US defense business that we're expecting in the near future.

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**Angus Burton** - *Marathon Capital - Analyst*

That's great. I had one last question, then I'll get off the queue, which is your two acquisitions really are showing some nice pipeline. Do you feel you've gotten all the cost efficiencies you can out of them, or do you think there's still some more to come?

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**Mark Blodgett** - *StockerYale, Inc - Chairman, CEO*

I'm going to let Tim talk about that in a second, but before I turn it over to him, I mean, obviously, with Photonic Products, as most of our long-term shareholders know, we had a bit of a misfire to begin with, with the acquisition, in that some changes were made, or some changes weren't made, and we quickly moved, in the summer of last year, to make some management changes post-acquisition. And we also reduced some cost that was put into the business by the prior manager and founder of the company. And by the end of the quarter-- by the end of the year, we started to see, really, the benefit of those types of changes.

With Spectrode, that's really unique in the sense that we really bought technology there. We bought the technology for two reasons -- one, this large defense contractor. One of the largest, probably in the top five in the world, or top three, already had interest in the thulium pulse technology. But we also bought it because we see opportunities in the medical market for thulium pulse lasers as well.

So one is a technology bent and the other is an operational bent. And then I'll let Tim talk about operating efficiencies and whether we'll expect to see continued operating efficiencies.

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**Tim Losik** - *StockerYale, Inc. - COO, CFO*

Thanks, Mark. As Mark just mentioned, the Spectrode acquisition, the cost structure there is quite lean and we're quite proud of that, and it is a technology acquisition. On the Photonic Products side, as well as across the operations -- we said this on the last call, I'll reiterate it -- there's always opportunity for improvement from a cost structure perspective. I think the gross margin this quarter is bearing out those improvements starting to take shape, and we are vigilant and focused on continuing to wring costs out of the organization.

But not just cost -- production, efficiency, productivity and, as Mark said in his opening remarks, working smarter and doing more with what we have as we grow the business and control the cost structure as we grow the business.

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**Angus Burton** - *Marathon Capital - Analyst*

Thanks.

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**Operator**

Thank you. (OPERATOR INSTRUCTIONS) Again, I'm not registering any questions at this time. (OPERATOR INSTRUCTIONS) And Management, with there being no further questions, please continue with any closing comments.

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**Mark Blodgett** - *StockerYale, Inc - Chairman, CEO*

Well, those are all our comments and we appreciate everybody taking the time to listen to our call, and we'll look forward to reporting our progress next quarter. Thank you very much.

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**Operator**

Thank you. Ladies and gentlemen, this does conclude the StockerYale Second Quarter 2008 Earnings Conference Call. If you would like to listen to a replay of today's conference in its entirety, you can do so by dialing 1-800-405-2236 or 303-590-3000; input the access code 11116856. Those numbers again -- 1-800-405-2236 or 303-590-3000. On either number, enter the access code 11116856.

ACT would like to thank you very much for your participation and wish you a very pleasant rest of your day. You may now disconnect.