HEI, Inc.



Annual Report Fiscal Year 2008

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HEI, INC. CONSOLIDATED BALANCE SHEETS (AUDITED)

(AUDITED)			
	Fiscal Period Ending		
	January 3,	September 1,	
	<u>2009</u>	<u>2007</u>	
	(In thousands, except	-	
ASSETS	uai	ia)	
Current assets:			
Cash and cash equivalents	\$ 7	\$ 177	
Accounts receivable, net of allowance for doubtful	Ψ ,	Ψ 177	
accounts of \$77 and \$106, respectively	4,686	4,449	
Inventories, net	3,474	3,260	
Deferred income taxes	435	528	
Other current assets	835	321	
Total current assets	9,437	8,735	
	<u></u>	0,733	
Property and equipment:	216	216	
Land	216	216	
Building and improvements	4,327	4,302	
Fixtures and equipment Accumulated depreciation	23,964	21,829	
•	(21,590)	(20,456)	
Net property and equipment	6,917	5,891	
Security deposit	528	526	
Other long-term assets	408	550	
Total assets	\$ 17,290	\$ 15,702	
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current liabilities:			
Checks issued in excess of cash in bank	\$ 509	\$ 191	
Current maturities of long-term debt	1,026	848	
Accounts payable	1,434	3,215	
Customer deposit liabilities	73	31	
Accrued liabilities	1,391	1,462	
Total current liabilities	4,433	5,747	
Deferred income taxes	435	528	
Other long-term liabilities, less current maturities	1,870	1,717	
Long-term debt, less current maturities	5,923	4,350	
Total other long-term liabilities, less current			
maturities	8,228	6,595	
Total liabilities	12,661	12,342	
	12,001	12,342	
Shareholders' equity:			
Undesignated stock; 5,000,000 shares authorized; none issued			
	-	-	
Convertible preferred stock, \$.05 par;			
167,000 shares authorized; 32,000 shares issued and outstanding; liquidation preference at \$26 per share			
	2	2	
(total liquidation preference \$832,000)	2	2	
Common stock, \$.05 par; 20,000,000 shares authorized; 10,374,000 and 9,570,000 shares issued			
	492	170	
and 9,630,000 and 9,543,000 outstanding	482	478 27.763	
Paid-in capital Accumulated deficit	27,955 (23,810)	27,763 (24,883)	
Total shareholders' equity			
Total liabilities and shareholders' equity	4,629	3,360	
Total habilities and shareholders equity	\$ 17,290	\$ 15,702	

The accompanying notes are an integral part of the consolidated financial statements.

HEI, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(AUDITED)

	Fiscal Periods Ended					
	16 months ended January 3, 2009		12 months ended September 1, 2007			2 months ended eptember 2, 2006
	(In	thousands,	except share and p			share data)
Net sales Cost of sales	\$	55,751 45,183	\$	38,384 36,817	\$	49,061 41,223
Gross profit		10,568		1,567		7,838
Operating expenses: Selling, general and administrative Research, development and engineering Operating income (loss)		7,212 1,658		5,653 2,330		8,429 4,001
Operating income (loss)		1,698		(6,416)	_	(4,592)
Interest expense Other income (expense), net		(836) 211		(1,312) 540		(776) (34)
Income (loss) from continuing operations before income taxes Income tax provision		1,073		(7,188)		(5,402)
Income (loss) from continuing operations Loss from discontinued operations Gain on sale of discontinued operations		1,073		(7,188) (217) 1,748		(5,402) (655)
Net income (loss)	\$	1,073	\$	(5,657)	\$	(6,057)
Income (loss) per common share — basic and diluted: Continuing operations Discontinued operations Net income (loss)	\$	0.11	_	(0.75) 0.16 (0.59)		(0.57) (0.07) (0.64)
Weighted average common shares outstanding: Basic and diluted	9	<u>,575,000</u>		9,522,000		9,469,000

The accompanying notes are an integral part of the consolidated financial statements

HEI, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (AUDITED)

				Convertible							R	elated	,	Total
	Common			Preferred	C	onvertible	A	dditional			P	arty—	S	Share-
	Stock Shares	Cor	mmon	Stock Shares	I	Preferred]	Paid-In	Ac	cumulated]	Notes	H	olders'
	Outstanding	S	tock_	Outstanding		Stock	9	<u>Capital</u>		<u>Deficit</u>	Re	<u>xeivable</u>	<u>I</u>	<u>Equity</u>
					(In t	housands, ex	cept	share data)					
Balance August 31, 2005	9,379,000	\$	469	32,000	\$	2	\$	26,701	\$	(13,169)	\$	(207)	\$	13,796
Net loss	-		-	-		-		-		(6,057)		-		(6,057)
Payments on officers loans	-		-	-		-		-		-		139		139
Stock based compensation expense Issuance of common stock to landlord recognized as	-		-	-		-		503		-		-		503
long-term asset	100,000		5	-		-		331		-		-		336
Issuance of common shares under stock benefit plans														
and option plans	25,000		1	-		-		46		-		-		47
Balance September 2, 2006	9,504,000		475	32,000		2		27,581		(19,226)		(68)		8,764
Net loss			-			-		-		(5,657)		-		(5,657)
Payments on former director loan	-		-	-		-		-		-		51		51
Write-off of former director loan	-		-	-		-		-		-		17		17
Stock based compensation expense	-		-	-		-		185		-		-		185
Is suance of common shares under stock benefit plans														
and option plans	39,000		3			-		(3)		-		-		-
Balance September 1, 2007	9,543,000		478	32,000	_	2		27,763		(24,883)		-		3,360
Net income	-		-	-		-		-		1,073		-		1,073
Stock based compensation expense	-		-	-		-		196		-		-		196
Issuance of common shares under stock benefit plans														
and option plans	87,000		4					(4)				-		-
Balance January 3, 2009	9,630,000	\$	482	32,000	\$	2	\$	27,955	\$	(23,810)	\$	-	\$	4,629

The accompanying notes are an integral part of the consolidated financial statements

HEI, INC. CONSOLIDATED STATEMENTS OF CASH FLOWS (AUDITED)

		Fiscal Period Ended	<u>L</u>
	16 months ended January 3, 2009	12 months ended September 1, 2007	12 months ended September 2, 2006
	(In thousand	s, except share and p	er share data)
Cash flow from operating activities:			
Net income (loss)	\$ 1,073		,
Depreciation and amortization	2,234	1,989	2,473
Adjustments to reconcile net income (loss) to cash flow from			
operating activities:	(2.0)	(40)	(2.2)
Change in accounts receivable allowance	(29)	` '	(33)
(Gain) loss on disposal of property and equipment Gain on sale of discontinued operations	(51)		49
Write off of former director loan	-	(1,748)	-
Stock based compensation expense	196	17 185	503
Changes in operating assets and liabilities:	190	103	303
Accounts receivable	(208)	4,211	106
Inventories	(214)	,	1,044
Other current assets	(561)		820
Accounts payable	(1,781)		(284)
Customer deposit liabilities	42	-	(== -)
Accrued liabilities	82	(569)	(1,269)
Net cash flow provided by (used in) operating activities	783	1,298	(2,648)
Cash flow from investing activities:			
Additions to property and equipment	(3,024)	(451)	(955)
Proceeds from the sale of assets	52	177	96
Additions to patents	(50)	(10)	(22)
Security deposit	-	24	1,030
Proceeds from sale of discontinued operations		2,953	
Net cash flow provided by (used in) investing activities	(3,022)	2,693	149
Cash flow from financing activities:			
Checks written in excess of cash in bank	318	191	-
Issuance of common stock under stock plans	-	_	47
Officer/former director note repayment	-	51	139
Payment of debt issuance costs	- 4.455	(118)	- (7.10)
Repayment of long-term debt	(1,125)		(749)
Proceeds from long-term debt	1,233	2,457	-
Net proceeds from long-term debt - revolving line of credit Net borrowings (repayments) on line of credit	1,643	(5,948)	3,385
Net cash flow provided by (used in) financing activities	2,069	(4,488)	2,822
Net increase (decrease) in cash and cash equivalents	(170)	(497)	323
Cash and cash equivalents, beginning of year	177	674	351
Cash and cash equivalents, end of year	\$ 7	\$ 177	\$ 674
Supplemental disclosures of cash flow information:		_	_
Interest paid	\$ 803	\$ 1,269	\$ 799

Supplemental disclosures of non-cash financing and investing activities:

In Fiscal 2006, capital lease obligations related to property and equipment were \$2,314 and issuance of common stock to landlord recognized as a long-term asset was \$336.

In Fiscal 2008 and 2007, the company issued common stock for vested restricted stock awards of \$4 and \$3, respectively

The accompanying notes are an integral part of the consolidated financial statements

HEI, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1

Overview

HEI, Inc. is referred to herein as "HEI," the "Company," "us," "we" or "our," unless the context indicates otherwise. We operate three facilities in North America in support of our global based customers. We provide contract manufacturing solutions to customers through our internal substrate and microelectronic assembly capabilities and our medical box build transitional manufacturing services. Our primary markets are medical, telecommunications, industrial, military and aerospace. We support our customers' products from initial product development and design through manufacturing to worldwide distribution and aftermarket support.

Fiscal 16 months in 2008

HEI changed its fiscal year end to the Saturday closest to December 31. The revised fiscal year 2008 ended on January 3, 2009 which is a 16 month reporting period and is identified here in as Fiscal 2008. During fiscal year 2006, the Company had changed its fiscal year end to a 52 or 53 week period ending on the Saturday closest to August 31. Fiscal year 2007 ended September 1, 2007 and fiscal year 2006 ended on September 2, 2006, and are identified herein as Fiscal 2007 and Fiscal 2006, respectively.

Discontinued operations

The Company sold substantially all of the assets and liabilities of its RFID business effective August 31, 2007. The divestiture, which occurred at the end of Fiscal 2007, is treated as a discontinued operation for the Company. All results of operations and assets and liabilities of RFID for all periods presented have been restated and classified as discontinued operations. All references to the business are based on results of operations from continuing operations.

Summary of Significant Accounting Policies

Principles of Consolidation. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation.

Revenue Recognition. Revenue for manufacturing and assembly is recognized upon shipment to the customer which represents the point at which the risks and rewards of ownership have been transferred to the customer.

Our Advanced Medical Operations development contracts are typically discrete time and materials projects that generally do not involve separately priced deliverables. Development contract revenue is recognized ratably as development activities occur based on contractual per hour and material reimbursement rates. Development contracts are an interactive process with customers as different design and functionality is contemplated during the design phase. Upon reaching the contractual billing maximums, we defer revenue until contract extensions or purchase orders are received from customers. We occasionally have contractual arrangements in which part or all of the payment or billing is contingent upon achieving milestones or customer acceptance. For those contracts we evaluate whether the contract should be accounted using the completed contract method if the term of the arrangement is short-term or using the percentage of completion method for longer-term contracts.

The company collects taxes from customers to be remitted to governmental authorities. The Company's policy is to present taxes imposed on revenue-producing transactions on a net basis.

Cash Equivalents. The Company considers its investments in all highly liquid debt instruments with original maturities of three months or less at date of purchase to be cash equivalents. The Company is operating under a revolving line of credit which funds our cash needs on a daily basis. We do not maintain cash balances as part of this arrangement other than small operating accounts.

Accounts Receivable. The Company reviews customers' credit history before extending unsecured credit and establishes an allowance for uncollectible accounts based upon factors surrounding the credit risk of specific customers and other information. Credit risk on accounts receivable is minimized as a result of the diverse nature of the Company's customer base. Invoices are generally due 30 to

90 days after presentation. Accounts receivable that extend past their due date are considered past due. The Company does not accrue interest on past due accounts receivable. Receivables are written off only after all collection attempts have failed and are based on individual credit evaluation and specific circumstances of the customer. Accounts receivable are shown net of an allowance for uncollectible accounts of \$77,000 and \$106,000 at January 3, 2009 and September 1, 2007, respectively. During Fiscal 2008 and Fiscal 2007, the Company reduced the allowance for uncollectible accounts by \$29,000 and \$18,000, respectively. Accounts receivable over 90 days past due, including discontinued operations accounts receivable over 90 days past due, were \$29,000 and \$66,000 at January 3, 2009 and September 1, 2007, respectively.

Inventories. Inventories are stated at the lower of cost or market and include materials, labor, and overhead costs. Cost is determined using the first-in, first-out method (FIFO). A large portion of the inventory is purchased based upon contractual forecasts and customer purchase orders, in which case excess or obsolete inventory is generally the customers' responsibility. Inventory reserves of \$214,000 and \$529,000 at January 3, 2009 and September 1, 2007, respectively, are established for excess and slow-moving inventory, which are netted against the inventory balances shown in the consolidated financial statements.

Property and Equipment. Property and equipment are stated at cost. Depreciation and amortization are provided on the straight-line method over the estimated useful lives of the property and equipment. The approximate useful lives of building and improvements are 10-39 years and fixtures and equipment are 3-10 years. Depreciation and amortization expense on property and equipment, including capital leases, for both continuing and discontinued operations was \$1,997,000, \$1,831,000 and \$2,320,000 for the fiscal years ended January 3, 2009, September 1, 2007 and September 2, 2006, respectively.

Maintenance and repairs are charged to expense as incurred. Major improvements and tooling costs are capitalized and depreciated using the straight-line method over their estimated useful lives. The cost and accumulated depreciation of property and equipment retired or otherwise disposed of is removed from the related accounts, and any resulting gain or loss is credited or charged to operations.

Patents. External costs associated with patents are capitalized and amortized over 84 months or the remaining life of the patent, whichever is shorter. Amortization expense related to patents was \$117,000, \$88,000 and \$88,000 for Fiscal 2008, 2007 and 2006, respectively. Amortization expense is expected to approximate \$52,000, \$16,000, \$16,000, and \$10,000 in each of the next four fiscal years, respectively, at which time the patents will be fully amortized. The book value of the patents is as follows (included in other long-term assets):

	As of January 3,	As of September
	2009	1, 2007
Patent asset balance	\$ 640,000	\$ 590,000
Less accumulated amortization	(546,000)	(429,000)
Net patent value	\$ 94,000	\$ 161,000

Impairment of Notes Receivable. The Company routinely performs an analysis as to the probability that a receivable is collectible. A note receivable is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the note receivable agreement including scheduled interest payments. At the end of Fiscal 2007, the Company had written off the remaining balance of a note receivable from a former director as uncollectible. No notes receivable are recorded on the books of the Company at January 3, 2009.

Impairment of Long-lived and Intangible Assets. We continually evaluate whether events and circumstances have occurred that indicate the remaining estimated useful life of long-lived assets may warrant revision, or that the remaining balance of these assets may not be recoverable. We evaluate the recoverability of our long-lived assets in accordance with Statement of Financial Accounting Standards No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets." When deemed necessary, we complete this evaluation by comparing the carrying amount of the assets against the estimated undiscounted future cash flows associated with them. If such evaluations indicate that the future undiscounted cash flows of long-lived assets are not sufficient to recover the carrying value of such assets, the assets are adjusted to their estimated fair values. The Company assesses the impairment of its manufacturing equipment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important which could trigger an impairment review, and potentially an impairment charge, include the following: significant underperformance relative to historical or projected future operating results; significant changes in the manner of use of the acquired

assets or the Company's overall business strategy; significant negative market or economic trends; and significant decline in the Company's stock price for a sustained period changing the Company's market capitalization relative to its net book value. Considerable management judgment is necessary in estimating future cash flows and other factors affecting the valuation of long-lived assets, including intangible assets, including the operating and macroeconomic factors that may affect them. We use historical financial information, internal plans and projections and industry information in making such estimates. There were no asset impairments in Fiscal 2008, Fiscal 2007 or Fiscal 2006.

Research, Development and Engineering. The Company expenses all research, development and engineering costs as incurred.

Shipping and Handling. The Company includes shipping and handling revenue in net sales and shipping and handling costs in cost of sales.

Advertising. Advertising costs are charged to expense as incurred. Advertising costs were \$112,000, \$95,000 and \$511,000 for the periods Fiscal 2008, Fiscal 2007, and Fiscal 2006, respectively, and are included in selling, general and administrative expense.

Income Taxes. Deferred income tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the consolidated financial statements or income tax returns. Deferred income tax assets and liabilities are determined based on the differences between the financial statement and tax bases of assets and liabilities using currently enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts more likely than not to be realized. Income tax expense (benefit) is the tax payable (receivable) for the period and the change during the period in deferred income tax assets and liabilities.

Stock-based Compensation. On December 16, 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment", which is a revision of SFAS No. 123 and supersedes APB Opinion No. 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. Pro forma disclosure of the income statement effects of share-based payments is no longer an alternative. For the Company, SFAS No. 123(R) was effective for all share-based awards granted on or after September 1, 2005. In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date. Compensation expense for the unvested awards was measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123. We implemented SFAS No. 123(R) on September 1, 2005 using the modified prospective method.

We have granted stock options over the years to employees and directors under various stockholder approved stock option plans. As of January 3, 2009, 363,700 stock options are outstanding. The fair value of each option grant was determined as of grant date, utilizing the Black-Scholes option pricing model. The Company calculates expected volatility for stock options and awards using historical volatility as the Company believes the expected volatility will approximate historical volatility. The Company estimates the forfeiture rate for stock options using 10% for key employees and 15% for non-key employees. Based on these valuations, we recognized compensation expense of \$54,000 (\$.01 per share) in Fiscal 2008 related to the amortization of the unvested portion of these options compared to \$125,000 (\$0.01 per share) for Fiscal 2007 and compared to \$437,000 (\$0.05 per share) for Fiscal 2006. The amortization of each option grant will continue over the remainder of the vesting period of each option grant. Stock based compensation expense for outstanding options as of January 3, 2009 is expected to approximate \$9,000 and \$3,000 in each of the next two fiscal years, respectively, at which time they will be fully amortized.

During Fiscal 2006, we modified the terms of 100,000 options to accelerate vesting on any unvested portion of these grants and to extend the exercise period on 25,000 options for 90 days beyond normal terms. The effect of these actions was an additional non-cash expense of \$42,000 in Fiscal 2006. No changes or modifications were made to any outstanding options during Fiscal 2008 or Fiscal 2007.

Stock based compensation expense related to the restricted stock was \$142,000, \$60,000 and \$24,000 for Fiscal 2008, Fiscal 2007, and Fiscal 2006, respectively. As of January 3, 2009, 745,000 shares of restricted stock remain unvested. Stock based compensation expense for outstanding restricted stock as of January 3, 2009 is expected to approximate \$144,000, \$84,000, \$142,000, \$218,000 and \$115,000 in each of the next five fiscal years, respectively.

There were no options granted in the sixteen months ended January 3, 2009 or in the twelve months ended September 1, 2007. There were 5,000 options granted in the twelve months ended September 2, 2006.

Customer Deposits. Customer deposits result from cash received in advance of manufacturing services being performed.

Income (Loss) Per Common Share. Basic income (loss) per share ("EPS") is computed by dividing net income or loss by the weighted average number of common shares outstanding during each period. Diluted earnings (loss) per share are computed by dividing net income or loss by the weighted average number of common shares outstanding assuming the exercise of convertible preferred stock, dilutive stock options and warrants. The dilutive effect of the stock options, restricted stock and warrants is computed using the average market price of the Company's stock during each period under the treasury stock method. During periods of loss, convertible preferred stock, options, restricted stock and warrants are not dilutive and are thus excluded from the calculation.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates.

Financial Instruments. The fair value of accounts receivable and accounts payable approximate their carrying value due to the short-term nature of these instruments. The fair market values of the Company's borrowings and other long-term liabilities outstanding approximate their carrying values based upon current market rates of interest.

Discontinued Operations: The sale of the Company's radio frequency identification ("RFID") business unit to a third party was completed on August 31, 2007 pursuant to the terms of an Asset Purchase Agreement dated August 30, 2007. The transaction involved the sale of substantially all of the assets and liabilities of RFID. The Company has restated the previously reported financial results of RFID to report the net results as a separate line in the consolidated statements of operations as "Loss from discontinued operations" for all periods presented. In accordance with Emerging Issues Task Force (EITF) 87-24, "Allocation of Interest to Discontinued Operations", the Company elected to not allocate consolidated interest expense to the discontinued operations where the debt is not directly attributed to or related to the discontinued operations. All of the financial information in the consolidated financial statements and notes to the consolidated financial statements has been revised to reflect only the results of continuing operations.

New Accounting Pronouncements. The FASB has published FASB Interpretation (FIN) No. 48 (FIN No. 48), Accounting for Uncertainty in Income Taxes, to address the noncomparability in reporting tax assets and liabilities resulting from a lack of specific guidance in FASB Statement of Financial Accounting Standards (SFAS) No. 109 (SFAS No. 109), Accounting for Income Taxes, on the uncertainty in income taxes recognized in an enterprise's financial statements. Specifically, FIN No. 48 prescribes (a) a consistent recognition threshold and (b) a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and provides related guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for our Fiscal 2009 and we do not believe it will have a material effect on our consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin 108, "Considering the Effects on Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," ("SAB 108"). SAB 108 requires registrants to quantify errors using both the income statement method (i.e. iron curtain method) and the rollover method and requires adjustment if either method indicates a material error. If a correction in the current year relating to prior year errors is material to the current year, then the prior year financial information needs to be corrected. A correction to the prior year results that are not material to those years, would not require a "restatement process" where prior financials would be amended. SAB 108 was effective for our Fiscal 2007 and did not have a material effect on our financial position, results of operations or cash flows.

Note 2

Liquidity

We generated net income for the 16-month reporting period of Fiscal 2008 of \$1,073,000, a net loss for the 12-month reporting period of Fiscal 2007 of (\$5,657,000), and a net loss for the 12-month reporting period of Fiscal 2006 of (\$6,057,000). Net sales increased in Fiscal 2008 and declined in Fiscal 2007 as compared to the prior fiscal year. The Company began cutting costs at the end of Fiscal 2006 and continued throughout all of Fiscal 2007 as a result of the previously declining sales. The reductions were made across the board in the areas including operations, selling, general and administrative, research and development, and engineering. These cost reductions had little to no impact in reducing the operating loss during Fiscal 2006 and the severance costs and capitalized inventory overhead adjustments negatively impacted results during Fiscal 2007. The operating losses sustained during Fiscal 2007 were funded

through borrowing under our various line of credit facilities. During Fiscal 2006, the operating losses were funded in part by the refund of the security deposit on our AMO facility in the amount of \$1.35 million (net of additional security deposits on other debt of \$320,000).

By the beginning of Fiscal 2008, the Company had realigned its costs with existing revenues and began to show profitable operations. At the same time that we were cutting costs, we focused on operational improvements and began lean flow initiatives at two of our three operations. The impact was to improve gross margins and improve the flow of product through our plants.

On November 3, 2006, Thomas F. Leahy, the Chairman of the Board of Directors of the Company, loaned the Company \$5,000,000 dollars (the "Secured Loan"). The Company's obligations under the Secured Loan were evidenced by a promissory note (the "Note") and a security agreement. The Note had an original principal amount of \$5,000,000, and required the Company to pay monthly installments of interest, and a maturity of November 2, 2007. The Company used \$2,200,000 of the proceeds of the Secured Loan to satisfy the Company's obligations under its accounts receiveable agreement with Beacon Bank of Shorewood, Minnesota dated May 29, 2003, as amended. The remainder of the proceeds were available for general working capital needs. The Secured Loan was paid off in full on May 15, 2007. During the period of time that this related party Note was outstanding, the Company paid Mr. Leahy a total of \$451,000 in interest payments.

On May 15, 2007, the Company entered into a three year \$8.0 million revolving credit facility pursuant to a Credit and Security Agreement with Wells Fargo Business Credit, and a three year \$340,000 term loan. On August 31, 2008, the Company signed an amendment to the Credit and Security Agreement to reduce the overall revolving credit facility to \$6.0 million and to extend the term of the agreement by two years to May 15, 2012. Borrowings under these facilities were used to repay the \$5.0 million loan to the Company by Thomas F. Leahy, the Company's Chairman of the Board, to repay certain obligations of the Company and for general operating purposes. Mr. Leahy guaranteed the financing package in an amount not to exceed \$4.0 million and provided collateral to secure the guarantee in the amount of \$4.0 million. In return, he is paid a guarantee fee in the amount of \$8,000 per month by the Company in consideration for the guarantee and collateral pledge. Mr. Leahy's collateral pledge was reduced during Fiscal 2008 to \$3.35 million. The revolving credit facilities are secured by accounts receivable and inventories and a third mortgage position on the Company's Victoria, Minnesota production facility. The term loan is secured by a first priority security interest in all non-leased assets at the Company's Tempe, Arizona production facility. The revolving line of credit advance rates are based on outstanding balances of both domestic and foreign accounts receivable and certain inventory balances. The interest rate on the revolving line of credit advances is 2% over prime and the term loan interest rate is 2.25% over prime, except upon an event of default. As of January 3, 2009, the prime rate was 3.25%. The term loan has a 60 month amortization period with monthly payments that began June 1, 2007 with the balance due and payable in full on May 15, 2012. The credit facilities require a minimum interest charge of \$150,000 per year and there is an unused line fee of 0.25% under the revolving credit facility with a term date of May 15, 2012.

These credit facilities with Wells Fargo Business Credit ("Wells") contain customary affirmative and negative covenants. The financial covenants include a limitation on capital expenditures and a minimum debt service coverage ratio that began the Company's fiscal year 2008. The creation of indebtedness outside the credit facility, creation of liens, making of certain investments, sale of assets, and incurrence of debt are all either limited or require prior approval from Wells under those facilities. These credit facilities also contain customary events of default such as nonpayment, bankruptcy, and change in the Company's Chairman of the Board, which if they occur may constitute an event of default. The Company was in compliance with all of the debt covenants as of January 3, 2009.

On August 31, 2007, the Company sold its RFID business unit for \$3 million cash, resulting in a pre-tax gain of approximately \$1.7 million reported in the Company's Fiscal 2007 results. Cash proceeds from the sale were used to reduce borrowing under the Company's existing credit facility.

At January 3, 2009 our sources of liquidity consisted primarily of approximately \$1.6 million of borrowing capacity under our revolving credit facility. Our liquidity, however, is affected by many factors, some of which are based on the normal ongoing operations of our business, the most significant of which include the timing of the collection of receivables, the level of inventories and capital expenditures.

During Fiscal 2008, the Company purchased approximately \$3 million in new capital equipment, primarily in support of its Tempe Arizona and Victoria Minnesota operations. During Fiscal 2007, we limited spending for manufacturing equipment. The Company expects to add additional capital equipment in Fiscal 2009, but on a conservative basis as a result of the current US and global economic situation. It is expected that these expenditures will be funded from cash generated from operations and available debt

financing. The Company has pre-approval under its current credit facilities for approximately \$2 million of additional capital expenditures for Fiscal 2009.

In the event future cash flows and borrowing capacities are not sufficient to fund operations at the present level, additional measures will be taken including efforts to further reduce expenditure levels that may include reduction of spending for research and development, engineering, elimination of budgeted raises, and reduction of non-strategic employees and the deferral or elimination of capital expenditures. In addition, we believe that other sources of liquidity are available which may include issuance of the Company's stock, the expansion of our credit facilities and the issuance of long-term debt.

Management believes that existing, current and future lending capacity and cash generated from operations will supply sufficient cash flow to meet short-term and long-term debt obligations, working capital, capital expenditure and operating requirements for at least the next 12 months.

Other Financial Statement Data

Note 3

The following provides additional information concerning selected consolidated balance sheet accounts at January 3, 2009 and September 1, 2007:

	Fiscal period ended				
	<u>Janua</u>	ry 3, 2009	September 1, 2007		
		(In thou	usands)		
Inventories:					
Purchased parts	\$	2,935	\$	2,591	
Work in process		218		325	
Finished goods		321	-	344	
	\$	3,474	\$	3,260	
Accrued liabilities:					
Employee related costs	\$	865	\$	973	
Real estate taxes		78		16	
Current portion of long-term liabilities		79		79	
Warranty reserve		31		11	
Deferred revenue		116		-	
Other accrued liabilities		222		383	
	\$	1,391	\$	1,462	
Other long-term liabilities:	'			_	
Remaining sublease lease obligation	\$	422	\$	474	
Unfavorable operating lease, net		433		487	
Accrued lease expense		1,094		835	
Total		1,949		1,796	
Less current maturities		79		79	
Total other long-term liabilities	\$	1,870	\$	1,717	

Note 4

Warranty Obligations

Sales of our products are subject to limited warranty guarantees that typically extend for a period of twelve months from the date of manufacture. The Company offers extended warranty coverage on certain products it manufactures. If an extended warranty is purchased by a customer the Company recognizes revenue over the life of the warranty period and records the estimated warranty expense over the same period. Warranty terms are included in customer contracts under which we are obligated to repair, replace or refund the purchase price of any components or assemblies our customers deem defective due to workmanship or materials. We do, however, reserve the right to reject warranty claims where we determine that failure is due to normal wear, customer modifications, improper maintenance, or misuse. Warranty provisions are based on estimated returns and warranty expenses applied to current period revenue and historical warranty incidence over the preceding twelve-month period. Both the experience and the warranty liability are evaluated on an ongoing basis for adequacy. The following is a roll forward of the Company's product warranty accrual for each of the fiscal periods ending January 3, 2009:

	Balance at Begi	nning					Bala	nce at End <u>of</u>
(In thousands)	of Year		Pro	visions	Cla	aims_		<u>Year</u>
Fiscal 2008	\$	11	\$	20	\$	-	\$	31
Fiscal 2007	\$	12	\$	7	\$	8	\$	11
Fiscal 2006	\$	132	\$	(79)	\$	41	\$	12

Note 5

Long-Term Debt, including Revolving Line of Credit Facility

Our long-term debt consists of the following:

	January 3, 2009	September 1, 2007
	(In th	ousands)
Commerce Bank mortgage payable in monthly installments of principal and interest of \$11 based on a twenty-year amortization with a final payment of approximately \$1,035 due in November 2009; collateralized by our Victoria facility	\$ 1,053	\$ 1,097
Wells Fargo Business Credit Term Loan #1 payable in monthly principal installments of \$6 through May 2012 based on a 60 month amortization with a final payment of approximately \$6 due in May 2012; collateralized by equipment located at our Tempe facility	227	323
•	227	323
Wells Fargo Business Credit Term Loan #2 payable in monthly principal installments of \$7 through May 2012 based on a 60 month amortization with a final payment of approximately \$114 due in May 2012; collateralized by select equipment located at our Victoria facility	376	-
Wells Fargo Business Credit Term Loan #3 payable in monthly principal installments of \$14 through May 2012 based on a 60 month amortization with a final payment of approximately \$263 due in May 2012; collateralized by select equipment located at our Tempe facility	830	-
Wells Fargo Business Credit Revolving Line of Credit through May 2012; available borrowing is based on advance rates of accounts receivable and certain inventories; collateralized by substantially all assets of the Company	3,758	2,114
Capital lease and commercial loan obligations; payable in installments of \$56 with periods ending February 2009 through February 2010; collateralized with certain machinery and		
equipment	705	1,664
Total Less current maturities	6,949 1,026	5,198 848
Total long-term debt	\$ 5,923	\$ 4,350

The Company had two separate loans in the original aggregate amount of \$2,350,000 under Term Loan Agreements with Commerce Bank, a Minnesota state banking association, and its affiliate, Commerce Financial Group, Inc., a Minnesota corporation. The first loan, with Commerce Bank, in the amount of \$1,200,000 was executed on October 14, 2003. This loan remains outstanding and is secured by our Victoria, Minnesota facility. The term of the first loan is six years with a nominal interest rate of 6.50% per year for the first three years. The rate was adjusted per the original agreement on November 1, 2006 to 9.25% per year. Monthly payment of principal and interest is based on a twenty-year amortization with a final payment of approximately \$1,035,000 due on November 1, 2009 (see Note 17). The second loan, with Commerce Financial Group, Inc., in the amount of \$1,150,000 was executed on October

28, 2003. The second loan was secured by our Victoria facility and certain equipment located at our Tempe facility. The second loan was due October 27, 2007, but the loan was paid off early through the use of the proceeds from the Wells Fargo Business Credit revolving line of credit and term loan facilities that were entered into on May 15, 2007. There was no outstanding balance under the second loan as of September 1, 2007 or Janaury 3, 2009.

During Fiscal 2006, the Company entered into several capital lease agreements to fund the acquisition of machinery and equipment, primarily at our Tempe facility. Most of these leases were entered into with Commerce Financial Group and are secured by the equipment being leased and a secured interest in our Victoria building. The total principal amount of these leases as of January 3, 2009 is \$698,000 with an average effective interest rate of 12.4%. These agreements are for 36 to 45 months. At the end of the lease we have the option to purchase the equipment for \$1 or at an agreed upon value which is generally not less than 15% nor greater than 20% of the original equipment cost.

On May 15, 2007, the Company entered into a three year \$8.0 million revolving credit facility pursuant to a Credit and Security Agreement with Wells Fargo Business Credit, and a three year \$340,000 term loan. On August 31, 2008, the Company signed an amendment to the Credit and Security Agreement to reduce the overall revolving credit facility to \$6.0 million and to extend the term of the agreement by two years to May 15, 2012. Borrowings under these facilities were used to repay the \$5.0 million loan to the Company by Thomas F. Leahy, the Company's Chairman of the Board, to repay certain obligations of the Company and for general operating purposes. Mr. Leahy guaranteed the financing package in an amount not to exceed \$4.0 million and provided collateral to secure the guarantee in the amount of \$4.0 million. In return, he is paid a guarantee fee in the amount of \$8,000 per month by the Company in consideration for the guarantee and collateral pledge. Mr. Leahy's collateral pledge was reduced during Fiscal 2008 to \$3.35 million. The revolving credit facilities are secured by accounts receivable and inventories and a third mortgage position on the Company's Victoria, Minnesota production facility. The term loan is secured by a first priority security interest in all non-leased assets at the Company's Tempe, Arizona production facility. The revolving line of credit advance rates are based on outstanding balances of both domestic and foreign accounts receivable and certain inventory balances. The interest rate on the revolving line of credit advances is 2% over prime and the term loan interest rate is 2.25% over prime, except upon an event of default. As of January 3, 2009, the prime rate was 3.25%. The term loan has a 60 month amortization period with monthly payments that began June 1, 2007 with the balance due and payable in full on May 15, 2012. The credit facilities require a minimum interest charge of \$150,000 per year and there is an unused line fee of 0.25% under the revolving credit facility with a term date of May 15, 2012. At January 3, 2009, the availability under the revolving credit facility based on collateral was approximately \$1.6 million.

Principal maturities of long-term debt at January 3, 2009, are as follows:

(In the	ousands)
\$	369
	365
	367
	4,295
	59
-	789
\$	6,244

Future minimum capital lease payments are as follows for the fiscal years ending after January 3, 2009:

Fiscal Years Ending	(In thousa	ands)
2009	\$	705
2010		49
Total		754
Less: amount representing interest		(49)
Present value of future minimum lease payments		705
Less: current portion		(657)
Capital lease obligations, net of current portion	\$	48

The book value of the capital leases are as follows:

	Fiscal period ended					
		<u>January 3, 2009</u>		<u>September 1, 2007</u>		
	(In thousands)					
Capital lease asset balance	\$	3,060	\$	3,092		
Less accumulated amortization		(1,650)		(908)		
Net capital lease asset value	\$	1,410	\$	2,184		

Note 6

Line of Credit

In April 2006, the Company entered into a \$2,000,000 revolving line of credit with Beacon Bank that was secured by a portion of our inventory and our foreign accounts receivable and guaranteed by the Small Business Administration (the "Line of Credit"). The Line of Credit expired in April 2007 and was paid off in April and May 2007.

In May 2003, the Company entered into an accounts receivable agreement (the "Credit Agreement") with Beacon Bank of Shorewood, Minnesota which was scheduled to expire February 1, 2007. The Credit Agreement provided for a maximum amount of credit of \$5,000,000. The Credit Agreement was an accounts receivable backed facility and was additionally secured by inventory, intellectual property and other general intangibles. This Credit Agreement was paid off in November 2006.

Note 7

Income Taxes

Income tax expense (benefit) for the fiscal periods ended January 3, 2009, September 1, 2007 and September 2, 2006, consisted of the following:

	Fiscal period ended					
	<u>Januar</u>	y 3, 2009	Septembe (In thou		Septembe	r 2, 2006
Current:						
Federal	\$	-	\$	-	\$	-
State		-		-		-
Deferred		<u>-</u>		_		<u>-</u>
Income tax expense (benefit)	\$	<u>-</u>	\$	<u>=</u>	\$	

Actual income tax expense (benefit) differs from the expected amount based upon the statutory federal tax rates as follows:

		Fiscal period ended	
	January 3, 2009	September 1, 2007	September 2, 2006
Federal statutory tax rate	34.0%	(34.0)%	(34.0)%
State income tax rate (net of federal tax effect)	4.9%	(5.2)%	(5.2)%
Change in valuation allowance	(42.3)%	40.3%	43.3%
Permanent differences and other	3.4%	(1.1)%	(4.1)%
Effective tax rate	<u>0.0%</u>	<u>0.0%</u>	<u>0.0%</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at January 3, 2009 and September 1, 2007 are as follows:

	Fiscal year ended			
	January 3, 2009			nber 1, 2007
		(In thou	sands)	
Deferred tax assets (current):				
Receivables	\$	30	\$	40
Inventories		199		263
Accrued liabilities		206		225
		435		528
Deferred tax assets (long-term):				
Net operating loss carry-forward		10,537		11,829
Capital loss carry-forward		-		235
Stock based compensation		22		68
Other		197		189
Gross deferred tax assets (long-term)		10,756		12,321
Less: Deferred tax assets valuation allowance		(10,298)		(12,103)
Net deferred tax assets (long-term)		458		218
Deferred tax liabilities (long-term):				
Property and equipment		(893)		(746)
Net deferred tax liabilities (long-term)		(893)		(746)
Net deferred tax asset	\$		\$	_

The Company has federal and state net operating loss carry-forwards at January 3, 2009, of approximately \$28.3 and \$12.3 million, respectively, which is available to reduce income taxes payable in future years. If not used, this carry-forward will expire in years 2012 through 2027. Under the Tax Reform Act of 1986, the utilization of this tax loss carry-forward may be limited as a result of significant changes in ownership.

The valuation allowance for deferred tax assets as of January 3, 2009 was \$10,298,000 and as of September 1, 2007 was \$12,103,000. The total valuation allowance for the fiscal period ended January 3, 2009 decreased \$1,805,000, increased by \$2,282,000 and \$2,626,000 for the fiscal years ended September 1, 2007 and September 2, 2006, respectively. The valuation allowance decrease in the current year primarily as a result of taxable income generated during the year, which included an adjustment of \$1,350,000 to decrease net operating loss carryforwards and valuation to their proper amounts. In assessing the recovery of the deferred tax asset, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income in the periods in which those temporary differences become deductible. Management considers the scheduled reversals of future deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment.

Note 8

Stock Benefit Plans

1998 Plan. Under the Company's 1998 Stock Option Plan (the "1998 Plan"), a maximum of 2,000,000 shares of common stock may be issued pursuant to qualified and nonqualified stock options. Stock options granted become exercisable in varying increments with a portion tied to the closing stock price or up to a maximum of ten years, whichever comes first. The exercise price for options granted

is equal to the closing market price of the common stock on the date of the grant. The 1998 Plan expired November 18, 2008. At January 3, 2009, no shares were available for grant under the 1998 Plan.

1989 Plan. Under the Company's 1989 Omnibus Stock Compensation Plan (the "1989 Plan"), a maximum of 2,000,000 shares of common stock may be issued pursuant to qualified and nonqualified stock options, stock purchase rights and other stock-based awards. Stock options granted become exercisable in varying increments with a portion tied to the closing stock price or up to a maximum of ten years, whichever comes first. Generally, the exercise price for options granted is equal to the closing market price of the common stock on the date of the grant.

Under the 1989 Plan, substantially all regular full-time employees are given the opportunity to designate up to 10% of their annual compensation to be withheld, through payroll deductions, for the purchase of common stock at 85% of the lower of (i) the market price at the beginning of the plan year, or (ii) the market price at the end of the plan year. No shares were purchased under the 1989 Plan in connection with the employee stock purchase plan during Fiscal 2008, 2007 or 2006. The 1989 Plan expired November 18, 2008. At January 3, 2009, no shares were available for grant under the 1989 Plan.

Directors' Plan. During Fiscal 1999, the shareholders approved the 1998 Stock Option Plan for Non-employee Directors (the "Director's Plan"). Under the Director's Plan, 425,000 shares are authorized for issuance, with an initial year grant of 55,000 shares and an annual grant thereafter of 10,000 shares to each non-employee director. These grants are effective each year upon adjournment of the annual shareholders' meeting at an exercise price equal to the market price on the date of grant. The options become exercisable at the earlier of seven years after the grant date or on the first day the market value equals or exceeds \$25.00. These options expire ten years after the grant date. No shares were issued under the Director's Plan during Fiscal 2008, 2007 or 2006. The Director's Plan expired November 18, 2008. At January 3, 2009, no shares were available for grant under the Director's Plan.

2005 HEI, Inc. Employee Stock Purchase Plan. During Fiscal 2006, the shareholders approved the 2005 HEI, Inc. Employee Stock Purchase Plan, which included a total of 300,000 shares of the Company's Common Stock reserved for issuance under the Plan. The purpose of the Plan was to provide eligible employees with an opportunity to increase their proprietary interest in the success of the Company by purchasing Common Stock from the Company on favorable terms and paying for such purchases through periodic payroll deductions. No shares were purchased under this Plan in Fiscal 2006. The 2005 HEI, Inc. Employee Stock Purchase Plan was terminated effective December 31, 2006 as the Plan was never implemented and no shares were purchased under the Plan.

Change of Control. Under the terms and conditions of the Company's 1989 Plan and the Director's Plan, a change of control in the Company's Board of Directors, under certain circumstances, requires a vesting of all unexercised stock options. As of January 3, 2009, approximately 331,000 of the 364,000 outstanding options are fully vested and have expiration dates ranging from February 2009 through June 2015.

Summary of Activity. The following is a summary of all activity involving the above stock option plans:

	Options Outstanding	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value
Balance, August 31, 2005	1,656,975	\$4.59	,
Granted	5,000	3.69	
Exercised	(25,000)	1.87	
Cancelled	(300,000)	<u>3.87</u>	
Balance, September 2, 2006	1,336,975	<u>\$4.80</u>	
Granted			
Exercised			
Cancelled	(453,650)	<u>3.16</u>	
Balance, September 1, 2007	883,325	\$5.64	
Granted			
Exercised			
Cancelled	(519,625)	6.32	
Balance, January 3, 2009	<u>363,700</u>	<u>\$4.66</u>	<u>\$0</u>
Options exercisable	<u>331,450</u>	<u>\$4.71</u>	<u>\$0</u>

The aggregate intrinsic value in the preceding table represent the total pretax intrinsic value, based on the Company's closing stock price of \$0.75 as of January 3, 2009, which theoretically could have been received by the option holders had all option holders exercised their options as of that date. There were no in-the-money options outstanding as of January 3, 2009.

Options that were exercisable as of January 3, 2009, September 1, 2007 and September 2, 2006 were 331,450, 712,606 and 857,250, respectively. The average exercise price of exercisable options at January 3, 2009, September 1, 2007 and September 2, 2006 was \$4.71, \$5.86 and \$5.47, respectively.

The following table summarizes information about stock options outstanding as of January 3, 2009:

	Options Outstanding			Options Ex	<u>ercisable</u>
	Number of	Weighted Average Exercise	Weighted Average Remaining	Number of	Weighted Average Exercise
Range of Exercise Prices	Options	Price	Contractual Life	Options	Price
\$1.68	50,000	\$1.68	4.21	50,000	\$1.68
\$2.75-3.40	209,000	3.04	5.16	186,750	3.01
\$5.88-7.70	62,500	6.94	2.62	52,500	7.13
\$10.75-14.56	<u>42,200</u>	12.85	<u>1.64</u>	42,200	12.85
	<u>363,700</u>	\$4.66	<u>4.18</u>	<u>331,450</u>	<u>\$4.71</u>

There were no options granted in Fiscal 2008 or 2007. The weighted average grant-date fair value of options granted during our fiscal year ended September 2, 2006 was \$1.87. The weighted average fair value of options was determined separately for each grant under the Company's various plans by using the fair value of each option and warrant grant on the date of grant, utilizing the Black-Scholes option-pricing model and the following key weighted average assumptions:

		Fiscal year ended	
	January 3, 2009	September 1, 2007	September 2, 2006
Risk-free interest rates	N/A	N/A	4.50%
Expected life	N/A	N/A	4 years
Volatility	N/A	N/A	61%
Expected dividends	N/A	N/A	None

Common Stock Warrants. In May, 2005, the Company issued five year warrants to purchase 527,152 shares of common stock at an exercise price of \$3.05 in connection with a private equity offering. In February 2004, the Company issued warrants to purchase 424,800 share of common stock at an exercise price of \$3.72 in connection a private equity placement. These warrants vested immediately and expire five years from date of grant. In August 2001, the Company issued 47,500 Warrants in connection with a financing transaction. These warrants vested immediately at an exercise price of \$8.05 per share of Common Stock and expired August 2006.

Restricted Stock Awards. Restricted stock awards are awards of common stock that are subject to restrictions on transfer and to a risk of forfeiture if the awardee leaves the Company before the restrictions lapse. The holder of a restricted stock award is generally entitled at all times on and after the date of issuance of the restricted shares to exercise the rights of a shareholder of the Company, including the right to vote the shares and the right to receive dividends on the shares. The value of such stock was established by the market price on the date of the grant. Compensation expense is being recorded over the applicable restricted stock vesting period, utilizing an estimated annual forfeiture rate of 15%. A summary of the Company's restricted stock activity for the Fiscal period ended January 3, 2009 is presented in the following table:

	GI.	ghted Average ant Date Fair	Weighted Average Remaining Contractual
_	Shares	Value	Term
Unvested, beginning of period	27,000	\$ 3.18	
Granted	819,289	0.99	
Vested	(86,723)	1.01	
Forfeited	(15,000)	 3.30	
Unvested, end of period	744,566	\$ 1.02	3.09 years

As of January 3, 2009, there was \$703,000 of total unrecognized compensation costs related to the outstanding restricted stock awards which is expected to be recognized over a weighted average period of 3.09 years.

Note 9 Net Income (Loss) Per Share Computation

The components of net income (loss) per basic and diluted share are as follows:

	Jan	uary 3, 2009 (In	Septe	al period ended ember 1, 2007 nds, except share		tember 2, 2006
Basic:						
Income (loss) from continuing operations	\$	1,073	\$	(7,188)	\$	(5,402)
Loss from discontinued operations		-		(217)		(655)
Gain on sale of discontinued operations		_		1,748		
Net income (loss)	\$	1,073	\$	(5,657)	\$	(6,057)
Income (loss) per common share:						
Continuing operations	\$	0.11	\$	(0.75)	\$	(0.57)
Discontinued operations		_		0.16		(0.07)
Net income (loss) per common share	\$	0.11	\$	(0.59)	\$	(0.64)
Weighted average number of common shares outstanding		9,575,000		9,522,000		9,469,000
Diluted:						
Income (loss) from continuing operations	\$	1,073	\$	(7,188)	\$	(5,402)
Loss from discontinued operations		-		(217)		(655)
Gain on sale of discontinued operations	_	_		1,748	. —	<u> </u>
Net income (loss) Income (loss) per common share:	<u>\$</u>	1,073	\$	(5,657)	\$	(6,057)
meome (1033) per common share.						
Continuing operations	\$	0.11	\$	(0.75)	\$	(0.57)
Discontinued operations		_		0.16		(0.07)
Net income (loss) per common share	\$	0.11	\$	(0.59)	\$	(0.64)
Weighted average number of common shares outstanding Effect of convertible preferred stock		9,575,000		9,522,000		9,469,000
Effect of dilutive stock options, restricted stock and warrants		 .				
Weighted average shares assuming dilution		9,575,000		9,522,000		9,469,000

Approximately 2,060,000, 1,835,000 and 2,289,000 shares under stock options, restricted stock and warrants have been excluded from the calculation of diluted net loss per common share as they are antidilutive for our fiscal periods ended January 3, 2009, September 1, 2007 and September 2, 2006, respectively.

Note 10

Equity Offerings

Sale of Convertible Preferred Stock

On May 9, 2005, we completed the sale of 130,538 shares of our Series A convertible preferred stock ("preferred stock") in a private placement to a group of institutional and accredited investors. Gross proceeds to us from the offering were \$3.4 million. Each share of

preferred stock is convertible into ten shares of our common stock, which in the aggregate would represent an additional 1,305,380 shares of common stock. Through January 3, 2009, 985,380 shares of common stock have been issued in connection with the conversion of 98,538 shares of Convertible Preferred Stock.

The purchase price of the preferred stock was \$26.00 per share. In connection with the financing, we also issued to the investors and the agent five-year warrants to purchase up to 527,152 shares of common stock at an exercise price of \$3.05 per share. If the warrant holders exercise the warrants in full we would receive an additional approximately \$1.6 million in cash proceeds. There are no dividend, coupon or redemption rights associated with our preferred stock; however our preferred stock includes a liquidation preference. The Convertible Preferred Shares have voting rights on an "as if" converted basis. We agreed to register for resale by the investors the common stock issuable upon conversion of the preferred stock. The preferred stock will not be separately registered or listed on The NASDAQ Capital Market. We issued warrants to purchase 25,000 shares of our common stock at an exercise price of \$3.05 per share as compensation to the placement agent who assisted in the private placement. The registration rights relating to the common stock issuable upon conversion of the preferred stock expired on June 23, 2007 and the S-1 Registration Statement is not current as of January 3, 2009.

In the event that the Company liquidates or dissolves, the holders of each outstanding share of preferred stock will be entitled to receive an amount equal to \$26.00 per share, plus any declared but unpaid dividends, in preference to the holders of our common stock or any other class of our capital stock ranking junior to our preferred stock. After the full payment of the preference amount to the holders of our preferred stock, and provision or payment of our debts and other liabilities, our remaining assets or property are distributable upon such liquidation shall be distributed pro rata among the holders of our common stock.

Note 11

Related Party Note Payable, Guarantee by Related Party and Notes Receivable-Related Parties-Officers and Former Directors

On November 3, 2006, Thomas F. Leahy, the Chairman of the Board of Directors of the Company, loaned the Company \$5,000,000 (the "Secured Loan"). The Company's obligations under the Secured Loan were evidenced by a promissory note (the "Note") and a security agreement. The Note had an original principal amount of \$5,000,000, required the Company to pay monthly installments of interest, and was due and payable on November 2, 2007. The unpaid principal of the Note was repayable at any time without prepayment penalty or premium. Unpaid principal due under the Note bore interest at the rate of fifteen percent (15%) per annum, commencing on November 3, 2006 with such interest rate increasing by one percent (1%) each calendar month, beginning January 1, 2007, up to a maximum of twenty percent (20%) per annum. The Note was paid off on May 15, 2007 through the use of the proceeds from the Wells Fargo Busienss Credit revolving line of credit and term loan facilities entered into on May 15, 2007 (see Note 5). During the period of time that this related party Note was outstanding, the Company paid Mr. Leahy a total of \$451,000 in interest payments.

In order to provide an inducement to Wells Fargo Business Credit to advance funds sufficient to pay off his outstanding loan while providing the Company with adequate working capital access under the revolving line of credit facility, Mr. Leahy guaranteed the financing package in an amount not to exceed \$4 million and provided collateral to secure the guarantee in the amount of \$4 million (subsequently reduced to \$3.35 million in 2008). In return for the guarantee and collateral pledge, he is paid a guarantee fee in the amount of \$8,000 per month by the Company. The total guarantee fee paid to Mr. Leahy for the 16-month period of Fiscal 2008 and Fiscal 2007 was \$128,000 and \$28,000, respectively and the guarantee fee is expected to continue for all long as the guarantee is in place. The Company cannot currently determine how long the guarantee will be in place.

In Fiscal 2001, the Company recorded notes receivable of \$1,266,000 from certain officers and directors in connection with the exercise of stock options. Of the remaining balance of \$68,000 as of the end of Fiscal 2006, \$51,000 was paid to the Company during Fiscal 2007 and the remaining balance of \$17,000 was written off as uncollectible at the end of Fiscal 2007.

Note 12

Litigation Recoveries

During Fiscal 2003, we commenced litigation against Mr. Fant, our former Chief Executive Officer and Chairman. The complaint alleged breach of contract, conversion, breach of fiduciary duty, unjust enrichment and corporate waste resulting from, among other things, Mr. Fant's default on his promissory note to us and other loans and certain other matters. During Fiscal 2003 and 2004, we

obtained judgments against Mr. Fant totaling approximately \$2,255,000, excluding interest. During Fiscal 2004 and 2005, we obtained, through garnishments and through sales of common stock previously held by Mr. Fant, approximately \$1,842,000 of recoveries. In Fiscal 2005 and 2004, we recognized \$481,000 and \$1,361,000 of these recoveries, respectively. In March 2007, the Company received a final settlement of \$275,000 before deducting accumulated legal fees of approximately \$50,000, which is included in other income in the consolidated statements of operations for Fiscal 2007. Following the receipt of the settlement, the Company ceased all further action in this matter.

Note 13

Employee Benefit Plans

The Company has a 401(k) plan covering all eligible employees. Employees can make voluntary contributions to the plan of up to 90% of their compensation not to exceed the maximum specified by the Internal Revenue Code. The plan also provides for a discretionary contribution by the Company. During our fiscal periods ended January 3, 2009, September 1, 2007 and September 2, 2006, the Company contributed \$194,000, \$196,000 and \$225,000, respectively to the plan for both continuing and discontinued operations.

Note 14

Commitments and Contingencies

We lease an approximate 13,000 square foot production facility in Tempe, Arizona for our high density flexible substrate operations. The lease extends through July 31, 2010. Base rent is approximately \$100,000 per year. We lease another approximately 4,000 square foot mixed office and warehouse space facility in Tempe, Arizona that is used for office and storage space in support of the Tempe operation. The lease coincides with the lease on the other Tempe space and terminates July 31, 2010. The base rent is approximately \$32,000 per year.

We lease an approximate 152,000 square foot facility in Boulder, Colorado for our AMO segment operations. Our base rent is approximately \$1,542,000 for Fiscal 2009. In addition to the base rent, we pay all operating costs associated with this building. The annual base rent increases each year by 3%. The Boulder facility is leased until September 2019. Currently, we occupy approximately 76,000 square feet of the facility and approximately 30,000 is vacant. In April 2005, we entered into a ten year sublease agreement for approximately 21,000 square feet with a high quality tenant. This is a ten year lease which provides for rental payments and reimbursement of operating costs. Aggregate rental and operating cost payments payable of approximately \$281,000 per year commenced in November 2006. We have also subleased approximately 25,000 square feet of warehouse space to three additional tenants with agreements ranging from month-to-month to several years in length, which contribute approximately \$96,000 on an annualized basis. We are continuing to look for sublease tenants for the remaining 30,000 square feet of vacant space.

Total rent expense for the periods ended January 3, 2009, September 1, 2007 and September 2, 2006 including common area costs and real estate taxes was \$2,470,000, \$1,967,000 and \$2,156,000, respectively for both continuing and discontinued operations.

The operating lease and other contractual commitments, future minimum lease payments and excluding executory costs such as real estate taxes, insurance and maintenance expense, by year and in the aggregate are as follows:

Fiscal year ending	Minimum Operating Lease Commitments		
	(In t	housands)	
2009	\$	1,741	
2010		1,686	
2011		1,636	
2012		1,685	
2013		1,736	
Thereafter		11,033	
Total minimum lease payments	\$	19,517	

Note 15

Discontinued Operation and Sale of RFID Business Unit

On August 31, 2007, the Company completed the sale of the Company's RFID business unit ("RFID") to a third party. The Company acquired RFID in October 2001 and operated the business unit as part of its Microelectronics business. RFID provided radio frequency identification products to the industrial and consumer markets. All results of operations and assets and liabilities of RFID have been restated and classified as discontinued operations.

The sale of RFID was completed on August 31, 2007 pursuant to the terms of an Asset Purchase Agreement dated August 30, 2007. The transaction involved the sale of RFID for \$3 million cash, including substantially all assets and liabilities of RFID at closing. The sales price was not subject to a price adjustment.

The gain on the sale of RFID is calculated as follows and reflected in the results for Fiscal 2007:

(In thousands)	
Cash received	\$ 3,000
Less: Transferred assets, net of liabilities of RFID	(1,205)
Less: Transaction costs	(47)
Gain on sale	\$ 1,748

Condensed consolidated statements of operations for RFID for fiscal years ended September 1, 2007 and September 2, 2006 are as follows:

(In thousands)	Fiscal		
	2	2007	2006
Net sales	\$	3,234 \$	3,570
Gross profit		538	124
Selling, general and administrative		583	534
Research and development		183	237
Other income (expense), net		11	(8)
Income (loss) from discontinued operations	\$	(217) \$	(655)

Depreciation expense for RFID was \$127,000 and \$249,000 for Fiscal 2007 and Fiscal 2006, respectively.

Note 16 Major Customers and Concentration of Credit Risk

The table below sets forth the approximate percentage of net sales to major customers that represented over 10% of our revenue.

		Fiscal Period Ended	
Customer	January 3, 2009	<u>September 1, 2007</u>	<u>September 2, 2006</u>
Customer A	7%	14%	10%
Customer B	10%	11%	15%
Customer C	12%	6%	6%
Customer D	<u>11%</u>	<u>10%</u>	<u>7%</u>
Total	40%	41%	<u>38%</u>

Accounts receivable from these customers represented 46% and 49% of the total accounts receivable at January 3, 2009 and September 1, 2007, respectively.

The Company generally sells its products to OEMs in the United States and abroad in accordance with supply contracts or purchase orders specific to certain manufacturer product programs. The Company performs ongoing credit evaluations of its customers' financial conditions and, generally, does not require collateral from its customers. The Company's continued sales to these customers are often dependent upon the continuance of the customers' product programs.

Note 17

Subsequent Event

Following the end of Fiscal 2008, the Company entered into an agreement with Wells Fargo Business Credit to refinance its Victoria Minnesota facility. The effect of the refinancing is to reduce the Company's interest rate on the mortgage and to extend the maturity date of the balance due from November 2009 to May 2019. As a result of the agreement, the Company has recorded the balance of the mortgage as long-term debt on its balance sheet as of January 3, 2009.



INDEPENDENT AUDITORS' REPORT

To the Shareholders, Audit Committee and Board of Directors HEI, Inc. and subsidiaries Victoria, MN

We have audited the accompanying consolidated balance sheet of HEI, Inc. and subsidiaries as of January 3, 2009 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the 16 months then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 audit provides 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 HEI, Inc. and subsidiaries as of January 3, 2009 and the results of their operations and their cash flows for the 16 months then ended, in conformity with U.S. generally accepted accounting principles.

Minneapolis, Minnesota

April 21, 2009



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders, Audit Committee and Board of Directors HEI, Inc. and subsidiaries Victoria. MN

inhow, Krause; Company, LLP

We have audited the accompanying consolidated balance sheet of HEI, Inc. and subsidiaries as of September 1, 2007, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for the fiscal years ended September 1, 2007 and September 2, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated 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 its 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 consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall consolidated 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 HEI, Inc. and subsidiaries as of September 1, 2007 and the results of their operations and their cash flows for the fiscal years ended September 1, 2007 and September 2, 2006, in conformity with U.S. generally accepted accounting principles.

Minneapolis, Minnesota November 30, 2007