WINLAND ELECTRONICS ANNUAL REPORT 98

WINLAND ELECTRONICS

IS A LEADING FULL SERVICE

DESIGNER AND MANUFACTURER

OF CUSTOM ELECTRONIC

CONTROLS AND

ASSEMBLIES

WINLAND ELECTRONICS, INC.

Business Description

Winland Electronics, Inc. designs, engineers and produces high quality electronic controls for some of the most discriminating, value-driven, and quality-conscious OEM customers in the world.

Market-savvy customers like Select Comfort Corporation, Johnson Worldwide Associates, CIC Systems, Inc., Scotsman Industries, Inc., PeopleNet Communications Corporation, and others have forged lasting partnerships with Winland to enhance customer satisfaction and long-term commercial success. These relationships often include Winland's engineers, manufacturing professionals, and procurement specialists in core product development roles to help optimize manufacturability, quality, and product performance.

Before 1985, the company derived most of it revenues from the sale of security devices that were designed to monitor and detect changes in temperature and humidity, water leakage, and power failure. Although Winland currently ranks as a leading supplier of proprietary products to the security and industrial marketplace, sales from these products account for only about 10 percent of annual revenues.

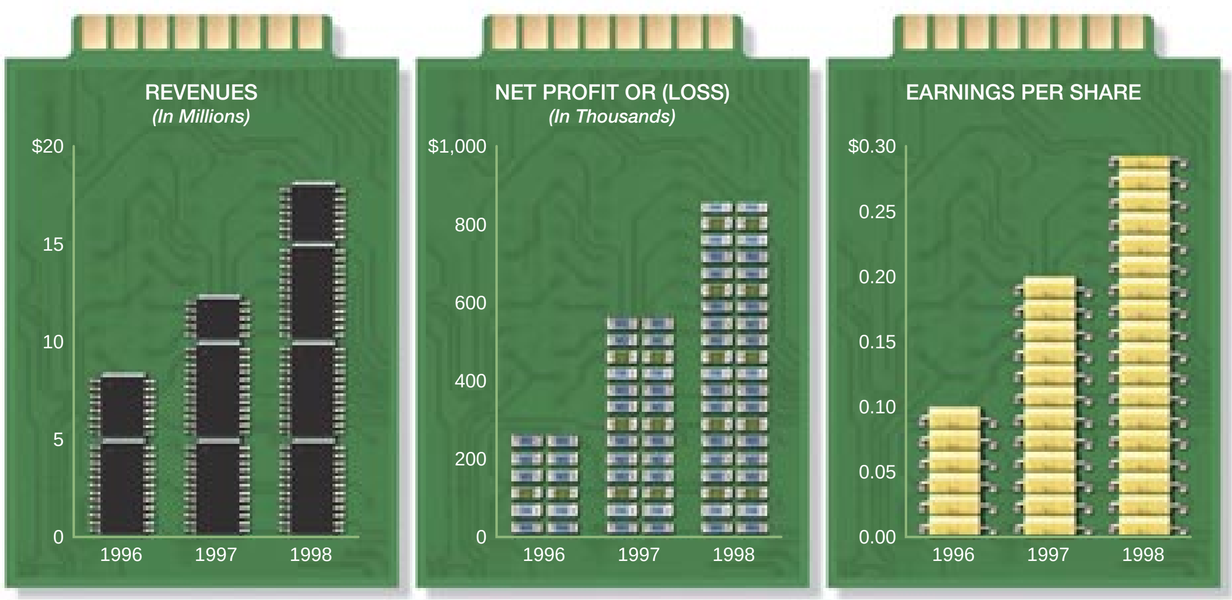
In 1984, in an effort to diversify its business, the Company began to design and manufacture custom electronic controls and assemblies for OEM customers. During the past five years, a rapid and comprehensive ramp-up of facilities, manufacturing capacity and technical expertise have helped propel Winland into one of the nation's fastest growing companies in its field. Today, the sale of design engineering and manufacturing services to OEM customers accounts for nearly 90 percent of Winland's total revenues.

Winland Electronics Inc. provides product design, value engineering, manufacturing engineering, high-end factory automation, testing, out-of-warranty repair, shipping, and warehousing services. The value-added nature of these services helps to distinguish the company from traditional providers of contract manufacturing. Most important, with the growing trend of corporate downsizing and outsourcing certain operations, Winland provides its customers a full turnkey design, engineering, and manufacturing solution that addresses both the challenge and the high cost of rapid technological change.

Contents

Financial Highlights

	Years ended December 31, 1998	1997	1996
FOR THE YEAR			
Net Sales	$ 18,175,509	$ 12,382,878	$ 8,361,226
Net Income	$ 855,595	$ 566,687	$ 264,147
Earnings Before Income Tax	$ 1,095,595	$ 607,181	$ 327,019
PER SHARE DATA			
Diluted Earnings Per Share	$ 0.29	$ 0.20	$ 0.10
Weighted Average Common Shares Outstanding Including Potentially Dilutive Shares	2,935,058	2,875,977	2,729,968
AT YEAR END			
Total Shareholders' Equity	$ 3,828,068	$ 2,908,679	$ 2,310,216
Long-term Debt	$ 3,429,975	$ 3,543,461	$ 2,951,764
Total Assets	$ 11,630,599	$ 10,349,120	$ 8,290,948



President's Letter

TO OUR SHAREHOLDERS

On behalf of your Board of Directors and everyone at Winland Electronics, I am pleased to present the results of 1998, the most successful year in the company's history. These results are very gratifying, because of how boldly they characterize the spirit, the will, and the dedication of our team.

From the day-to-day interaction with customers to the implementation of marketing, financial and manufacturing strategies, Winland employees have worked together to consistently deliver customer commitments, while complying with financial and growth objectives.

1998 Financial Results

For the year, net sales totaled $18,175,509, up 47 percent from $12,382,878 during 1997 and 117 percent from $8,361,226 in 1996. Net income increased 51 percent to $855,595, or 29 cents per diluted share, from $566,687, or 20 cents per diluted share, recorded in 1997. Winland realized this increase in net income during 1998 even though the company incurred an additional income tax expense of nearly $200,000 compared to 1997. Three-year growth in net income was 224 percent, or nearly twice the rate of Winland's sales growth during the same three years.

During 1998, operating income increased 53 percent to $1,478,599 compared to $968,462 in 1997. We are also very pleased to report Winland's continuing ability to control operating expenses during a year of rapid sales growth. As a percentage of net sales, operating expenses declined during 1998 and were 13.4 percent compared to 14.2 percent of sales, during 1997.

Highlights of 1998

Many significant events and achievements of 1998 are directly attributable to efforts that began several years ago to take control of, plan, and effectively manage, the inevitable changes that rapid growth produces. This process began with examining Winland's business in ways never before undertaken. We addressed endless questions and challenges, and took inventory of our skills and our resources. We audited the quality and value of our products. We analyzed the marketplace today and attempted to pinpoint where it was going in the future. Finally, we took a hard look at what kind of customer relationships would be the most mutually rewarding in the long run.

Ultimately, this process evolved to the development of a plan that clearly established a corporate vision, a mission, guiding principles, and an employee developed set of core ideologies that could be the basis for future success and the maximizing of business opportunities. The process involved investment in both time and resources, and included every member of Winland's team. As a result, our customers, suppliers, and virtually everyone who comes in contact with Winland or its people have come to anticipate a level of professionalism that is rare, if not unexpected, in business.

"Winland's success isn't happening without attracting attention.
During 1998, the fast track of your company's growth brought two prestigious awards.

Increasingly, Winland is being recognized for its expertise as a specialist in designing, engineering and producing high quality electronic controls. During September 1998, Winland was named to Deloitte & Touche's Minnesota Fast 50, a ranking of the state's 50 fastest-growing technology companies based on the non-compounded percentage of growth in revenues from 1993-1997. In addition, during November 1998, Winland was selected by IW Growing Companies, an edition of INDUSTRY WEEK publication, the leading management magazine for small to mid-sized manufacturers, to be in the inaugural class of the IW Growing Companies 25, America's Most Successful Small Manufacturers.

Because such a very large part of our business is customer and relationship driven, we are pleased to highlight certain key customers and the nature of Winland's partnerships with them in this 1998 Annual Report. In the future, we will share similar information about other Winland customers who have played an important role in the company's success and growth.

Winland and its people have grown, and are "stepping up to the future together."

As Winland is being continuously pushed forward by the effort, dedication, and expertise of its team members, the people find themselves being pulled forward in the process. In recent months, Winland has promoted many key people under our program of internal advancement.

During January of 1999, Winland appointed Lorin Krueger to President and Chief Operating Officer, promoting him from his position of Senior Vice President of Operations. For 22 years, Lorin has been critical to the growth and success of Winland. Last September, Winland promoted Steve Vogel to Vice President of Engineering from his previous responsibilities as Engineering Manager. Steve joined Winland in 1994 and was Engineering Manager since 1996. Kim Kleinow was appointed to Vice President of Procurement and Materials after 14 years of employment. Lisa Severson, Winland's Accounting Manager and a 10-year employee, was promoted to Director of Accounting. In December, Linda Annis, a 4-year employee, was promoted to Manager of Administration, with primary responsibilities in Investor Relations and Human Resources. Jodi Tuchek, a 9-year employee, was promoted to Manager of Cost Accounting. Susan Foede, who has worked in sales and customer service for 3 years, was promoted to Customer Service/Inside Sales Manager. Deb Johnson, who has 3 years experience in Winland's purchasing department, was promoted to Manager of Purchasing and Supply. These people and the positions they now fill are essential to Winland's vision and plan for success. We congratulate them!

Facilities were strained by the demands of business growth during 1998, and in late December 1998, management made the decision to expand our four-year-old facility. Recently, Winland started construction on a 5,000 square foot building addition. Although manufacturing space within our 53,000 square foot facility is more than adequate for production, all existing office space has been occupied. The new addition will accommodate future space requirements in engineering, purchasing, accounting, information systems, marketing, sales, and customer service. Completion is expected in May. Also, earlier last year, we built our new office space in the manufacturing area for additional production engineers and technicians as well as a conference/training room.

The energy, enthusiasm, and optimism that fueled Winland's operations during 1998 all continue into 1999. We have significant work to accomplish in many areas, in order to implement a wide variety of forward-looking initiatives. One important example is our completion of the final steps to achieve ISO 9001 registration before the end of the year.

With Winland's growth posture in recent years, it becomes increasingly important that we identify vital, new avenues for growth and enhanced shareholder value. As Chairman and CEO, my priorities will include overall strategic development, finance, investor relations and ongoing contact with Winland's key partners. My activities, and the collective effort of all company personnel, are directed toward fully exploiting opportunities in a vast and dynamic marketplace. Thank you for your encouragement and ongoing support.

Sincerely,

W. Kirk Hankins
Chairman of the Board and Chief Executive Officer
March 30, 1999

Business Review

Significant Events

During the past year, Winland Electronics reached record-level financial performance and significantly expanded its ability to meet the needs of new and existing customers. Notable among the company's many achievements during 1998 were the following:

May 1998 – Winland appointed McGladrey & Pullen LLP as independent auditors. McGladrey & Pullen LLP is the nation's eighth largest certified public accounting and consulting firm.

May 1998 – The company received $9.2 million in purchase orders from Select Comfort Corporation for electronic controls used with the adjustable-firmness air-sleep system.

September 1998 – Winland was named to Deloitte & Touche's Minnesota Fast 50, a ranking of the state's 50 fastest-growing technology companies based on the non-compounded percentage of revenue growth from 1993-1997.

November 1998 – Winland was named to Industry Week magazine's prestigious IW Growing Companies 25.

December 1998 – The company made the decision to construct a 5,000 square foot building addition to provide additional office space. Completion is expected in May 1999.

December 1998 – Winland received a purchase order in excess of $5 million from Select Comfort Corporation.

In January of this year, Winland also announced the appointment of Lorin Krueger to President and Chief Operating Officer.

Core Expertise

Throughout 1998, Winland continued to expand its design engineering and manufacturing capability. Many of the company's core strengths have evolved as Winland has responded to customer needs and market dynamics. Along the way, Winland has developed a high degree of technical expertise in certain specialties where market demand is extremely high, yet industry shortages of qualified personnel are acute. For example, worldwide applications for wireless technology are growing exponentially, and Winland's depth of experience in this area has grown dramatically. Overall, Winland's experience in the following key technology categories becomes an increasingly valuable gateway to customer success.

Analog cellular telephones — Global Positioning Systems (GPS) — Data transmission via AC line carrier — Fine resolution ultrasonic measurement — Ultra low-power electronic circuits — Digital signal processing (DSP) — Microprocessor hardware/software design — Power mosfet switching circuit design — RF signal/data transmission — UL and FCC testing expertise — Electronic sensor manufacturing — Digital and analog circuit design

Technological Innovation is a High Priority at Winland

Winland Electronics now provides creative, high-quality electronic products for more than a dozen Original Equipment Manufacturer (OEM) partners. The majority of these OEM partners also contract with Winland for value added services such as product design and software development. During 1998, Winland received a number of purchase orders for engineering services and, as a result, close to 100 new design projects were started during the year. These design projects were initiated to improve existing products and to develop new products for Winland's OEM customers. To broaden the company's product line, the company also started certain proprietary design projects for the purpose of developing new Winland products. Ongoing emphasis on research and development has provided Winland with expert knowledge and in areas such as microcontroller software and hardware design, digital and analog circuit design, wireless and other communications controls, printed circuit board design, layout, and prototyping.

Winland's engineers use computer aided drafting to create two and three-dimensional mechanical drawings and prints. These prints are used by purchasing personnel when placing orders for parts and by manufacturing department personnel as a visual guide of the assembly process. In addition, engineering assists the OEM customer in the design and construction of functional and test fixtures and systems.

The continued trend toward corporate downsizing has resulted in more companies looking to the outside sources for assistance with their electronic design and manufacturing needs. To continue capitalizing on this opportunity and to adequately service a growing OEM customer base, Winland invested $694,000 in research and development, which amounts to approximately 4.7 percent of sales in 1998. As a result, our engineering team is prepared to meet these changing customer needs with innovative designs and solutions.

Supporting Our Greatest Asset

Management recognizes that Winland's employees are its single greatest asset. The hard work and dedication of our employees has taken Winland from two full-time employees with $230,000 in sales in 1983 to the end of 1998 where we employed more than 120 people and recorded sales of over $18 million. To help our employees reach their full potential, Winland provides comprehensive education programs on topics like leadership, growth strategy and quality systems, as well as specific job skills training such as soldering, computer software applications, and electronic assembly techniques.

The company has worked hard to develop and implement a number of best-in-class quality and business systems. This includes partnering with customers to develop quality assurance programs tailored to their specific needs. Winland personnel are trained in process control methods, and use industry measures such as IPC (Institute for Interconnecting and Packaging Electronic Circuits) as the basis for workmanship. These programs and systems have been successful in expanding employee knowledge, raising skill levels, and improving job performance. Last year our employees produced over 550,000 electronic controls and assemblies that were sold to customers in the United States and throughout the world.

The success and rapid growth of Winland Electronics has created a sizable pool of well paid engineering, office, and manufacturing jobs in Southern Minnesota. We believe that Winland's most significant contribution to our community has been an aggressive, ongoing level of job creation that supports regional economic growth and stability.

In addition, Winland is committed to a robust benefits package for employees which includes: a 401-K retirement plan with partial matching company contribution; a stock option plan for management-level personnel; a flexible benefits plan; competitive medical and dental coverage; long-term disability and life insurance; and an employee stock purchase plan.

Winland has developed a reputation as being a good place to work in Southern Minnesota, and all of these programs contribute to the company's success in attracting and retaining some of the Midwest's best skilled, brightest, and most motivated employees.

Managing the Supply Chain

Because raw material costs account for a high percentage of the total cost to produce an electronic control or assembly, Winland's success has always relied heavily upon efficient and cost-effective inventory management. As a result, our procurement department is always looking for ways to realize the company's goals of increasing customer service and manufacturing flexibility while reducing inventory levels and costs. With this goal in mind, last year the procurement department worked jointly with the multi-billion dollar electronics distributor, Arrow Electronics, to further expand the Arrow CARES® Customer Automated Replenishment System at Winland.

The Arrow CARES® system is a user-friendly materials management solution. Replenishment of components is achieved using a multiple bin Kanban or minimum/maximum method, that releases items in whole units or “bins”. As soon as the first bin of parts is empty, an operator scans the bar code on that bin. This prompts the system to generate a replenishment order that is automatically sent by fax or electronic data interchange (EDI) to the designated supplier. While waiting for the arrival of the new parts, the operator utilizes the inventory from the second bin. The cycle is completed when the new parts arrive, just before the second bin is depleted.

Winland started out slowly with the new inventory replenishment system by testing the system with just 10 parts for a six-month period to make sure that everything was going well. By September 1998, we increased the number of high volume parts on the new system to 46, representing parts from four different component manufacturers. At the end of 1998, that number had grown to more than 150 components from 12 separate manufacturers with a total value of more than $2 million. This new system has enabled Winland to increase its inventory turns on these parts by more than 400 percent. Other benefits include more stable inventory levels, more rapid response to customer order changes, lower costs due to parts obsolescence, and improved on-time delivery to Winland’s customers.

In today’s highly competitive global marketplace, companies that excel in procurement and materials management have a clear edge in acquiring new business, retaining customer partnerships, and achieving financial objectives. Through value-added partnerships with key suppliers, Winland has established a supply chain that provides competitive pricing, reliable delivery, quality components, and profitable new-business referrals.

Manufacturing Systems

The employees on Winland’s manufacturing floor produced electronic controls and assemblies that generated record revenues of just over $18 million in 1998 and increased the company’s production output by 47 percent compared to the prior year. These impressive gains in manufacturing output and productivity were possible in part due to continuing emphasis on identifying and implementing an array of manufacturing best practices. As these practices become part of the manufacturing process, they help to drive the company into a mode of continuous improvement throughout the manufacturing floor.

Some of the best practices currently in use at Winland include: 1) Tracked cost reduction and avoidance, 2) Defects traceable to the component, machine, process, or operator, 3) Work flow measurement, 4) Bar code system for test, data storage, material replenishment, and process setup, 5) A root cause corrective action system used to facilitate permanent resolution to problems, 6) Continued improvements to the quality system, and 7) Monthly gross margin meetings with participation from all departments.

Winland’s production technicians manufacture single, double-sided, and multi-layer electronic printed circuit assemblies, which include thru-hole, surface mount, and mixed technology. Because teamwork is central to our success, Winland’s production floor is organized into work cells. With this approach, every team member adds special care and personal ownership to their assigned project. The team approach has also been helpful in reducing learning and experience curves, and has reduced factory bottlenecks.

A dramatic repositioning of the company several years ago required decisions and tactics implemented well ahead of the current market opportunity. As a result, Winland is equipped, staffed, and structured to compete “beyond its size.” This includes core expertise in high demand areas such as “designing for manufacturability” and an efficient worldwide system for raw materials sourcing. Thus equipped, Winland intends to continue attracting new, profitable “customers of choice” by providing genuine, world-class solutions for these customers.

Managing Information

As the information age changes, the way that information is used also changes on a daily basis. The IT/IS /MIS Departments have been important to Winland's success and in fueling company growth. These departments have been busy this past year upgrading the enterprise technologies and capabilities of Winland's internal systems.

The Management Information Systems department has been customizing reports and utilities to help employees do their jobs more effectively. The Information Technology department has customized and advanced Winland's manufacturing software package. The information system is used throughout the company to supply information and reports on day-to-day activities. Winland will continue to upgrade current systems in 1999. These upgrades will provide a more efficient user interface and facilitate easier retrieval of information.

The Information Systems department has also been updating the enterprise e-mail and voice mail systems. Workstations are also being updated to current technology in order to adapt to planned improvements in the information system. Winland has invested in upgrading internal systems hardware and software during the past five years. These investments allow Winland to maximize its investments in manufacturing, engineering, procurement, and financial systems as we move into the next millennium.

Relationship Marketing

Winland Electronics is widely recognized as a leading designer and manufacturer of custom electronic controls and assemblies in the Midwestern United States. Our management team continues to position the company in the full-service segment of the electronic manufacturing services market (EMS). Within this market, Winland responds to OEM customer needs by providing a mix of value added services that go well beyond traditional contract manufacturing. These services include product design, value engineering, manufacturing engineering, testing, out-of-warranty repair, shipping and warehousing.

Winland continues to be successful in forming long term business relationships with OEM customers. The value-added nature of our service mix has enabled us to create strong technological bonds with our customers. As a result, many OEM customers rely on Winland to complete the electronic design work necessary to successfully launch their new products. In addition, at least one current OEM customer has contracted with Winland for order fulfillment and warehousing needs. This type of daily, multi-level interaction with our customers actually creates a degree of mutual dependence between us and leads to increased customer satisfaction, confidence, and loyalty. It also fosters a true spirit of partnership as both manufacturer and customer work together to create new products and successfully launch them through the manufacturing process and into the marketplace.

During the customer proposal stage, Winland consciously avoids posturing itself in the weak and transitory "lowest bidder" position. Instead, the company seeks to establish lasting bonds with customers that are based upon mutual respect, effective teamwork, and trust. With this in mind, management continues to profile and seek out new OEM customer prospects that need a more complete solution to their manufacturing needs.

In the future, our management team will meet these objectives by staying focused on what we do best – responding to customer needs with exceptional service, technical expertise, and consistent delivery of quality, cost-effective controls and assemblies to our OEM customers. Winland continues to maintain its presence in the security and industrial markets with the sales of Winland's line of environmental sensors. In addition, the company has begun selected new design projects with the objective of broadening the Winland line of proprietary products.

Business Partnerships

An important part of Winland's growth strategy is to continue developing long-term business partnerships with forward-thinking companies. By promoting its design and engineering expertise in combination with state-of-the-art assembly technology, Winland has attracted a diverse mix of valued customers that include:

Select Comfort

PeopleNet Communications

Johnson Worldwide Associates
(Minn Kota Operations)

Leisure Life Limited

Scotsman Ice Machines

CIC Systems

Assembled Products

Certified Power

Rimage Systems Group

Squid Ink

The following examples describe in greater detail the kind of business partnerships that Winland has developed.

Johnson Worldwide Associates – Minn Kota® Operations

Winland has been an active business partner of JWA since 1984. Winland worked closely with JWA engineers in developing the Maximizer technology and has produced control assemblies for JWA since 1984. The product is marketed under the JWA trade name of Minn Kota. Minn Kota has risen to become the world's No. 1 manufacturer of trolling motors by using the same foundation of excellence and ingenuity that's been the company's hallmark for 65 years. The most recent product innovation is a product called the "Vantage™." The Vantage is a trolling motor with 12, 24 and 36-volt models delivering 50, 74 and 101 lbs. of thrust respectively, making it the most powerful transom mount trolling motor available to anglers, boaters and hunters.

Minn Kota products can be found in many retail stores including: Bass Pro, Cabelas, K-Mart and Wal-Mart.

Quote from Karen James, JWA's Minn Kota Operations Manager:

"Winland's engineering department is a valued source to us in helping design new products on short lead times. Winland has the latest technology and they have proven to be very responsive and at the same time willing to share in cost saving projects."

Original Minn Kota trolling motor and the new Vantage.

Corporate headquarters in Sturtevant, WI.

Manufacturing locations in 11 different countries with two facilities locally in Mankato, MN.

Website - www.jwa.com
Stock symbol - JWAIA

Select Comfort

Vision 2000 – Revolutionize the way people sleep through their state-of-the-art air sleep systems.

Established in 1987, Select Comfort is the founder and leader in the air bed industry. They design, manufacture, and market a line of air beds with adjustable firmness, including foundations and other sleep accessories.

Their corporate headquarters and manufacturing facility is located in Plymouth, Minnesota. A second manufacturing facility is located in South Carolina, with a third facility expected to open in Utah during 1999. They currently have over 270 retail stores nationwide, and call centers in MN and SC that total 100 outgoing and incoming direct sales staff.

Other facts:
Sales Growth: 1993 – $14 million
1998 – $246 million
Patents: 20 U.S. patents
Employees – 1,400 at its Minneapolis headquarters.
Public Company – December '98, AIRB. Started trading at $17 and has gone as high as $35.

An agreement was finalized in December of 1998 with Bed Bath & Beyond to sell their adjustable firmness air beds in selected retail stores. They are currently licensed in 13 stores in ten states with the possibility of additional locations being added in 1999.

Who's sleeping on air... Celebrities and pro athletes are turning to air bed technology for their beauty sleep, including: Paul Harvey, Rush Limbaugh, Danny Devito, Renee Russo, Rhea Perlman, David Cassidy, Jack Nicklaus, John Elway, Barry Bonds, and Minnesota's own Jake Reed and Tom Lehman.

Select Comfort's business relationship with Winland Electronics began in 1995. Initially, they were looking for a partner to help modify and improve the radio communications system on the Ultra series pump assembly. This assembly was being built for Select Comfort by a supplier in mainland China and was proving to be inconsistent in operation.

SELECT COMFORT®

Website - www.comfort.com
Stock symbol - AIRB

Winland's engineering department developed a modification for the system and our manufacturing area provided the skilled labor to make the modification to every unit received from China. Through Select Comfort's and Winland's combined efforts, we were able to provide a better product for the consumer.

From this beginning, the partnership has grown. Winland's engineering department works closely with the development staff at Select Comfort to create all new electronic products. Winland's manufacturing department also works closely with their engineering and manufacturing departments to improve efficiency and quality on existing and new products.

Professional golfer Tom Lehman is one of the many athletes and celebrities that have turned to air bed technology.

Winland was also chosen as one of Select Comfort's first Certified Suppliers. To be eligible for the certified supplier status Winland was required to meet high delivery and quality expectations. As a certified supplier, we will receive special consideration in supplier selection for new and existing products.

Quote from Kathleen J. Graber, Vice President Supply Chain Management:

"Winland Electronics has been a dedicated Supply Partner to Select Comfort since early 1995. They became a Certified Supplier in January 1997 as a result of their outstanding quality and delivery. We have come to rely on Winland for their expertise in design and manufacturing for the best electronic solutions for Select Comfort's applications."

PeopleNet Communications

Based in Chaska, Minnesota, Intouch Fleet Management, a division of PeopleNet Communications Corporation, provides Internet-based mobile communications services and satellite tracking to the transportation industry. Using the power and convenience of the Internet together with North America's largest wireless coverage area, PeopleNet delivers the nation's most flexible, affordable, and easy-to-use mobile communications and satellite tracking systems.

Over 200 different trucking companies have signed contracts in the last six months. Sales increased over 110% from 3rd to 4th quarter in 1998, and the number of employees has doubled.

Winland's business relationship with PeopleNet Communications began in the fall of 1996. PeopleNet was looking for a local company to help develop, manufacture, warehouse and ship their advanced and low cost vehicle tracking and location system. Winland has assisted PeopleNet in these and many other areas in the development of their product. These systems allow truck fleet owners to manage their equipment resources more efficiently by knowing at any time where their vehicles are located. Winland's extensive engineering and flexible manufacturing resources have enabled PeopleNet to produce a quality product in a very short period. Winland and PeopleNet continue to enhance their partnership in this growing market as the dawn of PeopleNet's new product offering approaches.

Quote from Ron Konezny, Vice President of Product Development and Strategic Planning:

"Winland fulfills a critical role for a young, growing company like PeopleNet. As a true, full-service manufacturer, Winland provides engineering, procurement, assembly, test, packaging, shipping, and warranty services for a cost and performance mix that we could find nowhere else. Because Winland spends a great deal of time understanding their customers' business and product, it puts them in a better position to deliver high quality and cost-effective solutions. Winland's strong engineering department helps each customer design the product with manufacturing assembly and quality in mind. Winland shares with PeopleNet an attitude of commitment and solutions."

INTOUCH
FLEET MANAGEMENT™

PeopleNet Communications
www.intouchavl.com

Selected Financial Data

The following table sets forth selected financial data for Winland Electronics, Inc. which has been derived from the Company's financial statements. The financial data listed below should be read in conjunction with "Management's Discussion and Analysis or Plan of Operation" and the audited financial statements and related notes thereto included elsewhere in this annual report.

	Years Ended December 31,	
	1998	1997
OPERATIONS DATA:		
Net Sales	$ 18,175,509	$ 12,382,878
Cost of Sales	(14,255,149)	(9,653,563)
Gross Profit	3,920,360	2,729,315
Operating Expenses	2,441,761	1,760,853
Other Income and Expenses	(383,004)	(361,281)
Net Profit Before Income Tax	1,095,595	607,181
Income Tax	240,000	40,494
Net Profit	$ 855,595	$ 566,687
EARNING PER SHARE DATA:		
Diluted Earnings Per Share	$ 0.29	$ 0.20
Weighted Average Common Shares Outstanding Including Potentially Dilutive Shares	2,935,058	2,875,977
BALANCE SHEET DATA:		
Working Capital	$ 2,448,966	$ 1,759,593
Total Assets	$ 11,630,599	$ 10,349,120
Long-Term Debt	$ 3,429,975	$ 3,543,461
Stockholders' Equity	$ 3,828,068	$ 2,908,679

Availability of Form 10-KSB

Shareholders of record may obtain the Company's annual report on Form 10-KSB for the fiscal year ended December 31, 1998, which will be filed with the Securities and Exchange Commission and will be available after April 1, 1999. This report (without exhibits) will be provided without charge upon written request to the Corporate Secretary.

Results of Operations – 1998 vs. 1997

Net Sales:

Net sales increased 46.8% to $18,175,509 for the year ended December 31, 1998, compared to $12,383,878 for 1997. The growth in net sales is primarily attributed to increased sales to OEM customers during 1998 over 1997. In 1998 and 1997, sales to OEM customers represented 89% and 85%, respectively, of total net sales. The Company currently has firm purchase agreements with Select Comfort Corporation to ship approximately $8.4 million of product during 1999. The Company also has firm purchase agreements with PeopleNet Communications Corporation to ship approximately $3.8 million in product in 1999. In addition to the above mentioned agreements, the Company has several smaller agreements with various OEM customers to be fulfilled in 1999.

The Company has continued to position itself as a full service designer and manufacturer of custom controls and assemblies for OEM customers. The loss of any OEM customer would likely have an adverse effect on the Company's short-term, and potentially long-term, results. The Company's marketing research indicates that a large potential market exists for electronic design and manufacturing services and that this market continues to grow rapidly.

Gross Profits:

Gross profit was $3,920,360 or 21.6% of net sales for the year ended December 31, 1998, compared to $2,729,315 or 22.0% of net sales for 1997. As a percentage of net sales, gross profit remained relatively constant.

Operating Expenses:

General and administrative expense was $1,449,376 or 8.0% of net sales for the year ended December 31, 1998, compared to $1,043,788 or 8.4% of net sales for 1997. The decline as a percentage of net sales in such expenses is primarily attributed to administrative efficiencies the Company realized. The actual general and administrative expense increased $405,588 for 1998 over 1997 due to the administrative support needed for the increased sales.

Marketing and customer relations expense was $297,964 or 1.6% of net sales for the year ended December 31, 1998, compared to $245,708 or 2.0% of net sales for 1997. The increase in marketing and customer relations expense as compared to 1997, arose in part to the Company's efforts to secure new, long-term OEM customer relationships to design and manufacture custom controls and assemblies. The actual marketing expense increased $52,256 for 1998 over 1997. In late 1998, to enable the Company to continue to offer exceptional service to its OEM and security/industrial customers, the marketing and customer relations department expanded its support personnel.

Research and development expense was $694,421 or 3.8% of net sales for the year ended December 31, 1998, compared to $471,357 or 3.8% of net sales for 1997. Although as a percentage of net sales the research and development expense remained constant for 1998 compared to 1997, the actual research and development expense increased $223,064 in 1998 over 1997. The increased research and development expense was needed to support the Company's efforts to expand its engineering capabilities with the addition of technical staff and the acquisition of additional test and development equipment, which resulted in increased depreciation expense being recognized.

Interest Expense:

Interest expense was $534,127 or 2.9% of net sales for the year ended December 31, 1998, compared to $445,158 or 3.6% of net sales for 1997. The increase in actual interest expense is primarily associated with additional short-term borrowing and borrowing through capital lease agreements on equipment needed to support the increased sales. The Company believes the additions of capital equipment will likely positively affect quality and efficiencies in current and future periods.

Net Income:

The Company reported net income of $855,595 or $0.29 per diluted share for the year ended December 31, 1998, compared to net income of $566,687 or $0.20 per diluted share for 1997. In 1998, the Company used its remaining net operating loss and tax credit carry forwards and as a result has incurred a substantial income tax expense for 1998, compared to 1997. Even with the increased income tax expense, the net income for 1998 increased 51% over 1997. The Company's increased profitability resulted primarily from increased sales, and increased efficiencies, combined with careful budgeting and cost control.

The Company believes inflation has not significantly affected its results of operations.

Results of Operations – 1997 vs. 1996

Net Sales:

Net Sales. Net sales increased 48.1% to $12,383,878 for the year ended December 31, 1997, compared to $8,361,226 for 1996. The growth in net sales is primarily attributed to sales to Select Comfort Corporation during 1997. The Company also had significant purchase agreements with PeopleNet Communications Corporation, Keyless Door Lock Company and CIC Systems (NZ), Inc.

Gross Profit:
Gross profit was $2,729,315 or 22.0% of net sales for the year ended December 31, 1997, compared to $1,929,040, or 23.1% of net sales, for 1996. The slight decrease in gross profit, as a percentage of net sales, for 1997 over 1996, is primarily related to the sales mix during the year.

Operating Expenses:
General and administrative expense was $1,043,788, or 8.4% of net sales, for the year ended December 31, 1997, compared to $815,206, or 9.7% of net sales, for 1996. The decline in general and administrative expense as a percentage of sales for 1997 compared to 1996 was primarily attributed to general and administrative expenses increasing at a slower rate than the sales. The actual expense increase, however, resulted from the demand of supporting higher sales.

Marketing and customer relations expense was $245,708, or 2.0% of net sales, for the year ended December 31, 1997, compared to $196,147 or 2.3% of net sales for 1996. While the Company continues to actively market its security/industrial products, it has shifted to emphasize the Company's design and manufacture of custom controls and assemblies, which produced the overall increase in marketing and customer relations expense. These custom controls and assemblies are sold primarily to the Company's OEM customers.

Research and development expense was $471,357, or 3.8% of net sales, for the year ended December 31, 1997, compared to $322,488, or 3.9% of net sales, for 1996. The Company has continued to expand its engineering capabilities throughout 1997, with the addition of technical staff and the acquisition of additional test and development equipment. Such expansion accounts for the overall increase in research and development expense.

Interest Expense:
Interest expense, including interest on the Company's revolving line of credit, other long and short-term notes and interest on capital lease obligations, equaled $445,158, or 3.6% of net sales, for the year ended December 31, 1997, compared to $341,693, or 4.1% of net sales, for 1996. As a percentage of net sales interest expense declined for 1997 compared 1996 due primarily to increased sales. The actual expense increases are primarily associated with additional short-term borrowing and borrowing through capital lease agreements on equipment needed to support the increase sales. The additions of capital equipment should have a positive effect on quality and efficiencies in subsequent periods.

Net Income:
The Company reported net income of $566,687, or $0.20 per diluted share, for 1997, compared to net income of $264,147, or $0.10 per diluted share, for 1996. The Company's increased profitability was the result of increased sales, combined with careful budgeting and cost control.

Liquidity and Capital Resources:
The current ratio on December 31, 1998 was 1.60 to 1, compared to 1.49 to 1 on December 31, 1997. Working capital equaled $2,448,966 on December 31, 1998, compared to $1,786,593 on December 31, 1997. The increase in working capital primarily reflects increases in accounts receivable due to increased sales, offset by increases in income taxes payable. The Company used its remaining net operating loss and tax credit carry forwards and has begun to incur income tax expense in 1998.

The Company has a revolving credit agreement with the Norwest Bank Minnesota South N.A. ("Norwest"), with a maximum loan limit of $3,500,000, subject to additional limitations set forth in the credit agreement. The interest rate is calculated at prime rate. At December 31, 1998, an outstanding balance of $1,629,227 existed under the line of credit. The agreement expires on June 30, 1999, at which time the Company anticipates that it will renew its working capital line of credit on terms similar to its existing line. The Company's management believes that the capital available through the current credit agreement, together with cash flows from operations, will be sufficient to meet the Company's capital needs at least through 1999.

The Company is currently indebted to the City of Mankato for a $1,700,000 building loan and a $500,000 state small cities loan, both of which are secured by a mortgage on the Company facility. These loans are payable in equal monthly installment payments of approximately $16,200 until January 1, 2000, at which time it will be necessary for the Company to renew the financing of the building.

Year 2000:
Year 2000 Background
The Company's overall goal is to be Year 2000 ready. To accomplish this goal, the Company is addressing the issue with respect to both its information technology (IT) and non-IT systems, as well as its business relationships with key third parties. To be ready, the Company needs to evaluate the Year 2000 issues and fix any problems it can so that all of its systems and relationships will be suitable for continued use into and beyond the Year 2000.

The Company began addressing the Year 2000 issue in 1996 using a multistep approach, including inventory and assessment, remediation and testing, and contingency planning. The

Company began by assessing its internal computer systems, including their components and machinery, that were susceptible to system failure or processing errors as a result of the Y2K issue. This phase is substantially complete. The Company's Year 2000 efforts have also included assessment of "embedded" systems (such as automated systems and telephone systems). In 1998, the Company hired an outside consultant to assist in the assessment and remediation phases of handling the Year 2000 issue.

As part of the assessment phase, the Company has also recently initiated plans for formal communications with certain key third parties, including suppliers, distributors, and customers in order to determine the extent to which the Company is vulnerable to those third parties' failure to remediate their own Year 2000 issues. The Company believes this part of the assessment phase will continue throughout 1999 and cannot predict the outcome of other companies' remediation efforts.

Year 2000 Costs

The Company plans to continue to work on its Year 2000 compliance efforts throughout 1999. To date, the Company has spent only a minimal amount during the assessment phase. Because the Company is still conducting the assessment phase of its Year 2000 analysis, it cannot yet predict the total remaining cost of its assessment, remediation and testing phases. As the Company continues its analysis, it will monitor such costs. The cost will depend on the availability of certain resources, third parties' Year 2000 readiness and other unpredictable factors.

Risk Assessment

At this time, the Company believes that its most reasonably likely worst case scenario is that the Company and/or its key customers could experience minor disruptions. In the event that such disruptions do occur, the Company does not expect that it would have a material adverse effect on the Company's financial condition and results of operations. Due to the complex issues surrounding Year 2000 and other significant business issues, however, it is difficult to predict outcomes and resulting consequences that could have a material adverse impact on the company's results of operations, financial condition and cash flows.

Contingency Plans

During 1999, the Company plans to prepare contingency plans if it determines that certain Year 2000 issues cannot be resolved by December 1999. Such plans will be designed so that the Company's critical business processes can be expected to continue to function on January 1, 2000 and beyond. The Company's contingency plans will be structured to address both remediation of systems and their components and overall business operating risks. These plans are intended to mitigate both internal risks as well as potential risks in the supply chain of the Company's suppliers and customers.

Cautionary Statements:

As provided for under the Private Securities Litigation Reform Act of 1995, the Company wishes to caution investors that the following important factors, among others, in some cases have affected and in the future could affect the Company's actual results of operations and cause such results to differ materially from those anticipated in forward-looking statements made in this document and elsewhere by or on behalf of the Company.

The Company derives a significant portion of its revenues from a small number of major OEM customers which are not subject to any long-term contracts with the Company. If any major customer should for any reason stop doing business with the Company, the Company's business would be significantly adversely affected. Some of the Company's key customers are not large well-established companies, and the business of each customer is subject to various risks such as market acceptance of new products and continuing availability of financing. To the extent that the Company's customers encounter difficulties, or the Company is unable to meet the demands of its OEM customers, the Company could be adversely affected.

The Company's ability to sustain continued increases in revenues and profits is dependent upon its ability to retain existing customers and obtain new customers. The Company competes for new customers with numerous independent contract design and manufacturing firms in the United States and abroad, many of whom have greater financial resources and a more established reputation. The Company's ability to compete successfully in this industry depends, in part, upon the price at which the Company is willing to manufacture a proposed product and the quality of the Company's design and manufacturing services. There is no assurance that the Company will be able to continue to win contracts from existing and new customers on financially advantageous terms, and the failure to do so could prevent the Company from achieving the growth it anticipates.

The operations and success of the Company depend, in part, upon the experience and knowledge of W. Kirk Hankins, the Company's Chief Executive Officer and Chief Financial Officer, and Lorin E. Krueger, the Company's President and Chief Operating Officer. The loss of either Mr. Hankins or Mr. Krueger would have a material adverse effect on the Company.

The impact of Year 2000 issues on the Company's business depends on the accuracy, reliability and effectiveness of the Company's and its suppliers' and customers' assessment and remediation of Year 2000 issues. There can be no assurance that the Company's efforts will result in complete resolution of Year 2000 issues in order to prevent a material effect on its critical business systems.

Financial Report

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Winland Electronics, Inc.
Mankato, Minnesota

We have audited the accompanying balance sheet of Winland Electronics, Inc. as of December 31, 1998, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Winland Electronics, Inc. for the year ended December 31, 1997, were audited by other auditors whose report, dated February 4, 1998, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards. 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 the 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 financial statements referred to above present fairly, in all material respects, the financial position of Winland Electronics, Inc. as of December 31, 1998, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

McGLADREY & PULLEN, LLP

Minneapolis, Minnesota
January 29, 1999

BALANCE SHEETS

December 31, 1998 and 1997

ASSETS (Note 3)	1998	1997
Current Assets		
Cash	$ 20,656	$ 23,542
Accounts receivable, less allowance for doubtful accounts 1998 $155,000; 1997 $5,000 (Note 10)	2,482,507	1,581,368
Other receivables	47,454	–
Inventories (Note 2)	3,763,939	3,745,996
Prepaid expenses	62,882	116,660
Deferred taxes (Note 6)	124,000	–
Total current assets	6,501,438	5,467,566
Other Assets		
Patents and trademarks, net of accumulated amortization 1998 $28,735; 1997 $27,206	5,505	7,034
Deferred taxes (Note 6)	–	17,741
	5,505	24,775
Property and Equipment, at cost (Note 4)		
Land and land improvements	270,009	270,009
Building	2,497,067	2,376,511
Machinery and equipment	3,001,256	2,628,804
Data processing equipment	842,352	522,859
Office furniture and equipment	267,472	227,303
	6,878,156	6,025,486
Less accumulated depreciation	1,754,500	1,168,707
	5,123,656	4,856,779
	$ 11,630,599	$ 10,349,120

See Notes to Financial Statements.

LIABILITIES AND STOCKHOLDERS' EQUITY	1998	1997
Current Liabilities		
Note payable to bank (Note 3)	$ 1,629,227	$ 1,733,227
Current maturities of long-term debt	573,183	494,606
Accounts payable	1,263,326	1,200,177
Accrued expenses:		
Compensation	310,136	210,790
Other	47,757	37,759
Income taxes payable	228,843	4,414
Total Current Liabilities	4,052,472	3,680,973
Deferred Revenue (Note 5)	209,084	216,007
Long-Term Debt, less current maturities (Note 3 and 4)	3,429,975	3,543,461
Deferred Taxes (Note 6)	111,000	–
Commitments and Contingencies (Note 4)		
Stockholders' Equity (Notes 7 and 9)		
Common stock, par value $0.01 per share; 20,000,000 shares authorized; issued and outstanding 1998 2,886,786 shares, 1997 2,808,039 shares	28,867	28,080
Additional paid-in capital	2,142,008	2,079,001
Retained earnings	1,657,193	801,598
	3,828,068	2,908,679
	$ 11,630,599	$ 10,349,120

STATEMENT OF INCOME

Years Ended December 31, 1998 and 1997

	1998	1997
Net sales (Note 10)	$ 18,175,509	$ 12,382,878
Cost of sales	14,255,149	9,653,563
Gross profit	3,920,360	2,729,315
Operating expenses:		
General and administrative	1,449,376	1,043,788
Research and development	694,421	471,357
Marketing	297,964	245,708
	2,441,761	1,760,853
Operating income	1,478,599	968,462
Other income (expenses):		
Interest expense	(534,127)	(445,158)
Interest income	151,428	53,028
Other	(305)	30,849
	(383,004)	(361,281)
Income before income taxes	1,095,595	607,181
Income taxes (Note 6)	240,000	40,494
Net income	$ 855,595	$ 566,687
Earnings per share data:		
Basic earnings per share	$ 0.30	$ 0.20
Basic average common shares outstanding	2,837,466	2,796,458
Diluted earnings per share	$ 0.29	$ 0.20
Diluted average common shares outstanding, including potentially dilutive shares	2,935,058	2,875,977

See Notes to Financial Statements.

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended December 31, 1998 and 1997

	Common Shares	Stock Amount	Additional Paid-In Capital	Retained Earnings	Total
Balance on December 31, 1996	2,751,071	$ 27,511	$ 2,047,794	$ 234,911	$ 2,310,216
Issuance of common stock in accordance with employee stock option and purchase plans (Notes 7 and 9)	56,968	569	29,921	–	30,490
Income tax benefit from exercise of nonqualified stock options	–	–	1,286	–	1,286
Net income	–	–	–	566,687	566,687
Balance on December 31, 1997	2,808,039	28,080	2,079,001	801,598	2,908,679
Issuance of common stock in accordance with employee stock option and purchase plans (Notes 7 and 9)	78,747	787	63,007	–	63,794
Net income	–	–	–	855,595	855,595
Balance on December 31, 1998	2,886,786	$ 28,867	$ 2,142,008	$ 1,657,193	$ 3,828,068

See Notes to Financial Statements.

STATEMENTS OF CASH FLOWS

Years Ended December 31, 1998 and 1997

	1998	1997
Cash Flows From Operating Activities		
Net income	$ 855,595	$ 566,687
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	647,435	438,414
Loss on disposal of equipment	28,644	110
Income tax benefit from exercise of nonqualified stock options	–	1,286
Deferred taxes	4,741	34,794
Changes in assets and liabilities:		
(Increase) decrease in:		
Accounts receivable	(901,139)	(253,982)
Other receivables	(47,454)	–
Inventories	(17,943)	(783,665)
Prepaid expenses	53,778	(45,681)
Increase in:		
Accounts payable	63,149	516,771
Accrued expenses and other	102,421	24,460
Income taxes payable	224,429	4,078
Net cash provided by operating activities	1,013,656	503,272
Cash Flows From Investing Activities		
Purchases of property and equipment	(533,708)	(262,625)
Proceeds from sale of equipment	–	11,665
Net cash used in investing activities	(533,708)	(250,960)
Cash Flows From Financing Activities		
Net (payments) borrowings on revolving credit agreement	(104,000)	153,000
Proceeds from long-term borrowings	115,000	–
Principal payments on long-term borrowings, including capital lease obligations	(557,628)	(431,759)
Proceeds from issuance of common stock	63,794	30,490
Net cash used in financing activities	(482,834)	(248,269)
Net increase (decrease) in cash	(2,886)	4,043
Cash		
Beginning of year	23,542	19,499
End of year	$ 20,656	$ 23,542
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 535,293	$ 434,841
Income taxes	10,571	–
Supplemental Schedule of Noncash Investing and Financing Activities		
Capital lease obligations incurred for the purchase of equipment	$ 407,718	$ 1,193,159

See Notes to Financial Statements.

NOTES TO FINANCIAL STATEMENTS

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

Nature of business: The Company operates in one business segment which includes the design and manufacture of electronic control devices. Sales are to customers located primarily in the Upper Midwest, and credit is granted based upon the credit policies of the Company.

A summary of the Company's significant accounting policies follows:

Use of estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures 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 from such estimates and assumptions.

Cash: The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

Inventories: Inventories are stated at the lower of cost (first-in, first-out method) or market.

Patents and trademarks: Patents and trademarks are stated at cost and are being amortized using the straight-line method over their economic useful lives.

Depreciation: It is the Company's policy to include depreciation expense on assets acquired under capital leases with depreciation expense on owned assets. Depreciation is computed using the straight-line method based on the estimated useful lives of the various assets as follows:

	Years
Land improvements	20
Building	39
Machinery and equipment	5-7
Data processing equipment	3-7
Office furniture and equipment	3-7

Long-lived assets: In accordance with Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of,* the Company reviews its long-lived assets and intangibles related to those assets periodically to determine potential impairment by comparing the carrying value of the long-lived assets with the estimated future cash flows expected to result from the use of the assets, including cash flows from disposition. Should the sum of the expected future cash flows be less than the carrying value, the Company would recognize an impairment loss. An impairment loss would be measured by comparing the amount by which the carrying value exceeds the fair value of the long-lived assets and intangibles. To date, management has determined that no impairment of long-lived assets exists.

Income taxes: Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Investment tax credits, research and development credits, and job credits are accounted for by the flow-through method whereby they reduce income taxes currently payable and the provision for income taxes in the period the assets giving rise to the credits are placed in service. To the extent such credits are not currently utilized on the Company's tax return, deferred tax assets, subject to considerations about the need for a valuation allowance, are recognized for the carryforward amount.

Fair value of financial instruments: In accordance with the requirements of Statement of Financial Accounting Standards (SFAS) No. 107, *Disclosures About Fair Value of Financial Instruments,* management estimates that the carrying value of long-term debt approximates fair value due to the variable-interest feature of the debt. The carrying value of all other financial instruments approximates fair value due to the short-term nature of the instruments.

Earnings per share: The Company has adopted SFAS No. 128, *Earnings Per Share,* which requires companies to present basic earnings per share and diluted earnings per share. Basic earnings per share is computed by dividing net earnings by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net earnings by the weighted-average number of common shares outstanding during the period, including potentially dilutive shares under the treasury stock method.

Reclassification: Certain 1997 amounts have been reclassified to be in conformity with the 1998 presentation.

During the year ended December 31, 1998, the Company changed its method of presenting the statement of cash flows for operating activities from the direct method (which showed principal components of operating cash receipts and payments) to the indirect method (which adjusts net income to remove the effects of noncash operating transactions). This change has been applied retroactively to the 1997 statement of cash flows.

NOTES TO FINANCIAL STATEMENTS

NOTE 2. INVENTORIES

The components of inventory at December 31, 1998 and 1997, are as follows:

	December 31	
	1998	1997
Raw materials	$2,676,738	$2,775,668
Work in progress	565,229	490,428
Finished goods	521,972	479,900
Total	$3,763,939	$3,745,996

NOTE 3. FINANCING ARRANGEMENT AND LONG-TERM DEBT

Financing arrangement: The Company has a $3,500,000 revolving line-of-credit agreement through June 1999. Interest on advances is at the bank's reference rate (7.75 percent at December 31, 1998) and is due monthly. Advances are due on demand, are secured by substantially all assets of the Company, and are subject to a defined borrowing base equal to 80 percent of qualified accounts receivable and 60 percent of inventories. In addition, the agreement contains certain reporting and operating covenants. Advances outstanding on the revolving line-of-credit agreement at December 31, 1998 and 1997, were $1,629,227 and $1,733,227, respectively.

Long-term debt: The following is a summary of long-term debt:

	December 31	
	1998	1997
6.941% note payable due in monthly installments of $13,117, including interest, to January 1, 2000, when the remaining balance is payable, secured by property and equipment	$ 1,522,723	$ 1,572,542
4% note payable due in monthly installments of $3,030, including interest, to January 1, 2000, when the remaining balance is payable, secured by property and equipment	430,761	449,481
Note payable in monthly installments of $8,334, plus interest at prime plus 0.75%, to October 2001, secured by accounts receivable	283,316	383,324
8.75% note payable due in monthly installments of $1,400, including interest, to July 2003, secured by equipment	167,660	–
Capitalized lease obligations, due in various monthly installments, with interest ranging from 8.95% to 9.5%, to October 2000, secured by equipment	130,584	230,714
Capitalized lease obligations, due in various monthly installments, with interest ranging from 8.5% to 9.96%, to August 2001, secured by equipment	342,219	333,793

NOTES TO FINANCIAL STATEMENTS

NOTE 3. FINANCING ARRANGEMENT AND LONG-TERM DEBT *(Continued)*

	December 31 1998	December 31 1997
Capitalized lease obligations, due in various monthly installments, with interest ranging from 8.88% to 10.04%, to October 2002, secured by equipment	$ 342,389	$ 394,685
Capitalized lease obligations, due in various monthly installments, with interest ranging from 8.5% to 9.3%, to April 2003, secured by equipment	235,804	–
Capitalized lease obligation, due in monthly installments of $9,399, with interest at 8.97%, to November 2004, secured by equipment	547,702	607,456
Other	–	66,072
	4,003,158	4,038,067
Less current maturities	573,183	494,606
Total long-term debt	$ 3,429,975	$ 3,543,461

Approximate maturities of long-term debt for years subsequent to December 31, 1998, are as follows:

1999	$ 573,000
2000	2,344,000
2001	420,000
2002	221,000
2003	297,000
Thereafter	148,000
Total	$ 4,003,000

NOTE 4. COMMITMENTS AND CONTINGENCIES

Capital leases: The Company is leasing certain equipment under capital leases. The cost and accumulated depreciation of assets acquired under capital leases at December 31, 1998 and 1997, are as follows:

	1998	1997
Cost	$ 2,522,665	$ 2,172,500
Accumulated amortization	756,053	457,000
Net leased property under capital leases	$ 1,766,612	$ 1,715,500

NOTES TO FINANCIAL STATEMENTS

NOTE 4. COMMITMENTS AND CONTINGENCIES *(Continued)*

The future minimum lease payments under capital leases and the aggregate present value of the net minimum lease payments at December 31, 1998, are as follows:

1999	$ 548,000
2000	438,000
2001	385,000
2002	241,000
2003	150,000
Thereafter	156,000
Total minimum lease payments	1,918,000
Less amount representing interest	319,000
	$ 1,599,000

The capital lease obligations are included in long-term debt.

Operating leases: The Company leases certain equipment and vehicles under noncancelable operating leases through 2002. The Company is responsible for all repairs and maintenance, insurance, and other related expenses in connection with these leases.

Rental and other related expenses for the above leases for the years ended December 31, 1998 and 1997, were approximately $113,000 and $100,000, respectively.

Approximate minimum future annual lease payments under these leases as of December 31, 1998, are as follows:

Years ending December 31:	
1999	$ 63,000
2000	42,000
2001	21,000
	$ 126,000

NOTE 5. DEFERRED REVENUE

During 1994, the Company and the city of Mankato entered into a tax increment financing agreement for the construction of the Company's operating facility. In connection with this agreement the city donated land and land improvements with a fair value of $270,009. The fair value of land and land improvements donated was accounted for as deferred revenue and is being amortized over 39 years, which is the life of the building.

NOTES TO FINANCIAL STATEMENTS

NOTE 6. INCOME TAXES

Components of the provision for income taxes are as follows:

	December 31 1998	December 31 1997
Current taxes	$ 235,000	$ 4,414
Deferred	5,000	34,794
Additional paid-in capital from benefit of stock options exercised	–	1,286
	$ 240,000	$ 40,494

During 1998 and 1997 the Company also received a tax benefit from the carryforward of net operating losses and tax credits totaling approximately $137,000 and $193,000, respectively.

The statutory income tax rate reconciliation to effective rate is as follows:

	December 31 1998	December 31 1997
Statutory U.S. income tax rate	35%	35%
State taxes, net of federal tax benefit	2%	6%
Tax benefit of NOL and credit carryforwards	(11%)	(34%)
Research and development tax credit	(3%)	0%
Other	(1%)	(1%)
Effective income tax rate	22%	6%

Net deferred taxes consist of the following components as of December 31, 1998 and 1997:

	December 31 1998	December 31 1997
Deferred tax assets:		
Loss carryforwards	$ –	$ 38,154
Tax credit carryforwards	–	92,146
Inventory	43,000	46,061
Allowance for doubtful accounts	57,000	–
Other	24,000	24,355
Total deferred tax assets	124,000	200,716
Less valuation allowance	–	(148,181)
Deferred tax assets	124,000	52,535
Deferred tax liabilities:		
Property and equipment	111,000	34,794
Net deferred tax assets	$ 13,000	$ 17,741

NOTES TO FINANCIAL STATEMENTS

NOTE 6. INCOME TAXES *(Continued)*

The components giving rise to the net deferred tax asset described above have been included in the accompanying balance sheets at December 31, 1998 and 1997, as follows:

	December 31	
	1998	1997
Current assets	$ 124,000	$ –
Noncurrent assets	–	17,741
Noncurrent liabilities	111,000	–

NOTE 7. STOCK-BASED COMPENSATION PLANS

Stock option plan: The Company has reserved 750,000 common shares for issuance under qualified and nonqualified stock options for its key employees and directors. Option prices are the market value of the stock at the time the option was granted. Options become exercisable as determined at the date of grant by a committee of the Board of Directors. Options expire over the term of the options, generally five years after the date of grant unless an earlier expiration date is set at the time of grant.

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation.* Accordingly, no compensation cost has been recognized for the stock option plan. Had compensation cost for the Company's stock option plan been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, the Company's earnings and earnings per share would have changed to the pro forma amounts indicated below:

	December 31	
	1998	1997
Net income–as reported	$ 855,595	$ 566,687
Net income–pro forma	750,147	484,950
Net income per share, basic–as reported	0.30	0.20
Net income per share, diluted–as reported	0.29	0.20
Net income per share, basic–pro forma	0.26	0.17
Net income per share, diluted–pro forma	0.25	0.17

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1998 and 1997:

	December 31	
	1998	1997
Expected life of options	3 years	3.5 years
Expected dividend yield	0.0%	0.0%
Expected stock price volatility	65.2%	64.0%
Risk-free interest rate	5.7%	5.5%

NOTES TO FINANCIAL STATEMENTS

NOTE 7. STOCK-BASED COMPENSATION PLANS *(Continued)*

The pro forma effect on earnings in 1998 and 1997 is not representative of the pro forma effect in future years because it does not take into consideration pro forma compensation expense related to grants made prior to 1995.

Additional information relating to all outstanding options as of December 31, 1998 and 1997, is as follows:

	1998		1997	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Options outstanding, beginning of year	345,000	$ 2.25	296,940	$ 1.80
Options exercised	(69,400)	0.63	(45,940)	0.11
Options expired	(17,600)	2.50	(6,000)	2.63
Options granted	112,000	2.11	100,000	2.71
Options outstanding, end of year	370,000	$ 1.89	345,000	$ 2.25
Weighted-average fair value of options granted during the year		$ 0.93		$ 1.31

The following table summarizes information about stock options and warrants outstanding at December 31, 1998:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
$1.75 to $1.8125	11,000	0.5	$ 1.78	11,000	$ 1.78
$1.75 to $1.925	112,000	1.6	1.83	93,100	1.83
$1.75 to $1.925	13,000	2.7	1.87	8,500	1.84
$1.75 to $1.925	122,000	3.5	1.76	39,800	1.76
$1.75 to $2.563	40,000	4.5	1.95	22,000	2.12
$2.819	30,000	4.9	2.82	30,000	2.82
$1.75	42,000	5.8	1.75	–	–
	370,000	2.8	$ 1.89	204,400	$ 1.99

At December 31, 1997, there were 169,150 options exercisable at a weighted-average exercise price of $1.40.

The Company also has outstanding warrants to purchase 37,000 shares of common stock. These warrants are exercisable at $2.20 per share through March 2000.

NOTES TO FINANCIAL STATEMENTS

NOTE 8. EARNINGS PER SHARE

The following table reflects the calculation of basic and diluted earnings per share:

	1998	1997
Earnings per share–basic:		
Income available for common shareholders	$ 855,595	$ 566,687
Weighted-average shares outstanding	2,837,466	2,796,458
Earnings per share–basic	$ 0.30	$ 0.20
Earnings per share–diluted:		
Income available to common shareholders	$ 855,595	$ 566,687
Weighted-average shares outstanding	2,837,466	2,796,458
Dilutive impact of options outstanding	93,320	72,851
Dilutive impact of warrants outstanding	4,272	6,668
Weighted-average shares and potential dilutive shares outstanding	2,935,058	2,875,977
Earnings per share–diluted	$ 0.29	$ 0.20

Options to purchase 40,000 and 107,600 shares of common stock at December 31, 1998 and 1997, respectively, were not included in the computation of diluted earnings per share because the option exercise prices were greater than the average market price of common shares.

NOTE 9. EMPLOYEE BENEFIT PLANS

Pension plan: The Company has a qualified defined contribution 401(k) profit sharing plan for its employees who meet certain age and service requirements. Employees are allowed to contribute up to 15 percent of eligible compensation, and the Company makes a contribution of one-third of the employees' contributions, up to a maximum of 10 percent. The Company contributed approximately $66,200 and $44,500 to the plan for the years ended December 31, 1998 and 1997, respectively. In addition, the Company may make additional discretionary contributions to the plan to the extent authorized by the Board of Directors. There were no discretionary contributions to the plan for the years ended December 31, 1998 and 1997.

Stock purchase plan: The Company has adopted an employee stock purchase plan to provide substantially all employees an opportunity to purchase shares of its common stock through payroll deductions, up to 15 percent of eligible compensation. The plan is carried out in two annual six- month phases beginning January 1 and July 1, the grant dates. On June 30 and December 31, the exercise dates, participant account balances are used to purchase shares of stock at the lesser of 85 percent of the fair value of shares on the grant date or the exercise date. The employee stock purchase plan expires December 31, 2002. A total of 100,000 shares were originally available for purchase under the plan. There were 9,347 and 11,028 shares purchased under the plan for the years ended December 31, 1998 and 1997, respectively.

NOTE 10. MAJOR CUSTOMERS

The Company has customers which accounted for more than 10 percent of net sales for the years ended December 31, 1998 and 1997, as follows:

	1998	1997
Sales percentage:		
Customer A	47%	53%
Customer B	14%	3%
Customer C	13%	17%
Accounts receivable percentage at December 31:		
Customer A	30%	37%
Customer B	34%	11%
Customer C	10%	20%

MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Since May 26, 1995, the Company's Common Stock has traded on Nasdaq SmallCap Market under the symbol WLET. The following table sets forth the high and the low bid quotations, as reported by the Nasdaq SmallCap Market. The bid quotations represent interdealer prices and do not include retail markets mark-ups, mark-downs or commissions and may not necessarily represent actual transactions.

Fiscal Year Ended December 31, 1998	Low	High
First Quarter	2 1/4	2 7/8
Second Quarter	2 1/8	3 1/4
Third Quarter	1 5/8	3 1/32
Fourth Quarter	1 3/4	3 1/2

Fiscal Year Ended December 31, 1997	Low	High
First Quarter	2 1/4	4 1/4
Second Quarter	2 1/2	3 1/2
Third Quarter	1 25/32	3 1/8
Fourth Quarter	2	3 1/8

On February 19, 1999, the fair market value of the Company's Common Stock was $2.875, based on the closing sale price on that date. As of December 31, 1998, the Company had approximately 509 shareholders of record.

The Company has never paid cash dividends on its Common Stock. The Board of Directors presently intends to retain earnings for use in the Company's business and does not anticipate paying cash dividends on Common Stock in the foreseeable future. Any future determinations as to the payment of dividends will depend on the financial condition of the Company and such other factors as are deemed relevant by the Board of Directors.

DIRECTORS AND EXECUTIVE OFFICERS

W. KIRK HANKINS
Chief Executive Officer,
Chief Financial Officer, and
Chairman of the Board of Directors of the Company

LORIN E. KRUEGER
President, Chief Operating Officer, Secretary
and a Director of the Company

KIRK P. HANKINS
Vice President of Sales and Marketing
and a Director of the Company

S. ROBERT DESSALET
Director of the Company;
Self-employed management consultant

THOMAS J. de PETRA
Director of the Company;
Chief Operating Officer of
International Concept Development, Inc.

PETE JONES
Director of the Company;
President of Crysteel Manufacturing, Inc.

DAVID EWERT
Director of the Company;
President/Chief Operating Officer of Jones Metal Products, Inc.

STEVE VOGEL
Vice President of Engineering

KIM KLEINOW
Vice President of Procurement and Materials

TERRY TREANOR
Vice President of Manufacturing

INDEPENDENT AUDITORS

McGLADREY & PULLEN, LLP
Certified Public Accountants
Minneapolis, Minnesota

REGISTRAR AND TRANSFER AGENT

NORWEST BANK MINNESOTA, N.A.
161 North Concord Exchange
South St. Paul, MN 55075-0738

CORPORATE COUNSEL

FREDRIKSON & BYRON, P.A.
Minneapolis, Minnesota

ANNUAL MEETING OF SHAREHOLDERS

The Annual Meeting of Shareholders will be held:
May 13, 1999 – 7:00 p.m.
Winland Corporate Offices
1950 Excel Drive
Mankato, Minnesota

WINLAND ELECTRONICS, INC.

WINLAND ELECTRONICS, INC.
1950 Excel Drive
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