

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-QSB

Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended December 31, 1998

OR

Transition report under Section 13 or 15(d) of the Exchange Act

For the transition period from to

Commission file number 0-23837

SurModics, Inc.

(Exact Name of Small Business Issuer as Specified in Its Charter)

MINNESOTA

(State or Other Jurisdiction of  
Incorporation or Organization)

41-1356149

(IRS Employer  
Identification No.)

9924 West 74th Street  
Eden Prairie, Minnesota 55344  
(Address of Principal Executive Offices)

(612) 829-2700  
(Issuer's Telephone Number, Including Area Code)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes            X            No

As of January 31, 1999, there were 7,245,305 shares of Common Stock outstanding.

Traditional Small Business Disclosure Format (check one):    Yes            No    X

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

SURMODICS, INC.  
Condensed Balance Sheets  
(In thousands, except share data)

	December 31, 1998	September 30, 1998
	----- (Unaudited)	-----
ASSETS		
CURRENT ASSETS:		
Cash & cash equivalents	\$1,019	\$1,344
Short-term investments	3,934	3,526
Accounts receivable, net	946	1,057
Inventories	431	380
Prepays and other	354	255
	-----	-----
Total current assets	6,684	6,562
	-----	-----
PROPERTY AND EQUIPMENT, net	1,430	1,240
LONG-TERM INVESTMENTS	16,061	16,249
OTHER ASSETS, net	540	254
	-----	-----

	\$24,715	\$24,305
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$134	\$305
Accrued liabilities	629	950
Deferred revenues	228	228
	-----	-----
Total current liabilities	991	1,483
DEFERRED REVENUES AND OTHER, less current portion	87	124
	-----	-----
Total liabilities	1,078	1,607
	-----	-----
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Common stock-		
\$.05 par value, 15,000,000 shares authorized;		
7,245,305 and 7,214,085 shares issued and outstanding	362	361
Additional paid-in capital	29,064	28,934
Unearned compensation	(155)	(170)
Stock purchase notes receivable	(118)	(182)
Accumulated other comprehensive income	82	278
Accumulated deficit	(5,598)	(6,523)
	-----	-----
Total stockholders' equity	23,637	22,698
	-----	-----
	\$24,715	\$24,305
	=====	=====

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

SURMODICS, INC.  
Condensed Statements of Income and Comprehensive Income  
(In thousands, except per share data)  
(Unaudited)

	Three Months Ended December 31,	
	1998	1997
REVENUES:		
Royalties	\$1,306	\$942
License fees	265	--
Product sales	630	497
Research and development	438	470
	-----	-----
Total revenues	2,639	1,909
	-----	-----
OPERATING COSTS AND EXPENSES:		
Product	283	250
Research and development	1,165	958
Sales and marketing	398	303
General and administrative	528	297
	-----	-----
Total operating costs and expenses	2,374	1,808
	-----	-----
INCOME FROM OPERATIONS	265	101
	-----	-----
OTHER INCOME:		
Interest income, net	269	50
Gain on sale of investments	99	--
	-----	-----
Other income, net	368	50
	-----	-----
INCOME BEFORE PROVISION FOR INCOME TAXES	633	151
INCOME TAX BENEFIT (Note 3)	292	--
	-----	-----
NET INCOME	925	151
	-----	-----
OTHER COMPREHENSIVE INCOME (LOSS), net of tax		
Unrealized losses on securities:		
Unrealized holding losses arising during the period	(196)	--
Less: reclassification adjustment for gains included in net income	99	--
	-----	-----
Other comprehensive income (loss)	(97)	--
	-----	-----
COMPREHENSIVE INCOME	\$828	\$151
	=====	=====
NET INCOME PER SHARE:		
Basic	\$0.13	\$0.03
Diluted	\$0.12	\$0.03
WEIGHTED AVERAGE SHARES OUTSTANDING:		
Basic weighted average common shares outstanding	7,230	4,904
Dilutive effect of outstanding stock options	602	509
	-----	-----
Diluted weighted average common shares outstanding	7,832	5,413

The accompanying notes are an integral part of these condensed financial statements.

SURMODICS, INC.  
Condensed Statements of Cash Flows  
(In thousands)  
(Unaudited)

	Three Months Ended December 31,	
	1998	1997
<b>OPERATING ACTIVITIES:</b>		
Net income	\$925	\$151
Adjustments to reconcile net income to net cash provided by operating activities-		
Depreciation and amortization	176	116
Amortization of unearned compensation, net	15	15
Deferred rent	(6)	(4)
Deferred taxes	(292)	-
Change in assets and liabilities:		
Accounts receivable	111	210
Inventories	(51)	5
Prepays and other	(99)	(93)
Accounts payable and accrued liabilities	(492)	(204)
Deferred revenues	(31)	(67)
Net cash provided by operating activities	256	129
<b>INVESTING ACTIVITIES:</b>		
Purchases of property and equipment, net	(361)	(301)
Purchases of investments available for sale	(8,972)	-
Sales of investments available for sale	8,556	250
Collections on stock purchase notes receivable	65	-
Other	-	(3)
Net cash used in investing activities	(712)	(54)
<b>FINANCING ACTIVITIES:</b>		
Issuance of common stock	131	-
Net increase (decrease) in cash and cash equivalents	(325)	75
<b>CASH AND CASH EQUIVALENTS:</b>		
Beginning of period	1,344	491
End of period	\$1,019	\$566

The accompanying notes are an integral part of these condensed financial statements.

SURMODICS, INC.  
Notes to Condensed Financial Statements  
(Unaudited)

(1) Basis of Presentation:

In the opinion of management, the accompanying unaudited condensed financial statements have been prepared in accordance with generally accepted accounting principles and reflect all adjustments, consisting solely of normal recurring adjustments, needed to fairly present the financial results for these interim periods. These financial statements include some amounts that are based on management's best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The results of operations for the three months ended December 31, 1998 are not necessarily indicative of the results that may be expected for the entire fiscal year.

According to the rules and regulations of the Securities and Exchange Commission, the Company has omitted footnote disclosures that would substantially duplicate the disclosures contained in the audited financial statements of the Company. Read together with the disclosures below, management believes the interim financial statements are presented fairly. However, these unaudited condensed financial statements should be read together with the financial statements for the year ended September 30, 1998 and footnotes thereto included in the Company's 10-KSB as filed with the Securities and Exchange Commission.

(2) New Accounting Pronouncements

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 131, "Disclosures about Segments of an Enterprise and Related Information," which establishes a new model for segment reporting, called the "management approach" and requires certain disclosures for each segment. The management approach is based on the way the chief operating decision maker organizes segments within a company for making operating decisions and assessing performance. The Company will adopt the provisions of SFAS No. 131 in the fourth quarter of fiscal 1999 by providing additional footnote disclosures.

(3) Income Taxes

Current accounting standards require that future tax benefits, such as net operating loss carryforwards ("NOLs"), be recognized to the extent that realization of such benefits is more likely than not. Through September 30, 1998, management had established a valuation allowance of \$2.6 million to offset tax benefits that did not meet the more likely than not criteria.

Based upon recent operating performance and other considerations, management concluded during the quarter ended December 31, 1998, that the Company will generate sufficient future taxable income to realize the deferred tax asset prior to the expiration of any NOLs. Therefore, the realization of the \$2.6 million net deferred tax asset is more likely than not. As a result, during the quarter, net income included the reversal of income tax valuation reserves of approximately \$525,000 reducing the Company's tax provision at statutory rates to a net credit of \$292,000 based upon the Company's estimated tax benefit rate for the full fiscal year.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION.

General

SurModics is a leading provider of surface modification solutions to medical device manufacturers. The Company's revenues are derived from four primary sources: fees from licensing its patented technology to customers; royalties received from licensees; the sale of photoreactive chemical compounds to licensees and stabilization products to the diagnostics industry; and research and development fees generated on projects for commercial customers and pursuant to government grants. In March 1998, the Company completed an initial public offering ("IPO") of 2.3 million shares of Common Stock which generated proceeds of approximately \$15.5 million, net of related offering costs.

Results of Operations

Three Months Ended December 31, 1998 and 1997

Revenues. The Company's revenues were \$2.6 million for the first quarter of fiscal 1999, an increase of \$730,000, or 38.2%, over the same period of fiscal 1998. The revenue components were as follows:

	1998	1997	\$ Increase (Decrease)	% Increase (Decrease)
	----	----	-----	-----
Royalties:				
Diagnostic	\$611	\$522	\$89	17.0%
PhotoLink(R)	695	420	275	65.4%
	---	---	---	
Total royalties	1,306	942	364	38.6%
License fees	265	-	265	N/A
Product sales:				
Reagents	245	107	138	129.0%
Stabilization	385	389	(4)	(1.0%)
	---	---	---	
Total product sales	630	496	134	27.0%
Research and development:				
Commercial	209	246	(37)	(15.0%)
Government	229	225	4	1.8%
	---	---	-	
Total research and development	438	471	(33)	(7.0%)
	---	---	---	
Total revenues	\$2,639	\$1,909	\$730	38.2%

The first quarter revenue growth was primarily due to an 82.9% increase in PhotoLink-related revenue. This included a 65.4% increase in PhotoLink royalties and a 129.0% increase in the sales of reagent chemicals (those chemicals used by licensees in the PhotoLink coating process). The growth in PhotoLink royalties was due to increases in the minimum royalty payments from certain clients, the introduction of additional licensed products by the Company's clients, and increased earned royalties from greater market penetration of coated products sold by licensees. The increase in reagent chemical sales was due to growing production of PhotoLink-coated devices by SurModics' clients. In addition, PhotoLink license fee revenue totaled \$265,000 during the first quarter of fiscal 1999, which included the completion of three new license agreements.

Product costs. The Company's product costs were \$283,000 for the first quarter of fiscal 1999, an increase of \$33,000, or 13.2%, over the same period of fiscal 1998. Overall product margins increased to 55.1% in the first quarter of fiscal 1999 from 49.7% in the same period of fiscal 1998. The margin improvement was primarily due to production efficiencies achieved in manufacturing reagent chemicals due to increased volumes.

Research and development expenses. Research and development expenses were \$1,165,000 for the first quarter of fiscal 1999, an increase of \$203,000, or 21.1%, over the same period of fiscal 1998. The change was primarily due to the added compensation and benefits, travel, laboratory supplies and general business expenses associated with additional technical personnel added by the Company over the last year; increased patent fees associated with the filing and maintaining of the patent portfolio, especially international patents; and increased depreciation expense associated with the build-out of additional laboratory space.

Sales and marketing expenses. Sales and marketing expenses were \$398,000 for the first quarter of fiscal 1999, an increase of \$95,000, or 31.5%, over the same period of fiscal 1998. This increase was primarily due to the additional compensation and benefit expenses associated with additional marketing personnel and higher spending for advertising and promotions.

General and administrative expenses. General and administrative expenses were \$528,000 for the first quarter of fiscal 1999, an increase of \$234,000, or 79.8%, over the same period of fiscal 1998. The increase was primarily due to the cost of maintaining a directors' and officers' liability insurance policy added after the IPO; new expenses associated with being a public company (such as investor relations costs, and other external reporting expenses); and costs associated with the recently appointed company President.

Income from operations. The Company's income from operations was \$265,000 for the first quarter of fiscal 1999, an increase of \$164,000, or 162.4%, over the same period of fiscal 1998.

Other income, net. The Company's other income was \$368,000 for the first quarter of fiscal 1999, an increase of \$318,000, or 636.0%, over the same period of fiscal 1998. The majority of this increase was due to additional interest income realized on the investments purchased with the proceeds of the public stock offering. In addition, the Company sold certain investments available for sale resulting in a gain of \$99,000, which can be offset in full by the Company's capital loss carryforwards for tax purposes.

Income tax benefit. The Company ended fiscal 1998 with \$2.6 million of deferred tax assets, which were offset in full by a valuation allowance. Based upon recent operating performance and other considerations, management concluded that the Company will generate sufficient future taxable income to realize the deferred tax asset prior to the expiration of any NOLs. As a result, during the quarter, net income included the reversal of income tax valuation reserves of approximately \$525,000 reducing the Company's tax provision at statutory rates to a net credit of \$292,000 based upon the Company's estimated tax benefit rate for the full fiscal year. It is anticipated that similar amounts will be recorded each quarter during the rest of the year in order to fully recognize the deferred tax asset by the end of the fiscal year. Excluding the effect of the reversal of income tax valuation reserves, the Company's net income and diluted net income per share would have been as follows on a proforma basis:

	Proforma	
	Three Months Ended December 31,	
	1998	1997
	----	----
Net income before provision for income taxes	\$633,000	\$151,000
Income tax provision	(231,000)	(55,000)
	-----	-----
Net income	\$402,000	\$96,000
Diluted net income per share	\$0.05	\$0.02

Other comprehensive income (loss). During the quarter ended December 31, 1998, the Company adopted SFAS No. 130, "Reporting Comprehensive Income," which establishes standards for reporting and displaying comprehensive income and its components in financial statements. The Company's other comprehensive loss was \$97,000 for the first quarter of fiscal 1999. This loss was due to a reduction in the market value of the Company's long-term investments available for sale. As of December 31, 1998, the Company still had a net \$82,000 unrealized gain related to those investments.

#### Year 2000 Compliance

The Company has evaluated its information technology infrastructure for Year 2000 compliance. The Company does not utilize any mainframe technology, but instead has an internal technical infrastructure comprised of client server networks and desktop microcomputers. The applications which run on these computers are primarily purchased software without any significant customized programming. Over the last two years, the Company has routinely upgraded most of its computer hardware, software and telecommunications systems. As a result of its internal reviews, the Company does not anticipate any problems related to Year 2000 compliance with its information technology infrastructure.

The Company is in the process of evaluating its non-information technology systems with regard to Year 2000 compliance. This is especially important related to embedded technology such as microcontrollers contained in various lab equipment, and raw material suppliers who support the Company's manufacturing process. Based upon information currently available, the Company does not anticipate any material disruption in its operations as a result of any failure by either non-information technology equipment or one of its suppliers to be in compliance. Compliance should not be an issue with the Company's products, since they are not date-sensitive.

Costs associated with Year 2000 compliance are expensed as incurred. To date, those costs have not been material. Based upon currently available information, the Company does not expect that the costs of addressing potential Year 2000 problems will have a material impact on the Company's financial condition or results of operations. The Company plans to devote the necessary resources to resolve any significant Year 2000 issues by no later than the end of fiscal year 1999.

Although the Company is committed to addressing any issues well in advance of the Year 2000, there are risks if the Company's objectives are not met. The most severe risk is business interruption. Specific examples of situations that could cause business interruption include, among others, (i) computer hardware or application software processing errors or failures; (ii) failure of lab or manufacturing equipment; (iii) outside suppliers who may not be Year 2000 compliant. Depending on the extent and duration of the business interruption resulting from non-compliant Year 2000 systems, such interruption could have a material adverse effect on the Company's financial condition and results of operations.

#### Liquidity and Capital Resources

As of December 31, 1998, the Company had working capital of approximately \$5.7 million and cash, cash equivalents and investments totaling approximately \$21.0 million. The Company generated positive cash flows from operating activities of \$256,000 in the first quarter, which was almost double the amount for the same period of last year, primarily due to the increased net income. A net of \$712,000 of cash was used for investing activities during the first quarter. The significant increase in investing activities between years was due to the repositioning of the public offering proceeds within an investment portfolio managed by an external investment manager. The investment manager is guided by an investment policy adopted by the Company. The Company's investments principally consist of U.S. government agency obligations and investment grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are three years or less. Finally, \$131,000 of cash was generated from financing activities due to the issuance of common stock related to the exercise of stock options.

As of December 31, 1998, the Company had no debt, nor did it have any credit agreements. The Company believes that its existing capital resources will be adequate to fund the Company's operations into the foreseeable future.



PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 2. Changes in Securities and Use of Proceeds.

Use of Proceeds for the period ending December 31, 1998.

(1)	Effective Date:	March 3, 1998
	SEC File Number:	333-43217
(2)	Offering Date:	March 3, 1998
(4) (i)	The offering has terminated; all securities registered were sold.	
(4) (ii)	Managing Underwriter:	John G. Kinnard and Company, Incorporated
(4) (iii)	Title of Securities:	Common Stock
(4) (iv)	Amount Registered:	2,300,000
	Aggregate Offering Price:	\$17,250,000
	Amount Sold:	2,300,000
	Aggregate Offering Price Sold:	\$17,250,000
(4) (v)	Underwriting Discount and Commissions	\$ 1,293,750
	Other Expenses	\$ 435,148
	Total Expenses	\$ 1,728,898
	All the above items represented direct or indirect payments to others.	
(4) (vi)	Net Offering Proceeds	\$15,521,102
(4) (vii)	Use of Net Offering Proceeds:	
	Research and development	\$ 305,000
	Sales and marketing	\$ 364,000
	Equipment upgrades	\$ 753,000
	Patent protection	\$ 75,000
	Working capital and general corporate purposes	\$ 353,000
	Money market funds	\$13,671,102
	All the above items represented direct or indirect payments to others.	

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

- (a) The Company held its Annual Meeting of shareholders on January 25, 1999.
- (b) Proxies were solicited pursuant to Regulation 14A under the Securities Act of 1934. The shareholders voted on three matters: (i) to amend the Bylaws to provide for the staggered election of directors and to restrict the removal of directors, (ii) to set the number of directors at seven, and (iii) to elect the Board of Directors. The shareholders approved all three matters by the following votes:

	Votes For -----	Votes Against -----	Votes Abstained -----	Broker Non-Votes -----
(i) Amend the Bylaws to provide for the staggered election of directors and to restrict the removal of directors .....	3,955,340	677,930	20,792	1,351,285
(ii) Set number of directors at seven .....	5,696,667	292,180	16,500	N/A
(iii) Elect Directors				
Dale R. Olseth.....	6,000,447	--	4,900	N/A
Donald S. Fredrickson.....	6,000,447	--	4,900	N/A
James J. Grierson.....	6,000,447	--	4,900	N/A
Patrick E. Guire.....	6,000,447	--	4,900	N/A
Kenneth H. Keller.....	6,000,447	--	4,900	N/A
David A. Koch.....	6,000,447	--	4,900	N/A
Kendrick B. Melrose.....	6,000,447	--	4,900	N/A

Item 5. Other Information.

None.

Item 6. Exhibits and Reports on Form 8-K.

- (a) Exhibits - 3.1 Bylaws, as amended to date  
                    27 Financial Data Schedule
- (b) Reports on Form 8-K - None

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SurModics, Inc.

February 12, 1999

By: /s/ Stephen C. Hathaway  
Stephen C. Hathaway  
Vice President & CFO  
(Principal Financial Officer)

Exhibit Index

Exhibit Number	Description
3.1	Bylaws, as amended to date
27	Financial Data Schedule

BYLAWS  
OF  
SURMODICS, INC.

(As Amended Through January 31, 1999)

ARTICLE 1.

OFFICES

1.1) Offices. The principal office of the corporation shall be 9924 West 74th Street, Eden Prairie, Minnesota, and the corporation may have offices at such other places within or without the State of Minnesota as the Board of Directors shall from time to time determine or the business of the corporation requires.

ARTICLE 2.

MEETING OF SHAREHOLDERS

2.1) Annual Meeting. The annual meeting of the shareholders of the corporation entitled to vote shall be held at the principal office of the corporation or at such other place, within or without the State of Minnesota, as is designated by the Board of Directors, or by written consent of all the shareholders entitled to vote thereat, at such time on such day of each year as shall be determined by the Board of Directors or by the President. At the annual meeting, the shareholders, voting as provided in the Articles of Incorporation, shall elect directors and shall transact such other business as shall properly come before the meeting.

2.2) Special Meetings. Special meetings of the shareholders entitled to vote shall be called by the Secretary at anytime upon request of the Chairman of the Board, the President or the Board of Directors (acting upon majority vote), or upon request by shareholders holding ten percent (10%) or more of the voting power of the shareholders.

2.3) Notice of Meetings. There shall be mailed to each shareholder entitled to vote, at his address as shown by the books of the corporation, a notice setting out the place, date and hour of the annual meeting or any special meeting, which notice shall be mailed at least five (5) days prior to the date of the meeting; provided, that (i) notice of a meeting at which an agreement of merger or consolidation is to be considered shall be mailed to all shareholders of record, whether or not entitled to vote, at least two (2) weeks prior thereto, (ii) notice of a meeting at which a proposal to dispose of all, or substantially all, of the property and assets of the corporation is to be considered shall be mailed to all shareholders of record, whether or not entitled to vote, at least ten (10) days prior thereto, and (iii) notice of a meeting at which a proposal to dissolve the corporation or to amend the Articles of Incorporation is to be considered shall be mailed to all shareholders of record, whether or not entitled to vote, at least ten (10) days prior thereto. Notice of any special meeting shall state the purpose or purposes of the

proposed meeting, and the business transacted at all special meetings shall be confined to purposes stated in the notice. Attendance at a meeting by any shareholder, without objection in writing by him, shall constitute his waiver of notice of the meeting.

2.4) Quorum and Adjourned Meeting. The holders of a majority of all shares outstanding and entitled to vote, represented either in person or by proxy, shall constitute a quorum for the transaction of business at any annual or special meeting of the shareholders. In case a quorum is not present at any meeting, those present shall have the power to adjourn the meeting from time to time, without notice other than announcement at the meeting, until the requisite number of voting shares shall be represented. At such adjourned meetings at which the required amount of voting shares shall be represented, any business may be transacted which might have been transacted at the original meeting.

2.5) Voting. At each meeting of the shareholders, every shareholder having the right to vote shall be entitled to vote in person or by proxy duly appointed by an instrument in writing subscribed by such shareholder. Each shareholder shall have one (1) vote for each share having voting power standing in his name on the books of the corporation except as may be otherwise required to provide for cumulative voting (if not denied by the Articles). Upon the demand of any shareholder, the vote for directors or the vote upon any question before the meeting shall be by ballot. All elections shall be determined and all questions decided by a majority vote of the number of shares entitled to vote and represented at any meeting at which there is a quorum except in such cases as shall otherwise be required by statute, the Articles of Incorporation or these Bylaws. Except as may otherwise be required to conform to cumulative

voting procedures, directors shall be elected by a plurality of the votes cast by holders of shares entitled to vote thereon.

2.6) Record Date. The Board of Directors may fix a time, not exceeding sixty (60) days preceding the date of any meeting of shareholders, as a record date for the determination of the shareholders entitled to notice of and to vote at such meeting, notwithstanding any transfer of any shares on the books of the corporation after any record date so fixed. The Board of Directors may close the books of the corporation against transfer of shares during the whole or any part of such period. In the absence of action by the Board, only shareholders of record twenty (20) days prior to a meeting may vote at such meeting.

2.7) Order of Business. The suggested order of business at the annual meeting and, to the extent appropriate, at all other meetings of the shareholders shall, unless modified by the presiding chairman be:

- (a) Call of roll
- (b) Proof of due notice of meeting or waiver of notice
- (c) Determination of existence of quorum
- (d) Reading and disposal of any unapproved minutes
- (e) Annual reports of officers and committees
- (f) Election of directors
- (g) Unfinished business
- (h) New business
- (i) Adjournment.

ARTICLE 3.

DIRECTORS

3.1) General Powers. The property, affairs and business of the corporation shall be managed by a Board of Directors.

3.2) Number, Term, Election and Qualifications. At each annual meeting the shareholders shall determine the number of directors, which shall be not less than three; provided, that between annual meetings the authorized number of directors may be increased by the shareholders or Board of Directors or decreased by the shareholders. However, notwithstanding the foregoing no increase or decrease in the number of directors may be effected except according to the further provisions contained in this Section 3.2. The directors shall be divided into three classes, designated Class I, Class II and Class III. Each class shall consist, as nearly as possible, of one-third of the total number of directors constituting the entire Board of Directors. At the 1999 Annual Meeting of Shareholders, Class I directors shall be elected for a one-year term, Class II directors for a two-year term and Class III directors for a three-year term. At each succeeding annual meeting of the shareholders beginning in 2000, successors to the class of directors whose term expires at that annual meeting shall be elected for a three-year term. A director shall hold office until the annual meeting for the year in which his or her term expires and until his or her successor shall be elected and shall qualify, or until his or her resignation or removal from office. If the number of directors is changed, any increase or decrease shall be apportioned among the classes so as to maintain, as nearly as possible, an equal number of directors in each class. In the event an increase or decrease makes it impossible to maintain an equal number of directors in each class, increases shall be allocated to the class or classes with the longest remaining term, and decreases shall be allocated to the class with the shortest remaining term. Any director elected to fill a vacancy resulting from an increase in such class shall hold office for a term that shall coincide with the remaining term of that class. In no event will a decrease in the number of directors result in the elimination of an entire class of directors, cause any class to contain a number of directors two or more greater than any other class, or shorten the term of any incumbent director. Any director elected to fill a vacancy not resulting from an increase in the number of directors shall have the same remaining term as that of his or her predecessor. No amendment to these Bylaws shall alter, change or repeal any of the provisions of this Section 3.2 unless the amendment effecting such alteration, change or repeal shall receive the affirmative vote of the holders of two-thirds (2/3) of all shares of stock of the corporation entitled to vote on all matters that may come before each meeting of shareholders.

3.3) Vacancies. Vacancies on the Board of Directors shall be filled by the remaining members of the Board, though less than a quorum; provided that newly created directorships resulting from an increase in the authorized number of directors shall be filled by two-thirds (2/3) of the directors serving at the time of such increase. Persons so elected shall be directors until their successors are elected by the shareholders, who may make such election at their next annual meeting or at any special meeting duly called for that purpose.

3.4) Quorum and Voting. A majority of the whole Board of Directors shall constitute a quorum for the transaction of business except that when a vacancy or vacancies exist, a majority of the remaining directors (provided such majority consists of not less than two directors) shall constitute a quorum. Except as otherwise provided in the Articles of Incorporation or these Bylaws, the acts of a majority of the directors present at a meeting at which a quorum is present be the acts of the Board of Directors.

3.5) First Meeting. As soon as practicable after each annual election of directors, the Board of Directors shall meet for the purpose of organization, electing or appointing officers of the corporation, and transaction of other business, at the place where the shareholders' meeting is held or at the place where regular meetings of the Board of Directors are held. No notice of such meeting need be given. Such first meeting may be held at any other time and place specified in a notice given as hereinafter provided for special meetings or in a waiver of notice signed by all the directors.

3.6) Regular Meetings. Regular meetings of the Board of Directors shall be held from time to time at such time and place as may from time to time be fixed by resolution adopted by a majority of the entire Board of Directors. No notice need be given of any regular meeting.

3.7) Special Meetings. Special meetings of the Board of Directors may be held at such time and place as may be designated in the notice or the waiver of notice of the meeting. Special meetings of the Board of Directors may be called by the Chairman of the Board, the President or by any two (2) directors. Unless notice shall be waived by all directors, notice, of such special meeting (including a statement of the purposes thereof) shall be given to each director at least twenty-four (24) hours in advance of the meeting if oral or two (2) days in advance of the meeting if by mail, telegraph or other written communication; provided, however, that meetings may be held without waiver of notice from or giving notice to any director while he is in the armed forces of the United States or outside the continental limits of the United States. Attendance at a meeting by any director, without objection in writing by him, shall constitute a waiver of notice of such meeting.

3.8) Compensation. Directors who are not salaried officers of the corporation shall receive such fixed sum per meeting attended or such fixed annual sum as shall be determined from time to time by resolution of the Board of Directors. Nothing herein contained shall be construed to preclude any director from serving this corporation in any other capacity and receiving proper compensation therefor.

3.9) Executive Committee. The Board of Directors may, by unanimous affirmative action of the entire Board, designate two or more of its number to constitute an Executive Committee, which, to the extent determined by unanimous affirmative action of the entire Board, shall have and exercise authority of the Board in the management of the business of the corporation. Any such Executive Committee shall act only in the interval between meetings of the Board and shall be subject at all times to the control and direction of the Board.

3.10) Order of Business. The suggested order of business at any meeting of the Board of Directors shall, to the extent appropriate and unless modified by the presiding chairman, be:

- (a) Roll call
- (b) Proof of due notice of meeting or waiver of notice, or unanimous presence and declaration by president
- (c) Determination of existence of quorum
- (d) Reading and disposal of any unapproved minutes
- (e) Reports of officers and committee
- (f) Election of officers
- (g) Unfinished business
- (h) New business
- (i) Adjournment.

3.11) Removal. Directors may be removed only for cause by vote of the shareholders or for cause by vote of a majority of the entire Board of Directors. No amendment to these Bylaws shall alter, change or repeal any of the provisions of this Section 3.2 unless the amendment effecting such alteration, change or repeal shall receive the affirmative vote of the holders of two-thirds (2/3) of all shares of stock of the corporation entitled to vote on all matters that may come before each meeting of shareholders.

#### ARTICLE 4.

##### OFFICERS

4.1) Number and Designation. The Board of Directors shall elect a President, a Secretary and a Treasurer, and may elect or appoint a Chairman of the Board, one or more Vice Presidents, and such other officers and agents as it may from time to time determine. Any two of the offices except those of President and Vice President may be held by one person.

4.2) Election, Term of Office and Qualifications. At each annual meeting of the Board of Directors, the Board shall elect the officers provided for in Section 4.1 and such officers shall hold office until the next annual meeting of the Board or until their successors are elected or appointed and qualify; provided, however, that any officer may be removed with or without cause by the affirmative vote of a majority of the entire Board of Directors (without prejudice, however, to any contract rights of such officer).

4.3) Resignations. Any officer may resign at any time by giving written notice to the Board of Directors or to the Chairman, President or Secretary. The resignation shall take effect at the time specified in the notice and, unless otherwise specified therein, acceptance of the resignation shall not be necessary to make it effective.



4.4) Vacancies in Office. If there be a vacancy in any office of the corporation, by reason of death, resignation, removal or otherwise, such vacancy shall be filled for the unexpired term by the Board of Directors at any regular or special meeting.

4.5) Chairman of the Board. The Board of Directors may, in its discretion elect one of its number as Chairman of the Board. The Chairman shall preside at all meetings of the shareholders and of the Board and shall exercise general supervision and direction over the more significant matters of policy affecting the affairs of the corporation, including particularly its financial and fiscal affairs. The Chairman of the Board may call a meeting of the Board whenever he deems it advisable.

4.6) President. The President shall have general active management of the business of the corporation. In the absence of the Chairman of the Board, he shall preside at all meetings of the shareholders and Board of Directors. He shall be the chief executive officer of the corporation and shall see that all orders and resolutions are carried into effect. He shall be ex-officio a member of all standing committees and shall perform all duties usually incident to the office of President and such other duties as may from time to time be assigned to him by the Board.

4.7) Vice President. Each Vice President shall have such powers and shall perform such duties as may be specified in these Bylaws or prescribed by the Board of Directors. In the event of absence or disability of the President, the Board of Directors may designate a Vice President or Vice Presidents to succeed to the powers and duties of the President.

4.8) Secretary. The Secretary shall be secretary and shall attend all meetings of the shareholders and Board of Directors. He shall act as clerk thereof and shall record all the proceedings of such meetings in the minute book of the corporation. He shall give proper notice of meetings of shareholders and directors. He may, with the Chairman of the Board, President or Vice President, sign all certificates representing shares of the corporation and shall perform the duties usually incident to his office and such other duties as may be prescribed by the Board of Directors from time to time.

4.9) Treasurer. The Treasurer shall keep accurate accounts of all monies of the corporation received or disbursed, and shall deposit all monies, drafts and checks in the name of and to the credit of the corporation in such banks and depositories as the Board of Directors shall designate from time to time. He shall have power to endorse for deposit the funds of the corporation as authorized by the Board of Directors. He shall render to the Chairman of the Board, President and the Board of Directors, whenever required, an account of all of his transactions as Treasurer and statements of the financial condition of the corporation, and shall perform the duties usually incident to his officer and such other duties as may be prescribed by the Board of Directors from time to time.

4.10) Other Officers. The Board of Directors may appoint one or more Assistant Secretaries, one or more Assistant Treasurers, and such other officers, agents and employees as the Board may deem advisable. Each officer, agent or employee so appointed shall hold office at the pleasure of the Board and shall perform such duties as may be assigned to him by the Board, Chairman of the Board or President.

#### ARTICLE 5.

##### INDEMNIFICATION

5.1) Indemnification of Directors and Officers. To the full extent permitted by Minnesota Statutes, Section 301.095, as amended from time to time, or by other provisions of law, each person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, wherever brought, whether civil, criminal, administrative or investigative, by reason of the fact that such person is or was a director or officer of the corporation or by reason of the fact that such person is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise at the request of the corporation, shall be indemnified by the corporation against expenses, including attorneys' fees, judgments, fines and amounts paid in settlement actually reasonably incurred by such person in connection with such action, suit or proceeding; provided, however, that the indemnification with respect to a person who is or was service as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise shall apply only to the extent such person is not indemnified by such other corporation, partnership, joint venture, trust or other enterprise. The indemnification provided by this section shall continue as to a person who has ceased to be a director or officer of the corporation and shall inure the benefit of the heirs, executors and administrators of such person.

5.2) Indemnification of Employees and Agents. Each person who is not eligible for indemnification pursuant to Section 5.1 above and who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, wherever brought, whether civil, criminal, administrative or investigative, by reason of the fact that such person is or was an employee or agent of the corporation or by reason of the fact that such person is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, may be indemnified by the corporation by action of the Board of Directors to the extent permitted and in accordance with the procedures described by Minnesota Statutes, Chapter 30.1, as amended from time to time, against expenses, including attorneys' fees, judgments, fines and amounts paid in settlement, actually and reasonably incurred by such person in connection with such action, suit or proceeding; provided, however, that the indemnification with respect to a person who is or was serving as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise shall apply only to the extent such person is not indemnified by such other corporation, partnership, joint venture, trust or other enterprise. The indemnification provided by this section shall continue as to a person who has ceased to be an employee or agent and shall inure to the benefit of the heirs, executors and administrators of such person.

5.3) Nonexclusivity. The foregoing right of indemnification in the case of a director or officer and permissive indemnification in the case of an agent or employee shall not be exclusive of other rights to which a director, officer, employee or agent may be entitled as a matter of law.

5.4) Insurance. To the full extent permitted by Minnesota Statutes, Section 301.095, as amended from time to time, or by other provisions of law, the corporation may purchase and maintain insurance on behalf of any indemnified party against any liability asserted against such person and incurred by such person in such capacity.

#### ARTICLE 6.

##### SHARES AND THEIR TRANSFER

6.1) Certificates of Stock. Every owner of stock of the corporation shall be entitled to a certificate, in such form as the Board of Directors may prescribe, certifying the number of shares of stock of the corporation owned by him. The certificates for such stock shall be numbered (separately for each class) in the order in which they shall be issued and shall be signed in the name of the corporation by the Chairman of the Board, President or a Vice President, and by the Secretary, Assistant Secretary, Treasurer, Assistant Treasurer, or any other proper officer of the corporation thereunto authorized by the Board of Directors. Signatures of the officers upon a certificate may be facsimiles if the certificate is countersigned by a transfer agent or registered by a registrar other than the corporation. Certificates on which a facsimile signature of a former officer appears may be issued with the same effect as if he were such officer on the date of issue.

6.2) Stock Record. As used in these Bylaws, the term "shareholder" shall mean, the person, firm or corporation in whose name outstanding shares of capital stock of the corporation are currently registered on the stock record books of the corporation. A record shall be kept of the name of the person, firm or corporation owning the stock represented by such certificates respectively, the respective dates of cancellation. Every certificate surrendered to the corporation for exchange or transfer shall be cancelled and no new certificate or certificates shall be issued in exchange for any existing certificate until such existing certificate shall have been so cancelled (except as provided for in Section 6.4 of this Article 6).

6.3) Transfer of Shares. Transfer of shares on the books of the corporation may be authorized only by the shareholder named in the certificate (or his legal representative or duly authorized attorney-in-fact) and upon surrender for cancellation of the certificate or certificates for such shares. The shareholder in whose name shares of stock stand on the books of the corporation shall be deemed the owner thereof for all purposes as regards the corporation ;provided, that when any transfer of shares shall be made as collateral security and not absolutely, such fact, if known to the Secretary of the corporation or the transfer agent, shall be so expressed in the entry of transfer.

6.4) Lost Certificates. Any shareholder claiming a certificate of stock to be lost or destroyed shall make an affidavit or affirmation of that fact in such form as the Board of Directors may require, and shall, if the directors so require, give the corporation a bond of indemnity in form and with one or more sureties satisfactory to the Board of at least double the value, as determined by the Board, of the stock represented by such certificate in order to indemnify the corporation against any claim that may be made against it on account of the alleged loss or destruction of such certificate, whereupon a new certificate may be issued in the same tenor and for the same number of shares as the one alleged to have been destroyed or lost.

6.5) Treasury Stock. Treasury stock shall be held by the corporation subject to disposal by the Board of Directors in accordance with the Articles and these Bylaws, and shall not have voting rights nor participate in dividends.

6.6) Inspection of Books by Shareholders. Shareholders shall be permitted to inspect the books of the corporation for a proper purpose at all reasonable times.

## ARTICLE 7

### GENERAL PROVISIONS

7.1 Dividends. Subject to the provisions of the Articles of Incorporation and of these Bylaws, the Board of Directors may declare dividends from the net earnings or net assets of the corporation available for dividends whenever and in such amounts as , in its opinion, the condition of the affairs of the corporation shall render it advisable.

7.2) Surplus and Reserves. Subject to the provisions of the Articles of Incorporation and of these Bylaws, the Board of Directors in its discretion may use and apply any of the net earnings or net assets of the corporation available for such purpose to purchase or acquire any of the shares of the capital stock of the corporation in accordance with law, or any of its bonds, debentures, notes, scrip or other securities or evidences of indebtedness, or from time to time may set aside from its net assets or net earnings such sums as it, in its absolute discretion may think proper as a reserve fund to meet contingencies, for the purpose of maintaining or increasing the property or business of the corporation, or for any other purpose it may think conducive to the best interests of the corporation.

7.3) Fiscal Year. The fiscal year of the corporation shall be established by the Board of Directors.

7.4) Seal. The corporation shall have such corporate seal or no corporate seal as the Board of Directors shall from time to time determine.

7.5) Securities of Other Corporations.

(a) Voting Securities Held by the Corporation. Unless otherwise ordered by the Board of Directors, the President shall have full power and authority on behalf of the corporation (i) to attend and to vote at any meeting of security holders of any other companies in which the corporation may hold securities; (ii) to execute any proxy for such meeting on behalf of the corporation and (iii) to execute a written action in lieu of a meeting of such

other company on behalf of this corporation. At such meeting, by such proxy or by such writing in lieu of meeting, the President shall possess and may exercise any and all rights and powers incident to the ownership of such securities that the corporation might have possessed and exercised if it had been present. The Board of Directors may, from time to time, confer like powers upon any other person or persons.

(b) Purchase and Sale of Securities. Unless otherwise ordered by the Board of Directors, the President shall have full power and authority on behalf of the corporation to purchase, sell, transfer or encumber any and all securities of any other company owned by the corporation and may execute and deliver such documents as may be necessary to effectuate such purchase, sale, transfer or encumbrance. The Board of Directors may, from time to time, confer like powers upon any other person or persons.

## ARTICLE 8.

### MEETINGS

8.1) Waiver of Notice. Whenever any notice whatsoever is required to be given by these Bylaws, the Articles of Incorporation or any of the laws of the State of Minnesota, a waiver thereof in writing, signed by the person or persons entitled to such notice, whether before, at or after the time stated therein, shall be deemed equivalent to the actual required notice.

8.2) Participation by Conference Telephone. Members of the Board of Directors, or any committee designated by the Board, may participate in a meeting of the Board of Directors or of such committee by means of conference telephone or similar communications equipment whereby all persons participating in the meeting can hear and communicate with each other, and participation in a meeting pursuant to this Section shall constitute presence in person at such meeting. The place of the meeting shall be deemed to be the place of origination of the conference telephone call or similar communication technique.

8.3) Authorization Without Meeting. Any action of the shareholders, the Board of Directors, or any lawfully constituted Executive Committee of the corporation which may be taken at a meeting thereof, may be taken without a meeting if authorized by a writing signed by all of the holders of shares who would be entitled to notice of a meeting for such purpose, by all of the directors, or by all of the members of such Executive Committee, as the case may be.

## ARTICLE 9

### AMENDMENTS OF BYLAWS

9.1) Amendments. Except as otherwise provided in specific provisions of these Bylaws, these Bylaws may be altered, amended, added to or repealed by the affirmative vote of a majority of the members of the Board of Directors at any regular meeting of the Board or at any special meeting of the Board called for that purpose, subject to the power of the shareholders to change or repeal such Bylaws and subject to any other limitations on such authority of the Board provided by the Minnesota Business Corporation Act.

1,000  
U.S. Dollars

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SEP-30-1999  
OCT-01-1998  
DEC-31-1998  
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1,019  
3,934  
946  
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431  
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