

NORTECH SYSTEMS INC  
Form 10-Q  
May 13, 2011  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

**FORM 10-Q**

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2011

OR

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**NORTECH SYSTEMS INCORPORATED**

Commission file number 0-13257

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State of Incorporation: **Minnesota**

IRS Employer Identification No. **41-1681094**

Executive Offices: **1120 Wayzata Blvd E., Suite 201, Wayzata, MN 55391**

Telephone number: **(952) 345-2244**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulations S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer

Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Number of shares of \$.01 par value common stock outstanding at May 6, 2011 - 2,742,992

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Table of Contents**PART 1****ITEM 1. FINANCIAL STATEMENTS****NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS**

| <b>ASSETS</b>  | <b>MARCH 31<br/>2011<br/>(Unaudited)</b> | <b>DECEMBER 31<br/>2010</b> |
|--|--|-----------------------------|
| Current Assets   |  |                             |
| Cash and Cash Equivalents                                      | \$ 255,950                               | \$ 230,582                  |
| Accounts Receivable, Less Allowance for Uncollectible Accounts | 17,657,468                               | 15,562,277                  |
| Inventories  | 20,474,687                               | 16,108,773                  |
| Prepaid Expenses   | 749,380                                  | 596,363                     |
| Income Taxes Receivable  | 312,066                                  | 376,001                     |
| Deferred Income Taxes  | 623,000                                  | 594,000                     |
| <b>Total Current Assets</b>                                    | <b>40,072,551</b>                        | <b>33,467,996</b>           |
| Property and Equipment, Net                                    | 9,342,048                                | 7,157,543                   |
| Finite Life Intangible Assets, Net of Accumulated Amortization | 166,999                                  | 202,150                     |
| Deferred Income Taxes  |  | 219,000                     |
| Other Assets   | 514,235                                  | 514,235                     |
| <b>Total Assets</b>  | <b>\$ 50,095,833</b>                     | <b>\$ 41,560,924</b>        |

See Accompanying Condensed Notes to Consolidated Financial Statements

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## NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

| LIABILITIES AND SHAREHOLDERS EQUITY  | MARCH 31<br>2011<br>(Unaudited) | DECEMBER 31<br>2010  |
|--|---------------------------------|----------------------|
| <b>Current Liabilities</b>   |                                 |                      |
| Line of Credit   | \$ 9,724,917                    | \$ 5,615,121         |
| Current Maturities of Long-Term Debt   | 2,121,421                       | 841,760              |
| Accounts Payable   | 12,699,085                      | 10,727,907           |
| Accrued Payroll and Commissions  | 2,638,147                       | 2,584,108            |
| Other Accrued Liabilities  | 739,717                         | 634,655              |
| <b>Total Current Liabilities</b>   | <b>27,923,287</b>               | <b>20,403,551</b>    |
| <b>Long-Term Liabilities</b>   |                                 |                      |
| Long-Term Debt, Net of Current Maturities  | 2,039,672                       | 1,731,318            |
| Deferred Income Taxes  | 52,000                          |                      |
| Other Long-Term Liabilities  | 157,935                         | 137,236              |
| <b>Total Long-Term Liabilities</b>   | <b>2,249,607</b>                | <b>1,868,554</b>     |
| <b>Total Liabilities</b>   | <b>30,172,894</b>               | <b>22,272,105</b>    |
| <b>Shareholders Equity</b>   |                                 |                      |
| Preferred Stock, \$1 par value; 1,000,000 Shares Authorized:                         |                                 |                      |
| 250,000 Shares Issued and Outstanding  | 250,000                         | 250,000              |
| Common Stock - \$0.01 par value; 9,000,000 Shares Authorized:                        |                                 |                      |
| 2,742,992 Shares Issued and Outstanding at both March 31, 2011 and December 31, 2010 | 27,430                          | 27,430               |
| Additional Paid-In Capital   | 15,706,280                      | 15,698,348           |
| Accumulated Other Comprehensive Loss   | (62,936)                        | (62,936)             |
| Retained Earnings  | 4,002,165                       | 3,375,977            |
| <b>Total Shareholders Equity</b>   | <b>19,922,939</b>               | <b>19,288,819</b>    |
| <b>Total Liabilities and Shareholders Equity</b>                                     | <b>\$ 50,095,833</b>            | <b>\$ 41,560,924</b> |

See Accompanying Condensed Notes to Consolidated Financial Statements

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## NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

|   | THREE MONTHS ENDED |               |
|---|--------------------|---------------|
|   | MARCH 31           |               |
|   | 2011               | 2010          |
| Net Sales   | \$ 28,998,197      | \$ 21,741,441 |
| Cost of Goods Sold  | 25,802,032         | 19,101,773    |
| Gross Profit  | 3,196,165          | 2,639,668     |
| Operating Expenses:   |                    |               |
| Selling Expenses  | 929,384            | 755,422       |
| General and Administrative Expenses   | 1,980,119          | 1,558,464     |
| Total Operating Expenses  | 2,909,503          | 2,313,886     |
| Income From Operations  | 286,662            | 325,782       |
| Other Income (Expense)  |                    |               |
| Interest Expense  | (119,942)          | (125,430)     |
| Bargain Purchase Gain   | 791,615            |               |
| Miscellaneous Income (Expense), net   | (19,147)           | (45,068)      |
| Total Other Income (Expense)  | 652,526            | (170,498)     |
| Income Before Income Taxes  | 939,188            | 155,284       |
| Income Tax Expense  | 313,000            | 60,000        |
| Net Income  | \$ 626,188         | \$ 95,284     |
| Earnings Per Common Share:  |                    |               |
| Basic and Diluted   | \$ 0.23            | \$ 0.03       |
| Weighted Average Number of Common Shares Outstanding Used for Basic and Diluted |                    |               |
| Earnings Per Common Share   | 2,742,992          | 2,740,548     |

See Accompanying Condensed Notes to Consolidated Financial Statements

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## NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

|   | THREE MONTHS ENDED<br>MARCH 31 |             |
|---|--------------------------------|-------------|
|   | 2011                           | 2010        |
| <b>Cash Flows From Operating Activities</b>   |                                |             |
| Net Income  | \$ 626,188                     | \$ 95,284   |
| Adjustments to Reconcile Net Income to Net Cash Provided by (Used in) Operating Activities:           |                                |             |
| Depreciation  | 488,337                        | 395,716     |
| Amortization  | 35,151                         | 35,946      |
| Stock-Based Compensation  | 7,932                          | 7,932       |
| Interest on Swap Valuation  | (7,842)                        | (4,648)     |
| Bargain Purchase Gain   | (791,615)                      |             |
| Deferred Income Taxes   | 242,000                        | 17,000      |
| Foreign Currency (Gain) Loss  |                                | (2,748)     |
| Changes in Current Operating Items, Net of Effects of Business Acquisition                            |                                |             |
| Accounts Receivable   | (180,468)                      | 97,471      |
| Inventories   | (4,365,914)                    | (1,729,602) |
| Prepaid Expenses and Other Assets   | (153,017)                      | 12,177      |
| Income Taxes Receivable   | 63,935                         | 84,911      |
| Accounts Payable  | 198,844                        | 1,530,606   |
| Accrued Payroll and Commissions   | 54,039                         | 431,764     |
| Other Accrued Liabilities   | (128,700)                      | (382,138)   |
| Net Cash Provided by (Used in) Operating Activities   | (3,911,130)                    | 589,671     |
| <b>Cash Flows from Investing Activities:</b>  |                                |             |
| Proceeds from Sale of Property and Equipment  | 600                            |             |
| Business Acquisition  | (1,042,389)                    |             |
| Purchase of Property and Equipment  | (219,524)                      | (147,540)   |
| Net Cash Used in Investing Activities   | (1,261,313)                    | (147,540)   |
| <b>Cash Flows from Financing Activities:</b>  |                                |             |
| Net Change in Line of Credit  | 4,109,796                      | (475,000)   |
| Proceeds from Long-Term Debt  | 1,380,869                      |             |
| Principal Payments on Long-Term Debt  | (292,854)                      | (225,336)   |
| Proceeds from Issuance of Common Stock  |                                | 12,500      |
| Net Cash Provided by (Used in) Financing Activities   | 5,197,811                      | (687,836)   |
| Effect of Exchange Rate Changes on Cash   |                                |             |
|   |                                | 324         |
| Net Increase (Decrease) in Cash and Cash Equivalents  | 25,368                         | (245,381)   |
| Cash and Cash Equivalents - Beginning   | 230,582                        | 245,381     |
| Cash and Cash Equivalents - Ending  | \$ 255,950                     | \$          |
| <b>Supplemental Disclosure of Cash Flow Information:</b>  |                                |             |
| Cash Paid During the Period for Interest  | \$ 120,997                     | \$ 131,395  |
| Cash Paid During the Period for Income Taxes  |                                | 1,615       |
| <b>Supplemental Noncash Investing and Financing Activities Due to Seller for Business Acquisition</b> |                                |             |
|   | \$ 500,000                     | \$          |

See Accompanying Condensed Notes to Consolidated Financial Statements



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**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*Basis of Presentation*

The accompanying unaudited consolidated financial statements for the interim periods have been prepared in accordance with Generally Accepted Accounting Principles in the United States of America (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, they do not include all of the financial information and footnotes required by GAAP for complete financial statements, although we believe the disclosures are adequate to make the information presented not misleading. It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in our latest shareholders' annual report on Form 10-K. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full year or for any other interim period. In our opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. In preparing these consolidated financial statements, we have made our best estimates and judgments of certain amounts included in the consolidated financial statements, giving due consideration to materiality. Changes in the estimates and assumptions used by us could have a significant impact on our financial results, since actual results could differ from those estimates.

*Principles of Consolidation*

The consolidated financial statements include the accounts of Nortech Systems Incorporated and its wholly owned subsidiary, Manufacturing Assembly Solutions of Monterrey, Inc. All significant intercompany accounts and transactions have been eliminated.

*Revenue Recognition*

We recognize revenue upon shipment of manufactured products to customers, when title has passed, all contractual obligations have been satisfied and collection of the resulting receivable is reasonably assured. We also provide engineering services separate from the manufacture of a product. Revenue for engineering services is recognized upon completion of the engineering process, providing standalone fair value to our customers. Our engineering services are short-term in nature. In addition, we have another separate source of revenue that comes from short-term repair services, which are recognized upon completion of the repairs and shipment of product back to the customer. Shipping and handling costs charged to our customers are included in net sales, while the corresponding shipping expenses are included in cost of goods sold.

Table of Contents**Stock Options**

Following is the status of all stock options as of March 31, 2011, including changes during the three-month period then ended:

|                               | Shares   | Weighted-Average Exercise Price Per Share | Weighted-Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|-------------------------------|----------|---|--|---------------------------|
| Outstanding - January 1, 2011 | 663,150  | \$ 7.32                                   |  |                           |
| Forfeited                     | (39,550) | \$ 7.28                                   |  |                           |
| Outstanding - March 31, 2011  | 623,600  | \$ 7.33                                   | 5.27   | \$ 2,895                  |
| Exercisable - March 31, 2011  | 292,000  | \$ 7.28                                   | 4.07   | \$                        |

There were no options exercised during the three months ended March 31, 2011. The total intrinsic value of options exercised during the three months ended March 31, 2010 was \$20. Cash received from option exercises during the three months ended March 31, 2010 was \$12,500.

Total compensation expense related to stock options with time-based vesting for both the three months ended March 31, 2011 and 2010 was \$7,932. As of March 31, 2011, there was approximately \$19,000 of unrecognized compensation expense related to unvested option awards that we expect to recognize over a weighted-average period of 0.61 years.

**Equity Appreciation Rights Plan**

In November 2010, the Board of Directors approved the adoption of the Nortech Systems Incorporated Equity Appreciation Rights Plan (the 2010 Plan ). The total number of Equity Appreciation Right Units (Units) the Plan can issue shall not exceed an aggregate of 750,000 Units, of which 100,000 Units were issued during the year ended December 31, 2010. There were no additional Units granted during the three months ended March 31, 2011.

The 2010 Plan provides that Units issued shall fully vest three years from the grant date unless terminated earlier. Units give the holder a right to receive a cash payment equal to the appreciation in book value per share of common stock from the base date, as defined, to the redemption date. Unit redemption payments under this plan shall be paid in cash within 90 days after we determine the book value of the Units as of the calendar year immediately preceding the redemption date. The Units issued during the year ended December 31, 2010 have a book value per Unit of \$6.84 and have a weighted average life remaining of 1.75 years at March 31, 2011. Total compensation expense related to these Units based on the estimated appreciation over their remaining term was \$26,541 for the three months ended March 31, 2011.

Table of Contents**Segment Reporting Information**

For the three months ended March 31, 2011 and 2010 all of our operations fall under the Contract Manufacturing segment within the Electronic Manufacturing Services industry. We strategically direct production between our various manufacturing facilities based on a number of considerations to best meet our customers' requirements. We share resources for sales, marketing, cash and risk management, banking, credit and collections, human resources, payroll, internal control, audit, taxes, SEC reporting and corporate accounting. Consolidated financial information is available that is evaluated regularly by the chief operating decision maker in assessing performance and allocating resources. Export sales represented 6% and 5% of consolidated net sales for the three months ended March 31, 2011 and 2010, respectively.

**Inventories**

Inventories are stated at the lower of cost (first-in, first-out method) or market (based on the lower of replacement cost or net realizable value). Costs include material, labor, and overhead required in the warehousing and production of our products. Inventory reserves are maintained for the estimated value of the inventories that may have a lower value than stated or quantities in excess of future production needs.

Inventories are as follows:

|                 | <b>March 31<br/>2011</b> | <b>December 31<br/>2010</b> |
|-----------------|--------------------------|-----------------------------|
| Raw Materials   | \$ 14,161,002            | \$ 11,277,741               |
| Work in Process | 4,393,351                | 3,477,236                   |
| Finish Goods    | 2,993,867                | 2,395,843                   |
| Reserve         | (1,073,533)              | (1,042,047)                 |
| Total           | \$ 20,474,687            | \$ 16,108,773               |

Table of Contents**Finite Life Intangible Assets**

Finite life intangible assets at March 31, 2011 and December 31, 2010 are as follows:

|                  | Remaining<br>Lives<br>(Years) | March 31, 2011              |                             |                   |
|------------------|-------------------------------|-----------------------------|-----------------------------|-------------------|
|                  |                               | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net Book<br>Value |
| Bond Issue Costs | 10                            | \$ 79,373                   | \$ 25,136                   | \$ 54,237         |
| Customer Base    | 1                             | 676,557                     | 563,795                     | 112,762           |
| Totals           |                               | \$ 755,930                  | \$ 588,931                  | \$ 166,999        |

|                  | Remaining<br>Lives<br>(Years) | December 31, 2010           |                             |                   |
|------------------|-------------------------------|-----------------------------|-----------------------------|-------------------|
|                  |                               | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net Book<br>Value |
| Bond Issue Costs | 11                            | \$ 79,373                   | \$ 23,814                   | \$ 55,559         |
| Customer Base    | 2                             | 676,557                     | 529,966                     | 146,591           |
| Totals           |                               | \$ 755,930                  | \$ 553,780                  | \$ 202,150        |

Estimated future amortization expense related to these assets is as follows:

|                   |            |
|-------------------|------------|
| Remainder of 2011 | \$ 105,000 |
| 2012              | 17,000     |
| 2013              | 5,000      |
| 2014              | 5,000      |
| 2015              | 5,000      |
| Thereafter        | 30,000     |
| Total             | \$ 167,000 |

**NOTE 2. CONCENTRATION OF CREDIT RISK AND MAJOR CUSTOMERS**

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable. With regard to cash and cash equivalents, we maintain our excess cash balances in checking accounts at one high-credit quality financial institution. These accounts may at times exceed federally insured limits. We grant credit to customers in the normal course of business and do not require collateral on our accounts receivable.

One customer accounted for 10% or more of our net sales for the three months ended March 31, 2011 and 2010. G.E.'s Medical Division accounted for 15% and 20% of net sales for the three months ended March 31, 2011 and 2010, respectively. GE's Transportation Division accounted for 4% and 9% of net sales for the three months ended March 31, 2011 and 2010, respectively. GE's Medical and Transportation Divisions combined accounted for 19% and 29% of net sales for the three month periods ended March 31, 2011 and 2010, respectively. Accounts receivable



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from G.E. s Medical and Transportation Divisions represented 12% and 14% of total accounts receivable at March 31, 2011 and December 31, 2010, respectively.

NOTE 3. FINANCING ARRANGEMENTS

On January 6, 2011, we entered into the first amendment to the third amended and restated credit agreement with Wells Fargo Bank (WFB), which provides for a line of credit arrangement of \$13.5 million, which expires if not renewed, on May 31, 2013. The credit arrangement also has a real estate term note with a maturity date of May 31, 2012, a new \$475,000 equipment term loan tied to equipment purchased in the Mankato acquisition (Note 8), and a new term loan of up to \$1.0 million for capital expenditures to be made in 2011. Both the line of credit and real estate term note are subject to variations in LIBOR rates. The weighted-average interest rate on our line of credit was 4.09% for the three months ended March 31, 2011. The line of credit and real estate term note with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. On March 31, 2011, we had an outstanding balance of \$9.7 million under the line of credit, unused availability of \$2.6 million supported by our borrowing base and were in compliance with all covenants.

NOTE 4. DERIVATIVE INSTRUMENTS AND HEDGING STRATEGIES

We are exposed to interest rate risk associated with fluctuations in the interest rates on our variable interest rate debt. In order to manage some of the risk, we have entered into an interest rate swap agreement with a notional amount of \$1.4 million with a goal to effectively convert our industrial revenue bond debt from a variable rate to a fixed rate of 4.07% for five years, maturing on June 28, 2011. The amortized notional amount outstanding at March 31, 2011 was approximately \$842,000. We do not use this interest rate swap for speculative purposes. The fair value of the swap of approximately \$10,000 and \$18,000 was recorded in other long-term liabilities at March 31, 2011 and December 31, 2010 respectively. The change in fair value of \$8,000 and \$(5,000) for the three-month periods ended March 31, 2011 and 2010, respectively, was recorded as a component of interest expense.

NOTE 5. NET INCOME PER COMMON SHARE

For the three months ended March 31, 2011 and 2010, the effect of all stock options is antidilutive. Therefore, no outstanding options were included in the computation of per-share amounts.

NOTE 6. INCOME TAXES

On a quarterly basis, we estimate what our effective tax rate will be for the full fiscal year and record a quarterly income tax provision based on the anticipated rate. As the year progresses, we refine our estimate based on the facts and circumstances by each tax jurisdiction. The effective tax rates for the quarters ended March 31, 2011 and 2010 were approximately 33% and 39%, respectively. The decrease in rate from 2010 principally relates to the federal R&D credit that



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was not included in the prior year provision as it was not extended until the fourth quarter of 2010.

At March 31, 2011 we had \$116,000 of net uncertain tax benefit positions recorded in other long-term liabilities that would reduce our effective income tax rate if recognized. The \$2,000 increase from December 31, 2010 was related to the accrual of estimated interest and penalties on uncertain positions.

## NOTE 7. COMPREHENSIVE INCOME

Comprehensive income is comprised of net income and other comprehensive loss. Other comprehensive loss includes gains and losses resulting from foreign currency translations. The details of comprehensive income are as follows:

|                                 | Three Months Ended<br>March 31 |           |
|---------------------------------|--------------------------------|-----------|
|                                 | 2011                           | 2010      |
| Net Income                      | \$ 626,188                     | \$ 95,284 |
| Other Comprehensive Loss:       |                                |           |
| Currency Translation Adjustment |                                | (208)     |
| Comprehensive Income            | \$ 626,188                     | \$ 95,076 |

## NOTE 8. ACQUISITIONS

On May 4, 2010, we acquired all of the intellectual property and assets, excluding cash and receivables, of Trivirix Corporation, Milaca, MN for cash of \$403,000. The fair value of assets acquired included \$303,000 in inventory and \$100,000 in property and equipment. This operation specializes in design, manufacturing and post-production services of complex electronic and electromechanical medical devices for diagnostic, analytical and other life-science applications. This acquisition expands our capabilities and expertise serving medical electronics manufacturers. The acquisition has been accounted for as a business combination and results of operations for Milaca since the date of acquisition are included in the consolidated financial statements.

On January 1, 2011, we completed the purchase of Winland Electronics, Inc. assets and certain liabilities relating to their EMS operations located in Mankato, MN. Winland is a designer and manufacturer of custom electronic control products and systems. This purchase provides needed manufacturing capacity, particularly for supporting medical and industrial customers with printed circuit board assemblies and higher-level builds. The acquisition has been accounted for as a business combination and results of operations since the date of acquisition are included in the consolidated financial statements.



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We paid \$1,042,389 in cash at closing and will make deferred payments of \$250,000 on each July 1, 2011 and October 1, 2011. We also agreed to purchase a minimum of \$2,200,000 of inventory as consumed over a period of 24 months. We have consumed \$2,100,000 of this inventory as of March 31, 2011.

In connection with the acquisition, we also entered into an agreement to manufacture certain products related to the production of Winland's remaining proprietary monitoring devices business unit and also agreed to a six year agreement to lease office and manufacturing space at 1950 Excel Drive, Mankato, Minnesota, 56001, and sublease 1,000 square feet back to Winland for one year.

The following table presents the allocation of the acquisition cost to the assets acquired and liabilities assumed, based on their estimated fair values at the time of the acquisition:

|                               |    |             |
|-------------------------------|----|-------------|
| Accounts receivable           | \$ | 1,914,723   |
| Property, plant and equipment |    | 2,451,000   |
| Accounts payable assumed      |    | (1,772,334) |
| Lease payoff                  |    | (259,385)   |
| Net assets acquired           | \$ | 2,334,004   |
|                               |    |             |
| Cash Paid at Closing          |    | 1,042,389   |
| Due to Winland                |    | 500,000     |
| Purchase price                |    | 1,542,389   |
| Bargain purchase gain         |    | 791,615     |
| Net assets acquired           | \$ | 2,334,004   |

We recognized a \$791,615 bargain purchase gain related to the excess fair value over the purchase price for the assets acquired.

The table below reflects our unaudited pro forma combined results of operations as if the acquisition had taken place as of January 1, 2010:

|                                   | <b>Pro Forma<br/>Three Months Ended<br/>March 31, 2010<br/>(unaudited)</b> |            |
|-----------------------------------|--|------------|
| Net Sales                         | \$   | 25,438,000 |
| Income from Continuing Operations | \$   | 25,000     |
| Net Income                        | \$   | 15,000     |
| Basic Income per Common Share     | \$   | 0.01       |

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Combined results for the two companies for the year ended December 31, 2010 were adjusted for the following in order to create the unaudited proforma results in the table above:

- Additional rent expense of approximately \$44,000 for the lease of the facility from Winland,
- Additional depreciation expense of approximately \$40,000 resulting from the adjustment of property and equipment to their fair values,
- Tax benefit of approximately \$51,000 using an effective tax rate of 39 percent,
- The impact of these adjustments on outstanding shares of 2,740,548 was to decrease proforma income per share by \$0.02.

The pro forma unaudited results do not purport to be indicative of the results which would have been obtained had the acquisition been completed as of the beginning of the earliest period presented. In addition they do not include any benefits that may result from the acquisition due to synergies that may be derived from the elimination of any duplicative costs.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Overview:

We are a Wayzata, Minnesota based full-service Electronics Manufacturing Services (EMS) contract manufacturer of wire and cable assemblies, printed circuit board assemblies, higher-level assemblies and box builds for a wide range of industries. We provide value added services and technical support including design, testing, prototyping and supply chain management to customers mainly in the Aerospace and Defense, Medical, and Industrial Equipment markets. We maintain manufacturing facilities in Baxter, Bemidji, Blue Earth, Fairmont, Mankato, Merrifield, and Milaca, Minnesota; Augusta, Wisconsin; and Monterrey, Mexico.

Summary of Results:

For the quarter ended March 31, 2011, we reported net sales of \$29.0 million compared to \$21.7 million reported in the same quarter of 2010, a 33% improvement, with the recent acquisitions accounting for \$5.5 million of the increase. Our 90-day backlog increased to \$20.0 million as of March 31, 2011 compared to \$19.0 million for the same period last year and \$18.5 million at the start of the quarter.

Our gross margin in the first quarter of 2011 was 11.0% compared to 12.1% in the first quarter of 2010. The margin percentage decrease is mainly attributed to the reinstatement of wages, incentives and benefits that had been suspended in the first six months of 2010, and absorbing the cost of integrating our acquisitions.

Income from operations totaled \$0.3 million for the first quarter of 2011 and 2010.

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Net income for the first quarter of 2011 totaled \$0.6 million or \$0.23 per diluted common share, \$0.1 million or \$0.04 per diluted common share excluding the bargain purchase gain of \$0.5 million, net of tax, compared to net income of \$0.1 million, or \$0.03 per diluted common share for the first quarter of 2010.

Cash used in operating activities for the three months ended March 31, 2011 was \$3.9 million compared to cash provided by operating activities of \$0.6 million for the same period in 2010. The

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revenue growth and related working capital increases in both accounts receivable and inventories account for the majority of the usage.

(1.) Results of Operations:

The following table presents statements of income data as percentages of total net sales for the periods indicated:

|                                     | Three Months Ended<br>March 31 |        |
|-------------------------------------|--------------------------------|--------|
|                                     | 2011                           | 2010   |
| Net Sales                           | 100.0%                         | 100.0% |
| Cost of Goods Sold                  | 89.0                           | 87.9   |
| Gross Profit                        | 11.0                           | 12.1   |
| Selling Expenses                    | 3.2                            | 3.5    |
| General and Administrative Expenses | 6.8                            | 7.1    |
| Income from Operations              | 1.0                            | 1.5    |
| Bargain Purchase Gain               | 2.7                            | 0.0    |
| Other Income (Expenses), Net        | (0.5)                          | (0.8)  |
| Income Before Income Taxes          | 3.2                            | 0.7    |
| Income Tax Expense                  | 1.0                            | 0.3    |
| Net Income                          | 2.2%                           | 0.4%   |

## Net Sales:

We reported net sales of \$29.0 million and \$21.7 million for the three months ended March 31, 2011 and 2010, respectively. The 2011 net sales were impacted by our two new acquisitions; the Milaca medical device operation acquired in May 2010 accounted for \$1.5 million and the Mankato operation acquired in January 2011 accounted for \$4.0 million of net sales for the three months ended March 31, 2011.

Net sales by industry markets for the three month period ended March 31, 2011 and 2010 are as follows:

| (in thousands)        | Three Months Ended<br>March 31 |            |             |
|-----------------------|--------------------------------|------------|-------------|
|                       | 2011<br>\$                     | 2010<br>\$ | %<br>Change |
| Aerospace and Defense | 4,410                          | 4,628      | (5)         |
| Medical               | 8,009                          | 5,730      | 40          |
| Industrial            | 16,579                         | 11,383     | 46          |
| Total Sales           | 28,998                         | 21,741     | 33          |

Net sales to our Aerospace and Defense customers for the three months ended March 31, 2011 was slightly lower than the three months ended March 31, 2010. The increase in net sales of \$2.3 million to our Medical customers was due to the Milaca and Mankato acquisitions which added \$1.5 million and \$0.8 million respectively. The Mankato acquisition also impacted the Industrial customers by \$3.2 million, while an

additional \$2.0 million increase in net sales was generated by our core industrial accounts.

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## Backlog:

Our 90-day order backlog as of March 31, 2011 was approximately \$20.0 million, compared to approximately \$18.5 million at the beginning of the quarter and \$19.0 million at March 31, 2010. Backlog by industry market is shown below.

| (in thousands)        | Backlog as of the Quarter Ended |                     |      | % Change |
|-----------------------|---------------------------------|---------------------|------|----------|
|                       | March 31<br>2011                | December 31<br>2010 |      |          |
| Aerospace and Defense | \$ 2,796                        | \$ 4,453            | (37) |          |
| Medical               | 5,325                           | 4,216               | 26   |          |
| Industrial            | 11,895                          | 9,813               | 21   |          |
| Total Backlog         | \$ 20,016                       | \$ 18,482           | 8    |          |

The lower 90 day Aerospace and Defense backlog is attributed to Defense budget funding delays and contractor project delays in the first quarter. The 90 day Medical backlog increased \$1.1 million due primarily to our Milaca acquisition in May 2010. The 90 day Industrial backlog increased \$2.1 million, with the Mankato acquisition accounting for substantially all of the increase.

## Gross Profit:

Gross profit percentage for the three months ended March 31, 2011 and 2010 was 11.0% and 12.1% of net sales, respectively. Our gross profit percentage decreased due to the reinstatement of wages, incentives and benefits that had been suspended in the first six months of 2010, and absorbing the cost of integrating our acquisitions.

## Selling Expense:

We had selling expenses of \$0.9 million or 3.2% of net sales and 0.8 million or 3.5% of net sales for the three months ended March 31, 2011 and 2010, respectively. Selling expense as a percent of sales remains lower than historical levels. We anticipate increased investment in selling and business development activities to support the increased revenue levels and growth through acquisitions.

## General and Administrative Expense:

Our general and administrative expenses were \$2.0 million or 6.8% of net sales and \$1.6 million or 7.2% of net sales for the three months ended March 31, 2011 and 2010, respectively. The increase in general and administrative dollars spent in 2011 is attributed to the re-instatement of wages and benefits to employees as we continue to recover from the 2009 economic downturn. It remains a management objective to continue to leverage our existing general and administrative resources as the company grows.

## Other Income (Expense):

Other income for the three months ended March 31, 2011 was \$0.7 million while other expense for the three months ended March 31, 2010 was \$0.2 million. In the three months ended March 31, 2011 we recognized a bargain purchase gain of \$0.8 million from the Mankato acquisition and experienced favorable interest expense and exchange rate fluctuations.

Income Taxes:

Income tax expense for the three months ended March 31, 2011 was \$313,000 compared to income tax expense of \$60,000 for the three months ended March 31, 2010 or approximately 33% and 39%,

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respectively. The annual effective tax rate for 2011 is expected to be approximately 33% compared to 36% for 2010. The decrease in rate from 2010 principally relates to the federal R&D credit that was not included in the prior year provision as it was not extended until the fourth quarter of 2010.

### Liquidity and Capital Resources:

We have satisfied our liquidity needs over the past several years through revenue generated from operations and an operating line of credit through WFB. Both the line of credit and real estate term note are subject to fluctuations in the LIBOR rates. The line of credit and real estate term note with WFB contain certain covenants which, among other things, require us to adhere to regular reporting requirements, abide by annual shareholder dividend limitations, maintain certain financial performance, and limit the amount of annual capital expenditures. The availability under our line is subject to borrowing base requirements, and advances are at the discretion of the lender. The line of credit is secured by substantially all of our assets. On March 31, 2011, we had an outstanding balance of \$9.7 million under the line of credit and unused availability of \$2.6 million supported by our borrowing base. We believe our financing arrangements and cash flows provided by operations will be sufficient to satisfy our future working capital needs.

Our working capital of \$12.1 million as of March 31, 2011 decreased from \$13.1 million at December 31, 2010 mainly due to increased line of credit and current maturities of long term debt of \$5.4 million, partially offset by increased inventories of \$4.4 million.

Net cash used in operating activities for the three months ended March 31, 2011 was \$3.9 million. The cash flow used in operations for the three months ended March 31, 2011 is the result of net income of \$0.6 million, adjusted for increased inventories of \$4.4 million and increased accounts receivable of \$0.2 million. \$2.8 million of the inventory increase was related to the Mankato acquisition (see Note 8).

Net cash used in investing activities of \$1.3 million for the three months ended March 31, 2011 is comprised of \$0.2 million in property and equipment purchases to support the business and \$1.0 million for the Mankato operation acquisition (see Note 8).

Net cash provided by financing activities for the three months ended March 31, 2011 was \$5.2 million, mainly due to the increase in borrowing on the line of credit and notes payable of \$5.5 million, partially offset by debt payments of \$0.3 million.

### Critical Accounting Policies and Estimates

Our significant accounting policies and estimates are summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2010. There have been no significant changes in these critical accounting policies since December 31, 2010. Some of our accounting policies require us to exercise significant judgment in selecting the appropriate assumptions for calculating financial estimates. Such judgments are subject to an inherent degree of uncertainty. These judgments are based on our historical experience, known trends in our industry, terms of existing contracts and other information from outside sources, as appropriate. Actual results could differ from these estimates.

### Forward-Looking Statements:



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Those statements in the foregoing report that are not historical facts are forward-looking statements made pursuant to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements generally will be accompanied by words such as anticipate, believe, estimate, expect, forecast, intend, possible, potential, predict, project, or other similar words that convey the uncertainty of future outcomes. Although we believe these forward-looking

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statements are reasonable, they are based upon a number of assumptions concerning future conditions, any or all of which may ultimately prove to be inaccurate. Forward-looking statements involve a number of risks and uncertainties. Important factors that could cause actual results to differ materially from the forward-looking statements include, without limitation:

- Volatility in the marketplace which may affect market supply and demand for our products;
- Increased competition;
- Changes in the reliability and efficiency of operating facilities or those of third parties;
- Risks related to availability of labor;
- Increase in certain raw material costs such as copper;
- Commodity and energy cost instability;
- General economic, financial and business conditions that could affect our financial condition and results of operations;
- Successful integration of recent acquisitions

The factors identified above are believed to be important factors (but not necessarily all of the important factors) that could cause actual results to differ materially from those expressed in any forward-looking statement made by us. Unpredictable or unknown factors not discussed herein could also have material adverse effects on forward-looking statements. All forward-looking statements included in this Form 10-Q are expressly qualified in their entirety by the forgoing cautionary statements. We undertake no obligations to update publicly any forward-looking statement (or its associated cautionary language) whether as a result of new information or future events.

Please refer to forward-looking statements and risks as previously disclosed in our report on Form 10-K for the fiscal year ended December 31, 2010.

**ITEM 4. CONTROLS AND PROCEDURES**

Evaluation of Disclosure Controls and Procedures:

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q, our management evaluated, with the participation of our Chief Executive Officer and Executive Vice President and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation in ensuring that information required to be disclosed in our Exchange Act reports is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting:

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II**

**ITEM 1. LEGAL PROCEEDINGS**

We are subject to various legal proceedings and claims that arise in the ordinary course of business.

**ITEM 6. EXHIBITS**

Exhibits.

- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
- 32 Certification of the Chief Executive Officer and Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Nortech Systems Incorporated and Subsidiary

Date: May 13, 2011

by

/s/ Michael J. Degen

Michael J. Degen  
President and Chief  
Executive Officer

Date: May 13, 2011

by

/s/ Richard G. Wasielewski

Richard G. Wasielewski  
Chief Financial Officer