NATCO GROUP INC
Form 10-Q
May 10, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2007

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number 1-15603

NATCO Group Inc.

(Exact name of registrant as specified in its charter)

Delaware	**22-2906892**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

2950 North Loop West

7th Floor

Houston, Texas	**77092**
(Address of principal executive offices)	**(Zip Code)**

713-683-9292

(Registrant s telephone number, including area code)

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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨

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

As of April 30, 2007, the issuer had outstanding 17,398,689 shares of common stock, par value $0.01 per share.

Table of Contents

NATCO GROUP INC.

FORM 10-Q

For the Quarter Ended March 31, 2007

TABLE OF CONTENTS

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

NATCO GROUP INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and par value data)

	March 31, 2007 (unaudited)	December 31, 2006 As Adjusted (Note 3)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 49,658	$ 35,238
Trade accounts receivable, less allowance for doubtful accounts of $1,283 and $1,183 as of March 31, 2007 and December 31, 2006, respectively	118,862	116,165
Inventories, net	47,542	42,451
Deferred income tax assets, net	5,969	5,353
Prepaid expenses and other current assets	4,885	5,075
Total current assets	226,916	204,282
Property, plant and equipment, net	35,096	34,603
Goodwill, net	80,965	80,893
Deferred income tax assets, net	834	1,203
Other assets, net	1,279	1,392
Total assets	$ 345,090	$ 322,373
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY		
Current liabilities:		
Trade accounts payable and other	$ 45,663	$ 40,545
Accrued expenses	48,470	49,281
Customer advanced billings and payments	41,196	35,387
Income taxes payable	4,337	1,236
Total current liabilities	139,666	126,449
Long-term deferred tax liabilities	680	611
Postretirement benefits and other long-term liabilities	7,370	7,809
Total liabilities	147,716	134,869
Commitments and contingencies		
Minority interest	398	337
Series B redeemable convertible preferred stock (aggregate redemption value of $15,000), $.01 par value; 15,000 shares authorized, issued and outstanding (net of issuance costs)	14,222	14,222
Stockholders equity:		
Preferred stock, $.01 par value; 5,000,000 shares authorized (of which 500,000 are designated as Series A and 15,000 are designated as Series B); no shares issued and outstanding (except Series B shares above)		
Series A preferred stock, $.01 par value; 500,000 shares authorized; no shares issued and outstanding		

Common stock, $.01 par value; 50,000,000 shares authorized; 17,389,155 and 17,357,557 shares issued and outstanding as of March 31, 2007 and December 31, 2006, respectively	174	174
Additional paid-in-capital	114,552	113,340
Retained earnings	65,084	56,681
Accumulated other comprehensive income	2,944	2,750
Total stockholders equity	182,754	172,945
Total liabilities, redeemable convertible preferred stock and stockholders equity	$ 345,090	$ 322,373

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

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

UNAUDITED STATEMENTS OF OPERATIONS

(in thousands, except earnings per share data)

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006 As Adjusted (Note 3)
Revenue:		
Products	$ 102,035	$ 97,006
Services	25,394	20,761
Total revenue	$ 127,429	$ 117,767
Cost of goods sold and services:		
Products	$ 77,819	$ 75,935
Services	13,516	10,466
Total cost of goods sold and services	$ 91,335	$ 86,401
Gross profit	$ 36,094	$ 31,366
Selling, general and administrative expense	20,378	16,994
Depreciation and amortization expense	1,390	1,445
Net interest (income) expense	(197)	640
Minority interest	61	
Loss on unconsolidated investment	85	
Other, net	555	(347)
Income before income taxes	$ 13,822	$ 12,634
Income tax provision	5,045	4,802
Net income	$ 8,777	$ 7,832
Preferred stock dividends	375	375
Net income available to common stockholders	$ 8,402	$ 7,457
Earnings per share:		
Basic	$ 0.49	$ 0.45
Diluted	$ 0.45	$ 0.41
Weighted average number of shares of common stock:		
Basic	17,199	16,663
Diluted	19,495	19,046

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

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006 (As Adjusted, Note 3)
Cash flows from operating activities:		
Net income	$ 8,777	$ 7,832
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Deferred income tax expense (benefit)	(144)	120
Depreciation and amortization expense	1,390	1,445
Non-cash interest expense	26	86
Share-based compensation expense	850	613
Tax benefit of share-based compensation	18	73
Minority interest	61	
Loss on unconsolidated investment	85	
Net periodic cost on postretirement benefit liability	(80)	50
Net payments on postretirement benefit liability	(211)	(234)
Loss on sale of property, plant and equipment	4	45
Change in assets and liabilities:		
Increase in trade accounts receivable	(2,414)	(3,661)
Increase in inventories	(5,039)	(6,986)
Decrease in prepaid expense and other current assets	380	197
Increase in long-term assets	(36)	(625)
Decrease in long-term liabilities	(155)	
Increase (decrease) in accounts payable	5,534	(7,199)
Increase (decrease) in accrued expenses	(1,356)	1,666
Increase in income tax payable	2,835	2,812
Increase in customer advanced billings and payments	5,777	11,149
Net cash provided by operating activities	16,302	7,383
Cash flows from investing activities:		
Capital expenditures for property, plant and equipment	(1,745)	(962)
Investments in joint venture		(375)
Investment in unconsolidated affiliate, net of cash acquired	(8)	
Proceeds from sales of property, plant and equipment	25	9
Net cash used in investing activities	(1,728)	(1,328)
Cash flows from financing activities:		
Repayments of long-term debt		(3,000)
Proceeds from the stock issuances related to stock options, net	162	534
Excess tax benefit of share-based compensation	183	327
Change in bank overdrafts	(507)	454
Net cash used in financing activities	(162)	(1,685)
Effect of exchange rate changes on cash and cash equivalents	8	34

Increase in cash and cash equivalents	14,420	4,404
Cash and cash equivalents at beginning of period	35,238	9,198
Cash and cash equivalents at end of period	$ 49,658	$ 13,602
Cash paid for:		
Interest	$ 81	$ 517
Income taxes	$ 2,138	$ 1,413

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

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(1) Organization and Basis of Presentation

NATCO Group Inc. is one of the leading providers of wellhead process equipment, systems and services used in the production of oil and gas. The Company s production equipment is used onshore and offshore in most major oil and gas producing regions of the world.

The accompanying consolidated interim financial statements and related disclosures are unaudited and prepared by NATCO Group Inc. pursuant to accounting principles generally accepted in the United States of America (US GAAP) and the rules and regulations of the United States Securities and Exchange Commission (SEC). As permitted by these regulations, certain information and footnote disclosures that would typically be required in financial statements prepared in accordance with US GAAP have been condensed or omitted. However, the Company s management believes that these statements reflect all the normal recurring and non-recurring adjustments necessary for a fair presentation, in all material respects, of the results of operations for the periods presented. These consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K filing for the year ended December 31, 2006.

The preparation of financial statements requires the Company s management to make estimates and assumptions that affect the amounts reported in the unaudited consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Certain comparative prior period amounts included in one of our segments revenue in the consolidated interim statements of operations have been reclassified to conform to the current period presentation. These reclassifications had no effect on previously reported interim statements of operations except as discussed in Note 3, Change in Accounting Principle.

References to NATCO and the Company are used throughout this document and relate collectively to NATCO Group Inc. and its consolidated subsidiaries.

(2) Summary of Significant Accounting Policies

Our significant accounting policies are described in Note 2 to our Annual Report on Form 10-K for the year ended December 31, 2006. The following changes were made to our significant accounting policies during the three months ended March 31, 2007:

- We adopted accounting policies related to uncertain tax position according to Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. See Note 9, Income Taxes.

- We adopted accounting policies related to the planned major maintenance activities according to FASB Staff Position (FSP) No. AUG AIR-1, Accounting for Planned Major Maintenance Activities. See Note 3, Change in Accounting Principle.

(3) Change in Accounting Principle

As of January 1, 2007, the Company changed its method of accounting for planned major maintenance activities from the accrue-in-advance method to the direct expense method, as required by FSP No. AUG AIR-1, Accounting for Planned Major Maintenance Activities. Previously, the Company accrued for the cost of upcoming periodic replacements or maintenance of membranes used in gas processing facilities owned by us in advance of performing the related replacements or maintenance, based on historical membrane replacements

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and/or maintenance. Costs expected to be paid in the future were classified as a current liability. Under the direct expense method, costs actually incurred are expensed in the same period.

The Company recorded this change in accounting principle in accordance with FSP No. AUG AIR-1 which requires retrospective application of the new accounting principle to all practicable prior accounting periods as if the principle had always been used. The accounting principle was retrospectively applied to the period of January 1, 2002 and to each period thereafter. Effective January 1, 2007, we began recording the actual cost related to the replacements and/or maintenance of membranes as incurred. The cumulative effect of the retrospective application of this accounting principle as of January 1, 2006 was a $464,000 decrease in total liabilities and a $296,000 increase in retained earnings, net of the $168,000 related tax expense.

The following tables present the effect of the retrospective application of this change in accounting principle on the Company s Balance Sheets, Statements of Operations and Statements of Cash Flows for the respective periods:

NATCO GROUP INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

	As of December 31, 2006		
	As Previously Reported	Effect of Change in Accounting Principle (in thousands)	As Adjusted
ASSETS			
Current assets	$ 204,450	$ (168)	$ 204,282
Long term assets	118,091		118,091
Total assets	$ 322,541	$ (168)	$ 322,373
LIABILITIES AND STOCKHOLDERS EQUITY			
Current liabilities	$ 126,913	$ (464)	$ 126,449
Long-term liabilities	8,420		8,420
Total liabilities	$ 135,333	$ (464)	$ 134,869
Minority interest	$ 337	$	$ 337
Series B redeemable convertible preferred stock	14,222		14,222
Total stockholders equity	172,649	296	172,945
Total liabilities and stockholders equity	$ 322,541	$ (168)	$ 322,373

7

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NATCO GROUP INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended March 31, 2006		
	As Previously Reported	Effect of Change in Accounting Principle	As Adjusted
	(in thousands, except earnings per share data)		
Total revenue	$ 117,767	$	$ 117,767
Total cost of goods sold and services	86,359	42	86,401
Gross profit	$ 31,408	$ (42)	$ 31,366
Income before income taxes	$ 12,676	$ (42)	$ 12,634
Income tax provision	4,817	(15)	4,802
Net income	$ 7,859	$ (27)	$ 7,832
Preferred stock dividends	375		375
Net income available to common stockholders	$ 7,484	$ (27)	$ 7,457
Earnings per share:			
Basic	$ 0.45	$	$ 0.45
Diluted	$ 0.41	$	$ 0.41

NATCO GROUP INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Three Months Ended March 31, 2006		
	As Previously Reported	Effect of Change in Accounting Principle	As Adjusted
		(in thousands)	
Cash flows from operating activities:			
Net income	$ 7,859	$ (27)	$ 7,832
Total adjustments to net income	(476)	27	(449)
Net cash provided by operating activities	7,383		7,383

Cash flows from investing activities:			
Net cash used in investing activities	(1,328)		(1,328)
Cash flow from financing activities:			
Net cash used in financing activities	(1,685)		(1,685)
Effect of exchange rate changes on cash and cash equivalents	34		34
Net increase in cash and cash equivalents	4,404		4,404
Cash and cash equivalents at beginning of period	9,198		9,198
Cash and cash equivalents at end of period	$ 13,602	$	$ 13,602

8

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(4) Inventories

Inventories consisted of the following amounts:

	March 31, 2007 (unaudited)	December 31, 2006
	(in thousands)	
Finished goods	$ 13,567	$ 10,879
Work-in-process	20,583	18,064
Raw materials and supplies	21,502	20,948
Inventories at FIFO, LIFO and weighted average	55,652	49,891
Inventory reserves	(8,110)	(7,440)
Net inventories	$ 47,542	$ 42,451

The Company s net inventories as of March 31, 2007 and December 31, 2006 by valuation method were:

	March 31, 2007 (unaudited)	December 31, 2006
	(in thousands)	
FIFO	$ 5,968	$ 5,874
Weighted average cost	640	725
LIFO	40,934	35,852
Net inventories	$ 47,542	$ 42,451

There were no reductions in LIFO layers as of March 31, 2007 and December 31, 2006.

(5) Costs and Estimated Earnings on Uncompleted Contracts Using Percentage-of-Completion Method

Costs and estimated earnings on uncompleted contracts using percentage-of-completion method were as follows:

	March 31, 2007 (unaudited)	December 31, 2006
	(in thousands)	
Cost incurred on uncompleted contracts percentage-of-completion	$ 134,571	$ 122,962

Estimated earnings	42,464	38,050
	177,035	161,012
Less billings to date	(178,104)	156,711
	$ (1,069)	$ 4,301
Included in the accompanying balance sheet under the captions:		
Trade Accounts receivable percentage-of-completion	$ 39,151	$ 35,407
Customer advanced billings and payments	(40,220)	(31,106)
	$ (1,069)	$ 4,301

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(6) Goodwill and Intangible Assets

In accordance with Statements of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, the Company evaluates intangible assets with indefinite lives, including goodwill, on an impairment basis, while intangible assets with a defined term, such as patents, are amortized over the useful life of the asset. The Company tests each business segment for impairment of goodwill annually at year end, or more frequently if there are indications of goodwill impairment. Goodwill was not impaired as of December 31, 2006. During the three months ended March 31, 2007, no additional testing was performed as management noted no indications of goodwill impairment.

Net goodwill of $80.9 million at December 31, 2006, was comprised of $47.4 million, $29.1 million and $4.4 million for the Oil & Water Technologies, Gas Technologies and Automation & Controls reporting units, respectively. Net goodwill of $81.0 million at March 31, 2007, was comprised of $47.5 million, $29.1 million and $4.4 million for the Oil & Water Technologies, Gas Technologies and Automation & Controls reporting units, respectively. The increase in net goodwill of $73,000 was due entirely to the foreign currency effect related to our Canadian subsidiary.

Intangible assets subject to amortization as of March 31, 2007 and December 31, 2006 were:

	As of March 31, 2007		As of December 31, 2006	
	Gross Carrying Amount (unaudited)	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
	(in thousands)			
Deferred financing fees	$ 861	$ 412	$ 858	$ 386
Patents	585	152	585	135
Other	732	258	693	223
Total	$ 2,178	$ 822	$ 2,136	$ 744

Amortization and interest expense of $78,000 and $104,000 related to deferred financing fees, patents and other were recognized for the three months ended March 31, 2007 and 2006, respectively. For segment reporting purposes, these intangible assets and the related accumulated amortization expense were allocated to each segment.

(7) Warranty Costs

Estimated future warranty obligations related to products are charged to cost of goods sold in the period in which the related revenue is recognized. A reconciliation of the changes in the Company s aggregate product warranty liability included in the consolidated balance sheet liability account Accrued expenses for the three months ended March 31, 2007, is set forth below (unaudited, in thousands).

Balance at December 31, 2006	$ 3,866
Foreign currency translation	12
Payments/charges	(338)
Net accruals	572
Balance at March 31, 2007	$ 4,112

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(8) Closure, Severance and Other

On December 15, 2005, the Board of Directors approved the final phase of restructuring the Company s UK operations by consolidating two offices in England into one location. As of March 31, 2007, the total estimated remaining liability related to the office consolidation was $1.9 million.

Pursuant to an amendment to his then effective employment agreement with the Company, entered into in September 2005, Mr. Patrick M. McCarthy agreed to continue as President of the Company in exchange for certain benefits and payments which included, among other things, payment of certain severance benefits, a guaranteed bonus for 2005, acceleration of vesting of certain options, lapse in restrictions on a portion of his restricted stock awards and continuation of certain health benefits following termination. The Company recorded a charge of $1.2 million in the third quarter of 2005 related to this amendment, in addition to the previously accrued expense of $155,000 related to his 2005 bonus. On June 26, 2006, the Company and Mr. McCarthy entered into an amended and restated Employment Agreement (the Employment Agreement), which became effective July 1, 2006. Under the terms of the Employment Agreement, which was reviewed and approved by the Company s Board of Directors, Mr. McCarthy was named as the Company s President and Chief Operating Officer to serve until July 1, 2008. While the Company did not incur additional charges with respect to effectiveness of the Employment Agreement, it remains liable for the severance obligation under the former arrangement, to be paid upon Mr. McCarthy s termination. At March 31, 2007, the Company had an aggregate liability of approximately $900,000 related to this matter.

In July and December 2004, the Company recorded severance expense of $2.5 million and $1.3 million, respectively, related to the termination of two executives and certain other administrative and operating personnel in the US, UK and Canada. At March 31, 2007, the Company had an aggregate liability of approximately $600,000.

Severance expense was zero and $50,000 for the three months ended March 31, 2007 and 2006, respectively.

A roll forward of the Company s accrued closure, severance and other expense as of December 31, 2006 and March 31, 2007 follows (in thousands):

Balance at December 31, 2006	$ 3,656
Payments	(271)
Severance accrual, net	
Foreign exchange impact	15
Balance at March 31, 2007 (unaudited)	$ 3,400

The estimated payment of this liability at March 31, 2007 is $1,395,000 in 2007, $473,000 in 2008, $764,000 in 2009, $71,000 in 2010 and $191,000 in 2011. There was approximately $500,000 in the non-cash portion of these remaining liabilities.

(9) Income Taxes

NATCO s effective income tax rate for the three months ended March 31, 2007 was 36.5%, which exceeded the amount that would have resulted from applying the U.S. federal statutory tax rate due to the impact of state income taxes, foreign income tax rate differentials and permanent differences.

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return as well as provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Effective January 1, 2007, the Company adopted the provisions of FIN 48. The Company determined that there is no cumulative effect on our financial statements related to adopting FIN 48.

As of January 1, 2007, the Company provided for a liability of $824,000 for unrecognized tax benefits related to various federal income tax matters. If recognized, the entire amount of the liability would affect the effective tax rate. There were no changes to this liability during the quarter ended March 31, 2007. Any interest and penalties that may be incurred as part of this liability would be recognized as a component of interest expense. The Company s US federal tax returns are currently open to audit under the statute of limitations by the Internal Revenue Service for the years ending December 31, 2003 through 2006.

(10) Debt

In July 2006, the Company terminated its prior term loan and revolving credit facilities and entered into a new 2006 revolving credit facilities agreement with a maturity of June 30, 2011 and a total borrowing capacity of $85.0 million. The Company pays commitment fees on the undrawn portion of the facility, depending upon the ratio of Funded Debt to EBITDA, which was calculated at 0.25% at March 31, 2007. There were no borrowings outstanding under these facilities as of December 31, 2006 or March 31, 2007.

The Company had letters of credit outstanding of $14.3 million and available borrowing capacity of $70.7 million at March 31, 2007. Availability under our credit facilities is reduced by the amount of outstanding letters of credit and borrowings. The letters of credit, which support contract performance and warranties, expire at various dates through February 25, 2010. Fees related to these letters of credit were approximately 1.0% of the outstanding balance at March 31, 2007. At March 31, 2007, the Company had unsecured letters of credit and bonds totaling $478,000.

The Company s export sales credit facility, an international revolving credit agreement providing for loans of up to $10.0 million, subject to borrowing base limitations, expired March 31, 2007. As of that date there was no indebtedness or letters of credit outstanding under this facility.

(11) Postretirement Benefits

Health Care and Life Insurance Plans

The Company adopted SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), as of December 31, 2006.

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the components of net periodic cost on postretirement benefit liability under the Company s postretirement health care and life insurance benefit plans as of March 31, 2007 and 2006, respectively:

	For the Three Months Ended March 31,	
	2007	2006
	(unaudited, in thousands)	
Service cost	$	$
Interest cost	104	108
Amortization of:		
Prior service cost	(440)	(334)
Net loss from previous years	256	276
Net periodic cost on postretirement benefit liability	$ (80)	$ 50

During the quarter ended March 31, 2007, the Company made contributions of $211,000 to the Company s postretirement health care and life insurance benefit plans. We expect to contribute an aggregate of $644,000 to the plans in the year 2007.

Defined Contribution Plans

During the quarter ended March 31, 2007, the Company made contributions aggregating $1.0 million to the Company s defined contribution plans maintained in the US, Canada and the UK. This amount included certain additional discretionary matching contribution provided by the Company to eligible employees in the US and Canadian plans.

(12) Litigation

NATCO and its subsidiaries are defendants or otherwise involved in a number of other legal proceedings in the ordinary course of their business. While we insure against the risk of these proceedings to the extent deemed prudent by our management, we can offer no assurance that the type or value of this insurance will meet the liabilities that may arise from any pending or future legal proceedings related to our business activities. While we cannot predict the outcome of any legal proceedings with certainty, in the opinion of management, our ultimate liability with respect to these pending lawsuits is not expected to have a material adverse effect on our consolidated financial position, results of operations or cash flows.

(13) Share-Based Compensation

Overview

Effective January 1, 2006, the Company adopted SFAS No. 123R, Share-Based Payment.

As of March 31, 2007, the Company had 953,391 shares available for future awards under its long-term incentive compensation plans. The Company may elect to issue new shares or treasury shares, if any, under its long-term incentive compensation plans. Forfeitures were estimated at annual rates of 2.833% and 3.0%, respectively, for stock options granted and restricted stock awarded during the three months ended March 31, 2007 based on the Company s historical cancellation and forfeiture experience.

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The components of total share-based compensation expense, related to all of the Company s share-based options and awards recognized for the three months ended March 31, 2007 and 2006, were:

	For the Three Months Ended March 31, 2007	2006
	(unaudited, in thousands)	
Total share-based compensation expense	$ 850	$ 613
Less: Tax benefit of share-based compensation expense	(307)	(230)
Share-based compensation expense, net of tax, recognized in income	$ 543	$ 383

Stock Options

The Company values share-based options by applying the Black-Scholes-Merton Single Option Reduced Term valuation method which requires management to make various subjective assumptions.

The assumptions used to determine the fair value of stock option awards granted during the three months ended March 31, 2007 and 2006 were:

	For the Three Months Ended March 31, 2007	2006
	(unaudited)	
Expected term (years)	6.00	6.00
Volatility	45.00%	45.00%
Risk-free interest rate	5.25%-5.30%	4.87%
Dividend yield	0.00%	0.00%

Our stock option activities and related information are summarized below:

	Stock Options Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance at December 31, 2006	853,531	$ 9.17		
Granted	15,500	$ 34.44		
Exercised	(21,908)	$ 7.40		
Forfeited	(9,451)	$ 32.39		

Balance at March 31, 2007	837,672	$ 16.71	6.56	$ 14,587
Exercisable	490,702	$ 9.37	4.97	$ 12,144

	For the Three Months Ended March 31, 2007 (in thousands, except for weighted average grant date fair value)	2006
Weighted average grant date fair value of stock options granted	$ 17.50	$ 10.93
Total fair value of stock options vested	$ 127	$ 105
Total intrinsic value of stock options exercised	$ 543	$ 1,184
Cash proceeds from exercise of stock options	$ 162	$ 534
Tax benefit related to stock options exercised	$ 201	$ 400

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of March 31, 2007, there was $3.4 million of unrecognized compensation cost related to non vested stock options. This cost is expected to be recognized over a weighted-average period of 1.7 years.

Restricted Stock

Our restricted stock activities and related information are summarized below:

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2006	161,894	$ 21.43
Granted	9,690	$ 36.38
Vested		N/A
Forfeited		N/A
Nonvested at March 31, 2007	171,584	$ 22.27

	For the Three Months Ended March 31, 2007	2006
Weighted-average grant date fair value of restricted stock granted	$ 36.38	$ 21.80
Total fair value of restricted stock vested	N/A	N/A
Total intrinsic value of restricted stock vested	N/A	N/A

As of March 31, 2007 there was $2.1 million of total unrecognized compensation cost related to non vested restricted stock. That cost is expected to be recognized over a weighted-average period of 1.8 years.

(14) Earnings per Share

Per SFAS No. 128 Earnings per Share, the basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of shares outstanding for the period. The diluted earnings per common and potential common share is computed using net income available to common stockholders divided by the weighted average number of shares outstanding for the period, after applying the if-converted method to determine any incremental shares associated with convertible preferred stock and restricted stock outstanding. Net income available to common stockholders represents net income less preferred stock dividends accrued.

The Company computes incremental shares according to SFAS No. 123R requirements. The assumed proceeds used in the Treasury Method include the windfall tax benefit related to unrecognized compensation expense. For the purpose of weighted average shares calculation, the performance condition of some restricted stock has been taken into consideration. If anti-dilutive common shares were included for the quarters ended March 31, 2007 and 2006, the impact would have been a reduction of approximately 67,400 shares and 4,500 shares, respectively. At March 31, 2007, the Company included 1.9 million shares issuable upon conversion of the Series B Preferred Shares in the calculation of the diluted weighted average shares, as the inclusion of these shares was dilutive at the level of income in the quarters ended March 31, 2007 and 2006.

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents the computation of basic and diluted earnings per common and potential common share for the three months ended March 31, 2007 and 2006, respectively:

	For the Three Months Ended March 31, 2007			For the Three Months Ended March 31, 2006		
	Income	Weighted Average Shares Outstanding	Per-Share Amount	Income	Weighted Average Shares Outstanding	Per-Share Amount
	(unaudited; in thousands, except earnings per share amounts)					
				As Adjusted (Note 3)		
Net income	$ 8,777			$ 7,832		
Less: Convertible preferred stock dividends accrued	(375)			(375)		
Basic EPS:						
Income available to common stockholders	$ 8,402	17,199	$ 0.49	$ 7,457	16,663	$ 0.45
Effect of dilutive securities:						
Stock options		297			386	
Restricted stock		77			75	
Convertible preferred stock		1,922			1,922	
Diluted EPS:						
Plus: Convertible preferred stock dividends accrued	375			375		
Income available to common stockholders	$ 8,777	19,495	$ 0.45	$ 7,832	19,046	$ 0.41

(15) Industry Segments

NATCO s reporting segments are Oil & Water Technologies, Gas Technologies and Automation & Controls.

The Oil & Water Technologies segment includes both standard and traditional oil and gas separation and dehydration equipment sales and related services and built-to-order systems focused primarily on oil and water production and processing.

The Gas Technologies segment includes our CO_2 membrane business, the assets and operating relationship related to our gas processing facilities in West Texas and H_2S removal technologies including Shell Paques.

The Automation & Controls segment focuses on the manufacture and sale of new control panels and systems which monitor and control oil and gas production, as well as field service activities including repair, maintenance, testing and inspection services for existing systems.

NATCO s business units have separate management teams and infrastructures that offer different products and services. The business units were aggregated into three reporting segments (described above) since the long-term financial performance of these reportable segments is affected by similar economic conditions.

NATCO allocates corporate and other expenses to each of the operating segments based on headcount, total assets, revenues and bookings. Corporate assets are allocated to the segments based on the total assets of the

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

segment. The accounting policies of the segments are consistent with the policies used to prepare the Company s consolidated financial statements for the respective periods presented, as described in Note 2, Summary of Significant Accounting Policies to our Annual Report on Form 10-K for the year ended December 31, 2006 and Note 2 to the consolidated financial statements filed in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007. The Company evaluates the performance of its operating segments based on income before net interest (income) expense, depreciation and amortization expense, other, net and income tax provision.

Summarized financial information concerning the Company s reportable segments is shown in the following table:

	Oil & Water Technologies	Gas Technologies	Automation & Controls	Eliminations	Total
			(unaudited, in thousands)		
Three Months Ended March 31, 2007					
Revenues from unaffiliated customers	$ 89,049	$ 16,137	$ 22,243	$	$ 127,429
Inter-segment revenues	$ 194	$	$ 827	$ (1,021)	$
Segment profit	$ 7,005	$ 6,382	$ 2,183	$	$ 15,570
Total assets	$ 248,998	$ 60,414	$ 35,678	$	$ 345,090
Capital expenditures	$ 1,323	$ 208	$ 214	$	$ 1,745
Depreciation and amortization	$ 811	$ 447	$ 132	$	$ 1,390
Three Months Ended March 31, 2006					
As Adjusted (Note 3)					
Revenues from unaffiliated customers	$ 85,033	$ 12,702	$ 20,032	$	$ 117,767
Inter-segment revenues	$ 37	$	$ 840	$ (877)	$
Segment profit	$ 5,631	$ 6,029	$ 2,712	$	$ 14,372
Total assets	$ 213,233	$ 54,287	$ 32,107	$	$ 299,627
Capital expenditures	$ 836	$ 2	$ 124	$	$ 962
Depreciation and amortization	$ 806	$ 548	$ 91	$	$ 1,445

The following table reconciles total segment profit to net income:

	For the Three Months Ended March 31, 2007	2006
	(unaudited, in thousands)	As Adjusted (Note 3)
Total segment profit	$ 15,570	$ 14,372
Net interest (income) expense	(197)	640
Depreciation and amortization	1,390	1,445
Other, net	555	(347)
Net income before income taxes	13,822	12,634
Income tax provision	5,045	4,802
Net income	$ 8,777	$ 7,832

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table provides further information on revenues by product line within the Oil & Water Technologies segment for the three months ended March 31, 2007 and 2006.

	For the Three Months Ended March 31,	
	2007	2006
	(unaudited, in thousands)	
Traditional/standard/used equipment	$ 57,215	$ 52,822
Built-to-order	32,479	32,493
Eliminations	(451)	(245)
Total Oil & Water Technologies segment revenue	$ 89,243	$ 85,070

(16) Recent Accounting Pronouncements

In March 2006, the Emerging Issues Task Force (EITF) issued EITF No. 06-03, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). EITF No. 06-03 requires that the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer on either a gross (included in revenue and costs) or a net (excluded from revenue) basis is an accounting policy decision that should be disclosed pursuant to Accounting Principles Board (APB) Opinion No. 22, Disclosure of Accounting Policies. In addition, if any of such taxes are reported on a gross basis, a company should disclose, on an aggregate basis, the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. This issue applies to financial reports for interim and annual reporting periods beginning after December 15, 2006. The Company currently reports revenue on a net basis. The Company adopted EITF No. 06-03 on January 1, 2007. The application of EITF No. 06-03 had no effect on the Company s consolidated results of operations, financial position or cash flows.

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return as well as provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Effective January 1, 2007, the Company adopted the provisions of FIN 48. The Company determined that there was no cumulative effect on our financial statements related to adopting FIN 48.

In September 2006, the FASB issued Staff Position (FSP) No. AUG AIR-1, Accounting for Planned Major Maintenance Activities, which prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods. FSP No. AUG AIR-1 is effective for the fiscal year beginning after December 15, 2006. The Company adopted FSP No. AUG AIR-1 as of its effective date of January 1, 2007. The impact of the application of this Staff position is disclosed in Note 3 to the unaudited consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which will become effective as of January 1, 2008. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures of fair value measurements. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial positions or cash flows and will adopt it on January 1, 2008, if applicable.

Table of Contents

NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In February 2007, the FASB issued FSP No. FAS 158-1, Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88 and No. 106 and to the Related Staff Implementation Guides. This Staff Position provides (1) updated illustrations contained in Appendix B of Statement 87, Appendix B of Statement 87 and Appendix C of Statement 106 which were amended by Statement 158 and (2) updated questions and answers in all previous FASB Special Reports related to Statement 87, 88 and 106. FSP No. FAS 158-1 became effective as of the effective date of Statement 158 of December 31, 2006. There was no impact on the Company s consolidated results of operations, financial position or cash flows resulting from the adoption of FSP No. FAS 158-1.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment to FASB Statement No. 115, which permits entities the option to measure eligible items at fair value at specified election dates. SFAS No. 159 is effective as of January 1, 2008 with early adoption permitted. Under the standard, a business entity shall report unrealized gains and losses on items for which the fair value has been elected in earnings at each subsequent reporting date. The Company is currently assessing the impact, if any, of the adoption of SFAS No. 159 on its consolidated financial position and results of operations.

Table of Contents

Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Forward-Looking Statements

Management s Discussion and Analysis includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words believe, expect, plan, intend, designed to, estin project, will, could, may and similar expressions are intended to identify forward-looking statements. Forward-looking statements in this document include, but are not limited to, discussions of accounting policies and estimates, indicated trends in the level of oil and gas exploration and production and the effect of such conditions on the Company s results of operations (see Industry and Business Environment), growth plans for 2007 and beyond, future uses of and requirements for financial resources (see Liquidity and Capital Resources), impact of bookings on future revenues and anticipated backlog levels. Our expectations about our business outlook, customer spending, potential acquisitions, oil and gas prices and our business environment and that of the industry in general are only our expectations regarding these matters. Actual results may differ materially from those in the forward-looking statements contained in this report for reasons including, but not limited to: market factors such as pricing and demand for petroleum related products, the level of petroleum industry exploration and production expenditures, the effects of competition, the availability of a skilled labor force, world economic conditions, the level of drilling activity, the legislative environment in the United States and other countries, energy policies of OPEC, conflict involving the United States or in major petroleum producing or consuming regions, acts of war or terrorism, technological advances that could lower overall finding and development costs, weather patterns and the overall condition of capital markets for countries in which we operate.

Overview

Our organization has three operating segments: Oil & Water Technologies, Gas Technologies and Automation & Controls.

- The Oil & Water Technologies segment includes both standard and traditional oil and gas separation and dehydration equipment sales and related services and built-to-order systems focused primarily on oil and water production and processing.

- The Gas Technologies segment includes our CO_2 membrane business, the assets and operating relationship related to our gas processing facilities in West Texas and H_2S removal technologies including Shell Paques .

- The Automation & Controls segment focuses on the manufacture and sale of new control panels and systems which monitor and control oil and gas production, as well as field service activities including repair, maintenance, testing and inspection services for existing systems.

Critical Accounting Policies

The preparation of our consolidated financial statements requires us to make certain estimates and assumptions that affect the results reported in our consolidated financial statements and the accompanying notes. These estimates and assumptions are based on historical experience and on our future expectations that we believe to be reasonable under the circumstances. Note 2 to the consolidated financial statements filed in our Annual Report on Form 10-K for the year ended December 31, 2006 and Note 2 to the consolidated financial statements filed in our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 contain a summary of our significant accounting policies. We believe the following accounting policies are the most critical in the preparation of our consolidated financial statements:

Revenue Recognition: Percentage of Completion Method. We recognize revenues and related costs when products are shipped or services are rendered for (1) time and materials and service contracts, (2) manufactured goods produced in standard manufacturing operations and sold in the ordinary course of business through regular

Table of Contents

marketing channels and (3) certain customized manufactured goods that are smaller jobs with less customization, making them similar to such standard manufactured goods (that is, contracts valued at $250,000 or less having contract durations of four months or less). We recognize revenues using the percentage of completion method on contracts greater than $250,000 and having contract durations in excess of four months that represent customized, engineered orders of our products and qualify for such treatment in accordance with the requirements of AICPA Statement of Position 81-1, Accounting for Performance of Certain Production-Type Contracts (SOP 81-1). In addition, we use the percentage of completion method on all Automation & Controls segment equipment fabrication and sales projects that qualify for such treatment in accordance with the requirements of SOP 81-1. The Automation & Controls segment sells customized products fabricated to order pursuant to a large number of smaller contracts with durations of two to three months, with occasional large systems projects of longer duration. The segment does not produce standard units or maintain an inventory of products for sale. Due to the nature of the segment s equipment fabrication and sales operations, and the potential for wide variations in our results of operations that could occur from applying the as shipped methodology to smaller contracts for these customized, fabricated goods, this segment recognizes revenues, regardless of contract value or duration, applying the percentage of completion method. For the three months ended March 31, 2007, approximately 54.6% of total Company revenues were recorded on an as shipped or as performed basis and approximately 45.4% were recorded using the percentage of completion method.

With respect to contract revenues recorded utilizing the percentage of completion method, earned revenue is based on the percentage that costs incurred to date relate to total estimated costs of the project, after giving effect to the most recent estimates of total cost. Total estimated contract cost is a critical accounting estimate because it can materially affect revenue and net income and it requires us to make judgments about matters that are uncertain. Total costs expected to be incurred, and therefore recognition of revenue, could be affected by various internal or external factors including, but not limited to: changes in project scope (change orders), changes in productivity, scheduling, the cost and availability of labor, the cost and availability of raw materials, the weather, client delays in providing approvals at benchmark stages of the project and the timing of deliveries from third-party providers of key components. The cumulative impact of revisions in total cost estimates during the progress of work is reflected in the period in which these changes become known. Earned revenue reflects the original contract price adjusted for agreed claims and change order revenues, if applicable. Losses expected to be incurred on the jobs in progress, after consideration of estimated probable minimum recoveries from claims and change orders, are charged to income as soon as such losses are known. Claims for additional contract revenue are recognized if it is probable the claim will result in additional revenue and the amount can be reliably estimated. We generally recognize revenue and earnings to which the percentage of completion method applies over a period of two to six quarters. In the event a project is terminated by our customer before completion, our customer is liable for costs incurred under the contract. We believe our operating results should be evaluated over a term of one to three years to evaluate our performance under long-term contracts, after all change orders, scope changes and cost recoveries have been negotiated and realized.

Estimates are subjective in nature and it is possible that we could have used different estimates of total contract costs in our calculation of revenue recognized using the percentage of completion method. For the three months ended March 31, 2007, the Company had $54.3 million in revenues attributable to open percentage completion projects having an aggregate gross profit percentage of 23%. If we had used a different estimate of total contract costs for each contract in progress at March 31, 2007, a 1% increase or decrease in the estimated margin earned on each contract would have increased or decreased each of total revenue and pre-tax income for the three months ended March 31, 2007, by approximately $700,000. At March 31, 2007, the Company had two contracts in an aggregate loss position, with an estimated total loss of $1.8 million.

Goodwill evaluation. As required by SFAS No. 142, Goodwill and Other Intangible Assets, we evaluate goodwill annually for impairment by comparing the fair value of operating assets to the carrying value of those assets, including any related goodwill. As required by SFAS No. 142, we identified separate reporting units for purposes of this evaluation. We used our segments as the reporting units, and tested the segments as of December 31, 2006. In determining carrying value, we segregated assets and liabilities that, to the extent

Table of Contents

possible, are clearly identifiable by specific reporting unit. Certain corporate and other assets and liabilities, that are not clearly identifiable by specific reporting unit, are allocated as permitted by the standard. Fair value is determined by discounting projected future cash flows using our weighted average cost of capital, as calculated. In determining projected future cash flows for each segment, we make assumptions regarding the following key indicators: future market and sales growth rates (domestic and international), cost inflation, margin expectations, working capital, capital expenditure levels and tax levels. The fair value is then compared to the carrying value of the reporting unit to determine whether or not impairment has occurred at the reporting unit level. In the event an impairment is indicated, an additional test is performed whereby an implied fair value of goodwill is determined through an allocation of the fair value to the reporting unit s assets and liabilities, whether recognized or unrecognized, in a manner similar to a purchase price allocation, in accordance with SFAS No. 141, Business Combinations. Any residual fair value after this purchase price allocation would be assumed to relate to goodwill. If the carrying value of the goodwill exceeded the residual fair value, we would record an impairment charge for that amount.

In accordance with SFAS No. 142, the Company tested each business segment for impairment of goodwill at December 31, 2006, and, based upon the results of this testing, management determined that goodwill was not impaired. The Company will test each business segment for goodwill impairment annually, as required by the pronouncement, or more frequently if there are indications of goodwill impairment. No additional testing was performed during the quarter ended March 31, 2007, as management noted no indications of goodwill impairment.

Net goodwill of $80.9 million at December 31, 2006, was comprised of $47.4 million, $29.1 million and $4.4 million for the Oil & Water Technologies, Gas Technologies and Automation & Controls reporting units, respectively. Net goodwill of $81.0 million at March 31, 2007, was comprised of $47.5 million, $29.1 million and $4.4 million for the Oil & Water Technologies, Gas Technologies and Automation & Controls reporting units, respectively.

Deferred Income Tax Assets: Valuation Allowance. Based upon the level of historical taxable income and projected future taxable income over the periods to which our deferred tax assets are deductible in the applicable tax jurisdictions, we believe it is more likely than not we will realize the benefits of our deferred tax assets, net of the existing valuation allowance at March 31, 2007. However, the amount of the deferred tax asset considered realizable, and thus the amount of these valuation allowances, could change it future taxable income differs from our projections in the applicable tax jurisdictions. In certain foreign tax jurisdictions, we are not able to rely on projections of future taxable income to determine the realizability of our deductible differences and carryforwards. At March 31, 2007, a valuation allowance of $113,000 is recorded to offset deferred tax assets in these foreign jurisdictions.

Recent Accounting Pronouncements

In March 2006, the Emerging Issues Task Force (EITF) issued EITF No. 06-03, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). EITF No. 06-03 requires that the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer on either a gross (included in revenue and costs) or a net (excluded from revenue) basis is an accounting policy decision that should be disclosed pursuant to Accounting Principles Board (APB) Opinion No. 22, Disclosure of Accounting Policies. In addition, if any of such taxes are reported on a gross basis, a company should disclose, on an aggregate basis, the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. This issue applies to financial reports for interim and annual reporting periods beginning after December 15, 2006. The Company currently reports revenue on a net basis. The Company adopted EITF No. 06-03 on January 1, 2007. The application of EITF No. 06-03 had no effect on the Company s consolidated results of operations, financial position or cash flows.

Table of Contents

In June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return as well as provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Effective January 1, 2007, the Company adopted the provisions of FIN 48. The Company determined that there was no cumulative effect on our financial statements related to adopting FIN 48.

In September 2006, the FASB issued Staff Position (FSP) No. AUG AIR-1, Accounting for Planned Major Maintenance Activities, which prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods. FSP No. AUG AIR-1 is effective for the fiscal year beginning after December 15, 2006. The Company adopted FSP No. AUG AIR-1 as of its effective date of January 1, 2007. The impact of the application of this Staff position is disclosed in Note 3 to the unaudited consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which will become effective as of January 1, 2008. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures of fair value measurements. The Company is in the process of evaluating the impact, if any, of this standard on its consolidated results of operations, financial positions or cash flows and will adopt it on January 1, 2008, if applicable.

In February 2007, the FASB issued FSP No. FAS 158-1, Conforming Amendments to the Illustrations in FASB Statements No. 87, No. 88 and No. 106 and to the Related Staff Implementation Guides. This Staff Position provides (1) updated illustrations contained in Appendix B of Statement 87, Appendix B of Statement 87 and Appendix C of Statement 106 which were amended by Statement 158 and (2) updated questions and answers in all previous FASB Special Reports related to Statement 87, 88 and 106. FSP No. FAS 158-1 became effective as of the effective date of Statement 158 of December 31, 2006. There was no impact on the Company s consolidated results of operations, financial position or cash flows resulting from the adoption of FSP No. FAS 158-1.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment to FASB Statement No. 115, which permits entities the option to measure eligible items at fair value at specified election dates. SFAS No. 159 is effective as of January 1, 2008 with early adoption permitted. Under the standard, a business entity shall report unrealized gains and losses on items for which the fair value has been elected in earnings at each subsequent reporting date. The Company is currently assessing the impact, if any, of the adoption of SFAS No. 159 on its consolidated financial position and results of operations.

Industry and Business Environment

Our revenue and results of operations are closely tied to demand for oil and gas products and spending by oil and gas companies for exploration and development of oil and gas reserves. These companies generally invest more in exploration and development efforts during periods of favorable oil and gas commodity prices, and invest less during periods of unfavorable oil and gas prices. As supply and demand change, commodity prices fluctuate, producing cyclical trends in the industry. During periods of lower demand, revenue for service providers such as NATCO generally decline, as existing projects are completed, new projects are postponed and pricing decreases due to competitive pressures. During periods of recovery, revenue for process equipment providers can lag behind the industry due to the timing of new project awards.

Changes in commodity prices have impacted our business over the past several years. The following table summarizes the average price of domestic crude oil and Brent crude oil per barrel, the average wellhead price of

Table of Contents

natural gas per thousand cubic feet (Mcf), as published by the U.S. Department of Energy; the number of rotary drilling rigs in operation, as published by Baker Hughes Incorporated, for the three months ended March 31, 2007 and 2006 and for the years ended December 31, 2006 and 2005:

	Three Months Ended March 31,		Twelve Months Ended December 31,	
	2007	2006	2006	2005
Average price of crude oil per barrel in the U.S.	$ 58.08	$ 63.32	$ 66.06	$ 56.54
Average price of Brent crude oil per barrel	$ 57.76	$ 61.80	$ 65.19	$ 54.47
Average wellhead price of natural gas per Mcf in the U.S.	$ 6.39	$ 7.49	$ 6.41	$ 7.52
Average U.S. rig count	1,733	1,519	1,648	1,380
Average international rig count (excludes North America)[1]	982	896	925	850

(1) The Iran and Sudan rig counts were discontinued from the Baker Hughes publication beginning January 2006. For comparative purposes, the 2005 rig count numbers presented above exclude Iran and Sudan.

Historically, we have viewed operating rig counts as a benchmark of spending in the US oil and gas industry for exploration and development efforts. Our standard and traditional equipment sales, parts and services business generally relates to changes in rig activity. From a longer-term perspective, the US Department of Energy projects that worldwide petroleum and natural gas consumption is projected to increase at an average annual growth rate of 1.4% from 2003 through 2030, with higher consumption rates expected in the emerging economies, particularly in Asia (including China and India), where 43% of the total increase in world oil use is projected. As worldwide demand grows, producers in the oil and gas industry will increasingly rely on non-traditional sources of energy supply and expansion into new markets. As a result, additional and more complex equipment may be required from equipment and service suppliers to produce oil and gas from these fields, especially since many new oil and gas fields produce lower quality or contaminated hydrocarbon streams, requiring more complex production equipment. In general, these trends should increase the demand for our products and services.

Results of Operations

The following discussion of our historical results of operations and financial condition should be read in conjunction with our consolidated financial statements and related notes.

Three Months Ended March 31, 2007 Compared to Three Months Ended March 31, 2006

Consolidated Revenue and Gross Profit

	Three Months Ended March 31,			Percentage
	2007	2006 As Adjusted (Note 3)	Change	Change
	(unaudited) (in thousands, except percentage change)			
Revenue[1]	$ 127,429	$ 117,767	$ 9,662	8%
Cost of goods sold and services[1]	91,335	86,401	4,934	5%
Gross profit	$ 36,094	$ 31,366	$ 4,728	15%
Gross profit percentage	28%	27%	1%	4%

(1) The table above includes inter-segment elimination amounts for both revenues and cost of goods sold and services of $1.0 million and $877,000 for the three months ended March 31, 2007 and 2006, respectively.

Table of Contents

Oil & Water Technologies Segment

	Three Months Ended March 31, 2007	2006	Change	Percentage Change
	(unaudited)			
	(in thousands, except percentage change)			
Revenue	$ 89,243			