NORTECH SYSTEMS INC
Form 10-Q
August 04, 2006

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 June 30, 2006

OR

o 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

State of Incorporation: **Minnesota**

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

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

Telephone number: **(952) 345-2277**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No x

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 o

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.

Large Accelerated Filer o Accelerated Filer o Non-accelerated Filer x

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

Number of shares of $.01 par value common stock outstanding at August 1, 2006 - 2,648,729

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PART 1

ITEM 1. FINANCIAL STATEMENTS

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2006 AND DECEMBER 31, 2005

	JUNE 30 2006 (Unaudited)	DECEMBER 31 2005
ASSETS		
Current Assets		
Cash and Cash Equivalents	$ 696,113	$ 840,123
Accounts Receivable, Less Allowance for Uncollectible		
Accounts of $502,000 and $297,000, respectively	14,125,648	14,447,612
Inventories:		
Raw Materials	11,284,582	10,616,894
Work In Process	4,644,964	4,423,892
Finished Goods	2,641,561	2,027,118
Reserves	(1,416,850)	(1,218,434)
Total Inventories	17,154,257	15,849,470
Prepaid Expenses	426,201	466,083
Deferred Income Tax Assets	1,092,000	912,000
Total Current Assets	33,494,219	32,515,288
Property and Equipment		
Land	300,000	151,800
Building and Leasehold Improvements	5,857,619	4,819,919
Manufacturing Equipment	8,904,069	7,662,699
Office and Other Equipment	3,378,725	3,413,968
Construction in Progress	84,520	502,374
Total Property and Equipment	18,524,933	16,550,760
Accumulated Depreciation	(10,100,815)	(9,868,536)
Net Property and Equipment	8,424,118	6,682,224
Other Assets		
Finite Life Intangibles	91,716	209,307
Goodwill	75,006	75,006
Deferred Income Tax Assets	263,000	179,000
Restricted Cash	427,500	
Deposits	7,726	7,726
Total Other Assets	864,948	471,039
Total Assets	$ 42,783,285	$ 39,668,551

See Accompanying Condensed Notes to Consolidated Financial Statements

NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS
JUNE 30, 2006 AND DECEMBER 31, 2005

	JUNE 30 2006 (Unaudited)	DECEMBER 31 2005
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Bank Note Payable	$ 6,103,984	$ 4,228,234
Current Maturities of Notes Payable	1,741,179	1,207,305
Current Maturities of Bonds Payable	130,000	-
Checks Written in Excess of Bank Balance		1,200,000
Accounts Payable	9,769,395	9,902,998
Accrued Payroll and Commissions	3,096,978	2,849,472
Accrued Health and Dental Claims	400,000	271,104
Income Taxes Payable	112,808	317,487
Other Accrued Liabilities	229,272	324,360
Total Current Liabilities	21,583,616	20,300,960
Long-Term Liabilities		
Notes Payable (Net of Current Maturities)	2,609,258	2,714,227
Bonds Payable (Net of Current Maturities)	1,310,000	
Total Long-Term Liabilities	3,919,258	2,714,227
Total Liabilities	25,502,874	23,015,187
Shareholders Equity		
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: 2,648,729 and 2,618,197 Shares Issued and Outstanding at June 30, 2006 and December 31, 2005, respectively	26,487	26,182
Additional Paid-In Capital	14,380,732	14,306,602
Accumulated Other Comprehensive Loss	(41,033)	(21,032)
Retained Earnings	2,664,225	2,091,612
Total Shareholders Equity	17,280,411	16,653,364
Total Liabilities and Shareholders Equity	$ 42,783,285	$ 39,668,551

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
JUNE 30, 2006 AND 2005
(UNAUDITED)

	THREE MONTHS ENDED JUNE 30 2006	2005
Net Sales	$ 26,173,559	$ 20,562,916
Cost of Goods Sold	22,759,919	17,974,470
Gross Profit	3,413,640	2,588,446
Operating Expenses:		
Selling Expenses	1,127,525	936,709
General and Administrative Expenses	1,658,616	1,275,942
Total Operating Expenses	2,786,141	2,212,651
Income From Operations	627,499	375,795
Other Income (Expense)		
Interest Income	669	415
Miscellaneous Expense, net	9,283	(8,849)
Interest Expense	(190,786)	(161,400)
Total Other Expense	(180,834)	(169,834)
Income Before Income Taxes	446,665	205,961
Income Tax Expense	138,000	67,000
Net Income	$ 308,665	$ 138,961
Earnings Per Common Share:		
Basic	$ 0.12	$ 0.05
Weighted Average Number of Common Shares Outstanding Used for Basic Earnings Per Common Share	2,619,281	2,582,222
Diluted	$ 0.11	$ 0.05
Weighted Average Number of Common Shares Outstanding Plus Dilutive Common Stock Options	2,682,244	2,610,040

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
JUNE 30, 2006 AND 2005
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30 2006	2005
Net Sales	$ 52,191,178	$ 39,630,418
Cost of Goods Sold	45,618,787	34,677,439
Gross Profit	6,572,391	4,952,979
Operating Expenses:		
Selling Expenses	2,248,176	1,801,937
General and Administrative Expenses	3,095,746	2,459,914
Total Operating Expenses	5,343,922	4,261,851
Income From Operations	1,228,469	691,128
Other Income (Expense)		
Interest Income	1,002	779
Miscellaneous Expense, net	14,346	(14,522)
Interest Expense	(366,204)	(302,532)
Total Other Expense	(350,856)	(316,275)
Income Before Income Taxes	877,613	374,853
Income Tax Expense	305,000	137,000
Net Income	$ 572,613	$ 237,853
Earnings Per Common Share:		
Basic	$ 0.22	$ 0.09
Weighted Average Number of Common Shares Outstanding Used for Basic Earnings Per Common Share	2,618,742	2,582,185
Diluted	$ 0.21	$ 0.09
Weighted Average Number of Common Shares Outstanding Plus Dilutive Common Stock Options	2,683,587	2,609,879

See Accompanying Condensed Notes to Consolidated Financial Statements

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NORTECH SYSTEMS INCORPORATED AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
JUNE 30, 2006 AND 2005
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30 2006	2005
Cash Flows From Operating Activities		
Net Income	$ 572,613	$ 237,853
Adjustments to Reconcile Net Income to Net Cash		
Provided by Operating Activities:		
Depreciation	662,953	586,264
Amortization	196,964	196,980
Compensation on restricted stock and stock option grants	66,207	
Deferred Taxes	(264,000)	(203,000)
(Gain) Loss on Disposal of Assets	867	
Foreign Currency Transaction Gain	(6,210)	14,254
Changes in Current Operating Items:		
Accounts Receivable	314,227	(1,012,556)
Inventories	(1,304,787)	(974,287)
Prepaid Expenses and Other Assets	39,127	105,100
Income Taxes Payable	(204,017)	325,253
Accounts Payable	(130,674)	1,890,104
Accrued Payroll and Commissions	255,826	(14,519)
Accrued Health and Dental Claims	128,896	120,626
Other Accrued Liabilities	(95,088)	253,164
Net Cash Provided by Operating Activities	232,904	1,525,236
Cash Flows from Investing Activities:		
Proceeds from Sale of Assets	275	
Restricted Cash	(427,500)	
Purchase of Property and Equipment	(2,421,637)	(482,778)
Net Cash Used in Investing Activities	(2,848,862)	(482,778)
Cash Flows from Financing Activities:		
Net Change in Line of Credit	1,875,750	(595,823)
Proceeds from Notes Payable	1,100,926	
Proceeds from Bonds Payable	1,440,000	
Payments on Notes Payable	(672,021)	(509,419)
Payments for Bond Issue Costs	(79,373)	
Issuance of Stock	8,228	606
Checks in Excess of Bank Balance	(1,200,000)	64,000
Net Cash Provided by (Used in) Financing Activities	2,473,510	(1,040,636)
Effect of Exchange Rate Changes on Cash	(1,562)	(9,357)
Net Decrease in Cash and Cash Equivalents	(144,010)	(7,535)
Cash and Cash Equivalents - Beginning	840,123	555,783
Cash and Cash Equivalents - Ending	$ 696,113	$ 548,248
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$ 363,153	$ 161,533

Cash paid during the period for income taxes	771,000			
Supplemental schedule of noncash financing activity:				
Issuance of Common Stock on a restricted basis	$	212,040	$	

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 accounting principles generally accepted in the United States of America (GAAP) for interim financial information and in accordance with 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. These statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005. 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. Actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of reporting cash flows, we consider cash equivalents to be short-term, highly liquid interest-bearing accounts readily convertible to cash. The carrying amount approximates fair value.

Restricted Cash

At June 30, 2006, restricted cash of $427,500 is to be used for the purchase of equipment at the Blue Earth, Minnesota facility as required by the Industrial Revenue Bond agreement into which we entered on June 28, 2006 to purchase the Blue Earth, Minnesota facility, see Note 5.

Stock Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123R, *Share-Based Payment: An Amendment of FASB Statement No. 123,* (SFAS 123R) which requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS 123R is effective for financial statements issued for annual reporting periods that begin after June 15, 2005. In adopting SFAS 123R, we used the modified prospective transition method, as of January 1, 2006, the first day of our fiscal year 2006.

Under the modified prospective transition method, awards that are granted, modified or settled after the date of adoption will be measured and accounted for in accordance with SFAS 123R. Compensation cost for awards granted prior to, but not vested, as of the date SFAS 123R is adopted would be based on the grant date attributes originally used to value those awards for pro forma purposes under SFAS 123. Our condensed consolidated financial statements as of and for the first six months of fiscal 2006 reflect the impact of SFAS 123R. In accordance with the modified prospective transition method, the consolidated financial statements for the prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R. Share-based compensation expense before income taxes recognized under SFAS 123R for the three months and six months ended June 30, 2006 was $56,571 and $66,207, respectively.

Prior to January 1, 2006, we applied Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations in accounting for options and the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation.* Accordingly, no stock-based compensation expense for stock options was recognized in our consolidated statements of income prior to 2006, as the exercise price was equal to the market price of our stock on the date of grant.

On November 15, 2005, our Board of Directors accelerated the vesting of the then outstanding and unvested stock options. Had these vesting periods not been accelerated, under SFAS 123R we would have recognized approximately $370,000 in cumulative expense spread over five years beginning in fiscal 2006.

Had compensation cost for the our stock option plan been determined pursuant to SFAS 123 in 2005, net income and earnings per common share on a proforma basis would have been as follows:

	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2005
Net income, as reported	$ 138,961	$ 237,853
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(34,843)	(65,613)
Pro forma net income	$ 104,118	$ 172,240
Earnings per common share:		
Basic as reported	$ 0.05	$ 0.09
Basic pro forma	$ 0.04	$ 0.07
Diluted as reported	$ 0.05	$ 0.09
Diluted pro forma	$ 0.04	$ 0.07

SFAS 123R requires companies to estimate the fair value of share-based awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense in the condensed consolidated statement of operations over the requisite service periods. Share-based compensation expense for share-based awards granted prior to, but not yet vested as of December 31, 2005, is based on the grant date fair value estimated in accordance with the provisions of SFAS 123. For options granted subsequent to December 31, 2005, compensation expense is based on the grant date fair value estimated in accordance with SFAS 123R. Because share-based compensation expense is based on awards that are ultimately expected to vest, share-based compensation expense will be reduced to account for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the pro forma information required under SFAS 123 for periods prior to fiscal 2006, we accounted for forfeitures as they occurred.

We have two types of stock-based compensation awards consisting of restricted stock and stock options. Following is a summary of the key terms and methods of valuation for our stock-based compensation awards.

Restricted Stock

On March 7, 2006, 28,500 shares of restricted common stock were granted to our management and directors. This benefit was valued at the market price of the stock on the date of grant. These awards vest over a three-year term and are expensed ratably over the same period. The arrangements do contain an acceleration condition whereby if we attain certain financial measurements, the awards vest in their entirety on December 31, 2006. Total compensation expense related to restricted stock included in the statement of income for the three months and six months ended June 30, 2006 was $22,075 and $25,754, respectively. The following is the status of our restricted shares as of June 30, 2006, including changes during the six-month period ended June 30, 2006:

		Restricted Shares	Weighted-Average Grant Date Fair Value
Outstanding	January 1, 2006		$
Granted		28,500	7.44
Outstanding	June 30, 2006	28,500	$ 7.44
Exercisable on June 30, 2006			

As of June 30, 2006, there was approximately $186,000 of unrecognized compensation expense related to unvested restricted stock awards, which we expect to recognize over a weighted average period of 2.50 years.

Stock Options

On March 7, 2006, 73,500 options were granted to our management and directors with the exercise price equaling the closing price of the common shares on that date. To calculate the option-based compensation under SFAS 123R, we used the Black-Scholes option-pricing model, which we had previously used for the valuation of option-based awards for our pro forma information required under SFAS 123 for periods prior to fiscal 2006. Our determination of fair value of option-based awards on the date of grant using the Black-Scholes model is affected by our stock price as well as assumptions regarding a number of subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards, risk-free interest rate, and the expected life of the options. The risk-free interest rate is based on a treasury instrument whose term is consistent with the expected life of our stock options. The expected volatility, holding period, and forfeitures of options are based on historical experience.

Total compensation expense related to stock options included in our statement of income for the three months and six months ended June 30, 2006 was $34,496 and $40,453, respectively. For all grants, the amount of compensation expense to be recognized is adjusted for an estimated forfeiture rate, which is based on historical data.

Following is the status of our stock option plan as of June 30, 2006, including changes during the six-month period ended June 30, 2006:

	Options	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding January 1, 2006	287,000	$ 6.27		
Granted	73,500	$ 7.44		
Exercised	(2,000)	$ 4.00		
Forfeited	(2,000)	$ 8.00		
Outstanding June 30, 2006	356,500	$ 6.52	6.42	$ 243,520
Exercisable on June 30, 2006	283,000	$ 6.28	5.57	$ 261,160

As of June 30, 2006, there was approximately $275,000 of unrecognized compensation expense related to unvested option awards that we expect to recognize over a weighted average period of 2.50 years. SFAS 123R also requires that the tax benefit from the exercise of options be reflected in the statement of cash flows as a cash inflow from financing activities. Prior to the adoption of SFAS 123R, these tax benefits have been reflected as a cash inflow from operations.

Segment Reporting Information

Our results of operations for the three months and six months ended June 30, 2006 and 2005 represent a single segment referred to as Contract Manufacturing. Export sales represented 5% of consolidated net sales for the three-month and six-month periods ended June 30, 2006. Export sales represented 4% of consolidated net sales for the three-month and six-month periods ended June 30, 2005.

Long-lived assets by country are as follows:

	United States	Mexico	Total
June 30, 2006			
Net Property and Equipment	$ 7,814,371	$ 609,747	$ 8,424,118
Other Assets	856,222	8,726	864,948
December 31, 2005			
Net Property and Equipment	$ 5,995,465	$ 686,759	$ 6,682,224
Other Assets	271,529	199,510	471,039

Finite Life Intangible Assets

Finite life intangible assets at June 30, 2006 and December 31, 2005 are as follows:

	June 30, 2006 Estimated Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Deferred Bond Issue Costs	15	$ 79,373	$	$ 79,373
Non-Compete	4	1,526,384	1,526,384	
Other Intangibles	3	37,059	24,716	12,343
Totals		$ 1,642,816	$ 1,551,100	$ 91,716

	December 31, 2005 Estimated Lives (Years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Non-Compete	4	$ 1,526,384	$ 1,335,600	$ 190,784
Other Intangibles	3	37,059	18,536	18,523
Totals		$ 1,563,443	$ 1,354,136	$ 209,307

Amortization expense related to these assets is as follows:

Quarter ended June 30, 2006	$ 98,474
Quarter ended June 30, 2005	98,490
Six months ended June 30, 2006	196,964
Six months ended June 30, 2005	196,980

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

Remainder of 2006	$ 9,000
2007	11,000
2008	5,000
2009	5,000
2010	5,000
Thereafter	57,000

NOTE 2. PRINCIPLES OF CONSOLIDATION

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

NOTE 3. ACCOUNTING PRINCIPLES

In preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States, we must make decisions, which impact the reported amounts and related disclosures. Such decisions include the selection of the appropriate principles to be applied and the assumptions on which to base accounting estimates. In reaching such decisions, we apply judgment based on our understanding and analysis of the relevant circumstances.

The accounting principles followed in the preparation of the condensed consolidated financial information contained on Form 10-Q are the same as those described in our Annual Report on Form 10-K for the year ended December 31, 2005, except as previously noted herein. Refer to our Annual Report on Form 10-K for detailed information on accounting policies.

NOTE 4. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and trade accounts receivable. With regard to cash, we maintain our excess cash balances in checking accounts at three financial institutions. We do not require collateral on our receivables. Historically, we have not suffered significant losses with respect to trade accounts receivable.

Two customers accounted for 10% or more of our net sales for the three-month and six-month periods ended June 30, 2006 and 2005. For the three-month periods ended June 30, 2006 and 2005, G.E. Medical and Transportation Divisions accounted for 14% of net sales. For the six-month periods ended June 30, 2006 and 2005, G.E. Medical and Transportation Divisions accounted for 14% and 13% of net sales, respectively. Accounts receivable from G.E. Medical and Transportation Divisions at June 30, 2006 and 2005, represented 13% and 19% of total accounts receivable, respectively. For the three-month periods ended June 30, 2006 and 2005, Northrop Grumman Corp. accounted for 15% and 11% of net sales, respectively. For the six-month periods ended June 30, 2006 and 2005, Northrop Grumman Corp. accounted for 12% and 10% of net sales, respectively. Accounts receivable from Northrop Grumman Corp. at June 30, 2006 and 2005, represented 16% and 14% of total accounts receivable, respectively.

NOTE 5. LONG TERM DEBT

On June 28, 2006, we received $1.4 million in exchange for an industrial revenue bond with Wells Fargo Bank, N.A. (WFB), where the City of Blue Earth, Minnesota is issuer of the bond. The bond, which matures on June 1, 2021, bears a variable interest rate, which we have exchanged with WFB for a 5-year fixed rate of 4.07%, converting back to a variable rate in 2012. The bond is payable in annual installments per the agreement with WFB. Our first bond principal payment on June 1, 2007 will be $130,000. The proceeds of the bond were used to purchase the facility in Blue Earth, Minnesota.

On April 28, 2006, we entered into a 6th amendment to our credit agreement with WFB, increasing our line of credit arrangement from $8 million to $10 million and extending the maturity dates of the line of credit to April 30, 2008 and our real estate term note to July 30, 2011. The line of credit and other installment debt 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 ratios, and limit the amount of annual capital expenditures. On June 30, 2006, we had an outstanding balance of $6.1 million under the line of credit and unused availability of $3.7 million supported by the borrowing base level.

We received $1.1 million on April 5, 2006 in exchange for the promissory note, payable to WFB bearing an interest rate of 7.3%, payable over 36 monthly installments to March 15, 2009, with collateral comprised of equipment purchases.

NOTE 6. NET INCOME PER COMMON SHARE

The following is a reconciliation of the numerators and the denominators of the basic and diluted per common share computations.