NATCO GROUP INC
Form 10-K
March 17, 2008
Table of Contents

Index to Financial Statements

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

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.)
11210 Equity Drive, Suite 100, Houston, Texas	77041
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (713) 849-7500

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.01 par value per share, together with associated Series A Junior Participant Preferred Stock purchase rights	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ 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 ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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. (Check one):

Large accelerated filer	x	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 x

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, as reported by the New York Stock Exchange as of the last business day of the registrant s most recently completed second fiscal quarter:

As of June 30, 2007	$ 779,806,690

The number of shares outstanding of the registrant s common stock, $0.01 par value per share, as of March 11, 2008 was 18,722,418 shares.

Documents Incorporated by Reference (to the extent indicated in this report)

Specified portions of the 2008 Notice of Annual Meeting of Stockholders and Proxy Statement (Part III)

Table of Contents

Index to Financial Statements

NATCO Group Inc.

Annual Report on Form 10-K for the Year Ended December 31, 2007

TABLE OF CONTENTS

Table of Contents

Index to Financial Statements

PART I

Item 1. ***Business***

Our Business

NATCO Group Inc. is a Delaware corporation formed in 1988. Through our subsidiaries, we have designed, manufactured and marketed oil and gas production equipment and systems for over 80 years. We believe we are an industry leader in the development of oil and gas production equipment technology. We pioneered many of the original separation technologies for converting unprocessed hydrocarbon fluids into salable oil and gas and currently hold over 50 active US and equivalent foreign patents and numerous US and foreign trademarks. We provide equipment, systems and services used in the production of crude oil and natural gas to separate oil, gas and water within a production stream and to remove contaminants. Our products and services are used in onshore and offshore fields in most major oil and gas producing regions in the world. Separation and decontamination of a production stream is needed at almost every producing well in order to meet the specifications and environmental requirements of transporters and end users. Our products also are used in downstream refinery and processing facilities around the world to improve processing through advanced crude desalting and separation technologies.

We design and manufacture a diverse line of production equipment including, among other items: separators, which separate wellhead production streams into oil, gas and water; heaters, which prevent hydrates from forming in gas streams and reduce the viscosity of oil; dehydration and desalting units, which remove water and salt from oil and gas; gas conditioning units and membrane separation systems, which remove carbon dioxide and other contaminants from gas streams; water processing systems, which include systems for water re-injection, oily water treatment and other treatment applications; and control systems, which monitor and control production and other equipment.

From 2005 to the end of 2007, our organization was structured in three separate business segments that concentrated our proprietary technologies on specific end-use markets, allowing us to be responsive to our customers needs, as well as to new market opportunities. The segments were: Oil & Water Technologies, Gas Technologies and Automation & Controls:

The Oil & Water Technologies segment included our extensive branch distribution network located primarily in North America, including our standard and traditional oil and gas separation and dehydration equipment sales and related services and our worldwide engineered systems group, which focuses on designing and delivering built-to-order solutions mainly within the areas of oil and water production and processing systems.

The Gas Technologies segment included our carbon dioxide (CO_2) membrane business, the assets and operating arrangements related to certain CO_2 gas processing facilities in West Texas and hydrogen sulfide (H_2S) removal technologies including Shell Paques .

The Automation & Controls segment focused on sales and fabrication of 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, worldwide.

On January 1, 2008, we announced certain changes to our organization, designed to enhance management s execution of our Company s strategic plans, capture growth opportunities in our global business and ensure a consistent project delivery in our global business. We realigned our financial segment reporting, effective January 1, 2008 by consolidating all of our global built-to-order business and related activities, formerly reported in our Gas Technologies segment and, in part, in our Oil & Water Technologies segment, into a single financial reporting segment. Activities related to the sale of standard and traditional equipment and aftermarket parts sales and services, formerly reported as part of the Oil & Water Technologies segment, will be reported as a

Table of Contents

Index to Financial Statements

standalone segment. Our Automation & Controls segment will remain unchanged. As a result of these changes, we will report our first quarter of 2008 financial results based on the following defined segments:

Integrated Engineered Solutions: consisting of sales and related activities associated with all built-to-order projects delivered to global markets including oil, water and gas technologies as well as the Company s West Texas CO_2 processing facility.

Standard & Traditional Equipment Sales and Service: consisting of sales and related activities associated with the sale of standard and traditional equipment, as well as aftermarket parts sales and services both in the US and other areas of the world.

Automation & Controls: consisting of sales and related activities associated with the sale of control panels, packaged automation systems and field services.

We operate four primary manufacturing or fabrication facilities located in the US and Canada and maintain sub-contracting relationships with fabricators in the US and elsewhere around the world. We manage an extensive branch network system, primarily in North American markets, providing sales and service support for our standard and traditional product offerings. In addition, we have engineering and project management execution centers and sales offices in the US, UK, Canada, Japan, Malaysia and other international locations. We believe that, among our competitors, we have one of the larger installed bases of production equipment in the industry. We have achieved our position in the industry by maintaining technological leadership, capitalizing on our strong brand name recognition and offering a broad range of quality products and after-market sales and services.

Recent Developments

On February 28, 2008, the Audit Committee of the Board of Directors of the Company, with the assistance of outside counsel, initiated a review of certain payments made in a foreign jurisdiction in which the Company operates, which may present issues under the Foreign Corrupt Practices Act (FCPA). We have reported this matter to the Securities and Exchange Commission (SEC) and the US Department of Justice (DOJ) and intend to keep them apprised as to the progress of the review. In this connection, on March 11, 2008, the SEC informed us that it had opened a preliminary inquiry into the matter. The Company is cooperating with this inquiry. See the final risk factor discussed under Risk Factors and Legal Proceedings.

On March 4, 2008, the Company sent a notice of redemption to the holders of its Series B Redeemable Convertible Preferred Stock (Series B Preferred Shares), calling for the redemption of all the outstanding Series B Preferred Shares effective as of the close of business on March 25, 2008 for an aggregate redemption price of $9,915,000 plus payment of the related dividend since the last dividend payment date, amounting to approximately $275,000. On March 13, the holders of the Series B Preferred Shares sent a notice of conversion to the Company, requesting that the shares be converted into an aggregate of 1,270,340 shares of common stock immediately prior to the redemption time and requesting payment of the related dividend as discussed above. The conversion of the Series B Preferred Shares prior to the redemption time is permitted under the certificate of designations pursuant to which such shares have been issued. As of March 17, 2008, the holders of the Series B Preferred Shares had not tendered their share certificates to the Company, which is a requirement for the conversion notice to be effective. If the holders of the Series B Preferred Shares do not tender their share certificates prior to the redemption time, the Company intends to redeem the shares as indicated in the redemption notice.

On January 31, 2008, the Company acquired the shares of Linco-Electromatic, Inc., a Texas corporation, which designs, manufactures, distributes and services an extensive line of equipment used to measure oil in custody transfer. The acquisition of Linco, which will provide several new product lines and services for our customers, is expected to further leverage our North American branch network and our Automation & Controls business, to offer access to new markets and to add skilled field, fabrication and marketing employees to our workforce.

Table of Contents

Index to Financial Statements

On January 1, 2008 John U. Clarke, Chief Executive Officer and Patrick M. McCarthy, President and Chief Operating Officer, entered into new, three-year employment agreements with the Company. We also made certain changes to our organization to enhance execution of the Company s strategic plans in order to capture growth in our global business including the changes to our business segments discussed above.

In December 2007, we acquired ConSepT AS, a Norwegian process solutions company now known as NATCO Norway AS. The acquisition brought complementary and proprietary separation technologies to the Company, and added engineering expertise, product sales and product development capabilities based on a product line focused on gaining efficiencies in the separation trains of oil and gas production streams, and in particular, in high pressure gas regimes. The acquisition provides the Company with access to the Norwegian offshore market through a continuing presence in Trondheim, Norway and the opportunity to work with our new subsidiary s Norwegian customers which are expanding to other global markets.

In October 2007, we signed an agreement with Al-Rushaid Petroleum Investment Company, a Saudi Arabian enterprise to form a joint venture company in the Kingdom of Saudi Arabia. The joint venture will operate a new manufacturing facility within Al Rushaid s industrial complex in Jubail, expected to be completed by year-end 2008. The facility will manufacture proprietary separation and oil treating products for the upstream, downstream and petrochemical markets and deliver skidded packages incorporating NATCO production processing technologies for sale within the Kingdom of Saudi Arabia and certain other Middle Eastern countries. The joint venture operation, when fully staffed in 2009, is expected to significantly increase sales to both new build and retrofit markets within the region.

We expect to continue to accelerate our growth using strategic acquisitions and joint ventures that will add new technologies to fill gaps in, or complement, existing product lines or expand into new areas that will supplement our existing business.

We also remained focused on strengthening our financial flexibility during 2007. In June 2007, we entered into an export sales credit facility with a total borrowing capacity of $10.0 million that will expire on June 15, 2010. As of January 31, 2008, our available liquidity, including cash on hand and borrowing availability under our credit facilities, was approximately $110.2 million. Additionally, pursuant to the terms of our revolving credit facilities, we have the right to increase our borrowing capacity by $50 million.

During 2007, we reported record revenue, gross profit and earnings as a result of a strong market and continued improvements in execution. Our ongoing initiatives to recruit additional senior management personnel to focus on project delivery and integrated supply chain management, coupled with our balance sheet strength, have allowed us to sustain an attractive rate of growth while we remain well positioned to pursue opportunistic acquisitions. Market growth in 2007 was supported by historically high levels of exploration and production spending, attractive commodity prices, strong demand, declining quality of reserves, attractive refinery margins, changing production profiles and the complexity and remoteness of new development. We continue to expand in global markets, with international sales approximately equal US revenues in 2007.

We remained focused on leveraging the strength of our organization, operations and technology portfolio during 2007 through: (1) improved execution; (2) expansion of subcontracting opportunities; (3) new product development, including broader application of our Dual Frequency® electrostatic technology into the downstream segment of the oil and gas industry and expanding the reach of our Shell Paques technology into the synthetic gas market, as well as other technology advancements through focused R&D; (4) geographic expansion through marketing alliances/partnering; and (5) market expansion through technology alliances. We increased our use of subcontractors to supplement our internal manufacturing, fabrication and engineering capabilities, thereby allowing us to increase sales in our standard and traditional and built-to-order product lines.

During 2007, the Company made organizational additions to support our expanding business by recruiting experienced executives in the supply chain management and gas technologies areas and implemented enhanced training, development and succession planning programs designed to build our next generation of leaders. We

Table of Contents

Index to Financial Statements

moved our headquarters to a new facility in Houston, Texas in November 2007, which is expected to improve operational efficiency and accommodate our expected growth. To better show case our technology for our domestic and international customers, we plan to relocate our research and development (R&D) facility from Tulsa, Oklahoma to a newly-built, expanded facility in Houston, Texas, which is expected to be completed by the end of 2008.

Our goals for 2008 and beyond include focused market expansion initiatives designed to improve top line growth and profitability, continuing our globalization efforts, improving operating leverage from our strategic asset base in North America and building out our organizational leadership to support execution of our long-range strategic plans and the continued redeployment of free cash flow into organic growth opportunities, alliances and acquisitions.

In preparation for our anticipated growth requirements, our senior management has identified the need to implement an Enterprise Resource Planning (ERP) system to improve business processes, enhance integration and increase revenue and profitability. We have committed to the implementation of an ERP system, which is scheduled to occur in phases during 2008 and 2009 with an estimated cost of $10.0 million.

Our History

The following summarizes our general development over the past five years.

At various points in the period from 2002 to 2005, in response to weak market conditions, we streamlined certain of our operations to decrease excess production capacity and be more responsive to market trends, including the closure and consolidation of manufacturing and other facilities in Edmonton, Alberta, Canada; Covington, Louisiana; and Redruth, Cornwall, UK. Furthermore, we reallocated certain internal resources, realigned our worldwide marketing group, consolidated certain engineered systems operations in the UK, and closed an engineered systems business development office in Singapore.

In September 2004, we named John U. Clarke, then an independent director of the Company, as Chairman and interim CEO. The Board of Directors conducted a search for a replacement and appointed Mr. Clarke as Chairman and Chief Executive Officer of NATCO Group Inc. in December 2004. We named a new Corporate Controller and two new independent members to the Board of Directors during 2004 and 2005.

During 2005, we strategically repositioned our business by structuring into three segments focused on end-users Oil & Water Technologies, Gas Technologies and Automation & Controls. We also consolidated and integrated certain marketing functions by forming a global marketing group to better serve customers and pursue projects for continued growth in revenue and profitability. These changes were designed to position NATCO as a premier provider of efficient and customer focused equipment and services to the global energy market. In addition, our engineering offices located in the US, the UK, Japan and Canada became fully integrated Execution Centers working in concert with our Global Marketing group to provide seamless solutions to customers around the world. We substantially completed the steps necessary to consolidate our two UK operating offices into a single Execution Center under the direction of a newly named Managing Director.

During 2006 and 2007, we secured the continuing services of our president and chief operating officer and hired a new chief financial officer following the resignation of the incumbent. We also made key organizational leadership additions to strengthen our expanding business by recruiting experienced executives in engineered systems, human resources and supply chain management.

Industry

World demand for oil and gas remained strong in 2007. Energy economists are still predicting global energy consumption annual growth rates of 1.8% per year until 2030, according to the International Energy Outlook 2007, published by the Energy Information Agency (EIA) of the US Department of Energy. The most rapid growth in energy demand is expected from emerging market economies in Asia (including China and India), Central and Latin America, Africa, and the Middle East exceeding that of more mature economies.

Table of Contents

Index to Financial Statements

Demand for oil and gas production equipment and services is driven primarily by: levels of spending on exploration and development of production for oil and gas in response to worldwide demand; changing production profiles of existing fields (meaning the changing mix of lower oil, higher water cuts in the production stream and the level of contaminants); discovery of new oil and gas fields; quality of new hydrocarbon production; and increasingly remote locations of new production. Demand for downstream equipment and services is driven by: gasoline supply / demand balance influencing refining margins and driving reinvestment; worldwide political and economic situations affecting available crude slates; increasing dominance of heavy crude sources and opportunity crudes (lower cost crudes with high levels of contaminants); aging refining infrastructure, particularly in areas like the US; and tenuous supply situations in many markets driving refineries to produce at higher capacity while attempting to maximize unit run lengths.

We believe our oil and gas production equipment and services market continues to have significant growth potential due to the following:

Strong demand for oil and natural gas. According to the EIA, worldwide petroleum and natural gas consumption is projected to increase at an average annual growth rate of 2.0% and 1.9%, respectively, from 2004 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.

Long-term demand for oil and gas products should lead to increases in upstream activity. Continuing high levels of demand for oil and gas products as well as geopolitical risks of supply have resulted in a substantial rise in prices in the US and around the world in the recent five years. For example, in the US, the average price of crude oil per barrel has increased by 162% from $27.56 in 2003 to $72.32 in 2007 whereas the average wellhead price of natural gas per thousand cubic feet (Mcf) has increased by 28% from $4.97 in 2003 to $6.39 in 2007. In order to meet rising demand, the number of drilling rigs operating in North America and internationally has also increased in the same period. The average US rig count has increased 71% from 1,030 in 2003 to 1,768 in 2007 while the average international rig count, excluding North America, has increased 38% from 728 in 2003 to 1,005 in 2007, as published by Baker Hughes Incorporated. We believe rig counts will remain at or near historically high levels over the intermediate term in North America and will continue to rise internationally. With such activity levels, we anticipate demand for upstream oil and gas production equipment and services will remain strong.

Changing profile of existing production. Production decline in existing oil and gas fields causes the production profile and quality of recoverable reserves to change over time, either naturally or due to implementation of enhanced recovery techniques. As the mix of oil, gas, water and contaminants produced from mature fields changes, it results in lower quality or higher contaminates in hydrocarbon streams requiring more sophisticated, efficient and innovative production equipment to extract hydrocarbons from existing fields. Production profile changes often require retrofitting and de-bottlenecking of existing production equipment, which is an area of our expertise. Increasing demand for higher oil production in a scenario where the water-cut is increasing, is putting pressure on developing sub-sea water separation technology.

Long-term demand for refined products should lead to increases in downstream activity. World demand has caught up with refining capacity creating constrained supply situations in many markets. According to the EIA s US Operable Refinery capacity report as of December 2007, US refining capacity, which accounts for approximately one-quarter of the world refining capacity, has been effectively full since 2004 with little or no additional capacity expected in 2007. Worldwide number of

Table of Contents

Index to Financial Statements

refineries also remains stable, according to a December 2007 survey of *The Oil and Gas Journal*. Long-term forecasts from the EIA s Annual Energy Outlook 2005, predict petroleum product demand growing at an average of 1.6% per year through 2025. While the majority of the oil is expected to come from OPEC countries, significant increases in oil supply are expected from Canada and Central Asia. Heavy crudes, like Canadian bitumen, have become more popular feedstock. Worldwide refiners are facing more unpredictable crude and crude blends from the spot market, which should translate into an increased demand for our oil treating equipment products and services in what is a potential growth market for NATCO refinery sales.

Increasing focus on large-scale equipment packages and integrated systems projects. Due to the increased demand for oil and gas, energy companies are pursuing larger and more complex development projects that often require specialized production equipment. These projects may be in remote, deepwater or harsh environments, may involve complex production profiles and operations and typically involve more sophisticated solutions. Larger and more complex projects located in regions with limited infrastructure often require equipment suppliers like NATCO to deliver greater scope in the design and delivery of core technologies in order to secure an award.

Increasing need for technology solutions. Higher specification and performance standards, more stringent environmental regulations, cost reduction requirements and other similar considerations have increased demand for technology in production systems. New oil and gas fields, often located in remote places of the world or offshore require advanced technology solutions to reduce equipment size, weight and footprint on offshore platforms. Oil and gas fields in harsh environments also present special challenges that require technology and reliable equipment solutions with a high degree of engineering integrity which are NATCO s strengths.

Increasing requirements for environmentally-focused solutions. Virtually every industry is facing ever more stringent environmental laws and regulations affecting operations around the world. Reducing the production of CO_2 or greenhouse gases, reducing pollutants and other environmental hazards including hydrogen sulfide, restricting natural gas flaring, managing process waste water streams, disposal and water filtration, are requirements in nearly every market within the oil and gas industry. We provide process technology and equipment designed to handle these concerns and therefore more stringent environmental regulations may present additional business opportunities for us. For example: our patented VersaFlo ® single stage produced water flotation unit achieves stringent overboard water quality standards; our licensed Shell-Paques ® technology utilizes natural harmless bacteria in an aqueous solution to remove H_2S from produced natural gas or biogas to enable producers to achieve pipeline specifications while meeting the US Environmental Protection Agency s SOx (Sulfur Oxides) low emissions standards. Our patented CO_2 sequestration technologies (to capture the CO_2 from burning natural gas or coal or from removing CO_2 contamination from produced natural gas) such as Cynara ® membranes allow users to profitably utilize CO_2 by injection into aquifers (capturing CO_2 credits) or in recycling and reuse of CO_2 in enhanced oil recovery schemes where CO_2 is used as the production enhancement media.

Competitive Strengths

We believe our key competitive strengths are:

Market leadership and industry reputation. We have designed, manufactured and marketed oil and gas production equipment and systems for over 80 years. We believe that, among our competitors, we have one of the larger installed bases of production equipment in the oil and gas industry. We will continue to innovate and develop products and services to provide solutions for our customers.

Technological leadership. We believe we have established a position of global technological leadership by pioneering the development of innovative separation technologies. We continue to be a technological leader in areas such as: carbon dioxide separation using membrane technology; oil-water emulsion treatment using the latest electrostatic technology; seawater injection systems; complex

Table of Contents

Index to Financial Statements

produced oily water treatment systems and a variety of specialty applications. We hold over 50 active US and equivalent foreign patents and continue to invest in R&D activities.

Extensive line of products and services. We provide a broad range of high quality production equipment and services, ranging from standard processing and control equipment to highly specialized engineered systems and fully integrated solutions, for both upstream and downstream markets and customers around the world. Because we provide a broad range of products and services, our customers can save time and money by using a single supplier for process engineering, design, manufacturing and installation of and services for equipment, processes and related control systems.

Predictable project delivery system combined with established network of global subcontractors and fabricators complementing our North American fabrication and manufacturing capabilities. Through our project delivery system, we maintain relationships with subcontractors and fabricators in North America, the Middle East, Southeast Asia and other areas around the world, which permits us to deliver competitively priced equipment and systems to customers; minimize transportation costs and logistics; satisfy requirements to provide local content in certain markets and manage risks.

Experienced and focused management team. Our senior management team has extensive service in our industry with an average of over 20 years of experience. Additionally, our management team has a substantial financial interest in our continued success through equity ownership and incentives.

After-market parts and service. Through our extensive North American branch network, we provide replacement parts for our own equipment and for equipment manufactured by others. In addition, we offer operational and safety training to the oil and gas production industry, which provides marketing opportunities for our other products and services. Each branch of our North American marketing network serves as a local parts and service business. Our UK subsidiary also provides replacement parts and servicing for equipment it supplies and for equipment supplied by others throughout Europe, the Middle East and Africa.

Continued investment in research and development. We conduct product R&D activities at our facilities located in Tulsa, Oklahoma and Pittsburg, California for our own purposes and for our customers on a fee paid basis. Some of our latest technology innovations include: the continuing development of a compact electrostatic separator for both topsides and sub-sea applications; a new patent that couples all of our prior proprietary electrostatics products with our newest Dual Frequency® electrostatic technology to improve dehydration and desalting efficiencies for both upstream and downstream applications; advancing applications for our new 30 membrane for CO_2 separation that provides higher throughput and recovery utilizing a smaller foot print and reduced weight; continuing developments in compact separation techniques in our Porta-Test ® and ConSepT ® products to further reduce retention time requirements while achieving improved results for both surface and subsea applications; and a new combuster design based on our proven SHV (super-heated vapor) flare design.

Business Strategy

Our primary objective is to maximize profitability and cash flow by maintaining and enhancing our position as a leading provider of equipment, systems, services and solutions used in the production and refining of crude oil and natural gas. We intend to achieve this goal by pursuing the following business strategies:

Being commercially competitive in our markets. Certain of our markets are highly competitive and our customers are sensitive to the price of our products relative to those of our competitors. We continue to implement the concepts of lean management to eliminate wasted effort, reduce our manufacturing, engineering and distribution costs, increase capacity utilization and improve quality and time of delivery. We are also implementing significant improvements in our supply chain management processes, information technology and management systems. We expect that these improvement initiatives will lower operating costs, increase productivity and in combination with selective price increases result in strengthening profit margins over time.

Table of Contents

Index to Financial Statements

Introducing new technologies and products. We develop and acquire leading technologies that enable us to address the global market demand for increasingly sophisticated processing and production equipment and systems. We plan to continue pursuing the commercialization of new technologies through internal development, acquisitions and licenses.

Maintaining a safe work environment for our employees and customers. We believe incidents in the workplace are preventable and we are challenging our entire organization to meet the corporate objective of zero incidents. We believe that operating safely is a key measure of performance, which improves profitability and reduces costs for us and our customers.

Focusing on customer relationships. We provide our customers with solutions that result in improved process performance and lower operating costs. We believe our customers prefer to work with a small number of leading suppliers. Our size, scope of products, technological expertise, service orientation and ability to satisfy delivery requirements provide us with a competitive advantage in establishing preferred supplier relationships with customers. We intend to grow revenue and market share by establishing new, and further developing existing, customer relationships.

Optimizing the mix of our business for the highest margin work. A key part of our operating strategy is to enhance the utilization of available resources in order to produce increased levels of profitability. This means prospecting for and selecting projects and business that fit certain criteria considering items including: degree of complexity/execution risk; perceived value of the preferred solution to the customer; project duration; credit support requirements; anticipated cash flows; and contract structure. This selective approach is designed to increase the success of project awards, execution and increase overall profitability. As part of this strategy we intend to selectively outsource project activities, such as fabrication, in instances where it makes economic sense to do so.

Pursuing international growth opportunities. We have operated in international markets for more than 50 years. We intend to continue expanding internationally in targeted geographic regions, such as the Middle East, West Africa, Central and Southeast Asia, Latin America, Scandinavia and Russia. Export sales and international sales provided half of our total revenues for the year ended December 31, 2007. Revenue from overseas sales has grown over the past few years and is expected to become an even larger percentage of our business. Our engineering and project management offices located in the US, the UK, Japan and Canada are fully integrated Execution Centers working in concert with our global supply chain management as well as our marketing group to provide more seamless solutions to customers around the world. Our international joint ventures in Angola, Malaysia and soon, Saudi Arabia provide access to emerging markets with established local partners.

Table of Contents

Index to Financial Statements

Our revenues by geographic area for 2007 are set forth below.

Providing broad range solutions across the value chain. Our marketing strategy is to lead with our advanced process technology, become involved with our customers in the early stage of projects, provide the most complete scope of equipment and services consistent with our capabilities and focus on value added solutions.

Pursuing complementary acquisitions. Our industry is fragmented and contains many competitors with less extensive product lines or geographic scope. We continue to review potential strategic alternatives involving complementary technologies which would enhance our ability to offer integrated systems or expand our geographic reach, or that would increase product and services pull through at our branch locations. Our recent acquisition of ConSepT AS, a Norwegian process solutions company now known as NATCO Norway, brings to NATCO complementary and proprietary separation technologies, added engineering expertise and product development capabilities as well as access to the Norwegian market for NATCO products and services. Our January 2008 acquisition of Linco-Electromatic, Inc. provides several new products and services to our customers, which can be marketed using our existing North America branch network.

Joint ventures with other international companies. We have formed or agreed to form several international joint ventures with strategic local partners in Malaysia, Japan and Saudi Arabia. The strategic alliances enable NATCO to sell products and services in new regions with knowledgeable and experienced partners, strengthen customer contracts and permit NATCO to satisfy local content requirements in a number of key markets.

Gaining operating leverage from core strategic assets in North America. Our North American branch distribution network consists of 36 service centers strategically located in all the major supply basins in the US and Canada. These service centers sell new equipment and provide aftermarket parts and services for NATCO equipment and other providers. This distribution network is a key asset that can be leveraged by offering complementary products and services to both existing and new customers. As

Table of Contents

Index to Financial Statements

an integral part of our business strategy, we continuously look for ways to generate additional revenue through this distribution channel. Recent examples of this strategy are our SureFire™ pilotless burner systems acquired in 2006 and the Linco-Electromatic custody-transfer liquids measurement business acquired in January 2008.

Utilizing subcontractors. We selectively utilize subcontractors to satisfy customer demand for products and equipment where we can manage quality, cost and delivery schedules. In North America, we continue to optimize our manufacturing capacity by allocating work hours to higher value equipment. Our global business is based on reliance on subcontractors and fabricators worldwide.

Global Marketing

Our products and services are marketed primarily as NATCO branded or co-branded products through sales offices located in the US, Latin America, Southeast Asia, Japan, UK, Scandinavia and Russia, augmented by third party agents, representatives and technical applications specialists for specific customer requirements. We maintain agency relationships in most energy producing regions of the world to enhance our flexible allocation of global resources in countries where we do not have employees. We also market technology products and services through joint ventures in Malaysia and Japan and plan to market certain of our products through our joint venture in Saudi Arabia following its formation in 2008.

Our Oil & Water Technologies business has an extensive branch network, primarily in North America, through which we sell standard and traditional production equipment, spare parts and services directly to oil and gas operators. Our built-to-order businesses within our Oil & Water and Gas Technologies segments typically involve a significant pre-award investment (bidding costs) in engineering, design, estimating and planning in order to establish our technical qualifications, evaluate the requirements of the specific project, develop a conceptual solution which meets our customers requirements, estimate our costs to provide the system to the customer in the time frame required, and to establish our appropriate risk reward balance. Our Automation & Control business is primarily marketed under the TEST brand through an internal sales force.

Customers

We devote a considerable portion of our marketing time and effort to developing and maintaining relationships with key customers. Some of these relationships are project specific. However, our customer base ranges from independent operators to international and national oil companies as well as engineering, procurement and construction companies acting on behalf of end users. Our level of technical expertise, extensive distribution network and breadth of product offerings contributes to the maintenance of good working relationships with our customers. Several of our standard and traditional customers will award contracts that involve the manufacture and sale of multiple units over an extended period of time. These contracts may necessitate purchases of raw materials in advance lots to ensure favorable pricing. On large built-to-order projects, warranty and performance bonds may be required by customers as part of the contract terms and conditions. These bonds, which are issued under our bank credit facilities totaled $16.8 million, $9.5 million and $10.6 million at December 31, 2007, 2006 and 2005, respectively.

For the years ended December 31, 2007, 2006 and 2005 no single customer provided revenue exceeding 10% of our consolidated revenue. On a segment basis, our Oil & Water Technologies segment s revenue was derived from a large, varied group of customers, but the Gas Technologies and Automation & Controls segments each relied on a few major customers for a significant portion of revenue.

Competition

Contracts for our products and services generally are awarded on a competitive basis. The more important factors considered by customers in awarding contracts include the availability and capabilities of equipment and systems, the optimal technology solution, the ability to meet the customer s delivery schedule, value, reputation, experience and safety record.

Table of Contents

Index to Financial Statements

The primary competitors for our Oil & Water Technologies segment include Exterran, Aker Kvaerner Process Systems, Cameron International Company, US Filter, Weir Westgarth, J.W. Williams and numerous privately held, mainly regional companies. Competitors for our Gas Technologies business include UOP, a Honeywell company, Westfield Engineering, Prosep Technologies Inc. and Merichem. The primary competitors for our Automation & Controls business are W- Industries, MMR-Radon, P2S/SECO, E-Production Solutions, a subsidiary of Weatherford International, as well as numerous privately held companies operating in the Gulf Coast region.

We believe we are one of the larger providers of crude oil and natural gas production separation equipment in North America and have one of the larger market shares internationally. We further believe that our technology leadership, size, R&D, brand name recognition and marketing organization, taken together, provide us with certain competitive advantages relative to other participants in the industry.

Operating Segments

During 2007, our operating segments were Oil & Water Technologies, Gas Technologies and Automation & Controls. The products and services we offer through each segment are outlined below.

Oil & Water Technologies

Our 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 design and delivery of more complex oil and water production and processing systems worldwide.

Standard and Traditional Equipment

The standard and traditional product line consists of the sale and servicing of production equipment, replacement parts, and used equipment refurbishing and servicing, which is deployed primarily onshore in North America and in the Gulf of Mexico. Through our Canadian subsidiary, we provide traditional production equipment with modifications to operate in a cold weather environment. Equipment built for the North American oil and gas industry typically is based on an established, standardized NATCO design available via catalogue purchase, or variations of standardized equipment requiring limited customized engineering. We market standard and traditional production equipment and services through an extensive network of sales and service centers located in the US, Canada, Mexico and Venezuela.

Our production equipment includes:

Separators. Separators are used for the primary separation of a hydrocarbon stream into oil, water and gas. In addition to traditional separator solutions, we offer customers more advanced separation technologies utilizing proprietary devices inside vessels to achieve more efficient separation designed to reduce size and weight, improve separation efficiency and eliminate process problems.

Heaters. Heaters are used to reduce the viscosity of oil to improve flow rates and to prevent hydrates from forming in gas streams. We manufacture both standardized and customized direct and indirect fired heaters. In each system, heat is transferred to the hydrocarbon stream through a medium such as water, water/glycol, steam and salt or flue gas.

Oil Dehydration Equipment. Oil dehydrators are used to remove water from oil.

Water Treatment Equipment. Water treatment and conditioning equipment removes contaminants from water extracted during oil and gas production.

Gas Conditioning Equipment. Gas conditioning equipment removes contaminants from hydrocarbon and gas streams.

Table of Contents

Index to Financial Statements

In addition, we provide the following:

Equipment Refurbishment. We source, refurbish and integrate used oil and gas production equipment. Customers that purchase this equipment may benefit from reduced delivery times and lower equipment costs relative to new equipment. The used equipment market is focused primarily in North America, both onshore and offshore.

Parts, Service and Training. We provide replacement parts for our own equipment and for equipment manufactured by others. Each branch in our North American marketing network also serves as a local parts and service business. In addition, we offer operational and safety training to the oil and gas production industry, which provides a marketing tool for our other products and services.

Leased Equipment. We lease certain oil dehydrating, gas conditioning and water treatment equipment to our customers on a short or long-term basis.

Built-to-Order Systems

We design, engineer, procure, fabricate and manufacture engineered systems using our own facilities or third-party contractors for upstream and downstream oil and gas projects throughout the world, and provide start-up services for our custom-made engineered products. Engineered systems typically require a significant amount of technology, engineering, procurement, fabrication and project management. We utilize a project delivery system designed to integrate these functions into a smooth and well-managed value chain with integrated project management capabilities that provide effective risk management and timely delivery of a high quality project within budget.

We market built-to-order, engineered systems through our direct sales force based in the US, Latin America, Southeast Asia, Japan, UK, Scandinavia and Russia, augmented by independent representatives in other countries. We also use the unique oil testing capabilities of our R&D facility to enhance our capabilities in providing specific solutions that deliver to our customers requirements.

Built-to-order systems include:

Integrated Oil and Gas Processing Trains. These consist of multiple units that process oil and gas from primary separation through contaminant removal.

Offshore Production Systems. These consist of large skid-mounted processing units and can be used in conjunction with fixed offshore platforms, semi-submersible floating systems; floating, production, storage and offloading (FPSO) vessels; and other floating production vessels. Floating production equipment for oil must be specially designed to overcome the effects of wave motions on floating vessels. We pioneered and patented the first wave-motion production vessel internals system and continue to advance this technology at our R&D facility using a wave-motion table, which simulates a variety of sea states. We also utilize computational fluid dynamic (CFD) modeling and finite element analysis to ensure that our systems are optimally designed and fabricated to meet durability requirements at defined sea states.

Dehydration and Desalting System for Upstream and Downstream Applications. Dehydration and desalting involves the removal of water and salt from an oil stream. Desalting is a specialized form of dehydration, in which fresh water is injected into an oil stream to dilute the residual saltwater and remove it from the stream. Large production projects often use electrostatic technology to desalt oil. We believe that we are a leading developer of electrostatic technologies for oil treating and desalting. Some of our dehydration and desalting technologies, like the Electro Dynamic® Desalter and Dual Frequency® desalters, are well suited for oil refineries, where stringent desalting requirements are growing increasingly important. The requirements have increased as crude quality has changed and catalysts have become more sensitive and sophisticated, requiring lower levels of contaminants. These technologies reduce the

number and size of vessels required or improved processing for difficult crudes, which is particularly important in refinery applications.

Table of Contents

Index to Financial Statements

Water Injection Systems. We provide water injection systems used both onshore and offshore to remove contaminants from water to be injected into a reservoir during production so that the formation or its production characteristics are not adversely affected. These systems may involve media and cartridge filters, de-aeration, chemical injection and sulfate removal. Offshore facilities to treat raw seawater involving use of sulfate removal membranes can be, and often are, very large projects that are increasingly necessary for field development in locations such as the Gulf of Mexico, the North Sea and West Africa.

Produced Water Cleanup Systems. We design and engineer systems that, through the use of liquid/liquid hydro-cyclone technology and induced or dissolved gas flotation technology, remove oil and solids from a produced water stream. Oily water cleanup is often required prior to the disposal or re-injection of produced water.

Gas Processing Equipment. We offer standard and engineered processing equipment for the extraction of liquid hydrocarbons to meet feed gas and liquid product requirements. We manufacture several standard mechanical refrigeration units for the recovery of salable hydrocarbon liquids from gas streams. Low temperature extractor (LTX®) units are mechanical separation systems designed for handling high-pressure gas at the wellhead. These systems remove liquid hydrocarbons from gas streams more efficiently and economically than other methods.

Other Downstream Applications. We offer several technologies that have crossover applications in the refinery and petrochemical sectors particularly for oil and water treating. We also design and supply process facilities for hydrogen generation and purification, for refineries and petrochemical plants or industrial gas suppliers. In addition, our Dispersed Oil Extractor (DOX) technology cleans both heavy and light dispersed oil from water, which is beneficial to ethylene processors.

Other Proprietary Equipment. We design and supply a broad range of proprietary equipment that may be part of a larger system or may be sold separately to customers for applications in oil and gas projects or in retrofit applications. Such equipment includes wellhead desanders, sand cleaning facilities, sand fluidization and specialty oil heaters.

Gas Technologies

The Gas Technologies segment includes our CO_2 membrane business, the assets and operating relationship related to our gas processing facilities in West Texas, H_2S removal technologies including Shell Paques and our ConSepT brand of advanced technology separator equipment featuring internals for gas scrubbing, primary separation and produced water de-gassing.

Onshore Gas Processing Field Operations for Carbon Dioxide Removal. We manufacture gas processing facilities for the removal of carbon dioxide from hydrocarbon streams. These facilities use our proprietary Cynara® membrane technology which provides one of the more effective separation solutions for hydrocarbon streams containing high concentration of carbon dioxide. One of the markets for these facilities is production from wells such as those located in West Texas in which carbon dioxide injection is used to enhance the recovery of oil reserves. Utilizing this technology, we have participated in a series of arrangements with Kinder Morgan CO_2 Company, L.P. relative to gas processing of production at the Sacroc field in West Texas. These arrangements include provision of facilities which we operate and maintain, sale of other facilities which we operate on behalf of Kinder Morgan, and sale of facilities which Kinder Morgan operates and maintains. While these arrangements generally have a ten-year term from inception, all are terminable by Kinder Morgan after a specified notice period and payment of associated cancellation charges. Certain of such arrangements have a buyout requirement intended to partially compensate us for loss of contract and equipment value should Kinder Morgan elect to terminate the arrangement prior to the agreed term. All arrangements with Kinder Morgan were amended effective September 2007 for an additional ten-year period.

Table of Contents

Index to Financial Statements

Large Offshore Gas Processing Facilities. We also provide large gas processing facilities for the separation, heating, dehydration and removal of liquids and contaminants to produce pipeline-quality natural gas for large offshore facilities. These facilities use Cynara® membrane technology, which provides a cost-effective separation solution for hydrocarbon streams containing high concentrations of carbon dioxide. Primary markets for this application are production from gas wells, such as those located in Southeast Asia, which have high concentrations of naturally occurring carbon dioxide, and production fields that use CO_2 for enhanced oil recovery systems.

Separation of the H_2S and Sulfur Recovery. We license Shell Paques and Paques bio-desulfurization technology under agreements with Shell Global Solutions® since 2002. Shell Paques is licensed for use in natural gas production applications in North and South America, excluding Canada, while Paques is licensed for use in biogas applications in North America. These technologies potentially provide operating cost and environmental advantages over existing desulfurization technologies. The technology has been certified through the US Environmental Protection Agency s Environmental Technology Verification program. We have successfully commercialized this technology for high-pressure natural gas applications, and broadened the application to syngas streams from the gasification of coal or solid waste.

High Pressure Gas and Separation Equipment. Through the ConSepT brand, we offer a variety of complete separators with internals for gas scrubbing, primary separation and produced water de-gassing. The ConSepT Axial Flow Demisting Cyclone (DC) uses centrifugal forces to separate liquid droplets from a gas stream. The ConSepT Inlet Cyclone Distributor (ICD), a reversed flow cyclone, uses centrifugal forces to separate and distribute the incoming gas and liquid mixture to the vessel gas and liquid compartments, respectively. The ConSepT Swirl Inlet (SI), a vane diffuser, when used in combination with DC , achieves high separation efficiency. The ConSepT Inlet Vane Distributor (IVD) enhances the separation performance as it is designed with profiled vanes to gently reduce the inlet momentum from the inlet nozzle and into the vessel in order to minimize droplet break up and mixing of the fluids.

Automation & Controls

The primary market for automation and control systems is in offshore applications throughout the world. We market and service these products through subsidiaries with US locations in Houston, Texas and Harvey and New Iberia, Louisiana, and international locations in Angola, West Africa and Kazakhstan under the TEST brand. Products and services offered by the Automation & Control segment include:

Control Systems and Panels. We design, program, assemble, install and commission a variety of pneumatic, hydraulic, electrical and computerized control panels and systems for multiple industries. These systems monitor and change key parameters of oil and gas production systems. Key parameters include wellhead flow control, emergency shutdown of production and safety systems, hydraulic power unit controls, lighting systems, power generation, distribution and control, and quarters and production facilities controls. A control system consists of a control panel and related tubing, wiring, sensors and connections.

Engineering and Instrumentation Field Services. We provide the service of engineering and instrumentation professionals for start-up support, testing, maintenance, repair, renovation, expansion and upgrade of control systems, including those designed or installed by others for our customers worldwide. Our design and engineering staff also provide contract electrical engineering services.

Manufacturing and Fabrication Facilities

We operate four primary manufacturing and fabrication facilities supporting our Oil & Water Technologies and Gas Technologies segments. These range in size from approximately 47,600 square feet to approximately 130,000 square feet of manufacturing space which, together with manufacturing and fabrication provided by

Table of Contents

Index to Financial Statements

third-party subcontractors, support our product technology lines. We own three o