NATCO GROUP INC
Form 10-Q
November 14, 2001

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 SEPTEMBER 30, 2001,

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 the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

As of November 1, 2001 Class A, $0.01 par value per share, 15,127,209 shares
Class B, $0.01 par value per share, 542,071 shares

NATCO GROUP INC.

FORM 10-Q
FOR THE QUARTER ENDED SEPTEMBER 30, 2001

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PART I

ITEM 1. FINANCIAL STATEMENTS

NATCO GROUP INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE DATA)

	SEPTEMBER 30, 2001	DECE
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,899	$
Trade accounts receivable, net	81,459	
Inventories	38,829	
Prepaid expenses and other current assets	7,938	
Total current assets	130,125	
Property, plant and equipment, net	28,606	
Goodwill, net	80,925	
Deferred income tax assets, net	5,378	
Other assets, net	2,409	
Total assets	$ 247,443	$
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current installments of long-term debt	$ 7,000	$
Notes payable	--	
Accounts payable	38,590	
Accrued expenses and other	39,196	
Customer advances	13,090	
Total current liabilities	97,876	
Long-term debt, excluding current installments	47,559	
Postretirement benefit and other long-term liabilities	14,303	
Total liabilities	159,738	
Stockholders' equity:		
Preferred stock $.01 par value. Authorized 5,000,000 shares; no shares issued and outstanding	--	
Class A Common stock, $.01 par value. Authorized 45,000,000 shares; issued and outstanding 15,170,645 and 14,977,354 shares as of September 30, 2001 and December 31, 2000, respectively	152	
Class B Common stock, $.01 par value. Authorized 5,000,000 shares; issued and outstanding 542,071 and 699,874 shares as of September 30, 2001 and December 31, 2000, respectively	5	
Additional paid-in capital	96,998	
Accumulated earnings/(deficit)	3,157	
Treasury stock, 716,938 and 677,238 shares at cost as of September 30, 2001 and December 31, 2000, respectively	(6,608)	
Accumulated other comprehensive loss	(2,788)	
Note receivable from officer and stockholder	(3,211)	
Total stockholders' equity	87,705	
Commitments and contingencies		
Total liabilities and stockholders' equity	$ 247,443	$

See accompanying notes to unaudited condensed consolidated financial statements.

NATCO GROUP INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	THREE MONTHS ENDED SEPTEMBER 30,	
	2001	2000
Revenues	$ 74,522	$ 60,244
Cost of goods sold	53,905	43,979
Gross profit	20,617	16,265
Selling, general and administrative expense	13,767	9,690
Depreciation and amortization expense	2,176	1,307
Unusual charges	--	--
Interest expense	1,456	355
Interest cost on postretirement benefit liability	122	322
Interest income	(129)	(19)
Income before income taxes	3,225	4,610
Income tax provision	1,458	1,973
Net income	$ 1,767	$ 2,637
EARNINGS PER SHARE:		
Basic	$ 0.11	$ 0.17
Diluted	$ 0.11	$ 0.17
WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING:		
Basic	15,747	15,144
Diluted	15,941	15,688

See accompanying notes to unaudited condensed consolidated financial statements.

NATCO GROUP INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

NINE MONTHS ENDED
SEPTEMBER 30,

	2001	2000
Cash flows from operating activities:		
Net income	$ 3,663	$ 5,302
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Deferred income tax expense (benefit)	507	(403)
Depreciation and amortization expense	5,962	3,850
Non-cash interest income	(140)	(67)
Interest cost on postretirement benefit liability	766	965
Gain on the sale of property, plant and equipment	(156)	(75)
Change in assets and liabilities, net of acquisitions:		
(Increase) decrease in trade accounts receivable	4,044	(10,483)
Increase in inventories	(9,615)	(8,219)
Increase in prepaid expense and other current assets	(1,372)	(326)
(Increase) decrease in long-term assets	(1,526)	716
Increase in accounts payable	6,180	3,596
Increase (decrease) in accrued expenses and other	(5,177)	1,090
Increase (decrease) in customer advances	11,816	(134)
Net cash provided by (used in) operating activities	14,952	(4,188)
Cash flows from investing activities:		
Capital expenditures for property, plant and equipment	(6,388)	(6,138)
Proceeds from the sale of property, plant and equipment	257	276
Acquisitions, net of cash acquired	(48,224)	(17,239)
Proceeds of note receivable	--	1,067
Issuance of related party note receivable	(1,178)	--
Proceeds from settlement	1,500	--
Net cash used in investing activities	(54,033)	(22,034)
Cash flows from financing activities:		
Change in bank overdrafts	2,929	1,831
Net borrowings (repayments) under long-term revolving credit facilities	(6,577)	5,231
Repayments of short-term borrowings	(1,001)	--
Repayments of long-term debt	(3,500)	(27,858)
Borrowings of long-term debt	50,000	--
Issuance of common stock, net	98	47,199
Receipt from affiliate of remainder of net present value of postretirement benefit liability	--	600
Payments on postretirement benefit liability	(1,449)	(1,414)
Treasury shares repurchased	(292)	--
Other, net	138	220
Net cash provided by financing activities	40,346	25,809
Effect of exchange rate changes on cash and cash equivalents	(397)	(471)
Change in cash and cash equivalents	868	(884)
Cash and cash equivalents at beginning of period	1,031	1,747
Cash and cash equivalents at end of period	$ 1,899	$ 863
Cash payments for:		
Interest	$ 2,689	$ 788

Income taxes	$ 1,691	$ 1,801
Significant non-cash investing and financing activities:		
Promissory notes issued for business acquisition	$ --	$ 1,026
Partial settlement of a note arrangement with treasury shares	$ --	$ 1,525
Debt assumed in acquisition	$ --	$ 2,862
Issuance of common stock for acquisition	$ 85	$ 4,077

See accompanying notes to unaudited condensed consolidated financial statements.

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NATCO GROUP INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) BASIS OF PRESENTATION

The accompanying condensed consolidated interim financial statements and related disclosures are unaudited and have been prepared by NATCO Group Inc., ("the Company") pursuant to generally accepted accounting principles for interim financial statements and the rules and regulations of the Securities and Exchange Commission. As permitted by these regulations, certain information and footnote disclosures that would typically be required in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. However, the Company's management believes that these statements reflect all the normal recurring adjustments necessary for a fair presentation, in all material respects, of the results of operations for the periods presented, so that these interim financial statements are not misleading. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Form 10-K filing for the year ended December 31, 2000.

To prepare financial statements in accordance with generally accepted accounting principles, the Company's management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and reported amounts of revenues and expenses incurred during the reporting period. Actual results could differ from those estimates. Furthermore, certain reclassifications have been made to fiscal year 2000 amounts in order to present these results on a comparable basis with amounts for fiscal year 2001.

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

(2) CAPITAL STOCK

On February 1, 2001, NATCO issued 8,520 shares of Class B Common Stock to the former shareholders of The Cynara Company ("Cynara"), in connection with the achievement of certain performance criteria defined in the November 1998 purchase agreement. Goodwill was increased $85,000 as a result of this transaction.

During September 2001, the Company reacquired 39,700 shares of its Class A common stock pursuant to a stock repurchase plan for $292,000, an average cost of $7.35 per share. The cost to reacquire these shares has been recorded as treasury stock at September 30, 2001.

(3) EARNINGS PER SHARE

Basic earnings per share was computed by dividing net income by the weighted average number of shares outstanding for the period. Diluted earnings per common and common equivalent share was computed by dividing net income by the weighted average number of common and common equivalent shares outstanding for the period. For purposes of this calculation, outstanding employee stock options were considered common stock equivalents. Included in diluted shares were common stock equivalents related to employee stock options of 193,523 shares and 277,180 shares for the quarter and nine-month period ended September 30, 2001, respectively. For the same periods in 2000, common stock equivalents related to employee stock options totaled 543,829 shares and 601,038 shares. Anti-dilutive stock options were excluded from the calculation of common stock equivalents. The impact of these anti-dilutive shares would have been a reduction of 211,514 shares and 79,011 shares for the quarter and nine-month period ended September 30, 2001, respectively. The impact of anti-dilutive shares would have been a reduction of 13,834 shares and 8,717 shares for the quarter and nine-month period ended September 30, 2000, respectively.

(4) ACQUISITIONS

On March 19, 2001, the Company acquired all the outstanding share capital of Axsia Group Limited ("Axsia"), a privately held company based in the United Kingdom, for approximately $42.8 million, net of cash acquired. Axsia specializes in the design and

supply of water reinjection systems for oil and gas fields, oily water treatment, oil separation, hydrogen production and other process equipment systems. This acquisition was financed with borrowings under NATCO's term loan facility, and was accounted for using the purchase method of accounting. Results of operations for Axsia have been included in NATCO's condensed consolidated financial statements since the date of acquisition. The excess of the purchase price over the fair values of the net assets acquired is being amortized over a twenty-year period. Goodwill and accumulated amortization related to the Axsia acquisition were $48.4 million and $1.3 million, respectively, at September 30, 2001. Although the Axsia purchase price allocation has not yet been finalized, NATCO's management does not believe that the final purchase price allocation will differ materially from that as of September 30, 2001.

Assuming the Axsia acquisition occurred on January 1 of the respective year, the unaudited pro forma results of the Company for the nine-month periods ended September 30, 2001 and 2000, respectively, would have been as follows:

	PRO FORMA RESULTS NINE MONTHS ENDED	
	SEPTEMBER 30, 2001	SEPTEMBER 30, 2000
	(UNAUDITED)	(UNAUDITED)
Revenues	$ 234,938	$ 197,444
Income before income taxes ...	3,685	6,431
Net income	1,592	$ 2,948
Net income per share:		

Basic	$ 0.10	$ 0.21
Diluted	$ 0.10	$ 0.20

These pro forma results assume debt service costs associated with the Axsia acquisition, net of tax effect, calculated at the Company's effective tax rate for the applicable period, and nondeductible goodwill amortization. Although prepared on a basis consistent with NATCO's condensed consolidated financial statements, these pro forma results do not purport to be indicative of the actual results which would have been achieved had the acquisition been consummated on January 1 of the respective year, and are not intended to be a projection of future results.

Effective January 8, 2001, the Company entered into a Compromise Settlement Agreement with Phlipco, Inc., successor by merger to Enterra Petroleum Equipment Group, Inc. and Weatherford International, Inc., which resulted in a cash payment of $1.5 million to NATCO on May 31, 2001, to settle certain contingencies related to NATCO's acquisition of Total Engineering Systems Team, Inc. ("TEST") in 1997. The proceeds of this payment, net of related costs, were used to reduce goodwill associated with the TEST acquisition.

(5) UNUSUAL CHARGES

In June 2001, the Company recorded an unusual charge of $1.6 million. The charge consisted of $920,000 pursuant to an approved plan to close and merge an existing NATCO office into the operations of Axsia, acquired in March 2001. This charge included costs for severance, office consolidation and other expenses. Also, the Company withdrew a public debt offering and recorded an unusual charge of $680,000 for costs incurred related to the proposed offering.

Pursuant to an employment agreement, an executive officer was entitled to a bonus upon the occurrence of any sale or public offering of the Company. The bonus equaled one and one-half percent (1.5%) of the value of all securities owned by stockholders of the Company prior to the sale or offering, including common stock valued at the price per share received in either the sale or public offering, and any debt held by such stockholders. In July 1999, the Company amended the employment agreement to eliminate the bonus and agreed to lend the officer $1.2 million to purchase 136,832 shares of common stock. Per the agreement, the officer would receive a bonus equal to the outstanding principal and interest of the note upon the sale or public offering of the Company. During February 2000, after the Company completed an initial public offering of its Class A common stock, NATCO recorded expense of $1.3 million in settlement of its obligation under this agreement. The officer used the proceeds, net of tax, to repay the Company approximately $665,000. The outstanding balance of this note, including accrued interest, at September 30, 2001, was approximately $642,000. The loan accrues interest at 6% annually.

During the first quarter of 2000, NATCO incurred relocation charges of approximately $208,000 associated with the consolidation of an existing Company facility with a facility that was acquired in connection with the acquisition of Porta-Test International, Inc. ("Porta-Test").

(6) INVENTORIES

Inventories consisted of the following amounts:

	SEPTEMBER 30, 2001	DECEMBER 31, 2000
	(UNAUDITED)	
	(IN THOUSANDS)	
Finished goods	$ 8,511	$ 7,641
Work-in-process	15,029	10,403
Raw materials and supplies	16,039	11,203
Inventories at FIFO	39,579	29,247
Excess of FIFO over LIFO cost	(750)	(570)
	$ 38,829	$ 28,677

(7) COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS

Cost and estimated earnings on uncompleted contracts were as follows:

	SEPTEMBER 30, 2001	DECEMBER 31, 2000
	(UNAUDITED)	
	(IN THOUSANDS)	
Cost incurred on uncompleted contracts	$ 160,350	$ 67,477
Estimated earnings	56,329	34,475
	216,679	101,952
Less billings to date	199,683	91,301
	$ 16,996	$ 10,651
Included in the accompanying balance sheet under the captions:		
Trade accounts receivable	$ 19,622	$ 10,651
Advance payments	(2,626)	--
	$ 16,996	$ 10,651

(8) SHORT-TERM DEBT

In conjunction with the purchase of Porta-Test in January 2000, the Company issued a one-year promissory note for $1 million denominated in Canadian dollars, which accrued interest at 15% per annum. On January 24, 2001, the note was repaid along with accrued interest.

During February 2000, the Company issued a one-year promissory note for $338,000, with interest payable per annum at 10%, in conjunction with the acquisition of Modular Production Equipment, Inc. ("MPE"). In February 2001, the Company paid $206,000 as principal and interest.

(9) LONG-TERM DEBT

The consolidated borrowings of the Company were as follows:

	SEPTEMBER 30, 2001	DECEMBER 31, 2000
	(UNAUDITED)	
	(IN THOUSANDS)	
BANK DEBT		
Term loan with variable interest rate (5.99% at September 30, 2001) and quarterly payments of principal ($1,750) and interest, due March 16, 2006	$ 46,500	$ --
Revolving credit bank loans with variable interest rate (8.58% at December 31, 2000) and quarterly payment of interest, due November 30, 2001	--	14,959
Revolving credit bank loans with variable interest rate (6.23% at September 30, 2001) and quarterly payment of interest, due March 15, 2004	8,059	--
Less current installments	(7,000)	--
Long-term debt	$ 47,559	$ 14,959

On March 16, 2001, the Company entered into a new credit facility that consisted of a $50.0 million term loan, a $35.0 million U.S. revolving facility, a $10.0 million Canadian revolving facility and a $5.0 million U.K. revolving facility. The term loan matures on March 15, 2006, and each of the revolving facilities matures on March 15, 2004.

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Amounts borrowed under the term loan bear interest at a rate of 5.99% per annum as of September 30, 2001. Amounts borrowed under the revolving portion of the facility bear interest as follows:

- until April 1, 2002, at a rate equal to, at the Company's election, either (1) the London Interbank Offered Rate ("LIBOR") plus 2.25% or (2) a base rate plus 0.75%; and

- on and after April 1, 2002, at a rate based upon the ratio of funded debt to EBITDA (as defined in the credit facility) and ranging from, at the Company's election, (1) a high of LIBOR plus 2.50% to a low of LIBOR plus 1.75% or, (2) a high of a base rate plus 1.0% to a low of a base rate plus 0.25%.

NATCO will pay commitment fees of 0.50% per year until April 1, 2002 and 0.30% to 0.50% per year following 2002, depending upon the ratio of funded debt to EBITDA, on and after April 1, 2002, in each case on the undrawn portion of the facility.

The revolving credit facility is guaranteed by all the Company's domestic subsidiaries and is secured by a first priority lien on all inventory, accounts receivable and other material tangible and intangible assets. NATCO has also pledged 65% of the voting stock of its active foreign subsidiaries.

Borrowings of $50.0 million under the term loan facility were used primarily for the acquisition of Axsia. The remaining borrowings, along with additional borrowings under the revolving credit facility, were used to repay $16.5 million outstanding under a predecessor revolving credit and term loan facility.

As of September 30, 2001, the Company was in compliance with all restrictive

debt covenants. NATCO had letters of credit outstanding under the revolving credit facilities totaling $18.9 million at September 30, 2001. These letters of credit constitute contract performance and warranty collateral and expire at various dates through October 2004.

The Company maintains a working capital facility for export sales that provides for aggregate borrowings of $10.0 million, subject to borrowing base limitations, under which no borrowings were outstanding at September 30, 2001. Letters of credit outstanding under the export sales credit facility as of September 30, 2001 totaled $1.2 million. The export sales credit facility is secured by specific project inventory and receivables, and is partially guaranteed by the EXIM Bank. The export sales credit facility loans mature in July 2003.

The Company had unsecured letters of credit totaling $946,000 at September 30, 2001.

(10) INCOME TAXES

NATCO's effective income tax rate for the quarter ended September 30, 2001 was 45%, which exceeded the amount that would have resulted from applying the U.S. federal statutory tax rate, and was due primarily to non-deductible goodwill amortization expense of $1.1 million. A tax benefit associated with the exercise of employee stock options of $214,000 was allocated to equity during the nine-month period ended September 30, 2001. No stock options were exercised during the quarter ended September 30, 2001.

(11) INDUSTRY SEGMENTS

The accounting policies of the reportable segments were consistent with the policies used to prepare the Company's condensed consolidated financial statements for the respective periods presented. The Company evaluates the performance of its operating segments based on income before net interest expense, income taxes, depreciation and amortization expense, accounting changes, and nonrecurring items.

In the first quarter of 2001, the Company changed the presentation of its reportable segments by combining the traditional production equipment and services business segment with the NATCO Canada business segment, to form the North American Operations business segment. This change has been retroactively reflected in all periods presented.

In July 2000, the Company changed its presentation of certain assets acquired from Cynara in November 1998, and the related operating results, for segment reporting purposes. The majority of the assets were reclassified to the North American operations business segment from the engineered systems business segment. This change has been retroactively reflected in all periods presented.

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

	NORTH AMERICAN OPERATIONS	ENGINEERED SYSTEMS	AUTOMATION & CONTROL SYSTEMS	CORPORA ELIMINA

			(UNAUDITED, IN THOUSANDS)	
Three Months Ended September 30, 2001				
Revenues from unaffiliated customers ...	$ 37,326	$ 26,980	$ 10,216	$
Revenues from affiliates	1,302	580	858	(
Segment profit (loss)	3,103	4,314	897	(
Total assets	97,356	115,904	19,351	1
Capital expenditures	2,063	910	84	
Depreciation and amortization	1,243	823	100	
Three Months Ended September 30, 2000				
Revenues from unaffiliated customers ...	$ 33,145	$ 17,936	$ 9,163	$
Revenues from affiliates	1,617	96	1,143	(
Segment profit (loss)	2,428	3,902	1,261	(
Total assets	94,443	27,074	18,989	1
Capital expenditures	273	1,296	73	
Depreciation and amortization	761	375	141	
Nine Months Ended September 30, 2001				
Revenues from unaffiliated customers ...	$ 107,221	$ 79,350	$ 33,420	$
Revenues from affiliates	3,569	618	2,752	(
Segment profit (loss)	9,138	9,038	3,566	(
Total assets	97,356	115,904	19,351	1
Capital expenditures	3,068	2,322	340	
Depreciation and amortization	2,748	2,651	361	
Nine Months Ended September 30, 2000				
Revenues from unaffiliated customers ...	$ 86,865	$ 52,721	$ 28,448	$
Revenues from affiliates	4,809	96	3,157	(
Segment profit (loss)	5,602	10,286	3,759	(
Total assets	94,443	27,074	18,989	1
Capital expenditures	1,475	3,886	214	
Depreciation and amortization	2,307	1,017	421	

(12) DERIVATIVE ARRANGEMENTS

As of September 30, 2001, the Company was party to several foreign currency derivative arrangements as a result of the acquisition of Axsia on March 19, 2001. Specifically, the Company held foreign currency forward contracts used to mitigate risk associated with foreign currency exchange rates. In accordance with Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," the Company's policy is to record these contracts on the balance sheet at fair market value and to record any changes in fair value as charges to income in the current period. The Company had no derivative financial instruments as of January 1, 2001.

The objective of these derivative arrangements is to absorb the cash flow impact of possible exchange rate changes for Axsia projects that were required to settle in a currency other than British pounds sterling. During the quarter ended September 30, 2001, the Company terminated the majority of these contracts, which resulted in a loss of approximately $188,000, reflected as a component of general and administrative expense in the accompanying statements of operations for the quarter and nine-month period ended September 30, 2001.

The following table summarizes the Company's commitments to sell British pounds sterling under derivative forward contracts as of September 30, 2001:

LOCAL

CONTRACT TYPE	DATES	LOCAL CURRENCY	CURRENCY AMOUNT	STRIKE PRICE RANGE
Sell	10/1/2001 to 1/31/2002	Euros	620,751	1.6211 to 1.6223
Sell	12/1/2001 to 2/28/2002	US dollars	3,643,886	1.4710 to 1.4719

At September 30, 2001, the Company confirmed the fair market value of its forward contracts with the counter-party financial institutions. The Company intends to fulfill these foreign currency contract commitments that extend through February 2002 and does not currently intend to enter into new derivative arrangements as part of its risk management strategy.

(13) COMMITMENTS AND CONTINGENCIES

The Porta-Test purchase agreement, executed in January 2000, contains a provision to calculate a payment to certain former stockholders of Porta-Test Systems, Inc. for a three-year period ended January 24, 2003, based upon sales of a limited number of specified products designed by or utilizing technology that existed at the time of the acquisition. Liability under this arrangement is contingent upon attaining certain performance criteria, including gross margins and sales volumes for the specified products. If applicable, payment is required annually. In April 2001, the Company paid $226,000 under this arrangement related to the year ended January 24, 2001. Any future liabilities incurred under this arrangement will result in an increase in goodwill.

(14) POSTRETIREMENT BENEFITS

On May 1, 2001, the Company amended a postretirement benefit plan that provided medical and dental coverage to retirees of a predecessor company. Under the amended plan, retirees bear additional costs of coverage. Significant plan changes include higher deductibles, prescription coverage under a drug card program and the elimination of dental benefits. As of July 1, 2001, the Company obtained a third-party valuation of its liability under this plan arrangement, as amended, resulting in a cumulative unrecognized gain of $3.3 million. In accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," this unrecognized gain will be amortized to income over the remaining life expectancy of the plan participants.

(15) NEW ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") approved statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." This standard requires that any business combination initiated after June 30, 2001 be accounted for using the purchase method of accounting. This standard became effective on July 1, 2001. The Company does not expect this pronouncement to have a material effect on its financial condition or results of operations.

The FASB approved SFAS No. 142, "Goodwill and Other Intangible Assets" in June 2001. This pronouncement requires that intangible assets with indefinite lives, including goodwill, cease being amortized and be evaluated on an impairment basis. Intangible assets with a defined term, such as patents, would continue to be amortized over the useful life of the asset. This pronouncement becomes effective on January 1, 2002, for companies with a calendar year end. The Company had net goodwill of $80.9 million as of September 30, 2001. Goodwill amortization totaled $2.6 million for the nine months ended September 30, 2001.

The Company has not yet determined the impact that this pronouncement will have on its financial condition or results of operations. As permitted by the standard, the Company will determine and quantify its exposure under this pronouncement during fiscal 2002, after completing the required impairment testing.

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." This standard provides guidance on reporting and accounting for obligations associated with the retirement of long-lived tangible assets and the associated retirement costs. This standard is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company has not yet determined the impact that this pronouncement will have on its financial condition or results of operations.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement replaces SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and standardizes the accounting model to be used for asset dispositions and related implementation issues. This pronouncement becomes effective for financial statements issued for fiscal years beginning after December 15, 2001. The Company has not yet determined the impact that this pronouncement will have on its financial condition or results of operations.

(16) SUBSEQUENT EVENTS

During October 2001, the Company settled all remaining derivative arrangements acquired through the acquisition of Axsia on March 19, 2001, and recorded a loss of approximately $61,000 related to these settlements.

In October 2001, the Company amended its revolving debt facility to reduce the borrowing capacity in the U.S. from $35.0 million to $30.0 million, and to increase its borrowing capacity in the U.K. from $5.0 million to $10.0 million. No other material modifications were made to the agreement.

In October and November 2001, the Company reacquired 57,536 shares of its Class A common stock pursuant to a stock repurchase plan for $432,000, an average cost of $7.50 per share. The cost to reacquire these shares has been recorded as treasury stock.

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 (each a "Forward-Looking Statement"). The words "believe," "expect," "plan," "intend," "estimate," "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 regarding 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"), future uses of and requirements for financial resources (see " -- Liquidity and Capital Resources"), and anticipated backlog levels for 2001 (see " -- Liquidity and Capital Resources"). The Company's expectations about its business outlook, customer spending, oil and gas prices and the business environment for the Company and the industry in general are only its expectations regarding these matters. No assurance can be given that actual

results may not differ materially from those in the Forward-Looking Statements herein 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, world economic conditions, the level of drilling activity, the legislative environment in the United States and other countries, policies of the Organization of Petroleum Exporting Countries, conflict in major petroleum producing or consuming regions, the development of technology which could lower overall finding and development costs, weather patterns and the overall condition of capital and equity markets for countries in which the Company operates.

The following discussion should be read in conjunction with the financial statements, related notes and other financial information appearing elsewhere in this Form 10-Q. Readers are also urged to carefully review and consider the various disclosures advising interested parties of the factors that affect the Company, including without limitation, the disclosures made under the caption "Risk Factors" and the other factors and risks discussed in the Company's Registration Statement on Form S-1/A and subsequent reports filed with the Securities and Exchange Commission. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any Forward-Looking Statement to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any Forward-Looking Statement is based.

OVERVIEW

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

NATCO's operations are organized into three separate business segments: North American operations, a segment which primarily provides standardized components, replacement parts and used components and equipment servicing; engineered systems, a segment which primarily provides customized, large scale integrated oil and gas production systems; and automation and control systems, a segment which provides control panels and systems that monitor and control oil and gas production.

NATCO recognizes revenues from significant contracts (contracts greater than $250,000 and longer than four months in duration) and all automation and control systems contracts and orders on the percentage of completion method. The Company records revenues and profits on other sales as shipments are made. Earned revenue is based on the percentage that costs incurred to date bear to total estimated costs. If estimated total costs on any contract or work-in-process indicate a loss, the Company recognizes the entire loss immediately. NATCO generally recognizes revenue and earnings to which the percentage of completion method applies over a period of two to six quarters. Customers typically retain an interest in uncompleted projects.

ACQUISITIONS

On March 19, 2001, the Company acquired all the outstanding share capital of Axsia Group Limited ("Axsia"), a privately held company based in the United Kingdom, for approximately $42.8 million, net of cash acquired. Axsia specializes in the design and supply of water reinjection systems for oil and gas fields, oily water treatment, oil separation, hydrogen production and other process equipment systems. This acquisition was financed with borrowings under NATCO's term loan facility, and was accounted for using the purchase method of accounting. Results of operations for Axsia have been included in NATCO's condensed consolidated financial statements since the date of acquisition. The excess of the purchase price over the fair values of the net assets acquired is being amortized over a twenty-year period. Goodwill and accumulated amortization related to the Axsia acquisition were $48.4 million and $1.3 million,

respectively, at September 30, 2001. The purchase price allocation has not yet been finalized, but NATCO's management does not believe that the final purchase price allocation will differ materially from that as of September 30, 2001.

INDUSTRY AND BUSINESS ENVIRONMENT

NATCO is a leading provider of equipment, systems and services used in the production of crude oil and natural gas, primarily at the wellhead, to separate oil and gas within a production stream and to remove contaminants. The Company's products and services are used in onshore and offshore fields in most major oil and gas producing regions of the world. Separation and decontamination of a production stream is needed at almost every producing well in order to meet the specifications of transporters and end users.

One indicator of capital spending in the oil and gas industry is commodity prices. Energy prices were low in early 1999 but began to rise steadily mid-year as production cuts by OPEC and other oil producing countries reduced excess inventory levels. Energy prices remained high until the spring of 2000 when these same producers elected to increase production to bring energy prices down to more sustainable levels. Thus, the trend in crude oil prices in recent years has been an increase, as evidenced by the average spot price of West Texas Intermediate crude which was $30 per barrel for fiscal year 2000, compared to $19 per barrel for fiscal year 1999 and only $14 per barrel for fiscal year 1998. In early 2001, energy prices declined modestly to an average of approximately $27 per barrel, until September 2001, when prices dropped to $22 per barrel. This decrease in hydrocarbon prices during September 2001 was the result of a general slow-down in the U.S. economy, accelerated by significant terrorist acts in the United States on September 11, 2001. The long-term effect of this slow-down on hydrocarbon prices cannot be determined at this time. However, prices remained constant at approximately $22 per barrel throughout October 2001. The average natural gas price per MMBtu using the NYMEX Henry Hub price was $2 per MMBtu for fiscal years 1998 and 1999, and $4 per MMBtu for fiscal year 2000. At September 30, 2001, the spot prices of West Texas Intermediate crude and Henry Hub natural gas were approximately $22 per barrel of oil and $2 per MMBtu of natural gas, respectively.

Another indicator of capital spending in the oil and gas industry is the number of operating rigs in the U.S. and Canada, which has increased from 1,370 at September 30, 2000 to 1,472 at September 30, 2001, as published by Baker Hughes. This overall increase in rig count when comparing year to year may decline as the rig count in the United States has begun to trend downward in recent months.

The increase in oil prices in recent years has had a positive effect on the Company's overall sales for 2000 and 2001. Current price levels and recent rig count improvements have contributed to improved overall industry conditions and should also cause NATCO's customers to maintain their current level of exploration and development efforts. Although energy price levels and rig count increases are indicators that additional oil and gas production may occur throughout 2001, there can be no assurance that overall production will increase, that an increase in production trends will continue through 2001 or that such an increase in production would result in an increase in revenues for the Company.

The following discussion of NATCO's historical results of operations and financial condition should be read in conjunction with the Company's condensed consolidated financial statements and notes thereto.

RESULTS OF OPERATIONS

In the first quarter of 2001, the Company changed the presentation of its reportable segments by combining the traditional production equipment and services business segment with the NATCO Canada business segment, to form the North American operations business segment. This change has been reflected retroactively in all periods presented.

In July 2000, the Company changed its presentation of certain assets that were acquired from The Cynara Company ("Cynara") in November 1998, and the related operating results, for segment reporting purposes. The majority of the assets were reclassified to the North American operations business segment from the engineered systems business segment. This change has been retroactively reflected in all periods presented.

Three Months Ended September 30, 2001 Compared to Three Months Ended September 30, 2000

Revenues. Revenues of $74.5 million for the three months ended September 30, 2001 increased $14.3 million, or 24%, from $60.2 million for the three months ended September 30, 2000. The following table summarizes revenues by business segment for the quarters ended September 30, 2001 and 2000, respectively.

	THREE MONTHS ENDED SEPTEMBER 30, 2001	THREE MONTHS ENDED SEPTEMBER 30, 2000	CHANGE	PERCENTAGE CHANGE
	(UNAUDITED) (IN THOUSANDS, EXCEPT PERCENTAGE CHANGE)			
North American Operations	$ 38,628	$ 34,762	$ 3,866	11%
Engineered Systems	27,560	18,032	9,528	53%
Automation and Control Systems	11,074	10,306	768	7%
Corporate and Other	(2,740)	(2,856)	116	4%
Total	$ 74,522	$ 60,244	$ 14,278	24%

North American operations revenues increased $3.9 million, or 11%, for the quarter ended September 30, 2001, as compared to the quarter ended September 30, 2000, due to an increase in oilfield activity that resulted from improved gas prices in recent years. Throughout fiscal 2000 and into fiscal 2001, production activity increased and operating rig count rose in the United States, resulting in higher demand for the Company's traditional production process equipment, finished goods and domestic parts and services. These increases in equipment sales were partially offset by a decline in revenues in Canada, as several large projects in fiscal 2000 were completed. In addition, recovery in the oil and gas industry for Canada has stalled, as Canadian rig count declined from 355 at September 30, 2000 to 304 at September 30, 2001. Affiliated revenues for this business segment were $1.3 million for the quarter ended September 30, 2001, as compared to $1.6 million for the quarter ended September 30, 2000.

Revenues for the engineered systems business segment increased $9.5 million, or 53%, for the quarter ended September 30, 2001, as compared to the quarter ended September 30, 2000. This increase was primarily due to the acquisition of Axsia in March 2001, which provided revenues of $17.9 million for three months

ended September 30, 2001. This increase was partially offset due to a decline in revenues recognized under long-term engineering projects, including the Carigali-Triton Operating Company SDN BHD ("CTOC") contract, which provided $1.1 million of revenue for the quarter ended September 30, 2001, as compared to $11.6 million for the quarter ended September 30, 2000. Excluding the impact of the Axsia acquisition and the CTOC project, revenues for this business segment increased $2.2 million for the quarter ended September 30, 2001, compared to the respective period in 2000, primarily due to an increase in export projects. Engineered systems revenues of $27.6 million for the quarter ended September 30, 2001 included approximately $580,000 of affiliated revenues, as compared to $96,000 of affiliated revenues for the quarter ended September 30, 2000.

Revenues for the automation and control systems business segment increased $768,000, or 7%, for the quarter ended September 30, 2001, as compared to the quarter ended September 30, 2000. This increase in revenues was the result of higher demand for the Company's products and an increase in field services for both time and materials and quote job projects. Affiliated revenues of approximately $858,000 and $1.1 million were included in the results for the quarters ended September 30, 2001 and 2000, respectively.

The change in revenues for corporate and other represents the elimination of revenues of affiliates as discussed above.

Gross Profit. Gross profit for the quarter ended September 30, 2001 increased $4.4 million, or 27%, to $20.6 million, compared to $16.3 million for the quarter ended September 30, 2000. As a percentage of revenue, gross margins increased from 27% for the quarter ended September 30, 2000 to 28% for the quarter ended September 30, 2001. The following table summarizes gross profit by business segment for the quarters then ended:

	THREE MONTHS ENDED SEPTEMBER 30, 2001	THREE MONTHS ENDED SEPTEMBER 30, 2000	CHANGE	PERCENTAGE CHANGE
	(UNAUDITED) (IN THOUSANDS, EXCEPT PERCENTAGE CHANGE)			
North American Operations	$ 9,019	$ 7,531	$ 1,488	20%
Engineered Systems	9,543	6,476	3,067	47%
Automation and Control Systems	2,055	2,258	(203)	(9)%
Total	$ 20,617	$ 16,265	$ 4,352	27%

Gross profit for the North American operations business segment increased $1.5 million, or 20%, for the quarter ended September 30, 2001, as compared to the respective period in 2000. This increase in margin was due primarily to an 11% increase in revenues. In addition, the Company's CO2 field service operations and traditional production equipment provided more favorable margins in fiscal 2001 as compared to fiscal 2000. As a percentage of revenue, gross margins were 23% and 22% for the quarters ended September 30, 2001 and 2000, respectively.

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Gross profit for the engineered systems business segment for the quarter ended September 30, 2001 increased $3.1 million, or 47%, primarily due to a $7.1 million contribution from Axsia, which was acquired in March 2001, offset by a decline in contribution from large higher margin engineered systems projects, including CTOC. Excluding the impact of Axsia and the CTOC project, gross margin

for the engineered systems business segment increased approximately $928,000 due to an increase in export projects. Gross margin for engineered systems represented 35% and 36% of the segment's revenues for the quarters ended September 30, 2001 and 2000, respectively.

Gross profit for the automation and control systems business segment decreased $203,000, or 9%, for the quarter ended September 30, 2001, as compared to the quarter ended September 30, 2000. This decrease was related to a shift in sales mix from higher margin quote jobs to time and materials jobs. However, an increase in time and materials jobs resulted in an overall 7% increase in revenues for the segment. Gross margin as a percentage of revenue for the quarters ended September 30, 2001 and 2000, was 19% and 22%, respectively.

Selling, General and Administrative Expense. Selling, general and administrative expense of $13.8 million increased $4.1 million, or 42%, for the quarter ended September 30, 2001, as compared to the quarter ended September 30, 2000. This increase was largely related to the following factors: (1) the results of operations for Axsia which was acquired on March 19, 2001, (2) start-up costs related to the Singapore office opened in March 2001 to increase marketing efforts in Southeast Asia, (3) increased spending for technology and product development, and (4) higher employee medical costs.

Depreciation and Amortization Expense. Depreciation and amortization expense of $2.2 million for the quarter ended September 30, 2001, increased $869,000, or 66%, compared to $1.3 million for the quarter ended September 30, 2000. Depreciation expense of $1.0 million for the quarter ended September 30, 2001, increased $269,000, or 36%, as compared to the respective period for 2000. This increase was primarily due to the acquisition of Axsia in March 2001 and the addition of constructed assets placed in service in the fourth quarter of fiscal 2000. Amortization expense of $1.2 million for the quarter ended September 30, 2001, increased $600,000, or 107%, as compared to $563,000 for the quarter ended September 30, 2000. This increase was primarily due to amortization of goodwill associated with the Axsia acquisition.

Interest Expense. Interest expense was $1.5 million for the quarter ended September 30, 2001, as compared to $355,000 for the respective period in 2000. This increase of $1.1 million, or 310%, was due primarily to an increase in borrowings under the Company's term loan and revolving credit facilities. The Company borrowed $50.0 million against its new term loan facility to acquire Axsia in March 2001 and retire borrowings under its predecessor revolving credit facility. Outstanding debt at September 30, 2001 under the Company's credit facilities totaled $54.6 million, as compared to $11.2 million at September 30, 2000.

Interest Cost on Postretirement Benefit Liability. Interest cost on postretirement benefit liability decreased $200,000, or 62%, from $322,000 for the quarter ended September 30, 2000 to $122,000 for the quarter ended September 30, 2001. This decrease in interest cost was due to an amendment of the plan that provides medical and dental coverage to retirees of a predecessor company. Under the amended plan, retirees will bear more cost for coverages, thereby reducing the Company's projected liability and the related interest cost.

Provision for Income Taxes. Income tax expense of $1.5 million for the quarter ended September 30, 2001, decreased $515,000 from $2.0 million for the quarter ended September 30, 2000. The primary reason for this decrease in tax expense was a decrease in income before income taxes, which was $3.2 million for the quarter ended September 30, 2001, as compared to $4.6 million for the respective period in 2000. The effective tax rate increased from 43% in 2000 to 45% in 2001, due to the impact of non-deductible goodwill amortization expense.

Nine Months Ended September 30, 2001 Compared to Nine Months Ended September 30, 2000

Revenues. Revenues of $220.0 million for the nine months ended September 30, 2001 increased $52.0 million, or 31%, from $168.0 million for the nine months ended September 30, 2000. The following table summarizes revenues by business segment for the nine-month periods ended September 30, 2001 and 2000, respectively.

	NINE MONTHS ENDED SEPTEMBER 30, 2001	NINE MONTHS ENDED SEPTEMBER 30, 2000	CHANGE	PERCENTAGE CHANGE
	(UNAUDITED) (IN THOUSANDS, EXCEPT PERCENTAGE CHANGE)			
North American Operations	$ 110,790	$ 91,674	$ 19,116	21%
Engineered Systems	79,968	52,817	27,151	51%
Automation and Control Systems	36,172	31,605	4,567	14%
Corporate and Other	(6,939)	(8,062)	1,123	14%
Total	$ 219,991	$ 168,034	$ 51,957	31%

North American operations revenues increased $19.1 million, or 21%, for the nine months ended September 30, 2001, as compared to the nine months ended September 30, 2000, due to an increase in oilfield activity that resulted from improved gas prices in fiscal 2000. Throughout fiscal 2000 and into fiscal 2001, production activity increased and rig count rose in the United States, resulting in higher demand for the Company's traditional production process equipment, finished goods, domestic parts and services, export parts and services and CO2 membrane technology products. These increases in equipment sales were offset slightly by a decline in Canadian operations, due to a slower recovery in crude oil development in Canada and a delay in activity for several key customers. Affiliated revenues for this business segment were $3.6 million for the nine months ended September 30, 2001, as compared to $4.8 million for the nine months ended September 30, 2000.

Revenues for the engineered systems business segment increased $27.2 million, or 51%, for the nine months ended September 30, 2001, as compared to the nine months ended September 30, 2000. This increase was primarily due to the acquisition of Axsia in March 2001, which provided revenues of $48.9 million since the date of acquisition. This increase was partially offset by a decline in revenues recognized under long-term engineering projects, including the CTOC contract, which provided $34.8 million of revenue for the nine months ended September 30, 2000 as compared to $10.0 million for the nine months ended September 30, 2001. Excluding the impact of Axsia and the CTOC project, revenues for this business segment increased $3.1 million for the nine months ended September 30, 2001 as compared to the respective period in 2000, due primarily to an increase in export projects. Engineered systems revenues of $80.0 million for the nine months ended September 30, 2001 included approximately $618,000 of affiliated revenues, as compared to $96,000 of affiliated revenues for the nine months ended September 30, 2000.

Revenues for the automation and control systems business segment increased $4.6 million, or 14%, for the nine months ended September 30, 2001, as compared to the respective period in 2000. This increase in revenues was the result of higher demand for the Company's electrical and instrumentation products and an

increase in field services for both time and materials and quote job projects. Affiliated revenues of approximately $2.8 million and $3.2 million were included in the results for the nine-month periods ended September 30, 2001 and 2000, respectively.

The change in revenues for corporate and other represents the elimination of revenues of affiliates as discussed above.

Gross Profit. Gross profit for the nine months ended September 30, 2001 increased $11.4 million, or 25%, to $56.9 million, compared to $45.6 million for the nine months ended September 30, 2000. As a percentage of revenue, gross margins declined from 27% for the nine months ended September 30, 2000 to 26% for the nine months ended September 30, 2001. The following table summarizes gross profit by business segment for the periods then ended:

	NINE MONTHS ENDED SEPTEMBER 30,			
	2001	2000	CHANGE	PERCENTAGE CHANGE
	(UNAUDITED) (IN THOUSANDS, EXCEPT PERCENTAGE CHANGE)			
North American Operations.........	$ 26,555	$20,869	$5,686	27%
Engineered Systems................	23,297	17,866	5,431	30%
Automation and Control Systems....	7,063	6,826	237	3%
Total...................	$ 56,915	$45,561	$11,354	25%

Gross profit for the North American operations business segment increased $5.7 million, or 27%, for the nine months ended September 30, 2001, as compared to the respective period in 2000. This increase in margin was due primarily to a 21% increase in revenues. In addition, the Company's CO_2 field service operations and traditional production equipment provided more favorable margins in fiscal 2001 as compared to fiscal 2000. As a percentage of revenue, gross margins were 24% and 23% for the nine-month periods ended September 30, 2001 and 2000, respectively.

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Gross profit for the engineered systems business segment for the nine months ended September 30, 2001 increased approximately $5.4 million, or 30%, primarily due to a $15.1 million contribution from Axsia, offset by a decline in large engineered systems projects such as the CTOC project which provided gross margin of $14.5 million for the nine months ended September 30, 2000, as compared to $3.9 million for the nine months ended September 30, 2001. Excluding the impact of Axsia and the CTOC project, gross margin for the engineered systems business segment increased approximately $964,000 in 2001 as compared to 2000, and related primarily to export projects. Gross margin represented 29% and 34% of the segment's revenues for the nine-month periods ended September 30, 2001 and 2000, respectively. The decline in gross margin as a percentage of revenues was consistent with a decline in results from large, high margin projects such as CTOC.

Gross profit for the automation and control systems business segment increased $237,000, or 3%, for the nine months ended September 30, 2001, as compared to the nine months ended September 30, 2000. This increase was directly

related to a 14% increase in revenues partially offset by a shift in sales mix from higher margin quote jobs to time and materials jobs. Gross margin as a percentage of revenue for the nine-month periods ended September 30, 2001 and 2000, was 20% and 22%, respectively.

Selling, General and Administrative Expense. Selling, general and administrative expense of $38.4 million increased $9.5 million, or 33%, for the nine months ended September 30, 2001, as compared to the nine months ended September 30, 2000. This increase was largely related to the following factors: (1) the results of operations for Axsia which was acquired on March 19, 2001, (2) start-up costs related to the Singapore office opened in March 2001 to increase marketing efforts in Southeast Asia, (3) increased spending for technology and product development, and (4) higher employee medical costs.

Depreciation and Amortization Expense. Depreciation and amortization expense of $6.0 million for the nine months ended September 30, 2001, increased $2.1 million, or 55%, compared to $3.9 million for the nine months ended September 30, 2000. Depreciation expense of $3.0 million for the nine months ended September 30, 2001, increased $634,000, or 26%, as compared to the respective period for 2000. This increase was primarily due to the acquisition of Axsia in March 2001 and the addition of constructed assets placed in service in the fourth quarter of fiscal 2000. Amortization expense of $2.9 million for the nine months ended September 30, 2001, increased $1.5 million, or 102%, as compared to $1.5 million for the nine months ended September 30, 2000. This increase was primarily due to amortization of goodwill associated with the Axsia, Porta-Test International, Inc. ("Porta-Test"), Modular Production Equipment, Inc. ("MPE") and Engineered Specialties, Inc. ("ESI") acquisitions completed in March 2001, January 2000, February 2000 and April 2000, respectively. Also, amortization expense increased due to an increase in goodwill related to the acquisition of Cynara in November 1998. Pursuant to the Cynara purchase agreement, NATCO issued 8,520 shares and 418,145 shares of the Company's Class B common stock during February 2001 and June 2000, respectively, to Cynara's former shareholders based upon the achievement of certain performance criteria, and the cost of such shares was charged to goodwill.

Unusual Charges. Unusual charges for the nine months ended September 30, 2001 were $1.6 million, compared to $1.5 million for the nine months ended September 30, 2000. Costs incurred in 2001 include approximately $920,000 related to certain restructuring costs to streamline activities and consolidate offices in connection with the Company's acquisition of Axsia in March 2001, and an additional $680,000 related to the Company's decision to withdraw a public debt offering. Costs incurred for the nine months ended September 30, 2000 were primarily for compensation expense associated with the employment agreement of an executive officer. The terms of the agreement entitled the officer to a sum equal to an outstanding note and accrued interest, totaling $1.2 million at December 31, 1999, upon the sale of the Company's Class A common stock in an initial public offering. NATCO completed its initial public offering on January 27, 2000, and, per the agreement, the Company recorded compensation expense for the amount of the note and accrued interest, including related payroll burdens, totaling $1.3 million. In addition, the Company recorded relocation expenses totaling $208,000 associated with the consolidation of an existing Company facility with a facility that was acquired with the acquisition of Porta-Test.

Interest Expense. Interest expense was $3.7 million for the nine months ended September 30, 2001, as compared to $1.1 million for the respective period in 2000. This 232% increase in interest expense was due primarily to an increase in long-term debt under the new term loan and revolving credit facilities from $11.2 million at September 30, 2000 to $54.6 million at September 30, 2001. The Company borrowed $50.0 million against its new term loan facility to acquire Axsia and to retire borrowings under its predecessor revolving credit facility.

Interest Cost on Postretirement Benefit Liability. Interest cost on

postretirement benefit liability decreased $199,000, or 21%, from $965,000 for the nine months ended September 30, 2000 to $766,000 for the nine months ended September 30, 2001. This decrease in interest cost was due to an amendment of the plan that provides medical and dental coverage to retirees of a predecessor company. Under the amended plan, retirees will bear more cost for coverages, thereby reducing the Company's projected liability and the related interest cost.

Provision for Income Taxes. Income tax expense of $3.0 million for the nine months ended September 30, 2001, decreased $995,000 from $4.0 million for the nine months ended September 30, 2000. The primary reason for this decrease in tax expense was a decrease in income before income taxes, which was $6.6 million for the nine months ended September 30, 2001, as compared to $9.3 million for the respective period in 2000. This decline in tax expense was partially offset by an increase in the effective tax rate from 43% in 2000 to 45% in 2001, due primarily to non-deductible goodwill amortization expense.

LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2001, the Company had cash and working capital of $1.9 million and $32.2 million, respectively, as compared to cash and working capital of $1.0 million and $49.1 million, respectively, at December 31, 2000.

Net cash provided by operating activities for the nine months ended September 30, 2001 was $15.0 million, compared to net cash used in operations of $4.2 million for the nine months ended September 30, 2000. Factors that contributed to the increase in cash provided by operating activities during 2001 included an increase in customer advance payments on long-term projects and a decline in trade receivables due to collection of progress billings at Axsia.

Net cash used in investing activities for the nine months ended September 30, 2001 was $54.0 million, of which $48.3 was used to acquire Axsia and $6.4 million was used for capital expenditures. For the nine months ended September 30, 2000, $22.0 million was used for investing activities primarily to acquire Porta-Test, MPE and ESI, and for capital expenditures.

Net cash provided by financing activities for the nine months ended September 30, 2001 was $40.3 million, as compared to net cash provided by financing activities for the nine months ended September 30, 2000 of $25.8 million. The primary source of funds for financing activities for the nine months ended September 30, 2001 was net borrowings of $46.5 million under the term loan facility, partially offset by net repayments of $6.6 million under the Company's revolving credit facility. The primary source of funds for financing activities during the nine months ended September 30, 2000 was the issuance of the Company's Class A common stock through an initial public offering and the exercise of an over-allotment option by NATCO's underwriters, which provided $37.7 million and $10.5 million, respectively. These proceeds were used primarily to retire $27.9 million of outstanding debt under a term loan arrangement, to repay $3.0 million borrowed under the revolving credit agreement for the purchase of Porta-Test, and to repay $2.9 million of debt assumed in the acquisitions of Porta-Test and MPE.

On March 16, 2001, the Company entered into a new credit facility that consisted of a $50.0 million term loan, a $35.0 million U.S. revolving facility, a $10.0 million Canadian revolving facility and a $5.0 million U.K. revolving facility. The term loan matures on March 15, 2006, and each of the revolving facilities matures on March 15, 2004.

Amounts borrowed under the term loan facility bear interest at 5.99% per annum as of September 30, 2001. Amounts borrowed under the revolving facilities bear interest as follows:

- until April 1, 2002, at a rate equal to, at the Company's election, either (1) the London Interbank Offered rate ("LIBOR") plus 2.25% or (2) a base rate plus 0.75%; and
- on and after April 1, 2002, at a rate based upon the ratio of funded debt to EBITDA (as defined in the credit facility) and ranging from, at the Company's election, (1) a high of LIBOR plus 2.50% to a low of LIBOR plus 1.75% or, (2) a high of a base rate plus 1.0% to a low of a base rate plus 0.25%.

As of September 30, 2001, the weighted average interest rate of NATCO's borrowings under its revolving credit facility was 6.23%.

NATCO will pay commitment fees of 0.50% per year until April 1, 2002 and 0.30% to 0.50% per year following 2002, depending upon the ratio of funded debt to EBITDA, on and after April 1, 2002, in each case on the undrawn portion of the facility.

The revolving credit facility is guaranteed by all the Company's domestic subsidiaries and is secured by a first priority lien on all inventory, accounts receivable and other material tangible and intangible assets. NATCO has also pledged 65% of the voting stock of its active foreign subsidiaries.

On March 19, 2001, NATCO borrowed the entire $50.0 million available under the term loan portion of this new facility and used $45.0 million to purchase all the outstanding share capital of Axsia. The remaining borrowings of $5.0 million, along with additional borrowings under the revolving credit facility, were used to repay $16.5 outstanding under a predecessor revolving credit and term loan facility. As of September 30, 2001, the Company had borrowings of $46.5 million outstanding under the term loan facility.

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As of September 30, 2001, the Company was in compliance with all restrictive debt covenants. NATCO had letters of credit outstanding under the revolving credit facilities totaling $18.9 million at September 30, 2001. These letters of credit constitute contract performance and warranty collateral and expire at various dates through October 2004.

The Company maintains a working capital facility for export sales that provides for aggregate borrowings of $10.0 million, subject to borrowing base limitations, under which no borrowings were outstanding at September 30, 2001. Letters of credit outstanding under this facility at September 30, 2001 totaled $1.2 million. The export sales credit facility is secured by specific project inventory and receivables, and is partially guaranteed by the EXIM Bank. The export sales credit facility loans mature in July 2003.

The Company has unsecured letters of credit outstanding at September 30, 2001 of $946,000.

The Company's sales backlog at September 30, 2001 was $95.7 million and included backlog of $13.6 million related to Axsia, which was acquired on March 19, 2001. In addition, backlog at September 30, 2001 included $2.4 million related to the CTOC project, which contributed $23.5 million to backlog at September 30, 2000. Excluding the impact of the Axsia acquisition and the CTOC project, backlog at September 30, 2001 was $79.7 million as compared to $23.5

million at September 30, 2000. This increase in backlog was partially due to bookings of production equipment systems for large offshore projects in West Africa, Brazil and the Gulf of Mexico. Management expects to continue to build backlog in modest increments throughout fiscal 2001, with the potential for additional increases due to planned Southeast Asian CO2 separation projects for 2002.

During September 2001, NATCO repurchased 39,700 shares of its Class A common stock pursuant to a stock repurchase plan approved by the Company's board of directors in fiscal 2000.

At September 30, 2001, borrowing base limitations reduced the Company's available borrowing capacity under the term loan and revolving credit agreement and export sales credit agreement to $42.7 million and $1.7 million, respectively. However, NATCO's management believes that the Company's operating cash flow, supported by its borrowing capacity, will be adequate to fund operations throughout 2001. Should the Company decide to pursue additional acquisition opportunities during the remainder of 2001, the determination of the Company's ability to finance these acquisitions will be a critical element of the analysis of the opportunities.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") approved statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." This standard requires that any business combination initiated after June 30, 2001 be accounted for using the purchase method of accounting. This standard became effective on July 1, 2001. The Company does not expect this pronouncement to have a material effect on its financial condition or results of operations.

The FASB approved SFAS No. 142, "Goodwill and Other Intangible Assets" in June 2001. This pronouncement requires that intangible assets with indefinite lives, including goodwill, cease being amortized and be evaluated on an impairment basis. Intangible assets with a defined term, such as patents, would continue to be amortized over the useful life of the asset. This pronouncement becomes effective on January 1, 2002, for companies with a calendar year end. The Company had net goodwill of $80.9 million as of September 30, 2001. Goodwill amortization totaled $2.6 million for the nine months ended September 30, 2001. The Company has not yet determined the impact that this pronouncement will have on its financial condition or results of operations. As permitted by the standard, the Company will determine and quantify its exposure under this pronouncement during fiscal 2002, after completing the required impairment testing.

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." This standard provides guidance on reporting and accounting for obligations associated with the retirement of long-lived tangible assets and the associated retirement costs. This standard is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company has not yet determined the impact that this pronouncement will have on its financial condition or results of operations.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." This statement replaces SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and standardizes the accounting model to be used for asset dispositions and related implementation issues. This pronouncement becomes effective for financial statements issued for fiscal years beginning after December 15, 2001. The Company has not yet determined the impact that this pronouncement will have on its financial condition or results of operations.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's operations are conducted around the world in a number of different countries. Accordingly, future revenues and earnings are exposed to changes in foreign currency exchange rates when transactions are denominated in currencies other than the Company's functional currencies, the primary currencies in which the Company conducts its business in various jurisdictions. The majority of the Company's foreign currency transactions are denominated in the Canadian dollar and British pounds sterling, which are the functional currencies of NATCO Canada and Axsia, respectively. At NATCO Canada, contracts are generally denominated and settled in the functional currency, thereby mitigating risks associated with currency fluctuations. At Axsia, contracts may be denominated and settled in currencies other than its functional currency. At the date of acquisition, Axsia had entered into certain currency forward contract arrangements whereby Axsia purchased foreign currencies at a specified strike price in order to hedge exposure to currency fluctuations on contracts denominated in currencies other than the functional currency. NATCO assumed these contracts upon the purchase of Axsia in March 2001. The Company's policy is to record these contracts and their underlying balance sheet accounts at fair market value and to record any changes in fair value as charges to income in the current period. The nature of these derivative arrangements is to offset any negative impact of changes in foreign currency exchange rates, as any gain or loss recorded on the underlying asset or liability would be offset by a contrasting gain or loss on the derivative asset or liability. As such, these contracts mitigate exchange rate exposure related to these transactions. At September 30, 2001, the Company obtained the fair market value of the forward contracts from the counter-party financial institutions (See Note 12, "Derivative Arrangements)". The Company intends to fulfill these contractual commitments. NATCO does not intend to enter into new derivative arrangements as part of its risk management strategy.

The Company's financial instruments are subject to change in interest rates, including its revolving credit and term loan facility and its working capital facility for export sales. At September 30, 2001, the Company had borrowings of $46.5 million outstanding under the term loan portion of the revolving credit and term loan facility, at an interest rate of 5.99%. Borrowings, which bear interest at floating rates, outstanding under the revolving credit agreement at September 30, 2001, totaled $8.1 million. As of September 30, 2001, the weighted average interest rate of the Company's borrowings under its revolving credit facility was 6.23%. No borrowings were outstanding under the working capital facility for export sales at September 30, 2001.

Based on past market movements and possible near-term market movements, the Company's management does not believe that potential near-term losses in future earnings, fair values or cash flows from changes in interest rates are likely to be material. Assuming the Company's current level of borrowings, a 100 basis point increase in interest rates under its variable interest rate facilities would decrease the Company's current quarter net income and cash flow from operations by less than $100,000. In the event of an adverse change in interest rates, the Company could take action to mitigate its exposure. However, due to the uncertainty of actions that could be taken and the possible effects, this calculation assumes no such actions. Furthermore, this calculation does not consider the effects of a possible change in the level of overall economic activity that could exist in such an environment.

PART II

ITEM 1. Legal Proceedings

The Company is a party to various routine legal proceedings that are incidental to its business activities. The Company insures against the risk of these proceedings to the extent deemed prudent by its management, but the Company offers 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 its business activities. The Company's management does not, however, believe the pending legal proceedings, individually or taken together, will have a material adverse effect on the Company's results of operations or financial condition.

ITEM 2. Changes in Securities and Use of Proceeds

None.

ITEM 3. Defaults upon Senior Securities

None.

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

None.

ITEM 5. Other Information

None.

ITEM 6. Exhibits and Reports on Form 8-K

(a) See Index of Exhibits for a list of those exhibits filed herewith, which index includes and identifies management contracts or compensatory plans or arrangements required to be filed as exhibits to this Form 10-Q by Item 601(10)(iii) of Regulation S-K.

(b) Reports on Form 8-K. No reports were filed on Form 8-K for the quarter ended September 30, 2001.

(c) Index of Exhibits

EXHIBIT NO.	DESCRIPTION
2.1	-- Amended and Restated Agreement and Plan of Merger dated November 17, 1998 but effective March 26, 1998 among the Company, NATCO Acquisition Company, National Tank Company and The Cynara Company (incorporated by reference to Exhibit 2.1 of the Company's Registration Statement No. 333-48851 on Form S-1).
2.2	-- Stock Purchase Agreement dated as of May 7, 1997 among Enterra Petroleum Equipment Group, Inc., National Tank Company and Weatherford Enterra, Inc. (incorporated by reference to Exhibit 2.2 of the Company's Registration Statement No. 333-48851 on Form S-1).

2.3	-- Stock Purchase Agreement dated as of January 25, 2001 but effective March 16, 2001 between the Company and Axsia Group Limited (incorporated by reference to Exhibit 2.3 of the Company's Annual Report on Form 10-K for the period ended December 31, 2000).
2.4	-- Amendment of Stock Purchase Agreement dated as of March 16, 2001 between the Company and Axsia Group Limited (incorporated by reference to Exhibit 2.4 of the Company's Annual Report on Form 10-K for the period ended December 31, 2000).
3.1	-- Restated Certificate of Incorporation of the Company, as amended by Certificate of Amendment dated November 18, 1998 and Certificate of Amendment dated November 29, 1999 (incorporated by reference to Exhibit 3.1 of the Company's Registration Statement No. 333-48851 on Form S-1).

EXHIBIT NO.	DESCRIPTION
3.2	-- Certificate of Designations of Series A Junior Participating Preferred Stock (incorporated by reference to Exhibit 3.2 of the Company's Registration Statement No. 333-48851 on Form S-1).
3.3	-- Amended and Restated Bylaws of the Company, as amended (incorporated by reference to Exhibit 3.3 of the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2000).
4.1	-- Specimen Common Stock certificate (incorporated by reference to Exhibit 4.1 of the Company's Registration Statement No. 333-48851 on Form S-1).
4.2	-- Rights Agreement dated as of May 15, 1998 by and among the Company and ChaseMellon Shareholder Services, L.L.C., as Rights Agent (incorporated by reference to Exhibit 4.2 of the Company's Registration Statement No. 333-48851 on Form S-1).
4.3	-- Registration Rights Agreement dated as of November 18, 1998 among the Company and Capricorn Investors, L.P. and Capricorn Investors II, L.P. (incorporated by reference to Exhibit 4.3 of the Company's Registration Statement No. 333-48851 on Form S-1).
4.4	-- Registration Rights Agreement dated as of November 18, 1998 among the Company and the former stockholders of The Cynara Company (incorporated by reference to Exhibit 4.4 of the Company's Registration Statement No. 333-48851 on Form S-1).
10.1**	-- Directors Compensation Plan (incorporated by reference to Exhibit 10.1 of the Company's Registration Statement No. 333-48851 on Form S-1).
10.2**	-- Form of Nonemployee Director's Option Agreement (incorporated by reference to Exhibit 10.2 of the Company's Registration

Statement No. 333-48851 on Form S-1).

10.3** -- Employee Stock Incentive Plan (incorporated by reference to Exhibit 10.3 of the Company's Registration Statement No. 333-48851 on Form S-1).

10.4** -- Form of Nonstatutory Stock Option Agreement (incorporated by reference to Exhibit 10.24 to the Company's Registration Statement No. 333-48851 on Form S-1).

10.5 -- Commitment Letter dated November 24, 1994 from The Bank of Nova Scotia to NATCO Canada, Ltd. (incorporated by reference to Exhibit 10.5 of the Company's Registration Statement No. 333-48851 on Form S-1).

10.6 -- Service and Reimbursement Agreement dated as of July 1, 1997 between the Company and Capricorn Management, G.P. (incorporated by reference to Exhibit 10.6 of the Company's Registration Statement No. 333-48851 on Form S-1).

10.7** -- Form of Indemnification Agreement between the Company and its officers and directors (incorporated by reference to Exhibit 10.0 of the Company's Registration Statement No. 333-48851 on Form S-1).

10.8 -- Securities Exchange Agreement dated as of March 5, 1998 by and among the Company, Capricorn Investors, L.P. and Capricorn Investors II, L.P. (incorporated by reference to Exhibit 10.10 of the Company's Registration Statement No. 333-48851 on Form S-1).

10.9 -- Stockholders' Agreement by and among the Company, Capricorn Investors, L.P. and Capricorn Investors II, L.P. (incorporated by reference to Exhibit 10.11 of the Company's Registration Statement No. 333-48851 on Form S-1).

EXHIBIT NO.	DESCRIPTION
10.10**	-- Employment Agreement dated as of July 31, 1997 between the Company and Nathaniel A. Gregory, as amended as of July 12, 1999 (incorporated by reference to Exhibit 10.12 of the Company's Registration Statement No. 333-48851 on Form S-1).
10.11	-- Stockholder's Agreement dated as of November 18, 1998 among the Company, Capricorn Investors, L.P., Capricorn Investors II, L.P. and the former stockholders of The Cynara Company (incorporated by reference to Exhibit 10.19 of the Company's Registration Statement No. 333-48851 on Form S-1).
10.12**	-- Change of Control Policy dated as of September 28, 1999 (incorporated by reference to Exhibit 10.20 of the Company's Registration Statement No. 333-48851 on Form S-1).
10.13**	-- Severance Pay Summary Plan Description (incorporated by

reference to Exhibit 10.21 of the Company's Registration Statement No. 333-48851 on Form S-1).

10.14 -- Loan Agreement ($22,000,000 U.S. Revolving Loan Facility, $10,000,000 Canadian Revolving Loan Facility and $32,500,000 Term Loan Facility) dated as of November 20, 1998 among National Tank Company, NATCO Canada, Ltd., Chase Bank of Texas, National Association, The Bank of Nova Scotia and the other lenders parties thereto and joined in by NATCO Group, Inc., as amended (incorporated by reference to Exhibit 10.22 to the Company's Registration Statement No. 333-48851 on Form S-1).

10.15 -- International Revolving Loan Agreement dated as of June 30, 1997 between National Tank Company and Texas Commerce Bank, National Association, as amended (incorporated by reference to Exhibit 10.23 to the Company's Registration Statement No. 333-48851 on Form S-1).

10.16 -- Loan Agreement ($35,000,000 U.S. Revolving Loan Facility, $10,000,000 Canadian Revolving Loan Facility, $5,000,000 U.K. Revolving Loan Facility and $50,000,000 Term Loan Facility) dated as of March 16, 2001 among NATCO Group Inc., NATCO Canada, Ltd., Axsia Group Limited, The Chase Manhattan Bank, Royal Bank of Canada, Chase Manhattan International Limited, Bank One, N.A. (Main Office Chicago, Illinois), Wells Fargo Bank Texas, National Association, JP Morgan, a Division of Chase Securities, Inc., and the other lenders now or hereafter Parties hereto (incorporated by reference to Exhibit 10.16 of the Company's Annual Report on Form 10-K for the period ended December 31, 2000).

** Management contracts or compensatory plans or arrangements.

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SIGNATURES

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

NATCO Group Inc.
(Registrant)

By: /s/ J. MICHAEL MAYER

Name: J. Michael Mayer
Senior Vice President and
Chief Financial Officer

Date: November 14, 2001

By: /s/ RYAN S. LILES

Name: Ryan S. Liles
Vice President and Controller

(Principal Accounting Officer)

Date: November 14, 2001

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EXHIBIT INDEX

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