NATCO GROUP INC
Form 10-Q
August 10, 2001

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 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 August 1, 2001 Class A, $0.01 par value per share 15,165,368 shares
Class B, $0.01 par value per share 587,048 shares

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NATCO GROUP INC.

FORM 10-Q

FOR THE QUARTER ENDED JUNE 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)

	JUNE 30, 2001	DECEMBER 3 2000
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,708	$ 1,031
Trade accounts receivable, net	89,072	53,807
Inventories	36,170	28,677
Prepaid expenses and other current assets	9,093	2,965
Total current assets	139,043	86,480
Property, plant and equipment, net	26,397	23,430
Goodwill, net	81,628	36,534
Deferred income tax assets, net	4,704	5,409
Other assets, net	2,602	1,273
Total assets	$ 254,374	$ 153,126
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current installments of long-term debt	$ 7,000	$ --
Notes payable	--	1,005
Accounts payable	41,992	23,133
Accrued expenses and other	40,353	12,098
Customer advances	3,461	1,163
Total current liabilities	92,806	37,399
Long-term debt, excluding current installments	60,263	14,959
Postretirement benefit liability	14,243	14,589
Total liabilities	167,312	66,947
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 15,165,368 and 14,977,354 shares as of June 30, 2001 and December 31, 2000, respectively	152	150
Class B Common stock, $.01 par value. Authorized 5,000,000 shares; issued and outstanding 587,048 and 699,874 shares as of June 30, 2001 and December 31, 2000, respectively	6	7
Additional paid-in capital	96,998	96,601
Accumulated earnings/(deficit)	1,390	(506)
Treasury stock, 677,238 shares at cost as of June 30, 2001 and December 31, 2000	(6,316)	(6,316)
Accumulated other comprehensive loss	(2,013)	(1,864)
Note receivable from officer and stockholder	(3,155)	(1,893)
Total stockholders' equity	87,062	86,179
Commitments and contingencies		
Total liabilities and stockholders' equity	$ 254,374	$ 153,126

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 JUNE 30,		SIX M
	2001	2000	2001
Revenues	$ 82,559	$ 55,935	$ 145,469
Cost of goods sold	62,254	39,757	109,171
Gross profit	20,305	16,178	36,298
Selling, general and administrative expense	13,625	9,880	24,677
Depreciation and amortization expense	2,183	1,263	3,786
Unusual charges	1,600	--	1,600
Interest expense	1,583	438	2,289
Interest cost on postretirement benefit liability	322	322	644
Interest income	(74)	(44)	(108)
Income before income taxes	1,066	4,319	3,410
Income tax provision	546	1,848	1,514
Net income	$ 520	$ 2,471	$ 1,896
EARNINGS PER SHARE:			
Basic	$ 0.03	$ 0.17	$ 0.12
Diluted	$ 0.03	$ 0.16	$ 0.12
WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING:			
Basic	15,745	14,829	15,724
Diluted	16,089	15,391	16,043

See accompanying notes to unaudited condensed consolidated financial statements.

NATCO GROUP INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

	SIX MONTHS ENDED JUNE 30,	
	2001	2000

Cash flows from operating activities:		
Net income	$ 1,896	$ 2,665
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Deferred income tax benefit	(290)	(355)
Depreciation and amortization expense	3,786	2,543
Non-cash interest income	(84)	(58)
Interest cost on postretirement benefit liability	644	643
Gain on the sale of property, plant and equipment	(74)	(17)
Change in assets and liabilities, net of acquisitions:		
Increase in trade accounts receivable	(3,954)	(8,459)
Increase in inventories	(6,611)	(5,097)
Increase in prepaid expense and other current assets	(1,844)	(619)
(Increase) decrease in long-term assets	(1,579)	756
Increase in accounts payable	9,799	4,471
Increase (decrease) in accrued expenses and other	(2,602)	145
Increase in customer advances	2,344	540
Net cash provided by (used in) operating activities	1,431	(2,842)
Cash flows from investing activities:		
Capital expenditures for property, plant and equipment	(3,109)	(4,340)
Proceeds from the sale of property, plant and equipment	173	--
Acquisitions, net of cash acquired	(48,191)	(17,229)
Proceeds of note receivable	--	1,067
Issuance of related party note receivable	(1,178)	--
Proceeds from settlement	1,500	--
Other, net	--	20
Net cash used in investing activities	(50,805)	(20,482)
Cash flows from financing activities:		
Change in bank overdrafts	2,136	2,933
Net borrowings under long-term revolving credit facilities	4,129	513
Repayments of short-term borrowings	(1,001)	--
Repayments of long-term debt	(1,750)	(27,858)
Borrowings of long-term debt	50,000	--
Issuance of common stock, net	98	47,194
Receipt from affiliate of remainder of net present value of postretirement benefit liability	--	600
Payments on postretirement benefit liability	(1,007)	(683)
Other, net	92	147
Net cash provided by financing activities	52,697	22,846
Effect of exchange rate changes on cash and cash equivalents	354	(365)
Change in cash and cash equivalents	3,677	(843)
Cash and cash equivalents at beginning of period	1,031	1,747
Cash and cash equivalents at end of period	$ 4,708	$ 904

Cash payments for:

Interest	$ 1,567	$ 611
Income taxes	$ 1,159	$ 39
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.

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.

(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 344,028 shares and 319,652 shares for the quarter and six-month period ended June 30, 2001, respectively. For the respective periods in 2000, common stock equivalents related to employee stock options totaled 561,814 shares and 629,487 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 12,464 shares and 11,598 shares for the quarter and six-month period ended June 30, 2001, respectively. The impact of anti-dilutive shares would have been a reduction of 12,260 shares and 6,130 shares for the quarter and six-month period ended June 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 $47.8 million and $675,000, respectively, at June 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 June 30, 2001.

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

	PRO FORMA RESULTS SIX MONTHS ENDED	
	JUNE 30, 2001	JUNE 30, 2000
	(unaudited)	(unaudited)
Revenues	$160,416	$130,778
Income before income	1,010	2,621
Net income	210	560
Net income per share:		
Basic	$ 0.01	$ 0.04
Diluted	$ 0.01	$ 0.04

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 related to 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 June 30, 2001, was approximately $633,000. 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").

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(6) INVENTORIES

Inventories consisted of the following amounts:

	JUNE 30, 2001 (UNAUDITED)	DECEMBER 31, 2000
	(IN THOUSANDS)	
Finished goods	$ 7,949	$ 7,641

Work-in-process	12,183	10,403
Raw materials and supplies ..	16,698	11,203
Inventories at FIFO	36,830	29,247
Excess of FIFO over LIFO cost	(660)	(570)
	$ 36,170	$ 28,677

(7) COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS

Cost and estimated earnings on uncompleted contracts were as follows:

	JUNE 30, 2001 (UNAUDITED)	DECEMBE 200
	(IN THOUSANDS)	
Cost incurred on uncompleted contracts	$ 152,843	$ 67,
Estimated earnings	52,393	34,
	205,236	101,
Less billings to date	187,894	91,
	$ 17,342	$ 10,
Included in the accompanying balance sheet under the captions:		
Trade accounts receivable	$ 18,652	$ 10,
Advance payments	(1,310)	
	$ 17,342	$ 10,

(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:

	JUNE 30, 2001 (UNAUDITED)	DECEMBER 31, 2000
	(IN THOUSANDS)	

BANK DEBT		
Term loan with variable interest rate (5.99% at June 30, 2001) and quarterly payments of principal ($1,750) and interest, due March 16, 2006	$ 48,250	$ --
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 (7.22% at June 30, 2001) and quarterly payment of interest, due March 15, 2004	17,413	--
Revolving credit bank loans (Export Sales Facility) with variable interest rate (7.00% at June 30, 2001) and monthly payment of interest, due March 15, 2004	1,600	--
Less current installments	(7,000)	--
Long-term debt	$ 60,263	$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 June 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, 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 June 30, 2001, the Company was in compliance with all restrictive debt covenants. NATCO had letters of credit outstanding under the revolving credit facilities totaling $19.1 million at June 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, of which $1.6 million was outstanding as of June 30, 2001. The Company had no letters of credit outstanding under this facility as of June 30, 2001. 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 $936,000 at June 30, 2001.

(10) INCOME TAXES

NATCO's effective income tax rate for the quarter ended June 30, 2001 was 51.2%, 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 $1.0 million. A tax benefit associated with the exercise of employee stock options of $54,000 and $214,000, respectively, was allocated to equity during the quarter and six-month period ended June 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
			(unaudited, in thousands
THREE MONTHS ENDED JUNE 30, 2001			
Revenues from unaffiliated customers	$36,704	$34,413	$11,442

Revenues from affiliates............	857	30	849
Segment profit (loss)...............	3,088	2,954	1,426
Total assets........................	96,126	125,547	20,116
Capital expenditures................	551	672	181
Depreciation and amortization.......	595	1,380	111
THREE MONTHS ENDED JUNE 30, 2000			
Revenues from unaffiliated customers	$27,466	$17,937	$10,532
Revenues from affiliates............	1,823	--	1,122
Segment profit (loss)...............	2,644	3,158	1,841
Total assets........................	81,409	36,242	19,044
Capital expenditures................	735	1,558	50
Depreciation and amortization.......	704	407	144
SIX MONTHS ENDED JUNE 30, 2001			
Revenues from unaffiliated customers	$69,895	$52,370	$23,204
Revenues from affiliates............	2,267	38	1,894
Segment profit (loss)...............	6,035	4,724	2,669
Total assets........................	96,126	125,547	20,116
Capital expenditures................	1,005	1,412	256
Depreciation and amortization.......	1,480	1,828	261
SIX MONTHS ENDED JUNE 30, 2000			
Revenues from unaffiliated customers	$53,720	$34,785	$19,285
Revenues from affiliates............	3,192	--	2,014
Segment profit (loss)...............	3,174	6,384	2,498
Total assets........................	81,409	36,242	19,044
Capital expenditures................	1,311	2,694	141
Depreciation and amortization.......	1,546	642	280

(12) DERIVATIVE ARRANGEMENTS

As of June 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 as a hedge against fluctuations in 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. Under these derivative arrangements, the Company agreed to sell British pounds sterling at a contractual strike price in exchange for a specified amount of the local currency. For example, the Company purchases units of the local currency in order to settle commitments with its vendors. Based upon the current exchange rate, a gain or loss on the underlying liability is recorded, as well as an offsetting gain or loss on the derivative forward contract. The nature of these derivative arrangements provides a hedge to mitigate exchange rate exposure.

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

CONTRACT TYPE	DATES	LOCAL CURRENCY	LOCAL CURRENCY AMOUNT	STRIKE PRICE RANGE
Sell	8/1/2001 to 1/31/2002	Euros	945,281	1.5623 to 1.6223
Sell	7/1/2001 to 2/28/2002	US dollars	22,741,286	1.4710 to 1.5700
Sell	7/1/2001 to 9/30/2001	Kuwaiti dinars	136,000	.04495

At June 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.

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 $47.8 million and $675,000, respectively, at June 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 June 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. In early 2001, energy prices continued a modest decline. The average price of oil per barrel during 2000, using the West Texas Intermediate spot price, was approximately $30, and the average natural gas price per MMBtu during 2000, using the NYMEX Henry Hub price, was approximately $4 per MMBtu. The spot price of these commodities as of June 30, 2001 was approximately $26 per barrel of oil and $3 per MMBtu of natural gas.

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 1,247 at June 30, 2000 to 1,597 at June 30, 2001, as published by Baker Hughes.

The increase in oil prices since 1999 has had a positive effect on the Company's overall sales in 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 continue to increase their 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 its 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 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 June 30, 2001 Compared to Three Months Ended June 30, 2000

Revenues. Revenues of $82.6 million for the three months ended June 30, 2001 increased $26.6 million, or 48%, from $55.9 million for the three months ended June 30, 2000. The following table summarizes revenues by business segment for the quarters ended June 30, 2001 and 2000, respectively.

	THREE MONTHS ENDED JUNE 30, 2001	2000	CHANGE
	(UNAUDITED) (IN THOUSANDS, EXCEPT PERCENTAGE CHA		
North American Operations	$ 37,561	$ 29,289	$ 8,272
Engineered Systems	34,443	17,937	16,506
Automation and Control Systems	12,291	11,654	637
Corporate and Other	(1,736)	(2,945)	1,209
Total	$ 82,559	$ 55,935	$26,624

North American operations revenues increased $8.3 million, or 28%, for the quarter ended June 30, 2001, as compared to the quarter ended June 30, 2000, due to an increase in oilfield activity that resulted from continued favorable oil and gas prices, and was

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consistent with increased rig count in the United States and Canada. The Company experienced increased demand for its production process equipment, domestic parts and services and CO2 membrane technology products and field services. These increases in equipment sales were offset slightly by a decline in affiliated revenues in Canada, as several large projects in fiscal 2000 were completed. Affiliated revenues for this business segment were $857,000 for the quarter ended June 30, 2001, as compared to $1.8 million for the quarter ended June 30, 2000.

Revenues for the engineered systems business segment increased $16.5 million, or 92%, for the quarter ended June 30, 2001, as compared to the quarter ended June 30, 2000. This increase was primarily due to the acquisition of Axsia in March 2001, which provided revenues of $27.1 million for the three months ended June 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 $13.2 million of revenue for the quarter ended June 30, 2000, as compared to $581,000 for the quarter ended June 30, 2001. Excluding the impact of the Axsia acquisition and the CTOC project, revenues for this business segment increased $2.0 million for the quarter ended June 30, 2001, compared to the respective period in 2000, primarily due to an increase in export projects. Engineered systems revenues of $34.4 million for the quarter ended June 30, 2001 included approximately $30,000 of affiliated revenues. No affiliated revenues were included in the results of this business segment for the quarter ended June 30, 2000.

Revenues for the automation and control systems business segment increased $637,000, or 5%, for the quarter ended June 30, 2001, as compared to the quarter ended June 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 $849,000 and $1.1 million were included in the results for the quarters ended June 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 June 30, 2001 increased $4.1 million, or 26%, to $20.3 million, compared to $16.2 million for the quarter ended June 30, 2000. As a percentage of revenue, gross margins declined from 29% for the quarter ended June 30, 2000 to 25% for the quarter ended June 30, 2001. The following table summarizes gross profit by business segment for the quarters then ended:

	THREE MONTHS ENDED JUNE 30,		
	2001	2000	CHANGE
	(UNAUDITED) (IN THOUSANDS, EXCEPT PERCENTAGE CHANGE		
North American Operations	$ 9,130	$ 7,738	$ 1,392
Engineered Systems	8,568	5,592	2,976
Automation and Control Systems	2,607	2,849	(242)
Total	$20,305	$16,179	$ 4,126

Gross profit for the North American operations business segment increased $1.4 million, or 18%, for the quarter ended June 30, 2001, as compared to the respective period in 2000. This increase in margin was due primarily to a 28% increase in revenues, slightly offset by an unfavorable sales mix, as the sales increase generally related to lower margin standard production equipment. As a percentage of revenue, gross margins were 24% and 26% for the quarters ended June 30, 2001 and 2000, respectively.

Gross profit for the engineered systems business segment for the quarter ended June 30, 2001 increased $3.0 million, or 53%, primarily due to a $7.3 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 $488,000 due to an increase in export projects. Gross margin for engineered systems represented 25% and 31% of the segment's revenues for the quarters ended June 30, 2001 and 2000, respectively.

Gross profit for the automation and control systems business segment decreased $242,000, or 8%, for the quarter ended June 30, 2001, as compared to the quarter ended June 30, 2000. This decrease was related to a decline in revenues from quote jobs that generally provide more favorable margins. However, the increase in time and materials jobs resulted in an overall 5% increase in revenues for the segment. Gross margin as a percentage of revenue for the quarters ended June 30, 2001 and 2000, was 21% and 24%, respectively.

Selling, General and Administrative Expense. Selling, general and administrative expense of $13.6 million increased $3.7 million, or 38%, for the quarter ended June 30, 2001, as compared to the respective period in 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, (4) an increase in unabsorbed costs from the Company's CO2 membrane manufacturing facility, related to the windup of the CTOC project, and (5) higher employee medical costs.

Depreciation and Amortization Expense. Depreciation and amortization expense of $2.2 million for the quarter ended June 30, 2001, increased $920,000, or 73%, compared to $1.3 million for the quarter ended June 30, 2000. Depreciation expense of $1.0 million for the quarter ended June 30, 2001, increased $311,000, or 42%, as compared to the respective period for 2000. This increase was primarily due to the acquisition of Axsia in March 2001 that provided depreciation expense of $111,000 for the quarter, and capital expenditures of $8.1 million incurred during fiscal 2000, including a significant upgrade to the manufacturing facility in Pittsburg, California, completed and put into service in the fourth quarter of 2000. Amortization expense of $1.1 million for the quarter ended June 30, 2001, increased $609,000, or 116%, as compared to $525,000 for the quarter ended June 30, 2000. This increase was primarily due to amortization of goodwill associated with the Axsia acquisition of approximately $600,000.

Unusual Charges. Unusual charges for the quarter ended June 30, 2001 were $1.6 million, of which 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.

Interest Expense. Interest expense was $1.6 million for the quarter ended June 30, 2001, as compared to $438,000 for the respective period in 2000. This increase of $1.1 million, or 261%, 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 June 30, 2001 under the Company's credit facilities totaled $67.3 million, as compared to $6.6 million at June 30, 2000.

Provision for Income Taxes. Income tax expense of $546,000 for the quarter ended June 30, 2001, decreased $1.3 million from $1.8 million for the quarter ended June 30, 2000. The primary reason for this decrease in tax expense was a decrease in income before income taxes, which was $1.1 million for the quarter ended June 30, 2001, as compared to $4.3 million for the respective period in 2000. The effective tax rate increased from 42.8% in 2000 to 51.2% in 2001, due to the impact of non-deductible goodwill amortization expense.

Six Months Ended June 30, 2001 Compared to Six Months Ended June 30, 2000

Revenues. Revenues of $145.5 million for the six months ended June 30, 2001 increased $37.7 million, or 35%, from $107.8 million for the six months ended June 30, 2000. The following table summarizes revenues by business segment for the six-month periods ended June 30, 2001 and 2000, respectively.

SIX MONTHS ENDED
JUNE 30,

	2001	2000	CHANGE
		(UNAUDITED) (IN THOUSANDS, EXCEPT PERCENTAGE CH	
North American Operations	$ 72,162	$ 56,912	$15,250
Engineered Systems	52,408	34,785	17,623
Automation and Control Systems	25,098	21,299	3,799
Corporate and Other	(4,199)	(5,206)	1,007
Total	$ 145,469	$ 107,790	$37,679

North American operations revenues increased $15.3 million, or 27%, for the six months ended June 30, 2001, as compared to the six months ended June 30, 2000, due to an increase in oilfield activity in the United States and Canada, the Company's primary markets, as a result of continued favorable oil and gas prices. The Company experienced increased demand for its production process equipment, 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 delayed recovery in crude oil development in Canada and a lull in activity for several key customers. Affiliated revenues for this business segment were $2.3 million for the six months ended June 30, 2001, as compared to $3.2 million for the six months ended June 30, 2000.

Revenues for the engineered systems business segment increased $17.6 million, or 51%, for the six months ended June 30, 2001, as compared to the six months ended June 30, 2000. This increase was primarily due to the acquisition of Axsia in March 2001, which provided revenues of $31.0 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 $23.2 million of revenue for the six months ended June 30, 2000 as compared to $8.9 million for the six months ended June 30, 2001. Excluding the impact of Axsia and the CTOC project, revenues for this business segment increased $957,000 for the six months ended June 30, 2001 as compared to the respective period in 2000, due primarily to export engineered systems. Engineered systems revenues of $52.4 million for the six

months ended June 30, 2001 included approximately $38,000 of affiliated revenues. No affiliated revenues were included in the results of this business segment for the six months ended June 30, 2000.

Revenues for the automation and control systems business segment increased $3.8 million, or 18%, for the six months ended June 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 $1.9 million and $2.0 million were included in the results for the six-month periods ended June 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 six months ended June 30, 2001 increased $7.0 million, or 24%, to $36.3 million, compared to $29.3 million for the six months ended June 30, 2000. As a percentage of revenue, gross margins declined from 27% for the six months ended June 30, 2000 to 25% for the six months ended June 30, 2001. The following table summarizes gross profit by business segment for the periods then ended:

	SIX MONTHS ENDED JUNE 30,			PE
	2001	2000	CHANGE	
	(UNAUDITED) (IN THOUSANDS, EXCEPT PERCENTAGE CHANGE			
North American Operations	$17,536	$13,339	$4,197	
Engineered Systems	13,754	11,390	2,364	
Automation and Control Systems	5,008	4,568	440	
Total	$36,298	$29,297	$7,001	

Gross profit for the North American operations business segment increased $4.2 million, or 31%, for the six months ended June 30, 2001, as compared to the respective period in 2000. This increase in margin was due primarily to a 27% increase in revenues and favorable sales mix, including higher sales of domestic and export part and services and CO_2 membrane operations products, which generally provide higher margins than standard production equipment. As a percentage of revenue, gross margins were 24% and 23% for the six-month periods ended June 30, 2001 and 2000, respectively.

Gross profit for the engineered systems business segment for the six months ended June 30, 2001 increased approximately $2.4 million, or 21%, primarily due to an $8.0 million contribution from Axsia, offset by a decline in large engineered systems projects such as the CTOC project which provided gross margin of $9.1 million for the six months ended June 30, 2000, as compared to $3.5 million for the six months ended June 30, 2001. Excluding the impact of Axsia and the CTOC project, gross margins for the engineered systems business segment increased slightly in 2001 as compared to 2000. Gross margin represented 26% and 33% of the segment's revenues for the six-month periods ended June 30, 2001 and 2000, respectively. The decline in gross margin as a percentage of revenues was consistent with a decline in large high margin projects such as CTOC.

Gross profit for the automation and control systems business segment increased $440,000, or 10%, for the six months ended June 30, 2001, as compared to the six months ended June 30, 2000. This increase was directly related to an 18% increase in revenues offset slightly 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 six-month periods ended June 30, 2001 and 2000, was 20% and 21%, respectively.

Selling, General and Administrative Expense. Selling, general and administrative expense of $24.7 million increased $5.4 million, or 28%, for the six months ended June 30, 2001, as compared to the respective period in 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, (4) an increase in unabsorbed costs from the Company's CO_2 membrane manufacturing facility, related to the windup of the CTOC project, and (5) higher employee medical costs.

Depreciation and Amortization Expense. Depreciation and amortization expense of $3.8 million for the six months ended June 30, 2001, increased $1.2 million, or 49%, compared to $2.5 million for the six months ended June 30, 2000. Depreciation expense of $2.0 million for the six months ended June 30, 2001, increased $365,000, or 22%, as compared to the respective period for 2000. This increase was primarily due to the acquisition of Axsia in March 2001 and capital expenditures of $8.1 million during fiscal 2000, which included a significant upgrade to the manufacturing facility in Pittsburg, California, completed and put into service in the fourth quarter of 2000. Amortization expense of $1.8 million for the six months ended June 30, 2001, increased $878,000, or 99%, as compared to $887,000 for the six months ended June 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

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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 six months ended June 30, 2001 were $1.6 million, compared to $1.5 million for the six months ended June 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 six months ended June 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 $2.3 million for the six months ended June 30, 2001, as compared to $774,000 for the respective period in 2000. This 196% increase in interest expense was due primarily to an increase in long-term debt under the new term loan and revolving credit facilities from $6.6 million at June 30, 2000 to $67.3 million at June 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.

Provision for Income Taxes. Income tax expense of $1.5 million for the six months ended June 30, 2001, decreased $480,000 from $2.0 million for the six months ended June 30, 2000. The primary reason for this decrease in tax expense was a decrease in income before income taxes, which was $3.4 million for the six months ended June 30, 2001, as compared to $4.7 million for the respective period in 2000. In addition, the effective tax rate increased from 43% in 2000 to 44% in 2001, due primarily to non-deductible goodwill amortization expense.

LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2001, the Company had cash and working capital of $4.7 million and $46.2 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 six months ended June 30, 2001 was $1.4 million, compared to net cash used in operations of $2.8 million for the six months ended June 30, 2000. Factors, which contributed to the increase in cash provided by operating activities during 2001, included an increase in customer advance payments and accounts payable in greater proportion than the increase in accounts receivable.

Net cash used in investing activities for the six months ended June 30, 2001 was $50.8 million, of which $48.2 was used to acquire Axsia and $3.1 million was used for capital expenditures. For the six months ended June 30, 2000, $20.5 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 six months ended June 30, 2001 was $52.7 million, as compared to net cash provided by financing activities for the six months ended June 30, 2000 of $22.8 million. The primary source of funds for financing activities for the six months ended June 30, 2001 was net borrowings of $48.3 million under the term loan facility and net borrowing of $4.1 million under the Company's revolving credit facility. The primary source of funds for financing activities during the six months ended June 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 June 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 June 30, 2001, the weighted average interest rate of NATCO's borrowings under its revolving credit facility was 7.22%.

NATCO will pay commitment fees of 0.50% per year until April 1, 2002 and 0.30% to 0.50% per year, 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 $50.0 million 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 were used to repay $16.5 outstanding under a predecessor revolving credit and term loan facility. As of June 30, 2001, the Company had borrowings of $48.3 million outstanding under the term loan facility.

As of June 30, 2001, the Company was in compliance with all restrictive debt covenants. NATCO had letters of credit outstanding under the revolving credit facilities totaling $19.1 million at June 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, of which $1.6 million was outstanding at June 30, 2001. The Company had no letters of credit outstanding under this facility at June 30, 2001. 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 June 30, 2001 of $936,000.

The Company's sales backlog at June 30, 2001 was $101.3 million and included backlog of $25.0 million related to Axsia, which was acquired on March 19, 2001. In addition, backlog at June 30, 2001 included $3.5 million related to the CTOC project, which contributed $35.1 million to backlog at June 30, 2000. Excluding the impact of the Axsia acquisition and the CTOC project, backlog at June 30, 2001 was $72.7 million as compared to $25.0 million at June 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.

At June 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 $41.4 million and $1.2 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 calendar year ends. The Company has not 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 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 the functional currency. The Company has entered into certain currency forward contract arrangements whereby the Company purchases 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. 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 are an effective hedge to mitigate exchange rate exposure related to these transactions. At June 30, 2001, the Company obtained the fair market value of the forward contracts from the counter-party financial institutions. 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 June 30, 2001, the Company had borrowings of $48.3 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 June 30, 2001, totaled $17.4 million. As of June 30, 2001, the weighted average interest rate of the Company's borrowings under its revolving credit facility was 7.22%. Borrowings totaling $1.6 million were outstanding under the working capital facility for export sales at June 30, 2001, at a weighted average interest rate of 7.00%.

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

(c) There were no sales of equity securities sold by the Company during the three months ended June 30, 2001 that were not registered under the Securities Act of 1933, as amended (the "Securities Act"). However, on February 1, 2001, the Company sold and issued (without payment of any selling commission to any person) 8,520 shares of Class B Common Stock to the former shareholders of The Cynara Company, in connection with the achievement of certain performance criteria defined in the November 1998 purchase agreement.

The sales of the above securities were exempt from registration in reliance on Section 4(2) of the Securities Act.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Stockholders of NATCO Group Inc. was held on May 24, 2001 in Houston, Texas. At the Annual Meeting, the holders of 15,355,071 shares out of 15,736,019 shares entitled to vote as of the record date, were represented in person or by proxy, constituting a quorum. Proposals which were submitted to a vote of security holders included the following and were adopted by the margins indicated:

(1) Election of two (2) Class III members of the Board of Directors, each to hold office for a three-year term expiring at the annual meeting of stockholders in 2004.

Number of Shares

	For	Withheld	Broker Non-Vote
Nathaniel A. Gregory	14,491,195	863,876	0
Herbert S. Winokur, Jr.	15,304,221	50,850	0

Messrs. John U. Clarke and Patrick M. McCarthy will continue to serve as directors of the Company, each with a term expiring at the annual meeting of stockholders in 2002. Messrs. Keith K. Allan, Howard I. Bull and George K. Hickox, Jr. will continue to serve as directors of the Company, each with a term expiring at the annual meeting of stockholders in 2003.

(2) Ratification of KPMG LLP as the Company's independent public accountants for the fiscal year beginning January 1, 2001.

Number of Shares		
For	Against	Abstained
15,347,384	5,460	2,326

(3) Approval of the 2001 Stock Incentive Plan.

Number of Shares		
For	Against	Abstained
10,768,378	1,244,382	619,574

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. The Company filed a report on Form 8-K on June 8, 2001, pursuant to the Securities and Exchange Commission's rules for the acquisition of a significant subsidiary, to provide audited consolidated financial statements and related pro forma financial statements for Axsia Group Ltd., acquired on March 19, 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).
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).

EXHIBIT NO.		DESCRIPTION
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).
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).

EXHIBIT NO.		DESCRIPTION
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: August 10, 2001

By: /s/ Ryan S. Liles

Name: Ryan S. Liles
Vice President and Controller
(Principal Accounting Officer)

Date: August 10, 2001

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