NATCO GROUP INC
Form 10-K
March 14, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006 **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 N. Loop West, 7th Floor, Houston, Texas	**77092**
(Address of principal executive offices)	**(zip code)**

Registrant s telephone number, including area code: (713) 683-9292

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

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

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

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

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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

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

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity as of the last business day of the registrant s most recently completed second fiscal quarter.

As of June 30, 2006 $ 613,592,330

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date.

As of March 1, 2007 Common Stock, $0.01 par value per share 17,367,222 shares

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

Specified portions of the 2007 Notice of Annual Meeting of Stockholders and Proxy Statement (Part III)

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PART I

Item 1. ***Business***

Our Business

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

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

Our organization is structured in three separate business segments that concentrate our proprietary technologies on specific end-use markets, allowing us to be responsive to our customers needs, as well as new market opportunities. The segments are: Oil & Water Technologies, Gas Technologies and Automation & Controls:

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

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

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

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

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Developments in 2006

During 2006, the Company reported record bookings, backlog, segment profit and earnings as a result of a strong market and improvements in execution. The Company s growth was assisted by our strategic repositioning in 2005 (which included additions to leadership; realignment around core technologies to improve execution and customer responsiveness; cost structure improvements; revenue enhancements; and increased focus on profitability). These initiatives and much improved financial flexibility have allowed us to concentrate on growth in the markets we serve by leveraging our existing operations and through acquisitions.

Market growth in 2006 was supported by record exploration and production spending levels by our customers, attractive commodity prices, strong global oil and gas demand, declining quality of reserves, changing production profiles and the complexity and remoteness of new development. Among other successes during the year, we were awarded a $46.4 million contract for the sale of a process system employing our proprietary Cynara® membrane system technology that separates higher concentration of CO_2 from natural gas production streams. We continue to expand in global markets, with international sales surpassing US revenues in 2006.

We remained focused on leveraging the strength of our organization, operations and technology portfolio during 2006 through improved execution; expansion of subcontracting opportunities; new product development, particularly in the commercialization of our Dual Frequency® and Shell Paques technologies; geographic expansion through marketing alliances/partnering; and market expansion through technology alliances. We increased our use of subcontractors in a number of areas, thereby increasing sales in our standard and traditional product lines and our engineered systems groups. In July 2006, we entered into a joint venture agreement with Scomi Group BHD to pursue production processing opportunities, initially in the Southeast Asia market. Through this alliance, we expect to benefit from an ability to offer increased project scope for our customers and greater local content facilitated by Scomi Group BHD, a publicly traded Malaysian oilfield service company and a highly regarded local partner. The Company and Scomi act as subcontractors to the joint venture for their respective scopes of supply. We also completed the sale of a portion of our investment in NATCO Japan Company Ltd. to Modec Inc. and Daiichi Jitsugyo, Ltd., an existing shareholder, to expand the reach of NATCO Japan s product technologies and addressable markets, including the floating production, storage and off loading (FPSO) vessel market. NATCO Japan was previously owned 85%/15% by NATCO and Daiichi and historically focused on the Japanese refinery market for dehydration/desalting. During 2006, Modec acquired a 20% stake for $2.5 million, and Daiichi increased its stake by 5% for $500,000. NATCO now owns 60% of the venture. NATCO, Daiichi and Modec will act independently as subcontractors to the joint venture for our respective scopes of supply.

We expect to accelerate our rate of growth via acquisitions with the objective of adding new technologies to fill gaps in or complement existing product lines or expanding into new areas that will supplement our existing business. We invested in an entity in the first quarter of 2006 that added a new pilotless burner system to our product offerings, and will review other opportunities as they arise.

The Company also remained focused on strengthening our financial flexibility during 2006. In July, we entered into a new revolving facilities agreement, which provides for a revolving facility with an aggregate borrowing capacity of $85.0 million in the US, UK and Canada, and terminated our former term loan and revolving credit facilities agreement. In addition, we prepaid all remaining debt during the year, using cash from operations. We also are in negotiations to replace our existing $10.0 million export sales facility with a substantially similar facility prior to its expiration at the end of March 2007. As of January 31, 2007, our available liquidity, including cash on hand and borrowing availability under the revolving facilities, was approximately $115.1 million. Additionally, pursuant to the terms of our revolving credit facilities, we have the right to increase borrowing capacity by an additional $50.0 million.

Our goals for 2007 and beyond include completing all repositioning initiatives designed to improve top line growth and profitability, continuing our globalization efforts, building out our organization to support execution of our long-range strategic plans and redeploying free cash flow into organic growth opportunities, alliances and

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acquisitions. In 2006 and early 2007, the Company made organizational additions to strengthen its expanding business by recruiting experienced executives in the engineered systems, human resources and procurement areas; and enhancing training and development succession planning programs designed to build our next generation of leaders. We also secured the continuing services of our president and chief operating officer for an additional two-year period, as he agreed to defer his retirement, and replaced our chief financial officer with a highly qualified executive following the resignation of the incumbent.

Our Recent History

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

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

In December 2003, we placed into service an expansion of the gas-processing facilities in West Texas operated by NATCO on behalf of itself and its customer. This expansion increased the operating capacity at these facilities from 180 million cubic feet, or mmcf, per day to 367 mmcf per day. Our operating agreements for these facilities provide for daily processing minimums and annual escalations.

In September 2004, we named John U. Clarke, then an independent director of the Company, as Chairman and interim CEO. The Board of Directors conducted a search for a replacement and appointed Mr. Clarke as Chairman and Chief Executive Officer of NATCO Group in December 2004.

During 2005, we strategically repositioned our business as discussed above. In addition, we consolidated and integrated certain marketing functions by forming a global marketing group to better serve customers and pursue projects for continued growth in revenue and profitability. These changes were designed to position NATCO as a premier provider of efficient and customer focused equipment and services to the global energy market. In addition, our engineering offices located in the US, the UK, Japan and Canada became fully integrated Execution Centers working in concert with our Global Marketing Group to provide seamless solutions to customers around the world. We also substantially completed the steps necessary to consolidate our two UK operating offices into a single Execution Center under the direction of a newly named Managing Director. In addition, we named a new Corporate Controller and two new independent members to the Board of Directors during 2004 and 2005.

Industry

Global energy demand is influenced by changes in the gross domestic product of the world s economies. A recently published study by the Energy Information Agency of the US Department of Energy titled International Energy Outlook 2006 concludes that worldwide marketed energy demand will exhibit strong growth from 421 quadrillion British thermal units, or Btu, in 2003 to 722 quadrillion Btu in 2030, an increase of 71% over the period for an average annual growth rate of 2.0%. The most rapid growth in energy demand from 2003 to 2030 is projected from emerging market economies, with average demand growth projected at 3.7% per year in Asia (including China and India), 2.8% per year in Central and South America, 2.6% per year for Africa, 2.4% per year for the Middle East and 1.8% per year for emerging markets in Europe and Eurasia. Demand in mature economies in developed countries is projected to grow at 1.0% per year over the period.

Demand for oil and gas production equipment and services is driven primarily by the following: levels of spending on development of production of oil and gas in response to worldwide demand; the changing

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production profiles of existing fields (meaning the changing mix of lower oil, gas and higher water cuts in the production stream and the level of contaminants); the discovery of new oil and gas fields; the quality of new hydrocarbon production; investment in exploration and production efforts by oil and gas producers; and the increasingly remote locations of new production.

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

Increasing demand for oil and natural gas. According to the US Department of Energy, worldwide petroleum and natural gas consumption is projected to increase at an average annual growth rate of 1.4% from 2003 through 2030, with higher consumption rates expected in the emerging economies, particularly in Asia (including China and India), where 43% of the total increase in world oil use is projected. Sustained higher projected oil prices have dampened the annual growth rate in petroleum consumption over prior projections, but have led to an increase in projected natural gas supply and consumption. Increased natural gas prices may impact natural gas usage, with users moving to other fossil or alternative fuels as they become more cost-competitive, particularly for the electric power sector. As worldwide demand grows, producers in the oil and gas industry will increasingly rely on non-traditional sources of energy supply and expansion into new markets. As a result, additional and more complex equipment may be required from equipment and service suppliers to produce oil and gas from these fields, especially since many new oil and gas fields produce lower quality or contaminated hydrocarbon streams, requiring more complex production equipment. In general, these trends should increase the demand for our products and services.

Long-term demand for oil and gas products should lead to increases in drilling activity. Continuing high levels of demand for oil and gas products as well as geopolitical risks of supply have resulted in a substantial rise in prices since 2003. For example, the average price of crude oil in the US has increased by 60% from $41.47 per barrel in 2004 to $66.06 per barrel in 2006. In addition, the average wellhead price of natural gas in the US has increased by 17% from $5.50 per thousand cubic feet (mcf) in 2004 to $6.41 per mcf in 2006. In order to meet rising demand, the number of drilling rigs operating in North America and internationally has continued to increase in recent years. The average US rig count for 2006 was 1,648 as compared to 1,380 for 2005 and 1,190 for 2004, as published by Baker Hughes Incorporated. The average international rig count, excluding North America, for 2006, 2005 and 2004 was 925, 850 and 781, respectively. We believe rig counts will remain at or near historically high levels over the intermediate term in North America and will continue to rise internationally. With such activity levels, we anticipate demand for oil and gas production equipment and services will remain strong.

Changing profile of existing production. As production declines in existing oil and gas fields, the production profile and quality of recoverable reserves may change over time, either naturally or due to implementation of enhanced recovery techniques. The mix of oil, gas, water and contaminants produced from mature fields changes, resulting in lower quality or higher contaminates in hydrocarbon streams requiring additional and more sophisticated production equipment. The industry continues to seek more innovative and technologically efficient means of extracting hydrocarbons from existing fields, as production profiles change. Changing production profiles often require retrofitting and de-bottlenecking of existing production equipment, which is an area of our expertise. Increasing demand for higher oil production in a scenario where the water-cut is increasing, is putting pressure on developing subsea water separation technology.

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

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Increasing need for technology solutions. Higher specification and performance standards, environmental regulation, cost reduction requirements, desire to reduce space and weight of equipment and other similar considerations have increased demand for technology in production systems. Also, new oil and gas fields are often offshore and/or in remote places of the world. Advanced technologies have resulted in reduced equipment size, weight and footprint on offshore platforms. Those in harsh environments present special challenges that require technology and equipment solutions that are reliable with a high degree of engineering integrity.

Increasing environmental requirements. The oil and gas industry is facing ever more stringent environmental laws and regulations affecting operations around the world. The Kyoto Accord, being implemented in many countries outside the US, seeks to reduce the production of CO_2 or greenhouse gases and other environmental hazards that are believed to contribute to global warming trends. In addition, many countries are implementing laws dealing with other environmental restrictions such as: natural gas flaring, salt water disposal and water filtration. We provide process equipment designed to handle these concerns and in some cases more stringent environmental requirements may present additional business opportunities for us.

Competitive Strengths

We believe our key competitive strengths are:

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

Technological leadership. We believe we have established a position of global technological leadership by pioneering the development of innovative separation technologies. We continue to be a technological leader in areas such as carbon dioxide separation using membrane technology, oil-water emulsion treatment using the latest electrostatic technology, seawater injection systems, complex produced oily water treatment systems and a variety of specialty applications. We hold over 50 active US and equivalent foreign patents and continue to invest in research and development.

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

Established network of global sub-contractors and fabricators which serve to complement our North American fabrication and manufacturing capabilities. We maintain relationships with sub-contractors and fabricators in North America and around the world, which permits us to deliver competitively priced equipment and systems to customers; minimize transportation costs and logistics; and to satisfy requirements to provide local content in some markets.

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

After-market parts and service. Through our large North American branch network, we provide replacement parts for our own equipment and for equipment manufactured by others. Each branch of our marketing network also serves as a local parts and service business. These after-market parts and service activities generate a stream of recurring revenue and cash flow. We also offer

operational and safety training to the oil and gas production industry, which provides a marketing tool for our other products and services.

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Continued investment in research and development. We conduct product research and development activities at our facilities located in Tulsa, Oklahoma and Pittsburg, California for our own purposes and for our customers on a fee paid basis. One of our latest technology innovations is Dual Frequency® electrostatic oil separation, which offers additional efficiency to treat greater volumes of crude oil than traditional applications and has the advantage of a smaller equipment foot print. We also continue to advance technology related to the development of a compact coalescer for surface and subsea applications. Additionally, we have developed a new 30 membrane for CO_2 separation that will provide operators with higher throughput and recoveries utilizing a smaller foot print weight and lower operation and maintenance expense.

Business Strategy

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

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

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

Being competitively priced in our markets. Certain of our markets are highly competitive and our customers are sensitive to the price of our products relative to those of our competitors. In 2004 we introduced the concept of lean management to eliminate wasted effort, reduce our manufacturing, engineering and distribution costs, increase capacity utilization and improve quality and time of delivery. We expect that these continuous improvement initiatives will lower operating costs, increase productivity and in combination with selective price increases result in strengthening profit margins over time.

Pursuing international growth opportunities. We have operated in various international markets for more than 50 years. We intend to continue expanding internationally in targeted geographic regions, such as the Middle East, West Africa, Central and Southeast Asia, Latin American and Russia. Export sales and international operations provided more than half of total revenues for the year ended December 31, 2006. Revenue from overseas sales has grown over the past few years due to our expanding international presence and is expected to become an even larger percentage of our business. In order to help accomplish this goal, early in 2006 we hired a senior vice president of engineered systems to oversee our built-to-order product line related to oil and water technologies worldwide and all other engineered systems execution and delivery. Our engineering and project management offices located in the US, the UK, Japan and Canada are now fully integrated Execution Centers working in concert with our Global Marketing Group to provide more seamless solutions to customers around the world. In addition, we are in the process of expanding our presence in Southeast Asia to service expanding opportunities in that region, and are implementing more sophisticated processes and systems to enhance our project execution capabilities across all execution centers.

Providing integrated systems and solutions. We believe our integrated systems design enables us to reduce our customers production equipment and systems costs, shorten delivery times and increase run-time. Our marketing strategy is to lead with process technology, become involved with our clients

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in the early stage of projects, provide the most complete scope of equipment and services consistent with our capabilities and focus on value added solutions.

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

Pursuing complementary acquisitions. Our industry is fragmented and contains many competitors with less extensive product lines, and/or geographic scope. We continue to review potential strategic alternatives involving complementary technologies which would enhance our ability to offer integrated systems or expand our geographic reach, or that would increase product and services pull through at our branch locations.

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

Utilizing sub-contractors. We will selectively utilize sub-contractors to satisfy customer demand for products and equipment where we can manage quality, cost and delivery schedules. In North America, we will continue to optimize our manufacturing capacity by allocating man hours to higher value equipment manufacture while utilizing qualified sub-contractors to satisfy customer demand for our products. We will complement our export capabilities with continuing reliance on sub-contractors and fabricators worldwide.

Global Marketing

Our products and services are marketed primarily as NATCO branded or co-branded products through sales offices situated in the US, UK, Southeast Asia, Japan and Russia, augmented by third party agents, representatives and technical applications specialists for specific customer requirements. We maintain agency relationships in most energy producing regions of the world to enhance our efforts in countries where we do not have employees. Our Oil & Water Technologies business has an extensive branch network, primarily located in North America, through which we sell standard and traditional production equipment, spare parts and services directly to oil and gas operators. Our built-to-order business typically involves a significant pre-award investment in engineering, design and estimating in order to establish our technical qualifications, evaluate the requirements of the specific project, develop a conceptual solution which meets our clients requirements, estimate our cost to provide the system to the customer in the time frame required and to establish our appropriate risk reward relationship. Our Automation & Control business is primarily marketed under the TEST brand through an internal sales force.

Customers

We devote a considerable portion of our marketing time and effort to developing and maintaining relationships with key customers. Some of these relationships are project specific. However, our customer base ranges from independent operators to international and national oil companies as well as engineering, procurement and construction companies acting on behalf of end users. Our level of technical expertise, extensive distribution network and breadth of product offerings contributes to the maintenance of good working relationships with our customers. Several of our standard and traditional customers will award contracts that involve the manufacture and sale of multiple units over an extended period of time. These contracts may

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necessitate purchases of raw materials in advance lots to ensure favorable raw material pricing. On large built-to-order projects, warranty and performance bonds may be required by customers as part of the contract terms and conditions. These bonds, which are issued under our bank credit facilities totaled $9.5 million, $10.6 million and $9.4 million at December 31, 2006, 2005 and 2004, respectively.

For the years ended December 31, 2006, 2005 and 2004 there was no single customer that provided revenue exceeding 10% of our consolidated revenue. In regards to the concentration of revenue per segment, while our Oil & Water Technologies segment s revenue was derived from a large group of various customers, the Gas Technologies and the Automation & Controls segments relied on a few major customers for a significant portion of their revenue.

Competition

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

The primary competitors for our Oil & Water Technologies business include Hanover Compressor Co., Aker Kvaerner Process Systems, Petreco, US Filter, Weir Westgarth, Flint Energy Services and numerous privately held, mainly regional companies. Competitors for our Gas Technologies business include UOP, a Honeywell company, Westfield Engineering, Prosep Technologies Inc. and Merichem. The primary competitors for our Automation & Controls business are W- Industries, MMR-Radon, P2S/SECO, E-Production Solutions and numerous privately held companies operating in the Gulf Coast region.

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

Operating Segments

Our operating segments consist of: Oil & Water Technologies, Gas Technologies and Automation & Controls. The products and services we offer through each are outlined below.

Oil & Water Technologies

Our Oil & Water Technologies segment includes both standard and traditional oil and gas separation and dehydration equipment sales and related services and built-to-order systems focused primarily on design and delivery of more complex oil and water production and processing systems worldwide.

Standard and Traditional Equipment

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

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Our production equipment includes:

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

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

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

Water Treatment Equipment. We offer a complete line of water treatment and conditioning equipment for the removal of contaminants from water extracted during oil and gas production.

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

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

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

Built-to-order Systems

We design, engineer, procure, fabricate and manufacture engineered systems using our own facilities or third-party contractors for large production development projects throughout the world and provide start-up services for our custom- made engineered products. Engineered systems typically require a significant amount of technology, engineering, procurement, fabrication and project management. We are implementing a project delivery system designed to integrate these functions into a smooth and well-managed value chain with strong project management capabilities that will assure timely delivery of a high quality project at the cost and margin quoted.

We market built-to-order, engineered systems through our direct sales force based in the US, the UK, Southeast Asia and other international locations, augmented by independent representatives in other countries. We also use the unique oil testing capabilities of our research and development facilities to enhance our capabilities in providing production solutions using our engineered systems having equipment specifications that best suit our customers requirements.

Built-to-order systems include:

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

Offshore Production Systems. These consist of large skid-mounted processing units and can be used in conjunction with fixed offshore platforms, semi-submersible floating systems; floating, production, storage and offloading (FPSO) vessels; and other floating production vessels. Floating production equipment for oil must be specially designed to overcome the effects of wave motions on floating vessels. We pioneered and patented the first wave-motion production vessel internals system and

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continue to advance this technology at our research and development facility using a wave-motion table, which simulates a variety of sea states. We also utilize Computational Fluid Dynamic modeling and Finite Element Analysis to ensure that our systems are optimally designed and fabricated to meet durability requirements at defined sea states.

Dehydration and Desalting Systems. Dehydration and desalting involves the removal of water and salt from an oil stream. Desalting is a specialized form of dehydration, in which fresh water is injected into an oil stream to dilute the residual saltwater and remove it from the stream. Large production projects often use electrostatic technology to desalt oil. We believe that we are the leading developer of electrostatic technologies for oil treating and desalting. One of our dehydration and desalting systems, the Electro Dynamic Desalter, can be used in oil refineries, where stringent desalting requirements have grown increasingly important. These requirements have increased as crude quality has declined and catalysts have become more sensitive and sophisticated, requiring lower levels of contaminants. This technology reduces the number and size of vessels employed by this system and is particularly important in refinery and offshore applications where space is at a premium.

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

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

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

Downstream Facilities. We offer several technologies that have crossover applications in the refinery and petrochemical sectors. Most involve aspects of oil and water treating. Through our UK operation, we also design and supply process facilities for hydrogen generation and purification, which is used in refineries and petrochemical plants or by industrial gas suppliers. In addition, we provide DOX units to ethylene processors that clean both heavy and light dispersed oil from water.

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

Gas Technologies

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

Carbon Dioxide Field Operations. We manufacture gas-processing facilities for the removal of carbon dioxide from hydrocarbon streams. These facilities use our proprietary Cynara® membrane technology that provides one of the more

effective separation solutions for hydrocarbon streams containing high concentration of carbon dioxide. One of the markets for these facilities is production from wells such

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as those located in West Texas in which carbon dioxide injection is used to enhance the recovery of oil reserves. Utilizing this technology, we have participated in a series of arrangements with Kinder Morgan CO_2 Company, L.P. relative to gas processing of production at the Sacroc field in West Texas. These arrangements include provision of facilities which we operate and maintain, sale of other facilities which we operate on behalf of Kinder Morgan, and sale of facilities which Kinder Morgan operates and maintains. While these arrangements generally have a ten-year term from inception, all are terminable by Kinder Morgan after a specified notice period and payment of associated cancellation charges. Certain of such arrangements have a buyout requirement intended to partially compensate the Company for loss of contract and equipment value should Kinder Morgan elect to terminate the arrangement prior to the agreed term.

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

Separation of the H_2S and Sulfur Recovery. We license Shell Paques and Paques bio-desulfurization technology under agreements with Shell Global Solutions® entered into in 2002. Shell Paques is licensed for use in natural gas production applications in North and South America, excluding Canada, while Paques is licensed for use in biogas applications in North America. These technologies potentially provide operating cost and environmental advantages over existing desulfurization technologies for desulfurization facilities. The technology has been certified through the Environmental Protection Agency s Environmental Technology Verification program. We are continuing to evaluate the effectiveness of this technology for high-pressure natural gas applications. To date, the technology has been proven in a variety of applications, including biogas, high pressure natural gas, associated gas and landfill gas.

Automation & Controls

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

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

Engineering and Instrumentation Field Services. We provide the service of engineering and instrumentation professionals for start-up support, testing, maintenance, repair, renovation, expansion and upgrade of control systems, including those designed or installed by others for our customers worldwide. Our design and engineering staff also provide contract electrical engineering services. We also offer compliance services with complete facility audits, monthly testing, quarterly reviews and US Coast Guard inspections, as well as providing management services for monthly US Minerals Management Service paperwork and records.

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SCADA Systems. Supervisory control and data acquisition (SCADA) systems provide remote monitoring and control of equipment, production facilities, pipelines and compressors via radio, cellular phone, microwave and satellite communication links. SCADA systems reduce the number of personnel and frequency of site visits and allow for continued production during periods of emergency evacuation, thereby reducing operating costs.

Manufacturing and Fabrication Facilities

We operate four primary manufacturing and fabrication facilities ranging in size from approximately 47,600 square feet to approximately 130,000 square feet of manufacturing space which, along with other third-party sub-contractors, support our product technology lines. We own three of these facilities and lease one. Our major manufacturing facilities are:

Oil & Water Technologies

Standard and Traditional

Electra, Texas. We produce various types of low- and high-pressure production vessels, as well as skid-mounted packages at this 130,000 square foot facility.

Magnolia, Texas. We fabricate various types of low-pressure production vessels and skid packages at this 47,600 square foot facility. This facility also refurbishes used equipment.

Calgary, Alberta, Canada. We produce heavy wall and cold weather packaged equipment and systems primarily for the Canadian, Alaskan and Russian markets at this 93,000 square foot facility. This facility also does manufacturing and fabricating for both our standard and traditional and built-to-order product lines.

Built-to-order

New Iberia, Louisiana. We fabricate packaged production systems for delivery throughout the world at this 60,000 square foot, a 16-acre, waterfront facility, which can handle large integrated equipment systems. This facility has been organized to support the integrated project delivery system of our built-to-order systems groups.

Automation & Controls

We fabricate control panels at an 8,200 square foot facility that we own in Harvey, Louisiana and a 22,800 square foot facility that we lease in Houston, Texas.

Gas Technologies

Membranes for our Cynara technology are manufactured at an 8,000 square foot facility that we lease in Pittsburg, California.

Other

In 2004, we initiated, on a company-wide basis, the use of lean management techniques previously implemented at our Calgary facility to focus first on lean manufacturing and then general business processes. Lean manufacturing is a process designed to identify and eliminate waste in the manufacturing process through continuously improving product flow in an effort to meet customer needs. By more effectively producing products that specifically meet customer requirements we have reduced our manufacturing costs and increased utilization capacity at our existing facilities and improved productivity. Lean management applies the principles

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of eliminating waste and improving efficiency across the entire organization to better position the Company to realize its full potential. We continue to apply these principles to various aspects of our operations, including, during 2006, the worldwide engineering execution centers.

Our manufacturing operations are vertically integrated. At most locations, we are able to engineer, design, fabricate, inspect and test our products. Consequently, we are able to control the quality of our products, manage the cost of goods sold relative to the expected sales price and satisfy the delivery requirements of our customers.

Our New Iberia, Electra and Calgary facilities have been certified to ISO 9001 standards. This certification is an internationally recognized verification system for quality management overseen by the International Standards Organization based in Geneva, Switzerland. The certification is based on a review of our programs and procedures designed to maintain and enhance quality production and is subject to annual review and re-certification.

We maintain a high standard of health, safety and environmental performance at each facility. We fabricate to the standards of the American Petroleum Institute, the American Welding Society, the American Society of Mechanical Engineers and specific customer specifications. We use welding and fabrication procedures in accordance with the latest technology and industry requirements. We have instituted training programs to assure safe operations, upgrade skilled personnel and maintain high quality standards. We believe these programs generally enhance the quality of our products.

Raw Materials & Components

Materials and components used in our servicing and manufacturing operations and purchased for sale are generally available from multiple sources. The prices paid by us for raw materials may be affected by, among other things, energy, steel and other commodity prices; tariffs and duties on imported materials; and foreign currency exchange rates. While we attempt to mitigate the financial impact of higher raw materials costs on our operations by assigning appropriate bid validity dates to our contract proposals, applying surcharges to and adjusting prices on the products we sell, we are not always successful in anticipating price increases or in passing these increases on to our customers. Higher prices and lower availability of steel, stainless steel, special metal alloys containing chromium and nickel and other raw materials used in our business may adversely impact our profitability in future periods.

Research and Development

We believe we are an industry leader in the development of oil and gas production equipment technology. We pioneered many of the original separation technologies for converting unprocessed hydrocarbon fluids into salable oil and gas.

As of December 31, 2006, we held over 50 active US and equivalent foreign patents and numerous US and foreign trademarks. While important to our business, we would not expect the loss of any one of these patents to be material. In addition, we are licensed under several patents held by others.

We operate a research and development facility in Tulsa, Oklahoma, where we conduct technology and product development studies that are tailored to the needs of our customers. Our electrostatics pilot unit is capable of running client crudes for all our electrostatic offerings and those of our competitors. Through paid testing programs, we are able to show clients how our electrostatic technologies are better suited than those of our competitors. In addition, we utilize a simulation loop capable of flowing 6,000 barrels per day of crude and 10 million cubic feet per day of gas, and a wave motion table that allows customers to validate $1/20^{th}$ scale performance internals in dynamic wave motion conditions to run client paid studies that are linked to our products. In many cases, testing is applied to crude oil provided by our customers, resulting in an increase in our customers understanding and comfort with the actual performance of our products.

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At our manufacturing facility in Pittsburg, California, we are engaged in active, ongoing research and development in the area of membrane technology. We also have research and development operations at our facilities in the UK where we focus primarily on water treatment developments.

As a contracted service to our customers, we utilize Computational Fluid Dynamic (CFD) modeling to dynamically simulate the conditions of process equipment both offshore and onshore. CFD studies have been key to validating performance and durability of process equipment and are offered as a competitive advantage to our hardware sales.

We engage on a technical basis with customers for our technologies through both the use of our pilot testing facilities and through the problem solving capabilities of our Process Solutions Group engineers. In Tulsa, OK, we enter into contracts with our clients to run pilot or bench scale tests on their specific field production streams. Through such testing, we prove out our product capabilities and performance, often with customers in attendance to observe the testing progress. In addition, in order to provide that our key technologies are integrated into both retrofitting and greenfield projects appropriately, we enter into engineering contracts with our customers. Frequently, these engineering studies or pilot testing contracts can result in either direct awards from these clients or can favorably impact the client s buying specifications.

At December 31, 2006, we had 26 employees engaged in research and development and product commercialization activities.

Environmental Matters

We are subject to environmental regulation by federal, state and local authorities in the United States and in several foreign countries. Although we believe we are in substantial compliance with all applicable environmental laws, rules and regulations (laws), the field of environmental regulation can change rapidly with the enactment or enhancement of laws and stepped up enforcement of these laws, either of which could require us to change or discontinue certain business activities as further described under Risk Factors We may incur substantial costs to comply with our environmental obligations. We have been named as a potentially responsible *de minimis* party in connection with one federal superfund site under the US Comprehensive Environmental Response, Compensation and Liability Act, also known as CERCLA. At present, we are not involved in any material environmental matters of any nature and are not aware of any material environmental matters threatened against us.

Employees

At December 31, 2006 and 2005, we had 2,304 and 1,959 full-time employees, respectively. Of these, 135 and 151, or 6% and 8% of our workforce, respectively, were Canadian employees represented under collective bargaining agreements that extend through July 2007. The increase in the number of employees at year-end 2006 was due to overall increased activity, with the international operations of the Automation and Controls segment responsible for 9.4% of the rise. We believe our relationships with our employees and the bargaining unit representing our Canadian workers are satisfactory.

Available Information and Required Certifications

We are a reporting company under the Securities Exchange Act of 1934, as amended, and file reports, proxy statements and other information with the Securities and Exchange Commission. Copies of these reports, proxy statements and other information may be inspected and copied at the SEC s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. You may also access our filings on the SEC s website at *www.sec.gov*. Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and proxy statements, as well as any amendments and exhibits to those documents, are available free of charge through our website, *www.natcogroup.com*, as soon as reasonably practicable after we file them with, or furnish them to, the SEC. We also make available, free of charge on our website and in print to any stockholder who

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requests, our corporate governance guidelines, the charters of our board committees and our business ethics policies. Requests for copies can be directed to Investor Relations, telephone: 713-683-9292. The information contained on our website is not incorporated by reference into this Annual Report on Form 10-K and should not be considered part of this report.

We have attached to this report the required certifications under Section 302 of the Sarbanes-Oxley Act of 2002 regarding the quality of our public disclosures as Exhibits 31.1 and 31.2.

We previously filed with the New York Stock Exchange the 2006 annual CEO certification regarding our compliance with the NYSE s corporate governance standards as required by NYSE rule 303A.12 (a). There were no qualifications to the annual certification.

Item 1A. ***Risk Factors***

Risks Relating to Our Business

Our achievement of projected revenue and earnings targets in 2007 and beyond is dependent on our ability to successfully implement our strategic goals. We have adopted a business plan aimed at increasing our revenues during 2007. We expect this will be achieved through increased market penetration of existing products, greater pull-through in our branch network, and commercialization of new products. If we are unable to effectively execute these plans, our revenue and earnings could be lower than anticipated. Our ability to effectively execute these plans could be adversely affected if our business assumptions do not prove to be accurate or if adverse changes occur in our business environment, such as: potential declines or increased volatility in oil and natural gas prices that would adversely affect our customers and the energy industry causing a deferral or cancellation of spending plans; reduction in rig activity; reduction in prices or demand for our products and services; general global economic and business conditions, our ability to successfully integrate acquisitions, our ability to generate technological advances and compete on the basis of our technology, the potential for unexpected litigation or regulatory proceedings and potential higher prices for products used by us in our operations.

Our achievement of productivity improvements in 2007 and beyond is dependent on our ability to successfully execute our efficiency initiatives. Starting in 2004, we initiated on a company-wide basis the use of lean management techniques. Lean management is a process designed to identify and eliminate waste in the business process through continuously improving work flow in an effort to meet customer needs. By more effectively producing products that specifically meet customer requirements, we hope to reduce our costs and increase utilization capacity at our existing facilities and improve productivity. Lean management applies these principles to the entire organization to better position the Company to realize its full potential. During 2006, we completed the final phase of consolidating and integrating our UK-based operations into our global network of engineering execution centers.

Competition could result in reduced profitability and loss of market share. Contracts for our products and services are generally awarded on a competitive basis. Historically, our markets have been very competitive in terms of the number of suppliers providing alternative products and technologies. The most important factors considered by our customers in awarding contracts include: the availability and capabilities of our equipment; our ability to meet the customer s delivery schedule; price; our reputation; our technology; our experience; and our safety record.

In addition, we may encounter obstacles in our international operations that impair our ability to compete in individual countries. These obstacles may include: subsidies granted in favor of local companies; legal requirements for local content; taxes, import duties and fees imposed on foreign operators; contracts being denominated in local currencies; lower wage rates in foreign countries; and fluctuations in the exchange value of the United States dollar compared with the local currency. Any or all these factors could adversely affect our ability to compete and thus adversely affect our results of operations.

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Our international operations may experience interruptions due to political and economic risks. We operate our business and market our products and services throughout the world. We are, therefore, subject to the risks customarily attendant to international operations and investments in foreign countries. Moreover, oil and gas producing regions in which we conduct business include many countries in the Middle East, West Africa, Venezuela and other parts of the world, where risks remain high or have increased significantly of late. We cannot accurately predict whether these risks will increase or abate. These risks include: nationalization; expropriation; war, terrorism and civil disturbances; restrictive actions by local governments; limitations on repatriation of earnings; changes in foreign tax laws; changes in banking regulations; and changes in currency exchange rates.

The occurrence of any of these risks could have an adverse effect on regional demand for our products and services or our ability to provide them. Further, we may experience restrictions in travel to visit customers or start-up projects, and we may incur added costs by implementing security precautions. An interruption of our international operations could have a material adverse effect on our results of operations and financial condition.

Consistent with the laws of their respective jurisdictions of incorporation, our UK-based operations, our Japanese subsidiary and our Canadian subsidiary have made sales (as part of their ongoing businesses), and have informed us that they expect to continue making sales, of non-US equipment and services to customers in certain countries that are subject to US government trade sanctions (Embargoed Countries). In the past, these included sales to the Iraqi national oil companies permitted under the United Nations Oil-For-Food Program and to Iran, Sudan, Libya and Syria. Certain US sanctions on doing business in Iraq and Libya were lifted during 2004. Sales to customers in Embargoed Countries were less than 1% of our consolidated revenue in each of the years 2006 and 2005 and approximately 2% in 2004.

A substantial or extended decline in commodity prices could result in lower expenditures by the oil and gas industry, thereby negatively affecting our revenue and results of operations. Our business is substantially dependent on the condition of the oil and gas industry and its willingness to spend capital on the exploration for and development of oil and gas reserves. A substantial or extended decline in these expenditures may result in the discovery of fewer new reserves of oil and gas and/or the delay in development of known reserves, thereby adversely affecting the market for our production equipment and services. The level of these expenditures is generally dependent on the industry s view of future oil and gas prices, which have been characterized by significant volatility in recent years. Oil and gas prices are affected by numerous factors outside of our control, including: the level of exploration activity; worldwide economic activity; interest rates; the cost of capital and currency exchange rate fluctuations; environmental regulation; tax policies; energy policies and political requirements of national governments; coordination by the Organization of Petroleum Exporting Countries (OPEC); political environment, including war and terrorism; the cost of producing oil and gas; technological advances; changes in the supply of and demand for oil, natural gas and electricity; and weather conditions.

The dollar amount of our backlog, as stated at any given time, is not necessarily indicative of our future cash flow. Backlog consists of firm customer orders that have satisfactory credit or financing arrangements in place, for which authorization to begin work or purchase materials has been given and for which a delivery date has been indicated. We cannot guarantee the revenues projected in our backlog will be realized, or if realized, will result in profits.

Occasionally, a customer will cancel or delay a project for reasons beyond our control. In the event of a project cancellation, we are generally reimbursed for our costs, but typically have no contractual right to the total revenues expected from any such project as reflected in our backlog. In addition, projects may remain in our backlog for extended periods of time. If we were to experience significant cancellations or delays of projects in our backlog, our results of operations and financial condition could be materially adversely affected.

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Most of our contracts are fixed-price contracts that are subject to gross profit fluctuations, which may impact our margin expectations. Most of our projects, including larger engineered systems projects, are performed on a fixed-price basis. We are responsible for all cost overruns, other than any resulting from customer-approved change orders. Our costs and any gross profit realized on our fixed-price contracts will often vary from the estimated amounts on which these contracts were originally based. This may occur for various reasons, including: errors in estimates or bidding; changes in availability and cost of labor and materials; and variations in productivity from our original estimates. These variations and the risks inherent in engineered built-to-order projects may result in reduced profitability or losses on our projects. Depending on the size of a project, variations from estimated contract performance can have a significant negative impact on our operating results or our financial condition.

Long-term contracts for operation of owned separation facilities are cancelable. We operate certain of our assets under long-term contracts for our customers. In exchange for our ownership and operation of these assets, our customers pay us a tolling fee based on the facility s throughput. Each contract is cancelable at the customer s option subject to provisions which require, among other things, payment of significant cancellation fees. In the event of a cancellation, the Company would receive the cancellation charge and would retain custody of the assets, but would lose the future revenue stream associated with the cancelled contract. There can be no assurance the Company would have suitable alternative uses for the assets or cash which would offset the lost revenue from any canceled contract.

Certain of our segments relied, and may continue to rely, on a limited number of customers for a significant portion of their revenues. There have been and are expected to be periods where a substantial portion of the revenue in certain of our segments is derived from a small group of customers. We have a number of ongoing relationships with major oil companies, national oil companies and large independent producers. The loss of one or more of these ongoing relationships could have an adverse effect on our business and results of operations of the affected segments.

We may experience losses caused by being unable to collect amounts due from customers. We typically do business with our customers on an open account basis. Credit limits are established for each customer and the credit exposure with them is routinely monitored. It is possible that we could experience losses from customers inability to pay amounts due the company. For our custom engineered built-to-order systems, customers make payments to us as the work progresses toward completion. However, if a customer became insolvent or filed for bankruptcy protection the value of the equipment may be less than the amount owed by the customer thereby creating a loss for the Company. While we take reasonable precautions to safeguard against experiencing such losses, there is no assurance they will not occur.

Liability to customers under warranties may materially and adversely affect our cash flow. We typically warrant the workmanship and materials used in the equipment we manufacture. At the request of our customers, we may warrant the operational performance of the equipment we manufacture. Failure of this equipment to operate properly or to meet specifications may increase our costs by requiring additional engineering resources, replacement of parts and equipment or service or monetary reimbursement to a customer. Our warranties often are backed by letters of credit. At December 31, 2006, we had provided to our customers approximately $9.5 million in letters of credit related to performance and warranties. We have received warranty claims in the past, and we expect to continue to receive them in the future. To the extent that we incur warranty claims in any period substantially in excess of our warranty reserve, our results of operations and financial condition could be materially and adversely affected.

Our ability to attract and retain skilled labor is crucial to our profitability. Our ability to succeed depends in part on our ability to attract and retain skilled manufacturing workers, equipment operators, engineers and other technical personnel. Our ability to expand our operations depends primarily on our ability to increase our labor force. Demand for these workers can fluctuate in line with overall activity levels within our industry and from competition from other industries. A significant increase in the wages paid by competing employers

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could result in increases in the rates of wages we must pay. If this were to occur and we were unable to pass such cost increases on to customers, the effect would be a reduction in our profits and to the extent that our available work force were to contract, the effect would diminish our production capacity and profitability and impairment of our growth potential.

Our ability to manage third party sub-contractors could affect our profitability. For certain orders, we use third party contractors to do portions of the work. Also, in the future, we intend to increase our utilization of sub-contractors, especially for fabrication requirements, when it makes economic sense to do so. Using sub-contractors carries a degree of risk and could result in project delays; escalated costs; substandard quality; rework and warranty costs that may not be recoverable under the prime contract resulting in lower project margins or, possibly, losses due to non-performance; and liquidated damages. Any of the foregoing could adversely affect our business reputation and profitability.

Future acquisitions, if any, may be difficult to integrate, disrupt our business and adversely affect our operating results. We intend to consider and, if feasible, to make strategic acquisitions of other companies, assets and product lines that complement or expand our existing businesses. We cannot assure you we will be able to successfully identify suitable acquisition opportunities or to finance and complete any particular acquisition. Furthermore, acquisitions involve a number of risks and challenges, including: the diversion of our management s attention to the assimilation of the operations and personnel of the acquired business; possible adverse effects on our operating results during the integration process; potential loss of key employees and customers of the acquired companies; potential lack of experience operating in a geographic market of the acquired business; an increase in our expenses and working capital requirements; and the possible inability to achieve the intended objectives of the business combination. Any of these factors could adversely affect our ability to achieve anticipated levels of cash flow from an acquired business or realize other anticipated benefits of an acquisition.

Our quarterly revenues and cash flow may fluctuate significantly. Our revenues are substantially derived from significant contracts that are often performed over periods of two to six or more quarters. As a result, our revenue and cash flow may fluctuate significantly from quarter to quarter, depending upon our ability to replace existing contracts with new orders and upon the extent of any delays in completing existing projects.

Our insurance policies may not cover all claims against us or may be insufficient in amount to cover such claims. Some of our products are used in potentially hazardous production applications that can cause personal injury; loss of life; damage to property, equipment or the environment; and suspension of operations. We maintain insurance coverage against these and other risks associated with our business in accordance with standard industry practice. This insurance may not protect us against liability for some kinds of events, including events involving pollution, losses resulting from business interruption or acts of terrorism or damages from breach of contract by the Company or based on alleged fraud or deceptive trade practices. We cannot assure you our insurance will be adequate in risk coverage or policy limits to cover all losses or liabilities that we may incur. Moreover, we cannot assure that we will be able in the future to maintain insurance at levels of risk coverage or policy limits that we deem adequate. Any future damages caused by our products or services that are not covered by insurance or are in excess of policy limits could have a material adverse effect on our business, results of operations and financial condition.

We may incur substantial costs to comply with our environmental obligations. In our equipment fabrication and refurbishing operations, we generate and manage hazardous wastes. These include: waste solvents; waste paint; waste oil; wash-down wastes; and sandblasting wastes. We attempt to identify and address environmental issues before acquiring properties and to utilize industry accepted operating and disposal practices regarding the management and disposal of hazardous wastes. Nevertheless, either others or we may have released hazardous materials on our properties or in other locations where hazardous wastes have been taken for disposal. We may be required by federal, state or foreign environmental laws to remove hazardous wastes or to remediate sites where they have been released. We could also be subjected to civil and criminal penalties for violations of those laws. Our costs to comply with these laws may adversely affect our earnings.

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Our ability to obtain necessary financing may be limited. Our ability to execute our growth strategies may be limited by our ability to secure and retain reasonably priced financing. From time to time, we have utilized significant amounts of letters of credit to secure our performance, bids or milestone payments on large projects, and to provide guarantees or warranties to our customers. Outstanding letters of credit can consume a significant portion of our available liquidity under our revolving credit facilities. Some of our competitors are larger companies with better access to capital, which could give them a competitive advantage over us should our access to capital be limited.

Our system of internal controls is designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of our financial statements for external purposes. A loss of public confidence in the quality of our internal controls or disclosures could have a negative impact on us. Our system of internal controls is designed to provide reasonable assurance that the objectives of the control system are met. However, any system of internal controls is subject to inherent limitations and the design of our controls may not provide absolute assurances that all of our objectives will be entirely met. This includes the possibility that controls may be inappropriately circumvented or overridden, that judgments in decision-making can be faulty, and that misstatements due to errors or fraud may not be prevented or detected.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

We operate four primary manufacturing plants ranging in size from approximately 47,600 square feet to approximately 130,000 square feet of manufacturing space. In addition, we operate smaller, single-product manufacturing facilities at three branch sites. We also own and lease distribution and service centers, sales offices and warehouses. We lease our corporate headquarters in Houston, Texas. At December 31, 2006, we owned or leased approximately 757,000 square feet of facilities of which approximately 324,000 square feet was leased, and approximately 433,000 square feet was owned. Of the total manufacturing space, approximately 237,600 square feet was located in the United States and approximately 93,000 square feet was located in Canada.

The following chart summarizes the number of facilities owned or leased by us by geographic region and business segment in as of December 31, 2006.

	United States	Canada	Other
Oil & Water Technologies	37	5	4
Gas Technologies	3		1
Automation & Controls	2		1
Corporate and Other	1		
Totals	43	5	6

We believe our facilities are in good operating condition and that each of our significant manufacturing facilities is operating at a level consistent with the requirements of the industry in which it operates.

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Item 3. ***Legal Proceedings***

NATCO and its subsidiaries are defendants or otherwise involved in a number of legal proceedings in the ordinary course of their business. We also are parties to certain environmental proceedings as described in Item 1. Business Environmental Matters. While we insure against the risk of these proceedings to the extent deemed prudent by our management, we can offer no assurance that the type or value of this insurance will meet the liabilities that may arise from any pending or future legal proceedings related to our business activities. While we cannot predict the outcome of any legal proceedings with certainty, in the opinion of management, our ultimate liability with respect to any of these pending lawsuits, is not expected to have a significant or material adverse effect on our consolidated financial position, results of operations or cash flows.

Item 4. ***Submission of Matters to a Vote of Security Holders***

There were no matters submitted to a vote of security holders during the fourth quarter of 2006.

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PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Stock Market Information

Our common stock is traded on the New York Stock Exchange (NYSE) under the ticker symbol NTG. The following table sets forth, for the calendar quarters indicated, the closing high and low sales prices of our common stock reported by the NYSE for each of the fiscal years ended December 31, 2005 and 2006.

	Common Stock	
	High	Low
2005		
First Quarter	$ 12.64	$ 8.64
Second Quarter	13.76	9.97
Third Quarter	25.70	12.96
Fourth Quarter	27.11	19.05
2006		
First Quarter	$ 29.35	$ 20.73
Second Quarter	40.20	27.48
Third Quarter	41.30	28.11
Fourth Quarter	35.94	27.09

Stock Performance Graph

The following performance graph compares the five-year total stockholder return on our common stock, assuming a $100 investment, to the total return on the Standard & Poor s 500 Stock Index and the Philadelphia OSX Index, an index of oil and gas related companies which represents an industry composite of the Company s peer group, for the period beginning December 31, 2001 through December 29, 2006.

	Investment					
	12/31/2001	12/31/2002	12/31/2003	12/31/2004	12/30/2005	12/30/2006
NATCO	$ 100.00	$ 89.71	$ 108.43	$ 125.71	$ 292.29	$ 455.43
S&P 500	$ 100.00	$ 76.63	$ 96.85	$ 105.56	$ 108.73	$ 123.54
OSX	$ 100.00	$ 99.50	$ 107.82	$ 142.23	$ 209.02	$ 229.40

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Stockholders Matters

Our authorized common stock consists of 50,000,000 shares. As of December 31, 2006 we had no treasury shares. We had 17,367,222 shares outstanding as of March 1, 2007, held by 82 record holders and the closing price per share on such date was $31.20 as quoted by NYSE. The number of record holders of our common stock does not include the stockholders for whom shares are held in a nominee or street name.

Our shares outstanding as of December 31, 2006 included 161,894 shares of restricted stock as to which forfeiture restrictions have not lapsed. We had 5,000,000 shares of preferred stock authorized at March 1, 2007, of which 500,000 shares were designated Series A Junior Participating Preferred Stock and 15,000 shares were designated Series B Convertible Preferred Stock (Series B Preferred Shares). At that date, there were no Series A preferred shares outstanding and 15,000 Series B Preferred Shares outstanding, issued to five record holders. At March 1, 2006, the Series B Preferred Shares were immediately convertible, at the option of the holder, into 1,921,845 shares of common stock.

We do not intend to declare or pay any dividends on our common stock in the foreseeable future, but rather intend to retain any future earnings in excess of the preferred stock dividend amount for use in our business. Our 2006 revolving credit facilities restrict our ability to pay dividends and other distributions on our common stock. Pursuant to the terms of our Series B Preferred Shares we pay a semi-annual dividend to holders of such stock of 10% of the face value of the stock, or an aggregate of $1.5 million per year.

Issuer Purchases of Equity Securities

The following table summarizes the surrenders of the Company s equity securities during the three months ended December 31, 2006:

Period	Total Number of Shares Purchased[1]	Average Price Paid per Share[2]	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
October 1 to 31, 2006				
November 1 to 30, 2006	20,674	$ 35.575		
December 1 to 31, 2006				
Three months ended December 31, 2006	20,674	$ 35.575		

(1) This acquisition of equity securities was the result of surrender of restricted stock by certain recipients to pay required tax withholding on lapse of restrictions on the restricted stock, pursuant to the terms of the Company s-shareholder approved equity compensation plans and the terms of the equity grants pursuant to those plans.

(2) The purchase price of a share of stock used for tax withholding is the fair market value of the stock on the date of lapse of the restrictions of the restricted stock, based on the average high and low reported sales prices of the Company s common stock on that date (in accordance with the Company s equity compensation plans).

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Item 6. ***Selected Financial Data***

The following summary consolidated historical financial information for the periods and the dates indicated should be read in conjunction with our consolidated historical financial statements.

	For the Year Ended December 31,				
	2006	2005	2004	2003	2002
	(in thousands, except per share amounts)				
Statement of Operations Data:					
Revenues	$ 519,041	$ 400,486	$ 321,451	$ 281,462	$ 289,539
Cost of goods sold and services	381,643	303,702	246,717	215,459	219,354
Gross profit	137,398	96,784	74,734	66,003	70,185
Selling, general and administrative expense	71,508	60,409	54,230	51,476	53,947
Depreciation and amortization expense	5,494	5,226	5,376	5,069	4,958
Closure, severance and other	2,511	2,663	4,098	2,105	548
Interest expense	2,135	3,815	3,846	4,085	4,527
Interest cost on postretirement benefit liability		767	830	837	471
Interest income	(532)	(86)	(123)	(190)	(248)
Minority interest	337				
Other, net	(1,534)	1,939	2,820	1,211	400
Income before income taxes and cumulative effect of change in accounting principle	57,479	22,051	3,657	1,410	5,582
Income tax provision	19,508	7,866	3,043	1,243	1,705
Income before cumulative effect of change in accounting principle	37,971	14,185	614	167	3,877
Cumulative effect of change in accounting principle, net of income tax[(1)]				34	
Preferred stock dividends	1,500	1,500	1,500	1,152	
Net income (loss) allocable to common stockholders	$ 36,471	$ 12,685	$ (886)	$ (1,019)	$ 3,877
Earnings per share Basic	$ 2.16	$ 0.78	$ (0.06)	$ (0.06)	$ 0.25
Earnings per share Diluted	$ 1.97	$ 0.77	$ (0.06)	$ (0.06)	$ 0.24
Balance Sheet Data (at the end of the period)					
Total assets	$ 322,541	$ 283,743	$ 252,577	$ 237,728	$ 231,595
Stockholders equity	$ 172,649	$ 122,168	$ 96,190	$ 92,476	$ 91,852
Series B preferred stock, net	$ 14,222	$ 14,222	$ 14,222	$ 14,101	$
Long-term debt, excluding current installments	$	$ 20,964	$ 38,935	$ 38,003	$ 45,257
Postretirement and other long-term liabilities	$ 7,809	$ 9,814	$ 11,226	$ 11,897	$ 12,718

(1) We recorded in fiscal year 2003 the cumulative effect of a change in accounting principle associated with the adoption of Statement of Financial Accounting Standards (SFAS) No. 143, Accounting for Asset Retirement Obligations.

We reorganized our operations as of January 2005. Information for prior years has been restated to reflect this reorganization. See Item 1. Business, Our Recent History.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

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

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Overview

Our business segments are Oil & Water Technologies, Gas Technologies and Automation & Controls. The Oil & Water Technologies group is our largest segment and consists of two product lines. The first is our standard and traditional product line consisting of oil and gas separation and dehydration equipment sales and related services and an extensive North American branch distribution network. The second product line includes built-to-order process systems, which are focused primarily on oil and water production and processing systems designed and built to meet customer specifications. The Gas Technologies group includes our CO_2 membrane business, the assets and operating relationship related to gas processing facilities in West Texas and H_2S removal technologies, including Shell Paques. The Automation & Controls group focuses on sales of new control panels and systems that monitor and control oil and gas production, as well as field service activities, including repair, maintenance, testing and inspection services for existing systems. We allocate corporate and other expenses to each of the segments, rather than segregating these costs on a standalone basis. Certain reclassifications have been made to fiscal 2004 amounts in order to present these results on a comparable basis with amounts for fiscal 2005 and 2006.

Forward-Looking Statements

This Annual Report on Form 10-K, including Management s Discussion and Analysis of Financial Condition and Results of Operations, 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, designed to, estimate, will, could, may and similar expressions are intended to identify forward-looking Statements. Forward-looking statements in this document include, but are not limited to, discussions of accounting policies and estimates, indicated trends in the level of oil and gas exploration and production and the effect of such conditions on our results of operations (see Industry and Business Environment), growth plans for 2007 and beyond, future uses of and requirements for financial resources (see Liquidity and Capital Resources), impact of bookings on future revenues and anticipated backlog levels. Our expectations about our business outlook, customer spending, potential acquisitions, oil and gas prices and our business environment and that of the industry in general are only our expectations regarding these matters. Actual results may differ materially from those in the forward-looking statements contained in this report for reasons including, but not limited to: market factors such as pricing and demand for petroleum related products, the level of petroleum industry exploration and production expenditures, the effects of competition, the availability of a skilled labor force, world economic conditions, the level of drilling activity, the legislative environment in the United States and other countries, energy policies of OPEC, conflict involving the United States or in major petroleum producing or consuming regions, acts of war or terrorism, technological advances that could lower overall finding and development costs, weather patterns and the overall condition of capital markets for countries in which we operate.

The following discussion should be read in conjunction with the financial statements, related notes and other financial information appearing elsewhere in this Annual Report on Form 10-K. Readers are also urged to carefully review and consider the various factors, including, without limitation, the disclosures made in Item 1A. Risk Factors and the other factors and risks discussed in this Annual Report on Form 10-K and in subsequent reports filed with the Securities and Exchange Commission that may affect us and the outcomes related to our forward-looking statements. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statement to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any forward-looking statement is based.

Critical Accounting Policies and Estimates

The preparation of our consolidated financial statements requires us to make certain estimates and assumptions that affect the results reported in our consolidated financial statements and accompanying notes.

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These estimates and assumptions are based on historical experience and on our future expectations we believe to be reasonable under the circumstances. Note 2 to our consolidated financial statements contains a summary of our significant accounting policies. We believe the following accounting policies and estimates are the most critical in the preparation of our consolidated financial statements.

Revenue Recognition: Percentage-of-Completion Method. We recognize revenues and related costs when products are shipped and services are rendered for (1) time and materials and service contracts, (2) manufactured goods produced in standard manufacturing operations and sold in the ordinary course of business through regular marketing channels and (3) certain customized manufactured goods that are smaller jobs with less customization, making them similar to such standard manufactured goods (that is, contracts valued at $250,000 or less having contract durations of four months or less). We recognize revenues using the percentage of completion method on contracts greater than $250,000 and having contract durations in excess of four months that represent customized, engineered orders of our products and qualify for such treatment in accordance with the requirements of AICPA Statement of Position 81-1, Accounting for Performance of Certain Production-Type Contracts (SOP 81-1). In addition, we use the percentage of completion method on all Automation & Controls segment equipment fabrication and sales projects that qualify for such treatment in accordance with the requirements of SOP 81-1. The Automation & Controls segment sells customized products fabricated to order pursuant to a large number of smaller contracts with durations of two to three months, with occasional large systems projects of longer duration. The segment does not produce standard units or maintain an inventory of products for sale. Due to the nature of the segment s equipment fabrication and sales operations, and the potential for wide variations in our results of operations that could occur from applying the as shipped methodology to smaller contracts for these customized, fabricated goods, this segment recognizes revenues, regardless of contract value or duration, applying the percentage of completion method. In 2006, approximately 53.3% of total company revenues were recorded on an as shipped or as performed basis, and approximately 46.7% were recorded using the percentage of completion method.

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

Estimates are subjective in nature and it is possible that we could have used different estimates of total contract costs in our calculation of revenue recognized using the percentage of completion method. As of December 31, 2006, the Company had $105.2 million in revenues attributable to open percentage completion projects having an aggregate gross margin of 20.3%. If we had used a different estimate of total contract costs for each contract in progress at December 31, 2006, a 1% increase or decrease in the estimated margin earned on each contract would have increased or decreased total revenue and pre-tax income for the year ended

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December 31, 2006, by approximately $1.3 million. As of December 31, 2006, the Company had two contracts in a loss position, with an estimated aggregate loss of $1.8 million.

We reported our revenue net of any tax assessed by a government authority and imposed concurrent with or subsequent to a revenue-producing transaction between us and our customers.

Goodwill evaluation. As required by Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, we evaluate goodwill annually for impairment by comparing the fair value of operating assets to the carrying value of those assets, including any related goodwill. As required by SFAS No. 142, we identified separate reporting units for purposes of this evaluation. We used our segments as the reporting units, and tested the segments as of December 31, 2006. In determining carrying value, we segregated assets and liabilities that, to the extent possible, are clearly identifiable by specific reporting unit. Certain corporate and other assets and liabilities, that are not clearly identifiable by specific reporting unit, are allocated as permitted by the standard. Fair value is determined by discounting projected future cash flows using our weighted average cost of capital, as calculated. In determining projected future cash flows for each segment, we make assumptions regarding the following key indicators: future market and sales growth rates (domestic and international), cost inflation, margin expectations, working capital, capital expenditure levels and tax levels. The fair value is then compared to the carrying value of the reporting unit to determine whether or not impairment has occurred at the reporting unit level. In the event an impairment is indicated, an additional test is performed whereby an implied fair value of goodwill is determined through an allocation of the fair value to the reporting unit s assets and liabilities, whether recognized or unrecognized, in a manner similar to a purchase price allocation, in accordance with SFAS No. 141, Business Combinations. Any residual fair value after this purchase price allocation would be assumed to relate to goodwill. If the carrying value of the goodwill exceeded the residual fair value, we would record an impairment charge for that amount.

Net goodwill was $80.9 mil