

REGAL BELOIT CORP  
Form 10-Q  
November 07, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

**ý QUARTERLY REPORT  
PURSUANT TO SECTION 13 OR  
15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**for the quarterly period ended  
September 30, 2006**

**or**

**“ TRANSITION REPORT  
PURSUANT TO SECTION 13 OR  
15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**Commission file number  
001-07283**

**REGAL-BELOIT CORPORATION**  
(Exact name of registrant as specified in its charter)

**Wisconsin**  
(State of other jurisdiction of  
incorporation)

**39-0875718**  
(IRS Employer Identification  
No.)

**200 State Street, Beloit, Wisconsin 53511**  
(Address of principal executive office)

**(608) 364-8800**  
Registrant's telephone number, including area code

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

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  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

**30,927,534 Shares, Common Stock, \$.01 Par Value (as of October 31, 2006)**

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## REGAL-BELOIT CORPORATION

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## CAUTIONARY STATEMENT

**The following is a cautionary statement made under the Private Securities Litigation Reform Act of 1995:** With the exception of historical facts, the statements contained in this Quarterly Report on Form 10-Q or incorporated by reference may be forward- looking statements. Forward-looking statements represent our management's judgment regarding future events. In many cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "plan," "expect," "anticipate," "estimate," "believe," "predict," "intend," "potential" or "continue" or the terms or other words of similar import, although some forward-looking statements are expressed differently. We cannot guarantee the accuracy of the forward-looking statements, and you should be aware that results and events could differ materially and adversely from those contained in the forward-looking statements due to a number of factors, including:

- unexpected issues and costs arising from the integration of acquired companies and businesses, such as our acquisitions of the HVAC motors and capacitors businesses and the Commercial AC motors business from General Electric Company ("GE") in 2004;
- marketplace acceptance of acquisitions, including the loss of, or a decline in business from, any significant customers;
- unanticipated fluctuations in commodity prices and raw material costs and issues affecting our ability to pass increased costs on to our customers;
  - cyclical downturns affecting the markets for capital goods;
  - substantial increases in interest rates that impact the cost of our outstanding debt;
  - the impact of capital market transactions that we may effect;
    - unanticipated costs associated with litigation matters;

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- the success of our management in increasing sales and maintaining or improving the operating margins of our businesses;
  - actions taken by our competitors;
  - difficulties in staffing and managing foreign operations;
  - our ability to satisfy various covenant requirements under our credit facility; and
- other risks and uncertainties described in Item 1A “Risk Factors” of the Annual Report on Form 10-K filed on March 15, 2006 and from time to time in our reports filed with U.S. Securities and Exchange Commission.

All subsequent written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the applicable cautionary statements. The forward-looking statements included in this Form 10-Q are made only as of the date of this report, and we undertake no obligation to update these statements to reflect subsequent events or circumstances.

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**PART I - FINANCIAL INFORMATION**  
**REGAL-BELOIT CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In Thousands of Dollars)

| <b>ITEM I. FINANCIAL STATEMENTS</b>                      |                      |           | (Derived<br>from<br>Audited<br>Statments) |
|--|----------------------|-----------|---|
| <b>ASSETS</b>  | <b>(Unaudited)</b>   |           | December 31,                              |
|  | <b>September 30,</b> |           | 2005                                      |
|  | <b>2006</b>          |           |   |
| <b>Current Assets:</b>                                   |                      |           |   |
| Cash and Cash Equivalents                                | \$ 40,186            | \$        | 32,747                                    |
| Receivables, less Allowances for Doubtful<br>Accounts of |                      |           |   |
| \$5,765 in 2006 and \$2,653 in 2005                      | 267,381              |           | 197,118                                   |
| Inventories  | 241,366              |           | 224,316                                   |
| Prepaid Expenses and Other Current Assets                | 25,622               |           | 16,121                                    |
| Future Income Tax Benefits                               | 16,529               |           | 16,978                                    |
| <b>Total Current Assets</b>                              | <b>591,084</b>       |           | <b>487,280</b>                            |
| <b>Property, Plant and Equipment:</b>                    |                      |           |   |
| Land and Improvements                                    | 17,971               |           | 18,624                                    |
| Buildings and Improvements                               | 100,609              |           | 100,036                                   |
| Machinery and Equipment                                  | 352,891              |           | 336,171                                   |
| Property, Plant and Equipment, at Cost                   | 471,471              |           | 454,831                                   |
| Less - Accumulated Depreciation                          | (207,749)            |           | (210,502)                                 |
| <b>Net Property, Plant and Equipment</b>                 | <b>263,722</b>       |           | <b>244,329</b>                            |
| Goodwill   | 547,372              |           | 546,168                                   |
| Purchased Intangible Assets, net of Amortization         | 43,565               |           | 45,674                                    |
| Other Noncurrent Assets                                  | 21,307               |           | 19,103                                    |
| <b>Total Assets</b>                                      | <b>\$ 1,467,050</b>  | <b>\$</b> | <b>1,342,554</b>                          |
| <b>LIABILITIES AND SHAREHOLDERS' INVESTMENT</b>          |                      |           |   |
| <b>Current Liabilities:</b>                              |                      |           |   |
| Accounts Payable   | \$ 95,349            | \$        | 82,513                                    |
| Commercial Paper Borrowings                              | 47,737               |           | 25,000                                    |
| Dividends Payable  | 4,327                |           | 3,985                                     |
| Accrued Compensation and Employee Benefits               | 52,296               |           | 41,127                                    |
| Other Accrued Expenses                                   | 53,897               |           | 46,559                                    |
| Income Taxes Payable                                     | 20,032               |           | 18,923                                    |
| Current Maturities of Long-Term Debt                     | 907                  |           | 684                                       |
| <b>Total Current Liabilities</b>                         | <b>274,545</b>       |           | <b>218,791</b>                            |
| Long-Term Debt   | 362,176              |           | 386,332                                   |
| Deferred Income Taxes                                    | 59,800               |           | 59,993                                    |
| Other Non-Current Liabilities                            | 25,876               |           | 18,394                                    |
| Minority Interest in Consolidated Subsidiaries           | 11,119               |           | 11,048                                    |

## Shareholders' Investment:

Common Stock, \$.01 par value, 50,000,000 shares  
authorized,

31,678,134 issued in 2006 and 31,429,736 issued  
in 2005

|  |                     |              |
|--|---------------------|--------------|
|  | <b>317</b>          | 315          |
| Additional Paid-In Capital                                       | <b>325,376</b>      | 316,426      |
| Less-Treasury Stock, at cost, 774,100 shares in<br>2006 and 2005 | <b>(15,228)</b>     | (15,228)     |
| Retained Earnings  | <b>417,348</b>      | 343,161      |
| Unearned Compensation  | -                   | (657)        |
| Accumulated Other Comprehensive Income                           | <b>5,721</b>        | 3,979        |
| Total Shareholders' Investment                                   | <b>733,534</b>      | 647,996      |
| Total Liabilities and Shareholders' Investment                   | <b>\$ 1,467,050</b> | \$ 1,342,554 |

*See accompanying notes to Condensed Consolidated Financial Statements*

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**REGAL-BELOIT CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

(In Thousands of Dollars, Except Per Share Data)

|   | (Unaudited)           |                       |                       |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|   | September 30,<br>2006 | September 28,<br>2005 | September 30,<br>2006 | September 28,<br>2005 |
| Net Sales   | \$ 419,301            | \$ 345,894            | \$ 1,252,896          | \$ 1,052,485          |
| Cost of Sales   | 316,231               | 269,296               | 952,521               | 827,643               |
| Gross Profit  | 103,070               | 76,598                | 300,375               | 224,842               |
| Operating Expenses  | 50,021                | 41,990                | 145,842               | 128,560               |
| Income From Operations  | 53,049                | 34,608                | 154,533               | 96,282                |
| Interest Expense  | 5,038                 | 5,706                 | 15,287                | 17,053                |
| Interest Income   | 170                   | 309                   | 430                   | 385                   |
| Income Before Taxes and<br>Minority Interest                  | 48,181                | 29,211                | 139,676               | 79,614                |
| Provision For Income Taxes                                    | 17,623                | 9,771                 | 50,812                | 28,408                |
| Income Before Minority Interest                               | 30,558                | 19,440                | 88,864                | 51,206                |
| Minority Interest in Income, Net<br>of Tax                    | 818                   | 923                   | 2,027                 | 1,958                 |
| Net Income  | \$ 29,740             | \$ 18,517             | \$ 86,837             | \$ 49,248             |
| Per Share of Common Stock:                                    |                       |                       |                       |                       |
| Earnings Per Share - Basic                                    | \$ .96                | \$ .62                | \$ 2.82               | \$ 1.68               |
| Earnings Per Share - Assuming<br>Dilution                     | \$ .89                | \$ .59                | \$ 2.60               | \$ 1.62               |
| Cash Dividends Declared                                       | \$ .14                | \$ .13                | \$ .41                | \$ .38                |
| Average Number of Shares<br>Outstanding-Basic                 | 30,888,136            | 29,912,663            | 30,802,048            | 29,339,151            |
| Average Number of Shares<br>Outstanding-<br>Assuming Dilution | 33,440,015            | 31,234,336            | 33,347,817            | 30,399,710            |

*See accompanying notes to Condensed Consolidated Financial Statements.*





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**REGAL-BELOIT CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In Thousands of Dollars)

|   | (Unaudited)           |                       |
|---|-----------------------|-----------------------|
|   | Nine Months Ended     |                       |
|   | September 30,<br>2006 | September 28,<br>2005 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                       |                       |
| Net income  | \$ 86,837             | \$ 49,248             |
| Adjustments to reconcile net income to net cash provided by operating activities; net of effect of acquisitions |                       |                       |
| Depreciation and amortization   | 25,835                | 27,823                |
| Gain on sale of assets  | (1,881)               | (84)                  |
| Stock-based compensation expense  | 2,665                 | 407                   |
| Change in assets and liabilities, net   | (60,646)              | (12,318)              |
| Net cash provided by operating activities   | 52,810                | 65,076                |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                       |                       |
| Additions to property, plant and equipment  | (37,689)              | (21,734)              |
| Purchases of short-term investments, net  | (5,853)               | --                    |
| Business acquisitions, net of cash acquired   | (10,962)              | 6,612                 |
| Sale of property, plant and equipment   | 15,555                | 4,246                 |
| Other, net  | -                     | (343)                 |
| Net cash used in investing activities   | (38,949)              | (11,219)              |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                       |                       |
| Proceeds from stock offering  | -                     | 53,145                |
| Repayment of long-term debt, net  | (23,933)              | (99,193)              |
| Proceeds from commercial paper borrowings, net  | 22,737                | -                     |
| Dividends paid to shareholders  | (12,301)              | (10,749)              |
| Proceeds from the exercise of stock options   | 5,132                 | 1,316                 |
| Excess tax benefits from stock-based compensation   | 1,960                 | 193                   |
| Distribution to minority partners   | -                     | (1,315)               |
| Net cash used in financing activities   | (6,405)               | (56,603)              |
| <b>EFFECT OF EXCHANGE RATE ON CASH</b>  |                       |                       |
|   | (17)                  | (657)                 |
| Net increase (decrease) in cash and cash equivalents  | 7,439                 | (3,403)               |
| Cash and cash equivalents at beginning of period  | 32,747                | 31,275                |

|  |    |               |    |        |
|--|----|---------------|----|--------|
| Cash and cash equivalents at end of period | \$ | <b>40,186</b> | \$ | 27,872 |
|--|----|---------------|----|--------|

**SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:**

Cash paid for:

|              |    |               |    |        |
|--------------|----|---------------|----|--------|
| Interest     | \$ | <b>15,981</b> | \$ | 17,023 |
| Income taxes | \$ | <b>48,804</b> | \$ | 31,969 |

*See accompanying notes to Condensed Consolidated Financial Statements.*

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**REGAL-BELOIT CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2006**  
**(Unaudited)**

**1. BASIS OF PRESENTATION**

The accompanying (a) condensed balance sheet as of December 31, 2005, which has been derived from audited financial statements, and (b) unaudited interim condensed financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations, although the Company believes that the disclosures made are adequate to make the information not misleading.

It is suggested that these condensed financial statements be read in conjunction with the financial statements and the notes thereto included in the Company's Annual Report on Form 10-K filed on March 15, 2006.

In the opinion of management, all adjustments considered necessary for a fair presentation of financial results have been made. Except as otherwise discussed, such adjustments consist of only those of a normal recurring nature. Operating results for the three months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the entire fiscal year ending December 31, 2006.

**2. SHORT-TERM INVESTMENTS**

Short-term marketable investments include investments with original maturities of greater than three months and less than one year. Such marketable investments were classified as available-for-sale and are reported at fair market value and classified within Prepaid Expenses and Other Current Assets. Mark-to-market gains on such investments are not material.

**3. INVENTORIES**

Cost for approximately 84% of the Company's inventory is determined using the last-in, first-out (LIFO) inventory valuation method. The approximate percentage distribution between major classes of inventories was as follows:

|                                       | <u>September 30,</u><br><u>2006</u> | <u>December 31,</u><br><u>2005</u> |
|---------------------------------------|-------------------------------------|------------------------------------|
| Raw Material                          | 14%                                 | 13%                                |
| Work-in Process                       | 25%                                 | 25%                                |
| Finished Goods and Purchased<br>Parts | 61%                                 | 62%                                |

**4. COMPREHENSIVE INCOME**

The Company's comprehensive income for the third quarter and first nine months of 2006 and 2005 was as follows:

|                        | (In Thousands of Dollars)           |                       |                                     |                       |
|------------------------|-------------------------------------|-----------------------|-------------------------------------|-----------------------|
|                        | Third Quarter Ended                 |                       | Nine Months Ended                   |                       |
|                        | <b>September 30,</b><br><b>2006</b> | September 28,<br>2005 | <b>September 30,</b><br><b>2006</b> | September 28,<br>2005 |
| Net income as reported | \$ 29,740                           | \$ 18,517             | \$ 86,837                           | \$ 49,248             |

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Comprehensive income<br>(expense) from:  |           |           |           |           |
| Cumulative translation<br>adjustments  | (452)     | 932       | 60        | (1,046)   |
| Changes in fair value of<br>hedging activities,<br>net of tax  | 2,357     | 1,759     | 6,985     | 6,867     |
| Hedging activities reclassified<br>into earnings<br>from accumulated other<br>comprehensive<br>income ("AOCI"), net of tax | (1,366)   | (1,585)   | (5,290)   | (2,763)   |
| Additional Pension Liability   | -         | -         | (13)      | -         |
| Comprehensive income   | \$ 30,279 | \$ 19,623 | \$ 88,579 | \$ 52,306 |

Index**5. WARRANTY COSTS**

The Company recognizes the cost associated with its standard warranty on its products at the time of sale. The amount recognized is based on historical experience. The following is a reconciliation of the changes in accrued warranty costs for the third quarter and nine months of 2006 and 2005:

|                   | (In Thousands of Dollars)                    |         |                       |         |  |         |                       |         |
|-------------------|--|---------|-----------------------|---------|--|---------|-----------------------|---------|
|                   | Third Quarter Ended<br>September 30,<br>2006 |         | September 28,<br>2005 |         | Nine Months Ended<br>September 30,<br>2006 |         | September 28,<br>2005 |         |
| Beginning balance | \$   | 5,509   | \$                    | 5,615   | \$   | 5,679   | \$                    | 5,007   |
| Deduct: Payments  |  | (1,677) |                       | (1,433) |  | (4,797) |                       | (4,238) |
| Add: Provision    |  | 2,257   |                       | 1,602   |  | 5,207   |                       | 5,015   |
| Ending balance    | \$   | 6,089   | \$                    | 5,784   | \$   | 6,089   | \$                    | 5,784   |

**6. BUSINESS SEGMENTS**

The Company operates two strategic businesses that are reportable segments, Mechanical and Electrical:

|                           | (Unaudited)                            |                       |                       |                       |                       |                       |                       |                       |
|---------------------------|--|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                           | Mechanical Segment                     |                       | Nine Months           |                       | Third Quarter         |                       | Electrical Segment    |                       |
|                           | Third Quarter<br>September 30,<br>2006 | September 28,<br>2005 | September 30,<br>2006 | September 28,<br>2005 | September 30,<br>2006 | September 28,<br>2005 | September 30,<br>2006 | September 28,<br>2005 |
| Net Sales                 | 48,931                                 | \$ 49,318             | \$ 154,934            | \$ 149,465            | \$ 370,370            | \$ 296,576            | \$ 1,000,000          | \$ 1,000,000          |
| Income from Operations    | 5,458                                  | \$ 5,061              | \$ 16,299             | \$ 10,936             | \$ 47,591             | \$ 29,547             | \$ 1,000,000          | \$ 1,000,000          |
| % of Net Sales            | 11.2%                                  | 10.3%                 | 10.5%                 | 7.3%                  | 12.8%                 | 10.0%                 |                       |                       |
| Goodwill at end of period | 530                                    | 530                   | 530                   | 530                   | 546,842               | 561,200               |                       |                       |

**7. GOODWILL AND OTHER INTANGIBLES**

Changes in the carrying amount of goodwill for the nine months ending September 30, 2006 were as follows:

|                                    | (In Thousands of Dollars) |                    |            |
|------------------------------------|---------------------------|--------------------|------------|
|                                    | Electrical Segment        | Mechanical Segment | Total      |
| Balance as of December 31, 2005    | \$ 545,638                | \$ 530             | \$ 546,168 |
| Acquisition of Sinya (see Note 14) | 1,204                     | --                 | 1,204      |
| Balance as of September 30, 2006   | \$ 546,842                | \$ 530             | \$ 547,372 |

Purchased intangible assets consisted of the following:

**Summary of Purchased Intangible Assets with Definite Lives**

(In Thousands of Dollars)

| <u>Asset Description</u> | <u>Useful Life (years)</u> | <u>Gross Value</u> | <u>Accumulated Amortization</u> | <u>Net Book Value</u> |
|--------------------------|----------------------------|--------------------|---------------------------------|-----------------------|
| Non-Compete Agreements   | 5 years                    | \$ 5,351           | \$ 1,119                        | \$ 4,232              |
| Trademarks               | 3 - 5 years                | 4,960              | 2,790                           | 2,170                 |
| Patents                  | 9 - 10.5 years             | 15,410             | 2,721                           | 12,689                |
| Engineering Drawings     | 10 years                   | 1,200              | 217                             | 983                   |
| Customer Relationships   | 10 years                   | 28,600             | 5,109                           | 23,491                |
| <b>Total</b>             |                            | <b>\$ 55,521</b>   | <b>\$ 11,956</b>                | <b>\$ 43,565</b>      |

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(In Thousands of Dollars)  
December 31, 2005

| <u>Asset Description</u> | <u>Useful Life (years)</u> | <u>Gross Value</u> | <u>Accumulated Amortization</u> | <u>Net Book Value</u> |
|--------------------------|----------------------------|--------------------|---------------------------------|-----------------------|
| Non-Compete Agreements   | 5 years                    | \$ 2,440           | \$ 520                          | \$ 1,920              |
| Trademarks               | 3 - 5 years                | 4,960              | 1,760                           | 3,200                 |
| Patents                  | 9 - 10.5 years             | 15,410             | 1,565                           | 13,845                |
| Engineering Drawings     | 10 years                   | 1,200              | 127                             | 1,073                 |
| Customer Relationships   | 10 years                   | 28,600             | 2,964                           | 25,636                |
| Total                    |                            | \$ 52,610          | \$ 6,936                        | \$ 45,674             |

**Estimated Amortization Expense (In Millions of Dollars)**

| <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>2010</u> |
|-------------|-------------|-------------|-------------|-------------|
| \$ 6.8      | \$ 7.0      | \$ 5.8      | \$ 5.8      | \$ 5.1      |

Amortization expense recorded for the three months ended September 30, 2006 was \$1.7 million. We perform an annual evaluation of our goodwill and intangible assets in the fourth quarter of each fiscal year for impairment as required by SFAS 142, "Goodwill and Other Intangible Assets".

**8. SHARE-BASED COMPENSATION**

Effective January 1, 2006 the Company adopted Statement of Financial Accounting Standards (SFAS) 123(R), *Share-Based Payment* ("SFAS 123(R)"), using the modified prospective application transition method. Before the adoption of SFAS 123(R), the Company accounted for share-based compensation in accordance with Accounting Principles Board Opinion No. 25 ("APB 25"), *Accounting for Stock Issued to Employees*. Other than for restricted stock and dividend equivalents on phantom stock plans, which has been expensed over the respective vesting periods, no share-based employee compensation cost has been reflected in net income prior to January 1, 2006.

Under APB 25, the value of the restricted stock grants was reflected as a separate component reducing Shareholders' Investment with an offsetting increase to Paid-in Capital. Accordingly, as of December 31, 2005, the unamortized value of restricted stock grants amounting to \$0.7 million was reflected as a separate component of Shareholder's Investment. As a result of the adoption of SFAS 123(R), effective January 1, 2006, the unamortized value of restricted stock grants has been reclassified to Paid-in Capital.

The Company is authorized to make equity-based awards under various plans approved by the Company's shareholders. The Company has not enacted any changes in the quantity or type of instruments used in share-based payment programs as a result of SFAS 123(R). Additionally, the Company did not modify any outstanding options prior to the adoption of SFAS 123(R). The Company has elected to use the Black-Scholes modified prospective method of valuing equity compensation awards, consistent with the Company's approach under APB 25. For option grants prior to 2006, the Company utilizes the same assumptions used in its Black-Scholes method used to prepare the prior required disclosure.

SFAS 123(R) requires the reporting of the tax benefit from the tax deduction that is in excess of recognized compensation costs (excess tax benefits), if any, as a financing cash flow rather than as an operating cash flow.

During the three and nine months ended September 30, 2006, the Company recognized approximately \$0.8 million and \$2.7 million, respectively, in share-based compensation expense. The Company recognizes compensation expense on grants of share-based compensation awards on a straight-line basis over the vesting period of each award recipient. As of September 30, 2006, total unrecognized compensation cost related to share-based compensation awards was approximately \$7.3 million, net of estimated forfeitures, which the Company expects to recognize over a weighted average period of approximately 2.4 years. The total income tax benefit recognized relating to share-based compensation for the three and nine months ended September 30, 2006 was approximately \$0.2 million and \$2.0 million, respectively.

Under the Company's 1998 and 2003 stock plans, the Company is authorized to deliver up to 2.5 million shares of common stock upon exercise of non-qualified stock options or incentive stock options, or upon grant or in payment of stock appreciation rights, performance shares, performance units and restricted stock. Approximately 0.6 million shares were available for future grant or payment under the various plans at September 30, 2006.



IndexShare-based Incentive Awards

The Company uses several forms of share-based incentive awards including non-qualified stock options, incentive stock options and stock appreciation rights (SAR's). All grants are made at prices equal to the fair market value of the stock on the grant dates, and expire ten years from the grant date. The exercise price for certain share-based incentive awards may be paid in cash, shares of common stock or a combination of cash and shares.

The per share weighted average fair value of share-based incentive awards (options and SAR's) during the three months and nine months ended September 30, 2006 was \$15.02 and \$13.30, respectively. The Company estimated the fair value of the awards on the date of grant using the Black-Scholes pricing model and the following assumptions:

|                                 | (In Thousands of Dollars) |   |                    |   |                    |   |                    |   |  |  |  |  |
|---------------------------------|---------------------------|---|--------------------|---|--------------------|---|--------------------|---|--|--|--|--|
|                                 | Three Months Ended        |   |                    |   |                    |   | Nine Months Ended  |   |  |  |  |  |
|                                 | September 30, 2006        |   | September 28, 2005 |   | September 30, 2006 |   | September 28, 2005 |   |  |  |  |  |
| Average risk-free interest rate | 5.2                       | % | 4.1                | % | 4.8                | % | 4.0                | % |  |  |  |  |
| Expected dividend yield         | 1.3                       | % | 1.7                | % | 1.4                | % | 1.7                | % |  |  |  |  |
| Expected volatility             | 33.4                      | % | 30.4               | % | 30.4               | % | 32.8               | % |  |  |  |  |
| Average expected term (years)   |                           |   |                    |   |                    |   |                    |   |  |  |  |  |
| Options                         | 8.0                       |   | 8.0                |   | 8.0                |   | 8.0                |   |  |  |  |  |
| SAR's                           | 5.0                       |   | -                  |   | 5.0                |   | -                  |   |  |  |  |  |

The average risk-free interest rate is based on the weighted average of the five-year and ten-year U.S. Treasury security rates in effect as of the grant date. The expected dividend yield is based on the projected annual dividend as a percentage of the estimated market value of our common stock as of the grant date. The Company determined the expected volatility using a weighted average of daily historical volatility of our stock price over a period equal to the estimated remaining award life. The Company determined the expected term using historical data adjusted for the estimated exercise dates of unexercised awards.

A summary of share-based incentive plan grants (options and SAR's) activity during the three and nine months ended September 30, 2006 is as follows:

|   | Third Quarter Ended September 30, 2006 |                          |  |   | Nine Months Ended September 30, 2006 |                          |  |   |
|---|--|--------------------------|--|---|--------------------------------------|--------------------------|--|---|
|   | Shares                                 | Wtd. Avg. Exercise Price | Wtd. Avg. Remaining Contractual Term (years) | Aggregate Intrinsic Value (in millions) | Shares                               | Wtd. Avg. Exercise Price | Wtd. Avg. Remaining Contractual Term (years) | Aggregate Intrinsic Value (in millions) |
| Number of shares Outstanding at beginning of period | 1,812,750                              | \$ 25.24                 |  |   | 1,798,317                            | \$ 23.27                 |  |   |

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|                              |           |          |     |         |           |          |             |
|------------------------------|-----------|----------|-----|---------|-----------|----------|-------------|
| Granted                      | 27,650    |          |     | 280,250 |           |          |             |
| Exercised                    | 43,500    |          |     | 257,917 |           |          |             |
| Forfeited                    | 6,500     |          |     | 30,250  |           |          |             |
| Outstanding at end of period | 1,790,400 |          | 5.9 | \$ 46.2 | 1,790,400 |          | 5.9 \$ 46.2 |
| Exercisable at end of period | 1,113,610 | \$ 22.52 | 4.5 | \$ 25.1 | 1,113,610 | \$ 22.52 | 4.5 \$ 25.1 |

The table below presents share-based compensation activity for the three month and nine month periods ended September 30, 2006 and September 28, 2005:

|   | (In Thousands of Dollars) |                       |                       |                       |
|---|---------------------------|-----------------------|-----------------------|-----------------------|
|   | Third Quarter Ended       |                       | Nine Months Ended     |                       |
|   | September 30,<br>2006     | September 28,<br>2005 | September 30,<br>2006 | September 28,<br>2005 |
| Total intrinsic value of stock options exercised      | \$ 907                    | \$ 89                 | \$ 5,528              | \$ 507                |
| Cash received from stock option exercises             | 893                       | 170                   | 5,132                 | 1,316                 |
| Income tax benefit from the exercise of stock options | 210                       | 30                    | 1,960                 | 193                   |
| Total fair value of stock options vested              | 8,452                     | 8,652                 | 8,452                 | 8,652                 |

IndexRestricted Stock

The Company also granted restricted stock awards to certain employees. The Company recorded pretax compensation expense associated with the stock grants amounting to \$0.2 million and \$0.1 million for the three months ended September 30, 2006 and September 28, 2005, respectively. The Company recorded pretax expense for the nine months ended September 30, 2006 and September 28, 2005 of \$0.7 million and \$0.4 million, respectively. Restrictions generally lapse three years after the date of the grant. The Company values restricted stock awards at the closing market value of our common stock on the date of grant.

A summary of restricted stock activity for the three and nine months ended September 30, 2006 is as follows:

|   | Third Quarter Ended<br>September 30, 2006 |                         |   | Nine Months Ended<br>September 30, 2006 |                         |   |
|---|---|-------------------------|---|---|-------------------------|---|
|   | Shares                                    | Wtd. Avg.<br>Fair Value | Aggregate<br>Intrinsic<br>Value<br>(in<br>millions) | Shares                                  | Wtd. Avg.<br>Fair Value | Aggregate<br>Intrinsic<br>Value<br>(in<br>millions) |
| Restricted stock balance at beginning of period | 91,175                                    | \$ 32.03                |   | 44,175                                  | \$ 26.68                |   |
| Granted   | 2,500                                     | 42.19                   |   | 49,500                                  | 37.31                   |   |
| Restrictions lapsed                             | -   | -                       |   | -                                       | -                       |   |
| Forfeited                                       | -   | -                       |   | -                                       | -                       |   |
| Restricted stock balance at September 30, 2006  | 93,675                                    | \$ 32.30                | \$ 3.0  | 93,675                                  | \$ 32.30                | \$ 3.0  |

Prior Year Pro forma Expense

The following table illustrates the effect on net income and earnings per share as if the fair value-based method provided by SFAS 123(R) had been applied for all outstanding and unvested awards prior to the adoption of SFAS 123(R):

|   | (In Thousands of Dollars)                       |   |
|---|---|---|
|   | Third Quarter<br>Ended<br>September 28,<br>2005 | Nine Months<br>Ended<br>September 28,<br>2005 |
| Net income, as reported   | \$ 18,517                                       | \$ 49,248                                     |
| Add: Share-based employee compensation expense included in reported net income, net of related tax effects                                  | 111   | 373   |
| Deduct: Total share-based employee compensation expense determined under fair value-based method for all awards, net of related tax effects | (427)   | (1,308)                                       |
| Pro forma net income  | \$ 18,201                                       | \$ 48,313                                     |
| Earnings per share:   |   |   |
| Basic - as reported   | \$ .62  | \$ 1.68                                       |
| Basic - pro forma   | \$ .61  | \$ 1.65                                       |
| Diluted - as reported   | \$ .59  | \$ 1.62                                       |



Index**10. PENSION PLANS**

The Company accounts for its defined benefit pension plans under the provisions of SFAS No. 87, “Employers’ Accounting for Pensions”. The Company’s net periodic pension cost is comprised of the following components:

|                                    | (In Thousands of Dollars) |                       |                       |                       |
|------------------------------------|---------------------------|-----------------------|-----------------------|-----------------------|
|                                    | Third Quarter Ended       |                       | Nine Months Ended     |                       |
|                                    | September 30,<br>2006     | September 28,<br>2005 | September 30,<br>2006 | September 28,<br>2005 |
| Service cost                       | \$ 940                    | \$ 651                | \$ 2,820              | \$ 1,953              |
| Interest cost                      | 1,094                     | 886                   | 3,282                 | 2,658                 |
| Expected return on plan assets     | (1,227)                   | (1,123)               | (3,677)               | (3,369)               |
| Amortization of prior service cost | 123                       | 32                    | 369                   | 96                    |
| Amortization of net loss           | 1,578                     | 244                   | 4,748                 | 732                   |
| Net periodic benefit expense       | \$ 2,508                  | \$ 690                | \$ 7,542              | \$ 2,070              |

In the third quarter and first nine months of 2006, the Company contributed \$2.2 million and \$2.6 million, respectively, to defined benefit pension plans. The Company contributed \$0.1 million and \$0.2 million, respectively, in the third quarter and first nine months of 2005. The Company does not expect to make additional contributions in 2006. The Company contributed a total of \$0.3 million in 2005. The assumptions used in the valuation of the Company’s defined benefit pension plans and in the target investment allocation have remained the same as those disclosed in the Company’s 2005 Annual Report on Form 10-K.

**11. EARNINGS PER SHARE (EPS)**

The numerator for the calculation of basic and diluted earnings per share is net income. The denominator is computed as follows:

|                                      | (In Thousands)        |                       |                       |                       |
|--------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                      | Third Quarter Ended   |                       | Nine Months Ended     |                       |
|                                      | September 30,<br>2006 | September 28,<br>2005 | September 30,<br>2006 | September 28,<br>2005 |
| Denominator for basic EPS - weighted |                       |                       |                       |                       |
| average shares outstanding           | 30,888                | 29,913                | 30,802                | 29,339                |
| Effect of dilutive securities        | 2,552                 | 1,321                 | 2,546                 | 1,061                 |
| Denominator for diluted EPS          | 33,440                | 31,234                | 33,348                | 30,400                |

The increase from September 28, 2005 of 1.2 million dilutive securities in the quarter ended September 30, 2006, was due primarily to the effect of shares attributable to the Company’s convertible senior subordinated debt. Options for common shares where the exercise price was above the market price at September 30, 2006, totaling 14,500 shares, and at September 28, 2005, totaling 22,000 shares, have been excluded from the calculation of the effect of dilutive securities as the effect of such options is anti-dilutive.

**12. CONTINGENCIES**

An action was filed on June 4, 2004, and amended in September 2004, against one of the Company’s subsidiaries, Marathon Electric Manufacturing Corporation (“Marathon”), by Enron Wind Energy Systems, LLC, Enron Wind Contractors, LLC and Zond Minnesota Construction Company, LLC (collectively, “Enron Wind”). The action was filed

in the United States Bankruptcy Court for the Southern District of New York where each of the Enron Wind entities has consolidated its Chapter 11 bankruptcy petition as part of the Enron Corporation bankruptcy proceedings. In the action against Marathon, Enron Wind has asserted various claims relating to the alleged failures and/or degradations of performance of about 564 generators sold by Marathon to Enron Wind from 1997 to 1999. In January 2001, Enron Wind and Marathon entered into a “Generator Warranty and Settlement Agreement and Release of All Claims” (“Warranty Agreement”). This Warranty Agreement resolved various issues related to past performance of the generators, provided a limited warranty related to the generators going forward, and contained a release by all parties of any claims related to the generators other than those arising out of the obligations contained in the Warranty Agreement.

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Enron Wind is seeking to recover the purchase price of the generators and transportation costs totaling about \$21 million. In addition, although the Warranty Agreement contains a waiver of consequential, incidental, and punitive damages, Enron Wind claims that this limitation is unenforceable and seeks recovery of consequential, incidental and punitive damages incurred by it and by its customers, totaling an additional \$100 million. Enron Wind has asserted claims of breach of contract, breach of the implied covenant of good faith and fair dealing, promissory fraud, and intentional interference with contractual relations. Marathon has filed a motion with the court seeking to have many of Enron Wind's claims dismissed. Enron Wind has filed a motion with the court seeking a declaration that Marathon had an obligation under the Warranty Agreement to repair or replace the generators in the first instance regardless of whether an actual breach of warranty had occurred. The court has held hearings on both motions, but has not yet ruled.

The Company believes that this action is without merit and that it has meritorious defenses to the action. The Company intends to defend vigorously all of the asserted claims. The litigation is in an early discovery phase and it is difficult for the Company to predict the impact the litigation may ultimately have on the Company's results of operations or financial condition, including the expenses the Company may incur to defend against the action. As of September 30, 2006, the Company continues to accrue for anticipated costs in defending against this matter and such accumulated reserves at September 30, 2006 are immaterial.

During the third quarter of 2006, the Company received notice that the U.S. Environmental Protection Agency ("U.S. EPA") was seeking reimbursement for certain costs incurred in cleaning up an environmental site in Illinois. In 2004, the Company had previous communication from the U.S. EPA that it was identified as one of three potentially responsible parties ("PRP's") regarding this site. The Company had previously reached a settlement in 1999 with the U.S. EPA regarding this secure site. In 2004, management provided its expert's assessment of the site to the U.S. EPA, which had not proceeded with any enforcement action. The Company believes that it is not a PRP and intends to defend vigorously the associated claim. As of September 30, 2006, amounts that have been recorded in the Company's financial statements related to this contingency are immaterial.

The Company is, from time to time, party to other lawsuits arising from its normal business operations. It is believed that the outcome of these lawsuits will have no material effect on the Company's financial position or its results of operations.

**13. DERIVATIVE INSTRUMENTS**

The Company has entered into certain commodity forward contracts and options in connection with the management of its exposure to fluctuations in certain raw material commodity pricing. These derivative instruments have been designated as cash flow hedges. The Company has also entered into foreign currency forward contracts to reduce the exposure to the risks of changes in the exchange rates of the U.S. dollar, where the Company has operations where the functional currency is the local currency.

These contracts are recorded on the balance sheet at fair value and are accounted for as cash flow hedges, with changes in fair value recorded in accumulated other comprehensive income ("AOCI") in each accounting period. An ineffective portion of a hedge's change in fair value, if any, is recorded in earnings in the period of change. The impact of ineffectiveness was immaterial in the third quarters and nine months of 2006 and 2005.

In the third quarter and first nine months of 2006, \$1.1 million and \$1.7 million of net increased fair market value of derivative instruments, respectively, was recorded in AOCI. For the comparable periods of 2005, the net increased fair market value of derivative instruments recorded in AOCI was \$0.2 million and \$4.1 million, respectively. At September 30, 2006, the Company had a balance of \$8.6 million in assets, \$4.5 million in liabilities and a net after tax unrealized gain of \$6.4 million in AOCI. At September 28, 2005, the Company had a balance of \$6.4 million in assets and a net after tax gain of \$4.1 million in AOCI. At September 30, 2006, \$6.9 million of the total assets, \$3.9 million

of the total liabilities and \$5.3 million of the Company's AOCI gains related to commodity hedges, while \$1.7 million of the assets, \$0.6 million of the liabilities and \$1.1 million of AOCI gains related to foreign currency hedges. The Company estimates that \$5.9 million of the net gains will be reclassified from AOCI to the income statement within the next 12 months, based on valuations at September 30, 2006.

#### **14. ACQUISITIONS AND DIVESTURES**

On May 1, 2006, the Company completed the acquisition of selected assets and liabilities of Changzhou Sinya Electromotor Co. Ltd., Jiangsu Southern Sinya Electric Co. Ltd. and Changzhou Xiesheng Plastic Co. Ltd. (collectively "Sinya"). Sinya operations are located in Changzhou, China and primarily produce electric motors for the HVAC industry. The financial results for the business from the date of acquisition are included in the Electrical Segment. The purchase price was approximately \$13.0 million, subject to final working capital adjustments.

On May 8, 2006, the Company announced that it had completed the sale of substantially all of the assets of the Company's Regal Cutting Tools business to YG-1 Co. Ltd. for \$7.7 million. The Company recorded a net gain of \$0.2 million which was included as a reduction of operating expenses.

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During the second quarter of 2006, the Company disposed of real property located in New Bedford, Massachusetts. The proceeds from the sale were \$2.6 million. The Company recorded a net gain of \$1.6 million which was included as a reduction of operating expenses.

On February 7, 2005, the Company acquired 95% ownership of Changzhou Modern Technologies Co., LTD. (“CMT”). CMT is located in Changzhou, China and is producing fractional electric motors. The purchase price was \$3.2 million which the Company is paying over a three-year period. A second payment of \$0.6 million was made in February 2006.

**15. DEBT**

The Company’s indebtedness, as of September 30, 2006 and December 31, 2005, was as follows:

|  | (In Thousands of Dollars) |                         |
|--|---------------------------|-------------------------|
|  | September 30,<br>2006     | December<br>31,<br>2005 |
| Revolving credit facility (“Facility”)                                 | \$ 243,500                | \$ 267,100              |
| Commercial paper   | 47,737                    | 25,000                  |
| Industrial revenue bonds and other                                     | 4,583                     | 4,916                   |
| Subtotal - Senior indebtedness   | 295,820                   | 297,016                 |
| Convertible senior subordinated debentures (“2.75% Convertible Notes”) | 115,000                   | 115,000                 |
| Total debt   | 410,820                   | 412,016                 |
| Less: current debt   | (48,644)                  | (25,684)                |
| Total long-term debt, less current maturities                          | \$ 362,176                | \$ 386,332              |

Borrowings under the Facility bear interest at 30-day LIBOR plus a borrowing spread of .75%. All Facility borrowings are subject to a pricing grid, which can result in increases or decreases to the borrowing spread on a quarterly basis, depending on the Company’s leverage ratios. In addition, a non-use fee is payable quarterly on the average unused credit line under the Facility. At September 30, 2006, the non-use fee was 0.15%. The Facility contains customary limits and restrictions concerning investments, sales of assets, liens on assets, interest coverage ratios, maximum leverage, and minimum net worth. As of September 30, 2006, the Company was in compliance with all debt covenants.

There were \$47.7 million of commercial paper borrowings outstanding at September 30, 2006, all of which had original maturity terms of 91 days or less and had a weighted interest rate of 5.50%. Total commercial paper outstanding cannot exceed \$50 million under the terms of the Facility. The Facility provides the liquidity backstop for outstanding commercial paper. Accordingly, the combined outstanding balances of the Facility and commercial paper cannot exceed \$475.0 million.

The Company’s \$115.0 million, 2.75% convertible subordinated notes are convertible as the closing price of the Company’s common stock exceeded the contingent conversion share price of \$33.23 for the specified amount of time. As a result, holders of the notes may surrender the notes for conversion at any time until the maturing of the bonds in March 15, 2024. Holders that exercise their right to convert the notes will receive up to the principal amount in cash, with the balance of the conversion obligation, if any, to be satisfied in shares of Company common stock or cash, at the Company’s discretion. No notes have been converted into cash or shares of common stock as of September 30, 2006.

**16. RELATED PARTY TRANSACTIONS**

There were no related party transactions in the quarter ending September 30, 2006. During part of the quarter ended September 28, 2005, General Electric Company (“GE”) was a related party.

As part of the consideration paid for the acquisition of the HVAC Motors and Capacitors business on December 31, 2004, the Company issued to GE 4,559,048 shares of common stock (approximately 15% of the Company’s then outstanding common stock). In connection with the GE acquisitions, the Company and GE entered into various supply, transition services, and sales agreements. On August 11, 2005 GE sold all of the shares of the Company’s stock received in the HVAC Motors and Capacitors transaction, and, therefore, GE was no longer considered a “related party” of the Company. The amount paid to GE during the period from June 30, 2005 through August 10, 2005 and year-to-date through August 10, 2005 for trade payables, transition services and other payables of the businesses acquired from GE in 2004 was \$17.4 million and \$102.4 million, respectively.

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Index**17. COMPLETION OF STOCK OFFERING**

On August 16, 2005, the Company completed an offering of 6,089,369 shares of its common stock. The stock sold in the offering, which included shares sold to cover the underwriters' over-allotment option, consisted of all 4,559,048 shares owned by GE and 1,530,321 primary shares sold by the Company.

Based on the offering price of \$30.15 per share, the Company's net proceeds from the sale of the primary shares of common stock, after deducting the underwriting discount and estimated offering expenses payable by the Company, were approximately \$43.7 million. Pursuant to the terms of a shareholder agreement between the Company and GE, the Company also received payment of approximately \$9.4 million that was determined by reference to the amount of the net proceeds received by GE from the offering. The Company used the net proceeds to reduce outstanding long-term debt.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Unless the context requires otherwise, references in this Item 2 to "we", "us", "our" or the "Company" refer collectively to REGAL-BELOIT Corporation and its subsidiaries.

**OVERVIEW**

End markets for the Company's products continued to show strength during the third quarter of 2006. Net sales increased 21.2% to \$419.3 million from \$345.9 million in the third quarter of 2005. Net income in the third quarter of 2006 increased 60.5% to \$29.7 million as compared to \$18.5 million in the comparable period of 2005. Diluted earnings per share for the third quarter of 2006 increased 50.8% to \$.89 as compared to \$.59 for the third quarter of 2005.

The Company completed the acquisition of selected assets and liabilities of "Sinya" on May 1, 2006. (See note 14 to the notes to condensed consolidated financial statements). Results for this business are included in the Electrical Segment. The Company also completed the sale of substantially all of the assets of the Regal Cutting Tools business on May 8, 2006, the year-to-date results for which are included in results from operations.

**RESULTS OF OPERATIONS****Third Quarter 2006 versus Third Quarter 2005**

Sales for the third quarter of 2006 were \$419.3 million, which was a 21.2% increase over the \$345.9 million reported for the third quarter of 2005. The divestiture in the Mechanical Segment of the Regal Cutting Tools business (completed May 2006) reduced third quarter sales by approximately \$3.9 million. Sinya contributed sales of \$11.7 million for the third quarter of 2006. Excluding the impact of the sales related to the acquisition and divestitures, sales increased 19.2%.

|                   | (In Millions of Dollars)                                 |       |   |       |       |
|-------------------|--|-------|---|-------|-------|
|                   | <b>Three Months<br/>Ended<br/>September 30,<br/>2006</b> |       | Three Months<br>Ended<br>September 28, 2005 |       |       |
|                   | \$   | 419.3 | \$  | 345.9 |       |
|                   |  |       |   | %     |       |
| Sales as Reported | \$   | 419.3 | \$  | 345.9 | +21.2 |

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|                   |    |        |    |       |       |
|-------------------|----|--------|----|-------|-------|
| Acquisition Sales |    | (11.7) |    |       |       |
| Divested Sales    |    | -      |    | (3.9) |       |
| Adjusted Sales    | \$ | 407.6  | \$ | 342.0 | +19.2 |

Strong demand for our products has continued into the third quarter with all but one of our operating divisions reporting increased sales as compared to the third quarter of 2005. Electrical Segment sales increased 24.9% as compared to the third quarter of 2005. Sales of Commercial and Industrial motors increased 14.0%, sales of HVAC motors and capacitors increased 27.0% including the sales attributable to Sinya and sales of generators increased 28.2%. Mechanical Segment sales decreased 0.8%. The divestiture of the Cutting Tool business reduced segment sales by approximately \$3.9 million. All divisions across this Segment experienced sales increases during the third quarter of 2006, except for the Richmond Gear business which was adversely impacted by the high gasoline prices that continued to affect the end markets for this business.

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Gross margin for the third quarter of 2006 was 24.6%, as compared to 22.1% for the prior year period. Although material costs continued to put significant pressure on margins during the quarter, new products, enhanced productivity, pricing actions and positive product mix across our entire business drove the 2.5 percentage point margin improvement. The raw material cost increases resulted primarily from increases in the costs of copper and aluminum.

Operating expenses were \$50.0 million (11.9% of sales) versus \$42.0 million (12.1% of sales) in third quarter of 2005. Operating expenses in the third quarter of 2006 also included \$0.8 million related to the expensing of equity compensation. This amount compares to \$0.1 million in the prior year period resulting from the expense related to restricted stock awards. Income from operations was \$53.0 million in the third quarter of 2006 versus \$34.6 million in the comparable period of 2005, an increase of 53.2%. As a percent of sales, income from operations was 12.7% compared to 10.0% for the third quarter of 2005. This increase resulted from the contribution from new products, pricing actions, enhanced productivity, and the leveraging of fixed costs.

Net interest expense was \$4.9 million in the third quarter of 2006 versus \$5.4 million in the third quarter of 2005. This decrease was primarily driven by the lower level of debt outstanding. The effect of 2006 increases in interest rates was partially offset by a decrease in the Company's borrowing premium over LIBOR.

The tax rate for the third quarter of 2006 was 36.6% compared to 33.4% for the comparable period of 2005. Net income for the quarter was \$29.7 million, an increase of 60.5 % versus the \$18.5 million reported in the third quarter of 2005. Fully diluted earnings per share was \$.89, which compared to the \$.59 reported in the comparable period of 2005. The average number of diluted shares during the quarter was 33,440,015 compared to 31,234,336 for the same period last year.

**Nine Months Ended September 30, 2006 versus Nine Months Ended September 28, 2005**

Sales for the nine months ended September 30, 2006 were \$1,252.9 million, which was a 19.0% increase over the \$1,052.5 million reported for the comparable period of 2005. The divestitures in the Mechanical Segment of the Regal Cutting Tools (completed May 2006) and Illinois Gear (completed May 2005) businesses reduced sales by approximately \$7.1 and \$17.0 million, respectively in the nine months ended September 30, 2006 and September 28, 2005. The Sinya business reported sales of \$21.9 million for the nine month period ended September 30, 2006. Excluding the impact of the sales related to the acquisition and divestitures, sales increased 18.2%.

|                   | (In Millions of Dollars)                                |   |  |       |
|-------------------|---|---|--|-------|
|                   | <b>Nine Months<br/>Ended<br/>September 30,<br/>2006</b> |   | Nine Months<br>Ended<br>September 28, 2005 |       |
|                   | \$  | % | \$   | %     |
| Sales as Reported | 1,252.9   |   | 1,052.5                                    | +19.0 |
| Acquisition Sales | (21.9)  |   |  |       |
| Divested Sales    | (7.1)   |   | (17.0)                                     |       |
| Adjusted Sales    | \$ 1,223.9  |   | \$ 1,035.5                                 | +18.2 |

We saw strong demand for our products throughout the first nine months of 2006, driven by strong end market activity, including the impact of the SEER 13 federal energy legislation enacted in January of 2006. Electrical Segment sales increased 21.6% as compared to the first nine months of 2005. Sales for this segment showed strength in all product lines except China generator sales that have been adversely impacted by the improving power infrastructure and reliability in China. Included in these results are the results for the Sinya business acquired on May 1, 2006. Mechanical Segment sales increased 3.7%. The divestiture of the Regal Cutting Tool and Illinois Gear businesses reduced Mechanical Segment sales during the first nine months of 2006 by approximately \$7.1 million

over the same period last year.

Gross margin for the nine months ended September 30, 2006 was 24.0%, which is an improvement of 2.6 percentage points over the comparable period of 2005. Material costs had a significant impact on the first nine months of 2006; however, the contribution from new products, productivity efforts, pricing actions and positive product mix across our entire business drove the margin improvement. The raw material cost increases resulted primarily from increases in the costs of copper and aluminum. Also included in cost of sales was \$1.4 million of expense recorded in the second quarter of 2006 related to restructuring actions in the Electrical Segment. The majority of this cost related to restructuring activities in the Company's generator product line.

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Operating expenses were \$145.8 million (11.6% of sales) versus \$128.6 million (12.2% of sales) in the comparable period of 2005. Included in operating expenses in the first nine months of 2006 was a second quarter \$1.6 million gain resulting from the sale of real property in the Mechanical Segment. Also included in operating expenses was \$2.7 million related to the expensing of equity compensation. This amount compared to \$0.4 million in the prior year resulting from the expense related to restricted stock awards. Income from operations was \$154.5 million versus \$96.3 million in the comparable period of 2005, an increase of 60.4%. As a percent of sales, income from operations was 12.3% versus 9.1% for the comparable period of 2005. This increase reflected the contribution from new products, pricing actions, enhanced productivity, and the improved leveraging of fixed costs.

Net interest expense for the first nine months of 2006 was \$14.9 million versus \$16.7 million in the comparable period of 2005. This decrease was driven by the lower level of debt outstanding, coupled with a resulting decrease in the Company's borrowing premium over LIBOR. The decrease in debt was primarily due to cash generated in 2005, including the net proceeds from our August 2005 stock offering. The effect of 2006 interest rate increases was partially offset by a decrease in the Company's borrowing premium over LIBOR.

The tax rate for the nine month period ended September 30, 2006 was 36.4% as compared to 35.7% for the comparable period of 2005. Net income for the first nine months of 2006 was \$86.8 million, an increase of 76.4% versus the \$49.2 million reported in the comparable period of 2005. Fully diluted earnings per share for the first nine months of 2006 was \$2.60, 60.5% greater than the \$1.62 reported in the comparable period of 2005. The average number of diluted shares for the first nine months of 2006 was 33,347,817 compared to 30,399,710 last year.

**LIQUIDITY AND CAPITAL RESOURCES**

Our working capital was \$316.5 million at September 30, 2006, a 17.9% increase from \$268.5 million at year-end 2005. The \$48.0 million increase was due primarily to a \$70.3 million accounts receivable increase in the first nine months of 2006, partially offset by a \$12.8 million increase in accounts payable and \$22.7 million of higher commercial paper borrowings. The ratio of our current assets to our current liabilities ("current ratio") was 2.2:1 both at September 30, 2006 and at year-end 2005.

Net cash provided by operating activities was \$52.8 million for the first nine months of 2006 as compared to \$65.1 million for the comparable period in 2005. During the first nine months of 2006, net income and depreciation and amortization more than offset the impact of the increase in accounts receivable resulting from the increase in sales and timing of certain customer payments. Net cash used in investing activities was \$38.9 million in the first nine months of 2006, above the \$11.2 million used in last year's first nine months. Purchases of short-term investments and business acquisitions were the main factors in the greater cash used in investing activities. While 2006 additions to property, plant and equipment ("PP&E") of \$37.7 million in the first nine months of 2006 were up \$16.0 million from \$21.7 million in the comparable period of 2005, cash from PP&E sales of \$15.6 million in 2006 partially offset the increase in net PP&E from the 2005 period. At September 30, 2006, we had \$8.5 million of outstanding commitments for future capital expenditures. Capital expenditures for 2006 are expected to be between \$46 to \$50 million. Our cash flow used in financing activities was \$6.4 million during the first nine months of 2006 compared to \$56.6 million used in the first nine months of 2005.

Our outstanding long-term debt decreased to \$362.2 million at September 30, 2006 from \$386.3 million at December 31, 2005. The decrease was offset by a \$22.7 million increase in commercial paper proceeds. Of our total long-term debt, \$243.5 million was outstanding under our \$475 million unsecured revolving credit facility that expires on May 5, 2009 (the "Facility"). The Facility permits the Company to borrow at interest rates based upon a margin above the London Inter-Bank Offered Rate ("LIBOR"), which margin varies with the ratio of total funded debt to earnings before interest, taxes, depreciation and amortization ("EBITDA"). These interest rates also vary as LIBOR varies. We also pay a commitment fee on the unused amount of the Facility, which also varies with the ratio of our total debt to our

EBITDA. At September 30, 2006, the Company's margin above LIBOR was .75% and our commitment fee rate was .15%. The Facility requires us to meet specified financial ratios and to satisfy certain financial condition tests. We were in compliance with all of these ratios as of September 30, 2006.

In addition to the Facility, at September 30, 2006 we also had \$115 million of convertible senior subordinated debt outstanding at a fixed interest rate of 2.75%, \$47.7 million of short-term commercial paper borrowings and \$4.6 million of other senior debt. At September 30, 2006, our borrowing availability under the Facility was \$180.7 million based on the Facility's credit limit.

### **CRITICAL ACCOUNTING POLICIES**

#### *Revenue Recognition*

The Company recognizes revenue upon transfer of title, which generally occurs upon shipment of the product to the customer. The pricing of products sold is generally supported by customer purchase orders, and accounts receivable collection is reasonably assured at the time of shipment. Estimated discounts and rebates are recorded as a reduction of sales in the same period revenue is recognized. Product returns and credits are estimated and recorded at the time of shipment based upon historical experience. Shipping and handling costs are recorded as revenue when billed to the customers.



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### *Goodwill and Other Intangibles*

In accordance with SFAS No. 142, “*Goodwill and Other Intangible Assets*,” goodwill is not amortized; however it is tested for impairment in the fourth quarter, with any resulting adjustment charged to the results of operations. Amortization continues to be recorded for other intangible assets with definite lives.

### *Retirement Plans*

Approximately half of our domestic employees are covered by defined benefit pension plans with the remaining domestic employees covered by defined contribution plans. The large majority of our foreign employees are covered by mandated government programs. Our obligations under our domestic defined benefit plans are determined with the assistance of actuarial firms. The actuaries make certain assumptions regarding such factors as withdrawal rates and mortality rates. The actuaries also provide us with information and recommendations from which management makes further assumptions on such factors as the long-term expected rate of return on plan assets, the discount rate on benefit obligations and where applicable, the rate of annual compensation increases. Based upon the assumptions made, the investments made by the plans, overall conditions and movement in financial markets, particularly the stock market and how actual withdrawal rates, life-spans of benefit recipients and other factors differ from assumptions, annual expenses and recorded assets or liabilities of these defined benefit plans may change significantly from year to year. Based on our annual review of actuarial assumptions as well as historical rates of return on plan assets and existing long-term bond rates, we set the long-term rate of return on plan assets at 8.75% and the discount rate at 5.75% for our defined benefit plans as of December 31, 2005.

### *Use of Estimates and Assumptions*

The preparation of our condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States requires the use of estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

### *New Accounting Pronouncements*

In September 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS 157, *Fair Value Measurements* (“SFAS 157”). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 will be effective beginning in fiscal 2008. We are evaluating the new standard to determine the effect on our financial statements and related disclosures.

In September 2006, the FASB issued SFAS 158, *Employers’ Accounting for Deferred Benefit Pension and Other Postretirement Plans* (“SFAS 158”). SFAS 158 requires that public companies prospectively recognize through Accumulated Other Comprehensive Income the overfunded or underfunded status of their defined benefit plans as an asset or liability beginning in their 2006 year-end balance sheet. In addition, SFAS 158 affects the measurement date and required disclosures. SFAS 158 will be effective for the 2006 year end. We are evaluating the new standard to determine the effect on our financial statements and related disclosures.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 will be effective for us beginning in fiscal 2007. We are evaluating the interpretation to determine the effect on our financial statements and related disclosures.

In December 2004, the FASB issued SFAS No. 123(R), "*Share-Based Payment* ("SFAS 123(R)")", which requires companies to expense the value of employee stock options and similar equity-based awards. This SFAS 123(R) is a revision of FASB Statement 123, "*Accounting for Stock-Based Compensation*". SFAS 123(R) was adopted by the Company on January 1, 2006. Prior to the adoption of SFAS 123(R) the Company accounted for equity-based awards under the intrinsic method and compensation expense was included in a proforma footnote disclosure. Operating income has been reduced by \$0.8 million of equity-based compensation in the three months ended September 30, 2006 compared to \$0.1 million in the three months ended September 28, 2005. For the nine months ended September 30, 2006 and September 28, 2005, operating income was reduced by \$2.7 million and \$0.4 million, respectively, for equity-based compensation. The Company expects to record pretax expense of approximately \$3.5 million for the 2006 fiscal year.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risk relating to the Company's operations due to changes in interest rates, foreign currency exchange rates and prices of purchased raw materials. We manage the exposure to these risks through a combination of normal operating and financing activities and derivative financial instruments such as commodity cash flow hedges and foreign currency forward exchange contracts.

The Company is exposed to interest rate risk on certain of its short-term and long-term debt obligations used to finance our operations and acquisitions. At September 30, 2006, we had \$164.0 million of fixed rate debt and \$246.8 million of variable rate debt, the latter subject to interest rate risk. The variable rate debt is primarily under a credit facility with an interest rate based on a margin above LIBOR. As a result, interest rate changes impact future earnings and cash flow assuming other factors are constant. A hypothetical 10% change in our weighted average borrowing rate on outstanding variable rate debt at September 30, 2006, would result in a change in after-tax annualized earnings of approximately \$0.9 million.

The Company periodically enters into commodity futures and options hedging transactions to reduce the impact of changing copper, aluminum and natural gas commodity prices. Contract terms of commodity hedge instruments generally mirror those of the hedged item, providing a high degree of risk reduction and correlation.

We are also exposed to foreign currency risks that arise from normal business operations. These risks include the translation of local currency balances of foreign subsidiaries, intercompany loans with foreign subsidiaries and transactions denominated in foreign currencies. Our objective is to minimize our exposure to these risks through a combination of normal operating activities and the utilization of foreign currency contracts to manage our exposure on the transactions denominated in currencies other than the applicable functional currency. Due to our two acquisitions in August and December 2004, we have significantly increased our manufacturing operations outside the United States. In 2005 we began to enter into contracts to hedge foreign-currency denominated forecasted transactions. Contracts are executed with creditworthy banks and are denominated in currencies of major industrial countries. It is our policy not to enter into derivative financial instruments for speculative purposes. We do not hedge our exposure to the translation of reported results of foreign subsidiaries from local currency to United States dollars.

All hedges are recorded on the balance sheet at fair value and are accounted for as cash flow hedges, with changes in fair value recorded in accumulated other comprehensive income ("AOCI") in each accounting period. An ineffective portion of the hedge's change in fair value, if any, is recorded in earnings in the period of change. The impact due to ineffectiveness was immaterial for all periods included in this report.

In the third quarter and first nine months of 2006, \$1.1 million and \$1.7 million, respectively, of net increased fair market value of derivative instruments was recorded in AOCI. At September 30, 2006, we had a balance of \$8.6 million in assets, \$4.5 million in liabilities and a net after tax unrealized gain of \$6.4 million in AOCI, representing the fair market value of cash flow commodity and foreign currency hedges. Of the total assets, liabilities and AOCI related to derivatives at September 30, 2006, \$1.7 million, \$0.6 million and \$1.1 million, respectively, were related to currency hedges, with the balance relating to commodity hedges.

**ITEM 4. CONTROLS AND PROCEDURES**

Evaluation of Disclosure Controls and Procedures. The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end

of such period, the Company's disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

Changes in Internal Control Over Financial Reporting. During the quarter ended September 30, 2006, the Company completed the transition from order management and cash collection applications and processes being provided under a Shared Services Agreement with General Electric Company ("GE") for certain Electrical Group facilities acquired from GE to applications and processes controlled and managed by the Company. As a result, these Electrical Group facilities are now subject to the same accounting processes and internal controls as other Electrical Group manufacturing facilities.

Except for the preceding change, there were no changes in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(f) and 15d - 15(f) of the Exchange Act that occurred during the fiscal quarter to which this quarterly report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II - OTHER INFORMATION**

Items 2, 3 and 5 are inapplicable and have been omitted.

**ITEM 1. LEGAL PROCEEDINGS**

An action was filed on June 4, 2004, and amended in September 2004, against one of the Company's subsidiaries, Marathon Electric Manufacturing Corporation ("Marathon"), by Enron Wind Energy Systems, LLC, Enron Wind Contractors, LLC and Zond Minnesota Construction Company, LLC (collectively, "Enron Wind"). The action was filed in the United States Bankruptcy Court for the Southern District of New York where each of the Enron Wind entities has consolidated its Chapter 11 bankruptcy petition as part of the Enron Corporation bankruptcy proceedings. In the action against Marathon, Enron Wind has asserted various claims relating to the alleged failures and/or degradations of performance of about 564 generators sold by Marathon to Enron Wind from 1997 to 1999. In January 2001, Enron Wind and Marathon entered into a "Generator Warranty and Settlement Agreement and Release of All Claims" ("Warranty Agreement"). This Warranty Agreement resolved various issues related to past performance of the generators, provided a limited warranty related to the generators going forward, and contained a release by all parties of any claims related to the generators other than those arising out of the obligations contained in the Warranty Agreement.

Enron Wind is seeking to recover the purchase price of the generators and transportation costs totaling about \$21 million. In addition, although the Warranty Agreement contains a waiver of consequential, incidental, and punitive damages, Enron Wind claims that this limitation is unenforceable and seeks recovery of consequential, incidental and punitive damages incurred by it and by its customers, totaling an additional \$100 million. Enron Wind has asserted claims of breach of contract, breach of the implied covenant of good faith and fair dealing, promissory fraud, and intentional interference with contractual relations. Marathon has filed a motion with the court seeking to have many of Enron Wind's claims dismissed. Enron Wind has filed a motion with the court seeking a declaration that Marathon had an obligation under the Warranty Agreement to repair or replace the generators in the first instance regardless of whether an actual breach of warranty had occurred. The court has held hearings on both motions, but has not yet ruled.

The Company believes that this action is without merit and that it has meritorious defenses to the action. The Company intends to defend vigorously all of the asserted claims. The litigation is in an early discovery phase and it is difficult for the Company to predict the impact the litigation may ultimately have on the Company's results of operations or financial condition, including the expenses the Company may incur to defend against the action. As of September 30, 2006, the Company continues to accrue for anticipated costs in defending against this matter and such accumulated reserves at September 30, 2006 are immaterial.

During the third quarter of 2006, the Company received notice that the U.S. Environmental Protection Agency ("U.S. EPA") was seeking reimbursement up to \$2 million for certain costs incurred in cleaning up an environmental site in Illinois. In 2004, the Company had previous communication from the U.S. EPA that it was identified as one of three potentially responsible parties ("PRP's") regarding this site. The Company had previously reached a settlement in 1999 with the U.S. EPA regarding this secure site. In 2004, management provided its expert's assessment of the site to the U.S. EPA, which had not proceeded with any enforcement action. The Company believes that it is not a PRP and intends to defend vigorously the associated claim. As of September 30, 2006, amounts that have been recorded in the Company's financial statements related to this contingency are immaterial.

The Company is, from time to time, party to other lawsuits arising from its normal business operations. It is believed that the outcome of these lawsuits will have no material effect on the Company's financial position or its results of operations.

**ITEM 1A. RISK FACTORS**

The business and financial results of the Company are subject to numerous risks and uncertainties. The risks and uncertainties have not changed materially from those reported in the Company's Annual Report on Form 10-K filed on March 15, 2006.

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**ITEM 6. EXHIBITS**

| <b><u>Exhibit Number</u></b> | <b><u>Exhibit Description</u></b>  |
|------------------------------|--|
| 31.1                         | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.          |
| 31.2                         | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.          |
| 32.1                         | Certifications of the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 |

**SIGNATURE**

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

**REGAL-BELOIT CORPORATION**  
(Registrant)

Date: November 7, 2006

By: /s/ David A. Barta

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David A. Barta  
Vice President, Chief Financial Officer  
(Principal Accounting and Financial Officer)

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