

BADGER METER INC  
Form 10-Q  
October 24, 2007

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
for the quarterly period ended September 30, 2007**

**BADGER METER, INC.  
4545 W. Brown Deer Road  
Milwaukee, Wisconsin 53223  
(414) 355-0400**

A Wisconsin Corporation  
IRS Employer Identification No. 39-0143280  
Commission File No. 1-6706

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  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.

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

As of October 16, 2007, there were 14,461,014 shares of Common Stock outstanding with a par value of \$1 per share.

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**Quarterly Report on Form 10-Q for Period Ended September 30, 2007**  
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**Special Note Regarding Forward Looking Statements**

Certain statements contained in this Form 10-Q, as well as other information provided from time to time by the Company or its employees, may contain forward looking statements that involve risks and uncertainties that could cause actual results to differ materially from those in the forward looking statements. The words anticipate, believe, estimate, expect, think, should and objective or similar expressions are intended to identify forward looking statements. All such forward looking statements are based on the Company's then current views and assumptions and involve risks and uncertainties that include, among other things:

- the continued shift in the Company's business from lower cost, local read meters toward more expensive, value-added automatic meter reading (AMR) systems;
- the success or failure of newer Company products, including the Orion<sup>®</sup> radio frequency AMR system, the absolute digital encoder (ADE ) and the Galaxy<sup>®</sup> fixed network AMR system;
- changes in competitive pricing and bids in both the domestic and foreign marketplaces, and particularly in continued intense price competition on government bid contracts for lower cost, local read meters;
- the actions (or lack thereof) of the Company's competitors;
- changes in the Company's relationships with its alliance partners, primarily its alliance partners that provide AMR connectivity solutions, and particularly those that sell products that do or may compete with the Company's products;
- changes in the general health of the United States and foreign economies, including, to some extent, housing starts in the United States and overall industrial activity;
- increases in the cost and/or availability of needed raw materials and parts, including recent increases in the cost of brass castings as a result of increases in commodity prices, particularly for copper, at the supplier level and resin as a result of increases in petroleum and natural gas prices;
- the ability of the Company to maximize the value of the remaining assets in its discontinued French operations;
- the Company's expanded role as a prime contractor for providing complete AMR systems to governmental authorities, which brings with it added risks, including but not limited to, Company responsibility for subcontractor performance; additional costs and expenses if the Company and its subcontractors fail to meet the agreed-upon timetable with the governmental authority; and the Company's expanded warranty and performance obligations;
- changes in foreign economic conditions, particularly currency fluctuations between the United States dollar and the euro;
- the loss of certain single-source suppliers; and
- changes in laws and regulations, particularly laws dealing with the use of lead (which can be used in the manufacture of certain meters incorporating brass housings) and Federal Communications Commission rules affecting the use and/or licensing of radio frequencies necessary for AMR products.

All of these factors are beyond the Company's control to varying degrees. Shareholders, potential investors and other readers are urged to consider these factors carefully in evaluating the forward looking statements and are cautioned not to place undue reliance on such forward looking statements. The forward looking statements made in this document are made only as of the date of this document and the Company assumes no obligation, and disclaims any obligation, to update any such forward looking statements to reflect subsequent events or circumstances.

**Table of Contents****Part I Financial Information****Item 1 Financial Statements****BADGER METER, INC.  
Consolidated Condensed Balance Sheets**

	September 30, 2007 (Unaudited)	December 31, 2006
	(In thousands)	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 4,552	\$ 3,002
Receivables	34,888	29,276
Inventories:		
Finished goods	7,855	9,122
Work in process	10,529	10,302
Raw materials	17,399	13,866
Total inventories	35,783	33,290
Prepaid expenses and other current assets	3,161	3,179
Deferred income taxes	3,758	3,737
Assets of discontinued operations, including \$470 and \$2,046 of cash (Note 6)	898	6,875
Total current assets	83,040	79,359
Property, plant and equipment, at cost	123,350	113,249
Less accumulated depreciation	(70,746)	(68,540)
Net property, plant and equipment	52,604	44,709
Intangible assets, at cost less accumulated amortization	513	636
Other assets	4,984	4,211
Deferred income taxes	3,509	3,510
Goodwill	6,958	6,958
Total assets	\$ 151,608	\$ 139,383
<b>Liabilities and shareholders equity</b>		
Current liabilities:		
Short-term debt	\$ 10,367	\$ 15,093
Current portion of long-term debt	2,710	1,944
Payables	13,962	10,597
Accrued compensation and employee benefits	6,775	6,181
Warranty and after-sale costs	2,276	2,954
Income and other taxes	9,801	621
Liabilities of discontinued operations (Note 6)	441	8,321

Total current liabilities	46,332	45,711
Other long-term liabilities	508	557
Deferred income taxes	216	199
Accrued non-pension postretirement benefits	7,096	6,903
Other accrued employee benefits	8,367	8,266
Long-term debt	3,654	5,928
Commitments and contingencies		
Shareholders' equity:		
Common stock	20,851	20,553
Capital in excess of par value	21,885	19,428
Reinvested earnings	87,695	77,479
Accumulated other comprehensive loss	(11,533)	(12,041)
Less: Employee benefit stock	(682)	(744)
Treasury stock, at cost	(32,781)	(32,856)
Total shareholders' equity	85,435	71,819
Total liabilities and shareholders' equity	\$ 151,608	\$ 139,383

*See accompanying notes to consolidated condensed financial statements.*

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**BADGER METER, INC.**  
**Consolidated Condensed Statements of Operations**

	Three Months Ended September 30, (Unaudited)		Nine Months Ended September 30, (Unaudited)	
	2007	2006	2007	2006
	(In thousands except share and per share amounts)			
Net sales	\$ 62,782	\$ 60,208	\$ 177,618	\$ 177,049
Cost of sales	40,114	42,319	116,161	117,544
Gross margin	22,668	17,889	61,457	59,505
Selling, engineering and administration	12,904	11,104	38,007	35,384
Operating earnings	9,764	6,785	23,450	24,121
Interest expense	348	458	1,015	1,166
Earnings from continuing operations before income taxes	9,416	6,327	22,435	22,955
Provision for income taxes	3,400	2,382	8,230	8,720
Earnings from continuing operations	6,016	3,945	14,205	14,235
Loss from discontinued operations net of income taxes	(265)	(4,464)	(414)	(6,474)
Net earnings (loss)	\$ 5,751	\$ (519)	\$ 13,791	\$ 7,761
Per share amounts:				
Earnings (loss) per share:				
Basic from continuing operations	\$ .42	\$ .28	\$ 1.00	\$ 1.03
Basic from discontinued operations	\$ (.02)	\$ (.32)	\$ (.03)	\$ (.47)
Total basic	\$ .40	\$ (.04)	\$ .97	\$ .56

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Diluted from continuing operations	\$	.41	\$	.28	\$	.97	\$	1.00
Diluted from discontinued operations	\$	(.02)	\$	(.32)	\$	(.02)	\$	(.45)
Total diluted	\$	.39	\$	(.04)	\$	.95	\$	.55
Dividends declared - Common stock	\$	.09	\$	.08	\$	.25	\$	.23
Shares used in computation of earnings per share:								
Basic		14,288,860		13,935,229		14,166,811		13,831,668
Impact of stock-based compensation		372,364				417,681		375,642
Diluted		14,661,224		13,935,229		14,584,492		14,207,310

*See accompanying notes to consolidated condensed financial statements.*

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**BADGER METER, INC.**  
**Consolidated Condensed Statements of Cash Flows**

	Nine Months Ended September 30, (Unaudited) (In thousands)	
	2007	2006
Operating activities:		
Net earnings	\$ 13,791	\$ 7,761
Adjustments to reconcile net earnings to net cash provided by (used for) operations:		
Depreciation	4,874	5,004
Amortization	123	235
Long-lived asset impairment		1,288
Deferred income taxes	(6)	(32)
Noncurrent employee benefits	2,681	3,204
Gain on disposal of long-lived assets	(495)	
Changes in:		
Receivables	(4,351)	(10,455)
Inventories	(1,533)	(390)
Prepaid expenses and other current assets	116	(278)
Current liabilities other than debt	5,747	(55)
Total adjustments	7,156	(1,479)
Net cash provided by operations	20,947	6,282
Investing activities:		
Property, plant and equipment	(12,659)	(7,941)
Proceeds on disposal of long-lived assets	3,194	
Other net	(529)	(256)
Net cash used for investing activities	(9,994)	(8,197)
Financing activities:		
Net increase (decrease) in short-term debt	(8,374)	12,400
Repayments of long-term debt	(1,446)	(12,504)
Dividends paid	(3,568)	(3,206)
Proceeds from exercise of stock options	1,159	2,326
Tax benefit on stock options	1,467	2,502
Issuance of treasury stock	132	365
Net cash provided by (used for) financing activities	(10,630)	1,883
Effect of foreign exchange rates on cash	(349)	(90)

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Increase (decrease) in cash	(26)	(122)
Cash beginning of period from continuing operations	3,002	3,215
Cash beginning of period from discontinued operations	2,046	1,188
Cash beginning of period	5,048	4,403
Cash end of period from continuing operations	4,552	3,110
Cash end of period from discontinued operations	470	1,171
Cash end of period	\$ 5,022	\$ 4,281

*See accompanying notes to consolidated condensed financial statements.*

**Table of Contents****BADGER METER, INC.****Notes to Unaudited Consolidated Condensed Financial Statements****Note 1 Basis of Presentation**

In the opinion of management, the accompanying unaudited consolidated condensed financial statements of Badger Meter, Inc. (the Company) contain all adjustments (consisting only of normal recurring accruals except as otherwise discussed) necessary to present fairly the Company's consolidated condensed financial position at September 30, 2007, results of operations for the three- and nine-month periods ended September 30, 2007 and 2006, and cash flows for the nine-month periods ended September 30, 2007 and 2006. The results of operations for any interim period are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Certain reclassifications have been made to the 2006 consolidated condensed financial statements to conform to the 2007 presentation due to the presentation of the Company's French operations as discontinued operations.

**Note 2 Additional Balance Sheet Information**

The consolidated condensed balance sheet at December 31, 2006 was derived from amounts included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. Refer to the footnotes to the financial statements included in that report for a description of the Company's accounting policies and for additional details of the Company's financial condition. The details in those notes have not changed except as discussed below and as a result of normal adjustments in the interim.

**Warranty and After-Sale Costs**

The Company estimates and records provisions for warranties and other after-sale costs in the period the sale is reported. After-sale costs represent a variety of activities outside of the written warranty policy, such as investigation of unanticipated problems after the customer has installed the product, or analysis of water quality issues. Provisions for warranty and after-sale costs are based upon historical experience of product failures together with any specific provision for known product problems. Changes in the Company's warranty and after-sale costs reserve for the nine-month periods ended September 30, 2007 and 2006 are as follows:

	Balance at beginning of year	Net additions charged to earnings	Costs incurred	Balance at September 30
(In thousands)				
2007	\$ 2,954	\$ 195	\$ (873)	\$ 2,276
2006	\$ 3,047	\$ 672	\$ (973)	\$ 2,746

**Note 3 Employee Benefit Plans**

The Company maintains a non-contributory defined benefit pension plan for its domestic employees and a non-contributory postretirement plan that provides medical benefits for certain domestic retirees and eligible dependents. The following table sets forth the components of net periodic benefit cost for the three months ended September 30, 2007 and 2006 based on a September 30 measurement date:

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(In thousands)	Pension benefits		Other postretirement benefits	
	2007	2006	2007	2006
Service cost	\$ 496	\$ 485	\$ 49	\$ 56
Interest cost	629	595	105	122
Expected return on plan assets	(883)	(918)		
Amortization of prior service cost	(37)	(28)		(9)
Amortization of net loss	282	318	28	59
Net periodic benefit cost	\$ 487	\$ 452	\$ 182	\$ 228

The following table sets forth the components of net periodic benefit cost for the nine months ended September 30, 2007 and 2006 based on a September 30 measurement date:

(In thousands)	Pension benefits		Other postretirement benefits	
	2007	2006	2007	2006
Service cost	\$ 1,488	\$ 1,455	\$ 147	\$ 168
Interest cost	1,887	1,785	315	365
Expected return on plan assets	(2,649)	(2,754)		
Amortization of prior service cost	(111)	(84)		(27)
Amortization of net loss	846	954	83	178
Net periodic benefit cost	\$ 1,461	\$ 1,356	\$ 545	\$ 684

The Company was not required to contribute funds to its pension plan as of the annual September 30 measurement date.

The Company disclosed in its financial statements for the year ended December 31, 2006 that it estimated it would pay \$777,000 in other postretirement benefits in 2007 based on actuarial estimates. As of September 30, 2007, \$267,000 of such benefits were paid. At September 30, 2007, the Company believes that its estimated payments for the full year will be lower than its original estimate, but it is difficult to predict because cash payments can vary significantly depending on the timing of postretirement medical claims and the collection of the retiree's portion of the costs. Note that the amount of benefits paid in calendar year 2007 will not impact the expense for postretirement benefits for the current year.

**Note 4 Guarantees**

The Company guarantees the debt of the Badger Meter Officers' Voting Trust ( BMOVT ). Prior to July 2002, the BMOVT obtained loans from a bank on behalf of the officers of the Company to allow the officers to purchase shares of the Company's Common Stock. The officers' loan amounts are secured by the Company's shares that were purchased with the loans' proceeds. There have been no loans made to officers by the BMOVT since July 2002. The Company has guaranteed \$0.2 million and \$0.5 million of the BMOVT's debt at September 30, 2007 and December 31, 2006, respectively. The current loan matures in April 2008, at which time it is expected to be renewed. The fair market value of this guarantee at September 30, 2007 continues to be insignificant because the secured value of the shares exceeds the loan amount. It is the Company's intention to eliminate the BMOVT by December 31, 2010, because it no longer fulfills its original purpose of providing officers with loans to purchase Common Stock.

The Company guarantees the outstanding debt of the Badger Meter Employee Savings and Stock Ownership Plan ( ESSOP ) that is recorded in the current portion of long-term debt, offset by a similar amount of unearned

compensation that has been recorded as a reduction of shareholders' equity. The loan amount is collateralized by shares of the Company's Common Stock. A payment of \$62,000 was made in the first quarter of 2007 that reduced the debt and the corresponding employee benefit stock balance included in shareholders' equity.

**Table of Contents****Note 5 Comprehensive Income (Loss)**

Comprehensive income (loss) for the three-month periods ended September 30, 2007 and 2006 was \$5.9 million and (\$0.5) million, respectively. Comprehensive income for the nine-month periods ended September 30, 2007 and 2006 was \$14.3 million and \$8.6 million, respectively.

Components of accumulated other comprehensive loss are as follows:

(In thousands)	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Cumulative foreign currency translation adjustment	\$ 1,597	\$ 1,658
Unrecognized pension and postretirement benefit plan liabilities	(13,130)	(13,699)
Accumulated other comprehensive loss	\$ (11,533)	\$ (12,041)

**Note 6 Discontinued French Operations**

At December 31, 2006, the Company discontinued its French operations due to past losses and the Company's evaluation that losses would continue in the future. The disposition of the French operations was completed via asset sale transactions during the second quarter of 2007. Information about the Company's discontinued French operations is included in the Notes to Consolidated Financial Statements in the 2006 Annual Report on Form 10-K under the heading Note 3 Discontinued Operations. The Company has narrowed its estimate for the final cumulative charges for the liquidation of its French operations to an amount not to exceed \$6.2 million of after-tax charges. This revised estimate is on the lower end of the Company's previously disclosed range of \$6.0 million to \$8.0 million. At September 30, 2007, \$5.8 million of charges net of the income tax benefit were cumulatively recognized in 2006 and 2007, with the remaining expenses to be recognized in the fourth quarter of 2007 as the remaining assets are liquidated and liabilities are settled.

Revenues from the French operations for the three-month periods ended September 30, 2007 and 2006 were zero and \$2.8 million, respectively. Revenues from the French operations for the nine-month periods ended September 30, 2007 and 2006 were \$1.9 million and \$9.4 million, respectively. Net losses from the French operations were \$0.3 million and \$4.5 million for the three-month periods ended September 30, 2007 and 2006, respectively, and \$0.4 million and \$6.5 million for nine-month periods ended September 30, 2007 and 2006, respectively.

The components of the assets and liabilities of discontinued operations included in the Consolidated Condensed Balance Sheets are as follows:

(In thousands)	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Assets of discontinued operations:		
Cash	\$ 470	\$ 2,046
Receivables	319	1,201
Inventories		827
Prepaid expenses and other current assets	109	181
Net property, plant and equipment		2,375
Intangible assets, at cost less accumulated amortization		245
Total assets of discontinued operations	\$ 898	\$ 6,875

Liabilities of discontinued operations:

Short-term debt	\$		\$	3,275
Payables		335		2,356
Accrued compensation and employee benefits		75		1,927
Warranty and after-sale costs				567
Income and other taxes		31		196
Total liabilities of discontinued operations	\$	441	\$	8,321

**Note 7 Income Taxes**

In June 2006, the FASB issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in a company's

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financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. The interpretation prescribes a recognition threshold and measurement attribute criteria for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years prior to 2003. The Company's policy is to recognize interest related to unrecognized tax benefits as interest expense and penalties as operating expenses. Accrued interest was \$0.3 million and there were no penalties accrued for the nine months ended September 30, 2007. The Company believes that it has appropriate support for the income tax positions taken and to be taken on its tax returns and that its accruals for tax liabilities are adequate for all open years based on an assessment of many factors including past experience and interpretations of tax law applied to the facts of each matter.

The Company adopted the provisions of FIN 48 on January 1, 2007. The adoption of FIN 48 did not impact the consolidated financial condition, results of operations or cash flows. At January 1, 2007, the Company had unrecognized tax benefits of \$7.7 million, which primarily related to uncertainty regarding the sustainability of certain deductions taken on the 2006 U.S. Federal income tax return related to the discontinued French operations of the Company. To the extent these unrecognized tax benefits are ultimately recognized, they will impact the effective tax rate in a future period. The amount of unrecognized tax benefits increased \$0.2 million during the quarter ended September 30, 2007 for interest associated with tax positions taken in prior periods.

**Note 8 Contingencies, Litigation and Commitments**

In the normal course of business, the Company is named in legal proceedings from time to time. There are currently no material legal proceedings pending with respect to the Company. The more significant legal proceedings are as follows.

The Company is subject to contingencies related to environmental laws and regulations. Currently, the Company is in the process of resolving matters relative to two landfill sites where it has been named as one of many potentially responsible parties. These sites are impacted by the Federal Comprehensive Environmental Response, Compensation and Liability Act and other environmental laws and regulations. At this time, the Company does not believe the ultimate resolution of these issues will have a material adverse effect on the Company's financial position or results of operations, either from a cash flow perspective or on the financial statements as a whole. This belief is based on the Company's assessment of its limited past involvement with these sites as well as the substantial involvement of other named third parties in these matters. However, due to the inherent uncertainties of such proceedings, the Company cannot predict the ultimate outcome of these matters. A future change in circumstances with respect to these specific matters or with respect to sites formerly or currently owned or operated by the Company, or with respect to off-site disposal locations used by the Company, could result in future costs to the Company and such amounts could be material.

Like other companies in recent years, the Company has been named as a defendant in numerous multi-claimant/multi-defendant lawsuits alleging personal injury as a result of exposure to asbestos, manufactured by third parties, and integrated into a very limited number of the Company's industrial products. The Company is vigorously defending itself against these claims. Although it is not possible to predict the ultimate outcome of these matters, the Company does not believe the ultimate resolution of these issues will have a material adverse effect on the Company's financial position or results of operations, either from a cash flow perspective or on the financial statements as a whole. This belief is based in part on the fact that that no claimant has demonstrated exposure to products manufactured or sold by the Company and that a number of cases have been voluntarily dismissed.

The Company has evaluated its worldwide operations to determine whether any risks and uncertainties exist that could severely impact its operations in the near term. Although the Company relies on single suppliers for certain castings and components in several of its product lines, alternate sources of supply exist for these items. Loss of certain suppliers could temporarily disrupt operations in the short term. The Company attempts to mitigate these risks by working closely with key suppliers, purchasing minimal amounts from alternative suppliers and by purchasing business interruption insurance where appropriate.





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The Company reevaluates its exposures on a periodic basis and makes adjustments to reserves as appropriate.

In the second quarter of 2007, the Company entered into a \$9.1 million contract to construct a 120,000 square foot building in Nogales, Mexico to accommodate the transfer of production from a nearby leased facility and from other locations in order to meet future needs. At September 30, 2007, \$5.5 million was paid with the remaining amounts scheduled to be paid throughout the construction period pending milestones. Completion of the facility and transfer of production is expected to occur in the third quarter of 2008.

### **Note 9 Accounting Pronouncements**

In September 2006, the FASB issued Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106 and 132(R) (SFAS 158). SFAS 158 requires employers that sponsor defined benefit pension and postretirement benefit plans to recognize previously unrecognized actuarial losses and prior service costs in the statement of financial position and to recognize future changes in these amounts in the year in which changes occur through comprehensive income. On December 31, 2006, the Company adopted the provisions of SFAS 158 by recognizing the funded status of its defined benefit pension and postretirement benefit plans in the statement of financial position based on the September 30, 2006 measurement date. Information about the Company's adoption of this statement is included in the Notes to Consolidated Financial Statements in the 2006 Annual Report on Form 10-K under the heading *Note 7 Employee Benefit Plans*. In addition, the Company will be required to measure the plan assets and benefit obligations as of the date of the year-end statement of financial position by December 31, 2008. The Company is currently evaluating the impact, if any, that the change in the measurement date will have on its consolidated financial position, results of operations and cash flows.

## **Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Business Description and Overview**

The Company is a leading marketer and manufacturer of products using flow measurement and control technologies developed both internally and with other technology companies. Its products are used to measure and control the flow of liquids in a variety of applications. The Company's product lines fall into two general categories, utility and industrial. The utility category is comprised of two product lines, residential and commercial water meters (with various automatic meter reading (AMR) technology systems), which are generally sold to water utilities and constitute a majority of the Company's sales. Industrial product line sales comprise the remainder of the Company's sales and include automotive fluid meters, small precision valves, electromagnetic meters, impeller flow meters and industrial process meters (all with related accessories and instrumentation).

Residential and commercial water meters and related systems are classified as local (or manual) read meters or AMR products. Local read meters consist of a water meter and a register. With AMR meters, the register digitally encodes the mechanical reading and its radio frequency transmitter communicates the data to a computerized system that collects the data and sends it to specific utility computerized programs. Net sales and the corresponding net earnings depend on unit volume and mix of products, with the Company generally earning higher margins on residential AMR products (the impact of AMR on commercial products is not as significant given the higher sales prices of commercial meters). The Company sells AMR products of other companies as well as its own proprietary products, Orion<sup>®</sup> and the Galaxy<sup>®</sup> fixed network AMR system. Proprietary products generally have higher margins than the other AMR products. Net sales and the corresponding net earnings are therefore also dependent on the mix of AMR products between proprietary and non-proprietary products. Orion<sup>®</sup> is currently being sold as a walk-by/drive-by system, but also has the ability to connect with a variety of other technologies, such as power line carrier, broadband over power line, municipal WI-FI and radio frequency systems to allow for remote reading of the data. The Galaxy<sup>®</sup> fixed network AMR system was introduced in late 2005 and has had limited sales to date.

There is a base level of annual business for utility products driven by replacement units and, to a much lesser extent, housing starts. Sales above the base level depend on conversions to AMR away from manual read meters. The Company believes that conversion from local read meters to AMR products can accelerate replacements of meters and result in growth, because it is estimated that only 20-25% of the U.S. water meter market has been converted to AMR. Badger Meter's strategy is to solve customers' metering needs with its proprietary meter reading systems or other systems available through alliances within the marketplace.



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The industrial products generally serve niche markets and have in the past utilized technology derived from utility products to serve industrial uses. As these markets evolve, these products are becoming more specialized to meet industrial flow measurement and communication protocol requirements. Serving these markets allows the Company to expand its technologies into other areas of flow measurement and control, as well as utilize existing capacity and spread fixed costs over a larger sales base.

**Business Trends**

At December 31, 2006, the Company discontinued its French operations due to past losses and the Company's evaluation that losses would continue in the future. The disposition of the French operations was completed via asset sale transactions in the second quarter of 2007. The Company now believes that the decision to discontinue its French operations will result in total after-tax charges up to \$6.2 million as assets are liquidated and liabilities are settled, of which \$5.4 million was recognized in 2006 and \$0.4 million was recognized to date in 2007. The Company expects the remaining assets to be recovered and liabilities to be settled before the end of 2007. All results associated with the Company's French operations have been removed from continuing operations and are presented as results of discontinued operations. See the Notes to Consolidated Financial Statements in the 2006 Annual Report on Form 10-K under the heading "Note 3 Discontinued Operations" for further discussion. The remainder of the discussion in this section relates to continuing operations.

As noted above, the Company sells AMR products of other companies as well as its own proprietary product, Orion®. The Company currently has a distribution agreement under which it resells products produced by Itron, Inc. Prior to the Company's introduction of its own proprietary Orion® products, Itron® water utility-related products were a significant contributor to the Company's results. The Company's Orion® products directly compete with Itron® water AMR products and, in recent years, many of the Company's customers have selected Orion® products. As a result, the Company's 2005 annual sales of Itron® products decreased approximately 12%, while Orion® sales doubled compared to 2004. In 2006, sales of Itron® products decreased nearly 16% while Orion® sales increased 39% compared to 2005. For the first nine months of 2007, Orion® sales were 2.5 times greater than those of Itron® sales. The Company expects similar trends to continue, although it also believes that Itron® products will remain a significant component of utility sales. Decreases in sales of Itron® products have generally been offset by increases in sales of Orion® products, which produce a higher gross margin than Itron® products. As a result, the Company does not expect this trend to have a material negative impact on the Company's financial position or results of operations.

**Results of Operations - Three Months Ended September 30, 2007**

Net sales for the three months ended September 30, 2007 increased \$2.6 million, or 4.3%, over the same period in 2006. The overall increase in net sales was driven primarily by increased sales of Orion® AMR products due to higher volumes and increased prices on major product lines.

Residential and commercial water meter sales represented 80.4% of total sales in the third quarter of 2007 compared to 82.0% in the third quarter of 2006. These sales increased \$1.1 million to \$50.5 million compared to \$49.4 million in the same period in 2006 due to increased sales of units utilizing AMR technologies and higher charges as a result of price increases. This was offset somewhat by lower volumes of local read and commercial meters. Notably, sales of the Company's proprietary AMR product, Orion®, increased nearly 32% over the amount sold in the third quarter of 2006. The increase in Orion® sales was somewhat offset by sales decreases in other AMR technologies, including Itron® products, which saw a 20% decline in sales over the same period last year.

Industrial sales are affected by economic conditions, domestically and internationally, in each of the markets served by the various product lines. In total, industrial products represented 19.6% of total sales for the three months ended September 30, 2007 compared to 18.0% for the same period in 2006. Industrial sales increased \$1.5 million to \$12.3 million in the third quarter of 2007 compared to \$10.8 million in the third quarter of 2006. The increase in sales was primarily driven by volume increases in all product lines.

Gross margins in total for the third quarter of 2007 were 36.1% compared to 29.7% in the third quarter of 2006. This increase in gross margin was due to the net increase in sales noted above, particularly the net increase in sales of Orion® AMR products, which carry higher margins. Price increases instituted in August 2006 and July 2007 to negate the effect of cost increases on purchased castings and other parts also contributed to the increase. Gross margins were also affected by the impact of higher margins on most of the industrial product lines.



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Selling, engineering and administration costs for the third quarter of 2007 were 20.6% as a percent of net sales compared to 18.4% for the same period in 2006. The increase in selling, engineering and administration costs as a percent of net sales was the result of higher employee incentives due to increased sales and results, increased reserves for uncollectible receivables and normal inflationary pressures, offset by continued cost containment efforts.

Interest expense for the third quarter was lower than the third quarter of 2006 due principally to lower debt levels.

The effective tax rate for the third quarter of 2007 was 36.1% compared to 37.6% in the same period in the prior year. The lower effective tax rate was due in part to an increase in the Federal income tax deduction available to manufacturers for qualified production activities in 2007.

As a result of the above-mentioned items, earnings from continuing operations for the third quarter of 2007 were \$6.0 million compared to \$3.9 million in the third quarter of 2006. On a diluted basis, earnings per share from continuing operations were \$0.41 per share for the third quarter of 2007 compared to \$0.28 for the same period in 2006.

**Results of Operations – Nine Months Ended September 30, 2007**

Net sales for the nine months ended September 30, 2007 increased \$0.6 million, or 0.3%, over the same period in 2006. The net increase was the result of reduced sales of certain utility products in the first quarter of 2007, which were more than offset by increases in Orion® related products in subsequent quarters of 2007 and increases in industrial product sales. Foreign exchange translations also contributed to the sales increase, notably the strengthening of the euro against the U.S. dollar.

Residential and commercial water meter net sales represented 79.4% of total sales for the first nine months of 2007 compared to 81.3% for the same period in 2006. These sales decreased \$3.0 million to \$140.9 million from \$143.9 million in the same period in 2006. Sales of local read meters declined nearly 5% offset by a 1.2% increase in sales of meters with AMR technology. Sales of commercial meters declined nearly 5%. The sales decline was attributed to the timing of orders and longer selling cycles. For the first nine months of 2007, Itron® sales declined 27% while Orion® sales increased over 25% compared to the same period in 2006.

Industrial product net sales represented 20.6% of total sales for the first nine months of 2007 compared to 18.7% for the same period in 2006. While the percentage increase was due in part to the decrease in utility products discussed above, these sales did increase 10.9% to \$36.7 million compared with \$33.1 million in the same period in 2006 due to a combination of both volume and price increases, particularly in automotive fluid meters, industrial products and impeller meters.

Gross margins in total for the nine months ended September 30, 2007 were 34.6% compared to 33.6% in the same period in 2006. Gross margins increased between 2006 and 2007 due to the net effects of product mix and price increases, offset somewhat by cost increases on purchased castings and other parts and lower volumes in certain product lines, as discussed above.

Selling, engineering and administration costs for the nine months ended September 30, 2007 were 21.4% as a percent of net sales compared to 20.0% for the same period in 2006. The increase in selling, engineering and administration costs as a percent of net sales was the result of higher legal fees associated with recently completed litigation, higher employee incentives due to higher sales and results, increased reserves for uncollectible receivables and normal inflationary pressures, offset by continued cost containment efforts.

Interest expense was approximately \$0.2 million lower for the first nine months of 2007 compared to the same period in 2006 due principally to lower debt levels.

The effective tax rate for the nine months ended September 30, 2007 was 36.7% compared to 38.0% in the same period in the prior year. The lower effective tax rate was due in part to an increase in the Federal income tax deduction available to manufacturers for qualified production activities in 2007.

As a result of the above-mentioned items, earnings from continuing operations were approximately \$14.2 million for both the nine months ended September 30, 2007 and 2006. On a diluted basis, earnings per share from continuing operations were \$0.97 and \$1.00, respectively, for the same periods. The decrease in earnings per share for the nine months ended September 30, 2007 on similar earnings was due to an increase in the weighted average shares outstanding in the 2007 period.



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**LIQUIDITY AND CAPITAL RESOURCES**

The main sources of liquidity for the Company are cash from operations and borrowing capacity. Cash provided by operations for the first nine months of 2007 was \$20.9 million versus \$6.3 million for the same period in 2006. The increase was primarily the net effect of increased earnings and a receipt of refundable income taxes.

The increase in the receivables balance from \$29.3 million at December 31, 2006 to \$34.9 million at September 30, 2007 was due primarily to the timing of sales and collections as well as increased pricing.

Inventories at September 30, 2007 increased to \$35.8 million from \$33.3 million at December 31, 2006 due primarily to the timing of orders, as well as higher material costs.

Net property, plant and equipment increased \$7.9 million since December 31, 2006. This was the result of \$12.7 million of capital expenditures, which included \$5.5 million associated with the construction of a new plant in Mexico that is expected to be completed in 2008, offset by depreciation expense and disposals.

Short-term debt decreased \$4.7 million to \$10.4 million at September 30, 2007 compared to \$15.1 million at December 31, 2006 due to the repayment of commercial paper borrowings as working capital was generated. Long-term debt combined with the current portion of long-term debt decreased as a result of regularly scheduled payments. The Company's debt is unsecured and does not carry any financial covenants.

Payables increased to \$14.0 million at September 30, 2007 from \$10.6 million at December 31, 2006 primarily as a result of the increase in inventory and the timing of payments. Accrued compensation and employee benefits increased \$0.6 million since December 31, 2006 to \$6.8 million due costs accrued for 2007 expenses to date, offset somewhat by payments of amounts accrued at December 31, 2006.

Income and other taxes increased to \$9.8 million at September 30, 2007 from \$0.6 million at December 31, 2006. At December 31, 2006, the Company recorded its net federal income tax position (refundable income tax net of the related reserves for uncertain tax positions) as a receivable. In the first quarter of 2007, the Company received payment of the refundable tax amounts and reclassified the reserve for uncertain tax positions to the income and other taxes liability in the Consolidated Condensed Balance Sheet. The remainder of the increase in income and other taxes was due to the timing of tax payments.

Common Stock and capital in excess of par value both increased since December 31, 2006 due to new stock issued under incentive plans in connection with the exercise of stock options. Employee benefit stock decreased as a result of a payment made on the Employee Savings and Stock Ownership Plan loan during the first quarter of 2007.

Accumulated other comprehensive loss was \$11.5 million at September 30, 2007 compared to a \$12.0 million loss at December 31, 2006 primarily due to the amortization in the Statement of Operations of certain pension and postretirement amounts included in accumulated other comprehensive loss as required under SFAS 158.

Badger Meter's financial condition remains strong. The Company believes that its operating cash flows, available borrowing capacity, including \$46.6 million of unused credit lines, and its ability to raise capital provide adequate resources to fund ongoing operating requirements, future capital expenditures and development of new products. The Company continues to take advantage of its local commercial paper market and from time to time may convert short-term debt into long-term debt.

**Other Matters**

There are currently no material legal proceedings pending with respect to the Company. The more significant legal proceedings are as follows.

The Company is subject to contingencies related to environmental laws and regulations. Currently, the Company is in the process of resolving matters relative to two landfill sites where it has been named as one of many potentially responsible parties. These sites are impacted by the Federal Comprehensive Environmental Response, Compensation and Liability Act and other environmental laws and regulations. At this time, the Company does not believe the ultimate resolution of these issues will have a material adverse effect on the Company's financial position or results of operations, either from a cash flow perspective or on the financial



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statements as a whole. This belief is based on the Company's assessment of its limited past involvement with these sites as well as the substantial involvement of other named third parties in these matters. However, due to the inherent uncertainties of such proceedings, the Company cannot predict the ultimate outcome of these matters. A future change in circumstances with respect to these specific matters or with respect to sites formerly or currently owned or operated by the Company, or with respect to off-site disposal locations used by the Company, could result in future costs to the Company and such amounts could be material.

Like other companies in recent years, the Company has been named as a defendant in numerous multi-claimant/multi-defendant lawsuits alleging personal injury as a result of exposure to asbestos, manufactured by third parties, and integrated into a very limited number of the Company's industrial products. The Company is vigorously defending itself against these claims. Although it is not possible to predict the ultimate outcome of these matters, the Company does not believe the ultimate resolution of these issues will have a material adverse effect on the Company's financial position or results of operations, either from a cash flow perspective or on the financial statements as a whole. This belief is based in part on the fact that no claimant has demonstrated exposure to products manufactured or sold by the Company and that a number of cases have been voluntarily dismissed.

No other risks or uncertainties were identified that could have a material impact on operations and no long-lived assets have become permanently impaired in value.

**Accounting Change**

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48), on January 1, 2007. See Note 7 to the Notes to Unaudited Consolidated Condensed Financial Statements in this Form 10-Q for information regarding this accounting change.

**Off-Balance Sheet Arrangements and Contractual Obligations**

The Company's off-balance sheet arrangements and contractual obligations are discussed in Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations under the headings Off-Balance Sheet Arrangements and Contractual Obligations in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, and have not materially changed since that report was filed except as follows.

In the second quarter of 2007, the Company entered into a \$9.1 million contract to construct a 120,000 square foot building in Nogales, Mexico to accommodate the transfer of production from a nearby leased facility and from other locations to meet future needs. At September 30, 2007, \$5.5 million was paid with the remaining amounts scheduled to be paid throughout the construction period pending milestones. Completion of the facility and transfer of production is expected to occur in the third quarter of 2008.

**Item 3 Quantitative and Qualitative Disclosures about Market Risk**

The Company's quantitative and qualitative disclosures about market risk are included in Part II, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations under the heading Market Risks in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, and have not materially changed since that report was filed.

**Item 4 Controls and Procedures**

Evaluation of Disclosure Controls and Procedures

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), the Company's management evaluated, with the participation of the Company's Chairman, President and Chief Executive Officer and the Company's Senior Vice President Finance, Chief Financial Officer and Treasurer, the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of the end of the quarter ended September 30, 2007. Based upon their evaluation of these disclosure controls and procedures, the Company's Chairman, President and Chief Executive Officer and the Company's Senior Vice President Finance, Chief Financial Officer and Treasurer concluded that the Company's disclosure controls and procedures were effective as of the end of the quarter ended September 30, 2007 to ensure that material information relating to the Company, including its consolidated subsidiaries, was made known to management by others within those entities as appropriate to allow timely decisions regarding disclosure, particularly during the period in which this Quarterly Report on Form



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10-Q was being prepared.

**Changes in Internal Control over Financial Reporting**

There was no change in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2007, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II Other Information**

**Item 6 Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification by the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification by the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Periodic Financial Report by the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

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

BADGER METER, INC.

Dated: October 24, 2007

By /s/ Richard A. Meeusen  
Richard A. Meeusen  
Chairman, President and Chief Executive  
Officer

By /s/ Richard E. Johnson  
Richard E. Johnson  
Senior Vice President Finance, Chief  
Financial Officer and Treasurer

By /s/ Beverly L.P. Smiley  
Beverly L.P. Smiley  
Vice President Controller

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**BADGER METER, INC.**  
**Quarterly Report on Form 10-Q for Period Ended September 30, 2007**  
**Exhibit Index**

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