

BADGER METER INC
Form 10-Q
April 23, 2008

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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 March 31, 2008**

**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, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting
company

(Do not check if a smaller reporting company)

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 April 14, 2008, there were 14,581,773 shares of Common Stock outstanding with a par value of \$1 per share.

BADGER METER, INC.
Quarterly Report on Form 10-Q for Period Ended March 31, 2008
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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 Badger Meter, Inc. (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 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, manual read meters toward more expensive, value-added automatic meter reading (AMR) systems and advanced metering infrastructure (AMI) systems;

the success or failure of newer Company products, including the Orion® radio frequency AMR system, the Galaxy® fixed network AMI system and the low profile Recordall® Model LP disc series meter;

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, manual 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/AMI 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 and scrap metal, at the supplier level and plastic resin as a result of increases in petroleum and natural gas prices;

the Company's expanded role as a prime contractor for providing complete AMR/AMI systems to governmental entities, 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 entity; 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 the U.S. Federal Communications Commission rules affecting the use and/or licensing of radio frequencies necessary for AMR/AMI 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**

	March 31, 2008 (Unaudited)	December 31, 2007
	(In thousands)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 6,286	\$ 8,670
Receivables	33,823	30,638
Inventories:		
Finished goods	8,871	8,225
Work in process	12,604	10,660
Raw materials	16,941	15,209
Total inventories	38,416	34,094
Prepaid expenses and other current assets	4,648	3,450
Deferred income taxes	3,089	3,082
Total current assets	86,262	79,934
Property, plant and equipment, at cost	128,746	125,678
Less accumulated depreciation	(72,719)	(71,100)
Net property, plant and equipment	56,027	54,578
Intangible assets, at cost less accumulated amortization	450	477
Other assets	5,079	4,919
Deferred income taxes	3,435	3,435
Goodwill	6,958	6,958
Total assets	\$ 158,211	\$ 150,301
Liabilities and shareholders equity		
Current liabilities:		
Short-term debt	\$ 7,838	\$ 10,844
Current portion of long-term debt	2,745	2,738
Payables	13,415	11,363
Accrued compensation and employee benefits	6,287	5,988
Warranty and after-sale costs	1,956	1,917
Income and other taxes	11,579	8,359
Total current liabilities	43,820	41,209

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Other long-term liabilities	601	627
Deferred income taxes	272	244
Accrued non-pension postretirement benefits	6,191	6,083
Other accrued employee benefits	6,552	7,040
Long-term debt	2,596	3,129
Commitments and contingencies		
Shareholders' equity:		
Common stock	20,970	20,902
Capital in excess of par value	25,396	24,655
Reinvested earnings	93,778	89,061
Accumulated other comprehensive loss	(8,536)	(9,191)
Less: Employee benefit stock	(658)	(682)
Treasury stock, at cost	(32,771)	(32,776)
Total shareholders' equity	98,179	91,969
Total liabilities and shareholders' equity	\$ 158,211	\$ 150,301

See accompanying notes to consolidated condensed financial statements.

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BADGER METER, INC.
Consolidated Condensed Statements of Operations

	Three Months Ended March 31, (Unaudited)	
	2008	2007
	(In thousands except share and per share amounts)	
Net sales	\$ 68,420	\$ 52,663
Cost of sales	43,896	36,408
Gross margin	24,524	16,255
Selling, engineering and administration	14,655	11,985
Operating earnings	9,869	4,270
Interest expense	252	352
Earnings from continuing operations before income taxes	9,617	3,918
Provision for income taxes	3,597	1,449
Earnings from continuing operations	6,020	2,469
Earnings from discontinued operations		103
Net earnings	\$ 6,020	\$ 2,572
Earnings per share amounts:		
Basic:		
from continuing operations	\$ 0.42	\$ 0.17
from discontinued operations	\$	\$ 0.01
Total basic	\$ 0.42	\$ 0.18
Diluted:		

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from continuing operations	\$	0.41	\$	0.17
from discontinued operations	\$		\$	0.01
Total diluted	\$	0.41	\$	0.18
Dividends declared - Common stock	\$	0.09	\$	0.08
Shares used in computation of earnings per share:				
Basic		14,394,862		14,057,135
Impact of diluted securities		355,374		482,951
Diluted		14,750,236		14,540,086

See accompanying notes to consolidated condensed financial statements.

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BADGER METER, INC.
Consolidated Condensed Statements of Cash Flows

	Three Months Ended March 31, (Unaudited) (In thousands)	
	2008	2007
Operating activities:		
Net earnings	\$ 6,020	\$ 2,572
Adjustments to reconcile net earnings to net cash provided by (used for) operations:		
Depreciation	1,770	1,722
Amortization	27	41
Deferred income taxes	13	(20)
Noncurrent employee benefits	861	822
Stock-based compensation expense	305	211
Changes in:		
Receivables	(2,919)	(2,505)
Inventories	(4,153)	(83)
Prepaid expenses and other current assets	(1,174)	(760)
Current liabilities other than debt	3,783	5,374
Total adjustments	(1,487)	4,802
Net cash provided by operations	4,533	7,374
Investing activities:		
Property, plant and equipment	(2,781)	(3,691)
Other net	(140)	(30)
Net cash used for investing activities	(2,921)	(3,721)
Financing activities:		
Net decrease in short-term debt	(3,221)	(4,346)
Repayments of long-term debt	(526)	(537)
Dividends paid	(1,303)	(1,132)
Proceeds from exercise of stock options	531	397
Tax benefit on stock options	810	532
Issuance of treasury stock	37	40
Net cash used for financing activities	(3,672)	(5,046)
Effect of foreign exchange rates on cash	(324)	(41)
Decrease in cash	(2,384)	(1,434)

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Cash	beginning of period from continuing operations	8,670	3,001
Cash	beginning of period from discontinued operations		2,047
Cash	beginning of period	8,670	5,048
Cash	end of period from continuing operations	6,286	1,778
Cash	end of period from discontinued operations		1,836
Cash	end of period	\$ 6,286	\$ 3,614

See accompanying notes to consolidated condensed financial statements.

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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 March 31, 2008, results of operations for the three-month periods ended March 31, 2008 and 2007, and cash flows for the three-month periods ended March 31, 2008 and 2007. 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.

Note 2 Additional Balance Sheet Information

The consolidated condensed balance sheet at December 31, 2007 was derived from amounts included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. 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 in which the sale is recorded, based on a lag factor and historical warranty claim experience. 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. Changes in the Company's warranty and after-sale costs reserve for the three-month periods ended March 31, 2008 and 2007 are as follows:

(In thousands)	Balance at beginning of year	Net additions charged to earnings	Costs incurred	Balance at March 31
2008	\$ 1,917	\$ 319	\$ (280)	\$ 1,956
2007	\$ 2,954	\$ 77	\$ (263)	\$ 2,768

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 March 31, 2008 and 2007 based on a September 30 measurement date:

(In thousands)	Pension benefits		Other postretirement benefits	
	2008	2007	2008	2007
Service cost	\$ 493	\$ 496	\$ 37	\$ 49
Interest cost	686	629	101	105
Expected return on plan assets	(864)	(883)		
Amortization of prior service cost (credit)	(36)	(37)	45	
Amortization of net loss	290	282	8	28

Net periodic benefit cost	\$ 569	\$ 487	\$ 191	\$ 182
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The Company previously disclosed in its financial statements for the year ended December 31, 2007 that it did not expect to contribute funds to its pension plan in 2008. While the Company believes that it will not be required to make any such contributions in 2008, such belief is based upon the estimated return on plan assets as of the annual measurement date of September 30.

The Company disclosed in its financial statements for the year ended December 31, 2007 that it estimated it would pay \$0.6 million in other postretirement benefits in 2008 based on actuarial estimates. As of March 31, 2008, \$29,000 of such benefits were paid. While the Company continues to believe that its estimated payments for the full year are reasonable, such estimates contain inherent uncertainties because cash payments can vary significantly depending on the timing of postretirement medical claims and the collection of the retiree's portion of certain costs. Note that the amount of benefits paid in calendar year 2008 will not impact the expense for postretirement benefits for the current year.

In September 2006, the Financial Accounting Standards Board (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). On December 31, 2006, the Company adopted the required provisions of SFAS 158 by recognizing the funded status of its defined benefit pension and postretirement benefit plans in the statement of financial position. Additionally, employers are required to measure the funded status of a plan as of the date of its year-end statement of financial position and provide additional disclosures. As permitted by the statement, the Company will adopt the measurement date provisions of SFAS 158 for the 2008 financial statements. The Company's pension plans previously used a September 30 measurement date. As a result of the adoption of the measurement date provisions of SFAS No. 158, during the fourth quarter of 2008, the Company will recognize a \$0.4 million, net of tax, reduction to the 2008 beginning of the year reinvested earnings. There will be no effect on the Company's results of operations or cash flows.

Note 4 Guarantees

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 \$23,000 was made in the first quarter of 2008 that reduced the debt and the corresponding employee benefit stock balance included in shareholders' equity.

Note 5 Comprehensive Income (Loss)

Comprehensive income for the three-month periods ended March 31, 2008 and 2007 was \$6.7 million and \$2.7 million, respectively.

Components of accumulated other comprehensive loss are as follows:

(In thousands)	March 31, 2008	December 31, 2007
Cumulative foreign currency translation adjustment	\$ 2,161	\$ 1,713
Unrecognized pension and postretirement benefit plan liabilities	(10,697)	(10,904)
Accumulated other comprehensive loss	\$ (8,536)	\$ (9,191)

Note 6 Discontinued French Operations

During 2006, the Company carefully evaluated strategic alternatives for its subsidiaries in Nancy, France, including restructuring, sale or shutdown. In the third quarter of 2006, the Company began the process under French law to obtain the approvals to close the operations. On October 16, 2006, the decision to discontinue the Company's French operations was finalized, and the subsidiaries were completely dissolved at December 31, 2007. Information about the Company's discontinued French operations is included in the Notes to Consolidated Financial Statements in the Company's 2007 Annual Report on Form 10-K under the heading Note 3 Discontinued Operations.

For the three-month period ended March 31, 2007, net sales from the French operations were \$1.8 million and net earnings were \$0.1 million.

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Note 7 Subsequent Events

In April 2008, the Company acquired the AMI technology used in its Galaxy[®] fixed network system from Miltel Communications Ltd. for a purchase price of approximately \$25.7 million. The technology agreement included the acquisition of the core technology, the exclusive right to manufacture the Galaxy[®] system and distribute it in certain water and gas utility markets, and a non-compete clause. The purchase price will be recorded in the second quarter of 2008 as intangible assets that will be amortized over estimated lives of 20 and 10 years for the core technology and non-compete arrangement, respectively. This acquisition was initially funded from commercial paper drawn on the Company's short-term line of credit, which was amended in April 2008 to increase availability to accommodate this purchase.

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 discussed below.

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 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.

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

Note 9 Accounting Pronouncements

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 was effective for the Company on January 1, 2008 and had no impact on its consolidated financial statements and notes thereto.

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not

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currently required to be measured at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 was effective for the Company on January 1, 2008 and had no impact on its consolidated financial statements and notes thereto.

Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations
Business Description and Overview

The Company is a leading manufacturer and marketer of products incorporating liquid flow measurement and control technologies, developed both internally and in conjunction with other technology companies. Its products are used to measure and control the flow of liquids in a wide variety of applications. The Company's product lines fall into two general categories, utility and industrial flow measurement. The utility category is comprised of two primary product lines—residential and commercial water meters that are used by water utilities as the basis for generating water and wastewater revenues. The market for these product lines is North America, primarily the United States, because these meters are designed and manufactured to conform to standards promulgated by the American Water Works Association. The utility flow measurement products constitute a majority of the Company's sales.

Industrial product line sales comprise the remainder of the Company's sales and include precision valves, electromagnetic inductive flow meters, impeller flow meters, and turbine and positive displacement industrial flow meters. Rounding out the industrial product line are automotive fluid meters for the measurement of various types of automotive fluids.

Residential and commercial water meters have generally been classified as either manual read meters or remote read meters via radio technology. A meter that is manually read consists of the water meter and a register displaying the meter reading. Remotely read meters equipped with radio technology convert the mechanical measurement to a digital format which is then transmitted via radio frequency to a receiver that collects and formats the data appropriately for the utility's billing computer. Drive-by systems are referred to as automatic meter reading (AMR) systems and have been the primary technology deployed by water utilities over the past decade, providing cost effective and accurate billing data. In a drive-by AMR system, a vehicle equipped for meter reading purposes collects meter reading data.

Of growing interest to water utilities are fixed network advanced metering infrastructure (AMI) systems. These systems do not rely on a drive-by data collector, but rather incorporate a network of data collectors that are always active or listening to the radio transmission from the utility's meters. Not only do fixed network systems eliminate the need for meter readers, but they have the ability to provide the utility with more frequent and diverse data at specified intervals. The Company's response to these market requirements is detailed further in the Business Trends section below.

The Company's net sales and corresponding net earnings depend on unit volume and mix of products, with the Company generally earning higher margins on meters equipped with AMR or AMI technology. In addition to selling its proprietary AMR/AMI products including the Orion® drive-by AMR technology and the Galaxy® fixed network AMI system, the Company also remarkets the Itron® drive-by AMR product under a license and distribution agreement. The Company's proprietary AMR/AMI products generally result in higher margins than the non-proprietary AMR/AMI products that the Company remarkets.

One distinctive advantage of the Orion® AMR technology is that while it is fundamentally a drive-by AMR system, the proprietary receiver technology of Orion® has been licensed to other technology providers, including those providing AMR/AMI products that communicate over power lines, broadband networks, municipal WiFi and proprietary radio frequency networks.

Utility meter sales, including sales of AMR and AMI products within this category, are generally derived from the water meter replacement requirements of customers, along with their plans for adoption and deployment of new technology. To a much lesser extent, housing starts also contribute to the base of new product sales. Over the last decade there has been a growing trend in the conversion to AMR/AMI from manually read water meters. This conversion rate is accelerating and contributing to an increased base of business available to meter and AMR/AMI producers. It is currently estimated that approximately 25-30% of water meters installed in the United States have been converted to AMR/AMI systems. Badger Meter's strategy is to solve customers' metering needs with its

proprietary meter reading systems or other systems available through its alliance partners in the marketplace.

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The industrial products generally serve a variety of niche flow measurement applications across a broad range of industries. Some of the flow measurement technologies now used industrially, such as positive displacement and turbine flow measurement, have been derived from utility meter technologies. Other technologies are very specific to industrial applications. In addition, a growing requirement is for industrial meters to be equipped with specialized communication protocols that control the entire flow measurement process. Serving both the utility and industrial flow measurement market enables the Company to use its wide variety of technology for specific flow measurement and control applications, as well as to utilize existing capacity and spread fixed costs over a larger sales base.

Business Trends

AMI is the growing standard of technology deployment in the electric industry. AMI provides an electric utility with two-way communication to monitor and control electrical devices at the customer's site. AMI deployments are always fixed network technologies. Although the Company does not participate in the electric market, the trend toward AMI is now affecting the water and gas utility AMR market as well. Specifically, in the water industry, fixed network AMI enables the water utility to capture interval readings from each meter on a daily basis. While two-way communication is extremely limited in water fixed network AMI, utilities are contemplating how two-way networks could benefit them. As noted above, the Company markets the Orion® drive-by AMR product line as well as the Galaxy® fixed network AMI product line. The Company is positioned to sell either product as this trend continues. Since both products have comparable margins, any acceleration or slowdown in this trend is not expected to have a significant impact on the Company.

Although there is growing interest in fixed network communication by water utilities, the vast majority of utilities currently installing AMR/AMI are selecting drive-by AMR technologies for their applications. The Company's Orion® technology has experienced rapid acceptance in the United States. By the end of 2007, more than 1,000 water utilities had selected Orion® as their AMR solution of choice. There are approximately 53,000 water utilities in the United States and the Company estimates that less than 30% of their services have been converted to an AMR technology. It is anticipated that even with growing interest in fixed network AMI, drive-by AMR will continue to be the primary product of choice by water utilities for a number of years. Drive-by AMR technology is simply the lowest cost form of AMR currently available to water utilities.

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. Itron® products are sold under an agreement between the Company and Itron, Inc. that expires in early 2009 and the Company is currently discussing with Itron an extension of the agreement. 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. In 2007, Orion® sales increased 24.8% compared to 2006 while Itron® licensed product sales decreased 21.7% compared to 2006. For the first three months of 2008, Orion® sales were 2.8 times greater than those of Itron® sales. The Company expects this trend to continue, although it also believes that Itron® licensed products will remain a significant component of utility sales. To date decreases in sales of Itron® licensed products have been offset by increases in sales of Orion® products, which produce a higher gross margin than Itron® licensed 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 March 31, 2008

Net sales for the three months ended March 31, 2008 increased nearly \$15.8 million, or 29.9%, to \$68.4 from \$52.7 million in the first three months of 2007. The increase was driven primarily by substantially higher sales volumes of the Company's utility products, especially the Orion® AMR systems.

Residential and commercial water meter and related automation sales represented 81.2% of total sales for the first quarter of 2008 compared with 76.6% in the first quarter of 2007. These sales were \$55.5 million, an increase of \$15.2 million, or 37.8% compared with \$40.3 million for the same period in 2007. The increase was due to volume increases in units utilizing AMR/AMI technology, and higher prices on manual read and commercial meters. Sales of the Company's proprietary AMR product, Orion®, and the remarketed Itron® product increased 51% and 9%, respectively, over the amounts sold in the first quarter of 2007 due to volume increases. Sales of commercial meters increased significantly due primarily to price increases. The increases were also due in part to the fact that sales in the first quarter of 2007 were negatively affected by the timing of orders.

Industrial sales are affected by economic conditions, both domestically and internationally, in each of the markets served by the various product lines. In total, the industrial products represented 18.8% of total sales for

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the first quarter of 2008 compared with 23.4% for the same period last year. Industrial sales for the quarter increased to \$12.9 million, a 4.0% increase over 2007's sales of \$12.4 million. This was a net result of increases in automotive fluid meter, electromagnetic meter and research and control valve sales offset by declines in impeller and other industrial product sales.

Total gross margin percentage for the three months ended March 31, 2008 was 35.8% compared with 30.9% for the three months ended March 31, 2007. The increase was the net result of higher volumes to absorb fixed manufacturing costs and increased prices partially offset by higher costs of raw materials.

Selling, engineering and administration costs increased nearly \$2.7 million, or 22.3%, in the first quarter of 2008 compared with the first quarter of 2007. The increase was due in part to increased sales gratuities related to efforts to establish a presence for Orion® in the natural gas industry, consulting costs related to sales process enhancements, higher employee incentive costs due to the increase in earnings compared to the first quarter of 2007, increased research and development costs, and the effects of foreign exchange rates. In addition, the Company experienced normal inflationary increases, which were offset by continuing cost containment efforts.

Interest expense for the first quarter of 2008 declined to \$0.3 million from \$0.4 million for the same period in 2007 due to lower debt levels.

Income taxes as a percentage of earnings from continuing operations before income taxes was 37.4% for the three months ended March 31, 2008 compared with 37.0% for the three months ended March 31, 2007.

As a re